2018 REG Book Update

Page numbers refer to 2018 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

Lecture 1.01 – Individual Income Tax Return

The AICPA has historically only tested amounts applicable to the calendar year previous to the year of the exam (e.g., 2018 tax numbers for the first half of 2019 and then 2019 numbers for the second half of 2019 and the first half of 2020); however, the examiners tend not to focus on inflation-adjusted numbers in exam questions. The Internal Revenue Code (IRC) is the basic foundation of federal tax laws and represents a codification of the federal tax laws of the United States.

Form 1040

**“For/To AGI”**

- Gross Income
- ± Adjustments (Schedule B, C, D, E, F [EMBRACED])
- Itemized (Sch. A)
- AGI (Income)
- (Deductions)
- Standard deduction ($24,000/$12,000-2018)
- 20% $199A QB1 Deduction

- **“For AGI” adjustments (EMBRACED)**
  - Interest on Student Loans - $2,500
  - Employment Tax-50%, Med. Premiums-100%
  - Moving Expenses (military only)¹
  - Business Expense (Sch. C)
  - Rent/Royalty & Flow-Through Entities (Sch. E)
  - Alimony (grandfathered only)²
  - Contributions to Retirement (KEOGH/IRA)
  - Early Withdrawal Penalty
  - Jury Duty pay
  - Health savings accounts (HSA)
  - Farm Income (Sch. F)

**“From AGI”**

- - Taxable Income
- × Tax Rate

- Tax Liability
  - (Credits)
  + SE tax
  + AMT
  - (Withholdings)
  - (Prepayments)

- Tax Due

⚠️ Tax Cuts and Jobs Act of 2017 (TCJA) Changes

1. The deduction for moving expenses has been suspended for 2018 – 2025 for most individuals; there is an exception for members of the U.S. armed forces on active duty, but this exception is not likely to be tested.

2. Alimony is not deductible for divorces/separations executed after 2018. Alimony payments attributable to divorce/separation agreements finalized prior to 2019 remain
3. Standard deductions have essentially been doubled for 2018 – 2025 and will continue to be adjusted for inflation.
4. Personal exemptions (including dependency exemptions) have been eliminated for 2018 – 2025.
5. For 2018 – 2025, we now have a 20% deduction for qualified business income (Section 199A) from certain flow-through entities. This will be discussed in another section.
6. Through 2025, the limitation for cash contributions donated to public charities has been increased to 60% of AGI.
7. Miscellaneous itemized deductions subject to the 2-percent of AGI limitation have been suspended for 2018 – 2025.
8. No longer includes home equity indebtedness that is not considered acquisition indebtedness for 2018 – 2025.
9. The deduction for state and local income and property taxes paid is now limited to a total of $10,000 ($5,000 MFS) for 2018 – 2025. Also, deductions for foreign real property taxes will not be allowed during this time.
10. The deduction for personal casualty losses is now generally limited to losses attributable to federally declared disasters for 2018 – 2025. This limitation does not apply to the extent the taxpayer has personal casualty gains; that is, any personal casualty loss may be deducted to the extent of the personal casualty gain.

Note: The final 2018 forms were unavailable at the time of publication.
### Form 1040

#### U.S. Individual Income Tax Return - 2018

**Sections:**
- **Wages, salaries, tips, etc.**
- **Tax-exempt interest**
- **Qualified dividends**
- **IRAs, pensions, and annuities**
- **Social security benefits**
- **Additional income and adjustments to income**
- **Adjusted gross income**
- **Tax-exempt income**
- **Qualified business income deduction**
- **Ordinary dividends**
- **Taxable interest**
- **Taxable amount**
- **Taxable amount**
- **Other taxes, attach Schedule 4**
- **Total tax, add lines 13 and 14**
- **Refundable credits**
- **Other payments or refundable credits from Schedule 5**
- **Refund**

#### Sections Containing Instructions:
- **Standard Deduction**
- **Married filing jointly or qualifying widows/widowers ($12,000)**
- **Head of household ($18,000)**
- **Refundable credits**

**Sign Here**

- **Your name**
- **Spouse’s name**
- **Firm’s name**
- **Preparer’s signature**
- **PTIN**

**For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.**

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**Form 1040 (2018) Page 2**

**2018 REG Book Update**

**June 29, 2018**

**DO NOT FILE**
### SCHEDULE 1
(Form 1040)

#### Additional Income and Adjustments to Income

- **Form 1040**
- **Attach to Form 1040.**
- **Go to www.irs.gov/Form1040 for instructions and the latest information.**

<table>
<thead>
<tr>
<th>Name(s) shown on Form 1040</th>
<th>Your social security number</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>10</strong> Taxable refunds, credits, or offsets of state and local income taxes</td>
<td><strong>10</strong></td>
</tr>
<tr>
<td><strong>11</strong> Alimony received</td>
<td><strong>11</strong></td>
</tr>
<tr>
<td><strong>12</strong> Business income or (loss). Attach Schedule C or C-EZ</td>
<td><strong>12</strong></td>
</tr>
<tr>
<td><strong>13</strong> Capital gain or (loss). Attach Schedule D if required. If not required, check here</td>
<td><strong>13</strong></td>
</tr>
<tr>
<td><strong>14</strong> Other gains or (losses). Attach Form 4797</td>
<td><strong>14</strong></td>
</tr>
<tr>
<td><strong>15a</strong> Reserved</td>
<td><strong>15b</strong></td>
</tr>
<tr>
<td><strong>16a</strong> Reserved</td>
<td><strong>16b</strong></td>
</tr>
<tr>
<td><strong>17</strong> Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E</td>
<td><strong>17</strong></td>
</tr>
<tr>
<td><strong>18</strong> Farm income or (loss). Attach Schedule F</td>
<td><strong>18</strong></td>
</tr>
<tr>
<td><strong>19</strong> Unemployment compensation</td>
<td><strong>19</strong></td>
</tr>
<tr>
<td><strong>20a</strong> Reserved</td>
<td><strong>20b</strong></td>
</tr>
<tr>
<td><strong>21</strong> Other income. List type and amount</td>
<td><strong>21</strong></td>
</tr>
<tr>
<td><strong>22</strong> Combine the amounts in the far right column. If you don’t have any adjustments to income, enter here and on Form 1040, line 6. Otherwise, go to line 23</td>
<td><strong>22</strong></td>
</tr>
<tr>
<td><strong>23</strong> Educator expenses</td>
<td><strong>23</strong></td>
</tr>
<tr>
<td><strong>24</strong> Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106</td>
<td><strong>24</strong></td>
</tr>
<tr>
<td><strong>25</strong> Health savings account deduction. Attach Form 8889</td>
<td><strong>25</strong></td>
</tr>
<tr>
<td><strong>26</strong> Moving expenses for members of the armed forces. Attach Form 3903</td>
<td><strong>26</strong></td>
</tr>
<tr>
<td><strong>27</strong> Deductible part of self-employment tax. Attach Schedule SE</td>
<td><strong>27</strong></td>
</tr>
<tr>
<td><strong>28</strong> Self-employed SEP, SIMPLE, and qualified plans</td>
<td><strong>28</strong></td>
</tr>
<tr>
<td><strong>29</strong> Self-employed health insurance deduction</td>
<td><strong>29</strong></td>
</tr>
<tr>
<td><strong>30</strong> Penalty on early withdrawal of savings</td>
<td><strong>30</strong></td>
</tr>
<tr>
<td><strong>31a</strong> Alimony paid</td>
<td><strong>31a</strong></td>
</tr>
<tr>
<td><strong>31b</strong> Recipient’s SSN</td>
<td><strong>31b</strong></td>
</tr>
<tr>
<td><strong>32</strong> IRA deduction</td>
<td><strong>32</strong></td>
</tr>
<tr>
<td><strong>33</strong> Student loan interest deduction</td>
<td><strong>33</strong></td>
</tr>
<tr>
<td><strong>34</strong> Reserved</td>
<td><strong>34</strong></td>
</tr>
<tr>
<td><strong>35</strong> Reserved</td>
<td><strong>35</strong></td>
</tr>
<tr>
<td><strong>36</strong> Add lines 23 through 35</td>
<td><strong>36</strong></td>
</tr>
<tr>
<td><strong>37</strong> Subtract line 36 from line 22. Enter here and on Form 1040, line 6.</td>
<td><strong>37</strong></td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 71478F

Schedule 1 (Form 1040) 2018

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### SCHEDULE 2
(Form 1040)

#### Tax

- **Form 1040**
- **Attach to Form 1040.**
- **Go to www.irs.gov/Form1040 for instructions and the latest information.**

<table>
<thead>
<tr>
<th>Name(s) shown on Form 1040</th>
<th>Your social security number</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>38-43</strong> Reserved</td>
<td><strong>38-43</strong></td>
</tr>
<tr>
<td><strong>44</strong> Tax (see instructions)</td>
<td><strong>44</strong></td>
</tr>
<tr>
<td>a Tax on child’s unearned income. Attach Form(s) 8814</td>
<td><strong>44a</strong></td>
</tr>
<tr>
<td>b Tax on lump-sum distributions. Attach Form 4972</td>
<td><strong>44b</strong></td>
</tr>
<tr>
<td>c Other taxes, List type and amount</td>
<td><strong>44c</strong></td>
</tr>
<tr>
<td><strong>45</strong> Alternative minimum tax. Attach Form 6251</td>
<td><strong>45</strong></td>
</tr>
<tr>
<td><strong>46</strong> Excess advance premium tax credit. Attach Form 8962</td>
<td><strong>46</strong></td>
</tr>
<tr>
<td><strong>47</strong> Add lines 38 through 46. This is your tax. Enter here and on Form 1040, line 14</td>
<td><strong>47</strong></td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 71478J

Schedule 2 (Form 1040) 2018

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### SCHEDULE 3
(Form 1040)

**Nonrefundable Credits**

<table>
<thead>
<tr>
<th>Credits</th>
<th>Description</th>
<th>Social Security Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>48</td>
<td>Foreign tax credit. Attach Form 1116 if required</td>
<td>48</td>
</tr>
<tr>
<td>49</td>
<td>Credit for child and dependent care expenses. Attach Form 2441-</td>
<td>49</td>
</tr>
<tr>
<td>50</td>
<td>Education credits from Form 8863, line 19</td>
<td>50</td>
</tr>
<tr>
<td>51</td>
<td>Retirement savings contributions credit. Attach Form 8880</td>
<td>51</td>
</tr>
<tr>
<td>52</td>
<td>Child tax credit and credit for other dependents</td>
<td>52</td>
</tr>
<tr>
<td>53</td>
<td>Residential energy credit. Attach Form 5695</td>
<td>53</td>
</tr>
<tr>
<td>54a</td>
<td>General business credit. Attach Form 3800</td>
<td>54a</td>
</tr>
<tr>
<td>b</td>
<td>Credit for prior year minimum tax. Attach Form 8801</td>
<td>54b</td>
</tr>
<tr>
<td>c</td>
<td>Other credits (see instructions)</td>
<td>54c</td>
</tr>
<tr>
<td>55</td>
<td>Add lines 48 through 54. These are your total nonrefundable credits. Enter here and on Form 1040, line 12</td>
<td>55</td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71480G Schedule 3 (Form 1040) 2018

### SCHEDULE 4
(Form 1040)

**Other Taxes**

<table>
<thead>
<tr>
<th>Credits</th>
<th>Description</th>
<th>Social Security Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>57</td>
<td>Self-employment tax. Attach Schedule SE</td>
<td>57</td>
</tr>
<tr>
<td>58a</td>
<td>Social security and Medicare tax on tip income not reported to employer. Attach Form 4137</td>
<td>58a</td>
</tr>
<tr>
<td>b</td>
<td>Uncollected social security and Medicare tax on wages. Attach Form 8919</td>
<td>58b</td>
</tr>
<tr>
<td>59</td>
<td>Additional tax on IRAs, other qualified retirement plans, and other tax-favored accounts. Attach Form 5329 if required</td>
<td>59</td>
</tr>
<tr>
<td>60a</td>
<td>Household employment taxes. Attach Schedule H</td>
<td>60a</td>
</tr>
<tr>
<td>b</td>
<td>Repayment of first-time homebuyer credit from Form 5405, Attach Form 5405 if required</td>
<td>60b</td>
</tr>
<tr>
<td>61</td>
<td>Health care individual responsibility (see instructions)</td>
<td>61</td>
</tr>
<tr>
<td>62a</td>
<td>Additional Medicare tax from Form 8824</td>
<td>62a</td>
</tr>
<tr>
<td>b</td>
<td>Net investment income tax from Form 8860</td>
<td>62b</td>
</tr>
<tr>
<td>c</td>
<td>Instructions: enter code(s)</td>
<td>62c</td>
</tr>
<tr>
<td>63</td>
<td>Section 965 net tax liability installment from Form 965-A</td>
<td>63</td>
</tr>
<tr>
<td>64</td>
<td>Add lines 57 through 63. These are your total other taxes. Enter here and on Form 1040, line 14</td>
<td>64</td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71481R Schedule 4 (Form 1040) 2018
### SCHEDULE 5 (Form 1040)

**Other Payments and Refundable Credits**

- **Form 1040**
- **Attach to Form 1040.**
- **Go to www.irs.gov/Form1040 for instructions and the latest information.**

<table>
<thead>
<tr>
<th>Other Payments and Refundable Credits</th>
<th>2018</th>
<th>OMB No. 1545-0074</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name(s) shown on Form 1040</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>65</td>
<td>Reserved</td>
</tr>
<tr>
<td>66</td>
<td>2018 estimated tax payments and amount applied from 2017 return</td>
</tr>
<tr>
<td>67a</td>
<td>Reserved</td>
</tr>
<tr>
<td>67b</td>
<td>Reserved</td>
</tr>
<tr>
<td>68-69</td>
<td>Reserved</td>
</tr>
<tr>
<td>70</td>
<td>Net premium tax credit. Attach Form 8962</td>
</tr>
<tr>
<td>71</td>
<td>Amount paid with request for extension to file (see instructions)</td>
</tr>
<tr>
<td>72</td>
<td>Excess social security and tier 1 tax withheld</td>
</tr>
<tr>
<td>73</td>
<td>Credit for federal tax on fuels. Attach Form 4136</td>
</tr>
<tr>
<td>74a</td>
<td>Amounts from Form 2439</td>
</tr>
<tr>
<td>b</td>
<td>Health coverage tax credit. Attach Form 8885</td>
</tr>
<tr>
<td>c</td>
<td>Reserved</td>
</tr>
<tr>
<td>d</td>
<td>Other amounts (see instructions)</td>
</tr>
<tr>
<td>75</td>
<td>Add lines 65, 66, 67a, and 68 through 74. These are your total other payments and refundable credits. Enter here and on Form 1040, line 17d.</td>
</tr>
</tbody>
</table>

**Your social security number**

---

### SCHEDULE 6 (Form 1040)

**Foreign Address and Third Party Designee**

- **Form 1040**
- **Attach to Form 1040.**
- **Go to www.irs.gov/Form1040 for instructions and the latest information.**

<table>
<thead>
<tr>
<th>Foreign Address</th>
<th>2018</th>
<th>OMB No. 1545-0074</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name(s) shown on Form 1040</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign country name</td>
<td>Foreign province/county</td>
<td>Foreign postal code</td>
</tr>
<tr>
<td>Third Party Designee</td>
<td>Do you want to allow another person to discuss this return with the IRS (see instructions)?</td>
<td></td>
</tr>
<tr>
<td>Designee's name</td>
<td>Phone no.</td>
<td>Personal Identification number (PIN)</td>
</tr>
</tbody>
</table>

**Your social security number**

---

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71483N

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Lecture 1.02 – Filing Requirements

An Individual **must file** a tax return if their income is greater than their standard deduction ($12,000 single / $18,000 HOH / $24,000 MFJ – 2018), or if they:

- Have net self-employment earnings of $400 or more
- Are claimed as a dependent on another taxpayer’s return, and have gross income greater than the dependent's standard deduction—
  - $1,050 (2018) or,
  - If larger, earned income plus $350 (not to exceed individual standard deduction) (e.g., Suzie, who is claimed on her parents’ return, has no unearned income but works at the corner store and makes $1,300 in 2018. She does not have to file a return because her standard deduction as a dependent is $1,300 plus $350, or $1,650. If Suzie had unearned income from dividends of $500 on top of her $1,300 earned income, she would have to file a return because her gross income is $1,800 and her filing threshold is still $1,650.)
- Are receiving advanced payments of the Earned Income Credit (EIC) or Premium Tax Credit (PTC)
- Are subject to the **Kiddie Tax**

The Kiddie tax was established to prevent the “wealthy” from avoiding taxes on their investment income by transferring the investments into the names of their children, who might not be subject to tax or, if so, would be taxed at lower rates. Thus, a child's unearned income above the following thresholds in 2018 is subject to tax at trust tax rates (i.e., 24%, 35% and 37%)*:

- $2,100, or
- If greater, $1,050 plus itemized deductions related to the production of the unearned income.

*TCJA modified the Kiddie tax rules for 2018 through 2025; a child's unearned income was previously taxed at the parent's tax rate, and this rule will become law again in 2026.

The Kiddie tax applies to children meeting the following conditions:

- The child has unearned income in excess of the threshold for the year ($2,100 - 2018);
- Either parent is alive as of the end of the taxable year;
- The child does not file a joint tax return for the year; and
- The child is:
  1. Under 18 years old as of the end of the tax year, or
  2. 18 years old with earned income that does not exceed 50% of the child's support, or
  3. A student between the ages of 19 and 24 with earned income that does not exceed 50% of the child's support.

In calculating the Kiddie tax, the child's unearned income can generally be broken down into three tiers as follows:


### Tier

<table>
<thead>
<tr>
<th>Tier</th>
<th>Child's Income</th>
<th>Amount of Unearned Income</th>
<th>Applicable Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Unearned income up to dependent’s standard deduction</td>
<td>$0 to $1,050</td>
<td>Not taxed</td>
</tr>
<tr>
<td></td>
<td>• If the child also has <em>earned</em> income, the $1,050 standard deduction will be applied to it first. (Remember, if larger, standard deduction = earned income + $350, not to exceed standard deduction for single individuals.)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Unearned income above standard deduction up to $2,100 threshold</td>
<td>$1,050 - $2,100</td>
<td>Child’s regular rate</td>
</tr>
<tr>
<td></td>
<td>• If the child also has <em>earned</em> income, up to $2,100 of unearned income is still shielded from trust tax rates.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Unearned income above $2,100 threshold</td>
<td>&gt;$2,100</td>
<td>Trust tax rates</td>
</tr>
</tbody>
</table>

For example, Richie, age 16, has $25,000 in unearned income and no earned income. The amount of Richie’s unearned income subject to the Kiddie tax is $25,000 total income – $2,100 threshold = $22,900:

1. $1,050 will not be taxed;
2. $1,050 will be subject to Richie’s tax rate; and
3. $22,900 will be subject to trust tax rates (i.e., the Kiddie tax).

If, however, Richie has $25,000 in unearned income and $1,000 earned income, the amount of Richie’s unearned income subject to the Kiddie tax is still $22,900: $26,000 total income – $1,000 earned income – $2,100 threshold = $22,900:

1. $1,050 (i.e., $1,000 earned + $50 unearned) will not be taxed;
2. $2,050 (all unearned) will be subject to Richie’s tax rate; and
3. $22,900 will be subject to trust tax rates.

If Richie has $25,000 in unearned income and $2,000 earned income, the amount of Richie’s unearned income subject to the Kiddie tax is still $22,900: $27,000 – $2,000 earned income – $2,100 threshold = $22,900:

1. $2,350 (i.e., $2,000 earned + $350 unearned) will not be taxed;
2. $1,750 (all unearned) will be subject to Richie’s tax rate; and
3. $22,900 will be subject to trust tax rates.

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**Methods of Accounting for Tax Purposes**

Section 446 of the tax code generally requires taxpayers to use the basis of accounting that is used in keeping their books; however, the overarching principle is that the method of accounting chosen should *clearly reflect income*. This means that the vast majority of individuals use the cash basis of accounting while entities are more likely to use the accrual basis of accounting. There are some other circumstances that further dictate which method must be used though:

- If the taxpayer’s annual gross receipts exceed $25 million on average for the most recent 3 tax years (i.e., the $25M gross receipts test), the accrual method may be required if purchases and sales of inventory are necessary for the determination of income.
- Some entities are prohibited from using the cash basis under Section 448:
  - C corporations unless they fall below the $25M gross receipts test
  - Partnerships that have a C corporation as a partner unless they meet the $25M gross receipts test
  - Tax shelters
Other Exceptions: This limitation generally does not apply to farming businesses and qualified personal service corporations (PSCs), where 95% of stock is owned by owner-employees (i.e., ownership test) and 95% of activities are in certain fields, such as health, law, accounting, etc. (i.e., function test).

Cash Basis

- **Recognize income** when:
  - Cash or property is received, at fair market value (FMV).
    - Even if “unearned” (i.e., advance payments) – still income when received (e.g., prepaid rent).
  - **Actually or constructively received**, whichever is earlier.
    - Income is constructively received when payment has been *made available* to the taxpayer and the taxpayer has an *unrestricted right to it*. For example, Dale's employer tells him that his check is available to be picked up on December 31st. Dale doesn't pick up the check until January, and he doesn't cash it until February, so he doesn't physically have the cash until February, but constructive receipt occurred on December 31st when the check was made available to Dale. If, however, the check is post-dated for February 1st, then it is not income until Dale has the right to cash the check on February 1st.

- **Report deductions** when:
  - Cash or check is disbursed.
  - Expenses are charged to a credit card.

  Note: Prepaid interest is not deductible; it must be amortized over the period to which it applies.

Accrual Basis

- **Recognize income** generally when “earned.”
  - This means that (1) *all events have occurred that fix the taxpayer’s right to the income* and (2) the amount can be *reasonably determined* (i.e., all events test).
  - The all events test is considered to be met no later than when the income is included in revenue in the financial statements (F/S) of the taxpayer. F/S for these purposes generally include only those certified as being prepared in accordance with GAAP/IFRS or those that are otherwise prepared for filing with certain regulatory or governmental agencies.
  - Advance payments (i.e., unearned income) generally must be recognized in the year received, unless the taxpayer makes an election to include only the part of the payment required to be recognized in the year of receipt (i.e., the part included in revenue for F/S purposes) and the remainder in the following year. Such election may be made for any category of advance payment and will remain in effect until consent to revoke the election is obtained from the IRS. **Note:** Advance payments for these purposes do not include rent and insurance premiums received. Rents and royalties received in advance must be included in taxable income in the period received.

- **Book expenses** as “incurred.”
  - This means that (1) a liability exists, (2) the amount can be *reasonably determined*, and (3) *economic performance* has occurred (i.e., property and/or services have been provided).
Lecture 1.03 – Individual Income Tax Return – Class Questions

1. Perle, a dentist, billed Wood $600 for dental services. Wood paid Perle $200 cash and built a bookcase for Perle's office in full settlement of the bill. Wood sells comparable bookcases for $350. What amount should Perle include in taxable income as a result of this transaction?
   
   a. $0  
   b. $200  
   c. $550  
   d. $600

2. A cash-basis taxpayer should report gross income
   
   a. Only for the year in which income is actually received in cash.  
   b. Only for the year in which income is actually received whether in cash or in property.  
   c. For the year in which income is either actually or constructively received in cash only.  
   d. For the year in which income is either actually or constructively received, whether in cash or in property.

3. Nan, a cash basis taxpayer, borrowed money from a bank and signed a 10-year interest-bearing note on business property on January 1 of the current year. The cash flow from Nan's business enabled Nan to prepay the first three years of interest attributable to the note on December 31 of the current year. How should Nan treat the prepayment of interest for tax purposes?
   
   a. Deduct the entire amount as a current expense.  
   b. Deduct the current year's interest and amortize the balance over the next two years.  
   c. Capitalize the interest and amortize the balance over the 10-year loan period.  
   d. Capitalize the interest as part of the basis of the business property.

Class Solutions

1. (c) When services are exchanged for cash and property, income will be measured at the amount of cash plus the fair value of property received. Perle received cash of $200 and a bookcase with a fair value of $350, for a total taxable amount of $550.

2. (d) The requirement is to determine the correct statement regarding the reporting of income by a cash-basis taxpayer. A cash-basis taxpayer should report gross income for the year in which income is either actually or constructively received, whether in cash or in property. Constructive receipt means that an item of income is unqualifiedly available to the taxpayer without restriction (e.g., interest on a bank deposit is income when credited to the account).

3. (b) In general, under the cash basis of accounting, individuals are allowed to deduct expenses in the year they are paid. However, interest on a loan that has been prepaid for a time beyond the end of the current taxable year cannot be deducted in the year the prepayment is made. In this case, Nan paid the current year interest and prepaid years 2 and 3. Nan is allowed to deduct only the interest attributable to the current year on her current year tax return and will be entitled to a tax deduction on her years 2
and 3 tax returns for the prepaid interest for years 2 and 3, respectively, that Nan paid in the current tax year.
## Lecture 1.04 – Gross Income

### GENERALLY INCOME

<table>
<thead>
<tr>
<th>Compensation for services including:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Wages and salaries (W-2)</td>
</tr>
<tr>
<td>• Tips</td>
</tr>
<tr>
<td>• Fees for jury duty service</td>
</tr>
<tr>
<td>• Bonuses and commissions</td>
</tr>
<tr>
<td>• Unemployment compensation</td>
</tr>
<tr>
<td>• Most fringe benefits, such as the rental value of using a company car on weekends for personal purposes</td>
</tr>
<tr>
<td>• Bargain purchases of employer merchandise/services</td>
</tr>
</tbody>
</table>

### NOT INCOME

| • Health insurance coverage         |
| • Group term life insurance coverage, up to a $50,000 policy |
| • Fringe benefits that primarily are incurred for the employer's benefit, such as free housing given to an on-site hotel manager |
| • Immaterial fringe benefits, such as free photocopies made on the company machine |
| • Employer-provided educational assistance |
| • Up to $5,000 of benefits under an employer dependent care assistance plan |
| • Up to employer's gross profit percentage of regular merchandise price |
| • Up to 20% of FMV of employer services obtained at discount |

- Prizes and awards
- Gambling winnings
- Illegal drug income (net of COGS)
- Treasure trove (i.e., if you find money or something of value and you keep it; it's taxable)

### A prize or award that is both:

- Tangible personal property up to certain dollar values
- Received by an employee for his years of company employment or safety achievement

**OR**

A prize or award where:

- No services required of recipient;
- Selected without action on recipient's part; *and*
- Payment assigned by recipient to a governmental unit or charitable organization.

### Scholarships and fellowships

A scholarship or fellowship that is both:

- Not compensation for required services
- Spent by a degree candidate for tuition

### Interest accrued each year on a zero-coupon bond or bond purchased at a discount

- Interest on state or municipal bonds
- Interest earned on qualified higher education bonds
- Interest on a Series EE U.S. savings bond is not reported as income until the time that the bond is redeemed.

### Dividends

- Stock dividends
- Dividends received from an S corporation
- Dividends received on a life insurance policy
- Dividends received from a mutual fund that invests in tax-exempt bonds

### Rents and royalties, including:

- Rent collected in advance by a landlord
- Nonrefundable deposits collected from tenants

### Refundable security deposits

- Proceeds withdrawn from a traditional IRA or pension plan if the original contributions to the plan

### The bargain discount from exercising a stock option to buy an employer's stock for a price below market value

A special type of stock option, called an incentive stock option (ISO)

### The portion, if any, of a traditional IRA pension withdrawal that represents the recovery of prior nondeductible
were excluded or deducted from income & contributions and all Roth IRA withdrawals.

<table>
<thead>
<tr>
<th>Injury awards, if they are for:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Punitive damages</td>
<td>• Damages for bodily injury, pain and suffering, and lost wages</td>
</tr>
<tr>
<td>• Lost business profits</td>
<td>• Emotional distress attributable to physical injury or sickness</td>
</tr>
<tr>
<td>• Non-physical injuries, such as age or race discrimination</td>
<td>• Workers’ compensation benefits</td>
</tr>
<tr>
<td>• Emotional distress (in excess of associated medical bills)</td>
<td></td>
</tr>
</tbody>
</table>

| Up to 85% of Social Security benefits if the taxpayer has substantial income in addition to the benefits | Up to 100% of Social Security benefits, if the taxpayer does not have much income in addition to benefits |

<table>
<thead>
<tr>
<th>State tax refunds, if the state taxes paid were originally claimed as a deduction in an earlier year</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Federal tax refunds</td>
<td></td>
</tr>
<tr>
<td>• State tax refunds in excess of the amount deducted in an earlier year</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>The interest component of an annuity. For example, assume that a person spends $400 to buy an annuity of $100 for each of 5 years, or $500 proceeds in total. Since a $100 interest profit is part of the $500 proceeds, the portion of each payment that is reported as income is: Profit/Total Proceeds=$100/$500=20%</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Gifts</td>
<td></td>
</tr>
<tr>
<td>• Inheritances</td>
<td></td>
</tr>
<tr>
<td>• Life insurance proceeds paid upon the death of the insured</td>
<td></td>
</tr>
<tr>
<td>• Child Support</td>
<td></td>
</tr>
<tr>
<td>• Property Settlement</td>
<td></td>
</tr>
<tr>
<td>• Alimony (no longer considered income for divorces/separations executed after 2018).</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cancellation of Debt</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Debt forgiven as gift, bequest, or inheritance</td>
<td></td>
</tr>
<tr>
<td>• Certain qualified student loans (includes discharge for death/disability of student for 2018-2025 under TCJA)</td>
<td></td>
</tr>
<tr>
<td>• Debt that would have provided a tax deduction</td>
<td></td>
</tr>
<tr>
<td>• Debt cancelled in Chapter 11 bankruptcy</td>
<td></td>
</tr>
<tr>
<td>• Debt cancelled when debtor is insolvent</td>
<td></td>
</tr>
<tr>
<td>• Qualified farm indebtedness</td>
<td></td>
</tr>
<tr>
<td>• Qualified real property business indebtedness</td>
<td></td>
</tr>
</tbody>
</table>

| Capital gains | Up to $250,000 gain on personal residence ($500,000 MFJ) |

**Note:** This is not meant to be an all-inclusive list. IRC Section 61 provides that all income from whatever source derived is includible in gross income unless specifically excluded by law.

### Gross Income

An item must be included in the gross income of an individual in the year it is **constructively received. This refers to when the cash becomes available to the taxpayer.** Thus, a dividend that is credited to the shareholder’s brokerage account but automatically reinvested in the purchase of additional shares is considered received by the taxpayer. The receipt of property or services is treated as the receipt of the cash that normally would have been required to pay for them.

### Earned Income

- **Salaries and wages (W-2)** are reported when cash or other consideration is received. **For example,** an expensive watch or stock in the corporation that is given to an employee is treated as compensation at the FMV of the property.
• **Tips** are normally reported by the employee to their employer and are included in the reported wages of that employee. Tips not reported to the employer must be directly reported on the tax return by the employee based on when the tips are received.

• Jury duty fees

• Unemployment compensation

• Payment in non-money form reported at FMV when received (stock, property)

• Premiums on group term life insurance over $50,000 are taxable (fringe benefits), but the death benefits received are tax free.

• Life insurance proceeds are generally tax free, unless purchased from a person other than the insurance co (as an investment) or if paid out in installments; then a pro rata part of the receipts is taxable as interest.
  o A qualified cafeteria plan (menu of benefits) is an employer-sponsored benefit plan where the employee can choose either cash (taxable) or benefits (accident insurance, life insurance, legal services – not taxable). With the exception of 401(k) plans, deferred compensation plans are excluded from qualifying cafeteria plans.

• Gambling winnings – Gross winnings must be included in gross income. Gambling losses may be claimed as itemized deductions to the extent of winnings.

• Prizes and awards are taxable, unless received for years of service or safety achievement and such prizes and awards do not exceed $400 (reported at FMV).

• Health and medical insurance coverage is not taxable.

• Immaterial fringe benefits are not taxable (e.g., Xeroxing resume).

• Illegal drug income, net of COGS (not any other expenses), is taxable.

**Scholarships**, taxable unless both (no strings):

• Not compensation for services and

• Money spent for tuition, books, or class supplies for degree-seeking student

**Interest** (Schedule B)

• State and local municipal bond interest is not taxable.

• All other government interest is taxable (e.g., Federal bonds, T-bills).

• Accrual basis taxpayers are taxed on interest on U.S. savings bonds in the period it accrues, regardless of when received.

• **Series HH** bonds, the last of which mature in 2024, were issued at face value.
  o Interest is payable twice per year.
  o Cash basis taxpayers are taxed on interest in the period received.

• **Series EE** savings bonds
  o Taxable interest is equal to the difference between the redemption value and the purchase price.
  o May be paper or electronic
    ▪ Paper issued at discount and redeemed at face value
    ▪ Electronic issued at face and redeemed at face plus accrued interest
  o Exempt if used for higher education for self, spouse, or dependent
    ▪ Bought by taxpayer (or spouse)
    ▪ Buyer at least 24 years of age
    ▪ Redeem directly – need not transfer to school
    ▪ Tuition and fees qualify, but room and board do not qualify.

• **Series E** savings bonds, which were issued prior to Series EE savings bonds, were issued at a discount and redeemed at face value.
• **Series I** savings bonds, which are inflation-indexed bonds, are issued at face value and redeemed at maturity at face value plus accrued interest.

• A **cash basis** taxpayer can choose either of the following methods for reporting interest income on Series E, EE, or I bonds:
  o Report all interest when bonds are redeemed or sold
  o Report interest as the increase in the redemption value of the bond each year

**Dividends (Schedule B)**

• Taxable when received **unless**:
  o Life insurance dividend - return of premium
    ▪ But interest on the dividend is taxable
  o Received from an S corporation
  o Stock dividends or stock splits on common stock
    ▪ Stock dividends from Preferred stock are taxable at FMV.
    ▪ Cash and property dividends from common stock are taxable.
  o Liquidating dividend - return of capital

• Qualified dividends are taxed at special 0%, 15% or 20%, similar to long-term capital gains. For 2018-2025, the applicable rate is determined based on income levels (adjusted for inflation after 2018), rather than tax brackets (see text box below for prior law).

  o **0%** tax rate if income is below $38,600 for single individuals, $77,200 for married filing jointly (MFJ) and surviving spouses (SS), and $51,700 for head of households (HOH)
  o **15%** tax rate if income is between the applicable 0% rate amount and below $425,800 for single individuals, $479,000 for MFJ and SS, and $452,400 for HH
  o **20%** tax rate for all other “high-income” individuals above these thresholds
  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 (i.e., the date on which the dividend payee is determined, usually 2 days prior to the record date).

  o **Note:** Special rates do not 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).

  **Prior Law**
  
  • 0% tax rate if in the first two tax brackets—10%, 15%
  • 15% tax rate if in the middle four tax brackets—25%, 28%, 33%, 35%
  • 20% tax rate if in the highest tax bracket—39.6%

**Stock Options**

• **Non-qualified** – taxed when **exercised**; excess of FMV over exercise price treated as compensation.

• **Qualified** (incentive stock option – **ISO**) – taxed when **sell** stock; difference between sales price and exercise price treated as capital gain or loss.
  o For AMT purposes, however, ISOs are taxed when exercised.
  o ISO must be held 2 years from grant date and 1 year from exercise date.
Injury awards

- Non-physical – **Taxable**
  - Age, race discrimination
  - Punitive damages
  - Lost business profits
- Bodily injury – **tax free (blood)**
  - Pain & suffering for physical injury
  - Workers’ compensation
  - Reimbursement of medical expenses paid and not itemized on Schedule A

Prizes and awards – Taxable at FMV unless *all* conditions satisfied:

- No services required of recipient.
- Selected without any action on recipient’s part.
- Payment assigned by recipient to a governmental unit or charitable organization so that recipient *never actually receives* the prize or award.
Lecture 1.05 – Gross Income Continued

Social Security Benefits

- **Social security benefits** may or may not be taxable based on a complicated calculation using **provisional income** (adjusted gross income before social security + tax-exempt income + one-half of social security benefits). As a result of the calculation, anywhere from 0 to 85% of benefits may be taxable. In general, a person collecting social security who has **less than $25,000** of provisional income can exclude all social security benefits, while taxpayers with provisional income **exceeding $60,000** usually are subject to the maximum 85% inclusion.

Debt Forgiveness

- In general, when a debtor's debts are cancelled, forgiven, or discharged, such as through relief in bankruptcy, the amount forgiven is **taxable to the debtor**.
- There are certain debts that are **not taxable** when forgiven. These include:
  - Amounts excludable from income such as gifts, bequests, or inheritances
  - Cancellation of certain qualified student loans (includes discharge for death/disability of student for 2018 – 2025 under TCJA)
  - Debt that, upon payment, would provide a tax deduction to the taxpayer
  - Debt that is cancelled in a Chapter 11 bankruptcy case
  - Debt that is cancelled when the debtor is insolvent, which is when debts exceed the market value of the debtor's assets
  - Qualified farm indebtedness
  - Qualified real property business indebtedness

Pensions and Annuities

- **Pension benefits and annuities** (other than excluded recovery of capital), including distributions from IRAs (other than Roth IRA accounts), may be taxable. The amount considered a return of capital will NOT be taxable. If the taxpayer did not pay any portion of the cost of the pension plan, such as one in which all costs were incurred by an employer, all benefits are taxable.

\[
\text{Cost of annuity} \quad \frac{\text{Expected total annuity payments}}{\text{Cost of annuity}} = \text{percentage of each payment that is excluded from taxes}
\]

- **Lump-sum distributions** from qualified pension, profit-sharing, stock bonus, and Keogh plans (but not IRAs) may be eligible for special tax treatment. Certain distributions may be rolled-over tax-free (within 60 days) to a traditional IRA account.

Foreign Earned Income Exclusion

- An individual meeting either a **bona fide residence test** or a **physical presence test** may elect to exclude up to $104,100 (2018) of income earned in a foreign country. Qualifying taxpayers also may elect to exclude additional amounts based on foreign housing costs.
  - To qualify, an individual must be a (1) U.S. citizen who is a foreign resident for an uninterrupted period that includes an entire taxable year (bona fide residence test), or (2) U.S. citizen or resident present in a foreign country for at least 330 full days in any 12-month period (physical presence test).
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.

Inheritances, Gifts and Life Insurance Proceeds

- Not taxable to recipient
  - However, any income received from the property is taxable.
  - Discussed in more detail in the Estate, Trust and Gift Tax section

Capital Assets (Sch. D)

- Individuals receive special tax rates for **long-term capital gains** (i.e., held over 1 year). For 2018–2025, the applicable rate is determined based on income levels (adjusted for inflation after 2018), rather than tax brackets, as previously discussed.
  - 0% tax rate if income is below $38,600 for single individuals, $77,200 for MFJ/SS, and $51,700 for HOH
  - 15% tax rate if income is between the applicable 0% rate amount and below $425,800 for single individuals, $479,000 for MFJ/SS, and $452,400 for HOH
  - 20% tax rate for all other “high-income” individuals above these thresholds
- Short-term capital gains (i.e., held 1 year or less) are taxed at ordinary tax rates.
- Net **capital loss** up to $3,000 is allowable against an individual's ordinary income ($1,500 for MFS).
  - Unused amount can be carried forward *indefinitely*.
  - Note that **corporations** cannot deduct a net capital loss, and no special tax rates apply; however, they can carry them back 3 years and forward 5 years to offset capital gains.
- In most cases, one must report capital gains and losses on Form 8949 and then report the totals on Schedule D.
- 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.
    - Exception: Gain on personal residence excludable up to $250,000, or $500,000 if MFJ.
  - Losses, however, 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.
Net Operating Losses (NOL)

TCJA Changes: NOLs may no longer be carried back 2 years, unless the taxpayer is a farmer. NOLs may now be carried forward indefinitely until they are used up. For any tax year to which an NOL deduction is carried forward, such deduction is now limited to 80% of taxable income for the year before the NOL.

- Generally, an NOL results from a business loss, but it could also result from a personal casualty loss. (Note that personal casualty losses are no longer deductible unless they are incurred as a result of a Federally Declared Disaster.)
- Include in calculation all taxable income and all deductions except the following:
  - Capital losses in excess of capital gains
  - Nonbusiness deductions (e.g., standard deduction) in excess of nonbusiness income
    - Wages and rental income are considered business income for NOL purposes.
  - NOL carryforwards
  - The Section 199A Qualified Business Income deduction
  - Personal exemption ($0 for 2018 – 2025 anyway)
- Corporations, similar rules

Sammy is in the comic book business. He is single and has the following income and deductions on his Form 1040 for year 1:

**Income**
- Wages from part-time job $1,500
- Interest on savings $500
- Net long-term capital gain on sale of real estate used in business $2,500

Sammy's total income $4,500

**Deductions**
- Net loss from business $8,000 ($42,000 income – $50,000 expenses)
- Net short-term capital loss—sale of stock $1,000
- Standard deduction $12,000

Sammy's total deductions $21,000

Sammy's deductions exceed his income by $16,500 ($21,000 – $4,500). However, to figure whether he has an NOL, the following deductions are not allowed:
- Nonbusiness net short-term capital loss $1,000
- Nonbusiness deductions (standard deduction, $12,000) – nonbusiness income (interest, $500) $11,500

Total deductions not allowed in NOL calculation $12,500

Thus, total deductions allowed is $8,500 ($21,000 total deductions – $12,500 disallowed deductions).

Therefore, Sammy's NOL for year 1 is $4,000 ($4,500 total income – $8,500 deductions allowed).
Sammy may carry the $4,000 NOL forward to the following year, but the amount he can take will be limited to 80% of taxable income. So, if Sammy's taxable income is $4,200 in year 2, then he may offset only $3,360 ($4,200 x 0.80), with the NOL deduction in year 2 and carry the remainder to the following year.
Lecture 1.06 – Tax Schedules

A  Itemized Deductions (personal expenses)
B  Interest and dividend income
C  Profit and loss from a business (Employer expenses / 1099 Income)
D  Capital gains and losses (S/T and L/T investments)
E  Supplementary income or loss (RRF-COP)
   • Rental Income
   • Royalties
      o Copyrights
      o Oil/Gas leases
      o Patents
   • Flow-through entities (Schedule K-1 income)
      o S corps, Partnerships, Estates & Trusts
F  Profit and Loss from Farming

Form 1040X–Amended return (3 years)
Form 1116–Foreign Tax Credit
Form 4562–Depreciation and Amortization
Form 4797–Sale of L/T business property (not inventory or receivables – Schedule C)

Note: The final 2018 forms were unavailable at the time of publication.
### SCHEDULE A (Form 1040)

Department of the Treasury
Internal Revenue Service ( IRS )

#### Itemized Deductions

Go to www.irs.gov/ScheduleA for instructions and the latest information.

Caution: If you are claiming a net qualified disaster loss on Form 4684, see the instructions for line 16.

**2018**

*Attachment Sequence No. 07*

Name(s) shown on Form 1040

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Medical and dental expenses (see instructions)</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>Enter amount from Form 1040, line 7</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>Multiply line 2 by 7.5% (0.075)</td>
<td>3</td>
</tr>
<tr>
<td>4</td>
<td>Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td>State and local income taxes or general sales taxes. You may include either income taxes or general sales taxes on line 5a, but not both. If you elect to include general sales taxes instead of income taxes, check this box.</td>
<td>5a</td>
</tr>
<tr>
<td>6</td>
<td>Other taxes. List type and amount.</td>
<td>6</td>
</tr>
<tr>
<td>7</td>
<td>Add lines 5e and 6</td>
<td>7</td>
</tr>
<tr>
<td>8</td>
<td>Home mortgage interest and points. If you didn't use all of your home mortgage loan(s) to buy, build, or improve your home, see instructions and check this box.</td>
<td>8a</td>
</tr>
<tr>
<td>9</td>
<td>Investment interest. Attach Form 4952 if required. See instructions.</td>
<td>9</td>
</tr>
<tr>
<td>10</td>
<td>Add lines 8a and 9</td>
<td>10</td>
</tr>
<tr>
<td>11</td>
<td>Gifts by cash or check. If you made any gift of $250 or more, see instructions.</td>
<td>11</td>
</tr>
<tr>
<td>12</td>
<td>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>12</td>
</tr>
<tr>
<td>13</td>
<td>Carryover from prior year</td>
<td>13</td>
</tr>
<tr>
<td>14</td>
<td>Add lines 11 through 13</td>
<td>14</td>
</tr>
<tr>
<td>15</td>
<td>Casually and theft loss(es) from a federally declared disaster (other than net qualified disaster losses). Attach Form 4684 and enter the amount from line 18 of that form. See instructions.</td>
<td>15</td>
</tr>
<tr>
<td>16</td>
<td>Other—From list in instructions. List type and amount.</td>
<td>16</td>
</tr>
<tr>
<td>17</td>
<td>Add the amounts in the far right column for lines 4 through 16. Also, enter this amount on Form 1040, line 8</td>
<td>17</td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see the instructions for Form 1040.

Cat. No. 17145C

Schedule A (Form 1040) 2018

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### SCHEDULE B (Form 1040)

**Department of the Treasury**

**Internal Revenue Service (IRS)**

**Name(s) shown on return**

<table>
<thead>
<tr>
<th>Part I</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong></td>
<td>List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see the instructions and list this interest first. Also show that buyer’s social security number and address.</td>
</tr>
<tr>
<td></td>
<td><strong>Amount</strong></td>
</tr>
</tbody>
</table>

Note: If you received a Form 1099-INT, Form 1099-DIV, or substitute statement from a brokerage firm, list the firm’s name as the payer and enter the total interest shown on that form.

| 2     | Add the amounts on line 1. |
| 3     | Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815. |
| 4     | Subtract line 3 from line 2. Enter the result here and on Form 1040, line 3b. |

**Note:** If line 4 is over $1,500, you must complete Part III.

### Part II

**Ordinary Dividends**

(See instructions and the instructions for Form 1040, line 3b.)

| 5     | List name of payer. |
|       | **Amount** |

Note: If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm’s name as the payer and enter the ordinary dividends shown on that form.

### Part III

**Foreign Accounts and Trusts**

(See instructions.)

| 7a    | At any time during 2018, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions. |
|       | **Yes** | **No** |
|       | If “Yes,” are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements. |
| 8b    | If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located. |
| 8c    | During 2018, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If “Yes,” you may have to file Form 3520. See instructions. |

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### Profit or Loss From Business

**Sole Proprietorship**

- **Social security number (SSN):** [Blank]
- **Employer ID number (EIN):** [Blank]

#### A Principal business or profession, including product or service (see instructions)
- **Enter code from instructions:** [Blank]

#### C Business name, if no separate business name, leave blank.

#### E Business address (including suite or room no.)
- City, town or post office, state, and ZIP code: [Blank]

#### F Accounting method:
- [ ] Cash
- [ ] Accrual
- [ ] Other (specify)

#### G Did you “materially participate” in the operation of this business during 2018? If “No,” see instructions for limit on losses.
- [ ] Yes
- [ ] No

#### H If you started or acquired this business during 2018, check here:
- [ ] Yes
- [ ] No

#### I Did you make any payments in 2018 that would require you to file Form 1099? (see instructions)
- [ ] Yes
- [ ] No

#### J If “Yes,” did you or will you file required Forms 1099?
- [ ] Yes
- [ ] No

### Part I Income

1. Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the “Statutory employee” box on that form was checked.

2. Returns and allowances: [Blank]

3. Subtract line 2 from line 1: [Blank]

4. Cost of goods sold (from line 42): [Blank]

5. **Gross profit.** Subtract line 4 from line 3.

6. Other income, including federal and state gasoline or federal tax credit or refund (see instructions).

7. **Gross income.** Add lines 5 and 6.

### Part II Expenses

**Enter expenses for business use of your home only on line 30.**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>Advertising</td>
</tr>
<tr>
<td>9</td>
<td>Car and truck expenses (see instructions)</td>
</tr>
<tr>
<td>10</td>
<td>Commissions and fees</td>
</tr>
<tr>
<td>11</td>
<td>Contract labor (see instructions)</td>
</tr>
<tr>
<td>12</td>
<td>Depletion</td>
</tr>
<tr>
<td>13</td>
<td>Depreciation and section 179 expense deduction (not included in Part III) (see instructions)</td>
</tr>
<tr>
<td>14</td>
<td>Employee benefit programs (other than on line 19)</td>
</tr>
<tr>
<td>15</td>
<td>Insurance (other than health)</td>
</tr>
<tr>
<td>16</td>
<td>Interest (see instructions):</td>
</tr>
<tr>
<td>17</td>
<td>Legal and professional services</td>
</tr>
<tr>
<td>18</td>
<td>Office expense (see instructions)</td>
</tr>
<tr>
<td>19</td>
<td>Pension and profit-sharing plans</td>
</tr>
<tr>
<td>20</td>
<td>Rent or lease (see instructions):</td>
</tr>
<tr>
<td>21</td>
<td>Repairs and maintenance</td>
</tr>
<tr>
<td>22</td>
<td>Supplies (not included in Part III)</td>
</tr>
<tr>
<td>23</td>
<td>Taxes and licenses</td>
</tr>
<tr>
<td>24</td>
<td>Travel and meals:</td>
</tr>
<tr>
<td>25</td>
<td>Utilities</td>
</tr>
<tr>
<td>26</td>
<td>Wages (less employment credits)</td>
</tr>
<tr>
<td>27</td>
<td>Other expenses (from line 48)</td>
</tr>
<tr>
<td>28</td>
<td>Total expenses before expenses for business use of home. Add lines 8 through 27a.</td>
</tr>
<tr>
<td>29</td>
<td>Tentative profit or loss. Subtract line 28 from line 7.</td>
</tr>
<tr>
<td>30</td>
<td>Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions).</td>
</tr>
</tbody>
</table>

**Simplified method filers only:** enter the total square footage of: (a) your home: and (b) the part of your home used for business. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30.

### Part III Net profit or (loss)

- Subtract line 30 from line 29.
- **If a profit:** enter on both Schedule C (Form 1040), line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2. (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3.
- **If a loss:** you must go to line 32.

### Part IV If you have a loss, check the box that describes your investment in this activity (see instructions).

- **If you checked 32a, enter the loss on both Schedule C (Form 1040), line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2.** (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3.
- **If you checked 32b, you must attach Form 6195.** Your loss may be limited.

---

**Simplified Method Worksheet:**

- Enter the total square footage of: (a) your home: and (b) the part of your home used for business. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30.
### Part III  Cost of Goods Sold (see instructions)

33 Method(s) used to value closing inventory:  
- [ ] Cost  
- [ ] Lower of cost or market  
- [ ] Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory?  
If “Yes,” attach explanation

35 Inventory at beginning of year, if different from last year’s closing inventory, attach explanation

36 Purchases less cost of items withdrawn for personal use

37 Cost of labor. Do not include any amounts paid to yourself.

38 Materials and supplies

39 Other costs

40 Add lines 35 through 39

41 Inventory at end of year

42 Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on line 4.

### Part IV  Information on Your Vehicle. Complete this part only if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year)

44 Of the total number of miles you drove your vehicle during 2018, enter the number of miles you used your vehicle for:

- [ ] Business
- [ ] Commuting (see instructions)
- [ ] Other

45 Was your vehicle available for personal use during off-duty hours?

46 Do you (or your spouse) have another vehicle available for personal use?

47a Do you have evidence to support your deduction?

b If “Yes,” is the evidence written?

### Part V  Other Expenses. List below business expenses not included on lines 8–26 or line 30.

- 
- 
- 
- 
- 
- 
- 

48 Total other expenses. Enter here and on line 27a

---

Schedule C (Form 1040) 2018
## SCHEDULE D (Form 1040)

**Capital Gains and Losses**

> Attach to Form 1040 or Form 1040-NR.


> Use Form 8949 to list your transactions for lines 1b, 2, 3b, 8b, 9, and 10.

### Part I  Short-Term Capital Gains and Losses—Assets Held One Year or Less

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.

<table>
<thead>
<tr>
<th></th>
<th>(d) Proceeds (sales price)</th>
<th>(e) Cost (or other basis)</th>
<th>(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)</th>
<th>(h) Gain or (loss) from column (d) and combine the result with column (g)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1a</td>
<td>Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1b</td>
<td>Totals for all transactions reported on Form(s) 8949 with Box A checked</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Totals for all transactions reported on Form(s) 8949 with Box B checked</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Totals for all transactions reported on Form(s) 8949 with Box C checked</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Short-term capital loss carryover. Enter the amount, if any, from line 8 of your <a href="#">Capital Loss Carryover Worksheet</a> in the instructions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Net short-term capital gain or (loss). Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Part II  Long-Term Capital Gains and Losses—Assets Held More Than One Year

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.

<table>
<thead>
<tr>
<th></th>
<th>(d) Proceeds (sales price)</th>
<th>(e) Cost (or other basis)</th>
<th>(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)</th>
<th>(h) Gain or (loss) from column (d) and combine the result with column (g)</th>
</tr>
</thead>
<tbody>
<tr>
<td>8a</td>
<td>Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8b</td>
<td>Totals for all transactions reported on Form(s) 8949 with Box D checked</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Totals for all transactions reported on Form(s) 8949 with Box E checked</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Totals for all transactions reported on Form(s) 8949 with Box F checked</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Capital gain distributions. See the instructions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Long-term capital loss carryover. Enter the amount, if any, from line 13 of your <a href="#">Capital Loss Carryover Worksheet</a> in the instructions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Net long-term capital gain or (loss). Combine lines 8a through 14 in column (h). Then go to Part III on the back</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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Cat. No. 11338H  Schedule D (Form 1040) 2017
## Part III Summary

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>16</td>
<td>Combine lines 7 and 15 and enter the result</td>
</tr>
<tr>
<td></td>
<td>- If line 16 is a gain, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below.</td>
</tr>
<tr>
<td></td>
<td>- If line 16 is a loss, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22.</td>
</tr>
<tr>
<td></td>
<td>- If line 16 is zero, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.</td>
</tr>
</tbody>
</table>

17 Are lines 15 and 16 both gains?
   - Yes. Go to line 18.
   - No. Skip lines 18 through 21, and go to line 22.

18 If you are required to complete the 28% Rate Gain Worksheet (see instructions), enter the amount, if any, from line 7 of that worksheet.

19 If you are required to complete the Unrecaptured Section 1250 Gain Worksheet (see instructions), enter the amount, if any, from line 18 of that worksheet.

20 Are lines 18 and 19 both zero or blank?
   - Yes. Complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). Don't complete lines 21 and 22 below.
   - No. Complete the Schedule D Tax Worksheet in the instructions. Don't complete lines 21 and 22 below.

21 If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the smaller of:
   - The loss on line 16 or
   - ($3,000), or if married filing separately, ($1,500)

   **Note:** When figuring which amount is smaller, treat both amounts as positive numbers.

22 Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b?
   - Yes. Complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42).
   - No. Complete the rest of Form 1040 or Form 1040NR.
### Supplemental Income and Loss

**Part I: Income or Loss From Rental Real Estate and Royalties**

**Note:** If you are in the business of renting personal property, use Schedule C or C-EZ (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

<table>
<thead>
<tr>
<th>A</th>
<th>Did you make any payments in 2018 that would require you to file Form(s) 1099? (See instructions)</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>If “Yes,” did you or will you file required Forms 1099?</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**1a. Physical address of each property (street, city, state, ZIP code)**

**1b. Type of Property (from list below)**

<table>
<thead>
<tr>
<th>Type of Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Single Family Residence</td>
</tr>
<tr>
<td>2. Multi-Family Residence</td>
</tr>
<tr>
<td>3. Vacation/Short-Term Rental</td>
</tr>
<tr>
<td>4. Commercial</td>
</tr>
<tr>
<td>5. Land</td>
</tr>
<tr>
<td>6. Royalties</td>
</tr>
<tr>
<td>7. Self-Rental</td>
</tr>
<tr>
<td>8. Other (describe)</td>
</tr>
</tbody>
</table>

| 2. For each rental real estate property listed above, report the number of its rental and personal use days, Check the Q/V box only if you meet the requirements to file as a qualified joint venture. See instructions. |
|---|---|---|---|
| A | Fair Rental Days |
| B | Personal Use Days |
| Q/V |

<table>
<thead>
<tr>
<th>Income:</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Rents received</td>
</tr>
<tr>
<td>4. Royalties received</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses:</th>
</tr>
</thead>
<tbody>
<tr>
<td>5. Advertising</td>
</tr>
<tr>
<td>6. Auto and travel (see instructions)</td>
</tr>
<tr>
<td>7. Cleaning and maintenance</td>
</tr>
<tr>
<td>8. Commissions</td>
</tr>
<tr>
<td>9. Insurance</td>
</tr>
<tr>
<td>10. Legal and other professional fees</td>
</tr>
<tr>
<td>11. Management fees</td>
</tr>
<tr>
<td>12. Mortgage interest paid to banks, etc. (see instructions)</td>
</tr>
<tr>
<td>13. Other interest</td>
</tr>
<tr>
<td>14. Repairs</td>
</tr>
<tr>
<td>15. Supplies</td>
</tr>
<tr>
<td>16. Taxes</td>
</tr>
<tr>
<td>17. Utilities</td>
</tr>
<tr>
<td>18. Depreciation expense or depletion</td>
</tr>
<tr>
<td>19. Other (list)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>20. Total expenses. Add lines 5 through 19</th>
</tr>
</thead>
</table>

| 21. Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198 |

<table>
<thead>
<tr>
<th>22. Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)</th>
</tr>
</thead>
</table>

| 23a. Total of all amounts reported on line 3 for all rental properties |
| 23b. Total of all amounts reported on line 4 for all royalty properties |
| 23c. Total of all amounts reported on line 12 for all properties |
| 23d. Total of all amounts reported on line 18 for all properties |
| 23e. Total of all amounts reported on line 20 for all properties |

<table>
<thead>
<tr>
<th>24. Income. Add positive amounts shown on line 21. Do not include any losses</th>
</tr>
</thead>
</table>

| 25. Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here |

| 26. Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule I (Form 1040), line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 |

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**Caution:** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

### Part II Income or Loss From Partnerships and S Corporations — Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you must check the box in column (a) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which any amount is not at risk, you must check the box in column (f) on line 28 and attach Form 6198 (see instructions).

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>27</td>
<td>Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses?</td>
<td>Yes, No</td>
</tr>
<tr>
<td>28</td>
<td>(a) Name</td>
<td>(b) Enter P for partnership; B for S corporation</td>
</tr>
<tr>
<td>A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Passive Income and Loss**

<table>
<thead>
<tr>
<th>Column</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>(g)</td>
<td>Passive loss allowed (attach Form 8582 if required)</td>
</tr>
<tr>
<td>(h)</td>
<td>Passive income from Schedule K-1</td>
</tr>
<tr>
<td>(i)</td>
<td>Nonpassive loss from Schedule K-1</td>
</tr>
<tr>
<td>(j)</td>
<td>Section 179 expense deduction from Form 4562</td>
</tr>
<tr>
<td>(k)</td>
<td>Nonpassive income from Schedule K-1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Column</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Totals</td>
</tr>
<tr>
<td>B</td>
<td>Totals</td>
</tr>
</tbody>
</table>

### Part III Income or Loss From Estates and Trusts

<table>
<thead>
<tr>
<th>Column</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>Name</td>
</tr>
<tr>
<td>(b)</td>
<td>Employer identification number</td>
</tr>
</tbody>
</table>

### Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMCIs)—Residual Holder

<table>
<thead>
<tr>
<th>Column</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>Name</td>
</tr>
<tr>
<td>(b)</td>
<td>Employer identification number</td>
</tr>
<tr>
<td>(c)</td>
<td>Excess inclusion from Schedules Q, line 2c (see instructions)</td>
</tr>
<tr>
<td>(d)</td>
<td>Taxable income (net loss) from Schedules Q, line 1b</td>
</tr>
<tr>
<td>(e)</td>
<td>Income from Schedules Q, line 3b</td>
</tr>
</tbody>
</table>

### Part V Summary

<table>
<thead>
<tr>
<th>Column</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>39</td>
<td>Combine columns (c) and (e) only. Enter the result here and include in the total on line 41 below</td>
</tr>
</tbody>
</table>

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**Part I  Farm Income—Cash Method. Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 9.)**

| 1a | Sales of livestock and other resale items (see instructions) | 1c |
| 1b | Subtract line 1b from line 1a. |  |
| 2 | Sales of livestock, produce, grains, and other products you raised | 2 |
| 3a | Cooperative distributions (Form(s) 1099-PATR) | 3a |
| 3b | Taxable amount | 3b |
| 4a | Agricultural program payments (see instructions) | 4a |
| 4b | Taxable amount | 4b |
| 5a | Commodity Credit Corporation (CCC) loans reported under election | 5a |
| 5c | Taxable amount | 5c |
| 6 | Crop insurance proceeds and federal crop disaster payments (see instructions) |  |
| 6a | Amount received in 2017 | 6a |
| 6b | Taxable amount | 6b |
| 6d | Amount deferred from 2016 | 6d |
| 7 | Custom hire (machine work) income | 7 |
| 8 | Other income, including federal and state gasoline or fuel tax credit or refund (see instructions) | 8 |
| 9 | Gross income. Add amounts in the right column (lines 1c, 2, 3b, 4b, 5a, 5c, 6b, 6d, 7, and 8). If you use the accrual method, enter the amount from Part III, line 50. See instructions. | 9 |

**Part II  Farm Expenses—Cash and Accrual Method. Do not include personal or living expenses. See instructions.**

| 10 | Car and truck expenses (see instructions). Also attach Form 4682 | 23 |
| 11 | Chemicals | 24 |
| 12 | Conservation expenses (see instructions) | 24a |
| 13 | Custom hire (machine work) | 24b |
| 14 | Depreciation and section 179 expense (see instructions) | 25 |
| 15 | Employee benefit programs other than on line 23 | 25 |
| 16 | Feed | 26 |
| 17 | Fertilizers and lime | 27 |
| 18 | Freight and trucking | 28 |
| 19 | Gasoline, fuel, and oil | 29 |
| 20 | Insurance (other than health) | 30 |
| 21 | Interest: | 31 |
| 21a | Mortgage (paid to banks, etc.) | 32 |
| 21b | Other | 32a |
| 22 | Labor hired [less employment credits] | 32b |
| 33 | Total expenses. Add lines 10 through 32. If line 32 is negative, see instructions | 33 |
| 34 | Net farm profit or loss. Subtract line 33 from line 9 | 34 |
| 35 | Did you receive an applicable subsidy in 2017? See instructions |  |
| 36 | Did you have to file Form(s) 1099 (see instructions) |  |

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**Part III  Farm Income—Accrual Method** (see instructions).

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Column 1</th>
<th>Column 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>37</td>
<td>Sales of livestock, produce, grains, and other products (see instructions)</td>
<td>37</td>
<td></td>
</tr>
<tr>
<td>38a</td>
<td>Cooperative distributions (Form(s) 1099-PATR)</td>
<td></td>
<td>38a</td>
</tr>
<tr>
<td>38b</td>
<td>Taxable amount</td>
<td>38b</td>
<td></td>
</tr>
<tr>
<td>39a</td>
<td>Agricultural program payments</td>
<td>39a</td>
<td>39b</td>
</tr>
<tr>
<td>39b</td>
<td>Taxable amount</td>
<td>39b</td>
<td></td>
</tr>
<tr>
<td>40</td>
<td>Commodity Credit Corporation (CCC) loans:</td>
<td></td>
<td>40a</td>
</tr>
<tr>
<td>40a</td>
<td>CCC loans reported under election</td>
<td></td>
<td></td>
</tr>
<tr>
<td>40b</td>
<td>CCC loans forfeited</td>
<td></td>
<td>40c</td>
</tr>
<tr>
<td>40c</td>
<td>Taxable amount</td>
<td></td>
<td></td>
</tr>
<tr>
<td>41</td>
<td>Crop insurance proceeds</td>
<td></td>
<td>41</td>
</tr>
<tr>
<td>42</td>
<td>Custom hire (machine work) income</td>
<td></td>
<td>42</td>
</tr>
<tr>
<td>43</td>
<td>Other income (see instructions)</td>
<td></td>
<td>43</td>
</tr>
<tr>
<td>44</td>
<td>Add amounts in the right column for lines 37 through 43 (lines 37, 38b, 39b, 40a, 40c, 41, 42, and 43)</td>
<td>44</td>
<td></td>
</tr>
<tr>
<td>45</td>
<td>Inventory of livestock, produce, grains, and other products at beginning of the year</td>
<td>45</td>
<td></td>
</tr>
<tr>
<td>46</td>
<td>Cost of livestock, produce, grains, and other products purchased during the year</td>
<td>46</td>
<td></td>
</tr>
<tr>
<td>47</td>
<td>Add lines 45 and 46</td>
<td></td>
<td>47</td>
</tr>
<tr>
<td>48</td>
<td>Inventory of livestock, produce, grains, and other products at end of year</td>
<td></td>
<td>48</td>
</tr>
<tr>
<td>49</td>
<td>Cost of livestock, produce, grains, and other products sold. Subtract line 48 from line 47*</td>
<td>49</td>
<td></td>
</tr>
<tr>
<td>50</td>
<td><strong>Gross income.</strong> Subtract line 49 from line 44. Enter the result here and on Part I, line 9</td>
<td>50</td>
<td></td>
</tr>
</tbody>
</table>

*If you use the unit-livestock-price method or the farm-price method of valuing inventory and the amount on line 48 is larger than the amount on line 47, subtract line 47 from line 48. Enter the result on line 49. Add lines 44 and 49. Enter the total on line 50 and on Part I, line 9.

**Part IV  Principal Agricultural Activity Codes**

- **Do not file Schedule F (Form 1040) to report the following.**
  - Income from providing agricultural services such as soil preparation, veterinary, farm labor, horticultural, or management for a fee or on a contract basis. Instead file Schedule C (Form 1040) or Schedule C-EZ (Form 1040).
  - Income from breeding, raising, or caring for dogs, cats, or other pet animals. Instead file Schedule C (Form 1040) or Schedule C-EZ (Form 1040).
  - Sales of livestock held for draft, breeding, sport, or dairy purposes. Instead file Form 4797.

- **These codes for the Principal Agricultural Activity classify farms by their primary activity to facilitate the administration of the Internal Revenue Code. These six-digit codes are based on the North American Industry Classification System (NAICS).**

- **Select the code that best identifies your primary farming activity and enter the six-digit number on line B.**

**Crop Production**

- 111100  Oilseed and grain farming
- 111210  Vegetable and melon farming

- 111300  Fruit and tree nut farming
- 111400  Greenhouse, nursery, and floriculture production
- 111900  Other crop farming

**Animal Production**

- 112111  Beef cattle ranching and farming
- 112112  Cattle feedlots
- 112120  Dairy cattle and milk production
- 112210  Hog and pig farming
- 112300  Poultry and egg production
- 112400  Sheep and goat farming
- 112510  Aquaculture
- 112900  Other animal production

**Forestry and Logging**

- 113000  Forestry and logging (including forest nurseries and timber tracts)
Lecture 1.07 – Adjustments for (to) AGI

(Student Interest for higher education)

- $2,500, phase out applies
- Applies to entire repayment period

(Self-Employment tax – pays both employer and employee’s share (15.3%))

- 50% of SE tax (7.65%) is deductible on return
  - 6.2% Social Security - on wages up to $128,400 – 2018
  - 1.45% Medicare – unlimited
- 100% of medical insurance premiums paid by a self-employed taxpayer for self and family are deductible (no member of the family may have coverage through an employer).

(Moving expenses)

TCJA Change: The deduction for moving expenses has been suspended for 2018 – 2025 for most individuals. There is an exception for members of the U.S. armed forces on active duty, but this exception is not likely to be tested.

(Business expenses (Schedule C – Sole Proprietorship/1099 Income))

- All costs of running a business
- All taxes paid by the business
- Bad debts recognized under direct write-off method
- The Uniform Capitalization Rules (UNiCAP – Section 263A), if applicable, requires that certain costs be capitalized to inventory produced or held for sale ($25 million gross-receipts test applies).
- Interest paid in advance is not deductible when paid, even by a cash basis taxpayer.
- Rent paid in advance is not deductible when paid, even by a cash basis taxpayer. Only the amount that applies to use of rented property during the tax year can be deducted. The rest can be deducted over the period to which it applies.
- Gifts to customers up to $25 per recipient per year
- $4 per promotional item
- 50% meals

TCJA Change: Entertainment expenses are generally no longer deductible after 2017.

- 100% travel
- Similar to a small corporation
- If no profit in 3 of 5 years, loss generally not deductible – Hobby Loss
  - Net Income (Other income) line 21
  - Expenses are not currently deductible as Misc. 2% deductions have been suspended until 2026.

(Rental, Royalty, & Flow-through entities (Schedule E))

- Generally, income is taxable when earned by an accrual basis taxpayer and when received by a cash-basis taxpayer. 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 does NOT *materially participate*.
  o Includes, but is not limited to:
    ▪ All limited partnership interests
    ▪ All rental activities (unless taxpayer is “real estate professional,” Schedule C)
  o **7 Tests for Material Participation**—Taxpayer must meet at least one of the following tests on an annual basis (Note: the first 3 are the most important to know):
    ▪ Taxpayer participates in the activity *more than 500 hours*.
    ▪ Taxpayer’s participation is *substantially all* of participation by all owners/nonowners (i.e., Taxpayer does most of the work).
    ▪ Taxpayer participates *more than 100 hours* and not less than any other owner/nonowner.
    ▪ Activity is a “significant participation activity” (i.e., more than 100 hours participation) and taxpayer participated in all significant participation activities for more than 500 hours.
    ▪ Materially participated in activity for 5 of last 10 years.
    ▪ Materially participated in activity for any 3 prior years for personal service activities.
    ▪ Depending on facts and circumstances, participation occurs on a *regular, continuous, and substantial* basis.

• **Passive Activity Losses** (PALs) are generally deductible only to the extent of passive gains. Note: These rules apply to individuals, estates, trusts (other than grantor trusts), closely held or nonpublicly traded C corporations, and personal service corporations. There is no limit on PALs that may be deducted by grantor trusts, partnerships, and S corporations, since they are flow-through entities and these items are passed through to the individual shareholders and partners.
  o Unused losses *carried forward until disposal of activity*
  o **Real Estate Professional Exception**—If taxpayer is considered a “real estate professional,” then losses from real estate rental activities may be treated as ordinary business losses and, thus, deducted against ordinary income. A taxpayer is a real estate professional if:
    ▪ *More than half* of the taxpayer’s personal services performed in trades/businesses during the year were performed in real property trades/businesses, and
    ▪ They materially participated in such activities for *more than 750 hours* during the year.
  o **Active Participation Exception**—If taxpayer only *actively participates* in the rental activity and has at least a 10% *interest* in the activity, they may deduct up to $25,000 of losses against ordinary income each year.
    ▪ *Reduced by 50% of modified AGI over $100,000*.
    ▪ No deduction if modified AGI exceeds $150,000.

For example, if the taxpayer meets the active participation requirements and has modified AGI of $110,000, the maximum amount of net losses from rental activities that can be deducted is $25,000 – 50% x ($110,000 MAGI – $100,000 threshold) = $20,000.

o Allocation is 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

For example, assume an entity has 3 passive activities with losses totaling $100,000 and 1 passive activity with a gain of $25,000:

- Activity 1 = $20,000 loss
- Activity 2 = $30,000 loss
- Activity 3 = $50,000 loss
- Activity 4 = $25,000 gain

The excess loss of $75,000 will be allocated as follows:

- Activity 1: $20,000/$100,000 x $75,000 = $15,000
- Activity 2: $30,000/$100,000 x $75,000 = $22,500
- Activity 3: $50,000/$100,000 x $75,000 = $37,500

The treatment of rental income and expenses for a dwelling unit that is also used for personal purposes (Vacation home) depends on whether the taxpayer uses it as a home. A dwelling unit is used as a home if personal use exceeds the greater of 14 days or 10% of the number of days rented.

- If a dwelling unit is used as a home and it is rented for less than 15 days during the tax year, rental income is excluded from gross income and expenses are not deductible as rental expenses. Can deduct on Schedule A.
- If it is rented for more than 14 days:
  - And personal use is more than the greater of 14 days or 10% of the number of days rented (considered a home), rental income is included and deductions are limited to gross rental income. Unused deductions may be carried forward to future years.
  - And personal use is not more than the greater of 14 days or 10% of the number of day’s rented (considered a real rental), rental income is included and all expenses allocated to the rental portion are allowed. Expenses in excess of income are subject to passive activity loss limits.

Depreciation is discussed in detail in another section.

Income from flow-through entities (e.g., partnerships, S corporations – discussed in another section) is taxable to the individual in the period in which it is reported (Schedule K-1) by the flow-through entity.
Alimony paid

TCJA Change: TCJA has repealed the deduction of alimony (and the corresponding inclusion in income for the payee) for divorces/separations executed after 2018. Alimony payments attributable to divorce/separation agreements finalized prior to 2019 will remain deductible by the payer and includible in the recipient's income, but this exception is less likely to be tested. Also note that payments for child support and property settlements are still exempt from taxation (and not deductible by the payer).

Prior Law
Alimony is both taxable to the recipient and deductible by the payer for divorce/separation agreements finalized prior to 2019. To be considered alimony, payment must satisfy all of the following conditions:

- Cash only or its equivalent (not property)
- Apart when payments made (do not live together)
- Not child support (Child support must be fully paid; thus, payments are applied to child support first.)
- Not designated as property settlement (not taxable/not deductible)
- Own return for payer and payee
- Terminates on death of recipient
Lecture 1.08 – Adjustments for (to) AGI (Continued)

Contributions to Retirement plan
Any taxpayer with earned income is generally entitled to establish and make contributions to an Individual Retirement Account (IRA). They can do so even if they are actively participating in other pension or profit-sharing plans. For purposes of eligibility for the IRA, earned income includes:
  - Salaries and wages
  - Net self-employment income

Contributions are limited for 2018 to $5,500 ($11,000 MFJ) per year, per individual (+$1,000 for individuals 50+). A married couple filing a joint return can establish and contribute $5,500 ($6,500 50+) each to separate IRAs as long as the earned income of the couple is at least $11,000 ($13,000 if both 50+). IRAs come in two basic varieties:
  - Traditional
  - Roth

The contribution limit per individual applies to the total contributed to both varieties of IRA. The full contribution limit for Roth IRAs applies to taxpayers with modified AGI below $120,000 ($189,000 MFJ) for 2018. The allowed contribution amount is reduced above these thresholds, and taxpayers with MAGI of $135,000 or more for 2018 ($199,000 MFJ) cannot contribute to a Roth IRA. Traditional IRAs generally can be used by all taxpayers regardless of AGI (unless they also actively participated in an employer's retirement plan during the year).

Contributions to a traditional IRA are deductible in arriving at AGI unless both of the following conditions apply:
  - The individual is actively participating in another pension or profit-sharing plan AND
  - AGI on the tax return exceeds a threshold amount ($73,000 single, $121,000 MFJ for 2018).

For a married couple, if the individual is not actively participating in another plan but the individual's spouse is a participant, contributions for the non-participating spouse cannot be deducted if the joint AGI exceeds $199,000 for 2018.

Contributions to a Roth IRA are not deductible. The benefit of a Roth IRA is that all withdrawals after the age of 59 ½ are exempt from taxation (as long as the Roth IRA has been in effect for at least 5 years), including both contributions and earnings. Withdrawals of contributions are exempt from taxation in all cases. Withdrawals from a traditional IRA are fully taxable (except to recover nondeductible contributions made earlier).

Contributions may still be made even after the taxpayer reaches age 70 ½. Roth IRA is not available if the taxpayer's modified AGI exceeds, for 2018, $135,000 ($199,000 MFJ).

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 deductible medical expenses
  - 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>Contribution Age Limit?</td>
<td>&lt; 70 ½ years old</td>
<td>No</td>
</tr>
<tr>
<td>Income Limit?</td>
<td>No</td>
<td>&lt; $135,000 ($199,000 MFJ) - 2018</td>
</tr>
<tr>
<td>Contributions Deductible?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Contribution Limit?</td>
<td>$5,500 (+$1,000 catch-up contribution for &gt; age 50) Limited to taxable compensation</td>
<td></td>
</tr>
<tr>
<td>Contribution Deadline?</td>
<td>Filing deadline (no extensions) – e.g., April 15</td>
<td></td>
</tr>
<tr>
<td>Required Minimum Distributions (RMDs)?</td>
<td>Yes, after age 70 ½</td>
<td>No</td>
</tr>
<tr>
<td>Withdrawals Generally Taxable?</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

10% penalty for distributions prior to age 59 ½

**Contributions to Education Savings Accounts**

Contributions of up to $2,000 per year can be made on behalf of any beneficiary (even someone unrelated to the contributor) under the age of 18 to **Coverdell Education Savings Accounts (ESA)** (formerly known as education IRAs).

- Contributions are *not deductible*, but amounts may be withdrawn free of taxation to pay elementary, middle, high school and college expenses (including tuition, fees, books, room and board) of the beneficiary.
- Amounts not spent by the time the beneficiary reaches the age of 30 are distributed to the beneficiary and subject to taxation and penalties. However, unspent amounts may be transferred to the ESA of another family member of the same generation without taxation or penalties.
- Contributions can be made up to the due date of the return (not including extensions).

**Qualified Tuition Programs (QTP – 529 plans)** were set up to allow a taxpayer to make *nondeductible* contributions to be used for qualified higher education* (undergraduate and graduate level).

- Earnings accumulate tax free as long as the money stays in the plan and is used for educational purposes.
- Educational purposes include tuition, room and board, books, supplies, fees, computer hardware, software, peripherals and internet access.
- There is a federal *penalty of 10%* if the funds are withdrawn for non-educational purposes.
- Two types of plans include either a *Prepaid program* (paid to the school) or a *Savings account plan*.
- Can contribute up to annual gift tax exclusion ($15,000 for 2018) or file an election that allows contributions larger than the exclusion amount to be taken into account ratably.
over 5 years (e.g., $75,000, as long as no further gifts to the same person for the next 5 years - $15,000 per year).

- No AGI phase-out limitation exists, and taxpayers can contribute to a Coverdell ESA and a QTP for the same beneficiary during the same year.

*TCJA Change: Up to $10,000 of distributions from a 529 plan may now be used, per student, for elementary or secondary school tuition expenses.

An **ABLE account** is a tax-advantaged savings account available to the disabled.

- Similar to a 529 plan, *nondeductible* contributions may be made to an ABLE account on behalf of a disabled beneficiary, and the earnings in the account accumulate tax free as long as the money is spent on qualifying expenses for the beneficiary.
  - Qualifying expenses include education, housing, transportation, and assistive technology.
- Funds held in an ABLE account do not count for the purposes of means testing for the receipt of various government disability benefits.

**TCJA Change:** Contributions are limited to the annual gift tax exclusion ($15,000 for 2018), plus (through 2025) contributions from the designated beneficiary up to the lesser of their compensation for the year or the amount equal to the poverty line for a one-person household. The designated beneficiary may claim the saver's credit with respect to the contributions they make.

**TCJA Change:** Through 2025, rollovers from 529 plans may be made to ABLE accounts (within annual contribution limits) for the same designated beneficiary or a family member of the designated beneficiary.

**Other retirement contributions** that may be deducted from gross income include:

- **Keogh plans** (i.e., qualified plans, which include defined contribution plans and defined benefit plans, but most are defined contribution plans)
- **Simplified employee pensions (SEPs)**
  - Up to lesser of 25% of compensation or $55,000 (2018)
- **SIMPLE plans**

These plans are established by business owners. On an individual return, contributions on behalf of the owner are deducted from gross income in arriving at AGI, while contributions on behalf of employees of the owner are claimed as ordinary business deductions in the computation of net business profit or loss.

The deduction for contributions to a defined-contribution Keogh plan for the self-employed individual is limited to **25% of net** self-employment income after the Keogh deduction and the self-employment tax deduction (this works out to 20% of self-employment income before the Keogh deduction). For instance, if the client has $100,000 self-employment income before making a Keogh contribution, the maximum allowable deduction is $20,000, and net self-employment income is $80,000. The maximum contribution allowed (as opposed to the deduction allowed for tax purposes) to a Keogh plan is the lesser of $55,000 (2018), or 100% of earned income. Contributions in excess of the deduction allowed for the year may be carried forward.

**SIMPLE plans** (Savings Incentive Match Plan for Employees) allow voluntary contributions up to $12,500 (2018) per year by each employee and by the individual employer, up to 100% of income. Withdrawals within 2 years are subject to a 25% tax penalty instead of the usual 10%.
Early Withdrawal penalty – premature interest withdrawal penalty (e.g., from a C.D.) is deductible.

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

Contributions to Health Savings Account (HSA)
Contributions to Health Savings Account (HSA) may be deducted by a self-employed taxpayer or employee (Form 8889 must be filed).
- Taxpayer must have high-deductible health plan (HDHP). Deductible must be at least $1,350 (2018) for self-only coverage and $2,700 (2018) for family coverage.
- Contribution is limited to lesser of deductible or limit of $3,450 in 2018 for self-only and $6,850 in 2018 for family.
- Taxpayers 55 or older may increase limit by $1,000.
- Amounts contributed by employer are excluded from W-2 gross income but reduce amount that employee can contribute.
- Distributions from HSA tax free if used for qualified medical expenses (those that would have normally been deductible on Schedule A for itemizers, excluding premiums on the HDHP itself).
- Schedule A deduction cannot be claimed for expenses paid from the HSA.
- Distributions that are not used for medical expenses are subject to taxation and 20% penalty. No penalty if distributions are made after the account beneficiary dies, becomes disabled, or turns 65.

Farm Income (Schedule F – similar to Schedule C)
- Accounting methods include:
  - Cash, Accrual, Crop method (Cost of producing the crop is deducted in the year the crop income is realized) or the Hybrid/combination method may be used if show income and is used consistently.
    - If cash method is used for figuring income, must be used for reporting expenses.
    - If accrual method is used for reporting expenses, must be used for figuring income.
- Income Items (farmers may elect to average farm income over 3 years)
  - Schedule F Income (subject to SE tax):
    - Raised livestock, produce, and grains held for sale
    - Livestock and other items bought for resale
  - Form 4797 Income (Not subject to SE tax):
    - Animals not held primarily for sale
    - Livestock held for draft, breeding, dairy or sporting purposes
    - Gains from sales of farmland or depreciable farm equipment
- Expense Items
  - Car and truck expense, chemicals and pesticides, depreciation and Section 179 deductions, feed purchased, fertilizers, mortgage interest, seeds and plants. Reasonable wages paid to children, meals to feed workers.
- Depreciation (Discussed in another section)
  - Section 179 deduction allows farmers to immediately expense new and used machinery and equipment, milk tanks, livestock (e.g., horses, cattle, hogs, sheep,
goats, mink and other fur-bearing animals), single-purpose agricultural structures (constructed to house, raise and feed livestock) and horticultural structures (greenhouse), as well as bulk-storage facilities.
Lecture 1.09 – Adjustments for (to) AGI – Class Questions

4. Dr. Merry, a self-employed dentist, incurred the following expenses:
   - Investment expenses $700
   - Custodial fees related to Dr. Merry's Keogh plan 40
   - Work uniforms for Dr. Merry and Dr. Merry's employees 320
   - Subscriptions for periodicals used in the waiting room 110
   - Dental education seminar 1,300

What is the amount of expenses the doctor can deduct as business expenses on Schedule C, Profit or Loss from Business?

   a. $1,620
   b. $1,730
   c. $1,770
   d. $2,430

5. The term active participation for a passive activity loss is relevant in relation to

   a. Rental real estate activities.
   b. Working interests in oil and gas properties.
   c. Passive activities in which the taxpayer materially participates.
   d. Passive activities in which the taxpayer does not materially participate.

6. Bartlet owns a manufacturing business and participates in the business. Which of the following conditions would cause the business to be considered a nonpassive activity for Bartlet?

   a. Bartlet participates in the business for more than 500 hours during a year.
   b. The business made a profit in any three of the last five years that preceded the current year.
   c. The business has at least 10 employees who, individually or collectively, work for the business more than 1,000 hours in a year.
   d. Bartlet files an election with the IRS postponing nonpassive activity classification.

7. With regard to the inclusion of social security benefits in gross income for the 20X3 tax year, which of the following statements is correct?

   a. The social security benefits in excess of modified adjusted gross income are included in gross income.
   b. The social security benefits in excess of one half the modified adjusted gross income are included in gross income.
   c. Eighty-five percent of the social security benefits is the maximum amount of benefits to be included in gross income.
   d. The social security benefits in excess of the modified adjusted gross income over $32,000 are included in gross income.
Class Solutions

4. (b) Dr. Merry's business deductions to be reported on Schedule C include the expense for uniforms ($320), the periodicals subscription cost ($110), and the dental education seminar ($1,300), for a total of $1,730. Dr. Merry's personal investment expenses are not deductible as a business deduction on Schedule C. The custodial fees related to a Keogh plan are also generally not deductible unless contributions do not cover the fees. Note: Personal investment expenses are also no longer deductible on Schedule A due to TCJA.

5. (a) The active participation rule applies to a taxpayer who doesn't qualify as a “real estate person” for purposes of deducting losses from rental real estate activities. If a taxpayer actively participates in a rental activity (and owns at least a 10% interest in the activity), they may deduct up to $25,000 of losses against ordinary income each year (with the remainder carried forward the same as other unused passive losses). Active participation means the taxpayer is involved in the management of the rental activity in some way (e.g., approval of new tenants), while the material participation rules are much more stringent and require a much higher level of participation. Answers (b), (c), and (d) are incorrect because the active participation rules do not apply to any other type of passive activity other than a rental activity.

6. (a) To be classified as a nonpassive activity for Bartlet, he must materially participate in the manufacturing business. This determination is made on a yearly basis according to the seven tests for material participation outlined in Regulation §1.469-5T. One of the seven tests is that the individual participates in the activity for more than 500 hours during the year. The fact that the business made a profit in any three of the last five years would qualify the business as a for-profit activity rather than a “hobby” under IRC §183. While the number of employees may have an effect on this determination, it does not describe Bartlet's involvement in the business. There is no such election with the IRS to postpone nonpassive activity classification.

7. (c) Social security benefits become partially taxable to a recipient with adjusted income in excess of a certain amount. The higher the recipient's income, above that amount, the greater the portion of social security benefits that will be taxable, up to a maximum of 85%. Answer (a) is incorrect because the taxable amount is based on a percentage, not the total of benefits in excess of an amount such as modified AGI. Answer (b) is incorrect because the taxable amount is based on a percentage, not the total of benefits in excess of an amount such as one-half of modified AGI. Answer (d) is incorrect because the taxable amount is based on a percentage, not the total of benefits in excess of an amount, such as the excess of modified AGI that is in excess of $32,000.
Lecture 1.10 – Standard & Itemized Deductions

Standard Deduction
The IRS automatically gives every taxpayer a standard deduction based on filing status.

⚠️ TCJA Change: Standard deductions have essentially doubled (now $12,000/$24,000 MFJ/ $18,000 HOH) for 2018 – 2025 and will continue to be adjusted for inflation.

- If being claimed as a dependent of another, standard deduction is the greater of $1,050 (2018) or earned income + $350, never to exceed the regular standard deduction.
- If elderly 65 or older and/or blind, additional deductions of $1,300 to $1,600 (2018).
- A taxpayer may claim a standard deduction where the amount depends on filing status. This is an alternative to claiming itemized deductions. The amount of the standard deduction based on filing status may be increased if the taxpayer (and/or spouse if MFJ) reached their 65th birthday during the tax year, and it may be increased further if the taxpayer (and/or spouse) is legally blind. The highest standard deduction would result from a married couple filing jointly if both taxpayer and spouse are at least 65 and both are legally blind. The dollar amounts of the standard deductions are indexed for inflation and change on an annual basis. The CPA exam consistently avoids testing amounts that change each year.

Itemized Deductions (Schedule A) (COMMITT)

Charitable contributions

- Charitable contributions to qualified organizations are generally deductible to the extent the taxpayer has provided cash or property that exceeds any value received from the charity. For example, if the taxpayer makes a contribution to their local public television station for $240 and receives books and videos worth $60 as thanks, the actual charitable contribution is only $180.

⚠️ TCJA Change: Amounts paid in exchange for the rights to purchase seats at a college athletic event are no longer deductible.

  - If donations of $250 or more are given, written substantiation from the donee organization is required.
  - Donations are deductible in the year the charity receives the funds. (Contributions made by credit card are deductible when they are charged.)
  - Ordinary payments to charitable organizations for services rendered (e.g., school tuition paid to a parochial school) are not contributions.
  - Donations to qualified organizations only (i.e., donations to needy individuals are not deductible.)
  - Volunteer services to a charitable organization may not be deducted except for out-of-pocket costs incurred in the performance of the volunteer work (such as transportation expenses between home and the site of the work – (Mileage, Parking & Tolls).

- Contributions of property are normally subject to two rules:
  - Ordinary Income Rule - Property is ordinary income property if its sale at FMV on the date it was contributed would have resulted in ordinary income or in short-
term capital gain. This includes inventory, self-created works of art, and capital assets held for ≤ 1 year. The amount you can deduct is its FMV minus the amount that would be ordinary income or short-term capital gain if you sold the property for its FMV. Generally, this rule limits the deduction to the lower of the tax basis in the property or the FMV on the date of the contribution.

- **Long-Term Capital Gain Rule** - Property is capital gain property if its sale at FMV on the date of the contribution would have resulted in a long-term capital gain. Long-term capital gain property includes non-business capital assets held more than 1 year and inherited assets (considered long-term regardless of holding period) that have increased in value, such as stocks, bonds, personal items (clothes, furniture, autos). This allows the taxpayer to claim the higher FMV of long-term capital gains property. The deduction of such property is limited to 30% of AGI in a tax year.

For example, assume a taxpayer with AGI of $100,000 donates stock to a qualified charity. The stock was purchased 10 years ago for $10,000 and was worth $40,000 on the date of the contribution. Since it qualifies as long-term capital gain property, the taxpayer may claim the FMV of $40,000, except that this exceeds 30% of AGI, so the deduction in the tax year is limited to $30,000 (i.e., $100,000 AGI × 30% limitation). The remaining $10,000 can be carried forward.

- Overall contributions are generally limited to 50% of AGI.
- Contributions exceeding any of the AGI limitations may be carried forward up to 5 years.

TCJA Change: Through 2025, the limitation for cash contributions donated to public charities has been increased to 60% of AGI.

Note: Corporations are limited to 10% of adjusted taxable income (ATI) and also have a 5-year carryforward.

**Other Miscellaneous Expenses**

- Gambling losses are deductible as an itemized deduction to the extent of winnings. Note: Gambling winnings are reported in income separately on Form 1040.
- Excess losses may not be carried over.
- Professional gamblers can deduct non-wagering business expenses on Schedule C.

TCJA Change: For 2018-2025, gambling losses include any expense incurred in connection with a gambling activity for any individual taxpayer (not just professionals) if such expense would otherwise be allowed as a deduction. This means other related expenses incurred (e.g., the individual’s travel expense to and from a casino), in addition to the cost of wagers, are also deductible, up to gambling winnings.

- Estate taxes on income in respect of a decedent (IRD).
TCJA Change: Miscellaneous itemized deductions subject to 2-percent of AGI limitation have been suspended for 2018 – 2025 (i.e., they will not be deductible again until 2026). See the “Prior Law” box below for a list of items no longer currently deductible.

Prior Law

Miscellaneous Expenses (BIT) Subject to 2% of AGI Limitation

- Business expenses of an Employee (e.g., mileage, travel, AICPA and Union dues, CPE/Job education, Uniforms, home office expense, etc.)
- Investment expenses (e.g., Safety deposit box; investment advisory fees and newsletters; and IRA custodial fees if paid separately and contributions do not cover the fees)
  - Does not include fees to buy or sell stock (included in calculation of gain/loss on sale).
  - Does not include investment interest, which is fully deductible on a different line of Schedule A.
- Tax preparation and Attorney fees (with respect to taxable income)

Medical expenses – paid and not reimbursed

TCJA Change: A 7.5% of AGI limitation applies for 2017 and 2018 only. The limitation reverts to 10% of AGI for 2019 and beyond.

- Deductible expenses include:
  - Most medical services (e.g., hospitals, doctors, dentists, nurses, labs, eye exams, x-rays, etc.)
    - Generally, nothing cosmetic, unless for specific injury, illness or birth defect
  - Most medical goods/devices (e.g., hearing aid and batteries, prescription glasses and contacts, crutches, wheelchair, etc.)
  - Health insurance premiums (except to the extent they've already been claimed for self-employed taxpayers in arriving at AGI or were paid out of HSAs with tax-free funds)
  - Long-term care insurance premiums on qualified policies
  - Transportation costs for medical and dental care (i.e., actual expenses for cab, bus, ambulance, personal vehicle, etc. or mileage, tolls and parking)
  - Prescription drugs and insulin
    - Minus insurance reimbursement in year received
  - Costs to install medically prescribed facilities in a home, such as a swimming pool for physical therapy to treat a specific medical condition or an elevator, to the extent the costs exceed the increase in the value of the home resulting from the addition

- Examples of nondeductible expenses tested on previous exams include:
  - Non-prescription drugs and medicines
  - Costs for general health improvement that are not treatments for specific medical conditions
  - Premiums on life insurance and policies to cover loss of earnings from injuries and illnesses
  - Plastic surgery, except to cure disfiguring illnesses, injuries, or birth defects
  - Medicare portion of social security and self-employment taxes
• Costs must be paid by the taxpayer (or spouse) during the tax year, but may be payments on behalf of the taxpayer, spouse, a dependent, or other people for whom the taxpayer provides over 50% of support, even if they do not qualify as dependents because the income or joint return tests are not satisfied.

• Medical expenses paid for a deceased spouse or dependent are deductible as medical expenses in the year paid, regardless of whether they were paid before or after the decedent’s death, provided the individual qualified as the taxpayer’s spouse or dependent either at the time the expenses were incurred or at the time payment was made.

• Reimbursements by insurance must be subtracted from deductible expenses.

• Payments made by credit card are considered to have been made in the period they are charged to the credit card, not in the period in which the taxpayer pays the credit card balance.

**Interest paid**

Interest on investments or personal residences may be claimed as itemized deductions. Note: Interest related to a business is claimed as a business deduction in arriving at net business profit or loss on Schedule C and is part of the reported gross income.

• **Investment interest expense**—refers to interest paid on borrowings that are used to make personal investments, such as margin loans in the purchase of stock.
  - Deductible to extent of net investment income (*Schedule B*)
  - Unused carried forward indefinitely
  - Interest paid in advance is not deductible in the period paid, even by a cash basis taxpayer; it is required to be allocated over the tax years to which it applies.

• **Mortgage loan interest**

  TCJA Change: The deduction for home mortgage interest has been limited to interest incurred on acquisition indebtedness up to $750,000 for 2018 to 2025; however, the new limitation only applies to such debt incurred after December 15, 2017. Refinancing a mortgage that was incurred prior to this date will be treated as if incurred on the original date of indebtedness and, thus, will be grandfathered in under the old rules as well.

  TCJA Change: Interest on home equity indebtedness that is not considered acquisition indebtedness has also been eliminated for 2018 – 2025.

  - Interest paid is deductible on **acquisition indebtedness up to $750,000** (if the home was purchased after December 15, 2017).
    - *Acquisition indebtedness* means debt used to buy, build, or substantially improve the home that secures the loan. Includes loans that replace previous acquisition indebtedness.
  - May be claimed on both a primary and secondary residence.
  - Includes “points” paid on a loan to acquire the residence (deductible immediately) or points paid on other qualified personal residence loans (deductible by amortization over the life of the loan).

**Prior Law**

<table>
<thead>
<tr>
<th>Home Mortgage</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000,000</td>
<td>$100,000</td>
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(2 homes)
Home equity loan interest is not deductible unless the loan is considered acquisition indebtedness.

For example, in January year 1, a taxpayer takes out a $500,000 mortgage to purchase a main home with a FMV of $800,000. In February year 1, the taxpayer takes out a $250,000 home equity loan to put an addition on the main home. Both loans are secured by the main home, and the total does not exceed the cost of the home, so all the interest is deductible since the total of both loans ($500,000 + $250,000) does not exceed the $750,000 limitation.

Now assume that the taxpayer uses the $250,000 home equity loan to purchase a vacation home instead. Since the loan is secured by the main home and not the vacation home, the interest on the home equity loan would not be deductible. However, if the taxpayer takes out a separate loan that is secured by the vacation home, then the interest on that loan would be deductible as acquisition indebtedness.

**Taxes paid**

If a taxpayer itemizes, certain taxes may be deducted on Schedule A (subject to limits for 2018–2025):

- State and local personal property taxes (e.g., registration on a car—a tax based on the value of the vehicle would be deductible, but not standard fees.)
- State and local real estate property taxes (must be the owner of the property—joint tenancy is okay)
  - Taxes due in a year in which the property is sold are apportioned between the buyer and seller on a daily basis within the real property tax year.
  - Assessments for improvements (e.g., streets, sewers) are not deductible but are added to the basis of the property.
- State, local, or foreign income taxes
  - Foreign income taxes paid may be claimed as a credit or deduction, but not both.
  - For people who live in one of nine states with no state taxes, state and local sales taxes (based on actual amount paid or an IRS table) may be deducted instead of state and local income taxes.
- Fees, Fines, Federal, FICA, FORGET IT!!
  - There is no deduction for taxes paid to the federal government or for gas or excise taxes.
  - Fees charged by state and local governments may not be deducted unless they are based specifically on income or property values.

TCJA Changes: The deduction for state and local income and property taxes paid is limited to a total of $10,000 ($5,000 MFS) for 2018 through 2025. Also, deductions for foreign real property taxes will not be allowed during this time. These limitations do not apply to taxes paid in connection with a trade or business.

**Theft and Casualty losses**

TCJA Change: The deduction for personal casualty losses is now generally limited to losses attributable to federally declared disasters for 2018 through 2025. This limitation does not apply to the extent the taxpayer has personal casualty gains; that is, any personal casualty loss may be deducted to the extent of the personal casualty gain.
Eligible personal **casualty losses that exceed 10% of AGI** may be deducted on Schedule A. A casualty loss is a *sudden event* (e.g., theft or destruction) that causes the taxpayer to lose an asset or for its value to seriously drop over the course of a time period not exceeding 30 days. Accidental breakage of items in the home by family members is not considered a casualty event. Progressive deterioration is also not included (e.g., termite, moth, or drought damage).

The loss is measured by the **drop in FMV** caused by the event but is limited to the **tax basis** of the asset. Costs incurred by the taxpayer to repair damaged property increase the tax basis of the property, but do not affect the drop in FMV loss measurement.

For example, assume the taxpayer purchased their home for $100,000, it was worth $200,000 prior to a fire caused by a federally declared disaster, and the fire reduced the property's value to $120,000. The taxpayer spent $50,000 to repair the damage resulting from the fire. The drop in FMV from the event was $200,000 - $120,000 = $80,000. The tax basis of the property is $100,000 + $50,000 = $150,000. The loss that may be claimed is $80,000, the lower of the loss in FMV ($80,000) or tax basis ($150,000).

Now assume all the same facts, except that the taxpayer bought the home for $10,000 in an auction. In this case, the taxpayer's basis in the property is $10,000 + $50,000 = $60,000. Thus, even though the loss in FMV is still $80,000, the loss that may be claimed is limited to the taxpayer's $60,000 basis.

Once the loss is determined, it must be reduced by all of the following:
- Insurance and government **reimbursements** that the taxpayer is entitled to receive (if reimbursements exceed the loss, an involuntary conversion gain has occurred).
- **$100 per event**
- **10% of AGI per year**

**TCJA Change:** The Pease limitation (i.e., the phase out of itemized deductions) has been suspended for 2018 – 2025.

**Prior Law**
The total of all itemized deductions was reduced by the **smaller of**:
- 3% of the amount by which AGI exceeds the annual limit, or
- 80% of the itemized deductions that are affected by the limit (not counting Gambling losses, Investment interest, Medical expenses and Casualty losses - GIMC)
Lecture 1.11 – Itemized Deductions – Class Questions

8. Clark filed Form 1040EZ for the 20X2 taxable year. In July 20X3, Clark received a state income tax refund of $900, plus interest of $10, for overpayment of 20X2 state income tax. What amount of the state tax refund and interest is taxable in Clark’s 20X3 federal income tax return?
   a. $0
   b. $10
   c. $900
   d. $910

9. During 20X3, Scott charged $4,000 on his credit card for his dependent son’s medical expenses. Payment to the credit card company had not been made by the time Scott filed his income tax return in 20X4. However, in 20X3, Scott paid a physician $2,800 for the medical expenses of his wife, who died in 20X2. Disregarding the adjusted gross income percentage threshold, what amount could Scott claim in his 20X3 income tax return for medical expenses?
   a. $0
   b. $2,800
   c. $4,000
   d. $6,800

10. Which of the following miscellaneous itemized deductions is not deductible on Schedule A?
    a. Gambling losses up to the amount of gambling winnings
    b. Medical expenses
    c. Real estate tax
    d. Employee business expenses

11. The Browns borrowed $20,000 this year, secured by their home, to purchase a new automobile. At the time of the loan, the fair market value of their home was $400,000, and it was unencumbered by other debt. The interest on the loan qualifies as
    a. Deductible personal interest.
    b. Deductible qualified residence interest.
    c. Nondeductible interest.
    d. Investment interest expense.
Class Solutions

8. (b) Since Clark filed a Form 1040EZ for 20X2, Clark could not have itemized deductions for that year, which is not allowed on a 1040EZ. A refund of state income taxes is only taxable in the year received if the recipient had itemized deductions in the year to which the refund applied. As a result, Clark would not be taxed on the state income tax refund. The interest received is not tax exempt and would be taxable, regardless of whether Clark itemized deductions.

9. (d) A taxpayer may deduct as medical expenses, subject to limitations, expenses paid on behalf of a dependent or spouse, including one that is deceased, as long as the individual qualified as a dependent or spouse either at the time the services were provided or at the time the payment was made. Payment of medical expenses by credit card are considered to be paid by the taxpayer in the period in which they are charged to the credit card, not the period in which the credit card balance is paid.

10. (d) Employee Business Expenses which were considered a miscellaneous itemized deductions subject to the 2% of AGI limitation are not deductible for 2018 – 2025. Answer (a) is incorrect because gambling losses, to the extent of winnings, are deductible as a miscellaneous itemized deduction that is not subject to the 2% reduction. Answer (b) is incorrect because medical expenses are deductible after reducing them by 10% of AGI. Answer (c) is incorrect because real estate taxes are deductible up to a $10,000 limit per taxpayer.

11. (c) Interest on qualified residence indebtedness up to $750,000 is deductible only if it is acquisition indebtedness. Acquisition indebtedness means debt that is used to buy, build, or substantially improve the home that secures the loan. Since the Browns used the proceeds of the loan to purchase an automobile, the amount is considered nondeductible personal interest.
Lecture 1.12 – Dependents & Filing Status

Personal Exemptions

⚠ TCJA Change: The deduction for personal exemptions (including dependency exemptions) under IRC Section 151 is reduced to $0 for 2018 – 2025. This reduction will NOT affect any other deduction, credit, etc., based on the rules for determining a dependent under IRC Section 152 (below).

Dependents

Dependent if all requirements met for “Qualifying Relative” or “Qualifying Child”:

- **Qualifying Child – JARRS**
  - No **Joint Return** with spouse
    - Unless filing only to get a total refund of taxes withheld or paid and weren't actually required to file.
  - **Age** – A qualifying child, unless disabled, must be:
    - Under age 19, or 24 if a full-time student for at least 5 months of the year, and
    - Younger than the taxpayer or the taxpayer’s spouse.
  - **Relationship** – Taxpayer's child, stepchild, foster child, sibling, step sibling, half sibling, or a descendant of any such individual (e.g., nephew or grandchild).
  - **Residency** – Child must live with the taxpayer more than half the year in the U.S.
  - **Support** – Child must NOT have provided more than 50% of their own support, not including scholarships. (So, the taxpayer DOESN’T need to support over 50%.)

- **Qualifying Relative - C-IRS-Jack you**
  - **Citizenship or Resident**
    - U.S. citizen or
    - Resident of U.S., Mexico, or Canada.
  - **Income** – Limited to $4,150 for 2018
    - Social security ignored
  - **Relative; or unrelated and a Household member for entire year**
    - The following relatives don't have to live with taxpayer:
      - Children, stepchildren, foster children, or a descendant or spouse of any of them (e.g., grandchildren and son-in-law) that do not qualify as a “qualifying child”
      - Siblings, including in-laws and half and step-siblings, and their descendants.
      - Parents, including step-parents and in-laws, or other direct ancestors.
      - Aunts and uncles, but does NOT include cousins.
    - Neither death nor divorce will dissolve any of the relationships established by marriage.
  - **Support** – Taxpayer must provide over 50% of total annual support.
    - Includes tax-exempt items like Social Security, AFDC
Multiple support agreement
If more than one person supports individual, but no one person pays more than 50%, can be dependent of any person who paid at least 10%.

- No Joint Return (same as qualifying child rule)

Filing Status
On every return, the taxpayer(s) must select the filing status, which is used to determine the tax rates on income and the value of various deductions, thresholds, and limitations. In selecting the status, the following choices should be considered in order, using the first one for which all requirements are satisfied:

- **Married Filing Jointly (MFJ)**
  - Determined on last day of year or at time of death.
  - If divorced during year, not MFJ.
  - Taxpayers are considered unmarried for the whole year if, on the last day of the year, they are divorced or are legally separated under a divorce or legal separate maintenance decree.
  - Includes same-sex married couples, not registered domestic partnerships or civil unions (Obergefell v. Hodges); thus, any rules that apply to MFJ/MFS also apply to same-sex married individuals.

- **Married Filing Separately (MFS)**
  - Each spouse files their own return.
  - In community property state, everything is split 50/50.

- **Qualifying widow (Surviving Spouse – SS) with a dependent child**
  - Spouse died in prior 2 years and qualified to file a joint return in year of death
  - Provided over 50% of cost of maintaining principal residence of dependent child (or stepchild)
  - Not remarried as of end of current year
  - Same rate as MFJ

- **Head of household (HOH)**
  - To quality – Both:
    - Taxpayer not married at year end - **and**
    - Taxpayer must maintain a home as the principal place of residence for over 50% of the year and provide more than 50% of costs of maintaining a household for:
      - Dependent “Qualifying Relative” living with the taxpayer, including uncle, aunt, nephew, niece or certain step-relatives and in-laws. Other relatives and unrelated persons may be dependents if they live with taxpayer for the entire year, but NOT qualify them as HOH.
      - “Qualifying Child,” stepchild, or grandchild living with the taxpayer (Must be a dependent. Note: Custodial parent who has released the right to claim the dependency exemption to the noncustodial parent by filing Form 8332 may still qualify for HOH status. Form 8332 does not qualify noncustodial parent for HOH status.)
      - Parent must be a dependent but need not live with the taxpayer.

- **Single** - all others
  - Includes those who are married but legally separated under a decree of separate maintenance.
Lecture 1.13 – Tax Credits & Other Taxes

Tax Credits

There are a few different credits (dollar-for-dollar reduction of taxes payable) related to having children and other dependents.

Family tax credit (formerly only Child tax credit)

TCJA Changes:

- The child tax credit has been increased to **$2,000 per qualifying child under age 17** for 2018 – 2025.
- The $2,000 child tax credit is phased out by $50 for each $1,000 (or fraction thereof) by which the taxpayer's MAGI exceeds $400,000 on a joint return, or $200,000 in all other cases.
- Once the amount of the allowable child tax credit is determined, that amount can now be increased by **$500 for each U.S. citizen/resident dependent** that does not qualify as a child dependent; thus, the provision is now collectively referred to as the “family tax credit.”
- There is also a provision known as the “additional child tax credit” for certain low-income taxpayers with one or more qualifying children when the taxpayer is not able to claim the full child tax credit for each child (because their tax liability is less than the available credit). The maximum amount that is refundable is now $1,400 per qualifying child (inflation adjusted after 2018). Note, however, that the actual amount of the refundable credit is determined under a somewhat complicated formula based on a number of factors, such as earned income and number of children and is, thus, beyond the scope of the CPA exam.

Prior Law

- $1,000 per qualifying child under age 17
- Much lower phaseout thresholds
- Up to $1,000 max refundable for certain low-income taxpayers

Child & Dependent Care credit

- A child and dependent care credit is available if the taxpayer requires care for a child under age 13 or a disabled dependent in order to be gainfully employed. The credit is based on the smallest of three amounts:
  - Actual dependent care expenses
  - Earned income
  - $3,000 (for care of one dependent) or $6,000 (for care of multiple dependents)
- For married couples, the earned income limit is based on the income of the lower-paid spouse. If, however, one of the couple is gainfully employed and the other is a full-time student, the limit is based on the earned income of the spouse who is gainfully employed.
- The credit percentage is between 20% and 35%, depending on the AGI of the taxpayer. For taxpayers with AGI over $43,000, the credit is the minimum of 20%.
- A taxpayer may claim the child and dependent care credit (if all other applicable requirements are met) for a child who lives with the taxpayer for more than half the year, even if the taxpayer does not provide more than half the cost of maintaining the household.
• Note: Any benefits received under an employer dependent care assistance plan and excluded from income must be subtracted from the maximum allowed credit (i.e., $3,000 or $6,000) before the percentage is applied.

Adoption credits
• The adoption credit is available for costs incurred in adopting a child under the age of 18. The credit is limited for 2018 to the first $13,810 of costs. Credits exceeding the tax liability may be carried forward up to 5 years. Phaseout exists.

Education credits (phases-out)
• There are two different credits associated with the payment of tuition and fees to qualified educational institutions.
  o The Hope scholarship credit (renamed the “American Opportunity Tax Credit”—AOTC) applies to the first 4 years of post-secondary school (i.e., post-high school) education. The credit is equal to 100% of the first $2,000 and 25% of the next $2,000 in payments, for a maximum credit of $2,500 per student. The credit may be claimed by a taxpayer for tuition, textbooks and fees of the taxpayer, spouse, or dependent, and may be claimed for payments on behalf of each student in the family. 40% of the credit is also refundable ($1,000). The AOTC has been made permanent by the 2015 PATH Act.
  o The lifetime learning credit applies to any year of education and can include tuition paid to a qualified institution for education to improve job skills. The credit is equal to 20% of the first $10,000 paid on behalf of all family members, for a maximum credit of $2,000 per family.

• There are several restrictions placed on both credits, including:
  o The credits generally apply only to tuition and fees paid to qualified institutions, and not other costs. Taxpayer must have valid Form 1098-T from the institution.
  o The credits are not available to individual taxpayers with modified AGI exceeding certain amounts.
  o The credit cannot be claimed on the tax return of the dependent.
  o Cannot claim both AOTC and a Lifetime learning credit for the same student in the same year.
  o Cannot be MFS.

Saver’s Credit
• The saver’s credit is available for low to moderate income workers to enable and encourage them to make voluntary contributions to IRAs and 401(k) plans. The amount of the credit is up to $1,000 ($2,000 MFJ) for making contributions to an IRA or an employer-sponsored retirement plan.

• The credit may be claimed by:
  o MFJ with income up to $63,000 in 2018.
  o HOH with income up to $47,250 in 2018.
  o Single and MFS with income up to $31,500 in 2018.

• The amount of the credit can range from 10% to 50% of the amount of IRA contribution made based on income and filing status (Form 8880).

Foreign Tax credit
• The foreign tax credit is available for payments of foreign income taxes that are not being claimed as itemized deductions. The calculation of the credit is identical to that for
corporations. One special exception for individuals, however, allows the taxpayer to claim a credit for up to $300 ($600 on a joint return) for foreign income taxes paid on investment income without being subject to any other limits. This enables a taxpayer whose mutual fund had withholdings on foreign dividends to claim a credit for the taxes paid by the mutual fund without the need for complicated computations. Credit is limited to portion of U.S. tax on foreign income.

**Credit for the elderly or disabled**
- The credit for the elderly or disabled is available only to those age 65 and older or those who are retired on permanent and total disability. Such individuals must have AGI less than $17,500 (or $25,000 MFJ if both spouses qualify) and nontaxable Social Security or its equivalent less than $5,000 ($7,500 MFJ).

**Earned Income Credit (EIC)**
- If a taxpayer has some form of earned income, they may qualify for this Refundable credit. Earned income for purposes of calculating EIC only includes taxable income.
- Since the EIC is a refundable credit, the excess of the credit over the tax liability is payable to the taxpayer in the form of a tax refund. In essence, a refundable credit is treated similarly to a payment of estimated tax or taxes withheld.
- A qualifying child does not have to meet the support test. Also, a qualifying child must have lived with the taxpayer in the United States for more than half the year and have a social security number that is valid for employment in the United States.
- If investment income is greater than $3,500 for 2018, the credit is denied.

In general, tax credits may be offset, dollar for dollar, against a tax liability in the period to which the credit applies. When the amount of the credit exceeds the amount of applicable tax due, unused credits can be carried back or forward, depending on the provisions of the credit. They may only be used, however, to reduce taxes and, with the exception of refundable credits such as the Earned Income Credit, cannot result in a refund to the taxpayer.

**Other Taxes**

**Self-Employment Taxes (Schedule SE)**
Individuals are subject to self-employment taxes on net self-employment income. This includes all business revenue reduced by all ordinary and necessary business expenses (except retirement plan contributions on behalf of the taxpayer).
- Tax rate double FICA rate
  - 6.2% OASDI (i.e., Social Security) tax on amounts up to $128,400 for 2018
  - 1.45% Medicare (i.e., Hospital Insurance—HI) tax—no maximum
    - Total 7.65% × 2 = 15.3%
  - 50% claimed as deduction for AGI.

  **Note:** Since ½ the self-employment tax is deductible, self-employment income must be multiplied by 92.35% (i.e. 100% – 7.65% deductible portion of SE tax) before it is multiplied by the 15.3% SE tax rate to determine the SE tax due.

**Increased Medicare Tax Rate (HI rate) for High-Income Earners**
The Medicare tax rate is increased by 0.9% for individual taxpayers earning in excess of the threshold levels ($250,000 MFJ and $200,000 all others).
For employees, the new rate is 2.35% (1.45% + 0.9%) on amounts in excess of the thresholds.

For self-employed individuals, the rate is increased from 2.9% to 3.8% on amounts in excess of the thresholds.

Surtax on Unearned Income

A surtax called the *Unearned Income Medicare Contribution Tax* is imposed on the *unearned income* of individuals, estates, and trusts. This is part of the Patient Protection and Affordable Care Act (PPACA). For individuals, the surtax is *3.8%* of the *lesser of*

1. The taxpayer’s **net** investment income
   - “Net” investment income is investment income reduced by allowable investment expenses. Investment income includes interest income, dividends, annuities, royalties, rents (other than those derived from a trade or business), capital gains (other than those derived from a trade or business), trade or business income that is a passive activity with respect to the taxpayer, and trade or business income with respect to the trading of financial instruments or commodities. Retirement plan distributions are excluded. OR

2. The excess of modified adjusted gross income (MAGI), which is AGI before any foreign earned income exclusion, over the threshold amount ($250,000 for MFJ/SS), $125,000 for a married individual filing a separate return (MFS), and $200,000 for all others
   - This effectively makes the tax rate on L/T capital gains and qualified dividends 23.8% (20% + 3.8%) for high-income taxpayers ($479,000 MFJ, $425,800 single - 2018). Still applies if income under $479k but over $250k, but rate would be 15% + 3.8% = 18.8%.

Roger and Louisa have investment income of $40,000 and MAGI of $300,000. The net investment income of $40,000 is lower than the excess of MAGI over the threshold ($300,000 - $250,000 = $50,000). Therefore, they will be taxed on the lower amount of $40,000 vs $50,000, which is $40,000 x 3.8% = $1,520. If investment income had been $75,000, then they would be taxed on the lower of $50,000 vs $75,000, or $50,000 x 3.8% = $1,900.

Universal Healthcare Coverage Mandate

The Patient Protection and Affordable Care Act imposes a penalty on those individuals who do not have health insurance.

TCJA Change: This penalty has been eliminated for tax years beginning after 2018.

Note: Your *marginal tax rate* is the rate at which your *last and your next* dollar of taxable income are taxed. Your *effective rate* is the average rate of taxation for *all* your dollars (total tax / total taxable income).

Note: The final 2018 forms were unavailable at the time of publication.
**Self-Employment Tax**

**Before you begin:** To determine if you must file Schedule SE, see the instructions.

**May I Use Short Schedule SE or Must I Use Long Schedule SE?**

*Note:* Use this flowchart only if you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.

---

**Section A—Short Schedule SE. Caution:** Read above to see if you can use Short Schedule SE.

1. **Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A.**

2. **Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1.**

3. **Combine lines 1a, 1b, and 2.**

4. **Multiply line 3 by 92.35% (0.9235). If less than $400, you don’t owe self-employment tax; don’t file this schedule unless you have an amount on line 1b.**

**Note:** If line 4 is less than $400 due to Conservation Reserve Program payments on line 1b, see instructions.

5. **Self-employment tax.** If the amount on line 4 is:
   - $128,400 or less, multiply line 4 by 15.3% (0.153). Enter the result here and on Schedule 4 (Form 1040), line 57, or Form 1040NR, line 55.
   - More than $128,400, multiply line 4 by 2.9% (0.029). Then, add $15,921.60 to the result. Enter the total here and on Schedule 4 (Form 1040), line 57, or Form 1040NR, line 55.

6. **Deduction for one-half of self-employment tax.**

**For Paperwork Reduction Act Notice, see your tax return instructions.**

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**Section B — Long Schedule SE**

**Part I  Self-Employment Tax**

**Note:** If your only income subject to self-employment tax is *church employee income*, see instructions. Also see instructions for the definition of church employee income.

**A** If you are a minister, member of a religious order, or Christian Science practitioner and you filed Form 4381, but you had $400 or more of other net earnings from self-employment, check here and continue with Part I [ ]

1. **Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A:**
   - **Note:** Skip lines 1a and 1b if you use the farm optional method (see instructions).
   - **1a**
   - **1b**

2. **Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Minsters and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report.**
   - **Note:** Skip this line if you use the nonfarm optional method (see instructions).
   - **2**

3. Combine lines 1a, 1b, and 2.
   - **3**

4. **If line 3 is more than zero, multiply line 3 by 92.35% (0.9235). Otherwise, enter amount from line 3.**
   - **4a**
   - **4b**

5. **Enter your church employee income from Form W-2. See instructions for definition of church employee income**
   - **5a**

6. **Multiply line 5a by 92.35% (0.9235). If less than $100, enter -0-**
   - **5b**

7. **Add lines 4c and 5b.**
   - **6**

8. **Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2018.**
   - **7 128,400.00**

9. Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11.
   - **9**

10. **Multiply the smaller of line 6 or line 9 by 12.4% (0.124).**
    - **10**

11. **Multiply line 6 by 2.9% (0.029).**
    - **11**

12. **Self-employment tax. Add lines 10 and 11. Enter here and on Schedule 4 (Form 1040), line 57, or Form 1040NR, line 55.**
    - **12**

13. **Deduction for one-half of self-employment tax.**
    - **13**

**Part II  Optional Methods To Figure Net Earnings (see instructions)**

**Farm Optional Method.** You may use this method only if (a) your gross farm income was less than $7,920, or (b) your net farm profit was less than $5,717.

14. **Maximum income for optional methods.**
    - **14 5,280.00**

15. **Enter the smaller of: two-thirds (%) of gross farm income (not less than zero) or $5,280. Also include this amount on line 4b above.**
    - **15**

**Nonfarm Optional Method.** You may use this method only if (a) your net nonfarm profit was less than $5,717 and also less than 72.189% of your gross nonfarm income, and (b) you had net earnings from self-employment of at least $400 in 2 of the prior 3 years. **Caution:** You may use this method no more than five times.

16. **Subtract line 15 from line 14.**
    - **16**

17. **Enter the smaller of: two-thirds (%) of gross nonfarm income (not less than zero) or the amount on line 16. Also include this amount on line 4b above.**
    - **17**

---

1 From Sch. F, line 9, and Sch. K-1 (Form 1065), box 14, code B.
2 From Sch. F, line 34, and Sch. K-1 (Form 1065), box 14, code A—minus the amount if you would have entered on line 1b had you not used the optional method.
3 From Sch. C, line 31; Sch. C-EZ, line 3; Sch. K-1 (Form 1065), box 14, code A; and Sch. K-1 (Form 1065-B), box 9, code J1.
4 From Sch. C, line 7; Sch. C-EZ, line 1; Sch. K-1 (Form 1065-B), box 14, code C; and Sch. K-1 (Form 1065-B), box 9, code J2.
Lecture 1.14 – Tax Credits & Other Taxes – Class Questions

12. Which of the following tax credits can result in a refund even if the individual had no income tax liability?

   a. Credit for prior year alternative minimum tax
   b. Elderly and permanently and totally disabled credit
   c. Earned income credit
   d. Child and dependent care credit

13. Juan recently started operating a flower shop as a proprietorship. In its first year of operations, the shop had a taxable income of $60,000. Assuming that Juan had no other employment-related earnings,

   a. The flower shop must withhold FICA taxes from Juan's earnings.
   b. Juan must pay self-employment tax on the earnings of the business.
   c. Juan will be exempt from self-employment taxes for the first three years of operations.
   d. Juan will be exempt from the Medicare tax because the business earnings are below the threshold amount.

Class Solutions

12. (c) The Earned Income Credit (EIC) is referred to as a refundable tax credit. When the amount of a refundable credit exceeds a taxpayer's tax liability, the excess is refunded to the taxpayer, similarly to an overpayment of taxes through estimated payments or withholding. Answer (a) is incorrect because a credit for a prior period's alternative minimum tax is not a refundable credit. Answer (b) is incorrect because the credit for the elderly and disabled is not a refundable credit. Answer (d) is incorrect because the child and dependent care credit is not a refundable credit.

13. (b) Individuals are subject to self-employment taxes on net self-employment income. This includes all business revenue reduced by all ordinary and necessary business expenses (except retirement plan contributions on behalf of the taxpayer). Juan is the owner/employer; thus, once the business's earnings are determined on Schedule C, his self-employment tax is 15.3% (which is equal to the combined amounts of the employer and employee portions of FICA tax) of such earnings. Answer (a) is incorrect because the flower shop must withhold FICA taxes from employees' wages. Answers (c) and (d) are incorrect because there are no such exemptions from self-employment taxes or from Medicare tax.
Lecture 1.15 – Alternative Minimum Tax

Individuals benefiting from large itemized deductions or special tax benefits may be subject to the alternative minimum tax (AMT). This is based on a calculation of alternative minimum taxable income (AMTI), which denies certain deductions and benefits available in the computation of regular taxable income. To calculate the AMT, the individual performs the following calculation:

\[
\text{AMT - Individuals} \\
\begin{align*}
\text{Regular taxable income} & \pm \text{Preferences/Adjustments (PLIERS)} \\
= \text{AMTI before exemption} & - \text{Exemption} \\
= \text{AMTI} & \times \text{Tax rate (26%/28%)} \\
= \text{Tentative minimum tax} & - \text{Regular tax} \\
= \text{AMT}
\end{align*}
\]

The taxpayer is required to adjust income for certain tax preferences, which can only increase AMTI. Tax Preferences (P) you need to know:

- **Private activity bond interest** is generally fully taxable for AMT purposes. Private activity bonds are used to finance nongovernmental activities, such as industrial development, student loans and low-income housing.

In addition, adjustments are income or expense items that are computed differently for AMT, which can either increase or decrease AMTI. Adjustments (ERILS) you need know:

- **Local and state and income taxes, all property taxes, and sales taxes paid** are not deductible.
- **Incentive stock options** are taxed when exercised for the difference between the exercise price and market price of the stock.
- **Excess depreciation on personal property** over 150% declining balance when double-declining balance was used for regular tax purposes.
- **Refunds of local and state taxes** paid that were included in income for regular tax purposes (because the payments were previously deducted) should be taken out of income for AMT purposes since the payment of those taxes are not deductible for AMT purposes.
- **Standard deduction** may not be claimed.

TCJA has effectively removed personal and dependency exemptions, miscellaneous itemized deductions subject to the 2-percent of AGI limitation, and interest on home equity indebtedness from the list of adjustments for AMT since they have all been suspended for regular tax purposes for 2018 – 2025.

Note that the following items are still allowed to be deducted for AMT purposes if they are otherwise eligible to be deducted for regular tax purposes: charitable contributions, other miscellaneous itemized deductions, medical expenses, mortgage interest, and theft or casualty losses.
In calculating the amount of the AMT, AMTI is reduced by an exemption amount. The result is the AMT base. The amount of the exemption depends on the filing status of the tax return and is phased out for taxpayers with AMTI (before exemption) exceeding certain amounts.

**The Individual AMT Exemptions are:**

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Exemption Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing joint</td>
<td>$109,400</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>54,700</td>
</tr>
<tr>
<td>Single and Head of Household</td>
<td>70,300</td>
</tr>
</tbody>
</table>

**Phaseout of exemptions:**

- **Married filing Joint (MFJ)**  
  \[= \frac{109,400 - 25\% \text{ (AMTI before exemption - $1,000,000)}}{109,400 - 25\% \text{ (AMTI before exemption - $1,000,000)}}\]
- **Married filing Separate (MFS)**  
  \[= \frac{54,700 - 25\% \text{ (AMTI before exemption - $500,000)}}{54,700 - 25\% \text{ (AMTI before exemption - $500,000)}}\]
- **All Others (Single, HOH)**  
  \[= \frac{70,300 - 25\% \text{ (AMTI before exemption - $500,000)}}{70,300 - 25\% \text{ (AMTI before exemption - $500,000)}}\]

The **Tentative minimum tax** equals the total of:

- 26% of the first $191,500 ($95,750 MFS) of AMT Base for 2018.
- 28% of the AMT Base above $191,500 ($95,750 MFS) for 2018

When the AMT is paid, the portion of the tax associated with timing preferences (primarily those involving incentive stock options) may be **carried forward indefinitely** and **credited** against regular income taxes in future years.

For example, assume an incentive stock option to purchase shares at $10 is exercised when the stock is worth $50. The $40 difference is not reported for regular tax purposes but is included as a preference in determining AMTI. Assume this preference causes the taxpayer to be subject to the AMT in the year of exercise. If the stock is sold years later for $75, a $65 gain on sale is reported for regular tax purposes, but $40 of that gain had already been taxed due to the AMT in the year of exercise. The AMT paid as a result of the exercise of the ISO several years ago is now claimed as a credit against the regular tax liability to avoid unfairly taxing the same gain twice.

Note that the AMT is only credited against **regular taxes** arising in later years as a result of the reversal of income differences. There is no AMT credit for taxes paid that are the result of exclusion preferences and adjustments (i.e., differences between AMTI and regular taxable income that do not reverse), such as private activity bond interest and the various itemized deductions that are not allowed for AMTI purposes.

The nonrefundable personal credits (e.g., child and dependent care credit, credit for the elderly and disabled, the adoption credit, the nonrefundable portions of the child tax credit and the AOTC, lifetime learning credit, etc.) are allowed to offset both regular tax liability and the alternative minimum tax.

**AMT has shown up on the CPA exam as a TBS problem for individuals.**
## Carryover Rules

<table>
<thead>
<tr>
<th>Loss Type</th>
<th>Carryback</th>
<th>Carryforward</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charitable Contributions</td>
<td>No</td>
<td>5 years</td>
</tr>
<tr>
<td>Net Operating Losses (NOL)</td>
<td>No</td>
<td>Indefinitely</td>
</tr>
<tr>
<td>Net Capital Losses:</td>
<td>3 years</td>
<td>5 years</td>
</tr>
<tr>
<td>Corporations (0 net Cap. loss)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Capital Losses:</td>
<td>No</td>
<td>Indefinitely</td>
</tr>
<tr>
<td>Individuals ($3,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment Interest</td>
<td>No</td>
<td>Indefinitely</td>
</tr>
<tr>
<td>Net Passive Losses</td>
<td>No</td>
<td>Indefinitely, or may be claimed when the investment is sold</td>
</tr>
<tr>
<td>Net Gambling Losses</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
Lecture 1.16 – Alternative Minimum Tax – Class Questions

14. Don Mills, a single taxpayer, had $70,000 in taxable income. Mills had no tax preferences. His itemized deductions were as follows:

- State and local income taxes $5,000
- Interest on loan to acquire primary residence $6,000
- Gambling losses $2,000

What amount did Mills report as alternative minimum taxable income before the AMT exemption?

a. $72,000
b. $75,000
c. $77,000
d. $83,000

15. Alternative minimum tax preferences include:

<table>
<thead>
<tr>
<th>Tax exempt interest from private activity bonds issued during the year</th>
<th>Charitable contributions of appreciated capital gain property</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

Class Solutions

14. (b) Alternative minimum taxable income (AMTI) is calculated by adjusting taxable income for certain tax preferences and by adding back the standard deduction (if the taxpayer does not itemize deductions) or state and local income taxes, property taxes, and sales taxes (if the taxpayer does itemize deductions). As a result, Mills would be required to add back his state and local income tax deduction of $5,000, so Mills' AMTI would be $70,000 + $5,000, or $75,000.

15. (b) Interest on specified private activity bonds issued after 1986 is considered a tax preference for AMT purposes. Charitable contributions are not included in the list of adjustments or tax preferences. Alternative minimum taxable income (AMTI) is calculated by adjusting taxable income for certain tax preferences and adding back certain deductions. Tax-exempt interest on private activity bonds is considered a tax preference and would be added to taxable income to determine AMTI. There is no tax preference for charitable contributions, nor is it an itemized deduction that is required to be added back, regardless of whether the contribution is made in cash or property.
Lecture 1.17 – Individual Taxation – Class Questions – TBS

Task-Based Simulation 1

Note: The following situation applies to TBS 1 and 2.

Mrs. Vick, a forty-year-old cash-basis taxpayer, earned $45,000 as a teacher and $5,000 as a part-time real estate agent in year 1. Mr. Vick, who died on July 1, year 1, had been permanently disabled on his job and collected state disability benefits until his death. For all of year 1 and year 2, the Vicks’ residence was the principal home of both their eleven-year-old daughter, Joan, and Mrs. Vick’s unmarried cousin, Fran Phillips, who had no income in either year. During year 1, Joan received $200 a month in survivor social security benefits that began on August 1, year 1, and will continue at least until her eighteenth birthday. In year 1 and year 2, Mrs. Vick provided over one-half the support for Joan and Fran, both of whom were U.S. citizens. Mrs. Vick did not remarry. Mr. and Mrs. Vick received the following in year 1:

<table>
<thead>
<tr>
<th>Income Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned income</td>
<td>$50,000</td>
</tr>
<tr>
<td>State disability benefits</td>
<td>1,500</td>
</tr>
<tr>
<td>Interest on:</td>
<td></td>
</tr>
<tr>
<td>Refund from amended tax return</td>
<td>50</td>
</tr>
<tr>
<td>Savings account and certificates of deposit</td>
<td>350</td>
</tr>
<tr>
<td>Municipal bonds</td>
<td>100</td>
</tr>
<tr>
<td>Gift</td>
<td>3,000</td>
</tr>
<tr>
<td>Pension benefits</td>
<td>900</td>
</tr>
<tr>
<td>Jury duty pay</td>
<td>200</td>
</tr>
<tr>
<td>Gambling winnings</td>
<td>450</td>
</tr>
<tr>
<td>Life insurance proceeds</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Additional information:

- Mrs. Vick received the $3,000 cash gift from her uncle.
- Mrs. Vick received the pension distributions from a qualified pension plan, paid for exclusively by her husband's employer.
- Mrs. Vick had $100 in gambling losses in year 1.
- Mrs. Vick was the beneficiary of the life insurance policy on her husband's life. She received a lump-sum distribution. The Vicks had paid $500 in premiums.
- Mrs. Vick received Mr. Vick's accrued vacation pay of $500 in year 2.

Items to be answered:

For items 1 and 2, determine and select from the choices below, the filing status for each item.

<table>
<thead>
<tr>
<th>Filing Status</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>S. Single</td>
<td>H. Head of household</td>
</tr>
<tr>
<td>M. Married filing joint</td>
<td>Q. Qualifying widow with dependent child</td>
</tr>
</tbody>
</table>
1. Determine the filing status and that Mrs. Vick can claim on the year 1 federal income tax return, to get the most favorable tax results.

2. Determine the filing status that Mrs. Vick can claim on the year 2 federal income tax return to get the most favorable tax results, if she solely maintains the costs of her home.

For items 3 through 9, determine the amount, if any, that is taxable and should be included in Adjusted Gross Income (AGI) on the year 1 federal income tax return filed by Mrs. Vick.

3. State disability benefits
4. Interest income
5. Pension benefits
6. Gift
7. Life insurance proceeds
8. Jury duty pay
9. Gambling winnings
Task-Based Simulation Solution 1

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

1. (M) 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.

2. (Q) While Mrs. Vick will not qualify to file as married filing jointly, but she will qualify for qualifying widow or surviving spouse. 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.

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 on Schedule A.
Task-Based Simulation 2

Items to be answered:

During year 1 the following payments were made or losses were incurred. For items 1 through 14, select the appropriate tax treatment. A tax treatment may be selected once, more than once, or not at all.

<table>
<thead>
<tr>
<th>Tax treatment</th>
<th>(A)</th>
<th>(B)</th>
<th>(C)</th>
<th>(D)</th>
<th>(E)</th>
<th>(F)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Not deductible.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Deductible in Schedule A—Itemized Deductions, subject to threshold of 10% of adjusted gross income.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Deductible in Schedule A—Itemized Deductions, subject to maximum of 50% of adjusted gross income.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Deductible on Form 1040 to arrive at adjusted gross income.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Deductible in full in Schedule A—Itemized Deductions.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F. Deductible in Schedule A—Itemized Deductions, subject to maximum of 60% of adjusted gross income.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. Premiums on Mr. Vick's personal life insurance policy.                        |     |     |     |     |     |     |
2. Penalty on Mrs. Vick's early withdrawal of funds from a certificate of deposit. |     |     |     |     |     |     |
3. Mrs. Vick's substantiated cash donation to the American Red Cross.           |     |     |     |     |     |     |
4. Payment of $2,450 in state income taxes.                                    |     |     |     |     |     |     |
5. Payment of $1,600 in real estate taxes on the Vick home.                    |     |     |     |     |     |     |
6. Loss on the sale of the family car.                                         |     |     |     |     |     |     |
7. Cost in excess of the increase in value of residence, for the installation of a stairlift in January year 2, related directly to the medical care of Mr. Vick. |     |     |     |     |     |     |
8. The Vicks' health insurance premiums for hospitalization coverage.          |     |     |     |     |     |     |
9. Mrs. Vick's donation of gently used furniture and clothing to the Salvation Army. |     |     |     |     |     |     |
10. Amortization over the life of the loan of points paid to finance the $150,000 mortgage at a lower rate on the Vick's new vacation home. The Vick's primary home is paid off. |     |     |     |     |     |     |
11. One-half the self-employment tax paid by Mrs. Vick.                        |     |     |     |     |     |     |
12. Mrs. Vick's $100 in gambling losses.                                        |     |     |     |     |     |     |
13. Mrs. Vick's union dues.                                                     |     |     |     |     |     |     |
14. Year 1 federal income tax paid with the Vicks' tax return on April 15, Year 2. |     |     |     |     |     |     |
Task-Based Simulation Solution 2

1. (A) Premiums on life insurance are not deductible, which is fair since the death benefits are not taxable.

2. (D) A penalty for early withdrawal of funds from a certificate of deposit is actually a reduction in the interest earned. As a result, it is a deduction for AGI on Form 1040.

3. (F) Charitable contributions are deductible as itemized deductions on Schedule A. Cash donations are allowed up to a maximum of 60% of AGI, and any unused portion may be carried forward up to 5 years.

4. (E) State and local income taxes are deductible in the year paid up to $10,000 per year. As a result, Mrs. Vick’s $2,450 in state income taxes are fully deductible as itemized deductions on Schedule A. Note that the $10,000 limitation applies to all state and local taxes (i.e., property, income, and sales taxes).

5. (E) Real estate taxes on the taxpayer’s principal residence are deductible in the year paid up to $10,000 per year; thus, Mrs. Vick’s $1,600 property taxes are fully deductible as itemized deductions on Schedule A. Note that the $10,000 limitation applies to all state and local taxes (i.e., property, income, and sales taxes).

6. (A) Gains from the sale of personal assets, including the family automobile, are taxable as capital gains. Losses on the sale of personal assets, however, are not deductible.

7. (B) Costs of home improvements that are directly related to a medical condition of a taxpayer, the taxpayer’s spouse, or a dependent, are deductible as medical expenses to the extent that they exceed the increase in the value of the home resulting from the improvement. As a medical expense, the costs are deductible on Schedule A as an itemized deduction and are reduced by 10% of AGI.

8. (B) Health insurance premiums are deductible as a medical expense. As a result, they are deductible as itemized deductions on Schedule A and are reduced by 10% of AGI.

9. (C) Charitable contributions are deductible as itemized deductions on Schedule A. Property donations are allowed up to a maximum of 50% of AGI, and any unused portion may be carried forward up to 5 years.

10. (E) Loan points paid to finance a mortgage at a lower rate are amortized over the life of the loan. The amortization is treated as an adjustment to the mortgage interest expense, which is fully deductible for primary and secondary homes on Schedule A as an itemized deduction, so long as the loan is for acquisition indebtedness and the taxpayer’s total acquisition indebtedness on the first and second homes does not exceed $750,000.

11. (D) One half of the self-employment tax paid by a self-employed taxpayer is allowed as an adjustment for AGI on Form 1040.

12. (E) Gambling losses are deductible to the extent of gambling winnings. While the winnings are included in AGI, losses, to the extent deductible, are treated as a miscellaneous itemized deduction on Schedule A.

13. (A) Union dues are considered an employee expense and are not deductible for 2018 to 2025.

14. (A) Federal income tax payments are not deductible.
Lecture 1.18 – Individual Taxation – Class Questions – TBS (Continued)

Task-Based Simulation 3

Alima Xanders has provided you with several documents to be used in determining her deductions. In addition, she prepared the following note attached to her documents.

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. In February, I got divorced and moved into a new house I bought closer to my new job. The costs are listed below.

Let me know if you need anything else. Thanks!

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
<th>SSN#</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alimony paid to Jim Johnson</td>
<td>$26,000</td>
<td>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 (60 miles).</td>
</tr>
</tbody>
</table>

Charity gifts:

- Local Church cash donations                   | 200    |
- Humane Society                                | 75     |
- Independent Political Party                   | 150    |

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 a home equity loan I obtained on my primary home to buy my vacation home in Colorado.

Review the documents Alima has provided. Complete the excerpts of 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. Also, since final 2018 forms were unavailable at
the time of publication, this TBS uses an older form. For 2018, lines 10 through 37 have been moved to the new Schedule 1. This does not, however, change the calculations.

Exhibits

---

Copy 1 — For State, City, or Local Tax Department

---

Copy B

---
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
### Mortgage Interest Statement

**GMC Mortgage CO**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Mortgage interest received from payer(s)/borrower(s)</strong></td>
<td>$3,850</td>
</tr>
<tr>
<td><strong>2. Points paid on purchase of principal residence</strong></td>
<td>$</td>
</tr>
<tr>
<td><strong>3. Refund of overpaid interest</strong></td>
<td>$</td>
</tr>
<tr>
<td><strong>4. Land Property Tax</strong></td>
<td>$569.04</td>
</tr>
<tr>
<td><strong>5. Loan Balance</strong></td>
<td>$75,691</td>
</tr>
</tbody>
</table>

**ALIMA XANDERS**

- **1098**
- **Form 1098**
- **Copy B**
- **For Payer/Borrower**

---

**COMMERCE MORTGAGE CO**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Mortgage interest received from payer(s)/borrower(s)</strong></td>
<td>$11,634</td>
</tr>
<tr>
<td><strong>2. Points paid on purchase of principal residence</strong></td>
<td>$</td>
</tr>
<tr>
<td><strong>3. Refund of overpaid interest</strong></td>
<td>$</td>
</tr>
<tr>
<td><strong>4. Land Property Tax</strong></td>
<td>$2,852.48</td>
</tr>
<tr>
<td><strong>5. Loan Balance</strong></td>
<td>$258,533</td>
</tr>
</tbody>
</table>

**ALIMA XANDERS**

- **1098**
- **Form 1098**
- **Copy B**
- **For Payer/Borrower**

---

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### Mortgage Interest Statement

**Form 1098**

<table>
<thead>
<tr>
<th>Payer/Borrower's Name</th>
<th>Social Security Number</th>
<th>Recipient's Name</th>
<th>Recipient's Federal Identification No.</th>
<th>Recipient's Address</th>
<th>Payer/Borrower's Address</th>
<th>Interest and Tax Information</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ALIMA XANDERS</td>
<td>XXX-XX-9698</td>
<td>XXX-XX-9698</td>
<td></td>
<td>8899 VISTA LANE</td>
<td>CITYVIEW, VA</td>
<td>Mortgage Interest Received</td>
<td>$6,800</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Points Paid on Purchase of Principal Residence</td>
<td>$</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Refund of Overpaid Interest</td>
<td>$</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>LAND PROPERTY TAX: $1,153</td>
<td></td>
<td></td>
<td>Loan Balance: $135,874</td>
<td></td>
</tr>
</tbody>
</table>

*Copy B for Payer/Borrower*

The information in boxes 1, 2, and 3 is important but not required to file Form 1098. It is furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that all or part of the deduction for this mortgage interest or for home points is because you overstated a deduction for this mortgage interest or for home points or because you did not report the refund of interest on your return.
### Excerpt from 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>7</td>
</tr>
<tr>
<td>8a</td>
<td>taxable interest. attach schedule B if required</td>
<td>8a</td>
</tr>
<tr>
<td>8b</td>
<td>tax-exempt interest. do not include on line 8a</td>
<td>8b</td>
</tr>
<tr>
<td>9a</td>
<td>Ordinary dividends. attach schedule B if required</td>
<td>9a</td>
</tr>
<tr>
<td>9b</td>
<td>qualified dividends</td>
<td>9b</td>
</tr>
<tr>
<td>10</td>
<td>Taxable refunds, credits, or offsets of state and local income taxes</td>
<td>10</td>
</tr>
<tr>
<td>11</td>
<td>Alimony received</td>
<td>11</td>
</tr>
<tr>
<td>12</td>
<td>Business income or (loss). Attach Schedule C or C-EZ</td>
<td>12</td>
</tr>
<tr>
<td>13</td>
<td>Capital gain or (loss). Attach Schedule D if required. If not required, check here</td>
<td>13</td>
</tr>
<tr>
<td>14</td>
<td>Other gains or (losses). Attach Form 4797</td>
<td>14</td>
</tr>
<tr>
<td>15a</td>
<td>IRA distributions</td>
<td>15a</td>
</tr>
<tr>
<td>16a</td>
<td>Pensions and annuities</td>
<td>16a</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>20a</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>22</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>23</td>
</tr>
<tr>
<td>24</td>
<td>Certain business expenses of reservists, performing artists, and fee-basis government officials. attach form 2106 or 2106-EZ</td>
<td>24</td>
</tr>
<tr>
<td>25</td>
<td>Health savings account deduction. attach form 8889</td>
<td>25</td>
</tr>
<tr>
<td>26</td>
<td>Moving expenses. attach Form 3903</td>
<td>26</td>
</tr>
<tr>
<td>27</td>
<td>Deductible part of self-employment tax. attach Schedule SE</td>
<td>27</td>
</tr>
<tr>
<td>28</td>
<td>self-employed SEP, SIMPLE, and qualified plans</td>
<td>28</td>
</tr>
<tr>
<td>29</td>
<td>self-employed health insurance deduction</td>
<td>29</td>
</tr>
<tr>
<td>30</td>
<td>penalty on early withdrawal of savings</td>
<td>30</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 8803</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>

---

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### Excerpt from Schedule A

<table>
<thead>
<tr>
<th>Medical and Dental Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Caution: Do not include expenses reimbursed or paid by others.</td>
<td></td>
</tr>
<tr>
<td>1 Medical and dental expenses (see instructions)</td>
<td></td>
</tr>
<tr>
<td>2 Enter amount from Form 1040, line 38</td>
<td></td>
</tr>
<tr>
<td>3 Multiply line 2 by 7.5% (0.075).</td>
<td></td>
</tr>
<tr>
<td>4 Subtract line 3 from line 1. If line 3 is more than line 1, enter 0.</td>
<td></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></td>
</tr>
<tr>
<td>b General sales taxes</td>
<td></td>
</tr>
<tr>
<td>6 Real estate taxes (see instructions)</td>
<td></td>
</tr>
<tr>
<td>7 Personal property taxes</td>
<td></td>
</tr>
<tr>
<td>8 Other taxes. List type and amount</td>
<td></td>
</tr>
<tr>
<td>9 Add lines 5 through 8</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interest You Paid</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>10 Home mortgage interest and points reported to you on Form 1098</td>
<td></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></td>
</tr>
<tr>
<td>12 Points not reported to you on Form 1098. See instructions for special rules</td>
<td></td>
</tr>
<tr>
<td>13 Mortgage insurance premiums (see instructions)</td>
<td></td>
</tr>
<tr>
<td>14 Investment interest. Attach Form 4952 if required. See instructions</td>
<td></td>
</tr>
<tr>
<td>15 Add lines 10 through 14</td>
<td></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></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></td>
</tr>
<tr>
<td>18 Carryover from prior year</td>
<td></td>
</tr>
<tr>
<td>19 Add lines 16 through 18</td>
<td></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) other than net qualified disaster losses. Attach Form 4684 and enter the amount from line 18 of that form. See instructions</td>
<td></td>
</tr>
</tbody>
</table>
### Task-Based Simulation Solution 3

#### Excerpt from Form 1040

<table>
<thead>
<tr>
<th>Income</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>7</td>
</tr>
<tr>
<td>8a</td>
<td>Taxable interest. Attach Schedule B if required</td>
<td>8a</td>
</tr>
<tr>
<td>8b</td>
<td>Tax-exempt interest. Do not include on line 8a</td>
<td>8b</td>
</tr>
<tr>
<td>9a</td>
<td>Ordinary dividends. Attach Schedule B if required</td>
<td>9a</td>
</tr>
<tr>
<td>9b</td>
<td>Qualified dividends</td>
<td>9b</td>
</tr>
<tr>
<td>10</td>
<td>Taxable refunds, credits, or offsets of state and local income taxes</td>
<td>10</td>
</tr>
<tr>
<td>11</td>
<td>Alimony received</td>
<td>11</td>
</tr>
<tr>
<td>12</td>
<td>Business income or (loss). Attach Schedule C or C-EZ</td>
<td>12</td>
</tr>
<tr>
<td>13</td>
<td>Capital gain or (loss). Attach Schedule D if required. If not required, check here</td>
<td>13</td>
</tr>
<tr>
<td>14</td>
<td>Other gains or (losses). Attach Form 4797</td>
<td>14</td>
</tr>
<tr>
<td>15a</td>
<td>IRA distributions</td>
<td>15a</td>
</tr>
<tr>
<td>15b</td>
<td>b Taxable amount</td>
<td>15b</td>
</tr>
<tr>
<td>16a</td>
<td>Pensions and annuities</td>
<td>16a</td>
</tr>
<tr>
<td>16b</td>
<td>b Taxable amount</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>20a</td>
</tr>
<tr>
<td>20b</td>
<td>b Taxable amount</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>22</td>
</tr>
<tr>
<td></td>
<td><strong>Total Income</strong></td>
<td>105,000</td>
</tr>
</tbody>
</table>

#### Adjusted Gross Income

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>23</td>
<td>Educator expenses</td>
</tr>
<tr>
<td>24</td>
<td>Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ</td>
</tr>
<tr>
<td>25</td>
<td>Health savings account deduction. Attach Form 8889</td>
</tr>
<tr>
<td>26</td>
<td>Moving expenses. Attach Form 2030</td>
</tr>
<tr>
<td>27</td>
<td>Deductible part of self-employment tax. Attach Schedule SE</td>
</tr>
<tr>
<td>28</td>
<td>Self-employed SEP, SIMPLE, and qualified plans</td>
</tr>
<tr>
<td>29</td>
<td>Self-employed health insurance deduction</td>
</tr>
<tr>
<td>30</td>
<td>Penalty on early withdrawal of savings</td>
</tr>
<tr>
<td>31a</td>
<td>Alimony paid b Recipient’s SSN</td>
</tr>
<tr>
<td>32</td>
<td>IRA deduction</td>
</tr>
<tr>
<td>33</td>
<td>Student loan interest deduction</td>
</tr>
<tr>
<td>34</td>
<td>Tuition and fees. Attach Form 8917</td>
</tr>
<tr>
<td>35</td>
<td>Domestic production activities deduction. Attach Form 8903</td>
</tr>
<tr>
<td>36</td>
<td>Add lines 23 through 35</td>
</tr>
<tr>
<td>37</td>
<td>Subtract line 36 from line 22. This is your adjusted gross income</td>
</tr>
</tbody>
</table>

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### 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 7.5% (0.075)</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>5,085</td>
</tr>
<tr>
<td>b General sales taxes</td>
<td></td>
</tr>
<tr>
<td>6 Real estate taxes (see instructions)</td>
<td>4,575</td>
</tr>
<tr>
<td>7 Personal property taxes</td>
<td>7</td>
</tr>
<tr>
<td>8 Other taxes. List type and amount ▶</td>
<td></td>
</tr>
<tr>
<td>9 Add lines 5 through 8</td>
<td>10,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interest You Paid</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>10 Home mortgage interest and points reported to you on Form 1098</td>
<td>10,634</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></td>
</tr>
<tr>
<td>12 Points not reported to you on Form 1098. See instructions for special rules</td>
<td>11</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>11,634</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>16,275</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>19,275</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) other than not qualified disaster losses. Attach Form 4684 and enter the amount from line 18 of that form. See instructions</td>
<td></td>
</tr>
</tbody>
</table>

### Explanation of solutions

**Form 1040**

Lines 23 through 31: null

These lines do not apply to Alima. She cannot deduct the $965 of moving expenses on Line 26 because moving expenses are generally not deductible, and she does not qualify as military personnel. Alima paid $26,000 in alimony to Jim Johnson, but since she got divorced this year and alimony is no longer deductible for divorces finalized after 2018, she cannot deduct it.

**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: $5,000**

Line 36 is the total of all deductions taken in arriving at AGI—$5,000.

**Line 37: $100,000**

Line 37 calculates AGI by subtracting Line 36 (total deductions for AGI—$5,000) 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: $10,000**
Line 9 is the total of all taxes paid by Alima—$10,560 ($5,985 + $4,575); however, state and local taxes paid are now limited to a total of $10,000. Note that future revisions of this tax form, which were not available at the time of publication, are likely to include a line that mentions the limitation, but that does not mean that you will necessarily get such a reminder on the actual exam.

**Line 10: $11,634**
Home mortgage interest is deductible for a primary and secondary residence, so Alima may deduct the $11,634 mortgage interest for her primary home (Commerce Mortgage), but the $6,850 interest on the home equity loan used to purchase the Colorado vacation home (State Mortgage) cannot be deducted because home equity interest is no longer deductible and the debt does not qualify as acquisition indebtedness. If Alima had obtained a separate loan to acquire the vacation home, then the mortgage interest would have been deductible because the vacation home would have secured the loan (making it acquisition indebtedness) rather than Alima’s primary residence. The GMC Mortgage interest on the vacant lot is not deductible since it does not qualify as either a primary or secondary home.

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

**Line 15: $11,634**
Line 15 is the total of deductible interest paid, which includes only $11,634 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.

Note that the following job-related expenses, tax preparation fees, and investment expenses used to be deductible as miscellaneous 2% itemized deductions, but such deductions have been suspended until 2025:
- $600 union dues
- $165 Nursing Journal subscriptions
- $1,350 job-hunting expenses
- $365 in tax preparation fees
- $100 for safe deposit box

The following expenses would not have been deductible regardless of the suspension on 2% miscellaneous itemized deductions:
- The $105 for the local newspaper is not specific to Alima's career so it wouldn't have been considered a job expense.
- The work clothes ($525) can be worn for other occasions so they wouldn't have been considered a job expense.
- The bank charges are not employee or investment expenses.
Task-Based Simulation 4

A taxpayer is trying to determine whether or not unemployment compensation received during the year is taxable. Which code section and subsection indicate whether unemployment compensation is taxable?

Task-Based Simulation 5

A taxpayer is required under a grandfathered divorce decree to make certain payments that consist of deductible alimony of $12,000 per year and child support of $15,000. Due to financial difficulties, however, the taxpayer made equal monthly payments totaling $9,000. The taxpayer is trying to determine what portion of the amount paid will be considered child support. Which code section, subsection, and paragraph indicate if the payments made will be considered child support?

Task-Based Simulation 6

A taxpayer was recently widowed and has a dependent child living in his home. He is trying to determine if he qualifies as a surviving spouse for tax purposes. Which code section, subsection, and paragraph will provide him with the general definition of a surviving spouse?
**Task-Based Simulation 7**

A taxpayer received a scholarship to a university in a state other than her state of residence. In order to qualify for the scholarship, the taxpayer is required to teach basic classes and perform various research projects. She is trying to determine the extent to which, if any, the scholarship will be taxable to her. Which code section, subsection and paragraph indicate whether or not the scholarship will be taxable to her?

---

**Task-Based Simulation 8**

A taxpayer is providing 100% of the support for a niece, who resided with him for the entire year. He is trying to determine if he may claim a $500 family tax credit for her as a qualifying relative. Which code section, subsection, and paragraph will provide him with information about what constitutes a qualifying relationship for the purposes of the family tax credit?
<table>
<thead>
<tr>
<th>Task-Based Simulation Solution 4</th>
<th>85</th>
<th>(a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Task-Based Simulation Solution 5</td>
<td>71</td>
<td>(c)</td>
</tr>
<tr>
<td>Task-Based Simulation Solution 6</td>
<td>2</td>
<td>(a)</td>
</tr>
<tr>
<td>Task-Based Simulation Solution 7</td>
<td>117</td>
<td>(c)</td>
</tr>
<tr>
<td>Task-Based Simulation Solution 8</td>
<td>152</td>
<td>(d)</td>
</tr>
</tbody>
</table>
Lecture 1.19 – Research Task Format

Research is tested in its own independent task-based simulation problem. Each REG exam will include at least 1 Research-type TBS. The Candidates will be asked to search through the database to find the appropriate reference to the Internal Revenue Code (IRC) that addresses the issue presented in the research problem.

Using the Authoritative Literature, the candidate will search for keywords associated with the question using the search box, which will pull up all references to those keywords within the literature. From there, the candidate should use the “search within” function to find specific instances of keywords within each subsection. Keywords will be highlighted in the text, and the candidate can skim through them to find the relevant text that answers the research problem.

Note: The candidate also has the option to drill down the table of contents of the relevant authoritative literature (in this case, the Internal Revenue Code), but this requires a bit more familiarity with the titles (see below).

Research questions will also alert the candidate if they have correctly formatted their answer by displaying “Your response is correctly formatted” in a box below the candidate response if the candidate has entered reference numbers correctly.

Don't forget that you can use the Authoritative Literature to look up answers to other TBSs in the exam!

IRC - Internal Revenue Code

Officially Title 26 of the United States Code, the IRC is comprised of eleven subtitles, A through K. The subtitles are each divided into chapters as follows (some chapters omitted):

Subtitle A – Income Taxes
  1 – Normal taxes and surtaxes
  2 – Tax on self-employment income
  2A – Unearned income Medicare contribution
  3 – Withholding of tax on nonresident aliens and foreign corporations
  4 – Taxes to enforce reporting on certain foreign accounts
  6 – Consolidated returns

Subtitle B – Estate and Gift Taxes
  11 – Estate tax
  12 – Gift tax
  13 – Tax on generation-skipping transfers
  14 – Special valuation rules
  15 – Gifts and bequests from expatriates

Subtitle C – Employment Taxes
  21 – Federal Insurance Contributions Act
  22 – Railroad Retirement Tax Act
  23 – Federal Unemployment Tax Act
  23A – Railroad Unemployment Repayment Tax
  24 – Collection of income tax at source on wages
  25 – General provisions relating to employment taxes

Subtitle D – Miscellaneous Excise Taxes

***
Subtitle E – Alcohol, Tobacco, and Certain Other Excise Taxes

Subtitle F – Procedure and Administration
61 – Information and returns
62 – Time and place for paying tax
63 – Assessment
64 – Collection
65 – Abatements, credits, and refunds
66 – Limitations
67 – Interest
68 – Additions to the tax, additional amounts, and assessable penalties
69 – General provisions relating to stamps
70 – Jeopardy, receiverships, etc.
71 – Transferees and fiduciaries
72 – Licensing and registration
73 – Bonds
74 – Closing agreements and compromises
75 – Crimes, other offenses, and forfeitures
76 – Judicial proceedings
77 – Miscellaneous provisions
78 – Discover of liability and enforcement of title
79 – Definitions
80 – General rules

Subtitle G – The Joint Committee on Taxation

Subtitle H – Financing of Presidential Election Campaigns

Subtitle K – Group Health Plan Requirements
100 – Group health plan requirements

Each chapter is further divided into subchapters. Some chapters are too specific to require subchapters, in which case the individual tax code sections are identified. Most research questions are derived from Subtitle A, Income Taxes, and Subtitle B, Estate and Gift Taxes. The subchapters for these are as follows:

Subtitle A – Income Taxes

CHAPTER 1 - NORMAL TAXES AND SURTAXES
  Subchapter A - Determination of Tax Liability (Sections 1-59)
  Subchapter B - Computation of Taxable Income (Sections 61-291)
  Subchapter C - Corporate Distributions and Adjustments (Sections 301-385)
  Subchapter D - Deferred Compensation, Etc. (Sections 401-436)
  Subchapter E - Accounting Periods and Methods of Accounting (Sections 441-483)
  Subchapter F - Exempt Organizations (Sections 501-530)
  Subchapter G - Corporations Used to Avoid Income Tax on Shareholders (Sections 531-565)
  Subchapter H - Banking Institutions (Sections 581-601)
  Subchapter I - Natural Resources (Sections 611-638)
  Subchapter J - Estates, Trusts, Beneficiaries, and Decedents (Sections 641-692)
  Subchapter K - Partners and Partnerships (Sections 701-777)
  Subchapter L - Insurance Companies (Sections 801-848)
  Subchapter M - Regulated Investment Companies and Real Estate Investment Trusts (Sections 851-860)
Subchapter N - Tax Based on Income From Sources Within or Without the United States (Sections 861-1000)
Subchapter O - Gain or Loss on Disposition of Property (Sections 1001-1111)
Subchapter P - Capital Gains and Losses (Sections 1201-1298)
Subchapter Q - Readjustment of Tax Between Years and Special Limitations (Sections 1301-1351)
Subchapter R - Election to Determine Corporate Tax on Certain International Shipping Activities Using Per Ton Rate (Sections 1352-1359)
Subchapter S - Tax Treatment of S Corporations and Their Shareholders (Sections 1361-1379)
Subchapter T - Cooperatives and Their Patrons (Section 1381-1388)
Subchapter U - Designation and Treatment of Empowerment Zones, Enterprise Communities, and Rural Development Investment Areas (Sections 1391-1397)
Subchapter V - Title 11 Cases (Sections 1398-1399)
Subchapter W - District of Columbia Enterprise Zone (Sections 1400-1400C)
Subchapter X - Renewal Communities (Sections 1400E-1400J)
Subchapter Y - Short-Term Regional Benefits (Sections 1400L-1400U3)

CHAPTER 2 - TAX ON SELF-EMPLOYMENT INCOME (Sections 1401-1403)
Section 1401 – Rate of tax
Section 1402 – Definitions
Section 1403 – Miscellaneous provisions

CHAPTER 2A – UNEARNED INCOME MEDICARE CONTRIBUTION (Section 1411)
Section 1411 – Imposition of tax

CHAPTER 3 - WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS (Sections 1441-1465)
Subchapter A – Nonresident Aliens and Foreign Corporations (Sections 1441-1446)
Subchapter B – Application of Withholding Provisions (Sections 1451-1465)

CHAPTER 4 - TAXES TO ENFORCE REPORTING ON CERTAIN FOREIGN ACCOUNTS (Sections 1471-1474)
Section 1471 – Withholdable payments to foreign financial institutions
Section 1472 – Withholdable payments to other foreign entities
Section 1473 – Definitions
Section 1474 – Special rules

CHAPTER 5 - REPEALED

CHAPTER 6 - CONSOLIDATED RETURNS (Sections 1501-1564)
Subchapter A – Returns and Payment of Tax (Sections 1501-1505)
Subchapter B – Related Rules (Sections 1551-1564)

Subtitle B – Estate and Gift Taxes

CHAPTER 11 - ESTATE TAX (Sections 2001-2210)
Subchapter A – Estates of Citizens or Residents (Sections 2001-2058)
Subchapter B – Estates of Nonresidents Not Citizens (Sections 2101-2108)
Subchapter C – Miscellaneous (Sections 2201-2210)

CHAPTER 12 - GIFT TAX (Sections 2501-2524)
Subchapter A – Determination of Tax Liability (Sections 2501-2505)
Subchapter B – Transfers (Sections 2511-2519)
Subchapter C – Deductions (Sections 2521-2524)

CHAPTER 13 - TAX ON GENERATION-SKIPPING TRANSFERS (Sections 2601-2664)
Subchapter A – Tax Imposed (Sections 2601-2604)
Subchapter B – Generation-Skipping Transfers (Sections 2611-2614)
Subchapter C – Taxable Amount (Sections 2621-2624)
Subchapter D – GST Exemption (Sections 2631-2632)
Subchapter E – Applicable Rate; Inclusion Ratio (Sections 2641-2642)
Subchapter F – Other Definitions and Special Rules (Sections 2651-2654)
Subchapter G – Administration (Sections 2661-2664)

CHAPTER 14 - SPECIAL VALUATION RULES (Sections 2701-2704)
Section 2701 – Special valuation rules in case of transfers of certain interests in corporations or partnerships
Section 2702 – Special valuation rules in case of transfers of interests in trusts
Section 2703 – Certain rights and restrictions disregarded
Section 2704 – Treatment of certain lapsing rights and restrictions

CHAPTER 15 – GIFTS AND BEQUESTS FROM EXPATRIATES (Section 2801)
Section 2801 – Imposition of tax

Sample Research Question:

Mr. Philipp received a distribution from a qualified tuition program that was not used to pay qualified higher education expenses and is trying to determine what portion, if any, should be included in gross income. To what section of the Internal Revenue Code will Mr. Philipp refer to determine the amount?

Solution: Since a qualified tuition program is considered an exempt organization, the information will be found in Subchapter F, Exempt Organizations, of Chapter 1, Normal Taxes and Surtaxes, from Subtitle A, Income Taxes.

<table>
<thead>
<tr>
<th>Section</th>
<th>Subsection</th>
</tr>
</thead>
<tbody>
<tr>
<td>§529</td>
<td>(c)</td>
</tr>
</tbody>
</table>
**Corporate Income Tax (1120)**

Gross income (worldwide)
- Ordinary deductions

Income before “special deductions”
- Charitable deduction
- Net Operating Loss (NOL) Carryforward
- Div. Received Deduction (DRD)

Taxable Income
× 21% tax rate*

Gross Tax Liability
- Tax Credits (Foreign tax credit/gen bus credit)

Net Regular Tax Liability
+ Personal Holding Company (PHC) Tax

Tax Liability (self-assessed on 1120)
+ Accumulated Earnings Tax (AET), if audited

Total Corporate Tax Liability

*TCJA repealed the graduated tax rate system for corporations and instituted a flat 21% tax rate in its place.
Lecture 2.04 – Income & Ordinary Deductions

Revenues

(same as individual tax with some exceptions)

- The general rule for the inclusion of income under Section 451 of the code is that income should be recognized in the year received, unless it is properly accounted for in a different year under the taxpayer's method of accounting for tax purposes. For cash-basis taxpayers, this means a taxpayer could earn the income but not include it in taxable income until it is actually received. (Remember: A corporation can use the cash basis method of accounting if it meets the $25M gross receipts test; however, the majority of corporations are accrual-basis taxpayers, so our discussions regarding corporate tax accounting will focus on accrual accounting rules.) For most corporations, however, revenue generally will be recognized at the earlier of when earned or collected.
  - Income is earned when (1) all events have occurred that fix the taxpayer's right to the income and (2) the amount can be reasonably determined (i.e., the all-events test has been met). The all events test is considered to be met no later than when the income is included in revenue in the financial statements (F/S) of the taxpayer. F/S for these purposes generally include only those certified as being prepared in accordance with GAAP/IFRS or those that are otherwise prepared for filing with certain regulatory or governmental agencies.
  - Advance payments (i.e., unearned income) generally must be recognized in the year received, unless the taxpayer makes an election to include only the part of the payment required to be recognized in the year of receipt (i.e., the part included in revenue for F/S purposes) and the remainder in the following year. Such election may be made for any category of advance payment and will remain in effect until consent to revoke the election is obtained from the IRS. Note: Advance payments for these purposes do not include rent and insurance premiums received. Rents and royalties received in advance must be included in taxable income in the period received.

Remember: Municipal bond interest is not taxable, and life insurance proceeds are generally not taxable.

- Capital Gains & Losses (Sch. D)
  When a corporation sells assets that are held for investment, the difference between the tax bases and proceeds from sale are recognized as capital gains and losses, taxed at the regular 21% corporate tax rate (i.e., no special rates apply to corporate capital gains like they do for individuals).
  - Capital losses for corporations, however, are deductible only to the extent of capital gains for a corporation (i.e., net capital losses are NOT deductible).
    - A corporation's net capital losses can be carried back 3 years and forward 5 years to offset capital gains in those years.
    - All loss carrybacks and carryforwards are considered Short Term (S/T).
Note: Individuals are allowed to claim a net loss of $3,000 per year; the rest is carried forward indefinitely.

- Noncurrent assets used in a trade or business are subject to special rules (discussed in more detail in the Property Tax Section):
  - If they are held for one year or less, gains and losses are treated as ordinary income or losses (i.e., ordinary assets).
  - If they are held for more than one year, losses are treated as ordinary losses and gains are treated as long-term capital gains (i.e., Sec. 1231 assets).

Deductions

(all reasonable operating expenses – must be ordinary and necessary)

- 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.
  - Economic performance occurs when property and/or services have been provided. Certain accrued items that are expected to be paid within a short period of time after accrual may be deducted when accrued if they are paid within 2½ months of the tax year-end. These items include the following payments to employees:
    - Wages
    - Bonuses
    - Vacation pay

- Organizational Expenses – State incorporation fees (including legal and accounting fees related to the incorporation)
  - A corporation may elect to deduct up to $5,000 of organizational expenditures. The $5,000 amount is reduced by the amount by which the organizational expenditures exceed $50,000. Any costs not currently deductible are amortized over 180 months (15 years), beginning with the month in which the active trade or business begins.
    - The entity must elect to amortize the organization costs in the period of organization.
    - If no election is made, the costs are capitalized and remain until the entity is liquidated.
  - Costs of issuing, printing, and selling stock (including legal and accounting fees related to the offering of securities) are NOT organizational expenses (reduction of APIC).

- Start-up Costs – Includes pre-opening expenses, such as employee training; advertising expenses; travel and other costs of securing distributors, suppliers, and customers; salaries and fees for executives, consultants, or other professional services; and other costs incurred in the process of investigating the creation or purchase of a business.
  - A corporation may elect to deduct up to $5,000 of start-up costs. The $5,000 amount is reduced by the amount by which the start-up costs exceed $50,000. Any costs not currently deductible are amortized over 180 months (15 years), beginning with the month in which the active trade or business begins.
The entity must elect to amortize the start-up costs no later than the filing date for the tax return, including extensions.
- If no election is made, the costs are capitalized and remain until the entity is liquidated.
  - Does NOT include deductible interest, taxes, research and experimental costs, or the actual expenses incurred in attempting to purchase a specific business.

- **Salaries, Wages, Bonuses, & Vacation pay** (if paid within 2 \( \frac{1}{2} \) months of year-end—3/15 for calendar year-end), payroll taxes, fringe benefits
  - Can deduct up to $1M of compensation expense for certain “covered employees.”
    - Covered employees include the principal executive officer, principal financial officer, and the 3 other highest paid executive officers of a public corporation.
    - Compensation expense for these purposes includes commissions and other performance-based compensation.
    - Once an employee is considered a covered employee, their status as such never changes.
    - Pay to other employees is not limited.
  - Premiums on **life insurance** to benefit an employee's family are deductible as a fringe benefit.
    - However, if the corporation is the beneficiary of a life insurance policy on an employee (a.k.a., Company-Owned Life Insurance, or COLI), the premiums paid on such policies are NOT deductible, since the proceeds are generally not taxable. The company may exclude from gross income benefits received only up to the total amount of premiums and other amounts paid by the policyholder for the contract; any excess would be taxable. Certain exceptions apply (e.g., director or highly compensated employee).
  - **Employee Achievement Awards** for length of service or safety may be deducted up to $400 under nonqualified plans and up to $1,600 for qualified plans per employee.
    - Must be tangible personal property (e.g., a watch).

TCJA has now specified in the code that “tangible personal property” does NOT include any of the following items, and thus such items given are NOT deductible to the employer or excludable by the employee (are taxable to employee): cash, cash equivalents, gift cards, gift coupons, or gift certificates (unless only for certain tangible personal property), vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items.

- **Bad Debt, Warranty Expense, & Other Estimated Losses** – Estimated losses are accrued for book purposes but cannot be claimed for tax purposes until they are actual losses; thus, they will cause temporary book-tax differences to be reported on Schedule M-1 or M-3 (discussed later).
  - **Business bad debts** are deductible in the year they become partially or wholly worthless, but amounts cannot be deducted unless actually written off the books (a.k.a., **direct write-off method**).
    - Allowance approaches are not permitted.
• Note: Nonbusiness bad debt is deductible only once wholly worthless, and taxpayers other than corporations must claim them as short-term capital losses.
  o Warranty costs cannot be claimed until repairs are actually made.
  o Lawsuits – Unlike GAAP, the tax code does not permit the deduction of losses just because they are probable and estimable.
  o Marketable securities – Changes in market value are not reported on the tax return. Gains and losses are only recognized for tax purposes at the time of sale.
  o Inventory – Declines in market value are not deductible until disposal of the inventory takes place.

• Interest Expense
  o Not deductible if loan proceeds used for tax-exempt investments. Note: The investment income limitation on interest expense deductions does NOT apply to corporations.

Unless the taxpayer meets the $25M gross receipts test or qualifies under another specific exemption for certain businesses, such as real property development, the business interest deduction is now limited to the sum of the following, with any disallowed interest expense being carried forward to the next tax year:
  ▪ Business interest income (does not include investment interest/income),
  ▪ 30% of the taxpayer's adjusted taxable income, and
  ▪ The taxpayer's floor plan financing interest for the tax year.
    • “Floor plan financing interest” means interest paid or accrued on debt used to finance motor vehicles held for sale or lease and which is secured by that same inventory.

• Meals & Travel

  Entertainment expenses are generally no longer deductible after 2017.
  o 50% of meals if they are not lavish or extravagant and the taxpayer or an employee was present.
    ▪ Note: When reimbursed meals are treated by the employer as compensation and wages to an employee, they are fully deductible to the entity. In this case, the employee will be taxed on the full amount of the reimbursement and will not be allowed to deduct 50% of the meals since employee business expenses are not currently deductible for individuals.
  o All out-of-town travel costs
  o Lodging expenses for non-away-from-home travel (i.e., Local lodging)
    ▪ If incurred for the convenience or personal benefit of the employee, such as additional employee compensation, to enable employees to avoid long commutes, to accommodate overtime, to provide temporary housing to a relocated employee, or for an employee’s use indefinitely, it is deductible to the employer and taxable to the employee.
    ▪ Safe Harbor Test: Deductible to employer and not taxable to employee as tax-free working condition fringe benefit if 4 conditions are met:
      Necessary for full participation in bona fide business meeting, conference, training activity, or other business function.
      Does not exceed 5 calendar days nor once per calendar quarter.
      Required by employer to remain at activity or function overnight.
Lodging is not lavish or extravagant.

- Facts and Circumstances Test: Even if such expenses do not meet the requirements above, they may still qualify as deductible if they are considered ordinary and necessary business expenses based on the facts and circumstances. For example, the expenses may still be deductible if they are required by the employer for a bona fide business purpose; they are not for social or personal benefit to the employee; and the lodging is not lavish or extravagant.

Qualified transportation fringe benefits for employees (i.e., payments/reimbursements to an employee for travel between the employee's residence and place of employment) are no longer deductible unless they are for the safety of the employee.

- **Casualty losses**
  - Business property – Lesser of adjusted basis immediately before the casualty, or decline in value.
  - Note that the limitations that apply to personal casualty losses (i.e., the $100 floor, 10% of AGI limitation, and federally declared disaster requirement previously discussed) for individuals do NOT apply to business casualty losses.

- **Goodwill, Franchises & Trademarks**
  - Amortized over 15 years for tax purposes.
  - For book, tested annually for impairment.

- **Fines, Federal, FORGET IT!!** – Some expenditures are never deductible.
  - Since the intention of government fines and penalties is punishment, no deduction is allowed, even though such penalties may appear to be in the form of interest.
  - Federal income taxes paid are treated as offsets against the federal tax owed (like a credit), and not as deductions.

- **Taxes**
  - Can deduct various state, local, and foreign taxes on the federal return (NOT federal income taxes).
  - Note: Limitations applicable to individuals do NOT apply to corporate deductions of taxes.

- **Research & Experimental Costs (a.k.a., R&D)**
  - Immediately or over a minimum of 60 months

- **Other Nondeductible Expenses**
  - **Costs of issuing stock** – These are treated as adjustments to the proceeds from sale.
  - **Lobbying costs** – Corporations are discouraged from political involvement and may not claim any costs associated with influencing candidates and legislation.
  - **Club dues** – These are considered too personal in nature to qualify as business expenses.
Lecture 2.05 – Charity, NOL & DRD Deductions

Deductions (continued)

- **Charitable Contributions**
  - Claimed after all ordinary deductions.
  - Limited to 10% of income before claiming deduction (10% ATI).
  - Adjusted Taxable Income (ATI) is Net Income before the following "special deductions" (Note: this is not the same usage of the term "special deductions" on Form 1120):
    - Charity
    - DRD
    - Capital loss carryback
  - Unused amount carried forward 5 years.
  - Pledge may be accrued and deducted if paid within 3 ½ months of year-end (i.e., by the tax return due date—4/15 for calendar year corporations).

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$200</td>
</tr>
<tr>
<td>Ordinary deductions</td>
<td>– 50</td>
</tr>
<tr>
<td>Adjusted Taxable Income (ATI)</td>
<td>150</td>
</tr>
<tr>
<td>Charity - $20M</td>
<td>– 15*</td>
</tr>
<tr>
<td>DRD</td>
<td>– 35</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$100</td>
</tr>
</tbody>
</table>

*Roger Corp. has $20M in charitable contributions, but the maximum deduction is 10% of its $150M ATI = $15M, so $5M is carried forward up to 5 years.

- **Net Operating Losses (NOL)** may now only be carried forward indefinitely and are limited to 80% of taxable income for the year to which it is carried. The NOL rules are essentially the same as for individuals, but the calculation for corporations is much simpler than for individuals; that is, you need only exclude any NOL carryforwards from the corporate calculation.
  - Gross income – excess allowable deductions + any NOLs carried forward to that year = Current Year NOL
  - Carryforward NOL allowed = Taxable income before the NOL × 80%
For example, assume that Roger Corp. has $100M in gross income, $115M in allowable deductions in year 1:

<table>
<thead>
<tr>
<th>Gross income</th>
<th>$100</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Allowable deductions)</td>
<td>− 115</td>
</tr>
<tr>
<td>NOL year 1</td>
<td>(15)</td>
</tr>
</tbody>
</table>

Now assume in year 2 Roger Corp. has $110M in gross income and $115M in allowable deductions, which includes the $15M NOL carried forward from year 1:

<table>
<thead>
<tr>
<th>Gross income</th>
<th>$110</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Allowable deductions)</td>
<td>− 115</td>
</tr>
<tr>
<td>NOL carryforward</td>
<td>+ 15</td>
</tr>
<tr>
<td>Taxable Income before NOL</td>
<td>10</td>
</tr>
<tr>
<td>(NOL carried forward allowed from year 1)</td>
<td>− 8*</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$  2</td>
</tr>
</tbody>
</table>

*Roger Corp. has a $15M NOL carryforward from year 1, but the maximum deduction is 80% of its $10M taxable income before the NOL = $8M, so $7M ($15M - $8M) of the NOL is carried forward to year 3.

- **Dividends** from other taxable domestic corporations:
  - Reported fully in gross income
  - **Dividends Received Deduction (DRD)** – Schedule C
    - To avoid triple taxation on dividends

<table>
<thead>
<tr>
<th>Percentage of ownership by corporate shareholder</th>
<th>Allowed DRD</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 20%</td>
<td>50% - Unaffiliated Co.</td>
</tr>
<tr>
<td>≥ 20% but &lt; 80%</td>
<td>65% - Unaffiliated Co.</td>
</tr>
<tr>
<td>≥ 80%</td>
<td>100% - Affiliated Co. (Control)</td>
</tr>
</tbody>
</table>

TCJA reduced the DRD deductions for interests in domestic corporations from 70% to 50% for less than 20% owned corporations, and from 80% to 65% for 20 - 80% owned corporations.

- If own at least 80%, may file consolidated tax returns and eliminate intercompany dividends – same effect.

- Investor **doesn’t qualify for DRD if:**
  - Dividends are from a foreign corporation (since IRS didn't tax investee)
  - Borrowed the money to buy the investment (Interest expense)
  - Received from a tax-exempt organization (muni-bond interest, not taxable)
Owned for less than 46 days (i.e., the taxpayer must hold the interest at least 46 days during the 91-day period beginning 45 days prior to ex-dividend date.)

- **Exception** if DRD < TI before DRD < Dividend

  There is a rare limitation on the amount of the DRD applicable to investments that qualify for the 50% or 65% DRD. This limitation applies when the taxable income (TI) before DRD is less than the amount of the dividend itself, but not lower than the dividend multiplied by the applicable percentage. In these cases, the DRD percentage is applied to TI before DRD instead of to the dividend itself. **For example,** if:
  
  Dividend = $100
  
  DRD = $50 (50% × $100)
  
  TI before DRD = $80
  
  - Then, DRD is limited to $40 ($80 TI × 50%) because:
    - $50 DRD < $80 TI before DRD < $100 Dividend

For example, assume the corporation’s gross revenue consists of sales and $100 in dividend income, and deductions other than the DRD total $490. Also assume the dividend was received from another taxable domestic corporation in which the investor holds a tiny 2% interest, so that the appropriate DRD is 50%. Let's look at five examples in which sales are (a) $530, (b) $500, (c) $470, (d) $420, and (e) $410. The calculation of taxable income is as follows:

<table>
<thead>
<tr>
<th></th>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
<th>(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td>530</td>
<td>500</td>
<td>470</td>
<td>420</td>
<td>410</td>
</tr>
<tr>
<td><strong>Dividend income</strong></td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td><strong>Gross income</strong></td>
<td>630</td>
<td>600</td>
<td>570</td>
<td>520</td>
<td>510</td>
</tr>
<tr>
<td><strong>Ordinary deductions</strong></td>
<td>(490)</td>
<td>(490)</td>
<td>(490)</td>
<td>(490)</td>
<td>(490)</td>
</tr>
<tr>
<td><strong>TI before DRD</strong></td>
<td>140</td>
<td>110</td>
<td>80</td>
<td>30</td>
<td>20</td>
</tr>
<tr>
<td><strong>DRD (50%)</strong></td>
<td>(50)</td>
<td>(50)</td>
<td>(40)</td>
<td>(50)</td>
<td>(50)</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td>90</td>
<td>60</td>
<td>40</td>
<td>(20)</td>
<td>(30)</td>
</tr>
</tbody>
</table>

Notice that the DRD is based on the dividend income ($100 × 50% = $50) in most of the examples. Only in example (c), in which TI before DRD is lower than $100 but not lower than $50, is the exception applicable, and the DRD is calculated on TI before DRD ($80 × 50% = $40). Because of the narrow range of income before DRD (between 50% and 100% of dividend income) in which the exception applies, this is a rarely-tested item. In general, the percentage will simply be applied to the dividend income. Note that the limitation does not apply when there is a net operating loss after subtracting the full DRD amount—examples (d) and (e).
Lecture 2.07 – Penalty Taxes & Credits

Accumulated Earnings Tax (AET)

To penalize corporations that accumulate earnings beyond the *reasonable needs* for expansion, retirement of debt and working capital needs.

- Excessive retained earnings in judgment of IRS
- Not self-assessed (by audit)
- Tax on undistributed income only *(20% rate)*
  - Reduce or eliminate if pay any of the following:
    - Actual dividend
    - Consent dividend – *hypothetical dividends* you pay taxes on, even though no money was actually received.
    - If already paid PHC tax (discussed later)

- **Safe harbor** allows certain amounts to be retained:
  - $250,000 for a manufacturing co. OR
  - $150,000 for personal service corporations (PSCs)—provides personal services by owner-employees, e.g., health, law, accounting, consulting;
  
  **PLUS**: Additional sums retained for the purpose of paying federal income taxes owed.

The sum of these two amounts is known as the minimum accumulated earnings credit.

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For example, assume a manufacturing corporation in its first year of existence reports taxable income of $500,000 and has a federal income tax liability of $100,000. It is allowed to accumulate $250,000 + $100,000 = $350,000, so the maximum amount that might be subject to the penalty tax is $500,000 - $350,000 = $150,000. As long as dividend distributions of at least $150,000 are made, this corporation cannot be liable for the accumulated earnings tax.

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**Certain controlled groups** are now limited to one $250,000 accumulated earnings credit, to be divided equally among its component members ($150,000 if any component member is a PSC).

Personal Holding Company (PHC) Tax

This tax was created to discourage the sheltering of certain types of passive income in corporations. This generally occurs when individuals in high individual tax brackets establish corporations to hold their personal investments in order to benefit from lower corporate tax rates on the income. As a result, the tax only applies to undistributed income of the corporation, after deducting corporate taxes and net long-term capital gains to arrive at undistributed personal holding company income (UPHCI). The tax can be reduced or eliminated by sufficient dividend
distributions, which of course results in the individual shareholders paying taxes on the dividends received.

- The **20% PHC tax** applies to UPHCI if both:
  - **5 or fewer** individuals own more than 50% of stock **AND**
  - **60% or more** of revenue is from passive sources (e.g., taxable interest, dividends, rental & royalty income).
- Self-assessed by filing Sch. PH with return (Form 1120)
- Can avoid if pay:
  - Actual dividend
  - Consent dividend (i.e., a hypothetical dividend)

### Personal Service Corporations (PSC)

⚠️ **TCJA** repealed the graduated tax rate system for corporations and instituted a flat 21% tax rate in its place; thus, the flat 35% tax rate that previously applied to PSCs has also been reduced to 21%.

A PSC is one that performs professional services and is predominantly owned by the parties providing those services. To qualify as a PSC, **two criteria** must be met:

- Substantially all activities involve the performance of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting services; and
- 95% or more of the stock is owned by employees performing those services. Includes:
  - Retired employees who had performed such services;
  - Estates of employees or retirees who performed such services; and
  - Persons who acquired stock as a result of the death of such an employee or retiree for the 2-year period beginning on the date of the employee's or retiree's death.

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

### Foreign Tax Credit

\[
\text{Foreign tax credit} = \frac{\text{U.S. tax liability} \times \text{Foreign income}}{\text{Worldwide income}} \times \text{actual foreign taxes paid}
\]

Once the full tax liability is determined, it is reduced by available tax credits. The most frequently tested is the **foreign tax credit**. This credit is available to U.S. corporations for income taxes paid to foreign countries on income that is also reported on the U.S. return. The credit is limited to the portion of the U.S. gross tax that applies to the income on which the foreign tax was assessed.
For example, assume that the following facts apply:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worldwide income</td>
<td>$100,000</td>
</tr>
<tr>
<td>Foreign income included in above</td>
<td>$30,000</td>
</tr>
<tr>
<td>U.S. gross tax before foreign credit</td>
<td>$20,000</td>
</tr>
<tr>
<td>Foreign income tax</td>
<td>$8,000</td>
</tr>
</tbody>
</table>

Since 30% ($30,000 / $100,000) of the total income is from a foreign country, 30% of the gross tax of $20,000, or $6,000, is the portion of the U.S. gross tax applicable to the foreign income and is the amount of the credit (the remaining $2,000 can be carried back 1 year or forward 10 years). A corporation may elect to claim the entire amount of foreign taxes as a deduction from taxable income instead of claiming the credit.

**General Business Credit**

The general business credit (claimed on Form 3800) is made up of numerous individual tax credits, including the investment credit, the work opportunity credit, the research credit, the low-income housing credit, the renewable electricity production credit, the orphan drug credit, the employer-provided child care credit, the differential wage payment credit, the small employer health insurance credit, to name just a few. We will not cover the individual credits since they are often very specific to certain industries and subject to frequent legislative changes; thus, they are highly unlikely to be tested at the specific credit level.

**Calculation of the Credit**

- The general business credit for a tax year is equal to the sum of:
  - Business credit carryforwards for the year
  - Current year business credit
  - Business credit carrybacks for the year
- This amount is generally limited, however, to the excess of the taxpayer's net income tax (i.e., regular tax + AMT*) over the greater of:
  - The tentative minimum tax for the year, or
  - 25% of the taxpayer's net regular tax liability over $25,000.
- Any general business credit that may not be claimed in the current year may be carried back 1 year and forward 20 years.

⚠️ TCJA repealed the AMT for corporations, but this credit applies to other taxpayers as well.
Section 1202 Stock

A similar provision, which was made permanent by the 2015 PATH Act, is Section 1202 Qualified Small Business Stock (QSBS). If certain requirements are met, gain on the sale of Section 1202 stock acquired after September 27, 2010, and held for more than 5 years, is 100% excludable from income, up to $10 million ($5 million if MFS) or, if greater, 10 times the total basis of such stock sold during the year. This exclusion also applies for purposes of the 3.8% surtax on unearned income.

- If acquired prior to February 18, 2009 – 50% exclusion
- If acquired after February 17, 2009, and before September 28, 2010 – 75% exclusion

Also note that TCJA repealed the Corporate AMT, so Lecture 2.13 and corresponding questions have been removed.
5. (N) The cost of entertaining clients is no longer deductible after 2017.
S Status Termination

An election to **terminate** a corporation’s status as an S corporation only requires shareholders holding **at least half** of the shares (again, including those that normally are non-voting shares) to agree (**50% - Voluntary**). An S corporation’s status will be revoked automatically (**Involuntary**) if an event occurs that causes it to violate one of the Small & Simple requirements (e.g., if shares are sold to a non-resident alien). Once an S corporation’s status has been revoked, it cannot reelect such status for **5 years**.

Unless a date is specified, a voluntary revocation made:

- Within the first 2½ months of the year is effective as of the 1st day of such taxable year.
- After the first 2½ months of the year shall be effective on the 1st day of the following year.

Per Sec. 1362, termination will **involuntarily** occur if the S corporation has passive investment income exceeding 25% of its gross receipts for each of 3 consecutive years and, if during these 3 years, the corporation was a corporation with accumulated earning and profits attributable to prior C corporation status. The termination is effective on the 1st day of the tax year following the 3rd consecutive year of violation. Passive investment income includes receipts from rents, royalties, dividends, interest, and annuities.

An S election termination can be effective at any time during a tax year, resulting in the need to allocate income between the resulting S short year and C corporation short year. If no special election is made, the income must be allocated on a daily basis between the two based on a 365-day year.
Lecture 3.04 – Qualified Business Income Deduction

Overview
In order to somewhat level the playing field for flow-through entities after reducing the corporate tax rate to 21%, Congress created a 20% Qualified Business Income (QBI) Deduction for S corporations, partnerships (including LLCs, LPs, etc.), sole proprietorships, trusts, estates and even some Schedule E businesses, effective in 2018. We say “somewhat” since the availability of the deduction depends on the type of business (e.g., service or non-service) and the amount of income it produces. There are 3 general categories of income a business can fall into:

1. **For Taxable Income (TI) of $0 – $315,000 (MFJ)**, the full deduction is allowed for any type of business.
2. **For TI of $315,001 (MFJ) up to $415,000 (MFJ)**, a wage/property limitation will partially apply.
   - If the business is a nonqualified business (i.e., service business), another reduction applies.
3. **If TI is over $415,000 (MFJ)**, the full wage/property limitation applies and the business must be a qualified business to claim the deduction.

Note: Unless this provision is extended, it will expire after 2025. The QBI deduction can get quite complicated, so we will stick to the basics for CPA exam purposes.

Qualified Business
“Qualified Business” means any business other than a Specified Service Trade or Business (SSTB), meaning any business involving the performance of services:
- In the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any business where the principal asset of such business is the reputation or skill of one or more of its employees/owners.
  - Notice that this specifically does NOT include engineering and architecture, since they are a part of building something, whereas accountants, lawyers, etc. only provide services, so Congress decided payment for such services generally should be taxed the same as wages, without a 20% deduction.
- That consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Qualified Business Income
“QBI” means the net amount of qualified items of income, gain, deduction, and loss, from a qualified business within the U.S. QBI does NOT include:
- Reasonable compensation paid to the taxpayer
- Guaranteed payments or other payments paid to a partner for services rendered
- Capital gains/losses
- Dividends (or the equivalent)
- Interest income (e.g., investment interest income) other than business interest income

The QBI deduction is determined at the partner/shareholder level, so each partner/shareholder takes into account their allocable share of each qualified item of income, gain, deduction, and loss,
and is treated as having W-2 wages and unadjusted basis of qualified property equal to their allocable share of such items.

QBI Deduction Per Business

Wage/Property Limitation
The deductible amount per business is equal to 20% of the business’s QBI but is generally limited to the greater of:

- 50% of W-2 wages, or
- 25% of W-2 wages + 2.5% of unadjusted basis of qualified property (i.e., the entity's depreciable tangible assets used in the production of QBI)

Lower Income Category 1 — $315,000 or less
If the taxpayer's taxable income does not exceed $315,000 MFJ/$157,500 others (i.e., the threshold) for 2018, the wage/property limitation above does not apply.

For example, Sara, a sole proprietor, is married and will file a joint return in 20X1. Sara has $300,000 of taxable income from a T-shirt business. W-2 wages were $100,000 and the unadjusted basis of qualified property is $60,000. What is the QBI deduction for the T-shirt business?

- 20% × $300,000 = $60,000
- Wage/Property limitation does not apply under the $315,000 threshold.

Middle Income Category 2 — $315,001 to $415,000
For taxpayers with taxable income up to $100,000 MFJ ($50,000 others) over the threshold (i.e., $315,000 MFJ/$157,500 others for 2018), where the wage/property limitation above would otherwise apply, the limitation will partially apply depending on where the taxpayer's income is in that $100,000/$50,000 range above the threshold. The formulas that would apply for 2018 are as follows:

- MFJ: If $315,000 < TI < $415,000, deduction is reduced by the amount equal to: \[(TI - $315,000)/$100,000\] × (20% QBI – limitation).
- All others: If $157,500 < TI < $207,500, deduction is reduced by the amount equal to: \[(TI - $157,500)/$50,000\] × (20% QBI – limitation).

Now assume the same facts as in the last example, except that in 20X2 Sara increases her taxable income from the T-shirt business to $350,000. W-2 wages are still $100,000 and the unadjusted basis of qualified property is $60,000. What is the QBI deduction for the T-shirt business?

- 20% × $350,000 = $70,000
- Wage/Property Limitation—Greater of:
  - 50% × $100,000 wages = $50,000
  - (25% × $100,000 wages) + (2.5% × $60,000) = $26,500

- So here the wage limitation of $50,000 would apply, but since taxable income is below $415,000 (i.e., $315,000 threshold + $100,000), it will only partially apply.
  - \([(350,000 TI - $315,000 threshold)/$100,000] \times (70,000 - $50,000 limitation)\)
  - $35,000/$100,000 × $20,000 excess = $7,000 reduction applies
  - So, the QBI deduction is $70,000 – $7,000 partial limitation/reduction = $63,000
Note: If you were asked to calculate this deduction on the exam, you would likely be given the threshold amount to use since it is adjusted for inflation.

**Highest Income Category 3 — Over $415,000**

Again, same facts, but Sara increases her taxable income from the T-shirt business to $450,000 in 20X3. W-2 wages are still $100,000 and the unadjusted basis of qualified property is $60,000. What is the QBI deduction for the T-shirt business?

- **20% \times $450,000 = $90,000**
- **Wage/Property Limitation—Greater of:**
  - **50% \times $100,000 wages = $50,000**
  - **(25\% \times $100,000 wages) + (2.5\% \times $60,000) = $26,500**
- So here the wage limitation of $50,000 would apply in full, so, the QBI deduction is **$50,000**.

**Exception for Specified Service Trade or Businesses (SSTB)**

If the taxable income of a taxpayer is less than the sum of the threshold amount (i.e., 315,000 MFJ/$157,500), plus $100,000 MFJ ($50,000 others), then:

- Any specified service business of the taxpayer (i.e., a nonqualified business) will be treated as a qualified business, but only the **applicable percentage** of qualified income/deduction items, W-2 wages, and the unadjusted basis of qualified property, is used in the calculations.

  - “Applicable Percentage” means 100% reduced (not below zero) by the percentage equal to the ratio of Taxable Income over the threshold amount to $100,000 MFJ ($50,000 for others).

  - In other words, the deduction is allowed even for disqualified businesses if the taxpayer’s taxable income falls under the threshold amount and it is phased out for every dollar over the threshold, up to the $100,000 MFJ and $50,000 limits. Thus, for 2018, this exception applies in the following circumstances:
    - **MFJ: TI < $415,000**, but phaseout % = 100% – [(TI – $315,000)/$100,000].
    - **All others: TI < $207,500**, but phaseout % = 100% – [(TI – $157,500)/$50,000].

**Randy is single and is the sole owner of an S corporation that provides home healthcare.**

In year 1, the business produces $175,000 of taxable income. W-2 wages were $500,000 and the unadjusted basis of qualified property is $25,000. What is Randy’s QBI deduction for the home healthcare business?

- **First, we find the applicable percentage:** 100% – [($175,000 TI – $157,500)/$50,000] = 65%
- **Then we apply it to the QBI calculation:** 20% \times ($175,000 TI \times 65\%) = $22,750
- **Wage/Property Limitation—Greater of:**
  - **50\% \times ($500,000 wages \times 65\%) = $162,500**
  - **(25\% \times $500,000 wages \times 65\%) + (2.5\% \times $25,000 \times 65\%) = $81,656.25**
- **Here the wage/property limitation does not apply, so the deduction would be $22,750.**

Note: If the wage/property limitation had been low enough to apply, the same partial application calculation that applies in the middle income category above would have to be applied on top of this applicable percentage reduction.
Overall QBI Deduction Limit Per Taxpayer

Let's throw in yet another limitation: the overall QBI deduction per taxpayer is generally limited to the lesser of:

- Combined QBI Amount (i.e., total QBI deductions of all businesses owned), or
- 20% \(\times (\text{TI} – \text{NCG})\)
  - \(\text{TI} = \) Taxable Income computed without QBI deduction
  - \(\text{NCG} = \) Net Capital Gain

To demonstrate, let's assume Roger, who is married to Louisa, has taxable income of $310,000 that includes $20,000 of Louisa's income from a part-time job, a net capital gain of $10,000 and $280,000 ordinary business income from Roger's CPA Review S corp. Since this is his only business, his $56,000 QBI deduction (i.e., $280,000 \times 20\%) is considered his “combined QBI amount.” Thus, Roger's total QBI is limited to the lesser of:

- $56,000 combined QBI amount, or
- 20% \(\times ($310,000 – $10,000 \text{ NCG}) = $60,000\)

Summary

**Qualified Business**—generally any non-service business, but includes engineering and architecture businesses.

**QBI**—generally ordinary business income/deductions, but **NOT** compensation paid to taxpayer or other owners for services, cap gain/losses, dividends, or interest income other than business interest income.

**QBI Deduction**—20% of QBI

- **Wage/Property Limitation**—Greater of:
  - 50% of wages, or
  - 25% of wages + 2.5% of unadjusted basis of qualified property

3 Income Categories:

- **TI of $0–$315,000 MFJ / $157,500**—full deduction allowed for any type of business.
- **TI of $315,001 MFJ / $157,501 up to $415,000 MFJ/$207,500**—wage/property limitation will partially apply, and if a nonqualified business, another reduction applies.
- **TI over $415,000 MFJ / $207,500**—full wage/property limitation applies and must be a qualified business.

**Overall QBI Limit**—Lesser of:

- Combined QBI Deductions, or
- 20% \(\times (\text{TI} – \text{NCG})\)
7. Which of the following items of business income or deduction would be included in the calculation of qualified business income (QBI) for purposes of the QBI deduction?
   a. Wages
   b. Capital gain
   c. Investment interest
   d. Dividends
7. (a) Qualified business income (QBI) means the net amount of qualified items of income, gain, deduction, and loss, from a qualified business within the U.S., so QBI would include most items normally included in ordinary income, such as sales, wages, etc. QBI specifically does not include capital gains/losses, dividends, interest income or investment interest income, other than business interest income.
Termination for Tax Purposes

A partnership generally terminates for tax purposes under IRC §708(b) when no part of the business, financial operations, or venture of the partnership is carried on by any of its partners. Yes, for tax purposes, a partnership can have only one partner! However, note that under Section 801(6) of the Revised Uniform Partnership Act (i.e., state law), a partnership will dissolve after 90 days of being reduced to only one partner.

TCJA Change: The rule that terminated a partnership when 50% or more of the partnership interests changed hands within a 12-month period has been repealed.

A terminated partnership must file a final return that covers the period up to the date of termination. If the business continues, the new business must obtain a different tax identification number and file an initial return that begins from the date of the termination of the previous partnership. The end of the previous partnership and start of the new business are treated as distributions of all assets from the terminated partnership, followed by contributions of all the assets to the new business.

If a partnership divides into two or more separate partnerships, the partnership into which a majority of the interests of the old partnership are transferred is considered a continuation of that partnership, and the other partnerships are treated as brand-new businesses with new contributions of the transferred assets. If none of the separate partnerships holds a majority of previous interests, all are treated as new partnerships and the previous partnership is terminated.

If two or more partnerships merge and the partners in one of the businesses are given a majority of the interests of the merged entity, then the merged entity is considered a continuation of that previous partnership and the other previous partnerships are terminated. If no one former partnership gets a majority of interests in the new merged partnership, then all previous partnerships dissolve and the merged partnership is a new partnership with new contributions of the transferred assets.

Election to Adjust Basis of Partnership Property

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).
9. A partnership is considered terminated for income tax purposes when
   
a. Either 50% or more of the partnership interests are sold within a 12-month period or
   the partnership's business and financial operations are discontinued.
   
b. Either all of the interests in the partnership are sold within a 12-month period or the
   partnership's business and financial operations are discontinued.
   
c. Either only one partner remains to carry on the business or the partnership's business
   and financial operations are discontinued.
   
d. The partnership's business and financial operations are discontinued.
9. (d) A partnership generally terminates for tax purposes under IRC §708(b) when no part of the business, financial operations, or venture of the partnership is carried on by any of its partners. There is no longer a rule that terminates a partnership when 50% or more of the partnership interests are sold within a 12-month period. While a partnership will terminate under state law purposes after 90 days of only having one partner to carry on the business, this is not true for federal tax purposes.
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 $11,180,000 for 2018.

TCJA doubled the lifetime exclusion amount (adjusted for inflation) for estates of decedents dying and gifts made after 2017 and before 2026.

Since gift taxes are applied to each individual donor, a husband and wife may each use the annual and lifetime exclusions mentioned. They can also agree to split large gifts made by one of them and treat each as having given half of the amount. Each gift tax return represents one individual donor. Portability between spouses permits the surviving spouse to apply the decedent's unused exclusion amount to the surviving spouse's own transfers during life (gift) and at death (Estate).

Note: The Top tax bracket for the estate and gift tax is 40% for 2013 - 2018.

For example, assume that Gerald Generous, a single individual, files a gift tax return on 4/15/X2 for the first time, reporting gifts made to three different persons in 20X1:
- Fran Friend – Gerald gave $1,000,000 cash to Fran.
- Pat Parent – Gerald sold Pat his condo in Florida for $500,000 (its appraised value was $2,000,000 at the time of sale).
- Nellie Niece – Gerald established an irrevocable trust that paid all income to Gerald for 10 years, then transferred the trust corpus to Nellie at the end of that period. The value of the corpus was $4,500,000 when the trust was established, and the present value of the gift was determined to be $2,000,000.

The gift to Fran is $1,000,000, of which $985,000 must be reported after the annual exclusion.
The gift to Pat is $1,500,000, of which $1,485,000 must be reported after the annual exclusion.
The gift to Nellie is $2,000,000, and doesn't qualify for an annual exclusion since the corpus is not immediately available to Nellie (i.e., gift of future interest).

The total gifts reported on the return are $985,000 + $1,485,000 + $2,000,000 = $4,470,000. This uses $4,470,000 of the lifetime exclusion, but no tax is owed at this time. If Gerald makes reportable gifts of $8,000,000 more in his lifetime (assuming the lifetime exclusion of $11,180,000), however, he will have to pay gift taxes, since he will have exceeded the cumulative lifetime exclusion.

***

An estate tax return (Form 706) must be filed on behalf of anyone who, at the time of death, had a gross estate exceeding the lifetime exclusion. For someone dying in 2018, the Estate Tax Exclusion is $11,180,000 for 2018 with a maximum tax rate of 40% (MFJ is $22,360,000). The due date of the return is exactly 9 months after the date of death.

TCJA doubled the lifetime exclusion amount (adjusted for inflation) for estates of decedents dying and gifts made after 2017 and before 2026.
The valuation of the assets in the gross estate is normally based on fair market values at the **time of death**. If, however, the executor elects the **alternate valuation date (AVD)**, assets are valued at the time of distribution or sale from the estate. Items not distributed within 6 months of death have an alternative valuation of the FMV exactly **6 months** after the date of death. The alternate valuation may be elected for an estate only if it will reduce both the value of the gross estate and the amount of estate tax liability. **Note:** This valuation is used for both estate tax purposes as well as the heir's basis in such assets. This is referred to as a “stepped-up basis” or “stepped down basis,” depending on whether the property has appreciated or depreciated in value.

An exception to the FMV at time of death (or AVD) applies to appreciated property received by the decedent within one year of death. In such cases, the property retains the **original donor's basis** (a.k.a, “carryover basis”).

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 **$22,360,000 (2018)** 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% × $11,180,000 lifetime exclusion for 2018).
- The former *State Death Tax credit* has been replaced by the *State Death Tax deduction*.

Once these credits are claimed, the resulting net tax is reduced by gift taxes that were paid by the decedent over the course of their lifetime. Due to the unified nature of gift and estate taxes, gift taxes are not considered credits against the estate tax. Instead, they are reported as prior payments on the overall unified transfer tax, reducing the balance due on the estate tax return.

**Generation-Skipping Tax**

There is one additional component to the unified transfer tax that is reported on the estate tax return known as the *generation-skipping transfer (GST) tax*. This tax is imposed when the decedent's estate is transferring substantial property to beneficiaries at least 2 generations below the decedent.

The GST tax applies when amounts exceeding the lifetime exclusion are transferred. The lifetime exclusion is *$11,180,000 for 2018*. This exclusion is separate from the lifetime exclusion on gift and estate taxes, and any tax resulting from transfers exceeding this amount is owed in addition to those taxes.

The intent of the GST tax is to prevent taxpayers from avoiding the estate taxes on a generation by giving, for example, to grandchildren instead of children. The amount of the GST tax is usually reasonably close to the additional estate taxes that would have been paid to the government if the taxpayer had transferred the property to their children and then the children had transferred the property to the grandchildren. The GST tax does not apply to transfers to a grandchild if the taxpayer's child who is the parent of the grandchild is already deceased, since the grandchild is actually the first generation in that line below the taxpayer.
9. Don and Linda Grant, U.S. citizens, were married for the entire year 1 calendar year. In year 1, Don gave a $60,000 cash gift to his sister. The Grants made no other gifts in year 1. They each signed a timely election to treat the $60,000 gift as one made by each spouse. Disregarding the unified credit and estate tax consequences, what amount of the year 1 gift is taxable to the Grants for gift tax purposes?

   a. $0
   b. $30,000
   c. $45,000
   d. $60,000
9. (b) A taxpayer may give gifts up to $15,000 to an individual without being subject to gift tax. When a gift is made by a married individual, the husband and wife may elect to treat the gift as given equally by each, in which case, each would be entitled to the $15,000 exemption; therefore, a total of $30,000 of the $60,000 gift would be exempt, making the remaining $30,000 taxable.
10. (C) An outright gift of $6,000,000 exceeds the $15,000 exemption and would be subject to gift tax. In addition, it will be subject to the generation-skipping tax, which was established for circumstances like this. If a gift is made to a child that is subject to gift tax, and the child then makes the same gift to their child, it too will be subject to gift tax. Without the generation-skipping tax, one of those taxes could be avoided by making the gift directly to the grandchild. As a result, a gift of that nature is subject to both the gift tax and the generation-skipping tax.
Task-Based Simulation Solution 2

1. **(N)** The gift to Kamp is less than the annual exclusion and, as a result, would not be taxable.

2. **(P)** The gift totaling $20,000 would be subject to the annual $15,000 exclusion. As a result, it would be partially taxable to the extent of $5,000.

3. **(P)** Since Lane's aunt begins receiving distributions of the income immediately, she has a present interest. As a result, it will be subject to the $15,000 exclusion and will be partially taxable to the extent of $11,000.

4. **(F)** The remainder interest will not be distributed to Lane's cousin until the end of 5 years and, as a result, is a future interest, which is not subject to an exclusion and is fully taxable.

5. **(N)** There is an unlimited exclusion from gift tax for payments that are made for another party's tuition or medical expenses as long as they are made directly to the university or health care facility. As a result, payments for the grandchild's tuition would not be subject to gift tax.

6. **(F)** Since Lane's brother will not begin receiving distributions until 2 years after the establishment of the trust, Lane's brother has a future interest, which is not subject to any exclusion. As a result, the entire amount would be subject to gift tax.

7. **(N)** The beneficiary of a revocable trust is not receiving a completed gift. As a result, the income of the trust would revert to Lane, the Trustor, and would be considered a gift when given to his daughter. The $15,000 cash gift is a present interest and would be subject to the $15,000 exclusion, resulting in it not being taxable.
Lecture 6.02 – Section 179 & Other Cost Recovery Deductions

TCJA permanently increased the Section 179 deduction amount and the phaseout limit to $1,000,000 and $2,500,000, respectively. These amounts will be indexed for inflation after 2018. TCJA also expanded the definition of “qualified real property” eligible for the deduction.

As a way to stimulate investment in small businesses (and, in turn, the economy), simplify tax compliance, and reduce the burden of recordkeeping for depreciation purposes, the federal tax code permits businesses to make a Section 179 election to immediately expense certain New and Used depreciable property (i.e., “Section 179 Property”) used in the business, instead of capitalizing and depreciating it.

- Maximum expense amount is $1,000,000 for 2018.
- The phase out begins at $2,500,000; that is, the $1,000,000 limit is reduced $1 for every $1 spent over $2,500,000 on Section 179 property. Thus, the election is not available if such purchases exceed $3,500,000.

- **Section 179 Property**—Property eligible for the deduction includes:
  - The property must be acquired by purchase from an unrelated party for use in an active trade or business.
  - Tangible personal property (i.e., 3, 5, 7-year depreciable property used in the business—Section 1245 property)
  - Off-the-shelf Computer Software
  - **Qualified Real Property**
    - Generally any improvement to an interior portion of nonresidential real property after the building was first placed in service (e.g., remodeling the dining area of a restaurant when it has become outdated)

Note that the following types of improvements do NOT qualify:
- Enlarging the building
- An elevator or escalator
- The internal structural framework of the building

Any of the following improvements to nonresidential real property after the building was first placed in service:

- Roofs
- Heating, ventilation, and air-conditioning property
- Fire protection and alarm systems
- Security systems

- Property acquired by purchase from a related party does NOT qualify.
- Deduction NOT allowed if a net loss exists or if taking the depreciation expense would create a net loss. Disallowed amounts can be carried forward.
- NOT generally available on intangibles or real property (except for certain improvements as discussed above).
- The cost of a heavy SUV that may be expensed is limited to $25,000 (adjusted for inflation after 2018 under TCJA).
With respect to S corporations and partnerships, 179 limitations are applied at both the entity and owner level.

For example, if the maximum election permitted for the tax year is $1,000,000, this maximum is phased out on a dollar-for-dollar basis if the purchases of qualified property during the tax year exceed $2,500,000. As a result, a business that purchases $3,500,000 or more in tangible personal property may not use this election. A few examples of the maximum election follow:

<table>
<thead>
<tr>
<th>Qualified purchases</th>
<th>30,000</th>
<th>1,080,000</th>
<th>2,800,000</th>
<th>3,700,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum election</td>
<td>30,000</td>
<td>1,000,000</td>
<td>700,000</td>
<td>0</td>
</tr>
<tr>
<td>Remaining basis</td>
<td>0</td>
<td>80,000</td>
<td>2,100,000</td>
<td>3,700,000</td>
</tr>
</tbody>
</table>

Notice in the case of qualified purchases of $2,300,000, the purchases exceed the threshold of $2,500,000 by $300,000, so the maximum election is reduced from $1,000,000 to $700,000 ($1,000,000 - $300,000). In other words, a dollar-for-dollar reduction of $300,000 is equal to the amount by which the total purchase price exceeds the $2,500,000 threshold. In each example, the remaining basis (if any) is used to determine additional MACRS deductions based on the normal 3, 5, or 7 years, etc.

On the CPA Exam, tax threshold amounts subject to frequent change will often be provided within the related problems.

**Additional First-Year Depreciation (Bonus Depreciation)**

Bonus depreciation is an additional allowance of depreciation in the first year certain property is placed in service. Like the Section 179 deduction, this is yet another tool the government uses to stimulate business investment, simplify tax compliance, and reduce the burden of recordkeeping. As such, it is frequently adjusted by Congress to suit the needs of the current economic environment. Unlike the 179 deduction, this provision is not capped at a certain dollar amount.

Most recently, TCJA increased and extended the bonus depreciation deduction to 100% through 2022, at which point it will begin to phase out again by 20% each year until it is no longer available. The deduction was also expanded to include purchases of used property in addition to new property.

- **100-percent** bonus depreciation is available through 2022.
- Applies to qualified *new or used* assets (i.e., tangible Sec. 1245 property with a MACRS life of 20 years or less) in the year they are placed in service.
- Claimed after the Section 179 expense deduction, if elected, but before the Regular depreciation expense deduction. Note: This order makes more sense in years where less than 100% bonus depreciation is allowed (e.g., when the percentage is reduced to 80% in 2023).
- If the taxpayer does not wish to take the bonus depreciation allowed in the first year the property is placed in service, the taxpayer must make an election to opt out.
Please note that TCJA repealed the IRC §199 Domestic Production Activities Deduction; thus, this section of the material and the corresponding questions have been removed.
4. A taxpayer purchased and placed into service a $1,690,000 piece of equipment in a year with a maximum allowable Section 179 amount of $1,000,000 and a ceiling of $2,500,000 of qualifying property. The equipment is 7-year property. The first-year depreciation for 7-year property is 14.29%. Before considering any depreciation deduction, the taxpayer had $2,700,000 of taxable income. The taxpayer elected out of any bonus depreciation. What amount is the maximum allowable depreciation deduction?
   a. $241,501
   b. $1,000,000
   c. $1,098,601
   d. $1,690,000
3. (c) The Section 179 deduction, which allows a taxpayer to expense up to $1,000,000 in purchases of depreciable personal property, rather than to capitalize and depreciate it. For businesses acquiring large amounts of qualified property, the deduction begins phasing out after acquisitions totaling $2,500,000. It is reduced, dollar for dollar, for acquisitions in excess of $2,500,000 and is eliminated completely when acquisitions are $3,500,000 or greater. To qualify, the property must be acquired from an unrelated party and must be used in the taxpayer’s trade or business.

4. (c) Since there is no indication that the taxpayer acquired more than the $1,690,000 in tangible depreciable personal property during the period, the entire $1,000,000 Section 179 deduction is allowed. This reduces the depreciable basis in the asset to $690,000. It is depreciated using the double-declining balance method over 7 years, indicating depreciation in the 1st year will be $690,000 \times 14.29\% = $98,601. Thus, the maximum allowable depreciation deduction will be $1,000,000 + $98,601, or $1,098,601.
Lecture 7.01 – Property Types: Ordinary, 1231, & Capital Assets

There are 3 types of assets that may be held by a taxpayer:

- **Ordinary income assets** (current assets of a business, a.k.a., “Hot Assets”) – Generally refers to assets that were acquired or produced with the intention of being sold in the ordinary course of business.
  - Includes:
    - **Inventory**
    - **Receivables** arising from sales
    - Self-created **artistic work**
  - Tax Treatment: All gains/losses are taxed at ordinary tax rates. No special rate/treatment or limitations apply (assuming no related parties are involved).
  - Note: Assets used in a business for 1 year or less also generate ordinary gains/losses since they do not qualify as Section 1231 assets or capital assets.

- **Section 1231 assets** (non-current business assets) – Assets used in the trade or business and held longer than one year, whose eventual sale or disposal is only incidental to the business.
  - Includes:
    - **Depreciable** and **amortizable** property
    - **Land used in business**, PP&E
  - Must be held over 1 year:
    - Net 1231 **loss** is ordinary loss. (Form 4797)
    - Net 1231 **gain** is Long Term Capital Gain. (Schedule D)
  - Prior depreciation is recaptured as ordinary income on tangible personal property.
  - Tax treatment: **Best of both worlds!** Since a net 1231 gain is treated as a capital gain, it can be used to offset net capital losses that otherwise might not have been deductible in the current year. Since a 1231 loss is treated as an ordinary loss, it is fully deductible.
  - If held ≤ 1 year – Ordinary gains/losses

- **Capital assets** (non-business assets) – Assets that do not qualify as ordinary income or Section 1231 assets.
  - Includes:
    - **Investment** assets
    - **Personal use** assets (i.e., used by taxpayer or family/household)
    - **Goodwill**—Although goodwill is amortizable, it is not actually used by a business in a meaningful sense, since it doesn't diminish in value from usage, therefore, it is also treated as a capital asset.
  - Non-business bad debts write offs are always S/T capital losses.
  - NOT capital assets:
    - Property normally included in inventory or held for sale to customers in the ordinary course of business
    - Depreciable property and real estate used in business
• Accounts and notes receivable arising from sales or services in the taxpayer's business
• Copyrights, literary, musical or artistic compositions
• Treasury stock

Notice that the tax character of the item depends on the handling by the taxpayer. A *personal computer* would be an ordinary income asset to the manufacturer of the computer, a Section 1231 asset to an accounting firm which acquired the computer for use by its employees, and a capital asset to a person who bought it to run educational software for their children at home.

**Capital Asset Holding Period**

In general, short-term capital transactions refer to sales that take place within a year of the acquisition date, and long-term transactions are those held for longer than one year. There are two exceptions:

- **Inherited assets** – Sales are always classified as long-term (L/T).
- **Non-business bad debts** – Write-offs are always classified as short-term capital losses (S/T).

Note: When a security becomes worthless, the holding period is calculated by treating the property as if it was sold on the last day of the tax year in which it becomes worthless. *Worthless securities* generally receive capital loss treatment; however, if the loss is incurred by a corporation on an investment in an affiliated corporation (80% or more ownership), the loss is treated as an ordinary loss item.

**Netting Process and Tax Treatment**

- Long-term capital gains (LTCG) and losses (LTCL) are combined to determine the net long-term capital gain or loss for the year.
- Short-term capital gains (STCG) and losses (STCL) are combined to determine the net short-term capital gain or loss for the year.
- If the results of these combinations are both gains, stop, they are reported separately.
  - **STCG**—Ordinary tax rates apply.
  - **LTCG**—Special tax rates apply (0%, 15% and 20%) for individuals, but not corporations.
- If both are losses, stop, they are reported separately.
  - **Loss Treatment for Individuals**
    - Net capital loss of $3,000 ($1,500 MFS) is deductible against ordinary income. Short-term losses are claimed first.
    - No carryback is allowed, but can carry forward indefinitely. Carryforwards retain their character as short term or long term.
    - A net loss in any rate group is applied to reduce the net gain in the highest rate group first (e.g., 28% collectibles gain, 25% Unrecaptured Sec. 1250 gain, then 15% capital gain).
  - **Loss Treatment for Corporations**
    - Net capital loss not deductible against ordinary income.
    - May be carried back to offset net capital gains in one of previous 3 tax years, and then carried forward to offset net capital gains in the next 5 tax years.
- If one is a net gain and the other is a net loss, they are combined to produce a single net capital gain or loss for the year, which will be treated as having the character of the larger of the two numbers being combined. See the examples that follow.
### The Netting Process and Tax Treatment Examples

<table>
<thead>
<tr>
<th></th>
<th>Both Gains</th>
<th>Both Losses</th>
<th>Opposites</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net LTCG &amp; LTCL</strong></td>
<td>LTCG $10</td>
<td>LTCL ($10)</td>
<td>LTCL ($10)</td>
</tr>
<tr>
<td></td>
<td>LTCG $10</td>
<td>LTCL ($3)</td>
<td>LTCL $3</td>
</tr>
<tr>
<td><strong>Net STCG &amp; STCL</strong></td>
<td>STCG $3</td>
<td>STCL ($3)</td>
<td>STCG $3</td>
</tr>
<tr>
<td></td>
<td>STCG $(3)</td>
<td>STCL ($10)</td>
<td>STCL $10</td>
</tr>
<tr>
<td>Report</td>
<td>LTCG $10</td>
<td>LTCL-$(10)</td>
<td>LTCL $(7)</td>
</tr>
<tr>
<td></td>
<td>STCG $(3)</td>
<td>STCL $(3)</td>
<td>STCL $(7)</td>
</tr>
<tr>
<td>Treatment for Individuals</td>
<td>LTCG—special rate</td>
<td>Deduct up to $3k against ordinary income; S/T is used first; Carryforward retains character.</td>
<td>Special rates</td>
</tr>
<tr>
<td></td>
<td>STCG—ordinary rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Treatment for Corps</td>
<td>Ordinary rate</td>
<td>Carryback 3 years; carryforward 5 years—all S/T.</td>
<td>Ordinary rate</td>
</tr>
</tbody>
</table>

**Long-term capital gains** of individuals generally benefit from a special tax rate of 15%. Lower-income individuals (i.e., up to $77,200 MFJ and $38,600 for single individuals for 2018) may qualify for a 0% long-term capital gains tax rate while high-income taxpayers ($479,000+ MFJ, $425,800+ single for 2018) are subject to a 20% rate. Note: No special capital gains rate applies for corporations.

A special long-term tax rate of 28% applies to all gains and losses on **collectibles** reported on Schedule D. Collectibles include works of art, rugs, antiques, metals (gold), gems, stamps, coins, alcoholic beverages and other certain tangible property.
Any trade or business that:

- Produces real or tangible personal property.
- Acquires property for resale with average annual gross receipts for past 3 years of more than $25 million.
  - Capitalized costs will be recovered through either depreciation/amortization, or if inventory, through cost of goods sold.
  - **Capitalized costs include:**
    - Pre-production: design, bidding exp, purchasing
    - Production costs: direct materials, labor, & production, indirect production costs (factory overhead)
    - Pre-Sale costs: storage, handling, excise tax (if levied before sale)

For inventory, the company must also **capitalize** most general, administrative, engineering, and overhead costs associated with holding the assets (such as storage costs, repackaging, warehousing) prior to sale. However, nonmanufacturing costs such as selling, advertising, marketing, research and development expenditures would be **expensed** as incurred. Also, businesses with **$25 million** or less in average gross receipts for the past 3 years are not required to follow these rules.
## 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><strong>Capital Assets</strong></td>
<td>All assets <em>except:</em></td>
<td><strong>INDIVIDUALS:</strong></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 during the current year.</td>
</tr>
<tr>
<td></td>
<td>• Depreciable or amortizable business assets, and land used in a business (1231)</td>
<td>• Carryforward indefinite.</td>
</tr>
<tr>
<td></td>
<td>• Treasury stock</td>
<td><strong>CORPORATIONS:</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Net loss: Not deductible</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Carryback 3 years</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Carryforward 5 years</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Considered S/T</td>
</tr>
<tr>
<td><strong>Ordinary Assets</strong></td>
<td>• Inventory</td>
<td>• Regular tax rates</td>
</tr>
<tr>
<td></td>
<td>• Business Receivables</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Self-created artistic works</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Assets used in a business 1 year or less</td>
<td></td>
</tr>
<tr>
<td><strong>Section 1231 Assets</strong></td>
<td>• Depreciable or amortizable business assets over 1 year</td>
<td>• Net gains are generally considered to be LTCG.</td>
</tr>
<tr>
<td></td>
<td>• Land used in a business over 1 year (parking lot and shed)</td>
<td>• Net losses are generally considered to be ordinary losses.</td>
</tr>
</tbody>
</table>
3. **Like-Kind Exchanges**

TCJA limited the Like-Kind Exchange rules to real property for exchanges occurring after 2017. Thus, for 2018 and beyond, business property such as delivery trucks, equipment, etc. no longer qualify for like-kind exchange treatment.

Section 1031 allows **real property** held for investment or productive use in a business to be exchanged tax free (i.e., neither gain nor loss is reported) when it is exchanged for similar property. If, however, the taxpayer receives monetary consideration (boot) as part of the exchange, a gain for the excess of the fair value over the tax basis of the property relinquished is recognized up to a maximum of the amount of boot received.

- **Boot** can result from the following:
  - Cash received
  - Unlike property received
  - Relief from debt that exceeds debt assumed

- If boot is received, **gain** is lesser of:
  - FMV of boot received
  - Realized gain

- **No loss** deduction.

- The like-kind exchange provisions do not apply to exchanges of real property held primarily for sale.

- Most exchanges of real property qualify as like-kind, except the exchange of U.S. property for foreign property, or vice versa.

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**Example:**

For example, assume that the taxpayer owned real estate with a basis of $200,000 and fair market value of $500,000, and this was exchanged for other real estate with a fair value of $400,000. In addition, the taxpayer was relieved of a mortgage on the old property of $150,000, assumed a mortgage on the new property of $80,000, and received $30,000 in cash.

Although the facts are complicated, the transaction makes financial sense, since the value given and received equal:

<table>
<thead>
<tr>
<th></th>
<th>Value Given</th>
<th>Value Received</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property</td>
<td>500,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Debt Relief</td>
<td>80,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>30,000</td>
</tr>
<tr>
<td>Total</td>
<td>580,000</td>
<td>580,000</td>
</tr>
</tbody>
</table>

Since the relinquished property had a basis of $200,000 and fair market value of $500,000, the realized gain was $300,000. The recognized gain is limited to the boot received, however, which includes the cash of $30,000 and the net debt relief of $70,000 ($150,000 debt relief - $80,000 debt assumption), for a total gain reported on the tax return of $100,000.
$400 FMV of new asset
+\(\text{\$100} \) Cash + Net debt relief
\[ \text{\$500} \]
(\text{\$200}) Book Value of Old Asset

\[ \text{\$300} \text{ Realized Gain / Recognized Gain} = \text{\$100} \] (for book \( \frac{100}{500} \times 300 = \text{\$60} \))

**The basis in the new asset** will be: the basis of the old (\text{\$200}) + liability assumed (\text{\$80}) + gain recognized (\text{\$100}) – Liability on old (\text{\$150}) – cash/boot received (\text{\$30}) = \text{\$200} \] New basis.

**Note:** This formula would include “+ cash/boot given” if cash/boot was given rather than received.

<table>
<thead>
<tr>
<th>New - basis</th>
<th>200 (plug)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>30</td>
</tr>
<tr>
<td>Liability old</td>
<td>150</td>
</tr>
<tr>
<td>Liability new</td>
<td>80</td>
</tr>
<tr>
<td>Old (Basis)</td>
<td>200</td>
</tr>
<tr>
<td>Gain</td>
<td>100</td>
</tr>
</tbody>
</table>

It is possible to execute a like-kind exchange and defer some or all taxes in the manner just discussed even when the sale of property and acquisition of similar property are in separate transactions. In order to do this, **all of the following conditions** must be satisfied:

- The proceeds from the sale of property must not be received by the taxpayer, but must instead be paid into a separate escrow account held by a **qualified intermediary**.
- The replacement property must be identified within 45 days after the sale (the qualified intermediary must be notified in writing).
  - The taxpayer may identify more than one property as the potential replacement, as long as either of the following is satisfied:
    - No more than 3 properties are identified, or
    - The total fair value of all identified properties doesn’t exceed 200% of the fair value of the property that was sold.
- The replacement property must actually be acquired **within 180 days** of the sale.

4. **Involuntary Conversions**

When the taxpayer realizes a gain from an involuntary conversion (**Section 1033 exchange**) of property, the gain may be deferred if the property is replaced within the statutory time limit established by law. The time limit is measured from the calendar year the taxpayer received the proceeds, and equals:

- **2 years** – Destruction or theft of property resulting in insurance recovery.
- **3 years** – Government condemnation or eminent domain award.
- **4 years** – Conversion in connection with a federally declared disaster.

Notice that the **time limit** is measured by calendar year, so the actual date for replacement is always December 31 of the year in which the **proceeds are received**.
For example, a taxpayer owns business property that is destroyed in a fire on 12/10/X1. The insurance company makes payment for the fair market value of the property (which exceeds its tax basis) on 1/20/X2. The taxpayer can defer the gain if all of the proceeds are used to replace the property by 12/31/X4. If the fire was part of a gigantic blaze that caused the president to declare the area a federal disaster area, the taxpayer has until 12/31/X6 to replace the property.

When proceeds are not fully reinvested in the new property, the gain is taxed to the extent of the unreinvested amount. Deferred gains reduce the basis of the replacement property. The deductibility of losses will depend on the taxpayer’s use of the property (i.e., business/investment vs. personal) and whether the loss occurred in a federally declared disaster area (remember, for 2018 – 2025, the deduction for personal casualty losses is generally limited to losses attributable to federally declared disasters.)

There are some special situations applicable to **individuals only**.

5. **Sale of Personal Assets**

One involves **losses** on sales of personal assets. Sales of assets held for personal, family, or household use at prices less than original cost are not reported, since they are presumed to represent consumption. For example, if a refrigerator is purchased for $1,000 and then sold 15 years later for $100, the drop in value is not a loss but the result of the use of the refrigerator for all those years (**consumption loss**). The only exception is for casualty losses attributable to federally declared disasters (2018 – 2025).

- Gains taxed
- Losses not deductible (consumption loss)
9. **Losses on Deposits in Insolvent Financial Institutions (Banks)**

A loss resulting from a nonbusiness deposit in an insolvent financial institution is treated as a nonbusiness bad debt, which is deductible up to $3,000 ($1,500 MFS) as a short-term capital loss on Schedule D.

**Prior Law**

Prior to 2018, an individual who incurred a loss on a deposit at a financial institution that became insolvent or bankrupt could deduct the estimated loss as either a personal *casualty loss* (in excess of 10% of AGI and $100 per event), or an *ordinary loss* up to $20,000 ($10,000 MFS), subject to reduction by 2% of AGI. (Miscellaneous itemized 2%). This treatment will presumably return to the law in 2026.
Unrelated Business Income (UBI)

Any exempt organization will have to file a business income tax return (Form 990-T) and pay income taxes if it has more than $1,000 of unrelated business income (UBI). If the organization is in the form of a corporation, it will pay tax at corporate tax rates, and if it is a trust, at trust tax rates. Estimated taxes are also due if it expects to owe more than $500 in taxes for the year.

Unrelated business income refers to income obtained from the operations of business activities not associated with the exempt purpose of the organization. The definition of unrelated business income specifically excludes:

- Legal games of chance used to raise funds, such as bingo.
- Activities only carried out on an intermittent basis, such as annual charity auctions.
- Business activities related to the organization’s purpose, such as sales of educational materials to members of a professional organization established to maintain and improve the skills of its members.
- Most investment income.
- Activities that are staffed entirely by volunteers working without pay.
- The sale of merchandise that was received as a gift or contribution.
- Convenience of members, employees or students (e.g., cafeteria or bookstore).

TCJA has enacted a rule that requires tax-exempt organizations to separately compute unrelated business taxable income (and net operating losses) for each trade or business activity of the organization starting in 2018. This means the expenses (and net operating losses) of one activity can no longer offset the revenues of another. Total UBTI is the sum of all separately calculated UBTI per activity, less the $1,000 deduction allowed per organization. UBTI cannot be less than $0.
### 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>
<tr>
<td><strong>27 months</strong> to file paperwork when comes into existence</td>
<td>Identify amount contributed</td>
<td><strong>Revenue per activity</strong> (Expenses per activity) UBTI per activity</td>
</tr>
<tr>
<td><strong>Public/Private</strong></td>
<td>Identify gross receipts/distributions</td>
<td><strong>Sum of UBTIs</strong> ($1,000) = UBTI</td>
</tr>
<tr>
<td>1) Private = Most of funding comes from private foundation or group of people,</td>
<td></td>
<td><strong>Corp Rate</strong></td>
</tr>
<tr>
<td>2) Rest are Public</td>
<td></td>
<td><strong>Trust Rate</strong></td>
</tr>
<tr>
<td><strong>UNLESS</strong> → No return</td>
<td></td>
<td><strong>Exceptions</strong> = Campus Bookstore and Cafeteria</td>
</tr>
<tr>
<td>1) You are a CHURCH</td>
<td></td>
<td>Related → for the benefit of the members (students)</td>
</tr>
<tr>
<td>2) Gross receipts &lt; $50,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Filing Requirements

Unlike corporations, an individual is not required to file a tax return if the gross income during the year is clearly insufficient for any tax liability to result. This is the case if the gross income of the taxpayer for the year does not exceed the sum of:

- The basic standard deduction based on filing status.
- The additional standard deductions based on age (≥ 65)

Note: For purposes of determining whether a return has to be filed, the taxpayer cannot use the additional standard deduction based on blindness, since it is not automatically available without supporting evidence.

Even if the taxpayer does not have gross income exceeding the calculated limit, a return must be filed if the taxpayer's net earnings from self-employment exceeds $400 since self-employment taxes will be due, even though income taxes are not. Note, however, that the taxpayer can actually have up to $433.13 (i.e., $400/.9235) of self-employment income before having to file a tax return. Since ½ the self-employment tax is deductible, self-employment income must be multiplied by 92.35% (i.e. 100% – 7.65% deductible portion of SE tax) to arrive at net earnings from self-employment, which is then multiplied by the 15.3% SE tax rate to determine the SE tax due.
International Tax Issues

Income Taxes
Many companies try to minimize their taxes by locating operations in foreign countries with lower tax rates, known as “tax havens.” The United States has a few rules to combat this abusive behavior, but the method depends on the type of foreign operation:

- **Foreign Branch** – a business operation carried on by a U.S. corporation, partnership, trust, estate, or individual, outside the United States. Such an activity must be considered a permanent establishment under the terms of a treaty between the United States and the foreign country.
  - Taxed on current U.S. income and losses are deductible.

- **Foreign Subsidiary** – a company incorporated under the laws of a foreign country where it is located, but which is partially or wholly owned by a U.S. corporation.
  - U.S. income tax is generally deferred until profits are repatriated back to U.S. in the form of dividends, and losses are not deductible; however, TCJA has introduced new rules to help migrate the international tax system to more current taxation of foreign income and permanent exclusion of certain dividends repatriated back to the U.S. (discussed later).
  - **Controlled Foreign Corporation (CFC)** is a foreign corporation where U.S. shareholders own more than 50% of the total voting power or value of all classes of the corporation's stock.
  - A shareholder is considered a “U.S. shareholder” if they own 10% or more of total voting power of all classes of stock, or 10% or more of the total value of all classes of stock in the foreign corporation.
    - **Subpart F Income of a Foreign Base Company** – To prevent a taxpayer from deferring income tax on certain movable income and shifting such income to a controlled foreign entity that may be taxed at a lower tax rate, every shareholder who, on the last day of the tax year, owns, directly or indirectly, 10% or more of the voting stock in a foreign corporation that was a CFC at any time during that taxable year will include the taxpayer's share of Subpart F income in gross income, regardless of whether the CFC actually makes a distribution. Subpart F income of a CFC is the sum of various factors that includes foreign base company income. There are 3 main categories of foreign base company income:
      - Foreign base company *sales* income – income received by a CFC from the purchase or sale of personal property involving a related person.
      - Foreign base company *services* income – income from the performance of services by or on behalf of a related person.
      - Foreign *personal holding company* income – investment income such as dividends, interest, rents and royalties.
    Foreign base company income is essentially income earned by a CFC that results from the purchase/sale, from or on behalf of a related party, of property that is manufactured, produced, or extracted outside of the
country of the CFC’s organization and is sold for use, consumption, or disposition outside of the country of its organization. This might also be the case, for example, if a CFC provides services to an entity in another country as the result of a contract entered into by the CFC’s parent from the United States.

**International Tax Reform**

In an effort to shift from a deferred tax regime to more current taxation of foreign profits, TCJA has created a sort of hybrid system by enacting a few new international tax rules to encourage the repatriation of foreign income. Among them, and perhaps the most important, is the so-called “Participation Exemption.” This is a new 100% dividends received deduction (DRD) that is generally available for the foreign-source portion of dividends received after 2017 from a “specified 10% owned foreign corporation” by domestic corporations that are at least 10% shareholders. A holding period of more than 365 days is required, and no foreign tax credit or deduction is allowed with respect to a dividend that qualifies for the deduction. Since a foreign corporation is already subject to tax in its country of incorporation, this provision generally eliminates any additional U.S. tax on such foreign profits.

In addition to this Participation Exemption, TCJA has provided new reduced tax rates for domestic corporations on “Foreign-Derived Intangible Income (FDII)” and “Global Intangible Low-Taxed Income (GILTI).” For 2019 through 2025, these tax rates are effectively 12.5% and 10%, respectively.

**Foreign-Derived Intangible Income (FDII)** is intangible income (i.e., income from the ownership, sale, etc., of intangible assets), derived from serving foreign markets. For example, Disney receives FDII from licensing its characters to a European apparel company for printing on T-shirts to be sold in Europe.

- \[ \text{FDII} = \text{Deemed Intangible Income} \times \text{Foreign-derived deduction eligible income (FDDEI)} \]
- \[ \text{Deduction Eligible Income (DEI)} \]

- **Foreign-Derived Deduction Eligible Income (FDDEI)** is any deduction eligible income from:
  - Property “sold,” (i.e., leased, licensed, exchanged, etc.), to any foreign person for a foreign use. Note: If a taxpayer sells property for further manufacture or modification within the U.S., it is not generally treated as sold for a foreign use, even if it is subsequently used for foreign use; however, there is an exception for property that is ultimately sold by a related party to a foreign unrelated party for foreign use.
  - Services provided to any foreign person, or with respect to any foreign property. Note: DEI from services provided to an unrelated person located within the U.S. is not treated as FDDEI, even if the other person uses the services in providing services resulting in FDDEI.

- **Deduction Eligible Income (DEI)** is the excess of gross income over allocable deductions (including taxes).
• **DEI = Gross Income – Allocable Deductions – Exceptions**

  ▪ *Exceptions:
    - Subpart F income
    - GILTI (see below)
    - Financial services income
    - Dividends from a CFC (Controlled Foreign Corp)
    - Domestic oil and gas extraction income
    - Foreign branch income

**Global Intangible Low-Taxed Income (GILTI)** is a new, wide-ranging category of income designed to tax foreign income at a low rate immediately (rather than it being deferred).

• **GILTI = U.S. shareholder’s Net CFC Tested Income – Net Deemed Tangible Income Return.**

  o **Net CFC Tested Income = CFC Tested Income – CFC Tested Loss.**

  ▪ **Tested Income = CFC’s gross income – allocable deductions (including taxes). CFC gross income does NOT include:**
    - Income derived from sources within the U.S.
    - Subpart F Income
    - Gross income excluded from the foreign base company income and the insurance income
    - Dividends received from a related person
    - Foreign oil and gas extraction income

  ▪ **Tested Loss** is the excess of the CFC’s allocable deductions over the CFC’s gross income.

  o **Net Deemed Tangible Income Return**—The excess of:

    ▪ 10% of the aggregate of a U.S. shareholder’s pro rata share of the *qualified business asset investment (QBAI)* of each CFC owned, over
    ▪ The amount of interest expense in excess of interest income included in the shareholder’s net CFC tested income.

    ▪ **Qualified Business Asset Investment (QBAI)**—The average of a CFC’s aggregate adjusted bases in “specified tangible property” as of the end of each quarter of the tax year that is depreciable and used in a trade or business of the CFC.

      o **Specified Tangible Property**—Any tangible property used in the production of tested income. Note that *dual use property*—property used both in the production of tested income and income which is not tested income—is considered specified tangible property in the same proportion as the tested income produced bears to the total gross income produced.

Even with the Participation Exemption and these new lower FDII and GILTI tax rates, corporations will still have the incentive to shift their profits to countries with lower tax rates, thus, TCJA has also created an additional base erosion *minimum tax* called the *Base Erosion and Anti-Abuse Tax (BEAT)* to protect against erosion of the U.S. tax base. An example of U.S. tax base erosion is the
placement of high-value functions and assets in low-tax countries in order to generate profits offshore.

- Only applicable to corporations with $500 million or more in average annual gross receipts over the previous 3 tax years.

- \[ \text{BEAT} = 10\% \times \text{Modified Taxable Income} \times (\text{Regular Tax Liability} - \text{Certain Tax Credits}) \]

  *Modified Taxable Income is taxable income adjusted for base erosion payments (i.e., generally any amount paid or accrued to a foreign related party).

The REG Blueprints indicate that these new complicated tax reform topics (i.e., FDII, GILTI, and BEAT) will only be tested at the Remembering & Understanding skill level; thus, it is unnecessary for you to learn how to calculate such taxes. You should, however, have a general understanding of what they are and how they apply to taxpayers.

**Withholding Taxes**

Salaries, wages, etc., paid to a nonresident alien (NRA) are subject to withholding in the same way as for U.S. citizens/residents if they are effectively connected with the conduct of a U.S. trade or business. However, the following types of U.S.-sourced income paid to NRAs are generally subject to withholding at 30%, unless a tax treaty provides for a lesser rate, or exemption:

- Nonemployee compensation
- Athletes and entertainers
- Interest Income effectively connected with a U.S. trade or business
- Dividend income
- Royalties
- Pensions and annuities
- Alimony
- Taxable scholarships/fellowships
- Social Security pensions – 85% of the U.S. Social Security pension paid to an NRA is taxable at the rate of 30%, for an effective rate of tax of 25.5%. The Social Security Administration generally withholds 25.5% federal income tax on U.S. Social Security pensions paid to NRAs.
Section 10.3 – Who May Practice

In order for a CPA to practice before the IRS, the CPA:

- Must not be currently under suspension or disbarment from practice before the IRS.
- Must file a declaration with the IRS indicating the CPA is currently qualified as a CPA and authorized to represent the party.

A CPA not currently under suspension or disbarment may provide written advice without filing a written declaration.

Note: A district court held in *James C. Sexton, Jr. and Esquire Group, LLC v. Karen L. Hawkins, Director of Office of Professional Responsibility, IRS*, that an individual suspended from practice before the IRS could still engage in the preparation of tax returns or offer tax advice since these activities are not considered to be “practice before the IRS.”
4) The final subquestion concerns the tax basis of a delivery van purchased as part of a trade-in transaction during the year. The default answer is “This tax basis is correct,” referring to a tax basis of $23,300. The choices are:

- [Original text] This tax basis is correct.
- The delivery van should have a tax basis of $39,212.
- The delivery van should have a tax basis of $32,300.
- The delivery van should have a tax basis of $31,510.
- The delivery van should have a tax basis of $30,400.
- The delivery van should have a tax basis of $25,388.

Studying the Tax Depreciation Worksheet, we see that an old van with an original basis of $18,125 and accumulated depreciation of $16,037 (i.e., $2,088 adjusted basis) was exchanged for a new van given a basis on the worksheet of $23,300. Turning to the delivery van invoice, we see the bottom-line amount was the $23,300 recorded in the depreciation worksheet. Should that be the basis?

Since the property exchanged is not real property, we know the exchange does not qualify as a Section 1031 nontaxable exchange, so the gain on the old van will have to recognized and the new van will simply be recorded at cost. The cost of the new van is equal to the value of consideration given: 23,300 cash + $9,000 old van = $32,300. To reinforce our conclusion, we could reconstruct the journal entry to see the big picture. The $6,912 of gain recognized is the difference between the $9,000 in value received for the old van less the $2,088 adjusted basis (i.e., $18,125 cost - $16,037 accumulated depreciation).

<table>
<thead>
<tr>
<th>New Van</th>
<th>Basis in new asset acquired?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated Depreciation</td>
<td>16,037</td>
</tr>
<tr>
<td>Old Van</td>
<td>18,125</td>
</tr>
<tr>
<td>Cash</td>
<td>23,300</td>
</tr>
<tr>
<td>Gain on Old Van</td>
<td>6,912</td>
</tr>
</tbody>
</table>

The correct answer, then is:

*The delivery van should have a tax basis of $32,300.*