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PREFACE

New to this Edition

INDIVIDUALS

- Complete updating of the chapter material for the provisions in the Tax Cuts and Jobs Act of 2017 and the subsequent guidance affecting individual taxpayers
- Complete updating of significant court cases and IRS rulings and procedures during 2018 and early 2019
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2019
- Whenever new updates become available, they will be accessible via MyLab Accounting
- Focus on critical thinking skills with additional Tax Strategy and Critical Thinking Problems
- Updating of the end-of-chapter tax return problems to 2018 (2018 tax forms are included because the 2019 tax forms were not available when this edition went to print)
- Addition of shorter tax form problems, focusing on single forms or schedules

CORPORATIONS

- Complete updating of the chapter material for the provisions in the Tax Cuts and Jobs Act of 2017 and the subsequent guidance affecting corporations and other entities
- The comprehensive corporate tax return, Problem C:3-66, has all new numbers for the 2018 forms
- The comprehensive partnership tax return, Problem C:9-58, has all new numbers for the 2018 forms
- The comprehensive S corporation tax return, Problem C:11-62, has all new numbers for the 2018 forms
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2019
- Whenever new updates become available, they will be accessible via MyLab Accounting
- Focus on critical thinking skills with additional Tax Strategy and Critical Thinking Problems
- Addition of shorter tax form problems, focusing on single forms or schedules

SOLVING TEACHING AND LEARNING CHALLENGES

The Rupert/Anderson/Hulse 2020 Series in Federal Taxation is appropriate for use in any first course in federal taxation, and comes in a choice of three volumes:

- Federal Taxation 2020: Individuals
- Federal Taxation 2020: Corporations, Partnerships, Estates & Trusts (the companion book to Individuals)
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- The *Individuals* volume covers *all* entities, although the treatment is often briefer than in the *Corporations* and *Comprehensive* volumes. The Individuals volume, therefore, is appropriate for colleges and universities that require only one semester of taxation as well as those that require more than one semester of taxation. Further, this volume adapts the suggestions of the Model Tax Curriculum as promulgated by the American Institute of Certified Public Accountants
- The *Corporations, Partnerships, Estates & Trusts* and *Comprehensive* volumes contain three comprehensive tax return problems whose data change with each edition, thereby keeping the problems fresh. Problem C:3-66 contains the comprehensive corporate tax return, Problem C:9-58 contains the comprehensive partnership tax return, and Problem C:11-62 contains the comprehensive S corporation tax return, which is based on the same facts as Problem C:9-58 so that students can compare the returns for these two entities
- The *Corporations, Partnerships, Estates & Trusts* and *Comprehensive* volumes contain sections called Financial Statement Implications, which discuss the implications of Accounting Standards Codification (ASC) 740. The main discussion of accounting for income taxes appears in Chapter C:3. The financial statement implications of other transactions appear in Chapters C:7, C:8, and C:16 (Corporations volume only)

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Instructor's Solutions Manual authored by Kenneth Anderson from University of Tennessee, David Hulse from University of Kentucky, and Timothy Rupert from Northeastern University	• Solutions to discussion questions • Solutions to problems • Solutions to comprehensive and tax strategy problems
Test Bank authored by Anthony Masino from East Tennessee State University and Ann Burstein Cohen from SUNY at Buffalo	Over 2,000 multiple-choice, true/false, short-answer, essays, and worked problems. • Type (Multiple-choice, true/false, short-answer, essay) • Page references to where content is found in the text
Computerized TestGen	TestGen allows instructors to: • Customize, save, and generate classroom tests • Edit, add, or delete questions from the Test Item Files • Analyze test results • Organize a database of tests and student results.
PowerPoint Presentations authored by Allison McLeod from University of North Texas	Slides include key graphs, tables, and equations in the textbook. PowerPoints meet accessibility standards for students with disabilities. Features include, but not limited to: • Keyboard and Screen Reader access • Alternative text for images • High color contrast between background and foreground colors
Multistate Tax Chapter authored by Michael Schadewald from University of Florida	An entire chapter, complete with problems (and solutions) dedicated to multi-state tax practices.
TaxAct 2018 Professional Software	Available online with Individuals, Corporations, and Comprehensive Texts—please contact your Pearson representative for assistance with the registration process. This user-friendly tax preparation program includes more than 80 tax forms, schedules, and worksheets. TaxAct calculates returns and alerts the user to possible errors or entries. Consists of Forms 990, 1040, 1041, 1065, 1120 and 1120S.

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Our policy is to provide annual editions and to prepare timely updated supplements when major tax revisions occur. We are most appreciative of the suggestions made by outside reviewers because these extensive review procedures have been valuable to the authors and editors during the revision process.

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Please send any comments to Kenneth E. Anderson, David S. Hulse, or Timothy J. Rupert.

CHAPTER

1

AN INTRODUCTION TO TAXATION



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Discuss the history of taxation in the United States
2. Describe the three types of tax rate structures
3. Describe the various types of taxes
4. Discuss the criteria for a "good" tax structure, the objectives of the federal income tax law, and recent tax reform proposals
5. Describe the tax entities in the federal income tax system
6. Identify the various tax law sources and understand their implications for tax practice
7. Describe the legislative process for the enactment of the tax law
8. Describe the administrative procedures under the tax law
9. Describe the components of a tax practice
10. Understand the importance of computer applications in taxation

CHAPTER OUTLINE

History of Taxation in the United States...1-2
Types of Tax Rate Structures...1-4
Other Types of Taxes...1-7
Criteria for a Tax Structure...1-12
Entities in the Federal Income Tax System...1-16
Tax Law Sources...1-24
Enactment of a Tax Law...1-24
Administration of the Tax Law and Tax Practice Issues...1-26
Components of a Tax Practice...1-29
Computer Applications in Tax Practice...1-31

Federal income taxes have a significant effect on business, investor, and personal decisions in the United States. Because tax rates can be as high as 21% on corporations and over 40% on individuals, virtually every transaction is impacted by income taxes. The following examples illustrate the impact of the tax law on various decisions in our society:

- Because of the deductibility of home mortgage interest and real estate taxes, an individual may decide to purchase a home rather than to continue to rent an apartment.
- An investor may decide to delay selling some stock because of the significant taxes that may result from the sale.
- A corporation may get a larger tax deduction if it leases property rather than purchasing the property.

The purpose of this text is to provide an introduction to the study of federal income taxation. However, before discussing the specifics of the U.S. federal income tax law, it is helpful to have a broad conceptual understanding of the taxation process. This chapter provides an overview of the following topics:

- Historical developments of the federal tax system
- Types of taxes levied and structural considerations
- Objectives of the tax law, including a discussion of recent tax reform proposals
- Taxpaying entities in the federal income tax system
- Tax law sources and the legislative process
- Internal Revenue Service (IRS) collection, examination, and appeals processes
- The nature of tax practice, including computer applications and tax research

KEY POINT

In many situations, the use of the tax laws to influence human behavior is deliberate. As will be seen later in this chapter, tax laws are often used to achieve social and economic objectives.

HISTORY OF TAXATION IN THE UNITED STATES

OBJECTIVE 1

Discuss the history of taxation in the United States

EARLY PERIODS

The federal income tax is the dominant form of taxation in the United States. In addition, most states and some cities and counties also impose an income tax. Both corporations and individuals are subject to such taxes.

Prior to 1913 (the date of enactment of the modern-day federal income tax), the federal government relied predominantly on customs duties and excise taxes to finance its operations. The first federal income tax on individuals was enacted in 1861 to finance the Civil War but was repealed after the war. The federal income tax was reinstated in 1894, however, that tax was challenged in the courts because the U.S. Constitution required that an income tax be apportioned among the states in proportion to their populations. This type of tax system, which would be both impractical and difficult to administer, would mean that different tax rates would apply to individual taxpayers depending on their states of residence.

HISTORICAL NOTE

The reinstatement of the income tax in 1894 was the subject of heated political controversy. In general, the representatives in Congress from the agricultural South and West favored the income tax in lieu of customs duties. Representatives from the industrial eastern states were against the income tax and favored protective tariff legislation.

In 1895, the Supreme Court ruled that the tax was in violation of the U.S. Constitution.[1] Therefore, it was necessary to amend the U.S. Constitution to permit the passage of a federal income tax law. This was accomplished by the Sixteenth Amendment, which was ratified in 1913. The Sixteenth Amendment, while being an extraordinarily important amendment, consists of one sentence.

> **Sixteenth Amendment to the Constitution of the United States**
>
> The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

[1] *Pollock v. Farmers' Loan & Trust Co.*, 3 AFTR 2602 (USSC, 1895). Note, however, that a federal income tax on corporations that was enacted in 1909 was held to be constitutional because it was treated as an excise tax. See *Flint v. Stone Tracy Co.*, 3 AFTR 2834 (USSC, 1911).

REVENUE ACTS FROM 1913 TO THE PRESENT

HISTORICAL NOTE

The Revenue Act of 1913 contained sixteen pages.

The Revenue Act of 1913 imposed a flat 1% tax (with no exemptions) on a corporation's net income. The rate varied from 1% to 7% for individuals, depending on the individual's income level. However, very few individuals paid federal income taxes because a $3,000 personal exemption ($4,000 for married individuals) was permitted as an offset to taxable income. These amounts were greater than the incomes of most individuals in 1913.

HISTORICAL NOTE

Before 1939, the tax laws were contained in the most current revenue act, a reenactment of a prior revenue act plus amendments. In 1939, a permanent tax code was established; it was revised in 1954 and 1986.

Various amendments to the original law were passed between 1913 and 1939 as separate revenue acts. For example, a deduction for dependency exemptions was provided in 1917. In 1939, the separate revenue acts were codified into the Internal Revenue Code of 1939. A similar codification was implemented in 1954. The 1954 codification, which was known as the Internal Revenue Code of 1954, included the elimination of many "deadwood" provisions, a rearrangement and clarification of numerous code sections, and the addition of major tax law changes. Whenever changes to the Internal Revenue Code (IRC) are made, the old language is deleted and the new language added. Thus, the statutes are organized as a single document, and a tax advisor does not have to read through the applicable parts of all previous tax bills to find the most current law. In 1986, significant changes were made to the tax law, and the basic tax law was redesignated as the Internal Revenue Code of 1986. In December 2017, the Tax Cuts and Jobs Act (TCJA) was passed by Congress, effective on January 1, 2018. While the major changes relate to businesses, there are significant changes for all taxpayers. The important changes of TCJA are included in this textbook.

The federal income tax became a "mass tax" on individuals during the early 1940s. This change was deemed necessary to finance the revenue needs of the federal government during World War II. In 1939, less than 6% of the U.S. population was subject to the federal income tax; by 1945, 74% of the population was taxed.[2] To accommodate the broadened tax base and to avoid significant tax collection problems, Congress enacted pay-as-you-go withholding in 1943.

A major characteristic of the federal income tax since its inception to today is the manner in which the tax law is changed or modified. The federal income tax is changed on an **incremental** basis rather than a complete revision basis. Under so-called incrementalism, when a change in the tax law is deemed necessary by Congress, the entire law is not changed, but specific provisions of the tax law are added, changed, or deleted on an incremental basis. Thus, the federal income tax has been referred to as a "quiltwork" of tax laws, referring to the patchwork nature of the law. Without question, one of the principal reasons for the complexity of the federal income tax today is the incremental nature of tax legislation.

REVENUE SOURCES

ADDITIONAL COMMENT

In 2017, 150 million individual income tax returns were filed, and collections from individuals totaled $1.45 trillion.

As mentioned earlier, the largest source of federal revenues is individual income taxes. Other major revenue sources include Social Security (FICA) taxes and corporate income taxes (see Table I:1-1). Two notable trends from Table I:1-1 are (1) the gradual increase in social insurance taxes from 1960 to 2019 and (2) the gradual decrease in corporate income taxes for the same period. Individual income taxes have remained fairly stable during the past 60 years.

TYPICAL MISCONCEPTION

It is often assumed that the tax revenue from corporation income taxes is the largest source of tax revenue. However, the revenue generated from this tax only represents approximately 7% of total federal revenues in 2019.

▼ **TABLE I:1-1**

Breakdown of Federal Revenues

	1960	1975	2000	2019
Individual income taxes	44%	45%	50%	50%
Social insurance taxes and contribution	16	32	32	36
Corporation income taxes	23	15	10	7
Other	17	8	8	7
Total	100%	100%	100%	100%

Source: Council of Economic Advisers, *Economic Indicators* (Washington, DC: U.S. Government Printing Office, 1967, 1977, 2018).

[2] Richard Goode, *The Individual Income Tax* (Washington, DC: The Brookings Institution, 1964), pp. 2–4.

TYPES OF TAX RATE STRUCTURES

OBJECTIVE 2

Describe the three types of tax rate structures

THE STRUCTURE OF INDIVIDUAL INCOME TAX RATES

Virtually all tax structures are comprised of two basic parts: the **tax base** and the **tax rate**. The tax base is the amount to which the tax rate is applied to determine the tax due. For example, an individual's tax base for the federal income tax is *taxable income*, as defined and determined by the income tax law. Similarly, the tax base for the property tax is generally the fair market value of property subject to the tax. The tax rate is merely the percentage rate applied to the tax base.

ADDITIONAL COMMENT

In the 1950s, the top marginal tax rate for individual taxpayers reached 92%. This astonishingly high rate only applied to taxpayers with very high taxable incomes but still is an extremely confiscatory tax rate.

Tax rates may be progressive, proportional, or regressive. A **progressive rate** structure is one where the rate of tax increases as the tax base increases. The most notable tax that incorporates a progressive rate structure is the federal income tax. Thus, as a taxpayer's taxable income increases, a progressively higher rate of tax is applied. For 2019, the federal income tax rates for individuals begin at 10% and increase to 12%, 22%, 24%, 32%, 35%, and 37% as a taxpayer's taxable income increases.[3] Examples I:1-1 and I:1-2 show how the progressive rate structure of the federal income tax operates.

EXAMPLE I:1-1 ▶ Alice, who is single, has $30,000 taxable income in 2019. Her federal income taxes for the year are $3,406, computed as follows: the first $9,700 of taxable income is taxed at 10% and the remaining $20,300 at 12%. (For tax rates, see the Quick Reference section of the text.)

Allen, who also is single, has taxable income of $60,000. A 10% rate applies to the first $9,700 of taxable income, 12% on the next $29,775, and a 22% rate applies to the taxable income over $39,475. Thus, Allen's total tax is $9,059 [(0.10 × $9,700) + (0.12 × $29,775) + (0.22 × $20,525)].

If Allen's taxable income is $120,000, a 24% rate applies to $35,800 of his taxable income ($120,000 − $84,200) because the 24% rate applies to taxable income above $84,200 for a single individual and his total tax for the year is $22,975. Thus, the tax rates are progressive because the rate of tax increases as a taxpayer's taxable income increases. ◀

LEGISLATIVE BACKGROUND

Beginning with tax year 2018, the top rate for high-income individual taxpayers was decreased to 37% from 39.6%.

Notice in Example I:1-1 that taxable income has doubled in size in the three cases, but the income taxes have more than doubled (i.e., $3,406 to $9,059 to $22,975). This demonstrates how a progressive rate structure operates.

EXAMPLE I:1-2 ▶ Assume the same facts as in Example I:1-1 except that Alice has taxable income of $240,000. Of Alice's taxable income, $35,900 ($240,000 − $204,100) is subject to the 35% rate. Alternatively, if Allen has taxable income of $600,000, $89,700 ($600,000 − $510,300) is subject to the top marginal rate of 37%. ◀

A **proportional tax** rate, sometimes called a **flat tax**, is one where the rate of tax is the same for all taxpayers, regardless of the level of their tax base. This type of tax rate is generally used for real estate taxes, state and local sales taxes, personal property taxes, customs duties, and excise taxes. A flat tax has been the subject of considerable discussion over the past 30 years and promises to be a controversial topic as the debate on federal income tax reform continues into the future.

EXAMPLE I:1-3 ▶ Assume the same facts as in Example I:1-1, except that a 17% tax rate applies to all amounts of taxable income. Based on the assumed flat tax rate structure, Alice's federal income tax is $5,100 on $30,000 of taxable income; Allen's tax is $10,200 on $60,000 of taxable income and $20,400 on $120,000 of taxable income. The tax rate is proportional because the 17% rate applies to both taxpayers without regard to their income level. As you can see, a proportional tax rate results in lower taxes for higher income taxpayers and slightly higher taxes for other taxpayers.[4] ◀

[3] See the Quick Reference section of the text for the 2019 tax rates and Chapter I:2 for a discussion of the computation procedures. 2018 rate schedules and tax tables are located immediately before Appendix A.

[4] This example assumes the same tax base (taxable income) for the flat tax as with the current federal tax. Most flat tax proposals allow only a few deductions and, therefore, would generate higher taxes than in the example.

SELF-STUDY QUESTION

Assume a tax system with a tax of $1,000 on taxable income of $10,000 and a $1,500 tax on taxable income of $20,000. Is the tax rate system progressive, proportional, or regressive?

ANSWER

This tax system is regressive. Even though the amount of tax has increased, the rate of taxation has decreased from 10% on the first $10,000 of taxable income to 5% on the second $10,000 of taxable income.

ADDITIONAL COMMENT

In recent years, many countries around the world significantly reduced their tax rates on corporations. As a result, the top 35% tax rate in the United States was one of the highest statutory corporate rates in the world and led many U.S. corporations to move their international operations to other countries. For example, Ireland imposes a 12.5% rate on corporations.

A **regressive tax** rate decreases with an increase in the tax base (e.g., income). Regressive taxes, while not consistent with the fairness of the income tax,[5] are found in the United States. The Social Security (FICA) tax is regressive because a fixed rate of tax of 6.20% for OASDI for both the employer and employee is levied up to a ceiling amount of $132,900 for 2019. So, for example, assume Taxpayer A has income subject to Social Security of $80,000 and Taxpayer B income of $400,000. Taxpayer A's OASDI would be $4,960 ($80,000 × 0.062), Taxpayer B's OASDI would be $8,240 ($132,900 × 0.062). Taxpayer A's average rate of OASDI tax is 6.2% while Taxpayer B's average rate of tax is 2.06% ($8,240/$400,000). Sales taxes, which are levied by many states, are also regressive when measured against the income base.

THE STRUCTURE OF CORPORATE TAX RATES

Corporations are separate entities and are subject to income tax.[6] Beginning with the 2018 tax year, corporations are subject to a flat rate of 21%,[7] a rate that is a substantial reduction from the top rate for 2017 of 35%. For 2017 and many earlier years, the corporate tax rates were progressive in nature, ranging from 15% to 35%. The reduction in corporate tax rates for 2018 and future years were made for two principal reasons: (1) to make the corporate income tax rate in the United States more competitive with other countries around the world, and (2) to attempt to stimulate the economy and create jobs in the United States. Time will tell if this strategy for corporate income taxes is effective.

MARGINAL, AVERAGE, AND EFFECTIVE TAX RATES FOR TAXPAYERS

A taxpayer's **marginal tax rate** is the tax rate applied to an incremental amount of taxable income that is added to the tax base. The marginal tax rate concept is useful for planning because it measures the tax effect of a proposed transaction.

EXAMPLE I:1-4 ▶ Tania, who is single, is considering the purchase of a personal residence that will provide a $20,000 tax deduction for interest expense and real estate taxes in 2019. Tania's taxable income would be reduced from $185,000 to $165,000 if she purchases the residence. Because a 32% tax rate applies to her taxable income from $165,000 to $185,000, Tania's marginal tax rate is 32%. Thus, Tania's tax savings from purchasing the personal residence would be $6,400 (0.32 × $20,000). ◀

While the marginal tax rate measures the tax rate applicable to the next $1 of income or deduction for a taxpayer, there are two other tax rates that are used primarily by tax policymakers: average tax rate and effective tax rate. The **average tax rate** is computed by dividing the total tax liability by the amount of taxable income. This represents the average rate of tax for each dollar of taxable income. For example, a single taxpayer with taxable income of $550,000 in 2019 would incur a total tax liability of $168,488. The taxpayer's marginal tax rate is 37%, but his average tax rate is 30.6% ($168,488/$550,000).

[5] See the discussion of equity and fairness later in this chapter.

[6] See Chapter I:16 of this textbook for a more complete discussion of the taxation of C Corporations.

[7] Sec. 11(b).

ADDITIONAL COMMENT

One method of calculating economic income is to start with adjusted gross income (AGI), add back items of excludible income, such as tax-exempt bond interest, proceeds of life insurance policies, etc., and then deduct certain nondeductible business expenses, such as life insurance premiums, penalties and fines, etc.

The **effective tax rate** is the total tax liability divided by total economic income. **Total economic income** includes all types of economic income that a taxpayer has for the year. Thus, economic income is much broader than taxable income and includes most types of excludible income, such as tax-exempt bond interest, and generally permits business deductions but not personal-type deductions. It should be pointed out that economic income is *not* statutorily defined and experts may disagree on a precise calculation. The basic purpose of calculating the effective tax rate is to provide a broad measure of taxpayers' ability to pay taxes. Accordingly, the effective tax rate mainly is used by tax policymakers to determine the fairness of the income tax system.

EXAMPLE I:1-5 ▶ Amelia, who is single, has adjusted gross income of $140,000 and economic income of $175,000 in 2019. The difference is attributable to $35,000 of tax-exempt bond interest. If Amelia has personal deductions of $30,000, then her taxable income is $110,000, and her total tax is $20,575. Her average tax rate is 18.70% ($20,575 ÷ $110,000). Amelia's effective tax rate is 11.76% ($20,575 ÷ $175,000). Amelia's effective tax rate is considerably lower than her average tax rate because of her substantial amount of tax-exempt income. ◀

STOP & THINK

Question: Gwen, a single taxpayer, has seen her income climb to $190,000 in the current year. She wants a tax planner to help her reduce her tax liability. In planning for tax clients, tax professionals almost exclusively use the marginal tax rate in their analysis rather than the average tax rate. Why is the marginal tax rate much more important in the tax planning process than the average tax rate?

Solution: Because tax planning is done at the margin, a single taxpayer who has taxable income of $190,000 has a marginal tax rate of 32% (at 2019 rates), but an average tax rate of 22.17%, computed as follows:

Taxable income		$190,000
Tax on first $160,725 of taxable income		$32,749
Remaining taxable income	$29,275	
Times: Marginal tax rate	× 0.32	9,368
Total tax liability		$ 42,117

$$\text{Average tax rate} = \frac{\text{Total tax}}{\text{Taxable income}} = \frac{\$\ 42{,}117}{\$190{,}000} = 22.17\%$$

If a tax planner could reduce Gwen's taxable income by $10,000, Gwen's tax liability would decrease by $3,200 ($10,000 × 0.32). When the taxpayer wants to know how much she can save through tax planning, the appropriate marginal tax rate yields the answer.

Overall, estimated effective federal income tax rates for individuals have increased slightly during the period 2003–2012,[8] amounting to 12.6% in 2012 as compared with 9.1% in 2003. For the highest 20% of households, the effective individual income tax rate increased to 18.0% in 2012 from 14.4% in 2003. The effective tax rate for individuals in the United States is relatively low compared to most other industrialized countries.

ADDITIONAL COMMENT

In the determination of tax rates, one should consider the incidence of taxation that involves the issue of who really bears the burden of the tax. If a city raises the real property tax but landlords simply raise rents to pass on the higher taxes, the tax burden is shifted to their tenants. The concept has important implications in determining any kind of average or effective tax rate.

DETERMINATION OF TAXABLE INCOME AND TAX DUE

As will be discussed in later chapters, the federal income taxes imposed on all taxpayers (individuals, corporations, estates, and trusts) are based on the determination of taxable income. In general, taxable income is computed as follows:

Total income (income from whatever source derived)	$xxx
Minus: Exclusions (specifically defined items, such as tax-exempt bond interest)	(xx)

[8] Congressional Budget Office, *Effective Federal Tax Rates Under Current Law, 2001 to 2014* (Washington, DC: U.S. Government Printing Office, August, 2004), p. 10. The CBO uses the tax liability divided by comprehensive household income in computing effective tax rates.

Gross income	$xxx
Minus: Deductions (business expenses and itemized deductions)	(xx)
Taxable income	$xxx
Times: Applicable tax rate	× .xx
Income tax before credits	$xxx
Minus: Tax credits	(xx)
Total tax liability	$xxx
Minus: Prepayments	(xx)
Balance due or refund	$xxx

Each different type of taxpayer (individuals, corporations, etc.) computes taxable income in a slightly different manner, but all use the general framework above. An introductory discussion of the various types of taxpayers is provided later in this chapter. More detailed discussions of individual taxpayers (Chapter I:2) and corporation taxpayers (Chapter I:16) are examined in this *Individuals* book. Corporations, estates, and trusts are further examined in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts.*

Other Types of Taxes

OBJECTIVE 3

Describe the various types of taxes

State and Local Income and Franchise Taxes

In addition to federal income taxes, many states and local jurisdictions impose income taxes on individuals and businesses. These state and local taxes have gradually increased over the years and currently represent a significant source of revenue for state and local governments but also represent a significant tax burden on taxpayers.

State and local income taxes vary greatly in both form and rates.[9] Only seven states do not impose an individual income tax.[10] In most instances, state income tax rates are mildly progressive and are based on an individual's federal adjusted gross income (AGI), with minor adjustments.[11] For example, a typical adjustment to a state income tax return is interest income on federal government bonds, which is subject to tax on the federal return but is not subject to state income taxes. Some states also allow a deduction for federal income taxes in the computation of taxable income for state income tax purposes.

ADDITIONAL COMMENT

States that do not impose a state income tax depend on other taxes to support the government mission, principally sales taxes.

States imposing a state income tax generally require the withholding of state income taxes and have established mandatory estimated tax payment procedures. The due date for filing state income tax returns generally coincides with the due date for the federal income tax returns (e.g., the fifteenth day of the fourth month following the close of the tax year for individuals).

ADDITIONAL COMMENT

State income tax rates for individuals have increased significantly in the past 20 years. More than 23 states now have marginal tax rates of 6% or higher.

Most states impose a corporate income tax, although in some instances the tax is called a **franchise tax.** Franchise taxes for a particular state usually are based on a weighted-average formula consisting of net worth, income, and sales times modified federal taxable income.

Wealth Transfer Taxes

U.S. citizens are subject to taxation on certain transfers of property to another person. The tax law provides a unified transfer tax system that imposes a single tax on transfers of property taking place during an individual's lifetime (gifts) and at death (estates). (See the Quick Reference section of the text for the transfer tax rate schedules.) Formerly, the gift and estate tax laws were separate and distinct. The federal estate tax was initially enacted in 1916. The original gift tax law dates back to 1932. The gift tax was originally imposed to prevent widespread avoidance of the estate tax (e.g., taxpayers could make tax-free gifts of property before their death). Both the gift and estate taxes are wealth transfer taxes levied on the transfer

[9] For a thorough discussion of state and local taxes, see the chapter entitled *Multistate Income Taxation* that accompanies this textbook in electronic form on the Pearson Federal Taxation 2020 Web page at www.pearsonhighered.com/pearsontax.

[10] These states are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. New Hampshire has an income tax that is levied only on dividend and interest income and Tennessee's income tax applies only to income from stocks and bonds.

[11] See Chapter I:2 for a discussion of the AGI computation.

of property and are based on the fair market value (FMV) of the transferred property on the date of the transfer. Following are brief descriptions of the gift tax and estate tax.

KEY POINT

The $15,000 annual exclusion is an important tax-planning tool for wealthy parents who want to transfer assets to their children and thereby minimize their gift and estate taxes. A husband and wife who have three children could transfer a maximum of $90,000 [($15,000 × 2) × 3] to their children each year without incurring any gift tax.

The Federal Gift Tax. The **gift tax** is an excise tax that is imposed on the donor (not the donee) for transfers of property that are considered to be a taxable gift. A gift, generally speaking, is a transfer made gratuitously and with donative intent. However, the gift tax law has expanded the definition to include transfers that are not supported by full and adequate consideration.[12] To arrive at the amount of taxable gifts for the current year, a $15,000 (2019) annual exclusion is allowed per donee.[13] In addition, an unlimited marital deduction is allowed for transfers between spouses.[14] The formula for computing the gift tax is as follows:

FMV of all gifts made in the current year		$x,xxx
Minus: Annual donee exclusions ($15,000 per donee)	$xx	
Marital deduction for gifts to spouse	xx	
Charitable contribution deduction	xx	(xxx)
Plus: Taxable gifts for all prior years		xxx
Cumulative taxable gifts (tax base)		$x,xxx
Times: Unified transfer tax rates		× .xx
Tentative tax on gift tax base		$ xxx
Minus: Unified transfer taxes paid in prior years		(xx)
Unified credit		(xx)
Unified transfer tax (gift tax) due in the current year		$ xx

ADDITIONAL COMMENT

The gift tax was enacted to make the estate tax more effective. Without a gift tax, estate taxes could be easily avoided by large gifts made before death.

Note that the gift tax is cumulative over the taxpayer's lifetime (i.e., the tax calculation for the current year includes the taxable gifts made in prior years). The detailed tax rules relating to the gift tax are covered in Chapter C:12 in both *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* and the *Comprehensive* volume. The following general concepts and rules for the federal gift tax are presented as background material for other chapters of this text dealing with individual taxpayers:

- Gifts between spouses are exempted from the gift tax due to the operation of an unlimited marital deduction.
- The primary liability for payment of the gift tax is imposed on the **donor**. The donee is contingently liable for payment of the gift tax in the event of nonpayment by the donor.
- A donor is permitted a $15,000 annual exclusion for gifts of a present interest to each donee.[15]
- Charitable contributions are effectively exempted from the gift tax because an unlimited deduction is allowed.
- The tax basis of the property to the donee is generally the donor's cost. It is the lesser of the donor's cost and the property's FMV on the date of the gift if the property is sold by the donee at a loss. (See Chapter I:5 for a discussion of the gift tax basis rules.)
- A unified tax credit equivalent to an $11,400,000 deduction, adjusted for inflation, is available to offset any gift tax on taxable gifts that exceed the $15,000 annual exclusion.[16] The exclusion amount in 2018 was $11,180,000.

EXAMPLE I:1-6 ▶ Antonio makes the following gifts in the year 2019:

- $50,000 cash gift to his wife
- $20,000 contribution to the United Way

[12] Sec. 2512(b).

[13] Sec. 2503(b). The annual exclusion for gift tax purposes had been $10,000 for many years. However, for 2002–2005, the inflation adjustment increased the exclusion to $11,000, for 2006–2008, the exclusion was increased to $12,000, for 2009–2012 to $13,000, and for 2013–2017 to $14,000. For 2018 and later years, the current exclusion has been increased to $15,000.

[14] Sec. 2523(a).

[15] A gift of a present interest is an interest that is already in existence and the donee is currently entitled to receive the income from the property. A gift of a future interest comes into being at some future date (e.g., property is transferred by gift to a trust in which the donee is not entitled to the income from the property until the donor dies) and is not eligible for the $15,000 annual exclusion.

[16] The applicable exclusion amount had been $1,000,000 since 2002. Beginning in 2011, the exclusion was increased to $5,000,000, adjusted for inflation. Now, effective in 2019, the exclusion has been increased to $11,400,000. For further details, see *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*, 2020 Edition, Chapters C:12 and C:13.

- Gift of a personal automobile valued at $40,000 to his adult son
- Gift of a personal computer valued at $4,000 to a friend

The $50,000 gift to his wife is not taxed because of a $15,000 annual exclusion and a $35,000 marital deduction. The $20,000 contribution to the United Way is also not taxed because of the unlimited deduction for charitable contributions. The $40,000 gift Antonio made to his son is reduced by the $15,000 annual exclusion, leaving a $25,000 taxable gift.[17] The $4,000 gift to the friend is not taxed because of the annual exclusion of up to $15,000 in gifts to a donee in a tax year. Thus, total taxable gifts for the current year subject to the unified transfer tax are $25,000. ◀



Question: An important but frequently overlooked aspect of gift taxes is the interaction of gift taxes and income taxes. In many cases, gifts are made *primarily* for income tax purposes. Why would a gift be made for income tax purposes?

Solution: Gifts are frequently made to shift income from one family member to another family member who is in a lower marginal tax bracket. For example, assume Fran and Jan are married, have one 25-year-old son, earn $600,000 per year from their business, and generate $100,000 per year in dividends and interest from a substantial portfolio of stocks and bonds. With such a high level of income, Fran and Jan are in the 37% marginal tax bracket. If they make a gift of some of the stocks and bonds to their son, the dividends and interest attributable to the gift are taxed to the son at his marginal tax rate (maybe 10% or 12%). If the son's marginal tax rate is lower than 37%, the family unit reduces its overall income taxes.

The Federal Estate Tax. The **federal estate tax** is part of the unified transfer tax system that is based on the total property transfers an individual makes both during his or her lifetime and at death. The basic structure of the estate tax is shown in Example I:1-7.

EXAMPLE I:1-7 ▶

Amy dies during 2019. The formula for computing the estate tax on Amy's estate is as follows:

Gross estate (FMV of all property owned by the decedent at the date of death)		$xxx,xxx
Minus:	Deductions for funeral and administration expenses, debts of the decedent, charitable contributions, and the marital deduction for property transferred to a spouse	(x,xxx)
Taxable estate		$ x,xxx
Plus:	Taxable gifts made after 1976	xx
Tax base		$ x,xxx
Times:	Unified transfer tax rate(s)	× .xx
Tentative tax on estate tax base		$ xxx
Minus:	Tax credits (e.g., the unified tax credit equivalent to a $11,400,000 deduction in 2019)	(xx)
Gift taxes paid after 1976		(xx)
Unified transfer tax (estate tax) due		$ xx

◀

TYPICAL MISCONCEPTION

It is sometimes thought that the federal estate tax raises significant amounts of revenue, but it has not been a significant revenue producer since World War II. Only 11,917 estate tax returns were filed in 2015 generating approximately $17 billion in tax revenues. This amount represents about 1% of revenues generated by income taxes on individuals.

The federal estate tax has been on a roller coaster ride the last several years, with many changes and uncertainties. For a complete discussion of these developments, see *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts, 2020 Edition*, Chapter C:13. Since 2013, however, some certainty has been added to the estate tax law. The computation of the taxable estate and tax base (see Example I:1-7 above) is much the same as in prior years. However, the highest tax rate for tax years after 2012 has been increased to 40% from 35%. More importantly, the unified credit exclusion amount has been made permanent at $11 million per person and is indexed annually for inflation. For 2019, the unified credit exclusion amount is $11,400,000 ($11,180,000 for 2018). In essence, estates of individuals dying in 2019 generally will not be subject to estate taxes if their tax base is equal to or less

[17] This example assumes that the automobile is a gift rather than an obligation of support under state law and also assumes that Antonio's wife does not join with Antonio in electing to treat the gift to the son as having been made by both spouses (a gift-splitting election). If gift splitting was elected, donee exclusions of $30,000 (2 × $15,000) would be available, resulting in a taxable gift of only $10,000.

than $11,400,000. With this large exemption amount, most estates will not be subject to estate taxes.

The estate tax rules are discussed in more detail in Chapter C:13 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* and in the *Comprehensive* volume. The general rules discussed below are provided as background material for subsequent chapters of this text dealing with individual taxpayers:

- The decedent's property is valued at its FMV on the date of death unless the alternative valuation date (six months after the date of death) is elected. The alternative valuation date may be elected only if the aggregate value of the gross estate decreases during the six-month period following the date of death and the election results in a lower estate tax liability.
- The basis of the property received by the estate and by the decedent's heirs is the property's FMV on the date of death (or the alternate valuation date if it is elected).
- Property transferred to the decedent's spouse is exempt from the estate tax because of the estate tax marital deduction provision.
- The unified credit is $4,505,800, based on an exclusion amount of $11,400,000 and is computed as follows: [$345,800 + 0.40 (11,400,000 − 1,000,000)]. See the tax rates for estate and gift taxes in the Quick Reference section of the text.

EXAMPLE I:1-8 ▶ **Barry died in 2019, leaving a $12,000,000 gross estate. Of the $12,000,000 gross estate, one-half of the estate was transferred to his wife, administrative and funeral expenses are $30,000, Barry had debts of $200,000, and the remainder of the estate was transferred to his children. The estate tax due is computed as follows:**

Gross estate	$12,000,000
Minus: Marital deduction	(6,000,000)
Funeral and administrative expenses	(30,000)
Decedent's debts	(200,000)
Taxable estate	$5,770,000
Plus: Taxable gifts made after 1976	0
Tax base	$5,770,000
Tentative tax on estate tax base	$2,253,800[a]
Minus: Tax credits (unified tax credit—see above or Quick Reference for table)	(4,505,800)
Unified transfer tax due	$ —0— ◀

[a] $345,800 + [0.40 × ($5,770,000 − $1,000,000)]

Because of the generous credit and deduction provisions (e.g., the unified tax credit and the unlimited marital deduction), few estates are required to pay estate taxes. As can be seen above, the gross estate of the decedent was $12 million but no estate taxes were due primarily because of the large marital deduction and the unified credit. However, estate taxes arise, as is demonstrated below in Example I:1-9.

EXAMPLE I:1-9 ▶ **Assume the same facts for Barry as in Example I:1-8 except that Barry's gross estate is $30,000,000 rather than $12,000,000. The estate tax due is computed as follows:**

Gross estate	$30,000,000
Minus: Marital deduction	(15,000,000)
Funeral and administrative expenses	(30,000)
Decedent's debts	(200,000)
Taxable estate	$ 14,770,000
Plus: Taxable gifts made after 1976	0
Tax base	$ 14,770,000
Tentative tax on estate tax base	$ 5,853,800[b]
Minus: Tax credits (unified tax credit)	(4,505,800)
Unified transfer tax due	$ 1,348,000 ◀

[b] $345,800 + [0.40 × ($14,770,000 − $1,000,000)]

OTHER TYPES OF TAXES

ADDITIONAL COMMENT

Property taxes are a type of ad valorem tax, from the Latin phrase "according to value."

Although this text focuses primarily on the federal income tax, some mention should be made of the following other types of taxes levied by federal, state, and local governments.

- **Property taxes** are based on the value of a taxpayer's property, which may include both real estate and personal property. Real estate taxes are a major source of revenue for local governments. In addition, some state and local governments levy a personal property tax on intangibles such as securities and tangible personal property (e.g., the value of a personal automobile).
- **Federal excise taxes** and **customs duties** on imported goods have declined in relative importance over the years but remain significant sources of revenue. Federal excise taxes are imposed on alcohol, tobacco, gasoline, telephone usage, production of oil and gas, and many other types of goods. Many state and local governments impose similar excise taxes on goods and services.

ADDITIONAL COMMENT

Proposals to decrease reliance on the federal income tax have focused primarily on consumption taxes, such as a national sales tax or a value-added tax. A value-added tax basically is a sales tax levied at each stage of production on the "value added."

- **Sales taxes** are a major source of revenue for state and local governments. Sales taxes are imposed on retail sales of tangible personal property (e.g., clothing and automobiles). Some states also impose a sales tax on personal services (e.g., accounting and legal fees). Certain items often are exempt from the sales tax levy (e.g., food items or medicines), and the rates vary widely between individual state and local governments. Sales taxes generally are not deductible for federal income tax purposes. However, they are deductible if incurred in a trade or business. In addition, state and local sales taxes are deductible as an itemized deduction if the taxpayer elects to deduct them instead of deducting state and local income taxes.
- Employment taxes include Social Security (**FICA**) and federal and state unemployment compensation taxes. If an individual is classified as an employee, the FICA tax that is imposed on the employee is comprised of two parts: the old-age survivors, and disability insurance (OASDI) and the Medicare or hospital insurance (HI). The OASDI is 6.2% and is imposed on the first $132,900 (2019) of wages. This tax is imposed on both the employer and the employee at the same rate. Similarly, the HI portion is imposed on both the employer and the employee, but it has no ceiling on wages like the OASDI portion. In fact, the HI portion is generally 1.45% of wages, but beginning in 2013, the employee is required to pay an additional 0.9% on wages above $200,000 ($250,000 for married taxpayers filing a joint return). So while the employer will pay 1.45% on all wages, an employee who is single will pay 1.45% on the first $200,000 of wages and 2.35% on any wages over $200,000.

  If an individual is self-employed, a self-employment tax comprised of the OASDI and HI taxes is imposed. The OASDI portion is 12.4% on the individual's self-employment income of up to $132,900 (in 2019). The HI portion is 2.9% on the first $200,000 of self-employment income ($250,000 combined self-employment income for married taxpayers filing a joint return) and 3.8% (2.9% + 0.9%) on any self-employment income over that amount.

ADDITIONAL COMMENT

Revenue from employment taxes are indeed significant. In 2016, $1.115 trillion in employment taxes were collected, representing 34% of all Internal Revenue Service collections.

- Employers are required to pay federal and state unemployment taxes to fund the payment of unemployment benefits to former employees. The federal rate is 6.0% on the first $7,000 of wages for each employee in 2019.[19] However, a credit is granted for up to 5.4% of wages for taxes paid to the state government so that the actual amount paid to the federal government may be as low as 0.6%.[20] The amount of tax paid to the state depends on the employer's prior experience with respect to the frequency and amount of unemployment claims. In California, for example, the highest rate of unemployment tax imposed is 6.2% and this rate is subsequently adjusted down if the employer has a small number of unemployment claims to a minimum of 1.5%.

The types of taxes and structural considerations that were previously discussed are summarized in Topic Review I:1-1.

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[18] Self-employed individuals receive an income tax deduction equal to 50% of taxes paid on their self-employment income and this deduction is also allowed to compute the amount of self-employment income (see Secs. 164(f) and 1402(a)(12) and Chapter I:14).

[19] Sec. 3301.

[20] Sec. 3302. State unemployment taxes in some states are levied on tax bases above $7,000. For example, the wage base ceiling in North Carolina is $23,500 in 2018.

TOPIC REVIEW I:1-1

Types of Taxes and Tax Structure

Type of Tax	Tax Structure	Tax Base
Individuals:		
Federal income tax	Progressive	Gross income from all sources unless specifically excluded by law reduced by deductions and exemptions
State income tax	Progressive	Generally based on AGI for federal income tax purposes with adjustments
Federal gift tax	Progressive	FMV of all taxable gifts made during the tax year
Federal estate tax	Progressive	FMV of property owned at death plus taxable gifts made after 1976
Corporations:		
Federal corporate income tax	Progressive	Gross income from all sources unless specifically excluded by law reduced by deductions
State corporate income tax	Proportional or progressive	Federal corporate taxable income with adjustments
State franchise tax	Proportional	Usually based on a weighted-average formula consisting of net worth, income, and sales
Other Types of Taxes:		
Property taxes	Proportional	FMV of personal or real property
Excise taxes	Proportional	Customs and duties on imported and domestic goods from alcohol to telephone usage
Sales taxes	Proportional	Retail sales of tangible personal property or personal services
FICA and self-employment taxes	Regressive	Based on wages or self-employment income
Unemployment taxes	Regressive	Usually first $7,000 of an employee's wages

Criteria for a Tax Structure

OBJECTIVE 4

Discuss the criteria for a "good" tax structure, the objectives of the federal income tax law, and recent tax reform proposals

Establishing criteria for a "good" tax structure was first attempted in 1776 by economist Adam Smith.[21] Smith's four "canons of taxation"—equity, certainty, convenience, and economy—are still used today when tax policy issues are discussed. Many have added a fifth canon of simplicity. Below is a discussion of these criteria and how they relate to income taxes as well as other taxes.

EQUITY

A rather obvious criteria for a good tax is that the tax be equitable or fair to taxpayers. However, equity or fairness is elusive because of the subjectivity of the concept. What one person may conclude is fair in a particular situation may be considered totally unfair by another person. In other words, fairness is relative in nature and is extremely difficult to measure. For example, the deductibility of mortgage interest on a taxpayer's home certainly seems to be a fair provision for taxpayers. However, for taxpayers who do not own a home but live in a rental apartment, the deductibility of mortgage interest may not be considered as fair because the renter cannot deduct any portion of the rent paid. In other types of situations, the federal tax law includes various measures to ensure that taxpayers are treated fairly. For example, a foreign tax credit is available to minimize the double taxation that would otherwise occur when U.S. taxpayers earn income in a foreign country that is taxed by

[21] Adam Smith, *The Wealth of Nations* (New York: Random House, Modern Library, 1937), pp. 777–779.

KEY POINT

Using retroactive dates for changes in the tax law does not help to accomplish the objective of certainty. For example, the effective date of major changes in the estate tax was recently made on a retroactive basis. These retroactive changes created considerable uncertainty for taxpayers and their advisors.

both the United States and the country in which it is earned. (See the glossary at the end of this volume for a definition of tax credits and Chapter I:14 for a discussion of the foreign tax credit.) Two aspects of equity are commonly discussed in the tax policy literature, **horizontal equity** and **vertical equity**. Horizontal equity refers to the notion that similarly situated taxpayers should be treated equally. Thus, two taxpayers who each have income of $50,000 should both pay the same amount of tax. Vertical equity, on the other hand, implies that taxpayers who are not similarly situated should be treated differently. Thus, if Taxpayer A has income of $100,000 and Taxpayer B has income of $20,000, Taxpayers A and B should not pay the same amount of income tax. Vertical equity provides that the incidence of taxation should be borne by those who have the **ability to pay** the tax, based on income or wealth. The progressive rate structure is founded on the vertical equity premise.

CERTAINTY

A certain tax (1) ensures a stable source of government operating revenues and (2) provides taxpayers with some degree of certainty concerning the amount of their annual tax liability. A tax that is simple to understand and administer provides certainty for taxpayers. For many years, our income tax laws have been criticized as being overly complex and difficult to administer. Consider the remarks of a noted tax authority at a conference on federal income tax simplification:

> Tax advisers—at least some tax advisers—are saying that the income tax system is not working. They are saying that they don't know what the law provides, that the IRS does not know what the law provides, that taxpayers are not abiding by the law they don't know.[22]

While the above statement is 40 years old, it certainly is still viable today. This uncertainty in the tax law causes frequent disputes between taxpayers and the IRS and has resulted in extensive litigation.

ADDITIONAL COMMENT

Humorist Jim Boren has proposed a constitutional amendment that would require any retroactive tax increases to be followed by retroactive elections for president, vice president, and all members of Congress.

The federal tax system has made some attempts to provide certainty for taxpayers. For example, the IRS issues advance rulings to taxpayers, which provides some assurance concerning the tax consequences of a proposed transaction for the taxpayer who requests the ruling. The taxpayer may rely on the ruling if the transaction is completed in accordance with the terms of the ruling request. For example, if a merger of two corporations is being considered, the transaction can be structured so that the shareholders and the corporations do not recognize gain or loss. If a favorable ruling is received and the transaction is completed as planned, the IRS cannot later assert that the merger does not qualify for tax-free treatment.

CONVENIENCE

A tax law should be easily assessed, collected, and administered. Taxpayers should not be overly burdened with the maintenance of records and compliance considerations (preparation of their tax returns, payment of their taxes, and so on). The income tax in the United States does not fare well in this category, as the annual preparation of income tax returns as well as accumulation of underlying records is a formidable task. One of the reasons that the sales tax is such a popular form of tax for state and local governments is that it is convenient for taxpayers to pay and for the government to collect. The consumer need not complete a tax return or keep detailed records.

ADDITIONAL COMMENT

For tax year 2014, approximately 82 million tax returns were prepared by paid tax-return preparers. This represents approximately 55% of all tax returns filed.

ECONOMY

An economical tax structure should require only minimal compliance and administrative costs. The IRS collection costs, amounting to less than 0.5% of revenues, are minimal relative to the total collections of revenues from the federal income tax. Estimates of taxpayer compliance costs are less certain. One indicator of total compliance costs for taxpayers is the demand for tax professionals. Tax practice has been and continues to be one of the fastest growing areas in public accounting firms. Most large corporations also maintain sizable tax departments that engage in tax research, compliance, and planning activities. In addition, many commercial tax return preparer services are available to assist taxpayers who have relatively uncomplicated tax returns.

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[22] Sidney L. Roberts, "The Viewpoint of the Tax Adviser: An Overview of Simplification," *Tax Adviser*, January 1979, p. 32.

Complying with the tax laws is enormously expensive for both businesses and individuals in the United States. Americans will spend more than 8.9 billion hours complying with IRS tax filing requirements in 2016, and tax compliance will cost approximately $409 billion.[23] Compliance with state and local taxes costs billions more. Clearly, the cost of complying with the nation's tax laws is significant, in terms of both money and time. With some simplification for low and middle income taxpayers in the TCJA of 2017, compliance costs may decrease slightly for tax years after 2017.

A more difficult question is whether the tax structure is economical in terms of taxpayer compliance. The issues of tax avoidance and tax evasion are becoming increasingly more important. The IRS estimates the gross tax gap to be $458 billion, which is just over 18% of total taxes owed.[24] The tax gap is defined as the difference between the reported tax liability and the true tax liability.

SIMPLICITY

One of the important measures of any tax system is that of simplicity, or at least, not undue complexity. Taxpayers should be able to understand and comply with any tax system within reasonable boundaries. The sales tax is an example of a tax system that is relatively simple, although the sales tax as it applies to businesses can become fairly complex. The federal income tax system in the United States has become inordinately complex over the years and complexity is one of the major criticisms of the income tax. The following is a quote from the report from the President's Advisory Panel on Federal Tax Reform:[25]

> In short, our current tax code is a complicated mess. Instead of clarity, we have opacity. Instead of simplicity, we have complexity. Instead of fair principles, we have seemingly arbitrary rules. Instead of contributing to economic growth, it detracts from growth. Time and time again, witnesses told the Panel about these failings in the tax code.

While simplicity is an admirable goal of any tax system, achieving this goal in the federal income tax system is difficult and involves the trade-off of other important objectives. For example, simplicity and fairness are almost impossible to achieve together. If the income tax law is extremely simple, like a flat tax rate on all income, the possible result is that many taxpayers will not be treated fairly. Consider this case, two taxpayers, A and B both earn $100,000 per year and we have a flat rate tax of 20% so that each taxpayer will pay $20,000 in income taxes for the year. However, assume that taxpayer B has a severe illness that requires him to pay medical expenses of $60,000 per year. Should both A and B pay the same income tax for the year? There is no absolute correct answer in this case, it depends on your definition of fairness. Thus, making the income tax law simple may not be the top priority in tax reform.

OBJECTIVES OF THE FEDERAL INCOME TAX LAW

The primary objective of the federal income tax law is to raise revenues for government operations. In recent years, the federal government has broadened its use of the tax laws to accomplish various economic and social policy objectives.

ADDITIONAL COMMENT

Among the provisions in the tax law that are designed to enhance the level of health care are the deductibility of medical expenses, deductibility of charitable contributions to hospitals, and exclusion of fringe benefits provided by employers for medical insurance premiums and medical care.

Economic Objectives. The federal income tax law is used as a fiscal policy tool to stimulate private investment, reduce unemployment, and mitigate the effects of inflation on the economy. Consider the following example: Tax credits for businesses operating in distressed urban and rural areas (empowerment zones) are allowed to provide economic revitalization of such areas. This is a clear example of using the federal income tax law to stimulate private investment in specific areas.

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[23] Scott A. Hodge, "The Compliance Costs of IRS Regulations," Fiscal Fact No. 512, *Tax Foundation,* June 15, 2016.

[24] Internal Revenue Service Research, Analysis and Statistics, 2016, "Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2008-2010," Publication 1415 (Rev 5-2016), Internal Revenue Service, May.

[25] Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System*, November 2005, p. 2. See the discussion of tax reform in this chapter.

Many items in the tax law are adjusted for inflation by using the consumer price index, including the tax brackets and standard deduction amounts. These inflation adjustments provide relief for individual taxpayers who would otherwise be subject to increased taxes due to the effects of inflation. (See Chapter I:2 for a discussion of the tax computation for individuals.)

Encouragement of Certain Activities and Industries. The federal income tax law also attempts to stimulate and encourage certain activities, specialized industries, and small businesses. One such example is the encouragement of research activities by permitting an immediate write-off of expenses and a special tax credit for increasing research and experimental costs. Special incentives are also provided to the oil and gas industry through percentage depletion allowances and an election to deduct intangible drilling costs.

Certain favorable tax provisions are provided for small businesses, including reduced corporate tax rates of 21%. Favorable ordinary loss (instead of capital loss) deductions are granted to individual investors who sell their small business corporation stock at a loss, provided that certain requirements are met.[26] In addition, noncorporate investors may exclude up to 50% of the gain realized from the disposition of qualified small business stock if the stock is held for more than five years.[27]

Social Objectives. The tax law attempts to encourage or discourage certain socially desirable or undersirable activities. For example:

ADDITIONAL COMMENT

Deductible contributions made by self-employed individuals to their retirement plans (Keogh plans) totaled $24.7 billion in 2016. Charitable deductions totaled over $234 billion that same year.

- Special tax-favored pension and profit-sharing plans have been created for employees and self-employed individuals to supplement the social security retirement system.
- Charitable contributions are deductible to encourage individuals to contribute to charitable organizations.
- The claiming of a deduction for illegal bribes, fines, and penalties has been prohibited to discourage activities that are contrary to public policy.

EXAMPLE I:1-10 ▶ Able Corporation establishes a qualified pension plan for its employees whereby it makes all of the annual contributions to the plan. Able's contributions to the pension trust are currently deductible and not includible in the employees' gross income until the pension payments are distributed during their retirement years. Earnings on the contributed funds also are nontaxable until such amounts are distributed to the employees. ◀

EXAMPLE I:1-11 ▶ Anita contributes $10,000 annually to her church, which is a qualified charitable organization. Anita's marginal tax rate is 24%. Her after-tax cost of contributing to the church is only $7,600 [$10,000 − (0.24 × $10,000)]. ◀

EXAMPLE I:1-12 ▶ Ace Trucking Company incurs $10,000 in fines imposed by local and state governments for overloading its trucks during the current tax year. The fines are not deductible because the activity is contrary to public policy. ◀

The tax law objectives previously discussed are highlighted in Topic Review I:1-2.

Income Tax Reform. On December 22, 2017, President Donald J. Trump signed the TCJA into law. While controversial in nature and supported entirely by the Republicans in Congress, the TCJA is the law of the land. The new law focuses primarily on business taxation, with most of the tax cuts going to corporations.

[26] Sec. 1244.

[27] Sec. 1202.

TOPIC REVIEW I:1-2

Objectives of the Tax Law

Objective	Example
Stimulate investment	Provide a tax credit for the purchase of business equipment
Prevent taxpayers from paying a higher percentage of their income in personal income taxes due to inflation (bracket creep)	Index the tax rates and standard deduction for inflation
Encourage research activities that will in turn strengthen the competitiveness of U.S. companies	Allow research expenditures to be written off in the year incurred and offer a tax credit for increasing research and experimental costs
Encourage social objectives	Provide a tax deduction for charitable contributions; provide favorable tax treatment for contributions to qualified pension plans

However, individual taxpayers also have lower tax rates at every level, although relatively small. As mentioned earlier, supporters of the TCJA hope the new law will stimulate the economy and create jobs in a substantive way. Details of the TCJA are provided throughout the book where appropriate.

ENTITIES IN THE FEDERAL INCOME TAX SYSTEM

OBJECTIVE 5

Describe the tax entities in the federal income tax system

The federal income tax law levies taxes on taxpayers. However, not all entities that file income tax returns pay income taxes. For example, a partnership is required to file a tax return but does not pay any income tax because the income (or loss) of the partnership is allocated to the partners who report the income or loss on their individual tax returns. Therefore, the various entities in the federal income tax system may be classified into two general categories, *taxpaying entities* and *flow-through entities*.[28] Taxpaying entities generally are required to pay income taxes on their taxable income. Flow-through entities, on the other hand, generally do not directly pay income taxes but merely pass the income on to a taxpaying entity. The major entities in each category are as follows:

Taxpaying Entities	*Flow-through Entities*
Individuals	Sole proprietorship
C corporations (regular corporations)	Partnerships
	S corporations
	Limited Liability Company (LLC) or Limited Liability Partnership (LLP)
	Trusts

[28] Some entities have characteristics of both categories of entities, including certain types of trusts and S corporations.

Each of these entities is discussed below. The purpose of this section is to provide an overall picture of the various entities in the federal income tax system.

TAXPAYING ENTITIES

Individuals. Individual taxpayers are the principal taxpaying entities in the federal income tax system. In 2019, income taxes paid by individual taxpayers are expected to comprise nearly 50% of total federal revenues. If Social Security taxes are included, individual taxpayers will pay approximately 86% of total federal revenues (see Table I:1-1 for details). Thus, the study of taxation of individuals is a very important topic and is discussed extensively in this *Individuals* textbook.

Individuals pay income taxes on all gross income minus allowable deductions. Gross income minus allowable deductions is referred to as *taxable income*. Gross income subject to taxation may be broadly classified into three categories:

- Earned income from sources such as salaries and wages, business income, and retirement income.
- Investment income, including interest income, dividends, capital gains, and rents and royalties.
- Flow-through income from partnerships, limited liability companies (LLCs), Subchapter S corporations, estates, and trusts.

Allowable deductions include expenses attributable to the gross income above and certain personal deductions specifically allowed under the tax law. Gross income and allowable deductions are discussed in detail later in this textbook.

The TCJA 2017 made significant changes to the computation of taxable income for individual taxpayers for taxable years beginning after December 31, 2017. Individual taxpayers use the tax formula below to compute their taxable income in 2019:

Total income, from whatever source derived	$xxx
Minus: Exclusions, as provided in the tax law	(xxx)
Gross income	xxx
Minus: Deductions for adjusted gross income	(xxx)
Adjusted gross income (AGI)	xxx
Minus: Deductions from AGI:	
Greater of itemized deductions or standard deduction	(xxx)
Qualified Business Income Deduction	(xxx)
Taxable income	$xxx

Exclusions are items of income that the tax law specifically exempts from taxation. They include such items as gifts, inheritances, interest income from state and local bonds, loans, and life insurance proceeds. Exclusions are discussed in Chapter I:4.

Once an individual determines that an expenditure is allowed as a deduction for tax purposes, he or she must classify the deduction as *for* AGI or *from* AGI. This classification is very important and is discussed in Chapter I:6. Deductions *for* AGI basically are (1) expenses connected with a taxpayer's business or rental property, or (2) other specified deductions, such as contributions to an Individual Retirement Account (IRA) and a number of other specific items. Deductions *from* AGI are either itemized deductions or the standard deduction, whichever is greater. Itemized deductions primarily are personal-type deductions of the taxpayer, such as medical expenses, state and local taxes, mortgage interest, and charitable contributions. Itemized deductions are discussed in Chapter I:8. The standard deduction is a set amount that all taxpayers may deduct. For 2019, the standard deduction is $12,200 ($24,400 for married couples filing a joint return) and is indexed annually for inflation. Thus, if a single taxpayer's itemized deductions for 2019 were $10,000, the taxpayer would deduct the standard deduction of $12,200 instead. On the other hand, if the taxpayer's itemized deductions were $14,000, the taxpayer would deduct $14,000 because that amount exceeds the standard deduction.

Personal and dependency exemptions were allowed prior to 2018. However, the TCJA eliminated these as deductions for individual taxpayers.

Once taxable income is determined, tax rates are applied to this amount to arrive at the income tax liability for the year. Certain credits are allowed that reduce the income tax liability on a dollar-for-dollar basis. Individual income tax rates may be found in the Quick Reference section of the text. Because individuals are subject to withholding and estimated tax payment rules, they may pay a balance due or receive a refund upon filing their tax return.

Individual taxpayers are required to file a tax return annually, Form 1040, which is due on or before April 15 of the year following the taxable year. As can be seen from the tax rate schedules located in the Quick Reference section of the text, rates range from 10% to 37%.

EXAMPLE I:1-13 ▶ Jeff Payne, a single taxpayer, is employed by a large corporation and has the following information for the current year of 2019:

INCOME AND OTHER RECEIPTS	
Salary from corporation	$120,000
Interest income from savings account	13,000
Interest on New York City bond	600
Loan from bank	20,000
Share of income from a partnership in which Jeff is a partner	8,600
Gift from Jeff's grandmother	11,000
Total	$173,200
DEDUCTIONS AND PAYMENTS	
Itemized deductions	17,000
Federal income taxes withheld from salary	25,000

Jeff's taxable income and income tax liability for 2019 would be computed as follows:

Total income		$173,200
Minus: Exclusions:		
Interest on New York City bond	$ 600	
Loan from bank	20,000	
Gift from Jeff's grandmother	$11,000	(31,600)
Gross income		141,600
Minus: Deductions for AGI		0
Adjusted gross income (AGI)		141,600
Minus: Deductions from AGI:		
Itemized deductions		(17,000)
Taxable income		$124,600

The itemized deductions of $17,000 exceed Jeff's allowable standard deduction for 2019 of $12,200 and, therefore, are used to reduce taxable income.

To compute Jeff's income tax liability for the year, the 2019 rate schedules in the Quick Reference section of the text are used. Jeff's income tax liability (using single taxpayer rates) would be $24,079 [$14,383 + 0.24($124,600 − $84,200)]. Since Jeff had $25,000 of federal income taxes withheld from his salary, he would be entitled to a tax refund of $921 ($25,000 − $24,079). ◀

Some types of income are taxed at lower rates. For example, dividends from most U.S. corporations are subject to a maximum rate of 20%. This 20% maximum rate also applies to long-term capital gains, such as gains on the sale of stocks and bonds. With these lower rates, a high-income taxpayer in the 37% marginal tax bracket would only pay a maximum of 20% on any qualified dividends received or long-term capital gains. The remainder of the taxpayer's income would be subject to the higher rates. Taxpayers whose tax rates are below the 37% top rate generally are subject to a maximum tax rate of 15% on qualified dividends and long-term capital gain.

C Corporations. C corporations, many times referred to as regular corporations, also are taxpaying entities. These corporations, both publicly-held corporations traded on stock exchanges and privately-owned corporations, accounted for approximately 7% of total federal revenues in 2019. The percentage of federal revenues provided by C corporations has been steadily declining over the past 40 years, a concern of tax policymakers as more and more taxes are being shifted to individual taxpayers. A major disadvantage of C corporations is they are subject to so-called double taxation. Double taxation results from the corporation paying income tax on its taxable income and shareholders paying income tax on any dividends received from the corporation or on the gain from selling their stock in the corporation. Thus, the same corporate income is subjected to taxation twice—once at the corporate level and again at the shareholder level. For many years, much tax planning has been directed at trying to so arrange the tax affairs of a C corporation to avoid double taxation. This discussion of C corporations is divided into two parts, (1) taxation of C corporations and (2) the operation of double taxation.

Taxation of C Corporations. C corporations are taxed on their taxable income in a manner similar to individuals. The major difference between corporations and individuals is that corporations are not allowed personal deductions. Thus, the concept of AGI does not pertain to corporations. Taxable income for corporations is computed as follows:

Total income, from whatever source derived	$xxx
Minus: Exclusions, as provided in the tax law	(xxx)
Gross income	xxx
Minus: Deductions (ordinary and necessary expenses related to the corporation's trade or business)	(xxx)
Taxable income	$xxx

This taxable income is subject to a flat tax rate of 21%. A more detailed discussion of corporation taxation is contained in Chapter I:16 of this *Individuals* textbook and Chapter C:3 of the *Corporations, Partnerships, Estates, and Trusts* volume.

EXAMPLE I:1-14 ▶ During the current taxable year, Crimson Corporation generated gross income of $1,500,000 and had ordinary and necessary deductions of $900,000, resulting in taxable income of $600,000. Based on the corporation rates, Crimson would be subject to taxes of $126,000 ($600,000 × 21%). ◀

C corporations are required to file tax returns annually using Form 1120, which is generally due on or after the 15th day of the fourth month after the close of the corporation's tax year (e.g., April 15 for calendar year taxpayers).

Double Taxation of C Corporation Earnings. As mentioned previously, C corporations are subject to double taxation. The corporation pays income tax on its taxable income and then shareholders must pay income tax on any dividends paid by the corporation or on the sale of their stock. Under current tax laws, the impact of double taxation has been substantially decreased by reducing to zero, 15% or 20% the maximum tax rate on most corporate dividends received by individuals. Prior to this reduction in tax rates on qualified dividends, dividends were subject to tax at regular tax rates. Single taxpayers who have taxable income of less than $39,375 have a 0% tax rate on qualified dividends. Single

ADDITIONAL COMMENT

It should be noted that individual taxpayers may also be subject to an additional 3.8% Medicare tax on the dividends as part of a net investment income tax.

taxpayers who have taxable income of more than $39,375 but less than $434,550 pay a marginal tax rate of 15% on qualified dividends while taxpayers who have taxable income of greater than $434,550 pay a marginal tax rate of 20% on qualified dividends. Thus, under current tax law, a single taxpayer with taxable income of $400,000 has a marginal tax rate of 35% on ordinary income but pays only a 15% tax rate on any dividends received. The same reduced tax rates apply to long-term capital gains on the sale of their corporate stock. The Quick Reference section of the text has the income level cutoffs for the other filing statuses.

EXAMPLE I:1-15 ▶ Using the same facts for Crimson Corporation in Example I:1-14, assume the corporation paid dividends to shareholders during 2019 of $400,000. Further assume that the taxable income of the shareholders is such that they pay a tax rate of 15% on qualified dividends. The shareholders collectively would have to pay individual income taxes of $60,000 ($400,000 × 15%) as the tax rate on qualified dividends is 15%. The total tax on the corporation's taxable income of $600,000, therefore, would be $186,000 ($126,000 paid by Crimson Corporation plus $60,000 paid by the shareholders), or an effective tax rate of 31% ($186,000/$600,000). The 31% is only federal income taxes and does not include any state or local income taxes that the corporation may have to pay. ◀

The double taxation of dividends paid by C corporations has long been criticized as creating income taxes that are too high. Before 2018, corporations were subject to income taxes as high as 35%, and then individuals would typically be taxed on dividends received at rates of 15% to 20%. This so-called "double taxation" could create total taxes of 55% (35% + 20%) on the same income. However, with the corporate rate reduced to 21% in 2018 under the TCJA, the combined taxes are not nearly as onerous as in prior years.

FLOW-THROUGH ENTITIES

The simplest form of a flow-through entity is the sole proprietorship as there are no formal requirements to form such an entity. The net income earned by the proprietor is reported on Schedule C of Form 1040. Thus, the income of the sole proprietorship merely flows to the proprietor's individual tax return. The net income of the sole proprietorship is subject to income tax only once (at the individual level) but is also subject to self-employment tax (Social Security and Medicare taxes).

Flow-through entities, such as partnerships, limited liability companies (LLCs), limited liability partnerships (LLPs), and S corporations have the major advantage of being subject to only one level of taxation. All of these entities file tax returns, but, in general, the entities do not pay any income taxes. The income earned by the entity is allocated to the owners based on their proportionate ownership or some other allocation arrangement. Thus, the entity income tax return is really just an information return. The income allocated to the owners is then reported on their own tax returns. The income of the entity, therefore, is subject to a single level of taxation. This single level of tax is a major advantage of the flow-through form over C corporations.

As a result of the TCJA, to better equalize the tax breaks given to C corporations (i.e., 21% tax rate), most flow-through entities may deduct 20% of qualified business income (QBI). Qualified Business Income is net income from business activities and does not include investment income (interest, dividends, etc.).

EXAMPLE I:1-16 ▶ Assume AB Partnership is in the wholesale hardware business and A and B are 50-50 partners. During 2019, the AB Partnership had gross business receipts of $1,000,000 and business deductions of $400,000, resulting in net income of $600,000. The partnership also had interest and dividend income of $50,000. Based on the above information, AB partnership would have qualified business income (QBI) of $600,000 as the $50,000 of interest and dividends is not part of QBI. Therefore, each partner would be entitled to a 20% deduction of their share of QBI, or $60,000 ($600,000 × 50% × 20%). There are several limitations on the 20% deduction, primarily a limitation based on W-2 wages, and the deduction is not allowed for personal service activities, such as lawyers, accountants, etc. The deduction and limitations are discussed in other areas of this textbook. ◀

To ensure a single level of taxation for flow-through entities, the tax law employs a unique method of basis adjustments. Every owner of the entity has an *adjusted basis* (basis) in his or her ownership interest. An owner's basis in a flow-through entity is determined as follows:

- Each owner obtains an original basis in his or her ownership interest upon the formation of the entity (investment in the entity) or purchase of the interest.
- The owner's basis increases for any additional capital contributions to the entity in subsequent years.
- The owner's basis increases for the owner's share of income for tax purposes or decreases for losses.
- The owner's basis increases for the owner's share of entity liabilities. Differences exist between partnerships and S corporations as to which liabilities are added to an owner's basis. Details on this topic are covered in later chapters of this textbook.
- The owner's basis decreases for money or property distributed to the owner by the entity.

Without these basis adjustments, the owner could be subject to double taxation upon selling his or her interest or upon dissolution of the entity. Practitioners refer to this basis as "outside basis" as opposed to "inside basis," which is the entity's basis in its assets.

EXAMPLE I:1-17 ▶ Wildcat Company is a flow-through entity with two owners, Rich and Teresa. Each owner has a $10,000 original basis in the entity. In its first year of operations, Wildcat Company earns $50,000, which is allocated $25,000 to each owner. Thus, each owner reports $25,000 in his individual income tax return even though the entity does not distribute any of the earnings to the owners. At the beginning of the second year, Rich sells his interest to Steve for $35,000. If Rich did not get an increased basis adjustment for his $25,000 of earnings, he would recognize a $25,000 gain ($35,000 selling price − $10,000 basis in the entity) on the sale of his interest, which taxes him twice on the $25,000. However, both Rich and Teresa do increase their bases to $35,000 ($10,000 original basis + $25,000 share of entity earnings) at the end of the first tax year. Therefore, when Rich sells his interest for $35,000, he incurs no additional taxable gain ($35,000 selling price − $35,000 basis in the entity = $0 gain). ◀

Below is a brief description of the four basic types of flow-through business entities.

Partnerships. A partnership is the classic flow-through entity as it has been around the longest. The Internal Revenue Code (IRC) defines a partnership as "a syndicate, group, pool, joint venture, or other incorporated organization" that carries on any business, financial operation, or venture.[29] Thus, if two or more individuals, corporations, trusts, or estates decide to operate a business or financial venture, the business or venture can be classified as a partnership. Unlike a corporation, which must file incorporation documents with the state, partnerships require no legal documentation. However, tax advisors strongly advise partnerships to have written agreements as to the operation of the partnership and how income, deductions, losses, and credits will be allocated to the partners. Most states have laws that govern the rights and restrictions of partnerships and their partners.

Partnerships file an annual income tax return which is just an information return because the partnership entity is not subject to taxation. The return, Form 1065 (U.S. Partnership Return of Income), reports the results of the partnership's operations. An accompanying form, Schedule K-1, reports the separate income, deductions, losses, and credits that flow through to the partners. The partners, in turn, take the information from their Schedule K-1 and report the various items on their individual returns.

EXAMPLE I:1-18 ▶ Donald and Minnie form a real estate company and decide to operate as a partnership, the DM Partnership. Donald is a 60% partner and Minnie is a 40% partner. Donald invests $60,000 into DM and Minnie contributes real estate with a basis and fair market value of $40,000. In its first year of operation, DM Partnership earns ordinary income of $150,000. The partnership files Form 1065 and reports the $150,000 but is not subject to any income taxation. Included in the

[29] Sec. 761(a).

partnership return are two Schedule K-1s that report $90,000 to Donald ($150,000 × 60%) and $60,000 ($150,000 × 40%) to Minnie. Donald reports $90,000 on his individual income tax return, Form 1040, and Minnie reports $60,000 on her individual return. If the partnership distributed $72,000 to Donald and $48,000 to Minnie during the year, the distributions are considered a return of capital and are not taxable to either partner. Donald's adjusted basis in his partnership interest would be $78,000 ($60,000 + $90,000 − $72,000) and Minnie's adjusted basis would be $52,000 ($40,000 + $60,000 − $48,000). ◀

S Corporations. S corporations are a special form of corporation treated by the tax laws as flow-through entities. They are incorporated under state law just as any other corporation but, if they so elect, are treated as flow-through entities for tax purposes. S corporations are so named because the rules pertaining to this type of entity are located in Subchapter S of the IRC. S corporations have been referred to as "corporations taxed like a partnership." Although this statement is partially true, important differences exist, such as a limitation on the number of shareholders, strict rules on allocation of income or losses, and several other differences. Similar to partnerships, S corporations are not taxed and income, deductions, losses, and credits flow through to its shareholders. Allocations of income, deductions, losses, and credits to shareholders are based on a per share–per day basis. Importantly, S corporation shareholders enjoy limited liability, as do C corporation shareholders.

To achieve S corporation status, the corporation must file an S election and all of its shareholders must consent to that election. S corporations annually file an information return, Form 1120S (U.S. Income Tax Return for an S Corporation), which reports the results of the corporation's operations and, like partnerships, also submits Schedule K-1 to each shareholder which reports the allocable share of income, deduction, loss, and credit that flow through to each shareholder.

Similar to partnerships, S corporations impose only a single level of taxation to its shareholders and the tax law uses basis adjustments to achieve this single level of taxation. The basis adjustments for S corporation shareholders are nearly identical to those for partnerships. The major difference is how liabilities affect the basis of S corporation shareholders. S corporation shareholders obtain basis only for *direct* loans to the corporation and they treat their debt basis separately from stock basis. Partners of a partnership generally increase their basis for all partnership liabilities.

EXAMPLE I:1-19 ▶ Paul and Peter form a corporation in Ohio as equal shareholders. Upon advice from their tax advisor, they decide to elect S corporation status for federal and state tax purposes and file the necessary forms. Both Paul and Peter invest $25,000 in the corporation and each receives 100 shares of common stock of the corporation. During the first year, the corporation reports net ordinary income of $62,000 and a long-term capital gain of $10,000 of Form 1120S. Each shareholder receives a $20,000 distribution from the corporation during the year. In Year 1, the corporation pays no federal or state income taxes, but both Paul and Peter report $31,000 of ordinary income and $5,000 of long-term capital gain on their individual returns. Since the shareholders have sufficient basis, the $20,000 distribution to each shareholder is not subject to taxation. Paul and Peter would each have a basis in their S corporation stock of $41,000 ($25,000 + $31,000 + $5,000 − $20,000) at the end of Year 1. ◀

EXAMPLE I:1-20 ▶ In Year 2, the corporation earns $74,000 of ordinary income and no capital gains. Also, on July 1 of Year 2, Peter sells one-half (50 shares) of his stock to Mary. So, from July 1 to December 31, Paul owns 50% of the corporate stock and Peter and Mary each own 25%. S corporation earnings must be allocated on a per share–per day basis, so the income of $74,000 is allocated to each shareholder as follows:

Paul	$74,000 × 365/365 × 50% = $37,000
Peter	($74,000 × 181/365 × 50%) + ($74,000 × 184/365 × 25%) = $27,674
Mary	$74,000 × 184/365 × 25% = $9,326

◀

Limited Liability Companies. A limited liability company (LLC) is a legal entity under the laws of all 50 states and the District of Columbia and is a very popular organizational form. LLCs combine the best features of a partnership and a corporation by

being treated as a partnership while providing the limited liability protection of a corporation. Thus, LLC owners, called members, are subject to a single level of taxation and are not liable for the liabilities of the LLC.

An LLC is formed under state law similar to a corporation. After formed, the LLC elects whether to be taxed either as a partnership or a corporation.[30] Under Treasury Regulations, an LLC with more than one member is treated as a partnership unless the LLC affirmatively elects to be classified as a corporation. In most cases, LLCs will prefer to be classified as a partnership because of the tax advantages of a single level of taxation. If an LLC elects to be treated as a partnership, it files its tax return on Form 1065 (U.S. Partnership Return of Income). The LLC, however, is not legally a partnership; it is just treated as one for federal income tax purposes. A single member LLC is disregarded for tax purposes and the LLC income, deductions, etc. are reported directly on the member's Schedule C of Form 1040 as a sole proprietor. If an LLC elects to be taxed as a corporation under the Treasury Regulations, it would file Form 1120 (U.S. Corporation Income Tax Return). Further, S corporation status can be achieved by electing to be taxed as a corporation and then make an S election. Thus, the LLC would be considered an LLC for state law purposes but an S corporation for income tax purposes.

EXAMPLE I:1-21 ▶ Karen and David start a wholesale business and decide to operate the business as an LLC. They first must legally form the organization under state law. After the LLC is legally formed, they must decide how the LLC will be treated for income tax purposes. Because they want a single level of taxation, Karen and David elect to be treated as a partnership. Since being treated as a partnership is the default classification under Treasury Regulations, no forms need to be filed with the IRS. At the end of the first year, the LLC will file a Form 1065 and check the box indicating that the entity is an LLC filing as a partnership. All partner allocations, basis adjustments, and all other tax rules for the LLC are identical with partnership rules. ◀

Limited Liability Partnerships. All 50 states and the District of Columbia have statutes that allow a business to operate as a limited liability partnership (LLP). Basically, an LLP is similar to an LLC except that a partner of an LLP *is not* liable for any liability arising from acts of negligence or misconduct or similar acts of another partner of the LLP. Thus, an LLP is much more desirable than a general partnership where partners are liable for all partnership liabilities. Professional service organizations, such as many CPA firms, have adopted the LLP form, primarily to limit legal liability.

EXAMPLE I:1-22 ▶ The accounting firm of Gartman & Kuhn, CPAs, is operating as a general partnership and has 20 partners in the firm. The firm is concerned about the unlimited liability that exists for the partnership, especially in today's litigious environment. The firm decides to convert from a partnership to an LLP. The conversion is simple and tax-free,[31] and protects the partners of the new LLP entity against liabilities of the LLP arising from acts of negligence or misconduct of other partners or employees. ◀

OTHER ENTITIES

Trusts. Trusts are somewhat of a hybrid entity in that they may either be a taxpaying entity or flow-through entity. Also, there are a number of different types of trusts, so the discussion here is very general in nature. Trusts typically are subject to income taxation on all of its net income that is *not* distributed to the beneficiaries. The portion of net income that is distributed to beneficiaries is taxed to the beneficiaries. One drawback to the use of trusts is that the income tax rates are extremely progressive, reaching the 37% bracket when the taxable income of the trust reaches $12,750 in 2019. Trusts use Form 1041 to file its tax information.

EXAMPLE I:1-23 ▶ Ben establishes a trust for the benefit of his daughter. The principal amount of the trust is $500,000 and is projected to earn approximately 10% per year. In the current year, the trust earned $50,000 of investment income and had $5,000 of expenses. If the trust did not make any

[30] The LLC makes the election pursuant to the "check-the-box" Regulations, Reg. Secs. 301.7701-1 through -4.

[31] Rev. Rul. 95-37, 1995-1 C.B. 130.

distributions during the year to the daughter, the entire $45,000 (less a small exemption) would be subject to income taxation to the trust. Much of the taxable income would be subject to taxation at the 37% rate. Alternatively, if the trust distributed the entire $45,000 to the daughter, she would report the $45,000 on her individual tax return. Assuming she does not have significant other income, she would most likely be in the 22% marginal tax bracket. The trust's taxable income would be zero and would have no income tax liability. ◀

TAX LAW SOURCES

OBJECTIVE 6

Identify the various tax law sources and understand their implications for tax practice

The solution to any tax question may only be resolved by reference to tax law sources (also referred to as tax law authority). Tax law sources are generated from all three branches of the federal government, i.e., legislative, executive, and judicial. The principal sources of tax law are as follows:

Branch	*Tax Law Source*
Legislative	Internal Revenue Code
	Congressional Committee Reports
Executive (Administrative)	Income Tax Regulations
	Revenue Rulings
	Revenue Procedures
	Letter Rulings
Judicial	Court Decisions

ADDITIONAL COMMENT

Knowledge of tax law sources could be considered the most important topic in this book. It is similar to the old Chinese proverb that states that if you give a person a fish you have fed him for one day, but if you teach a person how to fish you have fed him for the rest of his life. By analogy, if a person has a knowledge of the tax law sources, he or she should be able to locate the answers to tax questions throughout his or her career.

A thorough knowledge of the various sources above as well as the relative weights attached to each source is vital to tax professionals. Because of the vast volume of tax law sources, the ability to "find an answer" to a tax question is of fundamental importance. In addition, the evaluation of the weight (or importance) of different sources of authority is also crucial in arriving at a proper conclusion. For example, a decision of the U.S. Supreme Court on a tax matter would certainly carry more weight than a Revenue Ruling issued by the Internal Revenue Service.

Clearly, the most authoritative source of tax law is the Internal Revenue Code, which is the tax law passed by Congress. However, Congress is not capable of anticipating every type of transaction that taxpayers might engage in, so most of the statutes in the Code contain very general language. Because of the general language contained in the Code, both administrative and judicial interpretations are necessary to apply the tax law to specific situations and transactions. Thus, the regulations and rulings of the IRS and the decisions of the courts are an integral part of the federal income tax law. For a detailed discussion of tax law sources, see Chapter I:15 (Chapter C:1 of the *Comprehensive* edition). Topic Review I:1-3 provides an overview of the tax law sources.

ENACTMENT OF A TAX LAW

OBJECTIVE 7

Describe the legislative process for the enactment of the tax law

Under the U.S. Constitution, the House of Representatives is responsible for initiating new tax legislation. However, tax bills may also originate in the Senate as riders to nontax legislative proposals. Often, major tax proposals are initiated by the President and accompanied by a Treasury Department study or proposal, and then introduced into Congress by one or more representatives from the President's political party.

STEPS IN THE LEGISLATIVE PROCESS

The specific steps in the legislative process are discussed below and are summarized in Table I:1-2. These steps typically include:

1. A tax bill is introduced in the House of Representatives and is referred to the House Ways and Means Committee.
2. The proposal is considered by the House Ways and Means Committee, and public hearings are held. Testimony may be given by members of professional groups such

TOPIC REVIEW I:1-3

Tax Law Sources

Source	Key Points	Weight of Authority
LEGISLATIVE		
Internal Revenue Code	Contains provisions governing income, estate and gift, employment, alcohol, tobacco, and excise taxes.	Serves as the highest legislative authority for tax research, planning, and compliance activities.
ADMINISTRATIVE		
Treasury Regulations	Represents interpretations of the tax code by the Secretary of the Treasury. Regulations may be initially issued in proposed, temporary, and final form and may either be interpretative or legislative in nature.	Legislative regulations have a higher degree of authority than interpretative regulations. Proposed regulations do not have authoritative weight.
IRS Rulings	The IRS issues Revenue Rulings (letter rulings or published rulings), Revenue Procedures, Information Releases, and Technical Advice Memoranda.	These pronouncements reflect the IRS's interpretation of the law and do not have the same level of scope and authority as Treasury Regulations.
JUDICIAL		
Judicial doctrines	Judicial doctrines are concepts that have evolved from Supreme Court cases that are used by the courts to decide tax issues. Examples include substance over form, tax benefit rule, and constructive receipt.	Judicial doctrines that evolve from Supreme Court cases have substantial weight of authority because they have the force and effect of law.
Judicial interpretations	Tax cases are initially considered by a trial court (i.e., the Tax Court, a Federal district court, or the U.S. Court of Federal Claims). Either the taxpayer or the IRS may appeal to an appeals court. A final appeal is to the U.S. Supreme Court.	A trial court must abide by the precedents set by the court of appeals of the same jurisdiction. An appeals court is not required to follow the decisions of another court of appeals. A Supreme Court decision is the "law of the land."

ADDITIONAL COMMENT

Rep. Richard Neal of Massachusetts is the chairman of the House Ways and Means Committee, and the chairman of the Senate Finance Committee is Sen. Chuck Grassley of Iowa.

as the American Institute of CPAs and the American Bar Association and from various special-interest groups.

3. The tax bill is voted on by the House Ways and Means Committee and, if approved, is forwarded to the House of Representatives for a vote. Amendments to the bill from individual members of the House of Representatives are generally not allowed.
4. If passed by the House, the bill is forwarded to the Senate for consideration by the Senate Finance Committee, and public hearings are held.
5. The tax bill approved by the Senate Finance Committee may be substantially different from the House of Representatives' version.
6. The Senate Finance Committee reports the Senate bill to the Senate for consideration. The Senate generally permits amendments (e.g., new provisions) to be offered on the Senate floor.
7. If approved by the Senate, both the Senate and House bills are sent to a Joint Conference Committee consisting of an equal number of members from the Senate and the House of Representatives.
8. The Senate and House bills are reconciled in the Joint Conference Committee. This process of reconciliation generally involves substantial compromise if the provisions of both bills are different. A final bill is then resubmitted to the House and Senate for approval.
9. If the Joint Conference Committee bill is approved by the House and Senate, it is sent to the President for approval or veto.
10. A presidential veto may be overturned if a two-thirds majority vote is obtained in both the House and Senate.

HISTORICAL NOTE

For many years, only a few members of Congress were CPAs. This trend is changing. As of December 2015, ten members of the House of Representatives and two members of the Senate are CPAs.

▼ TABLE I:1-2
Steps in the Legislative Process

1. Treasury studies prepared on needed tax reform
2. President makes proposals to Congress
3. House Ways and Means Committee prepares House bill
4. Approval of House bill by the House of Representatives
5. Senate Finance Committee prepares Senate bill
6. Approval of Senate bill by the Senate
7. Compromise bill approved by a Joint Conference Committee
8. Approval of Joint Conference Committee bill by both the House and Senate
9. Approval or veto of legislation by the President
10. New tax law and amendments incorporated into the Code

11. Committee reports are prepared by the staffs of the House Ways and Means Committee, the Senate Finance Committee, and the Joint Conference Committee as the bill progresses through Congress. These reports help to explain the new law before the Treasury Department drafts regulations on the tax law changes as well as to explain the intent of Congress for passing the new law.

ADMINISTRATION OF THE TAX LAW AND TAX PRACTICE ISSUES

OBJECTIVE 8

Describe the administrative procedures under the tax law

ORGANIZATION OF THE INTERNAL REVENUE SERVICE

The **IRS** is the branch of the Treasury Department that is responsible for administering the federal tax law. It is organized on a type-of-taxpayer basis which allows the IRS to become more specialized. The responsibilities and functions of the various administrative branches include the following:

- The Commissioner of Internal Revenue, appointed by the President, is the chief officer of the IRS. This individual is supported by the Chief Counsel's office, which is responsible for preparing the government's case for litigation of tax disputes.
- The National Office includes a deputy commissioner, a series of assistants to the commissioner, and a chief counsel. A significant responsibility of the National Office is to process ruling requests and to prepare revenue procedures that assist taxpayers with compliance matters.
- Four operating divisions, organized functionally, including (1) Wage and Investment Income, (2) Small Business and Self-Employed, (3) Large Business and International, and (4) Tax Exempt and Government Entities.
- Tax service centers, located around the country, perform tax return processing work, based on the four divisions above. They also select tax returns for audit.
- For the 2017 fiscal year, the IRS had approximately 77,000 full-time equivalent employees and a budget of $11.5 billion. The number of employees in 2017 is a decrease of 14.4% from 2012. In 2017, the IRS collected $3.4 trillion, 91 percent of federal government receipts.

ADDITIONAL COMMENT

A survey of members of the American Institute of CPAs found that more than half of the 1,036 members who responded had an unfavorable opinion of the IRS. However, the accountants gave the IRS good marks for courtesy and a willingness to solve problems.

ENFORCEMENT PROCEDURES

ADDITIONAL COMMENT

Individuals may call 800-366-4484 to report misconduct of IRS employees.

All tax returns are initially checked for mathematical accuracy and items that are clearly erroneous. The Form W-2 amounts (e.g., wages, and so on), Form 1099 information return amounts (e.g., relating to dividend and interest payments, and so on) and other forms filed with the IRS by the payer are checked against the amounts reported on the tax return. If differences are noted, the IRS Center merely sends the taxpayer a bill for the corrected amount of tax and a statement of the differences. This type of examination is referred to as a correspondence audit. In some instances, the difference is due to a classification error by the IRS, and the additional assessment can be resolved by written correspondence. A refund check may be sent to the taxpayer if an overpayment of tax has been made.

EXAMPLE I:1-24 ▶

Bart is an author of books and properly reports royalties on Schedule C (Profit or Loss from Business). The IRS computer matching of the Form 1099 information returns from the publishing companies incorrectly assumes that the royalties should be reported on Schedule E (Supplemental Income and Loss). If the IRS sends the taxpayer a statement of the difference and an adjusted tax bill, this matter (including the abatement of added tax, interest, and penalties) should be resolved by correspondence with the IRS. ◀

ADDITIONAL COMMENT

The IRS audit rate has continued to decline over the past 10 years. In 2016, the percentage of returns audited by the IRS dropped to 0.60%. Of course, the audit rate varies by levels and types of income. Higher income taxpayers and self-employed taxpayers face higher audit rates.

SELECTION OF RETURNS FOR AUDIT

The U.S. tax system is based on self-assessment and voluntary compliance. However, enforcement by the IRS is essential to maintain the integrity of the tax system. The IRS uses both computers and experienced personnel to select returns for examination. With respect to the use of the computer, a **Discriminant Function System (DIF)** is used to classify returns to be selected for audit. The DIF system generates a "score" for a return based on the potential for the return to generate additional tax revenue. After returns are scored under the DIF system, the returns are manually screened by experienced IRS personnel who decide which returns warrant further examination. In the aggregate, less than 1% of all individual returns are selected for examination each year. Some examples of situations where individuals are more likely to be audited include the following:

ADDITIONAL COMMENT

A special task force has recommended that the percentage of returns audited be increased to 2.5%. Many individuals feel that the probability of being audited is so low as to be disregarded.

- Individuals who are sole proprietors and claim expenses in connection with their trade or businesses, especially if significant tax losses are incurred.
- Itemized deductions exceeding an average amount for the person's income level
- Filing of a refund claim by a taxpayer who has been previously audited, where substantial tax deficiencies have been assessed
- Individuals who are self-employed with substantial business income or income from a profession (e.g., a medical doctor)



ETHICAL POINT

A CPA is not permitted to recommend a position to a client that exploits the IRS audit selection process.

Audit Procedures. Audits of most individuals are handled through an **office audit procedure** in an office of the IRS. In most cases, an individual is asked to substantiate a particular deduction, credit, or income item (e.g., charitable contributions that appear to be excessive). The office audit procedure does not involve a complete audit of all items on the return.

EXAMPLE I:1-25 ▶

Brad obtains a divorce during the current year and reports a $30,000 deduction for alimony. The IRS may conduct an office audit to ascertain whether the amount is properly deductible as alimony and does not represent a disguised property settlement to Brad's ex-wife. Brad may be asked to submit verification (e.g., a property settlement agreement between the spouses that designates the payments as alimony). ◀

KEY POINT

A taxpayer may appear on his or her own behalf before the IRS during an audit. An attorney or CPA in good standing is authorized to practice before the IRS upon the filing of a written statement that he or she is currently so qualified and is authorized to represent the taxpayer.

A **field audit procedure** often is used for corporations and individuals engaged in a trade or business. A field audit generally is broader in scope than the office audit (e.g., several items on the tax return may be reviewed). A field audit usually is conducted at the taxpayer's place of business or the office of his or her tax advisor.

Most large corporations are subject to annual audits. The year under audit may be several years prior to the current year because the corporation often will waive the statute of limitations pending the resolution of disputed issues.

STATUTE OF LIMITATIONS

Most taxpayers feel a sense of relief after they have prepared their income tax return and have mailed it to the IRS. However, the filing of the tax return is not necessarily the end of the story for that particular taxable year. It is possible, of course, that the IRS may select their tax return for audit after the return has been initially processed or a taxpayer may have filed an amended return to correct an error or omission.

REAL-WORLD EXAMPLE

Based on an IRS audit, the Mustang Ranch, Nevada's most famous legal bordello, was assessed some $13 million in taxes. When the amount owed could not be paid, the IRS sold the property to recoup the taxes.

Both the IRS and taxpayers can make corrections to a return after it has been originally filed. Fortunately, both only have a limited time period in which to make such corrections. This time period is called the **statute of limitations** and prevents either the taxpayer or the IRS from changing a filed tax return after the time period has expired. The general rule for the statute of limitations is three years from the later of the date the tax return was actually filed or its due date.[32] However, a six-year statute of limitations applies if the taxpayer omits items of gross income that in total exceed 25% of the gross income reported on the return.[33] The statute of limitations remains open indefinitely if a fraudulent return is filed or if no return is filed.[34]

EXAMPLE I:1-26 ▶ Betty, a calendar-year taxpayer, is audited by the IRS in February 2019 for the tax year 2017. During the course of the audit, the IRS proposes additional tax for 2017, because Betty failed to substantiate certain travel and entertainment expense deductions. During the course of the audit, the IRS discovers that Betty failed to file a tax return for 2012, and in 2014 an item of gross income amounting to $26,000 was not reported. Gross income reported on the 2014 return was $72,000. Assuming Betty's 2017 return was filed on or before its due date (April 15, 2018), the IRS may assess a deficiency for 2017 because the three-year statute of limitations will not expire until April 15, 2021. A deficiency also may be assessed for the 2014 return because a six-year statute of limitations applies since the omission is more than 25% of the gross income reported on the return. A deficiency also may be assessed for 2012 as there is no statute of limitations for fraud. ◀

ADDITIONAL COMMENT

More than 150 penalties can be imposed on taxpayers. In fact, applying the penalties has become so complicated that the IRS is currently considering ways to consolidate and simplify them.

INTEREST

Interest accrues on both assessments of additional tax due and on refunds that the taxpayer receives from the government.[35] No interest is paid on a tax refund if the amount is refunded by the IRS within 45 days of the day prescribed for filing the return (e.g., April 15) determined without regard to extensions.[36] If a return is filed after the filing date, no interest is paid if the refund is made within 45 days of the date the return was filed.

EXAMPLE I:1-27 ▶ Beverly, a calendar-year taxpayer, files her 2018 tax return on March 1, 2019, and requests a $500 refund. No interest accrues on the refund amount if the IRS sends the refund check to Beverly within 45 days of the April 15, 2019, due date. ◀

ADDITIONAL COMMENT

In addition to the penalties listed on this page, the government also assesses penalties for civil fraud and criminal fraud. Criminal fraud carries a maximum penalty of $100,000, a prison sentence of up to five years, or both.

PENALTIES

Various nondeductible penalties are imposed on the net tax due for failure to comply, including

- A penalty of 5% per month (or fraction thereof) subject to a maximum of 25% for failure to file a tax return[37]

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[32] Secs. 6501(a) and (b)(1). Similar rules apply to claims for a refund filed by the taxpayer. Section 6511(a) requires that a refund claim be filed within three years of the date the return was filed or within two years of the date the tax was paid, whichever is later. For more information on the rules for statute of limitations, see Chapter C:15 in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*.

[33] Sec. 6501(e). See also *Stephen G. Colestock*, 102 T.C. 380 (1994), where the Tax Court ruled that the extended six-year limitation period applied to a married couple's entire tax liability for the tax year at issue, not just to items that constituted substantial omissions of gross income. Thus, the IRS was able to assert an increased deficiency and additional penalties attributable to a disallowed depreciation deduction.

[34] Sec. 6501(c).

[35] Sec. 6621(a). The rate is adjusted four times a year by the Treasury Department based on the current interest rate for short-term federal obligations. The interest rate individual taxpayers must pay to the IRS on underpayments of tax is the federal short-term rate plus three percentage points. The interest rate paid to taxpayers on overpayments of tax is the federal short-term rate plus two percentage points. The annual interest rate on noncorporate underpayments and overpayments for the period October 1, 2018, through December 31, 2018, was 5%.

[36] Sec. 6611(e).

[37] Sec. 6651(a)(1). The penalty assessed may be very small in some instances even though the taxpayer owes a large tax bill for the year because penalties are imposed on the net tax due. The percentages are increased to 15% per month (or fraction thereof) up to a maximum of 75% if the penalty is for fraudulent failure to file under Sec. 6651(f).

ADDITIONAL COMMENT

In many cases, these penalties can be avoided if the taxpayer can show there is "reasonable cause." See Chapter C:15 in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* for further discussion.

- A penalty of 0.5% per month (or fraction thereof) up to a maximum of 25% for failure to pay the tax that is due[38]
- An accuracy-related penalty of 20% of the underpayment for items such as negligence or disregard of rules or regulations, any substantial understatement of income tax, or any substantial misstatement of valuation[39]
- A 75% penalty for fraud[40]
- A penalty based on the current interest rate for underpayment of estimated taxes[41]
- Significant penalties on tax return preparers have been enacted by Congress. In general, these new penalties are applicable for any position on a tax return where there is a "realistic possibility" (one-in-three chance) that the position would not be upheld in a court of law. The penalty is not assessed if the position is disclosed in the return.

ADDITIONAL COMMENT

Pete Rose, major league baseball's all-time hit leader, was sent to prison in 1990 for income tax evasion.

ADMINISTRATIVE APPEAL PROCEDURES

If an IRS agent issues a deficiency assessment, the taxpayer may make an appeal to the IRS Appeals Division. Some disputes involve a gray area (e.g., a situation where some courts have held for the IRS whereas other courts have held for the taxpayer on facts that are similar to the disputed issue). In such a case, the taxpayer may be able to negotiate a compromise settlement (e.g., a percentage of the disputed tax amount plus interest and penalties) with the Appeals Division based on the "hazards of litigation" (i.e., the probability of winning or losing the case if it is litigated).

COMPONENTS OF A TAX PRACTICE

OBJECTIVE 9

Describe the components of a tax practice

Tax practice is a rapidly growing field that provides substantial opportunities for tax specialists in public accounting, law, and industry. The tasks performed by a tax professional may range from the preparation of a simple Form 1040 for an individual to the conduct of tax research and planning for highly complex business situations. Tax practice consists of the following activities:

- Tax compliance and procedure (i.e., tax return preparation and representation of a client in administrative proceedings before the IRS)
- Tax research
- Tax planning and consulting
- Financial planning

TYPICAL MISCONCEPTION

Many people believe that a tax practitioner should serve in the capacity of a neutral, unbiased expert. They tend to forget that tax practitioners are being paid to represent their clients' interests. A tax practitioner may sometimes recommend a position that is defensible, but where the weight of authority is on the side of the IRS.

TAX COMPLIANCE AND PROCEDURE

Preparation of tax returns is a significant component of tax practice. Tax practitioners often prepare federal, state, and local tax returns for individuals, corporations, estates, trusts, and so on. In larger corporations, the tax return preparation (i.e., compliance) function usually is performed by a company's internal tax department staff. In such a case, a CPA or other tax practitioner may assist the client with the tax research and planning aspects of their tax practice, and may even review their return before it is filed.

An important part of tax practice consists of assisting the client in negotiations with the IRS. If a client is audited, the practitioner acts as the client's representative in discussions with the IRS agent. If a tax deficiency is proposed, the practitioner assists the client if

[38] Sec. 6651(a)(2). If the failure to file penalty (5%) and the failure to pay the tax penalty (0.5%) are both applicable, the failure to file penalty is reduced by the failure to pay penalty per Sec. 6651(c)(1). Further, the penalty is increased to 1% per month after the IRS notifies the taxpayer that it will levy on the taxpayer's assets.

[39] Sec. 6662.

[40] Sec. 6663.

[41] Sec. 6654.

an administrative appeal is contemplated with the IRS's Appellate Division. In most instances, an attorney is retained if litigation is being considered.

TAX RESEARCH

Tax research is the search for the best possible defensibly correct solution to a problem involving either a completed transaction (e.g., a sale of property) or a proposed transaction (e.g., a proposed merger of two corporations). Research involves each of the following steps:

- Determine the facts.
- Identify the issue(s).
- Identify and analyze the tax law sources (i.e., code provisions, Treasury Regulations, administrative rulings, and court cases).
- Evaluate nontax (e.g., business) implications.
- Solve the problem.
- Communicate the findings to the client.

SELF-STUDY QUESTION

Do large national CPA firms generally stress the importance of tax research in connection with tax-return preparation or tax planning?

ANSWER

The large CPA firms emphasize their skills in tax planning. Sometimes a slight alteration of a proposed transaction can save the client substantial tax dollars. This is high-value-added work and can be billed at premium rates.

Tax research may be conducted in connection with tax return preparation, tax planning, or procedural activities. A more thorough discussion of tax research is presented in Chapter I:15.

TAX PLANNING AND CONSULTING

Tax planning involves the process of structuring one's affairs so as to minimize the amount of taxes *and* maximize the after-tax return. Thus, optimal tax planning is *not* to just pay the least amount of tax but to maximize after-tax cash flows. A text from several years ago on tax research and planning has delineated the following tax planning principles:[42]

- Keep sufficient records.
- Forecast the effect of future events.
- Support the plan with a sound business purpose.
- Base the plan on sound legal authorities.
- Do not carry a good plan too far.
- Make the plan flexible.
- Integrate the tax plan with other factors in decision making.
- Conduct research to learn whether a similar plan has previously proved unsuccessful (e.g., a court case involving similar facts may have upheld the IRS's position).
- Consider the "maximum" risk exposure of the client (e.g., if the plan is subsequently challenged by the IRS and the tax treatment is disallowed, what is the economic impact upon the taxpayer?).
- Consider the effect of timing (e.g., whether it is more beneficial to take a deduction in one year versus another).
- Shape the plan to the client's needs and desires.

ADDITIONAL COMMENT

Several national accounting firms have divided their tax departments into two basic groups, consulting and compliance. The tax consultants work with clients in tax planning and consulting matters and do not prepare tax returns. Tax returns are prepared by the compliance staff.

CPAs and attorneys frequently are engaged by their clients to perform consulting services to optimize the client's tax situation. For example, a major corporation client is considering the acquisition of a major international corporation and wants to make sure that the tax implications of such an acquisition are properly managed. The CPA will be engaged to perform a thorough review of the transaction to ensure that the client is fully aware of the tax results of the acquisition, and possibly may request an advance ruling from the IRS.

Because of the importance of planning in tax practice, subsequent chapters in this text include a separate section on tax planning to discuss issues that are related to the topical coverage. These tax planning principles should be kept in mind when attempting to use the

[42] Norton, Fred W., *Federal Taxation: Research, Planning, and Procedures 2Ed*, © 1979. Printed and Electronically reproduced by permission of Pearson Education, Inc., Upper Saddle River, New Jersey. The tax planning principles are still viable today.

tax planning recommendations. Also, a systematic approach to tax planning developed by two noted academicians, Myron Scholes and Mark Wolfson, is discussed in Chapter I:18.

FINANCIAL PLANNING

A relatively new field for tax professionals is that of financial planning for individual clients. Since taxes are an integral part of any financial plan and since a tax specialist regularly meets with his or her clients (filing returns and other tax matters), the area of financial planning has become increasingly a part of tax practice. The typical steps in performing a financial planning engagement include the following steps:

- Determine the client's financial goals and objectives.
- Review the client's insurance coverage for adequacy and appropriateness.
- Recommend an investment strategy, including risk analysis and asset allocation.
- Review tax returns to ensure that, through proper tax planning, the client is maximizing his or her after-tax cash flow.
- Review the client's retirement plans to assure compliance with the law and possible new alternatives.
- Review all documents related to estate and gift planning and work with the client's attorney to minimize all transfer taxes and fulfill the client's objectives.

COMPUTER APPLICATIONS IN TAX PRACTICE

OBJECTIVE 10

Understand the importance of computer applications in taxation

KEY POINT

The use of computers has become very important in tax practice ranging from tax return preparation to tax research. It is essential that students having an interest in taxation develop advanced computer skills.

ADDITIONAL COMMENT

The Volunteer Income Tax Assistance (VITA) program sponsored by the IRS is aimed at taxpayers who need help with their federal return but cannot afford to pay for the assistance. Many college students put their textbook knowledge to work through VITA programs.

TAX RETURN PREPARATION

To prepare tax returns, most tax practitioners purchase tax preparation software from companies such as Commerce Clearing House or Intuit. This software allows the preparation of accurate and professional-looking tax returns. A word of caution, however, is in order. As with any computer software, the preparation of tax returns using the computer requires as much knowledge and expertise from the preparer as doing the returns by hand. A recent trend in tax return preparation is the **electronic filing** of tax returns, i.e., a "paperless" tax return. Taxpayers send their returns electronically to the IRS for processing, thereby saving enormous amounts of paper and, perhaps, reducing human error.

TAX PLANNING APPLICATIONS

Performing tax planning for clients involves the evaluation of alternative courses of action. This evaluation process can be very time-consuming because of the tax calculations necessary to arrive at an optimal solution. The computer has become an essential tool in this process because of the speed with which the tax calculations can be made. Many tax professionals now use sophisticated software to perform tax planning for their clients. A prime example of the use of the computer in tax planning has been in deciding whether a taxpayer should invest in a Roth Individual Retirement Account (Roth IRA) or a regular IRA (see Chapter I:7 for more details on IRAs). There are many factors to consider, including current and projected tax rates, current and projected level of income, jurisdictional issues, etc. With the computer, a tax professional can vary the assumptions and create a number of alternatives within a relatively short period of time. To perform this task by hand would require an enormous commitment of time. The field of data analytics is increasingly used in tax practice. As with most aspects of life, the impact of the computer on tax planning has been highly significant and will only increase in the future.

TAX RESEARCH APPLICATIONS

Computerized information-retrieval systems are used in tax research and are rapidly replacing books as the principal source of tax-related information. Most commercial research services are offered on the internet. The principal Internet services are RIA's *Checkpoint*

and CCH's *Tax Research Network*. These commercial Internet services contain a wide range of materials available to tax researchers who subscribe to the service. In addition, the IRS has a home page (www.irs.gov) that taxpayers can access for forms, publications, and other related materials. All of the major accounting firms and many other tax organizations have home pages that allow users to access a myriad of tax information.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:1-1 The Supreme Court in 1895 ruled that the income tax was unconstitutional because the tax needed to be apportioned among the states in proportion to their populations. Why would the requirement of proportionality be so difficult to administer?

I:1-2 Why was pay-as-you-go withholding needed in 1943?

I:1-3 Congressman Patrick indicates that he is opposed to tax proposals that call for a flat tax rate because the structure would not tax those individuals who have the ability to pay the tax. Discuss the position of the congressman, giving consideration to tax rate structures (e.g., progressive, proportional, and regressive) and the concept of equity.

I:1-4 The governor of your state stated in a recent political speech that he has never supported any income tax increases as the tax rates have remained at the same level during his entire term of office. Yet, you believe that you are paying more tax this year than in previous years even though your income has not increased. How can both you and the governor be correct? In other words, is it possible for the government to raise taxes without raising tax rates?

I:1-5 Carmen has computed that her average tax rate is 16% and her marginal tax rate is 24% for the current year. She is considering whether to make a charitable contribution to her church before the end of the tax year. Which tax rate is of greater significance in measuring the tax effect for her decision? Explain.

I:1-6 Why are the gift and estate taxes called wealth transfer taxes? What is the tax base for computing each of these taxes?

I:1-7 Cathy, who is single, makes gifts of $50,000 to each of her two adult children.
- **a.** Who is primarily liable for the gift tax on the two gifts, Cathy or the two children?
- **b.** If Cathy has never made a taxable gift in prior years, is a gift tax due on the two gifts?

I:1-8 Carlos inherits 100 shares of Allied Corporation stock from his father. The stock cost his father $8,000 and had a $25,000 FMV on the date of his father's death in 2019. The alternate valuation date was not elected. If Carlos sells the Allied Corporation stock for $27,000, what would be his taxable gain on the sale?

I:1-9 Most estates are not subject to the federal estate tax.
- **a.** Why is this the case?
- **b.** Do you believe most estates should be subject to the federal estate tax?

I:1-10 Indicate which of the following taxes are generally progressive, proportional, or regressive:
- **a.** State income taxes
- **b.** Federal estate tax
- **c.** Corporate state franchise tax
- **d.** Property taxes
- **e.** State and local sales taxes

I:1-11 Carolyn operates a consulting business as a sole proprietor (unincorporated). Carolyn has been approached by one of her major clients to become an employee. If she accepts the new job, she would no longer operate her consulting business. From the standpoint of paying Social Security taxes, would Carolyn's Social Security taxes increase or decrease if she becomes an employee? Why? (Assume Carolyn will earn less than $200,000.)

I:1-12 The three different levels of government (federal, state, and local) must impose taxes to carry out their functions. For each of the types of taxes below, discuss which level of government primarily uses that type of tax.
- **a.** Property taxes
- **b.** Excise taxes
- **c.** Sales taxes
- **d.** Income taxes
- **e.** Employment taxes

I:1-13 A "good" tax structure has five characteristics.
- **a.** Briefly discuss the five characteristics.
- **b.** Using the five characteristics, evaluate the following tax structures:
  1. Federal income tax
  2. State sales tax
  3. Local ad valorem property tax

I:1-14 Two commonly-recognized measures of the fairness of an income tax structure are "horizontal equity" and "vertical equity."
- **a.** Discuss what is meant by horizontal equity and vertical equity as it pertains to the income tax.

b. Why is it so difficult to design a "fair" tax structure?

I:1-15 The primary objective of the federal income tax law is to raise revenue. What are its secondary objectives?

I:1-16 If the objectives of the federal tax system are multifaceted and include raising revenues, providing investment incentives, encouraging certain industries, and meeting desired social objectives, is it possible to achieve a simplified tax system? Explain.

I:1-17 Distinguish between *taxpaying entities* and *flow-through entities* from the standpoint of the federal income tax law.

I:1-18 Sally and Tom are married, have three dependent children, and file a joint return in 2019. If they have adjusted gross income (AGI) of $90,000 and itemized deductions of $10,000, what is their taxable income for 2019?

I:1-19 The Bruin Corporation, a C corporation, is owned 100% by John Bean and had taxable income in 2019 of $500,000. John is also an employee of the corporation. In December 2019, the corporation has decided to distribute $400,000 to John and has asked you whether it would be better to distribute the money as a dividend or salary. John, a single taxpayer, is in the 37% marginal tax bracket. How would you respond to Bruin Corporation? Consider only income taxes for this problem.

I:1-20 Discuss what is meant by the term "double taxation" of corporations. Develop an example of double taxation using a corporation and shareholder.

I:1-21 Limited liability companies (LLCs) are very popular today as a form of organization. Assume a client asks you to explain what this type of organization is all about. Prepare a brief description of the federal income tax aspects of LLCs.

I:1-22 For flow-through entities, such as partnerships, how does the tax law use partner basis adjustments to prevent double taxation of partnership income?

I:1-23 Partnerships and S corporations are flow-through entities. In connection with filing annual tax returns, these entities must include Form K-1 in the returns. What is Form K-1, what is its purpose, and who receives the form?

I:1-24 The PDQ Partnership earned ordinary income of $150,000 in 2019. The partnership has three equal partners, Pete, Donald, and Quint. Quint, who is single, uses the standard deduction, and has other income of $15,000 (not connected with the partnership) in 2019. He receives a $30,000 distribution from the partnership during the year. What is Quint's taxable income in 2019?

I:1-25 Why is a thorough knowledge of sources of tax law so important for a professional person who works in the tax area?

I:1-26 The Internal Revenue Code is the most authoritative source of income tax law. In trying to resolve an income tax question, however, a tax researcher also consults administrative rulings (Income Tax Regulations, Revenue Rulings, etc.) and court decisions. Why wouldn't the tax researcher just consult the Code since it is the highest authority? Similarly, why is there a need for administrative rulings and court decisions?

I:1-27 Congressional committee reports are an important source of information concerning the legislative enactment of tax law.

a. Name the three Congressional committee reports that are issued in connection with a new tax bill.

b. Of what importance are Congressional committee reports to tax practitioners?

I:1-28 What is the primary service function provided by the National Office of the IRS?

I:1-29 What types of taxpayers are more likely to be audited by the IRS?

I:1-30 Anya is concerned that she will be audited by the IRS.

a. Under what circumstances is it possible that the IRS will review each line item on her tax return?

b. Is it likely that all items on Anya's return will be audited?

I:1-31 a. What does the term "hazards of litigation" mean in the context of taxation?

b. Why would the IRS or a taxpayer settle or compromise a case based on the "hazards of litigation"?

I:1-32 If a taxpayer files his or her tax return and receives a tax refund from the IRS, does this mean that the IRS feels that the return is correct and will not be subject to a future audit.

I:1-33 What is the statute of limitations for transactions involving:

a. Fraud (e.g., failure to file a tax return)

b. Disallowance of tax deduction items

c. The omission of rental income that is greater than 25% of the taxpayer's reported gross income

I:1-34 In reference to tax research, what is meant by *the best possible defensibly correct solution*?

I:1-35 The profession of tax practice involves four principal areas of activity. Discuss these four areas.

I:1-36 Many tax professionals have moved into the field of financial planning for their clients.

a. How do taxes impact financial planning for a client?

b. Why do tax professionals have a perfect opportunity to perform financial planning for their clients?

I:1-37 Is the principal goal of tax planning to absolutely minimize the amount of taxes that a taxpayer must pay?

I:1-38 Explain how a computer can assist a tax practitioner in tax planning activities and making complex tax calculations.

PROBLEMS

I:1-39 *Tax Rates.* Latesha, a single taxpayer, had the following income and deductions for the tax year 2019:

INCOME:	Salary	$100,000
	Business Income	25,000
	Interest income from taxable bonds	10,000
	Tax-exempt bond interest	5,000
	TOTAL INCOME	140,000
DEDUCTIONS:	Business expenses	$ 9,500
	Itemized deductions	20,000
	TOTAL DEDUCTIONS	29,500

a. Compute Latesha's taxable income and federal tax liability for 2019 (round to dollars and ignore the qualified business income deduction for this problem).
b. Compute Latesha's marginal, average, and effective tax rates.
c. For tax planning purposes, which of the three rates in Part b is the most important?

I:1-40 *Tax Rates.* Based on the amounts of taxable income below, compute the federal income tax payable in 2019 on each amount assuming the taxpayers are married filing a joint return. Also, for each amount of taxable income, compute the average tax rate and the marginal tax rate.
a. Taxable income of $30,000.
b. Taxable income of $100,000.
c. Taxable income of $375,000.
d. Taxable income of $700,000.

I:1-41 *Marginal Tax Rate.* Jill and George are married and file a joint return. They expect to have $425,000 of taxable income in the next year and are considering whether to purchase a personal residence that would provide additional tax deductions of $40,000 for mortgage interest and real estate taxes.
a. What is their marginal tax rate for purposes of making this decision?
b. What is the tax savings if the residence is acquired?

I:1-42 *Gift Tax.* Betty, a married taxpayer, makes the following gifts during the current year (2019): $20,000 to her church, $100,000 to her daughter, and $40,000 to her husband. What is the amount of Betty's taxable gifts for the current year (assuming that she does not elect to split the gifts with her spouse)?

I:1-43 *Estate Tax.* Clay, who was single, died in 2019 and has a gross estate valued at $8,500,000. Six months after his death, the gross assets are valued at $9,000,000. The estate incurs funeral and administration expenses of $125,000. Clay had debts amounting to $150,000 and bequeathed all of his estate to his children. During his life, Clay made no taxable gifts.
a. What is the amount of Clay's taxable estate?
b. What is the tax base for computing Clay's estate tax?
c. What is the amount of estate tax owed if the tentative estate tax (before credits) is $3,235,800?
d. Alternatively, if, six months after his death, the gross assets in Clay's estate declined in value to $7,500,000, can the administrator of Clay's estate elect the alternate valuation date? What are the important factors that the administrator should consider as to whether the alternate valuation date should be elected?
e. How would your answer change in parts a, b, and c if Clay's gross estate was $18,500,000 rather than $8,500,000 and the tentative estate tax before credits was $7,235,800?

I:1-44 *Comparison of Tax Entities.*
a. Keith Thomas and Thomas Brooks began a new consulting business on January 1, 2019. They organized the business as a C corporation, KT, Inc. During 2019, the corporation was successful and generated revenues of $2,000,000. KT had operating expenses of $800,000 before any payments to Keith or Thomas. During 2019, KT paid dividends to Keith and Thomas in the amount of $450,000 each. Assume that Keith's wife earned $120,000 from her job, they file a joint return, have itemized deductions of $40,000, and have no children. Compute the total tax liability of KT and Keith and his wife for 2019.

b. Instead of organizing the consulting business as a C corporation, assume Keith and Thomas organized the business as a limited liability company, KT, LLC. KT made a distribution of $450,000 each to Keith and Thomas during 2019. Compute the total tax liability of KT and Keith for 2019. Ignore any additional tax on net investment income.

I:1-45 ***Partnership Income.*** Howard Gartman is a 40% partner in the Horton & Gartman Partnership. During 2019, the partnership reported the total items below (100%) on its Form 1065:

Ordinary income	$180,000
Qualified dividends	10,000
Long-term capital loss	(12,000)
Long-term capital gain	28,000
Charitable contributions	4,000
Cash distributions to partners	150,000

Howard and his wife Dawn, who file a joint return, also had the following income and deductions from sources not connected with the partnership:

Income	
Dawn's salary	$40,000
Qualified dividends	3,000
Deductions	
Mortgage interest	12,000
Real estate taxes	5,800
Charitable contributions	3,000

Howard and Dawn have two children. During 2019, Dawn had $4,500 in federal income taxes withheld from her salary and Howard made four estimated tax payments of $2,500 each ($10,000 total). Compute Howard and Dawn's Federal income tax liability for 2019 and whether they have a balance due or a tax refund. Ignore the child tax credits.

I:1-46 ***Interest and Penalties.*** In 2018, Paul, who is single, has a comfortable salary from his job as well as income from his investment portfolio. However, he is habitually late in filing his federal income tax return. He did not file his 2018 income tax return until December 4, 2019 (due date was April 15, 2019) and no extensions of time to file the return were filed. Below are amounts from his 2018 return:

Taxable income	$140,000
Total tax liability on taxable income	27,890
Total federal tax withheld from his salary	22,490

Paul sent a check with his return to the IRS for the balance due of $5,400. He is relieved that he has completed his filing requirement for 2018 *and* has met his financial obligation to the government for 2018.

Has Paul met *all* of his financial obligations to the IRS for 2018? If not, what additional amounts will Paul be liable to pay to the IRS?

I:1-47 ***IRS Audits.*** Which of the following individuals is most likely to be audited?

a. Connie has a $20,000 net loss from her unincorporated business (a cattle ranch). She also received a $200,000 salary as an executive of a corporation.

b. Craig has AGI of $20,000 from wages and uses the standard deduction.

c. Dale fails to report $120 of dividends from a stock investment. His taxable income is $40,000 and he has no other unusually large itemized deductions or business expenses. A Form 1099 is reported to the IRS.

I:1-48 ***Statute of Limitations.*** In April 2019, Dan is audited by the IRS for the year 2017. During the course of the audit, the agent discovers that Dan's deductions for business travel and entertainment are unsubstantiated and a $600 deficiency assessment is proposed for the tax year 2017. The agent also examined some prior year returns. The agent discovers that Dan failed to report $40,000 of gross business income on his 2015 return. Gross income of $60,000 was reported in 2015. The agent also discovers that Dan failed to file a tax return in 2010.

Will the statute of limitations prevent the IRS from issuing a deficiency assessment for 2017, 2015, or 2010? Explain.

TAX STRATEGY AND CRITICAL THINKING PROBLEM

I:1-49 Pedro Bourbone is the founder and owner of a highly successful small business and, over the past several years, has accumulated a significant amount of personal wealth. His portfolio of stocks and bonds is worth nearly $8,000,000, owns real estate worth $6,000,000, and generates income from dividends and interest of nearly $320,000 per year. With his salary from the business and his dividends and interest, Pedro has taxable income of approximately $700,000 per year and is clearly in the top individual marginal tax bracket. Pedro is married and has three children, ages 16, 14, and 12. Neither his wife nor his children are employed and have no income. Pedro has come to you as his CPA to discuss ways to reduce his individual tax liability as well as to discuss the potential estate tax upon his death. You mention the possibility of making gifts each year to his children. Explain how annual gifts to his children will reduce both his income during lifetime and his estate tax at death.

CASE STUDY PROBLEM

I:1-50 Rick Cabela, a high income client, has contacted you for advice regarding two new proposed business ventures and other tax planning ideas. Rick already operates a highly successful consulting business that earns approximately $2,000,000 net after expenses, and he reports this amount on his personal income tax return. Below are the details:

- Rick is considering the purchase of several apartment buildings for rental purposes. He believes the apartments would generate a tax loss of approximately $100,000 in each of the first three years, then operate profitably thereafter. Rick would like to use the tax losses for the first three years to reduce his personal income taxes.
- Rick is also considering investment in a blueberry farm. He intends to purchase some farmland and turn it into a blueberry farm. The costs in the first year would be the land, equipment, blueberry plants, and labor to develop the farm. In years 2–4, labor costs and maintenance would be the primary financial outlays. No revenue would be earned until year 5 when Rick believes the farm will be very profitable, generating net profits of approximately $100,000 per year. With the substantial cash outlays in the first four years and very little revenue, Rick believes the tax losses would reduce his personal income taxes. Assume the farm is a valid business and Rick materially participates in the activity of the farm.
- Because of his high income, Rick's income tax liability is very high. He read in a financial journal that the contribution of appreciated stock to a charitable organization is a good idea for tax purposes. He has some stock in Apple Co. for which he paid $10,000 several years ago, and the shares are now worth $200,000.

For each of the situations above, what are the principal tax issues that Rick should consider?

TAX RESEARCH PROBLEM

I:1-51 Read the following two cases and explain why the Supreme Court reached different conclusions for cases involving similar facts and issues:

- *CIR v. Court Holding Co.*, 33 AFTR 593, 45-1 USTC ¶9215 (USSC, 1945)
- *U.S. v. Cumberland Public Service Co.*, 38 AFTR 978, 50-1 USTC ¶9129 (USSC, 1950)

CHAPTER

2

DETERMINATION OF TAX



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Use the tax formula to compute an individual's taxable income
2. Determine the amount of deductions from Adjusted Gross Income
3. Calculate the income tax for individuals
4. Explain the basic income tax rules relating to business entities
5. Explain the basic income tax rules of capital gains and losses
6. Describe tax planning considerations for various tax matters
7. Describe compliance and procedural matters for filing tax returns

CHAPTER OUTLINE

Formula for Individual Income Tax...2-2
Deductions from Adjusted Gross Income...2-7
Determining the Amount of Tax...2-19
Business Income and Business Entities...2-27
Treatment of Capital Gains and Losses...2-30
Tax Planning Considerations...2-31
Compliance and Procedural Considerations...2-34

Each year, over 150 million individuals and married couples file tax returns on which they compute their federal income tax. This tax is imposed "on the taxable income of every individual."[1] The amount of tax actually owed by an individual taxpayer is determined by applying a complex set of rules that together make up the income tax law. To understand the income tax, it is necessary to study the basic formula on which the income tax computation is based. Therefore, this chapter introduces the income tax formula and begins the development of its components. Because the income tax formula constitutes the basis of the income tax, most of the remainder of this book is an expansion of the formula. In addition to individual taxpayers, about 7 million corporations and 4 million partnerships file returns each year. These entities are also discussed in this chapter.

FORMULA FOR INDIVIDUAL INCOME TAX

OBJECTIVE 1

Use the tax formula to compute an individual's taxable income

BASIC FORMULA

Most individuals compute their income tax by using the formula illustrated in Table I:2-1. The formula itself appears rather simple. However, the complexity of the income tax results from the intricate rules that must be applied in order to arrive at the amounts that enter into the formula.

The tax formula is incorporated into the income tax form. The tax formula illustrated in Table I:2-1 can be compared with Form 1040, which is reproduced in Figure I:2-1 (see pages I:2-8 and I:2-9). Some differences exist between the tax formula below and the tax form itself. For example, taxpayers generally are not required to report exclusions (nontaxable income) on their tax returns. One exception does require taxpayers to disclose tax-exempt interest income. A number of separate schedules are used to report various types of income, and some of these types of income are, in turn, detailed on yet additional schedules and forms. For example, Schedule 1 reports unemployment compensation received, the net profit or loss from a sole proprietorship, and certain other types of income (see Figure I:2-2, on page I:2-10). The net profit or loss from a sole proprietorship is calculated on Schedule C, where gross income from the business is reduced by related expenses that are deductions for adjusted gross income (AGI). Also, the federal government uses Form 1040 to collect other taxes, such as the self-employment tax. This tax is discussed in Chapter I:14, and Form 1040 has a line that includes it. The main reason for differences between the formula and the form is administrative convenience. That is, there is no reason to require taxpayers to disclose

ADDITIONAL COMMENT

The IRS estimated taxpayers would spend an average of 4 hours completing and submitting Form 1040 for 2018. Recordkeeping and other related activities increased the estimate to 11 hours, and additional forms and schedules added even more time.

ADDITIONAL COMMENT

Comedian Jay Leno's explanation as to why the IRS calls it Form 1040 was, "For every $50 you earn, you get $10 and they get $40."

TYPICAL MISCONCEPTION

As explained in Chapter I:1, the federal income tax includes a progressive tax rate structure, meaning that the tax rate increases as the tax base increases. For example, if a taxpayer is in the 22% marginal tax bracket, some taxpayers incorrectly assume that this means that all of their income is being taxed at 22%. Instead, the actual calculation will include some of the income taxed at 10%, some at 12% and only the last portion of income taxed at 22%.

▼ **TABLE I:2-1**
Tax Formula for Individuals

Income from whatever source derived	$ xxx,xxx
Minus: Exclusions	(xxx)
Gross income	$ xx,xxx
Minus: Deductions for adjusted gross income	(xxx)
Adjusted gross income	$ x,xxx
Minus: Deductions from adjusted gross income:	
Greater of itemized deductions or the standard deduction	(xx)
Qualified business income deduction	(xx)
Taxable income	$ x,xxx
Times: Tax rate or rates (from tax table or schedule)	× .xx
Gross tax	$ xx
Minus: Credits and prepayments	(x)
Net tax payable or refund due	$ xx

[1] Sec. 1.

income if the income is not subject to tax, it is more simple to report business income on a separate schedule, and it is convenient to collect other taxes on the same tax form.

The formula includes terms such as *gross income, exclusions, adjusted gross income, taxable income, gross tax,* and *credits.* These and other terms are defined below.

DEFINITIONS

Income. The term **income** includes both taxable and nontaxable income. Although the term is not specifically defined in the tax law, it does include income from any source.[2] Its meaning is close to that of the term **revenue**. However, it does not include a "return of capital." Thus, in the case of the sale of property, only the gain, not the entire sales proceeds, is viewed as income. This view extends to the sale of inventory, where gross profit is viewed as income, as opposed to the sale price.

Exclusion. Not all income is taxable. An **exclusion** is any item of income that the tax law says is not taxable. Congress, over the years, has specifically excluded certain types of income from taxation for various social, economic, and political reasons. Chapter I:4 discusses specific exclusions and the reasons for their existence. Table I:2-2 contains a sample of the major exclusions from gross income.

Gross Income. **Gross income** is income reduced by exclusions. In other words, it is income from taxable sources and is reported on the return (excluded income generally need not be disclosed). Section 61(a) contains a partial list of items of gross income. The items listed in Sec. 61(a) are shown in Table I:2-3. Note, however, that Sec. 61(a) states that unless otherwise provided, "gross income means all income from whatever source derived, including (but not limited to)" the listed items of income. Thus, even though an item is omitted from the list does not necessarily mean that the item is excluded. For example, illegal income, although omitted from the list, is taxable.[3]

ADDITIONAL COMMENT

One common exclusion, interest on state and local government bonds, must be reported on the tax return in amount only. It is not added to the other income items. In 2016, this reported tax-exempt interest totaled $61 billion.

▼ **TABLE I:2-2**
Major Exclusions

Gifts and inheritances
Life insurance proceeds
Welfare and certain other transfer payments
Certain scholarships and fellowships
Certain payments for injury and sickness:
Personal physical injury settlements
Worker's compensation
Medical expense reimbursements
Certain employee fringe benefits:
Health plan premiums
Group term life insurance premiums (limited)
Meals and lodging
Employee discounts
Dependent care
Certain foreign-earned income
Interest on state and local government bonds
Certain interest of Series EE bonds
Certain improvements by lessee to lessor's property
Alimony and separate maintenance payments (agreements executed after 2018)
Child support payments
Property settlements pursuant to a divorce
Gain from the sale of a personal residence (limited)
Qualified distributions from Roth retirement plans

[2] Sec. 61(a).

[3] *U.S. v. Manley S. Sullivan,* 6 AFTR 6753, 1 USTC ¶236 (USSC, 1927).

▼ TABLE I:2-3
Gross Income Items Listed in Sec. 61(a)

Compensation for services, including fees, commissions, fringe benefits, and similar items
Gross income derived from business
Gains derived from dealings in property
Interest
Rents
Royalties
Dividends
Alimony and separate maintenance payments (agreements executed before 2019)
Annuities
Income from life insurance and endowment contracts
Pensions
Income from discharge of indebtedness
Distributive share of partnership gross income
Income in respect of a decedent
Income from an interest in an estate or trust

Deductions for Adjusted Gross Income. In general, taxpayers may deduct expenses that are specifically allowed by the tax law. Allowable deductions include business and investment expenses generally, along with personal expenses that are specifically provided for in the IRC, such as charitable contributions. Most purely personal expenses are not deductible.

Deductions fall into two categories for individual taxpayers: deductions *for* adjusted gross income and deductions *from* adjusted gross income. In general, **deductions for adjusted gross income** are expenses connected with a trade or business. Many **deductions from adjusted gross income** are personal expenses that Congress has chosen to allow. This classification scheme, however, is not always followed. For example, interest expense on student loans is not a business expense, but Congress allows it to be deducted for adjusted gross income. Another example is the qualified business income deduction, which is deducted from AGI despite being related to business income (this deduction was briefly discussed in Chapter I:1). Table I:2-4 contains a partial list of deductions *for* adjusted gross income that is taken from Sec. 62. Deductions for adjusted gross income are discussed further in Chapter I:6.

ADDITIONAL COMMENT
For 2016, there were 150 million individual income tax returns filed. Of these, 61% had AGI under $50,000, and 5% had AGI over $200,000.

KEY POINT
Adjusted gross income (AGI) is a very important amount for individuals. They use it when calculating many of the exclusions, deductions, and credits discussed in later chapters.

Adjusted Gross Income. **Adjusted gross income (AGI)** is a measure of income that falls between gross income and taxable income. AGI is important because it is used in numerous other tax computations, especially to impose limitations. For example, AGI is used to establish a floor for the medical expense deduction and a ceiling for the charitable contribution deduction.

TYPICAL MISCONCEPTION
It is easy to confuse an exclusion with a deduction. An exclusion is a source of income that is omitted from the tax base, whereas a deduction is an expense that is subtracted in arriving at taxable income. Both have the effect of reducing taxable income.

Deductions from Adjusted Gross Income. Section 62 lists deductions *for* AGI (see Table I:2-4). Thus, any allowable deduction not listed in Sec. 62 is a deduction *from* AGI. The two categories of deductions *from* adjusted gross income are (1) itemized deductions or the standard deduction and (2) the qualified business income deduction.[4] Deductions from AGI are discussed further in Chapter I:8 of this textbook.

ADDITIONAL COMMENT
Itemized deductions were claimed on 30% of all returns filed in 2016. This percentage is likely to be much lower for 2018 through 2025 because the standard deduction allowed in those years is approximately double the amount that was allowed in 2016.

Itemized Deductions and the Standard Deduction. As mentioned above, taxpayers generally cannot deduct personal expenses.[5] Congress, however, allows taxpayers to deduct specified personal expenses, such as charitable contributions, home mortgage interest, and medical expenses.

[4] Sec. 63.

[5] Sec. 262.

▼ TABLE I:2-4
Partial List of Deductions for Adjusted Gross Income (Sec. 62)

Trade and business deductions
Reimbursed employee expenses
Losses from the sale or exchange of property
Deductions attributable to rents and royalties
Contributions to retirement plans (Keoghs and traditional IRAs)
Penalties forfeited because of premature withdrawal of funds from time savings accounts
*One-half of self-employment taxes paid
*Health insurance costs incurred by a self-employed person
Alimony and separate maintenance payments (agreements executed before 2019)
Jury duty pay remitted to an individual's employer
Interest on student loans
Contributions to health savings accounts

*Though not actually listed in Sec. 62, self-employment taxes and health insurance costs of self-employed persons are defined by Secs. 164(f) and 162(l), respectively, as trade or business deductions thereby indirectly enabling taxpayers to deduct these amounts for AGI.

ADDITIONAL COMMENT

Tax rate schedules, the standard deduction, and certain other amounts are adjusted annually for inflation. Because of "rounding conventions," not every amount changes each year.

Taxpayers have the choice of claiming either itemized deductions or the standard deduction. The amount of the standard deduction varies depending on the taxpayer's filing status, age, and vision. As a practical matter, for most taxpayers the standard deduction is greater than the total itemized deductions. Taxpayers with small amounts of deductible expenses do not itemize and, in fact, do not have to keep records of medical expenses and other itemized deductions. The relationship between itemized deductions and the standard deduction is discussed later in this chapter.

HISTORICAL NOTE

In 1986, when taxpayers were required merely to list their dependents' names, 77 million dependents were claimed. In 1987, when taxpayers were also required to list their dependents' Social Security numbers to help the IRS identify those improperly claimed, the number of dependents claimed decreased to 70 million.

Personal and Dependency Exemptions. Prior to 2018, individuals generally were allowed to deduct exemptions for themselves, as well as exemptions for dependents. For 2017, each of these deductions was $4,050. The Tax Cuts and Jobs Act of 2017 suspends these deductions for 2018 through 2025, making them zero for such years.

Qualified Business Income Deduction. Taxpayers other than C corporations generally may deduct from AGI 20% of qualified business income.[6] Individuals may claim this deduction whether they claim itemized deductions or the standard deduction. Qualified business income generally includes income from a flow-through entity, such as a partnership or S corporation, as well as income from a sole proprietorship. For higher-income taxpayers, qualified business income does not include income from accounting, consulting, financial services, and certain other activities. A limitation on the deduction applies, based on the qualified business' W-2 wages and unadjusted basis of property. Chapter C:9 discusses in further detail these and other details of the qualified business income deduction.

HISTORICAL NOTE

The highest marginal tax rate currently is 37% but has been higher in the past. For example, it was 50% in 1985, 70% in 1980, and 94% in 1945.

Taxable Income. **Taxable income** is adjusted gross income reduced by deductions *from* AGI. It is the amount of income that is taxed.

Tax Rates and Gross Tax. Tax rates are the percentage rates, set by Congress, at which income is taxed. There are seven tax rates ranging from 10% to 37%.

10%, 12%, 22%, 24%, 32%, 35%, and 37%

Taxpayers compute their tax by applying the percentage rates found in the tax rate schedules to taxable income. However, most taxpayers simply look in a tax table to find their gross tax. These two alternatives are discussed in more detail later in this chapter. Certain

[6] Sec. 199A.

▼ **TABLE I:2-5**
Partial List of Tax Credits

Refundable:
- Withholding from wages and back-up withholding
- Estimated tax payments
- Overpayment of prior year's tax that taxpayer applies to current-year tax
- Excess Social Security taxes paid
- Earned income credit
- Payments made with extension request
- Child credit (in some cases)
- American Opportunity credit (partially)

Nonrefundable:
- Adoption expense credit
- Credit for the elderly and disabled
- Foreign tax credit
- Child and dependent care credit
- Business energy credit
- General business credit
- Child credit (in some cases)
- American Opportunity credit (partially) and Lifetime Learning credit

types of income are taxed at special rates. For example, qualified dividends and many long-term capital gains are taxed at reduced rates (this is discussed later in this chapter). The gross tax is the amount of tax determined by this process.

SELF-STUDY QUESTION

If a taxpayer is in the 24% marginal tax bracket, would he or she prefer $100 of tax credits or $300 of tax deductions?

ANSWER

The taxpayer would prefer the $100 of tax credits. The $300 of deductions will result in a tax savings of $72 ($300 × 0.24), whereas the $100 of credits would result in a tax savings of $100.

Credits and Prepayments. **Tax credits**, which include prepayments, are amounts that can be subtracted from the gross tax to arrive at the net tax due or refund due. Credits may be classified as either refundable or nonrefundable tax credits. **Refundable tax credits** are allowed to reduce a taxpayer's tax liability to zero and, if some credit still remains, are refundable (paid) by the government to the taxpayer. Prepayments of tax, which are amounts paid to the government during the year through means such as withholding from wages, and selected other items are classified as **refundable tax credits**. **Nonrefundable tax credits** are allowances that have been created by Congress for various social, economic, and political reasons, such as the child and dependent care credits. Nonrefundable tax credits can be subtracted from the tax and may reduce the tax liability to zero. However, if the nonrefundable credits exceed the tax liability, none of the excess will be paid to the taxpayer. A partial list of refundable and nonrefundable tax credits can be found in Table I:2-5 and are covered in detail in Chapter I:14.

TAX FORMULA ILLUSTRATED

The following example illustrates the tax formula and Form 1040.

EXAMPLE I:2-1 ▶ The following facts relate to John A. and Anne B. Smith, who are married and file a joint return in 2018. Emma is their 9-year-old dependent daughter.

Salaries	$118,000
Interest Income:	
Taxable	4,000
Exempt	500
Traditional Individual Retirement Account (IRA) contributions	11,000
Itemized deductions	28,710
Federal income taxes withheld from salaries	8,900

Their tax is computed as follows:

Income:		
Salaries		$118,000
Taxable interest		4,000
Tax-exempt interest		500
Total		$122,500
Minus: Exclusion:		
Tax-exempt interest		(500)
Gross income		$122,000
Minus: Deductions for AGI:		
Traditional IRA contributions		(11,000)
Adjusted gross income		$111,000
Minus: Deductions from AGI:		
Itemized deductions		(28,710)
Taxable income		$ 82,290
Gross tax (2018 tax table)		$ 9,980*
Minus: Credits and prepayments		
Child credit	(2,000)	
Federal income tax withheld	(8,900)	(10,900)
Tax refund		$ 920

*The tax rate schedule yields a tax of $9,983. This small variance results from the ranges in the tax table. ◀

The taxpayers report this information on Form 1040 and Schedule 1 (see Figures I:2-1 and I:2-2). Note that the Form 1040 reports only some of the above amounts, such as AGI and the refund. Other amounts are detailed in other forms and schedules, such as the inclusion in Schedule 1 of the deduction for the traditional IRA contributions. Figures I:2-1 and I:2-2 do not show Schedules A and B, which the taxpayers would also complete to report the details of their itemized deductions and taxable interest.

DEDUCTIONS FROM ADJUSTED GROSS INCOME

OBJECTIVE 2

Determine the amount of deductions from Adjusted Gross Income

ITEMIZED DEDUCTIONS

Itemized deductions are claimed only if the total of such deductions exceeds the standard deduction. Here, consideration is given to which expenses may be itemized and the relationship between itemized deductions and the standard deduction.

Congress allows individuals to itemize specified personal expenses, including medical expenses, state and local income taxes and property taxes, home mortgage interest, and charitable contributions. A partial list of itemized deductions is found in Table I:2-6.

ADDITIONAL COMMENT

In 2016, the 45 million taxpayers who itemized claimed $1.3 trillion in deductions. Taxes paid comprised 44% of the total, whereas interest paid made up 24%.

Congress imposes various restrictions on the extent to which these items can be deducted:

- Medical expenses: Only the portion exceeding 10% of AGI is deductible.
- State and local taxes: Maximum amount deductible is $10,000 ($5,000 if married filing separately).
- Home mortgage interest: Only the interest on up to $750,000 is deductible ($1 million for debt incurred before December 16, 2017).
- Charitable contributions: Maximum amount deductible is 60% of AGI.

ADDITIONAL COMMENT

The floor for the medical expense deduction was 7.5% for 2017 and 2018.

These restrictions are discussed in more detail in Chapter I:8.

Form **1040** Department of the Treasury—Internal Revenue Service (99) **U.S. Individual Income Tax Return** **2018** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing status: ☐ Single ☑ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Your first name and initial	Last name	Your social security number
John A.	Smith	123 | 45 | 6789

Your standard deduction: ☐ Someone can claim you as a dependent ☐ You were born before January 2, 1954 ☐ You are blind

If joint return, spouse's first name and initial	Last name	Spouse's social security number
Anne B.	Smith	987 | 65 | 4321

Spouse standard deduction: ☐ Someone can claim your spouse as a dependent ☐ Spouse was born before January 2, 1954 ☐ Spouse is blind ☐ Spouse itemizes on a separate return or you were dual-status alien

☑ Full-year health care coverage or exempt (see inst.)

Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	Presidential Election Campaign (see inst.) ☐ You ☐ Spouse
1060 W. Addison St.		

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6.
Chicago, IL 60613

If more than four dependents, see inst. and ✓ here ▶ ☐

Dependents (see instructions): (1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see inst.): Child tax credit	Credit for other dependents
Emma	Smith	111 22 3333	Daughter	☑	☐
				☐	☐
				☐	☐
				☐	☐

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
		Teacher	
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
		Manager	

Paid Preparer Use Only

Preparer's name	Preparer's signature	PTIN	Firm's EIN	Check if:
				☐ 3rd Party Designee
Firm's name ▶		Phone no.		☐ Self-employed
Firm's address ▶				

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2018)

FIGURE I:2-1 ▶ FORM 1040 (Page 1)

▼ TABLE I:2-6
Partial List of Itemized Deductions

Medical expenses (over 10% of adjusted gross income)
Certain taxes (generally limited to $10,000):
State and local income and real property taxes
State and local personal property taxes
Residential interest and investment interest (limited)
Charitable contributions (limited)
Other miscellaneous deductions:
Federal estate tax attributable to income in respect of a decedent
Gambling losses to the extent of winnings
Amortization of bond premium
Amounts restored under claim of right

EXAMPLE I:2-2 ▶ For 2019, John and Jane are married, file a joint tax return, and have $175,000 of AGI. They paid $18,100 of medical expenses, $14,000 of state and local income taxes and property taxes, and $20,000 of charitable contributions. They may deduct $600 [$18,100 − (0.10 × $175,000)] of their medical expenses and only the first $10,000 of their state and local taxes. They may deduct all $20,000 of their charitable contributions because it is less than $105,000 (0.60 × $175,000). Their total itemized deductions are $30,600 ($600 + $10,000 + $20,000). ◀

Form 1040 (2018) Page 2

Attach Form(s) W-2. Also attach Form(s) W-2G and 1099-R if tax was withheld.	1	Wages, salaries, tips, etc. Attach Form(s) W-2				1	118,000
	2a	Tax-exempt interest	2a	500	b Taxable interest	2b	4,000
	3a	Qualified dividends	3a		b Ordinary dividends	3b	
	4a	IRAs, pensions, and annuities	4a		b Taxable amount	4b	
	5a	Social security benefits	5a		b Taxable amount	5b	
	6	Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22				6	122,000
	7	Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 36, from line 6				7	111,000
Standard Deduction for— • Single or married filing separately, $12,000 • Married filing jointly or Qualifying widow(er), $24,000 • Head of household, $18,000 • If you checked any box under Standard deduction, see instructions.	8	**Standard deduction or itemized deductions** (from Schedule A)				8	28,710
	9	Qualified business income deduction (see instructions)				9	
	10	Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-				10	82,290
	11	a Tax (see inst.) 9,980 (check if any from: 1 ☐ Form(s) 8814 2 ☐ Form 4972 3 ☐)					
		b **Add** any amount from Schedule 2 and check here ▶ ☐				11	9,980
	12	a Child tax credit/credit for other dependents 2,000			b **Add** any amount from Schedule 3 and check here ▶ ☐	12	2,000
	13	Subtract line 12 from line 11. If zero or less, enter -0-				13	7,980
	14	Other taxes. Attach Schedule 4				14	
	15	Total tax. Add lines 13 and 14				15	7,980
	16	Federal income tax withheld from Forms W-2 and 1099				16	8,900
	17	Refundable credits: a EIC (see inst.) ____ b Sch. 8812 ____ c Form 8863 ____					
		Add any amount from Schedule 5 ____				17	
	18	Add lines 16 and 17. These are your total payments				18	8,900
Refund	19	If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you **overpaid**				19	920
	20a	Amount of line 19 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐				20a	920
Direct deposit? See instructions.	▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings					
	▶ d	Account number					
	21	Amount of line 19 you want **applied to your 2019 estimated tax** ▶	21				
Amount You Owe	22	**Amount you owe.** Subtract line 18 from line 15. For details on how to pay, see instructions ▶				22	
	23	Estimated tax penalty (see instructions) ▶	23				

Go to *www.irs.gov/Form1040* for instructions and the latest information. Form **1040** (2018)

FIGURE I:2-1 ▶ FORM 1040 (continued)

STANDARD DEDUCTION

Itemized deductions are claimed only if the total amount of such deductions exceeds the standard deduction. The **standard deduction** is an amount set by Congress. It varies from year to year depending on the taxpayer's filing status, age, and vision (filing status is discussed later in the chapter).

KEY POINT

The dollar amount of the standard deduction generally increases each year because it is indexed to the rate of inflation.

Filing Status	*Standard Deduction*	
	2018	*2019*
Married couple filing jointly	$ 24,000	$ 24,400
Surviving spouse	24,000	24,400
Head of household	18,000	18,350
Single (unmarried individual other than surviving spouse or head of household)	12,000	12,200
Married individual filing separately	12,000	12,200

In 2019, a married taxpayer's or surviving spouse's standard deduction is increased by $1,300 ($1,300 in 2018) if he or she is elderly or blind ($2,600 if the taxpayer is elderly *and* blind) or has a spouse who is elderly or blind (for a maximum possible increase of $5,200 for a married couple). If a head of household or single taxpayer is elderly or blind, his or her standard deduction is increased by $1,650 ($1,600 in 2018) and $3,300 if the taxpayer is elderly *and* blind. Thus, in 2019, a single taxpayer, age 65 and not blind, is entitled to a $13,850 ($12,200 + $1,650) standard deduction. Two special rules relating to age and blindness are noted below.

SCHEDULE 1 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

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

OMB No. 1545-0074
2018
Attachment Sequence No. 01

Name(s) shown on Form 1040: John A. and Anne B. Smith
Your social security number: 123-45-6789

Additional Income	1–9b	Reserved		1–9b	
	10	Taxable refunds, credits, or offsets of state and local income taxes		10	
	11	Alimony received		11	
	12	Business income or (loss). Attach Schedule C or C-EZ		12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
	14	Other gains or (losses). Attach Form 4797		14	
	15a	Reserved		15b	
	16a	Reserved		16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
	18	Farm income or (loss). Attach Schedule F		18	
	19	Unemployment compensation		19	
	20a	Reserved		20b	
	21	Other income. List type and amount ▶		21	
	22	Combine the amounts in the far right column. If you don't have any adjustments to income, enter here and include on Form 1040, line 6. Otherwise, go to line 23		22	
Adjustments to Income	23	Educator expenses	23		
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	24		
	25	Health savings account deduction. Attach Form 8889	25		
	26	Moving expenses for members of the Armed Forces. Attach Form 3903	26		
	27	Deductible part of self-employment tax. Attach Schedule SE	27		
	28	Self-employed SEP, SIMPLE, and qualified plans	28		
	29	Self-employed health insurance deduction	29		
	30	Penalty on early withdrawal of savings	30		
	31a	Alimony paid **b** Recipient's SSN ▶	31a		
	32	IRA deduction	32	11,000	
	33	Student loan interest deduction	33		
	34	Reserved	34		
	35	Reserved	35		
	36	Add lines 23 through 35		36	11,000

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F Schedule 1 (Form 1040) 2018

FIGURE I:2-2 ▶ Schedule 1 (Form 1040)

ADDITIONAL COMMENT

Of all individual returns filed for 2016, 69% claimed the standard deduction. This percentage will be higher for 2018 through 2025 due to the much larger standard deduction allowed for these years.

- The increase in the standard deduction for elderly taxpayers is available if the taxpayer turns 65 during the tax year. For purposes of this requirement, a taxpayer is considered to be age 65 on the day before his or her sixty-fifth birthday. Thus, a taxpayer who reaches age 65 on January 1 of a year is deemed to have reached age 65 on December 31 of the preceding year. The adjustment is allowed on the final return of a deceased taxpayer only if he or she reached age 65 before death.
- The IRC defines blindness as corrected vision in the better eye of no better than 20/200 or a field of no greater than 20 degrees. Vision is determined as of the last day of the tax year or, in the case of a deceased taxpayer, as of the date of death.

The standard deduction simplifies the computation of taxable income. As previously noted, for most taxpayers the standard deduction is greater than total itemized deductions. Those taxpayers do not itemize and, in fact, do not even have to keep records of medical expenses and other itemized deductions.

Who actually itemizes and who does not? High-income taxpayers are more likely to itemize than low-income taxpayers simply because they incur more expenses that can be itemized. Another characteristic of taxpayers who generally itemize their deductions are

individuals who own their homes and incur home mortgage expenses and property taxes, which are both allowed as itemized deductions.

EXAMPLE I:2-3 ▶ In 2019, Joan is single and has $200,000 of AGI. She is a homeowner who pays $7,000 of property taxes on her home and $19,000 of interest on her $500,000 home mortgage. She also makes $11,000 of charitable contributions. Her taxable income is computed as follows:

Adjusted gross income		$200,000
Minus: Itemized deductions:		
Property taxes	$ 7,000	
Home mortgage interest	19,000	
Charitable contributions	11,000	(37,000)
Taxable income		$163,000

Joan claims her $37,000 of itemized deductions because they are greater than her $12,200 standard deduction. ◀

EXAMPLE I:2-4 ▶ Assume the same facts as in Example I:2-3 except that Joan is not a homeowner. Thus, she has no property taxes or home mortgage interest but does pay rent of $1,900 per month for an apartment. Her taxable income is computed as follows:

Adjusted gross income	$200,000
Minus: Standard deduction	(12,200)
Taxable income	$187,800

Joan claims a $12,200 standard deduction because it is greater than her itemized deductions of $11,000. Rent paid for a personal apartment is not deductible. ◀

Loss of the Standard Deduction. Congress decided that some taxpayers should not be permitted to use the standard deduction as they possibly would receive an unintended tax benefit.[7] The standard deduction is unavailable to three categories of taxpayers:

- An individual filing a return for a period less than twelve months because of a change in accounting period.
- A married taxpayer filing a separate return in instances where the other spouse itemizes.
- Nonresident aliens (individuals who are not U.S. residents and also are not U.S. citizens).

To illustrate why Congress does not permit certain taxpayers to claim the standard deduction, consider what could happen if a married couple files separate returns but only one spouse itemizes. On a separate return in 2019 when the standard deduction is $12,200, one spouse could claim all itemized deductions while the other uses the standard deduction.

EXAMPLE I:2-5 ▶ Clay and Joy, a married couple, have incomes of $70,000 and $68,000, respectively. Their itemized deductions total $17,500. They would claim a $24,400 standard deduction on a joint return. If Clay filed a separate return and claimed all of the itemized deductions, his itemized deductions of $17,500 would be greater than the $12,200 standard deduction. If Joy could claim the standard deduction on her return, their total deductions would equal $29,700 ($17,500 + $12,200). The law, however, requires that either they both itemize or they both use the standard deduction. ◀

Limitation on the Standard Deduction. A special rule applies to any individual who is a dependent of someone else, such as his or her parents. For 2019, a dependent's standard deduction is limited to the greater of (1) the dependent's earned income plus $350 or

[7] Sec. 63(c)(6).

(2) $1,100 ($350 and $1,050 in 2018). The purpose of this limitation is to prevent parents from shifting unearned income, such as interest and dividends, to their children and avoid paying tax on such income. Without this rule, children could use the standard deduction to offset interest and dividends.

EXAMPLE I:2-6 ▶ Webb and Beth are married, in the 37% marginal tax rate bracket, and have one son, Vincent, age 15. Vincent has no income and is claimed as a dependent by his parents. Webb and Beth transfer stocks and bonds that earn $3,000 in dividends and interest to Vincent. Their goal is to shift the $3,000 of income to Vincent to utilize his standard deduction. However, since Vincent is claimed as a dependent by his parents on their return, Vincent's standard deduction is limited to $1,100, i.e., the *greater* of $1,100 or his earned income plus $350 ($0 + $350). ◀

EXAMPLE I:2-7 ▶ Assume the same facts as in Example I:2-6 except Vincent has a part-time job and earns $2,000 in wages. Vincent's standard deduction would be $2,350 ($2,000 + $350). Alternatively, if Vincent's wages were $12,100, his standard deduction would be $12,200 (the maximum for a single individual). ◀

ADDITIONAL COMMENT

One should forsake any preconceived notions as to what constitutes a dependent before examining the dependency tests.

DEPENDENCY REQUIREMENTS

For many decades prior to 2018, individuals generally could deduct personal and dependency exemptions. For example, in 2017, an individual could deduct $4,050 for himself or herself (two $4,050 amounts for a married couple filing jointly), as well as an additional $4,050 for each dependent. The Tax Cuts and Jobs Act of 2017 suspended this deduction for 2018 through 2025, making it zero. Despite being unable to deduct an exemption for a dependent for such years, it is important to determine whether someone qualifies as the taxpayer's dependent, such as his or her child. Qualification as a dependent can affect the taxpayer's filing status and whether a child credit can be claimed (both are discussed later in the chapter). It also can affect several other tax return items, such as a deduction for the dependent's medical expenses.

To qualify as a dependent, an individual must meet the definition of either a **qualifying child** or a **qualifying relative**. Both types of dependents must meet several requirements:

- ▶ Meet a citizenship test.
- ▶ Meet a separate return test.
- ▶ Not themselves claim another person as a dependent.

Additional requirements also must be met, depending on whether the dependent is a qualifying child or a qualifying relative.

SELF-STUDY QUESTION

Beth's mother, who is a U.S. citizen, has moved to France to spend her retirement years. She has retained her U.S. citizenship, but she is now a resident of France. Is it possible for Beth to claim her mother as a dependent?

ANSWER

Yes, the mother need only be a U.S. citizen.

Requirements for All Dependents. The requirements applicable to both qualifying children and qualifying relatives are:

Citizenship. Dependents must be U.S. citizens[8] or nationals,[9] or residents of the U.S., Canada, or Mexico[10] for some part of the year.

Joint Return. Married dependents cannot file joint returns. However, a married individual can qualify as a dependent if he or she files a joint return solely to claim a refund of tax withheld (i.e., there is no tax on the joint return and there would have been no tax on two separate returns).[11]

[8] U.S. citizens living in foreign countries can claim adopted children as dependents even if the children are not U.S. citizens.

[9] A U.S. national is an individual born in an outlying possession such as American Samoa.

[10] A resident is a person who is not a U.S. citizen and who is legally residing in the United States with intent to stay here permanently (see Sec. 7701(b)).

[11] Rev. Rul. 54-567, 1954-2 C.B. 108 and Rev. Rul 65-34, 1965-1 C.B. 86. The theory is that the taxpayer is filing a claim for refund and not actually filing a tax return.

Additional Requirements for Qualifying Children. One type of dependent is a qualifying child. The following additional requirements must be met to be a qualifying child:

- A relationship test.
- An age test.
- An abode test.
- A support test.

Relationship Test. Eligible children include the taxpayer's children (including natural, adopted, foster, and stepchildren) and the taxpayer's siblings (including half-siblings and step-siblings) along with descendants of any of the above. A child is adopted if the child has been legally adopted or has been legally placed in a home for adoption.

Age Test. A qualifying child must be under age 19, a full-time student under age 24, or a permanently and totally disabled child.[12] A child is considered to be a student if he or she is in full-time attendance at a qualified educational institution during at least five months of the year. To be full-time, a student must carry the number of hours or courses the educational institution requires a student to take to be considered full-time.

Abode Test. A qualifying child must have the same principal abode as the taxpayer for more than half of the year. A noncustodial parent meets this requirement if the custodial parent agrees in writing.

Support Test. A qualifying child may not provide more than one-half of his or her own support during the year. Support is defined below in connection with the discussion of qualifying relatives. For a qualifying child, there is no requirement that the taxpayer provide more than one-half of the child's support, only that the qualifying child cannot provide more than one-half of his or her own support. This can be important in situations such as divorces where one spouse provides support, but the other has custody.

EXAMPLE I:2-8 ▶ Keith and Barbara file a joint return and have one son, Jeff, age 28. Because of a temporary illness, Jeff had to quit his job in June and moved back home to live with his parents. Keith and Barbara provided 70% of Jeff's support. Jeff earned $18,000. Jeff is not a qualifying child. Although he meets the relationship, abode, and support tests, he fails the age test. ◀

Additional Requirements for Qualifying Relatives. The other type of dependent is a *qualifying relative*. The following additional requirements must be met to be a qualifying relative:

- Relationship test.
- Gross income test.
- Support test.

Relationship Test. Qualifying relatives must either be related to the taxpayer or reside in the taxpayer's household for the entire year. The term "qualifying relative" is misleading because individuals who live with the taxpayer do not actually have to be related to the taxpayer. The relationship between the taxpayer and the dependent cannot violate local law.[13]

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[12] As noted, taxpayers attain the age 65, for purposes of the additional standard deduction, on the day before the anniversaries of their births. As a result, an individual whose birthday is January 1 is considered to be age 65 in the year prior to the individual's 65th birthday. A child whose 19th birthday falls on January 1 is considered to be under the age 19 in the previous year. The rule also is followed for purposes of determining whether the child is under age 24, and is used in connection with age 17 threshold associated with the child credit. Rev. Rul. 2003-72, 2003-2 C.B. 346.

[13] Sec. 152(f)(3). Qualification as a dependent has been disallowed where the relationship constituted "cohabitation" and was illegal in the state (*Cassius L. Peacock*, III, PH T.C. Memo ¶78.030, 37 TCM 177).

Individuals who meet the relationship test for a qualifying child, such as the taxpayer's children, siblings, and descendants of children and siblings, also meet the relationship test for a qualifying relative. The relationship test for a qualifying relative also includes the taxpayer's parents and their ancestors and siblings, the taxpayer's stepparents, and specified in-laws (mother, father, brother, sister, son, and daughter). As a result, a child who is not a qualifying child may be claimed as a dependent if he or she is a qualifying relative. For example, a taxpayer's 24-year-old son is a qualifying relative if he meets the support and gross income tests discussed below even though he is not a qualifying child because he fails the age test.

EXAMPLE I:2-9 ▶ Jesse provides support for three people: Tina (his friend, who is unrelated to Jesse and lives with him for the entire year), Judy (his cousin, who lives in another state), and Vicki (his daughter, who lives in her own home). Tina and Vicki, but not Judy, meet the relationship test for a qualifying relative. Although Tina is not related to Jesse, she resides in his household for the entire year. Judy does not meet the test; a cousin is not one of the relatives included for this test, and she does not live with Jesse. As Jesse's daughter, Vicki does meet the test; the fact that she does not live with Jesse is irrelevant. ◀

On a joint return, the qualifying relative needs to be related to only one spouse.[14] Once established, a relationship is not terminated by death or divorce.

EXAMPLE I:2-10 ▶ Ken and Lisa support Lisa's mother and claim her as a dependent on a joint return. Following Lisa's death, Ken continues to support Lisa's mother. Lisa's mother continues to be Ken's mother-in-law and can be claimed as a dependent. ◀

Gross Income Test. For 2019, the qualifying relative's gross income must be less than $4,200 ($4,150 in 2018). The statutory definition of gross income is used in applying this limitation. Therefore, nontaxable scholarships, tax-exempt bond interest, and nontaxable Social Security benefits are not considered, but salary, taxable interest, and rent are considered in deciding whether the person meets this test.

EXAMPLE I:2-11 ▶ Jim, age 22, a full-time college student, lives with his cousin who provides more than one-half of Jim's support. Jim earned $8,000 from a summer job. Even though Jim's cousin provided over one-half of his support, Jim is not his cousin's qualifying relative, as he does not meet the gross income test. Alternatively, if Jim lived with and was supported by his brother, he would be his brother's qualifying child. Qualifying children do not have to meet the gross income test. ◀

Support Test. The taxpayer must normally provide more than one-half of a qualifying relative's financial support during the year. Support includes amounts spent by the taxpayer, the dependent, and other individuals. Welfare[15] and Social Security benefits[16] spent on support count even if they are excluded from gross income. A scholarship received by a son, daughter, stepchild, or eligible foster child does not count as support.

EXAMPLE I:2-12 ▶ Tarer provided $6,000 of support for his mother, Mary. Tarer's sister provided $2,000. Mary spent $9,000 of her savings for her own support. Because Mary provided over one-half of her own support, she cannot be claimed as a dependent. ◀

[14] Reg. Sec. 1.152-2(d).
[15] Rev. Rul. 71-468, 1971-2 C.B. 115.
[16] Rev. Ruls. 57-344, 1957-2 C.B. 112, and 58-419, 1958-2 C.B. 57.

EXAMPLE I:2-13 ▶ George's father received Social Security benefits of $13,200, of which $3,600 were deposited into a savings account. He spent the remaining $9,600 on food, clothing, and lodging. George spent $11,200 to support his father. George meets the support test because the amount saved is not counted in the support test. ◀

ADDITIONAL COMMENT

A TV set bought by a parent for his 12-year-old child and set up in her bedroom was considered support. A power lawn mower, however, bought by a parent of a 13-year-old child was not considered support. The parent had assigned the child the job of mowing the lawn, and the power mower was intended to make the job more palatable. The lawn mower was considered a family item that benefits all members of the household. (Rev. Rul. 77-282, 1977-2 C.B. 52.)

Support includes amounts spent for food, clothing, shelter, medical and dental care, education, and the like.[17] Support is not limited to these items.[18] Support does not include the value of services rendered by the taxpayer to the dependent.[19] Also, the IRS and the courts have excluded various other expenses from support.[20]

Generally, the amount of support equals the cost of the item, but in the case of support provided in a noncash form, such as lodging, the amount of support equals the fair market value or fair rental value. The cost of an item such as a television or an automobile is included in support if the item actually is support.[21]

EXAMPLE I:2-14 ▶ Vicki's mother lives with her. Vicki purchased clothing for her mother costing $1,600 and provided her with a room that Vicki estimates she could have rented for $5,600. Vicki spent $5,000 for groceries she shared with her mother and $2,400 for utilities. In addition, Vicki purchased a television for $550 that she placed in the living room. Vicki and her mother both used the television. Vicki's support for her mother, at a minimum, includes:

Clothing	$1,600
Rental value of room	5,600
Food	2,500
Total	$9,700

Whether a portion of the utilities could be included in support would depend on whether the rental rate for the room included utilities. The fact that the mother used the television set probably would not be sufficient to cause its cost to be viewed as support. On the other hand, if the television set was a gift to the mother, was placed in her room, and was used exclusively by her, the cost probably would qualify as support. ◀

If a taxpayer contributes a lump sum for the support of two or more individuals, the amount is allocated between the individuals on a pro rata basis unless proof exists to the contrary.[22]

EXAMPLE I:2-15 ▶ Jaime pays rent of $12,600 for an apartment occupied by his aunts Alice, Beth, and Cindy. Alice spends $5,600 toward her own support, Beth spends $2,800, and Cindy spends $3,500. Jaime is assumed to have provided $4,200 of support for each aunt. Thus, assuming the other tests are met, Beth and Cindy are Jaime's qualifying relatives, but not Alice. ◀

EXAMPLE I:2-16 ▶ Paul and Mary have three children and are unclear whether they can claim their children as dependents. Information on the children is as follows:

- Peter, age 25, who served in the military immediately after high school, is a full-time college student. He worked part-time earning $3,200 and provided 20% of his support.

[17] Reg. Sec. 1.152-1(a)(2)(i).

[18] Examples of other items that have been held to be support include church contributions (Rev. Rul. 58-67, 1958-1 C.B. 62), telephone (*William K. Price, III*, 1961 PH T.C. Memo ¶61,173, 20 TCM 886), medical insurance premiums (*James Edward Parker*, 1959 PH T.C. Memo ¶52,182, 18 TCM 800), child care (*Marvin D. Tucker*, 1957 PH T.C. Memo ¶57,118, 16 TCM 488), toys (*Loren S. Brumber*, 1952 PH T.C. Memo ¶52,087, 11 TCM 289), and vacations (*George R. Melat*, 1953 PH T.C. Memo ¶53,141, 12 TCM 443).

[19] *Frank Markarian v. CIR.*, 16 AFTR 2d 5785, 65-2 USTC ¶9699 (7th Cir., 1965).

[20] Examples of items that have been excluded are funeral expenses (Rev. Rul. 65-307, 1965-2 C.B. 40), taxes (Rev. Rul. 58-67, 1958-1 C.B. 62), a rifle, lawn mower, boat insurance (*Harriet C. Flower v. U.S.*, 52 AFTR 1383, 57-1 USTC ¶9655 (D.C. Pa., 1957)), and life insurance premiums (*John F. Miller*, 1959 PH T.C. Memo ¶59,155, 18 TCM 673).

[21] Rev. Rul. 77-282, 1977-2 C.B. 52.

[22] Rev. Rul. 64-222, 1964-2 C.B. 47 and Rev. Rul. 72-591, 1972-2 C.B. 84.

- Mark, age 22, graduated from college in May (he was a full-time student for five months of the year), and accepted a job in June. He lived with his parents for the entire year, earned $28,000, and provided 70% of his own support.
- Ruth, age 18, graduated from high school in May, and moved into an apartment immediately after graduation. She earned $5,500 from a job and provided 30% of her own support for the year.

Assume Paul and Mary provide all the support not provided by the children. The first step is to determine whether any of the children are considered qualifying children. None of the children are qualifying children. Peter is over age 23. Mark provided more than 50% of his own support. Ruth did not live with her parents for more than one-half of the year. The second step is to determine whether any of the children are considered qualifying relatives. Peter is considered as a qualifying relative as he meets the relationship, gross income, and support tests. Mark fails both the gross income and support tests, and Ruth fails the gross income test. Thus, only Peter can be claimed as a dependent. ◄

Tie-Breaker Rules for Dependency. More than one person can meet the requirements to claim someone as a dependent. Tie-breakers decide who claims the dependent in such situations, as follows:

- First, taxpayers who meet the requirements to claim the dependent under the qualifying child rules have priority over individuals who meet the requirements for other relatives.
- The next priority provides that parents have priority over other individuals.
- Finally, if neither of the first two tie-breakers apply, the third tie-breaker specifies that the taxpayer with the highest AGI claims the dependent.

Consider a niece who lives with three aunts who contribute equal amounts to her support. Assuming other requirements are met, all three aunts satisfy the requirements to claim the niece as a dependent under the qualifying child rule. Taxpayers who meet the requirements to claim a dependent under the qualifying child rules have priority over individuals who meet the requirements for other relatives. This first tie-breaker would not determine who the niece is a dependent of because each aunt meets the qualifying child requirement. Moving to the second tie-breaker, parents have priority over other individuals. Again, the tie-breaker will not determine which aunt the niece is a dependent of because they are not the niece's parent. Thus, in this case, the niece is a dependent of the aunt with the greatest AGI. In cases involving two parents, their child generally is a dependent of the parent with whom the child resided for the longer period of time during the year. If the child spent equal amounts of time with each parent, the child is a dependent of the parent with the higher AGI.

Two provisions can override the normal operation of dependency rules:

- A Multiple Support Declaration (Form 2120) can enable a taxpayer to claim a dependent in situations where the taxpayer does not provide over one-half of the dependent's support. This can be very important when several individuals contribute to the support of an individual who otherwise is not a qualifying relative because no one provided more than one-half of the individual's support.
- A Release of Claim to Exemption for Child of Divorced or Separated Parents (Form 8332) can enable a noncustodial parent to claim his or her child as a dependent.

Multiple Support Agreements. Sometimes, a group of people collectively provide over one-half of an individual's support, but no one person provides over one-half of it. In this case, eligible members of the group may designate one group member to claim the individual as a qualifying relative. Each eligible member (other than the taxpayer claiming the qualifying relative) must agree in writing to this designation. The taxpayer claiming the qualifying relative must complete Form 2120 (Multiple Support Declaration, shown in Figure I:2-3). An eligible member is one who contributes more than 10% of the

qualifying relative's support and meets all other requirements for claiming the individual as a qualifying relative, including the relationship test.[23]

EXAMPLE I:2-17 ▶ John T. Abel lives alone. His support comes from the following sources:

Andy (son)	$ 600
Gabe (son)	4,200
Mable (daughter)	3,000
Betty (friend)	4,200
Total	$12,000

Either Gabe or Mable can claim John as a qualifying relative if the other agrees in writing. Andy cannot claim John as a qualifying relative because he did not provide over $1,200 (0.10 × $12,000) of John's support. Betty cannot claim him as a qualifying relative because she is not related to John and he does not live with her. For this reason, Andy and Betty need not agree in writing. Form 2120 is included in the return of the taxpayer claiming John as a qualifying relative. A completed Form 2120 is illustrated in Figure I:2-3. ◀

A multiple support agreement cannot be used to pass qualification as a dependent from a person for whom the dependent is a qualifying child to a person for whom the dependent is a qualifying relative.[24]

Form **2120**
(Rev. October 2018)
Department of the Treasury
Internal Revenue Service

Multiple Support Declaration

▶ Attach to Form 1040.

▶ Go to *www.irs.gov/Form2120* for the latest information.

OMB No. 1545-0074

Attachment Sequence No. **114**

Name(s) shown on return: Gabe I. Abel

Your social security number: 123 : 45 : 6789

During the calendar year 2018, the eligible persons listed below each paid over 10% of the support of:

John T. Abel
Name of your qualifying relative

I have a signed statement from each eligible person waiving his or her right to claim this person as a dependent for any tax year that began in the above calendar year.

Mable B. Abel — Eligible person's name — 222 : 11 : 0001 — Social security number

402 N. Lable Lane, Lawrence, NJ 08649 — Address (number, street, apt. no., city, state, and ZIP code)

Eligible person's name — Social security number

Address (number, street, apt. no., city, state, and ZIP code)

Eligible person's name — Social security number

Address (number, street, apt. no., city, state, and ZIP code)

Eligible person's name — Social security number

Address (number, street, apt. no., city, state, and ZIP code)

FIGURE I:2-3 ▶ FORM 2120

[23] Sec. 152(c).

[24] Sec. 152(d)(1)(D).

ADDITIONAL COMMENT

Form 8332 may be completed each year by the custodial parent to relinquish the right to claim the child as a dependent for only that year, or it may be completed once, relinquishing the right for all future years.

Parental Release. The child of divorced or separated parents generally is a dependent of the custodial parent. However, the child is a dependent of the noncustodial parent if the custodial spouse signs a completed Form 8332. The signed form is attached to the noncustodial spouse's return for each year the child is claimed as a dependent.[25] In the case of a divorce or separation, the custodial spouse probably would be reluctant to relinquish the right to claim the child as a dependent. A noncustodial parent, however, might be able to negotiate to obtain this right in exchange for increased child support payments.

EXAMPLE I:2-18 ▶ Hal and Pam obtain a divorce under the terms of which Pam receives custody of their son. Hal is ordered to pay $600 per month of child support. In absence of a written agreement to the contrary, Pam may claim their son as a dependent. ◀

EXAMPLE I:2-19 ▶ Assume the same facts as in Example I:2-18 except that Pam negotiates child support payments of $800 per month and agrees in writing to allow Hal to claim their son as a dependent. The written agreement will enable Hal to do so. ◀

EXAMPLE I:2-20 ▶ Andy and Beth obtain a divorce under the terms of which they share custody of their daughter. The divorce decree does not specify who is to claim their daughter as a dependent. Whoever has custody for the greater part of the year claims her as a dependent unless they agree otherwise in writing. If they share custody equally, the parent with the higher AGI claims the dependent. ◀

The rules for claiming dependents are summarized in Topic Review I:2-1.

CHILD CREDIT

ADDITIONAL COMMENT

There are two credits that have similar names: the child tax credit and the child and dependent care credit. They are quite different in how the credit amounts are computed and which dependents qualify. Chapter I:14 discusses the dependent care credit.

Individual taxpayers may claim a $2,000 credit for each qualifying child under age 17 plus a $500 credit for each other dependent.[26] Recall from earlier in the chapter that a credit reduces the tax rather than taxable income, so it reduces the tax dollar-for-dollar. Recall also that a qualifying child is one type of dependent. The child credit is reduced by $50 for each $1,000 (or fraction thereof) by which the taxpayer's AGI exceeds $200,000 ($400,000 for married filing jointly).[27] The amount of the credit and the phase-out thresholds are not indexed for inflation. To claim this credit, the taxpayer must provide the dependent's Social Security number.

EXAMPLE I:2-21 ▶ Jane and Bill are married and file jointly. They have two qualifying children under age 17, and $100,000 of AGI. They may claim a $4,000 ($2,000 × 2) child credit. The credit is not reduced because their AGI is not greater than $400,000. ◀

TOPIC REVIEW I:2-1

Dependency Requirements

- All dependents (1) must meet a citizenship test, (2) cannot normally file a joint return, and (3) cannot claim others as dependents.
- Qualifying children must (1) be the taxpayer's child or sibling (or a descendent of either), (2) be under 19, a full-time student under 24, or disabled, (3) live with the taxpayer for more than half the year, and (4) not provide more than one-half of their own support.
- Qualifying relatives must (1) be related to the taxpayer or reside in the taxpayer's household for the entire year, (2) have gross income less than $4,200 (2019), and (3) receive over one-half of their support from the taxpayer.

[25] In the case of divorces prior to 2008, the noncustodial spouse can substitute a copy of pages from the divorce decree that allows the noncustodial spouse to claim the child as a dependent.

[26] Sec. 24.

[27] For this purpose, AGI is modified by adding any amounts excluded from gross income under Secs. 911, 931, and 933, which relate to certain foreign earned income and possession's income.

EXAMPLE I:2-22 ▶ Assume the same facts as in Example I:2-21, except the couple's AGI is $405,000. Their AGI exceeds $400,000 by $5,000, so their credit is reduced by $250 ($50 × 5). They are allowed a $3,750 ($4,000 – $250) child credit. ◀

EXAMPLE I:2-23 ▶ Assume the same facts as in Example I:2-22, except the couple's AGI is $405,001. Their AGI exceeds $400,000 by $5,001, so their credit is reduced by $300 ($50 × 6). A sixth $50 reduction applies because the additional $1 of AGI is a fraction thereof. The couple is allowed a $3,700 ($4,000 – $300) child credit. ◀

EXAMPLE I:2-24 ▶ Martha is not married, has $80,000 of AGI, and has three dependents: (1) a qualifying child born on January 23, 2003, (2) a qualifying child born on April 11, 1999, and (3) a qualifying relative born on October 15, 1944. The two qualifying children are ages 16 and 20 at the end of 2019; the qualifying relative's age is irrelevant. Martha's total credit is $3,000: $2,000 for the first qualifying child, $500 for the second qualifying child, and $500 for the qualifying relative. ◀

The child credit is partially refundable. For 2019, its refundability is limited to the lesser of (1) 15% of the taxpayer's earned income in excess of $2,500 or (2) $1,400 per qualifying child under age 17 (if the taxpayer has one or two qualifying children).

EXAMPLE I:2-25 ▶ Georgia's two qualifying children under age 17 entitle her to a child credit of $4,000. Her salary is $25,000, and income tax before credits is $665. The credit offsets all $665 of Georgia's income tax before credits. The refundability of the remaining $3,335 ($4,000 – $665) of the credit is limited to the lesser of $3,375 (15% × ($25,000 – $2,500)) or $2,800 (2 × $1,400). Georgia thus will receive a refund of $2,800, plus any withholdings or estimated tax payments. ◀

If the taxpayer has three or more qualifying children under age 17, the limitation on the child credit's refundability is increased (but not decreased) to the excess of the taxpayer's Social Security tax paid over the taxpayer's earned income credit for the year. See Chapter I:14 in the *Individuals* volume for more detail regarding the child credit.

Determining the Amount of Tax

OBJECTIVE 3

Calculate the income tax for individuals

After taxable income is computed, the next step is to determine the gross tax. Most individuals determine the amount of gross tax by looking in the tax table. (See page T-2 after Chapter I:18 in *Individuals* volume or after Chapter C:15 in the *Comprehensive* volume.) This method allows the taxpayer to arrive at the gross tax without the need for multiplication and, therefore, simplifies the computation and reduces the number of errors. Individuals are required to use the tax table unless taxable income equals or exceeds the maximum income in the table (currently $100,000), or if the taxpayer files a short period return on account of a change in the annual accounting period.

Taxpayers who cannot use the tax table instead use the tax rate schedule (located after Chapter I:18 and in the Quick Reference section of the text). Taxpayers using the tax rate schedule must actually compute the tax.

EXAMPLE I:2-26 ▶ Liz is single and has taxable income of $48,210. Liz's tax is determined by reference to the tax table for single taxpayers. (At the time of this writing, the 2018 tax table was the most recent available.) The tax from the table is $6,549. ◀

EXAMPLE I:2-27 ▶ Jack and Pam are married, file a joint tax return, and have taxable income of $105,000 in 2019. They use the tax rate schedule to compute their tax. The tax is computed as follows:

Tax on $78,950	$9,086
Tax on remaining $26,050 at 22%	5,731
Gross tax	$14,817

◀

FILING STATUS

There are seven tax brackets applicable to individual taxpayers: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. These rates are progressive in that as a taxpayer's income increases, the taxpayer moves into higher tax brackets. The income level at which higher tax brackets begin depends on the taxpayer's filing status. There are five different filing statuses but only four rate schedules and/or tax tables because married couples filing jointly and certain surviving spouses use the same rate schedule or tax table. The five filing statuses are as follows:

- Married filing jointly
- Surviving spouse
- Head of household
- Single
- Married filing separately

Before 1948, one rate schedule was used by all taxpayers. Married couples often filed separate returns in order to have more income taxed at lower rates. This treatment was deemed to be unfair because various states allocated income between spouses differently. Some states used a community property law system while other states used a common law system. Today, only a few states continue to use the community property law system.[28]

KEY POINT

Currently the highest tax rates for a given amount of taxable income are generally those for single and married filing separately, and the lowest are those for married filing jointly and surviving spouse.

In general, community property law allocates community income equally between the spouses, regardless of which spouse actually earns the income. In other states, income belongs to the spouse who produces the income. With a progressive tax system, placing income on one return instead of two can result in a much greater tax. For this reason, couples residing in noncommunity property states often paid more tax than their counterparts who resided in community property states. In 1948, Congress developed the joint-rate schedule to rectify this problem. Unmarried taxpayers who headed families felt they also should receive tax relief because they shared their incomes with their families. So, in 1957, Congress created a rate schedule for heads of households. Below is a discussion of who is covered by each filing status.

SELF-STUDY QUESTION

If Congress were to adopt a truly proportional tax system, would it be necessary to have the four different tax rate schedules?

ANSWER

No, in a proportional tax system, there is no need for different rate schedules because all taxable income would be taxed at the same rate.

MARRIED FILING JOINTLY

Married couples may elect to file joint income tax returns.[29]

- To file a joint return, a couple must be legally married as of the last day of the tax year (for most individuals, this day is December 31). Common law marriages are recognized. An annulled marriage is viewed as never having been valid.
- The couple's marriage must be lawful and must be recognized by any U.S. state, possession, or territory.[30]
- Except in the case of death, spouses who file joint tax returns must have the same tax year-end.
- Both spouses must be U.S. citizens or residents. An exception allows a joint return if the nonresident alien spouse agrees to report all of his or her income on the return.[31]

STOP & THINK

Question: Some couples who marry find that their tax liabilities increase even if their combined taxable incomes remain unchanged, but many couples find that their tax liabilities decrease or do not change. Explain why the structure of the tax rate schedules produces these outcomes.

Solution: Couples who marry ordinarily change from two returns where incomes are taxed using the rate schedule for single individuals and/or heads of households to one

[28] Several states had either adopted or had begun to adopt community property laws in order to reduce the federal income taxes paid by their residents. After the joint rate schedule was created, states without a tradition of community property law returned to common law. For a more detailed discussion of community property states, see page I:3-6.

[29] Sec. 6013.

[30] Reg. Sec. 301.7701-18. The tax law does not treat a civil union, domestic partnership, or other similar relationship as a marriage unless the law of a U.S. state, possession, or territory denominates it as a marriage.

[31] Sec. 6013(g). Ordinarily, nonresident aliens are taxed only on U.S.-source income. Permitting a couple to take advantage of the lower tax rates on a joint return while reporting only one spouse's income would result in an unintended tax benefit.

ADDITIONAL COMMENT

Since marital status for the entire year is determined on the last day of the tax year, some couples actually plan for their wedding to occur on December 31 or January 1. In general, if only one person has income, the wedding should take place on December 31. If both have income, a January 1 wedding is better (for tax purposes).

return where the combined incomes are taxed using the married filing joint rate schedule. For example, the first $9,700 of a single individual's taxable income is taxed at 10%, and the next $29,775 ($39,475 − $9,700) is taxed at 12%. These tax bracket widths are $13,850 and $39,000 for a head of household and $19,400 and $59,550 for a married couple filing jointly. The effect of marriage on a couple's combined tax thus depends on their filing statuses before marriage, as well as the extent to which their combined income is attributable to each spouse.

Case 1: Individual #1 was single, with $80,000 of taxable income. Individual #2 was a head of household, with $79,000 of taxable income. The taxable income in the 10%, 12%, and 22% tax brackets as unmarried individuals versus a married couple filing jointly, as well as their total tax, is as follows (assuming their combined taxable incomes do not change when they marry):

	If unmarried					
	Individual #1		*Individual #2*		*Married filing jointly*	
Tax bracket	*Amount in tax bracket*	*Tax*	*Amount in tax bracket*	*Tax*	*Amount in tax bracket*	*Tax*
10%	$ 9,700	$ 970.00	$13,850	$ 1,385.00	$ 19,400	$ 1,940.00
12%	29,775	3,573.00	39,000	4,680.00	59,550	7,146.00
22%	40,525	8,915.50	26,150	5,753.00	80,050	17,611.00
	$80,000	$13,458.50	$79,000	$11,818.00	$159,000	$26,697.00

The individuals' taxes increase $1,420.50 ($26,697.00 − $13,458.50 − $11,818.00) when they marry. This increase occurs because $80,050 of taxable income is in the 22% tax bracket when they are married but only $66,675 ($40,525 + $26,150) when they are unmarried (taxable income in the 10% and 12% tax brackets decreases $4,150 and $9,225, respectively).

Case 2: Assume the same facts as Case 1, except Individual #2 was single. The taxes for Individual #1 if unmarried and for the couple if married are still $13,458.50 and $26,697.00, respectively. Individual #2's tax if unmarried is $13,238.50. The total tax if they are unmarried is $26,697.00 ($13,458.50 + $13,238.50), which is the same as when they are married. This occurs because the widths of the 10% and 12% tax brackets for married couples filing jointly are twice those for single individuals, so the same amounts of taxable income fall in those brackets whether they are married or not.

Case 3: Individual #1 was single, with $20,000 of taxable income. Individual #2 was single, with $75,000 of taxable income. The taxable income in the 10%, 12%, and 22% tax brackets as unmarried individuals versus a married filing jointly, as well as their total tax, is as follows (assuming their combined taxable incomes do not change when they marry):

	If unmarried					
	Individual #1		*Individual #2*		*Married filing jointly*	
Tax bracket	*Amount in tax bracket*	*Tax*	*Amount in tax bracket*	*Tax*	*Amount in tax bracket*	*Tax*
10%	$ 9,700	$ 970.00	$ 9,700	$ 970.00	$19,400	$ 1,940.00
12%	10,300	1,236.00	29,775	3,573.00	59,550	7,146.00
22%	-0-	-0-	35,525	7,815.50	16,050	3,531.00
	$20,000	$2,206.00	$75,000	$12,358.50	$95,000	$12,617.00

The individuals' taxes decrease $1,947.50 ($12,617 − $2,206.00 − $12,358.50) when they marry. This decrease occurs because $16,050 of taxable income is taxed at 22% when they are married but $35,525 when they are unmarried (taxable income in the 12% tax bracket increases $19,475).

SURVIVING SPOUSE

A widow or widower can file a joint return for the year his or her spouse dies if the widow or widower does not remarry. For the two years after the year of death, the widow or widower can file as a surviving spouse only if he or she meets specific conditions. The **surviving spouse** (sometimes called a qualifying widow or widower) must[32]

- Have not remarried as of the year end in which surviving spouse status is claimed.
- Be a U.S. citizen or resident.
- Have qualified to file a joint return in the year of death.
- Have at least one dependent son or daughter[33] living at home during the entire year and the taxpayer must pay over half of the expenses of the home.

KEY POINT

The surviving-spouse provision entitles the taxpayer to the lower joint return tax rate schedule and to the higher joint return standard deduction.

In the year of death, a joint return can be filed. On the joint return, the income of the deceased spouse (earned before death) and the survivor are both reported. In the two years following death, surviving spouse status can be claimed only if the conditions outlined above are met. Only the surviving spouse's income is reported. What the two situations have in common is that in both instances, the taxpayer can use the more favorable joint rate schedule and standard deduction amount.

EXAMPLE I:2-28 ▶ Connie and Carl are married and have no dependent children. Carl dies in the current year. Connie can file a joint return with Carl even though he did not live the entire year. Alternatively, separate returns can be filed for Connie and Carl applying the rate schedule for married individuals filing separately.

In subsequent years, Connie would file as a single taxpayer. On the other hand, if Connie and Carl had dependent children, Connie could file as a surviving spouse for the two tax years following his death. ◀

STOP & THINK

Question: Most recently-widowed individuals do not qualify for surviving spouse status. Why?

Solution: Most individuals are widowed late in life after their children are grown and have left home. As having a dependent child is a requirement for surviving spouse status, these individuals do not qualify for the special lower tax rate. Such individuals may ordinarily file a joint return in the year of the spouse's death.

ADDITIONAL COMMENT

Due in part to the high divorce rate in this country, the number of head-of-household returns has increased. For 1975, only 6% of individual returns claimed the head of household filing status. This percentage increased to 12% by 1996 and 14% by 2016.

HEAD OF HOUSEHOLD

A second rate schedule or tax table is available to a head of household. The head of household rates increase more rapidly than those applicable to married taxpayers filing jointly and surviving spouses, but more slowly than those applicable to single taxpayers. To claim head-of-household status, a taxpayer must meet all of the following conditions:[34]

- Be unmarried as of the last day of the tax year. Exceptions apply to individuals married to nonresident aliens[35] and to abandoned spouses.[36] An individual cannot claim head-of-household status in the year his or her spouse died. Such individuals must file a joint return or a separate return.
- Not be a surviving spouse.
- Be a U.S. citizen or resident.
- Pay over half of the costs of maintaining as his or her home a household in which a dependent lives for more than half of the tax year. An exception permits a taxpayer who maintains a household in which a qualifying child[37] lives for more than half of the tax year to claim head-of-household status when the qualifying child is not the taxpayer's dependent. This comes into play in the case of divorced parents when the noncustodial

[32] Sec. 2(a).
[33] Includes an adopted child or a stepchild, but not a foster child.
[34] Sec. 2(b).
[35] Specifically, this refers to an individual married to a nonresident alien if he or she meets the remaining head-of-household requirements.
[36] Abandoned spouse rules are discussed under a separate heading later in this chapter.
[37] Qualifying child has the same meaning as is associated with dependents except that the child cannot be married and must be a U.S. citizen, resident or national.

parent claims the child as a dependent. A second exception permits a taxpayer to claim head-of-household status if he or she maintains a separate household for a dependent parent. This enables the parent to continue living in his or her own home.

EXAMPLE I:2-29 ▶ Brad and Ellen divorce. Ellen receives custody of their child, and Brad is ordered by the court to pay child support of $6,000 per year. Ellen agrees in writing to allow Brad to claim their child as a dependent. If Ellen maintains the home in which she and her child live, she can claim head-of-household status even though the child is Brad's dependent. ◀

ADDITIONAL COMMENT

For 2016, the ratio of tax returns for married couples filing jointly to tax returns for married individuals filing separately was 18-to-1.

As noted, the taxpayer must pay over half of the costs of maintaining the household. These expenses include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such costs do not include clothing, education, medical treatment, vacations, life insurance, transportation, or the value of services provided by the taxpayer.[38]

SINGLE TAXPAYER

An unmarried individual who does not qualify as a surviving spouse or a head of household must file as a single taxpayer. The tax rates progress more rapidly than those that apply to other unmarried taxpayers.

EXAMPLE I:2-30 ▶ Becky, an unmarried taxpayer with no dependents, files her first tax return. She will file as a single taxpayer. ◀

KEY POINT

Several disadvantages are associated with the filing of separate returns by married individuals. For example, a taxpayer may lose all or part of the benefits of the deduction for individual retirement accounts, the child care credit, and the earned income credit.

MARRIED FILING SEPARATELY

Married individuals who choose to file separate returns must use the separate rate schedule. The rates on this schedule increase more rapidly than other individual rate schedules. The implications of joint returns versus separate returns are discussed later in this chapter.

EXAMPLE I:2-31 ▶ On December 31, Rose marries Joe. Because they were married before the year ended, they may elect to file jointly. Alternatively, they may file separate returns with each using the rate schedule applicable to separate returns. ◀

KEY POINT

When one thinks of a person who would qualify as an abandoned spouse, one thinks of a person in dire financial condition. If no relief were granted, this person would be required to use the married filing separately tax rate schedule, which contains the highest rates.

The filing requirements for individuals are summarized in Topic Review I:2-2.

ABANDONED SPOUSE

The particular rate schedule a taxpayer uses can have a great impact on the amount of tax. Without any special rule, an abandoned spouse would be required to file using the rate schedules for a married person filing separately. Congress has provided relief for taxpayers in this situation if they can meet certain conditions. A married individual can claim head-of-household status under the following circumstances:[39]

- The taxpayer lived apart from his or her spouse for the last six months of the year.
- The taxpayer pays over half of the cost of maintaining a household in which the taxpayer and a dependent son or daughter live for over half of the year.[40]
- The taxpayer is a U.S. citizen or resident.

The requirement that the taxpayer have a dependent child is met if a taxpayer who is otherwise qualified to claim the child as a dependent signs an agreement that allows the child's noncustodial parent to do so.[41]

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[38] Reg. Sec. 1.2-2(d).

[39] Sec. 2(c).

[40] Includes adopted child, stepchild, and foster child.

[41] Sec. 152(e).

WHAT WOULD YOU DO IN THIS SITUATION?

CHOICE OF RATE SCHEDULES

Jane Brown married Jim four years ago. Two years ago Jim lost his job. After looking for work for several months, Jim left town to look for work, and Jane has not heard from him. Jim's brother told Jane that he had heard that Jim lived in Texas, but a friend said he heard that Jim had been killed in an automobile accident.

Jane went back to school and completed a program as a medical technician. She returned to work this year, and she earned $35,000. She has asked you to prepare her tax return this year. She has asked you whether she should file as a single taxpayer, married person filing separately, or as a married person filing jointly. Because she has had a low income until recently, she has taken no legal steps to resolve her status. What should she do?

EXAMPLE I:2-32 ▶ In October, Bob and Gail decide to separate. Gail supports their children after the separation and pays the costs of maintaining their home. Gail cannot claim abandoned spouse status because Bob lived with her for over one-half of the year. If she had obtained a divorce before the end of the year, she could have filed as a head of household. In the absence of a divorce, Gail must file a separate return, unless both Bob and Gail agree to file a joint return. ◀

EXAMPLE I:2-33 ▶ Assume the same facts as in Example I:2-32 except that Gail continues to support her children and pay household expenses during the next year. She can file as a head of household even if she has not obtained a divorce. ◀

CHILDREN WITH UNEARNED INCOME

A child may own investments that generate unearned income, such as interest and dividends. Because the child owns the investments, the unearned income is taxed to him or her. If the child's tax bracket is lower than his or her parents' tax bracket, there is an opportunity to reduce the family's aggregate income taxes by transferring some of the parents' investments to the child. This opportunity is enhanced when some or all of the child's unearned income is offset by the standard deduction. However, the so-called "kiddie tax," discussed below, limits this tax avoidance opportunity.

EXAMPLE I:2-34 ▶ Jen is 10 years old and has no income. Her parents have taxable income that is in the 37% tax bracket. Their investments include corporate bonds that generate $10,000 of interest per year. If Jen's parents transfer ownership of the bonds to her, the $10,000 is taxed to Jen rather than her parents. Jen's taxable income is $8,900 because she can claim a $1,100 standard deduction. If the kiddie tax did not limit this tax avoidance opportunity, the family's aggregate tax would be $2,810 less (($10,000 × 37%) – ($8,900 × 10%)).[42] ◀

TOPIC REVIEW I:2-2

Filing Status and Requirements

Filing Status	Must Maintain Household	Must Have Dependent	Marital Status	Must Be Citizen	Tax Rates
Married filing jointly	No requirement	No	Married	Yes	Lowest rates, but two incomes are combined
Surviving spouse	Yes	Yes, son or daughter	Widowed in prior or second prior year	Yes	Uses same schedule as married couple filing joint return
Head of household	Yes	Generally, yes	Generally, unmarried	Yes	Intermediate tax rates
Single	No requirement	No	Unmarried	No	Highest tax rates for unmarried taxpayers
Married filing separately	No requirement	No	Married	No	Highest tax rates

[42] Jen's parents also would avoid the 3.8% tax on net investment income (see Chapter I:5), but they might incur gift tax on the transfer of the bonds to Jen (see Chapters I:1 and C:12).

KEY POINT

The kiddie tax does not apply to a child under age 18 until his or her unearned income exceeds $2,200. If the investments generating the unearned income have a 4% return, net unearned income will be zero if the investments are worth less than $55,000 ($2,200 ÷ 4%).

The tax law requires certain children with unearned income to calculate their tax in a special way. For 2019, the kiddie tax generally applies to a child whose unearned income is greater than $2,200 and who is one of the following types (ages are at the end of the year):

- Under age 18.
- Age 18 and the child's earned income is less than or equal to one-half of his or her support.
- Age 19 through 23, the child is a full-time student, and the child's earned income is less than or equal to one-half of his or her support.

EXAMPLE I:2-35 ▶ Tim was born on January 23, 2001. In 2019, he receives $2,400 of interest and $9,000 of wages from a part-time job. Tim provides $10,000 of his own support, and his parents provide $5,000 of his support. The kiddie tax does not apply to Tim because he is age 18 at the end of the year and his $9,000 of earned income exceeds $7,500 (½ × ($10,000 + $5,000)). His student status is irrelevant because he is not age 19 through 23.

Tim's parents cannot claim him as a dependent; he is not their qualifying child or qualifying relative because he provides more than one-half of his own support. Tim thus may claim a $12,200 standard deduction, which exceeds his AGI of $11,400 ($2,400 + $9,000). His taxable income and tax are zero. ◀

EXAMPLE I:2-36 ▶ Assume the same facts as in Example I:2-35, except that Tim's parents provide $11,000 of his support. The kiddie tax applies to Tim because he is age 18 and his $9,000 of earned income is less than $10,500 (½ × ($10,000 + $11,000)).

If Tim's parents can claim him as a dependent, his standard deduction is limited to the greater of $9,350 ($9,000 + $350) or $1,100. Tim's taxable income is $2,050 ($11,400 – $9,350). The calculation of the tax on this $2,050 is discussed below. ◀

ADDITIONAL COMMENT

If the child's itemized deductions directly connected with the production of the unearned income are less than or equal to $1,100, step 2 simplifies to unearned income less $2,200 (not less than zero).

Under the kiddie tax, a special tax rate schedule applies to the child's taxable income, which is determined as follows:[43]

1. Compute the child's taxable income in the normal fashion for dependents, as discussed earlier in this chapter.
2. Compute the child's net unearned income:

Unearned income (described below)	$xxx
Less: Statutory deduction of $1,100	(xxx)
Less: Greater of	
a. $1,100 of standard deduction, or	
b. Itemized deductions directly connected with the production of the unearned income	(xxx)
Equals: Net unearned income (not less than zero)	$xxx

3. Compute the child's earned taxable income (ETI), which is taxable income (from step 1) minus net unearned income (from step 2). However, ETI is not less than zero.
4. Determine the child's tax rate brackets, and apply them to the child's taxable income. For 2019, these brackets are determined as follows:[44]

10% tax rate: Portion of taxable income not over ETI plus $2,600

24% tax rate: Portion of taxable income over ETI plus $2,600 but not over ETI plus $9,300

35% tax rate: Portion of taxable income over ETI plus $9,300 but not over ETI plus $12,750

37% tax rate: Portion of taxable income over ETI plus $12,750

Unearned income is the child's investment income, including dividends, taxable interest, capital gains, rents, and royalties. It does not include earned income, such as wages and salaries.[45]

[43] Under the pre-2018 kiddie tax, a child's net unearned income was taxed at his or her parent's marginal tax rate. The kiddie tax is scheduled to revert to this treatment in 2026.

[44] The tax law does not allow these brackets to impose tax at rates that are less than those imposed by the tax rate schedule for the child's filing status. The details of this aspect of the kiddie tax are beyond the scope of this textbook.

[45] Sec. 1(g)(4).

EXAMPLE I:2-37 ▶ **Assume the same facts as in Example I:2-36, where Tim has $2,400 of interest income and $9,000 of wages and is subject to the kiddie tax. Tim's tax is calculated as follows:**

1. Compute Tim's taxable income:

Wages	$ 9,000
Interest income	2,400
Adjusted gross income	$ 11,400
Standard deduction ($9,000 + $350)	(9,350)
Taxable income	$ 2,050

2. Compute Tim's net unearned income:

Unearned income (interest)	$ 2,400
Statutory deduction of $1,100	(1,100)
$1,100 of standard deduction	(1,100)
Net unearned income (not less than zero)	$ 200

3. Compute Tim's earned taxable income:

Taxable income	$ 2,050
Net unearned income	(200)
Earned taxable income	$ 1,850

4. Determine Tim's tax rate brackets: The three thresholds for Tim's tax brackets are $4,450 ($1,850 + $2,600), $11,150 ($1,850 + $9,300), and $14,600 ($1,850 + $12,750). Tim's tax brackets thus are:

10% tax rate:	Portion of taxable income not over $4,450
24% tax rate:	Portion of taxable income over $4,450 but not over $11,150
35% tax rate:	Portion of taxable income over $11,150 but not over $14,600
37% tax rate:	Portion of taxable income over $14,600

Tim's taxable income of $2,050 is not over $4,450, so his tax is $205 ($2,050 × 10%). ◀

EXAMPLE I:2-38 ▶ **Assume the same facts as in Example I:2-34, where Jen is 10 years old and her parents own corporate bonds that generate $10,000 of interest per year. If her parents transfer the bonds to Jen, the kiddie tax applies to her because her $10,000 of unearned income exceeds $2,200 and she is under age 18. Assuming Jen is a dependent, her tax is calculated as follows:**

1. Taxable income: $10,000 − $1,100 = $8,900.
2. Net unearned income: $10,000 − $1,100 − $1,100 = $7,800.
3. Earned taxable income: $8,900 − $7,800 = $1,100.
4. Tax rate brackets: The dollar thresholds are $3,700 ($1,100 + $2,600), $10,400 ($1,100 + $9,300), and $13,850 ($1,100 + $12,750). Jen's tax brackets are:

10% tax rate:	Portion of taxable income not over $3,700
24% tax rate:	Portion of taxable income over $3,700 but not over $10,400
35% tax rate:	Portion of taxable income over $10,400 but not over $13,850
37% tax rate:	Portion of taxable income over $13,850

Jen's tax is $1,618 [($3,700 × 10%) + (($8,900 − $3,700) × 24%)]. ◀

As discussed in more detail in Chapters I:3 and I:5, an individual's dividend income and long-term capital gains generally are taxed at lower rates than other income. For a child subject to the kiddie tax, such income for 2019 generally is taxed at 0% if taxable income is not over ETI plus $2,650, at 15% if taxable income is over ETI plus $2,650 but not over ETI plus $12,950, and at 20% if taxable income is over ETI plus $12,950.

EXAMPLE I:2-39 ▶ Assume the same facts as in Example I:2-38, except the $10,000 is dividend income rather than interest income. Jen's taxable income is still $8,900, and her earned taxable income is still $1,100. Of her taxable income, $3,750 ($1,100 + $2,650) is tax-free, i.e., 0% tax rate, and $5,150 ($8,900 − $3,750) is taxed at 15%. Jen's tax is $773 ($5,150 × 15%). ◀

Parents of a child subject to the kiddie tax may elect to include the child's dividend and interest income on their own return.[46] This rule eliminates the need to file a tax return for the child. To be eligible for the election, the child's gross income must come solely from dividends and interest, and such income must not exceed $11,000 in 2019 ($10,500 in 2018). Furthermore, there can be no withholding or estimated payment using the child's Social Security number. Parents use Form 8814, Parents' Election to Report Child's Interest and Dividends.

STOP & THINK

Question: Jane and Bill have three dependent children (ages 13, 15, and 17). Jane operates a retail business and Bill farms. They earn over $200,000 each year. Can they reduce their family's taxes by employing their children in their businesses?

Solution: Yes, assuming the compensation they pay their children is reasonable. Although all three children are under age 18, none of them will be subject to the kiddie tax if each child's unearned income is less than $2,200. The compensation that Jane and Bill pay to their children would be earned income and thus would not trigger the kiddie tax for them.

The children may be able to perform a variety of services. They may be assigned chores on the farm, such as feeding livestock, milking, gathering eggs, or operating equipment. In the retail business, they can be assigned tasks such as filing, answering phones, stocking shelves, making deliveries, and operating cash registers. Jane and Bill can deduct as a business expense the reasonable compensation paid to their children, which reduces Jane and Bill's taxable income. Each child is taxed on the earned income he or she receives, but it is partially or wholly offset by his or her standard deduction. Even if it is larger than the standard deduction, it will be taxed at the child's marginal tax rate, which is less than that of Jane and Bill.

ADDITIONAL MEDICARE TAX AND NET INVESTMENT INCOME TAX

A payroll tax of 0.9% applies to earned income over $200,000 ($250,000 for married couples). An additional 3.8% tax applies to the lesser of investment income (including interest, capital gains, and dividends) or AGI in excess of $200,000 ($250,000 for married couples). These thresholds are not adjusted for inflation. The 0.9% Additional Medicare Tax is discussed in more detail in Chapter I:14, and the 3.8% net investment income tax is discussed in more detail in Chapter I:5.

BUSINESS INCOME AND BUSINESS ENTITIES

OBJECTIVE 4

Explain the basic income tax rules relating to business entities

How business income is reported depends on the type of entity. Sole proprietors report their business income on Schedule C of Form 1040 (Schedule F in the case of farmers). The income is taxed on the proprietor's Form 1040 along with the taxpayer's other income. For 2016, 17% of individual tax returns reported income or loss on Schedule C.

Corporations are divided into two groups: C corporations and S corporations. **C corporations**, also called **regular corporations**, are treated as taxable entities for tax purposes

[46] Sec. 1(g)(7).

▼ **TABLE I:2-7**
Tax Formula for C Corporations

Income from whatever source derived	$xxx
Minus: Exclusions	(xxx)
Gross income	$xxx
Minus: Deductions	(xxx)
Taxable income	$xxx
Times: Tax rate	×.21
Gross tax	$xxx
Minus: Credits and prepayments	(xxx)
Net tax payable or refund due	$xxx

KEY POINT

The tax formula for C corporations differs from the tax formula for individuals in several important respects. The corporate tax formula does not contain an adjusted gross income figure, itemized deductions, or the standard deduction.

and pay income taxes on the corporation's taxable income. Shareholders are taxed on dividends they receive from a C corporation but are not taxed on the corporation's undistributed income. Lower tax rates apply to dividends received by individual taxpayers. See Chapter I:3. Approximately 1.8 million corporations file the regular corporate return, Form 1120, each year.

The tax formula for C corporations is presented in Table I:2-7. A major difference between the formulas for individual and corporate taxpayers is the fact that there is only one category of deductions for corporations. Personal expenses do not come into consideration. Therefore, there are no itemized deductions or standard deductions. Unlike for individuals, the tax rate schedule for C corporations is not progressive. Instead, a flat 21% tax rate applies for 2018 and later years.

The second group of corporations, **S corporations**, generally are not treated as taxable entities for tax purposes. They are referred to as flow-through entities. S corporation shareholders are required to report their respective shares of the S corporation's income on their individual tax returns even if the income is not distributed. All shareholders must agree to the S corporation election when it is made. S corporations must also meet a series of conditions, such as having no foreign shareholders. S corporations report ordinary income and special items separately, and shareholders in turn report their respective shares of the ordinary income and of each special item. More than 4 million corporations file S corporation returns, Form 1120S, each year.

In one sense, there is no formula to compute an S corporation's taxable income because the corporation normally does not pay a tax. S corporations do file returns, but the returns are more informational in nature, much like the returns of a partnership. A residual income total, known as ordinary income, is computed on the return. Special items, such as capital gains and losses and charitable contributions, are kept separate from ordinary income. This is because every item that would receive special treatment on a shareholder's return is passed through to the shareholder with its status intact. Each shareholder reports his or her share of the ordinary income and his or her share of each special item. Losses pass through and generally can be deducted by shareholders up to their respective bases in the corporation's stock. Losses are also subject to other rules, such as the at-risk and passive activity loss rules, which are covered in Chapter I:9.

Partnerships, like S corporations, are flow-through entities for tax purposes. Partners report their respective shares of the partnership's income on their tax returns even if the income is not distributed. More than 4 million partnerships file returns, Form 1065, each year. Like S corporations, partnerships report ordinary income and special items separately, and the partners report their respective shares of the ordinary income and of each special item. Losses also pass through and generally can be deducted by partners on their returns.

EXAMPLE I:2-40 ▶ Jane is starting a business and is considering alternative organizational forms. She anticipates the business will earn $400,000 operating income annually before subtracting the $150,000 salary it will pay her and the $8,000 of charitable contributions it will make. Other distributions to her from the business will be $10,000.

Jane is single, has $27,000 of ordinary income from other sources, and has $18,000 of itemized deductions other than charitable contributions. Compare the income tax for 2019 if she organizes the business as a sole proprietorship, an S corporation, and a C corporation. Ignore payroll and other taxes. Assume her business' employees have W-2 wages that are large enough to allow Jane a full 20% qualified business income (QBI) deduction. Assume also that the business is not a specified service business (if it were, her QBI deduction could be reduced).

	Sole Proprietorship	*S Corporation*	*C Corporation*
Business Income:			
Operating income before subtracting Jane's salary	$400,000	$400,000	$400,000
Salary paid to Jane		(150,000)	(150,000)
Charitable contributions			(8,000)
Net business income	$400,000	$250,000	$242,000
Corporate income tax			$ 50,820
Jane's Income:			
Net business income (above)	$400,000	$250,000	
Salary from business (above)		150,000	150,000
Distributions from business[a]			10,000
Ordinary income from other sources	27,000	27,000	27,000
Adjusted gross income	$427,000	$427,000	$187,000
Itemized deductions	(26,000)[b]	(26,000)[b]	(18,000)
Qualified business income deduction	(80,000)[c]	(50,000)[d]	
Taxable income	$321,000	$351,000	$169,000
Jane's income tax	$ 87,544	$ 98,044	$ 33,835
Total income tax	$ 87,544	$ 98,044	$ 84,655

[a] For the S corporation and C corporation organizational form, distributions generally are called dividends.
[b] $8,000 charitable contributions made by business plus $18,000 other itemized deductions.
[c] $400,000 × 0.20.
[d] $250,000 × 0.20.

With a sole proprietorship, the business is not a separate entity; its activities are Jane's activities. Jane thus reports the $400,000 income from her business on Schedule C (Form 1040), and she deducts the $8,000 charitable contributions as part of her itemized deductions on Schedule A. No separate return is filed for the sole proprietorship. The salary is disregarded since the business is not a separate entity from Jane. She is allowed a 20% QBI deduction for the $400,000.

If the business is organized as a corporation and an S election is made, two income tax returns are filed: a Form 1120S for the corporation and a Form 1040 for Jane. Because of the S election, the corporation pays no income tax. Items reported on the Form 1120S "flow through" the corporation and are reported by Jane on her Form 1040. The corporation deducts the $150,000 salary when computing its income, but it is taxable to Jane. She also reports the remaining $250,000 of the corporation's income on her return and deducts the $8,000 charitable contributions as part of her itemized deductions. She is allowed a 20% QBI deduction for the $250,000.

If the business is organized as a corporation and an S election is not made, it is a C corporation that is taxed as a separate entity. The corporation files a Form 1120 on which it deducts the $100,000 salary and $8,000 charitable contributions, and it pays $50,820 (21% × $242,000) tax on the remaining income. The corporation cannot deduct the $10,000 dividend it pays. Jane reports on her Form 1040 the $150,000 salary and $10,000 dividend distributed by the corporation, but she is not allowed any QBI deduction for the business' income. Jane is taxed on the $10,000 dividend, and it is coming from income on which the corporation is taxed. However, a special provision reduces this "double tax" by taxing Jane on the dividends at 15%

instead of the higher rate that otherwise would apply. (See Chapter I:3.) As a result, the tax on her dividend is $1,500 (15% × $10,000), and the tax on her remaining income of $159,000 ($169,000 − $10,000) is $32,335 (using the tax rate schedule). Her total tax is $33,385. The total tax for the corporation and Jane is $84,655.

As shown, the total current income taxes will be lower if Jane organizes her business as a C corporation, even though the $10,000 dividend is taxed twice. This lower tax occurs because the income retained by the corporation is taxed at the corporation's 21% tax rate instead of Jane's higher marginal tax rate if it flowed through to her return. This tax savings will be reduced (and possibly reversed) in the future if the corporation distributes the retained income as a dividend. If the plans are to distribute the retained income in the near future, it is desirable to organize the business as a sole proprietorship so the distribution can be made without any future tax. This would also be the case if the business is organized as an S corporation, but Jane's QBI deduction will be smaller due to the salary the business will pay her.

Self-employment taxes and Social Security taxes should also be considered when selecting an organizational form for a new business. Although detailed consideration of these taxes is found in Chapter I:14, it is noted here that the self-employment tax, which generally applies to the sole proprietorship and partnership forms of doing business, would be greater than the Social Security tax which would apply only to the wages paid to Jane if she were to choose the S or C corporation organizational forms. Given the facts in this case, Jane might judge a sole proprietorship less favorably when these taxes are taken into consideration. Jane should also consider other taxes (e.g., state and local taxes) and nontax factors, such as liability protection, before making a final decision. ◀

The detailed rules of C corporations are covered in Chapter I:16, while S corporations and partnerships are covered in Chapter I:17 of the *Individuals* volume. All three are covered more extensively in the *Corporations*, *Partnerships, Estates & Trusts* volume and the *Comprehensive* volume.

TREATMENT OF CAPITAL GAINS AND LOSSES

OBJECTIVE 5

Explain the basic income tax rules of capital gains and losses

Capital gains and losses have been accorded favored tax treatment since 1922. Favored tax treatment essentially means that capital gains are taxed at a lower rate than is ordinary income. A purpose of the special rules is to distinguish capital appreciation from gains attributable to ordinary business transactions and speculation. This goal is accomplished by defining capital assets to not include certain business property (e.g., inventory and trade receivables) and by requiring taxpayers to hold capital assets for minimum time periods in order to benefit from the lower rates that are available to capital gains.

The discussion below is intended as a brief introduction to capital gains and losses. A detailed discussion of this topic is contained in Chapter I:5.

DEFINITION OF *CAPITAL ASSETS*

A **capital gain** or **loss** is the gain or loss from the sale or exchange of a capital asset. Unfortunately, the tax law merely states what is not a capital asset. In other words, **capital assets** are assets other than those listed in Sec. 1221. A detailed discussion is found in Chapter I:5. Here we simply note the categories of properties included on the list, which are thereby excluded from capital asset status are inventory, trade receivables, certain properties created by the efforts of the taxpayer (such as works of art), depreciable business property and business land, and certain government publications. All other assets are considered capital assets and include investment property (such as stocks and bonds) and personal-use property (such as personal residence or automobile). As noted, a purpose of the rules applicable to capital gains and losses is to distinguish capital appreciation from gains derived from ordinary business operations. The profit from the sale of inventory and trade receivables is viewed as business profit as opposed to capital appreciation. Thus, a gain realized by an artist on the sale of one of his or her own works is ordinary income from personal services. However, gain from the sale of artwork held as an investment or for personal use would be treated as a capital gain.

HISTORICAL NOTE

Net capital gains reported on individual income tax returns dropped from nearly $300 billion in 1986 to about $133 billion in 1987. The latter amount was more in line with 1984 and 1985. The large amount reported in 1986 was due to the fact that a 60% long-term capital gain deduction was available to individuals in 1986 but was repealed as of December 31, 1986. Many taxpayers sold capital assets to take advantage of the lower effective rates that existed in 1986.

TAX TREATMENT OF GAINS AND LOSSES

Capital gains and losses are divided into long-term (associated with property held over one year) and short-term (associated with property held one year or less). A single individual's 2019 net long-term capital gain generally is tax-free if taxable income is not over $39,375, at 15% if taxable income is over $39,375 but not over $434,550, and at 20% if taxable income is over $434,550. The 0%, 15%, and 20% rates apply to other filing statuses, but the dollar thresholds differ (e.g., $78,750 and $488,850 for married filing jointly; $52,750 and $461,700 for head of household). An additional 3.8% tax that applies to investment income, including capital gains and interest, received by higher-income taxpayers is discussed above. A net short-term capital gain is taxed at the same rate as other income.

On the other hand, individuals who suffer net capital losses can deduct them only against capital gains plus up to $3,000 of other income. A net capital loss in excess of $3,000 can be carried over and offset against future capital gains or, subject to the $3,000 limitation, deducted from other income.

TAX PLANNING CONSIDERATIONS

OBJECTIVE 6

Describe tax planning considerations for various tax matters

SHIFTING INCOME BETWEEN FAMILY MEMBERS

Because of the progressive tax system, families often can reduce their taxes by **shifting income** to family members who are in lower tax brackets.

EXAMPLE I:2-41 ▶ Mary, who is in the 37% tax bracket, shifted $5,000 of income to her 25-year-old son, Steve, by making a gift of a 10%, $50,000 corporate bond. Steve had no income as he suffered a business loss. In absence of the shift, 37% of the income would have gone for taxes. There is no tax on Steve's return because the income is offset by his loss. ◀

EXAMPLE I:2-42 ▶ Farouk, who is in the 37% tax bracket, shifted $2,000 of interest income to his 25-year-old daughter, Dana, who is in the 10% tax bracket. The tax savings from the shift is $540 [(0.37 × $2,000) – (0.10 × $2,000)]. ◀

ADDITIONAL COMMENT

All 50 states have enacted laws that simplify the procedures for making gifts to minors. This type of law, which in most states is called the Uniform Gifts to Minors Act, is especially important when making gifts of securities.

As noted earlier in this chapter, a special tax rate schedule applies to many individuals under age 24 who have net unearned income. Hence, a shifting of income to young children is often an ineffective method of minimizing tax.

Shifting income must be distinguished from assigning income. Earned income is taxed to the person who produces it. Income from property is taxed to the person who owns the property. Ordering income to be paid to another is an assignment of income that does not change who is taxed on the income (Chapter I:3). Normally, in the case of income from property, ownership of the property must be transferred in order to shift the income.

EXAMPLE I:2-43 ▶ John owns stock in Valley Corporation. John orders the corporation to pay this year's dividends to his daughter. John will be taxed on the income even though he has assigned it to another person. ◀

EXAMPLE I:2-44 ▶ Kay owns stock in Valley Corporation. Kay gives the stock to her 25-year-old son. Future dividends on Valley stock will be taxed to the son instead of to Kay. ◀

Individuals often are unwilling to give property away completely. As a result, personal preference may limit the amount of tax planning that is possible.

SPLITTING INCOME

Splitting income consists of creating additional taxable entities, especially corporations, in order to reduce an individual's effective tax rate.

EXAMPLE I:2-45 ▶ Tom is a taxpayer in the 37% tax bracket and is involved in a variety of businesses. One business has been producing $20,000 of income per year for several years. Tom incorporates the business. The tax rate for C Corporations is 21%. Thus, the tax on the income is reduced by $3,200 [(0.37 × $20,000) − (0.21 × $20,000)]. ◀

The creation of a new corporate entity to split income is not always desirable because the corporation's income will be taxed to the shareholder as a dividend if it is distributed. In addition, if income is allowed to accumulate in a corporation indefinitely, it may be subject to the personal holding company tax or accumulated earnings tax.[47]

KEY POINT

The ability to maximize itemized deductions by the timing of expenditures is somewhat limited. The most significant itemized deduction that lends itself to such a strategy is charitable contributions. Prepaid interest is not deductible until accrued.

MAXIMIZING ITEMIZED DEDUCTIONS

Timing expenditures properly often can increase deductions. In general, cash-basis taxpayers deduct expenses in the year paid. If itemized deductions are less than the standard deduction, the taxpayer will receive no tax benefit from itemized deductions. A taxpayer in that situation could defer some payments or accelerate others to maximize expenses in one year, thereby creating a sufficient amount of deductions in that year.

EXAMPLE I:2-46 ▶ Valerie and Chris are a married couple who file jointly. They normally have $9,000 of charitable contributions and $14,900 of other itemized deductions each year. Their $23,900 total itemized deductions are less than their $24,400 standard deduction, so they do not obtain any tax benefit from their charitable contributions. If they pay this year the $9,000 of charitable contributions they otherwise would pay next year, they would have total itemized deductions this year of $32,900 (($9,000 × 2) + $14,900). They thus would obtain a tax benefit from $8,500 ($32,900 − $24,400) of their charitable contributions. Their itemized deductions next year would be only $14,900, so they would still claim the standard deduction. ◀

Medical expenses are deductible only to the extent they exceed 10% of a taxpayer's AGI. In situations where medical expenses are just under the AGI threshold, taxpayers may be able to create a deduction by doubling up.

EXAMPLE I:2-47 ▶ Troy's AGI is $20,000. So far in 2019, Troy's medical expenses have totaled $1,975. Troy has received a bill from his dentist for $500 that is due January 15, 2020. By paying the bill in 2019, Troy will have a deduction for medical expenses of $475 [$1,975 + $500 − (0.10 × $20,000)]. This assumes that Troy's other itemized deductions exceed the standard deduction.[48] ◀

FILING JOINT OR SEPARATE RETURNS

Factors to Be Considered. In general, married couples may file either joint or separate returns. As noted earlier, if one spouse has significantly more than half of their combined income, filing separately will increase the couple's total income tax. Because of the potential tax saving from a joint return and because it is simpler to prepare one return than two, most married couples file jointly.

It should be noted that the joint return is not always preferred. Separate returns may result in increased deductions. Because only one spouse's income is reported on a separate return, medical expenses are more likely to exceed the 10% of adjusted gross income floor if one spouse incurs most of the medical expenses.

One significant impact of the joint return is the joint income tax liability. Both spouses may be liable for taxes owed on a joint return. This could be a major problem if a couple separates or divorces after filing a return.

EXAMPLE I:2-48 ▶ Jim and Pat file a joint return. They are both informed as to the relevant information pertaining to the return. The next year they separate, and Jim moves out of town without leaving a forwarding address. The IRS audits their joint return and disallows $400 of charitable contributions deducted on the original return. Pat may be held responsible for the additional taxes owed. The IRS does not have to attempt to locate Jim in order to collect the tax. ◀

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[47] These two taxes are discussed briefly in Chapter I:16 and extensively in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*.

[48] For a discussion of restrictions on the deductibility of prepaid medical expenses, see Chapter I:8.



ETHICAL POINT

Because innocent spouse rules are strict, it may sometimes be safer to file a separate return than run the risk of being held responsible for the acts of another.

Innocent Spouse Provision. When married couples file a joint return, each spouse generally is liable for the entire tax and any penalties imposed.[49] This is the case even if all of the income was earned by one spouse. This rule could prove unfair in some instances, especially where one spouse concealed information from the other. For that reason, the Code contains an **innocent spouse** provision. An innocent spouse is relieved of the liability for tax on unreported income if:

- The amount is attributable to erroneous items of the other spouse.
- The innocent spouse did not know and had no reason to know that there was such an understatement of tax.
- Under the circumstances, it would be inequitable to hold the innocent spouse liable for the understatement.
- The innocent spouse elects relief within two years after the IRS begins collection activities.[50]

EXAMPLE I:2-49 ▶ Dan and Joy file a joint return. Dan traveled much of the time and Joy had little information as to his whereabouts or income. Joy worked and her own salary was the sole source of her support. Their return was audited by the IRS. The audit disclosed that Dan had not reported income from a job he had held for several months during the year. In this situation, Joy may be able to use the innocent spouse provision in order to avoid being held liable for the tax on the unreported income. ◀

The election is permitted when the innocent spouse was aware of the understatement, but did not know or have reason to know the extent of the understatement. Relief is limited to the portion of the understatement attributable to the "unknown" amounts.

Separate Liability Election. Couples who file joint returns and are subsequently divorced, widowed, or separated may make a separate liability election. An electing spouse is liable only for the portion of any understatement attributable to him or her.

EXAMPLE I:2-50 ▶ Al and Ann divorce after filing a joint return. An IRS examination of the return reveals $20,000 of unreported income attributable to Al and $10,000 of unallowable deductions attributable to Ann. Together, these amounts result in an understatement of their tax by $9,000. If Ann can establish that she was unaware of Al's unreported income, she can make a separate liability election. She will be liable only for $3,000 of tax as she is responsible for only one third of the understatement. The allocation would not be different because only part of the deductions were disallowed because of an AGI floor. ◀

The election must be made within two years after the IRS begins collections efforts. The election may be made by both spouses. The election is invalid if the spouse responsible for the errors transfers assets to the "innocent" spouse in an effort to avoid payment.

Electing to Change to a Joint Return. In general, spouses who file separate returns for a given year may elect to change to a joint return by filing an amended joint return. This change is permitted after the due date but must occur within three years of the due date including extensions. Taxpayers may not change from a joint return to separate returns after the due date.[51]

[49] Sec. 6013(d)(3).

[50] Sec. 6015(b).

[51] Reg. Sec. 1.6013-1(a). However, a couple who filed a joint return whose marriage is later annulled must file amended returns as singles (Rev. Rul. 76-255, 1976-2 C.B. 40).

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 7

Describe compliance and procedural matters for filing tax returns

WHO MUST FILE

In general, an individual must file an income tax return if his or her gross income exceeds his or her standard deduction, including the additional standard deduction due to age.[52] The fact that the individual owes no tax does not mean that a return need not be filed. Recall from earlier in the chapter that gross income is income from taxable sources.[53] For 2019, the gross income filing thresholds generally are as follows:

	Under Age 65	*65 or Older*
Single	$12,200	$13,850
Married, filing jointly[a]	24,400	27,000[b]
Married, filing separately	5	5
Head of household	18,350	20,000
Surviving spouse	24,400	25,700

[a] $5, regardless of age, if the individual did not live with his or her spouse at the end of the year (or on the date his or her spouse died).
[b] $25,700 if one of the spouses is under age 65 and the other is age 65 or older.

KEY POINT

It is possible that a taxpayer may be required to file an income tax return but still have no tax liability.

ADDITIONAL COMMENT

An individual may file an income tax return even when not required to do so. For example, a single individual may have a good-faith belief that 2019 gross income is less than $12,200. By filing an income tax return and starting the statute of limitations, the individual limits the amount of time the IRS can audit the return.

There are three situations where a taxpayer must file even if gross income is less than the applicable amount shown above:

- Taxpayers who can be claimed as a dependent by another must file if they have either unearned income over $1,100 or total gross income over the standard deduction.
- Taxpayers who owe the 0.9% Additional Medicare Tax or the 3.8% Net Investment Income Tax (these are briefly discussed earlier in the chapter).
- Taxpayers with net self-employment income of $400 or more.

EXAMPLE I:2-51 ▶ Mary is age 64 and single. Her income is comprised of $11,000 of Social Security benefits and $14,000 of taxable pension benefits. As is discussed in Chapter I:3, the $11,000 is fully excluded from gross income in this case. Mary's $14,000 gross income is at least $12,200, so she is required to file an income tax return. ◀

EXAMPLE I:2-52 ▶ Assume the same facts as in Example I:2-51, except that Mary's taxable pension benefits are $9,000. Mary's total income of $20,000 ($9,000 + $11,000) is at least $12,200, but her gross income of $9,000 is not. Mary is not required to file an income tax return. ◀

DUE DATES AND EXTENSIONS

Tax returns for individuals and C corporations generally are due on the fifteenth day of the fourth month following the close of the tax year, which for calendar-year taxpayers is April 15.[54] Returns for partnerships and S corporations are due on the fifteenth day of the third month following the close of the tax year, which for calendar-year entities is March 15.[55] A due date that falls on a Saturday, Sunday, or a holiday is automatically extended to the next day that is not a Saturday, Sunday, or holiday.[56] As noted, individuals are required to file only if their gross income exceeds prescribed thresholds. Partnerships and corporations, however, are required to file even if they have no gross income.

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[52] Sec. 6012(f).

[53] For this purpose, excluded foreign earned income and the gain excluded from the sale of a principal residence are treated as gross income (Sec. 6012(c)). These exclusions are discussed in Chapters I:4 and I:12.

[54] Sec. 6072(a).

[55] Sec. 6072(b).

[56] Sec. 7503. A holiday is a legal holiday in the District of Columbia (or a legal holiday of the state of the IRS office the taxpayer is required to file the return).

Individuals may obtain an automatic extension of six months by filing Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Income Tax Return). Partnerships and S corporations also may obtain an automatic six-month extension by filing Form 7004 (Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns). C corporations also file Form 7004 to obtain an extension, but it is six or seven months, depending on the fiscal year-end.[57]

An extension to file a return is not an extension to pay any tax that is owed. Taxpayers must project their tax liability to the best of their ability and remit with the extension any amount that has not been prepaid through withholding or estimated payments. Interest and penalty may apply to amounts paid after the regular due date. See Chapter C:15 in the *Comprehensive* volume and the *Corporations, Partnerships, Estates, and Trusts* volume for more on payment requirements.

	Individuals	*Partnerships & S corporations*	*C corporations*
Returns	Form 1040	Forms 1065, 1120S	Form 1120
Return due date, generally	15th day of 4th month	15th day of 3rd month	15th day of 4th month
Automatic extension, generally	Form 4868 (6 months)	Form 7004 (6 months)	Form 7004 (6 or 7 months)

ADDITIONAL COMMENT

For 2016, 88% of individual tax returns were filed electronically.

FORM 1040

The federal income tax return for individuals is Form 1040. For many years prior to 2018, Form 1040 contained dozens of lines, with many additional forms and schedules providing details of amounts appearing on Form 1040. Forms 1040A and 1040EZ were simplified versions of Form 1040, which eased the compliance burden for individuals with simpler financial circumstances.

SELF-STUDY QUESTION

It is sometimes said that the hallmark of the U.S. federal income tax system is voluntary compliance. With so much information being reported to the IRS, how voluntary is the system?

Starting in 2018, the IRS simplified Form 1040 by relegating many of its complexities to new additional schedules. The new Form 1040 reports information about individuals the taxpayer is claiming as dependents (e.g., name, Social Security number), some details about the taxpayer's adjusted gross income (e.g., wages, salaries, and taxable interest), and other details leading to the taxpayer's additional tax due or refund. The new additional schedules include the following:

- Schedule 1 reports sources of income that are not reported on Form 1040, such as the net profit or loss from a sole proprietorship and the net amount of capital gains and losses. Details for some of these additional sources of income are reported on further schedules, such as Schedules C and D. Schedule 1 also reports various deductions for AGI, such as those for alimony paid and contributions to traditional IRAs.
- Schedule 2 reports the alternative minimum tax and the excess advance premium tax credit repayment, both of which are discussed in Chapter I:14.
- Schedule 3 reports various nonrefundable tax credits, such as the child care credit and education credits (which are discussed in Chapter I:14).
- Schedule 4 reports various other taxes imposed on the taxpayer, such as the 10% penalty on premature withdrawals from 401(k) accounts and the self-employment tax (which are discussed in Chapter I:7 and I:14).
- Schedule 5 reports estimated tax payments and other amounts that are similarly treated. Withholdings of federal income taxes are reported directly on Form 1040.

SYSTEM FOR REPORTING INCOME

There is a significant and expanding relationship between computers, tax returns, the taxpayer identification system, and information returns. The IRS keeps records based on taxpayer identification numbers. Individual taxpayers report information based on Social

[57] For further discussion of the tax return due date and extension period for C corporations, see Chapter C:15 in the *Comprehensive* and *Corporations, Partnerships, Estates & Trusts* volumes or Chapter I:16 in the *Individuals* volume.

ANSWER

The system is not very voluntary with respect to income subject to reporting. But some sources of income, such as income from self-employment, are not subject to reporting by a third party. Also, the IRS would have to audit a tax return to verify most of the deductions.

Security numbers, whereas employer identification numbers (EIN) are used by corporations, other taxpayers, and tax-exempt entities. Individuals who employ others have both a Social Security number and an employer identification number.

Employers, banks, stockbrokers, savings and loans, and so on report payments they make to others along with the payee's identification number. Today, the IRS' computers match much of the reported information with tax returns, using the taxpayer identification number as the cross-reference. The need for accurate information returns is obvious. Some major information returns are listed below:

Basic Form	*Type of Payment*	*Required if Amount Equals or Exceeds*
1099-R	Pensions and annuities including lump sum distributions	$ 10
W-2	Salary, wages, etc.	600
1099-DIV	Dividends	10
1099-INT	Interest	600[58]
1099-B	Sale of a security	All
1099-G	Unemployment compensation, tax refunds, etc.	10
1099-MISC	Miscellaneous income	Varies

This information-reporting system makes it more difficult for taxpayers to avoid IRS detection if they omit income from their returns. In some cases, an information form is required even if the income amount is less than the applicable threshold. For example, a W-2 is required if the employer withheld any income, Social Security, or Medicare tax, even if wages are less than $600.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:2-1 a. The tax law refers to gross income, yet the term gross income is not found on Form 1040. Explain.
b. Why is it important to understand the concept of gross income even though the term is not found on Form 1040?

I:2-2 Explain the distinction between income and gross income.

I:2-3 a. Explain the distinction between a deduction and a credit.
b. Which is worth more, a $10 deduction or a $10 credit?
c. Explain the difference between refundable and nonrefundable credits.

I:2-4 List the conditions that must be met in order to claim qualifying children and qualifying relatives as dependents. Briefly explain each one.

I:2-5 a. Briefly explain the concept of support.
b. If a taxpayer provides 50% or less of another person's support, is it possible for the taxpayer to claim that person as a dependent? Explain.
c. Does support include the value of an automobile? Explain.

I:2-6 Under what circumstances must a taxpayer use a tax rate schedule instead of a tax table?

I:2-7 a. What determines if an individual must file a tax return?
b. Is an individual required to file a tax return if he or she owes no tax?

I:2-8 Many homeowners itemize deductions while many renters claim the standard deduction. Explain.

I:2-9 Tax rules are often very precise. For example, a taxpayer must ordinarily provide "over 50%" of another person's support in order to claim that person as a qualifying relative. Why is the threshold "over 50%" as opposed to "50% or more?"

I:2-10 What is the normal due date for the tax return of calendar-year taxpayers? What happens to the due date if it falls on a Saturday, Sunday, or holiday?

I:2-11 Sometimes taxpayers may not be able to file their tax returns by the normal due date. Are extensions available? How long are the extensions? Do extensions enable taxpayers to delay paying the tax they owe?

[58] For banks and corporations the amount is $10.

I:2-12 Can tax-exempt income qualify as support? Explain.

I:2-13 Can a scholarship qualify as support?

I:2-14 Explain the purpose of the multiple support agreement.

I:2-15 Summarize the rules that explain which parent claims their children as dependents in cases of divorce.

I:2-16 What conditions must be met by a married couple before they can file a joint return?

I:2-17 Explain what is meant by the phrase *maintain a household*.

I:2-18 Under what circumstances, if any, can a married person file as a head of household?

I:2-19 a. Explain the principal difference in the tax treatment of an S corporation and a C corporation.
b. Why would a C corporation be used if an S corporation is generally exempt from tax?

I:2-20 Income earned by C corporations is taxed twice, once when the income is earned and again when it is distributed. If so, how is it possible that operating a business as a C corporation can reduce taxes.

I:2-21 a. What assets are excluded from capital asset status?
b. Are capital gains given favorable tax treatment?
c. What is the significance of an asset being classified as a capital asset?
d. Are capital losses deductible?

I:2-22 Is there any tax advantage for an individual who has held an appreciated capital asset for eleven months to delay the sale of the asset? Explain.

I:2-23 a. Explain the difference between income splitting and income shifting.
b. Why are taxpayers interested in shifting income from one tax return to another within the same family or economic unit?
c. Is there a relationship between the tax on unearned income of children and taxpayers who attempt to shift income?

I:2-24 a. Who is liable for additional taxes on a joint return?
b. Why is this so important?

I:2-25 Can couples change from joint returns to separate returns? Separate to joint?

ISSUE IDENTIFICATION QUESTIONS

I:2-26 This year, Yung Tseng, a U.S. citizen, supported his nephew who is attending school in the United States. Yung is a U.S. citizen, but his nephew is a citizen of Hong Kong. The nephew has a student visa, but he hopes to become a permanent U. S. resident. Other family members hope to come to the U.S. What issues must be considered by Yung?

I:2-27 Carmen and Carlos, who have filed joint tax returns for several years, separated this year. Carlos works in construction and is often paid in cash. Carlos says he only worked a few weeks this year and made $11,000. In prior years he made approximately $35,000 per year, and Carmen is surprised that his income is so low this year. Carmen received a salary of $38,000 as a medical laboratory technician. They have no dependents and claim the standard deduction. What tax issues should Carmen and Carlos consider?

I:2-28 Jane and Bill have lived in a home Bill inherited from his parents. Their son Jim lives with them. Bill and Jane obtain a divorce during the current year. Under the terms of the divorce, Jane receives possession of the home for a period of five years and custody of Jim. Bill is obligated to furnish over one-half of the cost of the maintenance, taxes, and insurance on the home and pay $6,000 of child support per year. Bill lives in an apartment. What tax issues should Jane and Bill consider?

PROBLEMS

I:2-29 ***Computation of Tax.*** The following information relates to two married couples:

	Smiths	*Millers*
Salary (earned by one spouse)	$30,000	$95,000
Taxable interest income	20	1,000
Deductible IRA contribution	0	6,000
Itemized deductions	900	26,400
Withholding	750	8,500

Compute the 2019 tax due or refund due for each couple. Assume that any restrictions on itemized deductions have been applied. Ignore credits.

I:2-30 ***Computation of Taxable Income.*** The following information relates to Tom, a single taxpayer, age 18:

Wages	$7,000
Taxable interest income	425
Itemized deductions	310

a. Compute Tom's taxable income assuming he is self-supporting.
b. Compute Tom's taxable income assuming he is a dependent of his parents.

I:2-31 ***Joint Versus Separate Returns.*** Carl has $60,000 of salary and $11,000 of itemized deductions. Carol has $90,000 of salary and $16,200 of itemized deductions. They are married and under age 65.
a. Compute their taxable incomes if they file separately and Carol claims itemized deductions on her return.
b. Compute their taxable income if they file jointly. Assume their total itemized deductions equals the sum of their separate itemized deductions.

I:2-32 ***Dependency Requirements.*** Wes and Tina are a married couple and provide financial assistance to several persons during the current year. For the situations below, determine whether the individuals qualify as Wes and Tina's dependents. In all of the situations below, assume that any dependency tests not mentioned have been met.
a. Brian is age 24 and Wes and Tina's son. He is a full-time student and lives in an apartment near campus. Wes and Tina provide over 50% of his support. Brian works as a waiter and earned $5,200.
b. Same as Part a except that Brian is a part-time student.
c. Sherry is age 22 and Wes and Tina's daughter. She is a full-time student and lives in the college dormitory. Wes and Tina provide over 50% of her support. Sherry works part-time as a bookkeeper and earned $5,000.
d. Same as Part c except that Sherry is a part-time student.
e. Granny, age 82, is Tina's grandmother and lives with Wes and Tina. During the current year, Granny's only source of income was her Social Security of $12,000 (the Social Security is wholly tax-exempt in this situation). Granny uses her income to pay for 40% of her total support; Wes and Tina provide the remainder of Granny's support.

I:2-33 ***Dependency Requirements.*** John and Carole file a joint return and have three children: Jack, age 23; David, age 20; and Kristen, age 15. All three children live at home the entire year. Below is information about each of the children for 2019:

- Jack: graduated from college last year and will start medical school next year. This year, Jack worked sparingly as he studied for the medical school entrance exam, but did earn $5,000. John and Carole provided 80% of Jack's support during the year.
- David: a full-time student at State U., earned $6,400 from a part-time job, and provided 40% of his own support.
- Kristen: a full-time student in high school, had no gross income, and provided none of her own support.

a. Based on the above facts, which of the children can be claimed as dependents by John and Carole this year?
b. How would your answer to Part a change if Jack began medical school in August of this year?
c. How would your answer to Part a change if Jack earned $3,000 rather than $5,000?
d. How would your answer to Part a change if David was a part-time student rather than a full-time student?
e. How would your answer to Part a change if David provided 60% of his own support rather than 40%?

I:2-34 ***Dependency Requirements and Child Credit.*** Robert provides more than half of the support for his daughter, Jane, and her two children. Jane earned $20,000. Robert, whose AGI is $160,000, paid the rent of $11,000 on Jane's apartment and provided an additional $15,000 support. Jane is age 30, and her children are age 7 and age 4. Robert is not married.
a. Can Robert claim Jane as a dependent?
b. Can Jane claim her children as dependents?
c. Who is entitled to the child credit?

I:2-35 ***Dependency Requirements.*** Juan helps support his mother Maria, his son Jose, and a niece Norma. How many dependents can Juan claim given these additional facts?

Maria lives with Juan. She receives $12,000 of Social Security benefits, which she uses to pay for food, clothing, medical expenses, and other living expenses (the Social Security is wholly tax-exempt in this situation). Juan provides Maria's room which has a rental value of $5,000 and pays an additional $4,000 toward her support.

Jose, age 12, lives with his mother, Linda. Juan pays $12,000 per year child support, and Linda provides an additional $4,000 of support.

Norma, age 20, is a part-time college student who lives in an apartment. She earned $6,000 working part-time and received a scholarship of $2,000. Norma's father provided $4,000 toward her support, and Juan provided $7,000.

I:2-36 ***Multiple Support Agreements.*** Anna, age 65, who lives with her unmarried son, Mario, received $7,000, which was used for her support during the year. The sources of support were as follows:

Social Security benefits	$1,500
Mario	2,600
Caroline, an unrelated friend	800
Doug, Anna's son	500
Elaine, Anna's sister	1,600
Total	$7,000

The Social Security benefits are wholly tax-exempt in this situation. Assume a multiple support agreement (Form 2120) is properly filed.

a. Who is eligible to claim Anna as a qualifying relative?
b. If Mario wants to claim Anna as a qualifying relative, who must agree to it?
c. If Mario claims Anna as a qualifying relative, what is his standard deduction?

I:2-37 ***Dependency Requirements and Child Credit: Divorced Parents.*** Joe and Joan divorce during the current year. Joan receives custody of their three children. Joe agrees to pay $5,000 of child support for each child.

a. Assuming no written agreement, who claims their children as dependents, and who claims the child credit for them Explain.
b. Would it make any difference if Joe could prove that he provided over one-half of the support for each child?

I:2-38 ***Form 1040 Schedules.*** Determine which of Schedules 1 through 5 the taxpayer(s) will file with Form 1040 for each case:

a. Abby and Bert are married, file a joint tax return, and have two qualifying children (ages 4 and 8). Their only income is $70,000 of salaries and wages, from which $4,500 of federal income taxes are withheld. They claim the standard deduction and child care credit.
b. Celeste is a full-time college student and a qualifying child of her parents. Her only income is $7,500 of wages from a part-time job. She claims the standard deduction.
c. Donna and Ernie (ages 64 and 67) are married, file a joint tax return, and have no dependents. Donna receives a $125,000 salary for the year, and Ernie receives $45,000 of taxable pension benefits. Federal income taxes of $30,000 are withheld. Donna and Ernie have $10,000 of qualified dividends and a $4,000 long-term capital gain from their investments. They claim itemized deductions rather than the standard deduction.
d. Fiona is age 12 and a dependent of her parents. Her only income is $25,000 of taxable interest from bonds she inherited from a grandparent. She made $3,100 of estimated tax payments.

I:2-39 ***Dependency Requirements and Child Credit.*** How many dependents does the taxpayer have, assuming the people involved are U.S. citizens? What amount of credit may be claimed for the taxpayer's dependents?

a. Andrew supports his cousin Mary, who does not live with him. Mary has no income and is single.
b. Bob and Ann are filing a joint return. Bob provided over one-half of his father's support. The father received Social Security benefits of $6,000 and taxable interest income of $800 (the Social Security benefits are wholly tax-exempt in this situation). The father is single and does not live with them.
c. Clay provides 60% of his single daughter's support. She earned $3,000 while attending school during the year as a full-time student. She is 22 years old.

d. Dave provided 30% of his mother's support and she provided 55% of her own support. Dave's brother provided the remainder. The brother agreed to sign a multiple support agreement.
e. Zoe and Walt are married and file jointly. They provide 60% of the support for their daughter (age 19 and a full-time student) and 100% of the support for their son (age 15), both of whom live with Zoe and Walt for the entire year. Their daughter has $6,700 of wages from a part-time job, and their son has no income.

I:2-40 ***Dependents, Child Credits, and Divorce.*** Juan and Maria, who have two young children, are in the process of obtaining a divorce. Juan expects to have $250,000 of income each year while Maria expects to have $180,000 of income each year. Assume the children will live with Maria after the divorce and that Juan will pay child support.
a. What advice can you provide them regarding the child credit?
b. What advice can you provide regarding tax rate schedules?

I:2-41 ***Marriage and Taxes.*** Bill and Mary plan to marry in December 2019. Bill's salary is $105,000 and he owns his residence. His itemized deductions total $19,000. Mary's salary is $86,000. Her itemized deductions total only $8,100 as she does not own her residence.
a. What will their 2019 tax be if they marry before year-end and file a joint return?
b. What will their combined 2019 taxes be if they delay the marriage until 2020?
c. What factors contribute to the difference in taxes?

I:2-42 ***Filing Requirement.*** Which of the following taxpayers must file a 2019 return?
a. Amy, age 19 and single, has $8,050 of wages, $800 of interest, and $350 of self-employment income.
b. Betty, age 67 and single, has a taxable pension of $9,100 and Social Security benefits of $6,200 (the Social Security benefits are wholly tax-exempt in this situation).
c. Chris, age 15 and single, is a dependent of his parents. Chris has earned income of $1,900 and interest of $400.
d. Dawn, age 15 and single, is a dependent of her parents. She has earned income of $400 and interest of $1,600.
e. Doug, age 25, and his wife are separated. He earned $5,000 while attending school during the year.

I:2-43 ***Head of Household.*** In the following situations, indicate whether the taxpayer qualifies as a head of household.
a. Allen is divorced from his wife. He maintains a household for himself and his dependent mother.
b. Beth is divorced from her husband. She maintains a home for herself and supports an elderly aunt who lives in a retirement home.
c. Cindy was widowed last year. She maintains a household for herself and her dependent daughter, who lived with her during the year.
d. Dick is not divorced, but lived apart from his wife for the entire year. He maintains a household for himself and his dependent daughter. He does not receive any financial support from his wife.

I:2-44 ***Filing Status.*** For the following independent situations, determine the filing status for the years in question.
a. Wayne and Celia had been married for 24 years before Wayne died in an accident in 2017. Celia and her son, Wally, age 21 in 2017, continued to live at home in 2017, 2018, 2019, and 2020. Wally worked part-time (earning $5,000 in each of the four years) and attended the university on a part-time basis. Celia provided more than 50% of Wally's support for all four years. What is Celia's filing status for 2017, 2018, 2019, and 2020?
b. Juanita is a single parent who maintained a household for her unmarried son Josh, age 19. Josh worked full-time and earned $16,000. Juanita provided approximately 40% of Josh's support but provided all the expenses of maintaining the household. What is Juanita's filing status?
c. Gomer and Gertrude are married and have one dependent son. In April, Gomer left Gertrude a note informing her that he needed his freedom and he was leaving her. As of December, Gertrude had not seen nor heard a word from Gomer since April. Gertrude fully supported her son and completely maintained the household. What is Gertrude's filing status assuming she was still legally married?

I:2-45 ***Computation of Additional Tax Due or Refund.*** Jim and Pat are married, file jointly, and have one dependent (12-year-old qualifying child). Jim receives a $92,000 salary. Pat is self-employed. Her sole proprietorship's revenues are $98,000, and its expenses are $48,000. Jim and Pat each make a $6,000 deductible contribution to a traditional IRA. Their itemized deductions are $26,000. Federal income taxes of $7,000 are withheld from Jim's paychecks, and Pat makes $3,000 of estimated tax payments. Determine the additional tax due or refund when Jim and Pat file their 2019 income tax return. Ignore any self-employment tax.

I:2-46 ***Itemized versus Standard Deduction.*** Jan, a single taxpayer, has adjusted gross income of $250,000, medical expenses of $10,000, home mortgage interest of $3,000, and property taxes of $2,000. Should she itemize or claim the standard deduction?

I:2-47 ***Kiddie Tax.*** Lucy is 17 years old and a dependent of her parents. She receives $9,000 of wages from a part-time job and $10,400 of taxable interest from bonds she inherited. Determine Lucy's taxable income and tax.

I:2-48 ***Computation of Additional Tax Due or Refund.*** John and Georgia are married, file jointly, and have three dependents (qualifying children ages 13, 16, and 18). They have salaries of $130,000, a capital loss of $8,000, and tax-exempt interest income of $1,000. They paid home mortgage interest of $10,000, state income taxes of $4,000, property taxes of $2,800, medical expenses of $3,000, and charitable contributions of $5,000. Federal income taxes of $11,000 were withheld from their paychecks. Compute the additional tax due or refund they have when filing their tax return.

I:2-49 ***Kiddie Tax.*** Mike and Linda are a married couple who file jointly. They have three dependent children who are full-time students in 2019. Mike and Linda provided $8,000 of support for each child. Information for each child is as follows:

	Karen	*Susan*	*Amelie*
Age	21	18	16
Wages	$3,000	$11,000	$5,900
Interest income	2,800	2,400	2,300

Compute each child's tax, assuming the interest income is taxable.

I:2-50 ***Computation of Tax.*** Georgia, a single taxpayer, operates a business that produces $100,000 of income before any amounts are paid to her. She has no dependents and no other income. She has itemized deductions of $18,000. Compute the *total* income tax that would be paid assuming the following additional facts. Ignore payroll taxes.

a. Georgia operates the business as an S corporation receiving a salary from the corporation of $70,000. The corporation distributes all of its remaining income to the shareholders.

b. She operates the business as a C corporation receiving a salary from the corporation of $70,000. The corporation distributes its *after* tax income to her as a dividend.

c. How would the total tax change in each of the first two requirements if the corporation made no payments to the owner other than the salary?

I:2-51 ***Child Credit.*** Lana, an unmarried taxpayer with AGI of $204,400, claims three dependent children, all under age 17. What is the amount of her child credit?

I:2-52 ***Capital Gains and Losses.*** Bob and Anna are in the 37% tax bracket for ordinary income and the 20% bracket for capital gains (ignore the 3.8% additional tax on investment income for higher-income taxpayers.) They have owned several blocks of stock for many years. They are considering the sale of two blocks of stock. The sale of one block would produce a gain of $10,000. The sale of the other would produce a loss of $15,000. For purposes of this problem, ignore any restrictions on deductions or credits based on AGI. They have no other gains or losses this year.

a. How much tax will they save if they sell the block of stock that produces a loss?

b. How much additional tax will they pay if they sell the block of stock that produces a gain?

c. What will be the impact on their taxes if they sell both blocks of stock?

I:2-53 ***Timing of Deductions.*** Virginia is a cash-basis, calendar-year taxpayer. Her salary is $90,000, and she is single. She plans to purchase a residence in 2020. She anticipates her property taxes and interest will total $8,100. Each year, Virginia contributes approximately $4,000 to charity. Her other itemized deductions total approximately $3,700. For

purposes of this problem, assume that 2020 tax rates and standard deductions are the same as for 2019.

a. What will her gross tax be in 2019 and 2020 if she contributes $4,000 to charity in each year?

b. What will her gross tax be in 2019 and 2020 if she contributes $8,000 to charity in 2019 but makes no contribution in 2020?

c. What will her gross tax be in 2019 and 2020 if she makes no contribution in 2019 but contributes $8,000 in 2020?

d. Alternative c results in a lower tax than either a or b. Why?

I:2-54 ***Computation of Tax.*** Maria is a single taxpayer. Her salary is $51,000. Maria realized a short-term capital loss of $5,000. Her itemized deductions total $4,000.

a. Compute Maria's adjusted gross income.

b. Compute her taxable income.

c. Compute her tax liability.

I:2-55 ***Income Shifting and Kiddie Tax.*** Ralph and Tina are married, file jointly, and have $500,000 of taxable income. They transfer ownership of corporate bonds to Pam, their single, dependent daughter. Pam's only gross income for the current year is the $14,000 of interest on the corporate bonds. In each of the following cases, determine the amount of tax the family saves in the current year because Pam owns the bonds rather than Ralph and Tina.

a. Pam is age 12.

b. Pam is age 25.

I:2-56 ***Filing Status.*** Gail and her husband have a son when her husband dies unexpectedly on January 1, 2019. Gail asks you, her tax professional, how her husband's death affects her taxes. Determine Gail's income tax each year from 2019 through 2023, assuming her only income is her $150,000 annual salary, her itemized deductions are $24,000 annually, and she has not remarried. Assume also that the tax rate schedules and standard deduction amounts for 2019 also apply in subsequent years.

a. The son was born on April 15, 2006, is Gail's dependent each year, and lives with Gail for all of each year.

b. The son was born on April 15, 1995, is not Gail's dependent each year, and lives with Gail for all of each year.

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:2-57 Jack is starting a business that he expects to produce $190,000 of income this year before compensating Jack for his services. He has $5,000 of other income and itemized deductions totaling $20,000. He wants to know whether he should incorporate or operate the business as a proprietorship. If a corporation is formed, he wants to know whether he should make an S election. If he incorporates, the corporation will pay Jack a salary of $100,000. He expects to distribute an additional $7,500 of corporate profits to himself each year. Jack is single.

Required: Which organizational form, proprietorship, S corporation, or C corporation, will produce the lowest total current income tax liability for Jack and his business? Ignore payroll and other taxes.

I:2-58 Andrea, who is in the 37% tax bracket, is interested in reducing her taxes. She is considering several alternatives. For each alternative listed below, indicate how much tax, if any, she would save? (For this problem, ignore the additional 3.8% tax.)

a. Give $2,000 to a charity. Assume she itemizes.

b. Give $2,000 to a charity. Assume she does not itemize.

c. Make a gift of bonds valued at $8,000 yielding $600 of interest annually to her 15-year-old daughter who has no other income.

d. Sell the bonds from part c for $8,000 and buy tax-exempt bonds yielding $300.

I:2-59 Nell and Nick are married, have a 2-year-old child (Toni), and are in the 35% tax bracket. They heard that taxes could be reduced by shifting income to children. Nell and Nick ask you, their tax adviser, whether this is feasible for them and whether there is a limit on the amount of income they can shift to Toni. They have some corporate bonds yielding 4.8% interest they could transfer to her. Determine the maximum amount of the bonds Nell and Nick could transfer to Toni while still reducing the family's total taxes.

TAX FORM/RETURN PREPARATION PROBLEMS

I:2-60 Zachary L. (SSN 123-45-6789) and Cici K. Mao (SSN 987-65-4321) reside at 520 Chestnut Street, Philadelphia, Pennsylvania 19106. They are both under 65 years old and have one dependent (their son, Oliver, age 4, SSN 111-22-3333). They do not wish to take advantage of the presidential election campaign check-off. Other relevant information includes:

Zachary's salary as a manager	$40,000
Cici's salary as a teacher	45,000
Interest (First National Bank)	200
Withholding	5,600

Complete their Form 1040 for 2018, assuming they are married and file jointly.

I:2-61 John R. Lane (SSN 111-44-6666) lives at 1010 Ipsen Street, Yorba Linda, California 90102. John, a single taxpayer, age 66, provided 60% of his cousin's support. The cousin lives in Arizona. He wants to take advantage of the presidential election campaign check-off. John was employed as an accountant before he retired during the year. Other relevant information includes

Salary	$50,000
Pension (all taxable)	41,000
Taxable interest income	240
Deductible contribution to IRA	5,500
Withholdings	12,100

John's itemized deductions total $11,000. Complete Form 1040 and Schedule 1 for 2018. Assume any estimated tax penalty is zero.

I:2-62 Tracy M. Kidwell (SSN 433-33-3333) is single, 12 years old, and a dependent of her parents. She resides at 600 S. Maestri Place, New Orleans, LA 70130. Tracy's only income is $9,000 of taxable interest, she does not itemize deductions, and she had no withholdings and made no estimated tax payments. Tracy's parents (Kelly S. and James R. Kidwell) are married, file jointly, and list Kelly's name first on their return (SSN 433-33-1111). Prepare Forms 1040 and 8615 for Tracy for 2018. Assume any estimated tax penalty is zero.



CASE STUDY PROBLEMS

I:2-63 Bala and Ann purchased as investments three identical parcels of land over a several-year period. Two years ago they gave one parcel to their daughter, Kim, who is now age 16. They have an offer from an investor who is interested in acquiring all three parcels. The buyer is able to purchase only two of the parcels now, but wants to purchase the third parcel two or three years from now, when he expects to have available funds to acquire the property. Because they paid different prices for the parcels, the sales will result in different amounts of gains and losses. The sale of one parcel owned by Bala and Ann will result in a $20,000 gain and the sale of the other parcel will result in a $28,000 loss. The sale of the parcel owned by Kim will result in a $19,000 gain. Kim has no other income and does not expect any significant income for several years. Bala and Ann, however, are in the 37% tax bracket. They do not have any other capital gains this year. Which two properties would you recommend that they sell this year? Why?

I:2-64 Larry and Sue separated at the end of the year. Larry has asked Sue to sign a joint income tax return for the year because he feels that the tax will be lower on a joint return. Larry and Sue both work. Sue received a salary of $25,000 and Larry's salary was $20,000. Larry works as a waiter at a local restaurant and received tips. The restaurant asked Larry to indicate the amount of tips he received so that they could report the information to the IRS. Larry reported to the employer that the tips amounted to $3,000, but Sue believes that the amount was probably $6,000 to $10,000. They do not have enough expenses to itemize. Sue has asked you what are the advantages and risks of filing a joint return.

TAX RESEARCH PROBLEMS

I:2-65 Ed provides all the support for his stepdaughter, her husband, and their child since his wife's death three years ago. Ed promised his late wife that he would support her daughter from a former marriage and her daughter's husband until they both finished college. They live in another state, and have no gross income. Which of the three individuals can Ed claim as dependents?

A partial list of research sources is

- Sec. 152
- Reg. Sec. 1.152-2
- *Desio Barbetti,* 9 T.C. 1097 (1947)

I:2-66 Bob and Sue were expecting a baby in January, but Sue was rushed to the hospital in December. She delivered the baby but it died the first night. Can Bob and Sue claim the baby as a dependent?

Research sources include Rev. Rul. 73-156, 1973-1 C.B. 58.

I:2-67 Larry has severe vision problems and, in the past, he has claimed the additional standard deduction available to blind taxpayers. This year Larry's doctor prescribed a new type of contact lens that greatly improved his vision. Naturally, Larry was elated, but unfortunately new problems developed. He suffered severe pain, infection, and ulcers from wearing the new lens. The doctor recommended that he remove the lens and after several weeks his eyes healed. The doctor told him that he could wear the contacts again, but only for brief time periods, or the problems would recur. Can Larry claim the additional standard deduction available to blind taxpayers?

Research sources include *Emanuel Hollman,* 38 T.C. 251 (1963).

CHAPTER

3

GROSS INCOME: INCLUSIONS



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Explain the difference between the economic, accounting, and tax concepts of income
2. Explain the principles used to determine who is taxed on a particular item of income
3. Determine when a particular item of income is taxable under both the cash and accrual methods of reporting
4. Apply the rules of Sec. 61(a) to determine whether items such as compensation, dividends, alimony, and pensions are taxable
5. Describe tax planning considerations for inclusions of gross income
6. Describe compliance and procedural considerations for gross income

CHAPTER OUTLINE

Economic, Accounting, and Tax Concepts of Income...3-2
To Whom Is Income Taxable?...3-6
When Is Income Taxable?...3-8
Items of Gross Income: Sec. 61(a)...3-13
Tax Planning Considerations...3-27
Compliance and Procedural Considerations...3-30

Computation of an individual's income tax liability begins with the determination of income. Although the meaning of the term **income** has long been debated by economists, accountants, tax specialists, and politicians, there is no universally accepted definition.

The Sixteenth Amendment to the Constitution gave Congress the power to tax "income from whatever source derived." To ensure the constitutionality of the income tax, this phrase is incorporated in Sec. 61(a), where **gross income** is defined as follows: "Except as otherwise provided . . . . gross income means all income from whatever source derived."

This chapter examines the concept of income for the purpose of determining what items of income are taxable. Chapter I:4 considers items of income that are excluded from gross income. As noted in Chapter I:2, many provisions in the tax law are created by a process of political compromise. Thus, there is no single explanation of why certain items are taxable and others are not. For this reason, determining whether a particular item of income is taxable often proves difficult.

ECONOMIC, ACCOUNTING, AND TAX CONCEPTS OF INCOME

OBJECTIVE 1

Explain the difference between the economic, accounting, and tax concepts of income

ECONOMIC CONCEPT

Economists define **income** as the amount an individual could consume during a period and remain as well off at the end of the period as he or she was at the beginning of the period. Economists include in income both the wealth that flows to an individual and changes in the value of the individual's store of wealth. Or, more simply, income equals consumption plus the change in wealth.

EXAMPLE I:3-1 ▶ Alice earned a salary of $40,000. She consumed $30,000 of food, clothing, housing, medical care, and other goods and services. Assets owned by Alice were worth $100,000 at the beginning of the year. Her assets, including $10,000 of salary that was saved, were worth $115,000 at the end of the year. Her liabilities did not change during the year. Alice's economic income is $45,000 [$30,000 + ($115,000 − $100,000)]. ◀

Under the economist's definition, unrealized gains, as well as gifts and inheritances, are income. Furthermore, the economist adjusts for inflation when measuring income. An individual has no income to the extent that an increase in the measured value of property is caused by a decrease in the value of the measuring unit. In other words, inflation does not increase wealth and, therefore, does not cause an individual to be better off.

ACCOUNTING CONCEPT

Accountants usually measure income when it is *realized* in a transaction. Values measured by transactions are relatively objective as accountants recognize (i.e., report) income, expenses, gains, and losses that have been realized as a result of a completed transaction. Accountants believe that the economic concept of income is too subjective to be used as a basis for financial reporting and, therefore, have traditionally used historical costs in measuring income instead of using unconfirmed estimates of changes in market value. In accounting, the meaning of the term *realization* is critical to the income measurement process. *Realization* generally results upon the occurrence of two events: (1) a change in the form or substance of a taxpayer's property (or phrased another way, a severance of the economic interest in the property) and (2) a transaction with a second party. Realization occurs when a taxpayer sells property. Conversely, the mere increase in value of property owned by a taxpayer will not result in the realization of income because there has been no change in the form of the property and no transaction with a second party.

EXAMPLE I:3-2 ▶ Assume the same facts as in Example I:3-1. The amount consumed by Alice, the increase in the value of the property owned by her, and inflation are all ignored by the accountant in measuring her income. Only when she sells or otherwise disposes of the assets that have increased in value will the accountant recognize the gain. Thus, Alice's accounting income is $40,000. ◀

TAX CONCEPT OF INCOME

The income tax law essentially adopts the accountant's concept of income rather than the economist's. The reasons for this relate to matters of administrative convenience and the wherewithal-to-pay concept. However, as we will see later, there are many differences between income for tax purposes and accounting income.

In general, three conditions must be met for amounts to be taxable.

- There must be economic benefit. The economic benefit is not limited to cash payments. Employees who receive a company's stock, rather than cash, are receiving an economic benefit. Taxpayers benefit even if they direct that payments be made to other persons. As a result, employees cannot avoid being taxed on their earnings by ordering that their salaries be paid directly to creditors or family members.
- The income must be realized. In general, realization occurs when the earning process is complete and a transaction with another party takes place that permits an objective measure of the income. This objective measurement increases "administrative convenience" which is discussed below. Unlike financial accounting, there are many exceptions that result in income being reported when the taxpayer receives payment even if that is at a time other than when the earning process is complete. These exceptions result in taxes being owed when the taxpayer has the "wherewithal to pay" (see below). Taxpayers who use the "cash method" of reporting, discussed later in the chapter, are normally taxed when payment is received.
- The income must be recognized. Some items of income are not taxable because of special provisions in the tax law. For example, certain real estate exchanges and corporate reorganizations are not taxable because of statutory nonrecognition rules. In such cases, the taxpayer receives a lower basis in replacement property, and that often means the income is recognized when the replacement property is sold. The tax law also contains exclusions that exempt specific types of income such as scholarships, inheritances, and municipal bond interest. Within statutory limitations, taxpayers are never taxed on such items of income.

Administrative Convenience. The economic concept of income is considered to be too subjective to be used in determining taxable income. The need for objectivity in taxation is evident. If taxpayers were required to report increases in value as income, some individuals would certainly understate values to reduce their tax liabilities. The IRS and even the most honest taxpayer often would disagree over values and, as a result, the tax system would be extremely difficult to administer. The disputes over valuation issues would be frequent and the courts would be burdened with added litigation. This problem is evidenced by the few situations where valuations are required in the determination of tax. For example, taxpayers who contribute property to charity usually can deduct the value of the property. The courts are continuously having to resolve disputes between taxpayers and the IRS over the value of such contributions. Furthermore, in the case of certain large contributions of property, taxpayers are required to attach to their returns appraisals of the contributed property. Penalties apply to taxpayers who substantially overvalue contributions.

In some instances, objectivity is achieved at the price of equity. For example, a taxpayer who owns land that has substantially declined in value generally cannot recognize the decline in value until it is realized through a disposition of the land. Similarly, an increase in value, no matter how large, is not taxed until a sale or exchange of the property has

occurred. A taxpayer with a modest salary may feel that it is unfair that he or she is taxed on the salary while another person is not taxed on unrealized gains amounting to millions of dollars. As noted above, however, it would be practically impossible to fairly and consistently administer an income tax law that was based on values.

KEY POINT

Section 446(a) states that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his or her income in keeping his or her books. This provision would seem to require that tax accounting rules would conform to financial accounting rules. However, as will be seen later in this and other chapters, there are many differences.

Wherewithal to Pay. The wherewithal-to-pay concept holds that a tax should be collected when the taxpayer is in the best position to pay the tax. A taxpayer who sells property and collects the cash is in a better position to pay the tax than a taxpayer who owns property that is merely increasing in value without a sale.

This concept is the rationale for several tax provisions. For example, the tax law allows a taxpayer who sells property on the installment basis to report the gain as the installment payments are collected, rather than at the time of the sale. Losses, on the other hand, cannot be reported on the installment basis, as the wherewithal-to-pay is not an issue. The concept is also used to justify differences between the tax law and financial accounting principles. Prepaid income is not income from an accounting standpoint until it is earned. The tax law, however, takes the position that prepaid income is subject to taxation at the time it is collected, rather than as it is earned. At the time of collection, the taxpayer clearly has the cash available to pay the tax. If the tax were deferred until the income is earned, the taxpayer may no longer have the cash.

KEY POINT

Congress has not adopted any particular concept or theory of income for tax purposes. Except as specifically limited by statute, the definition of income is broad and general.

Gross Income Defined. Section 61(a) provides the following general definition and listing of income items:

> General Definition. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> 1. Compensation for services, including fees, commissions, fringe benefits, and similar items
> 2. Gross income derived from business
> 3. Gains derived from dealings in property
> 4. Interest
> 5. Rents
> 6. Royalties
> 7. Dividends
> 8. Annuities
> 9. Income from life insurance and endowment contracts
> 10. Pensions
> 11. Income from discharge of indebtedness
> 12. Distributive share of partnership gross income
> 13. Income in respect of a decedent
> 14. Income from an interest in an estate or trust
>
> Note: Alimony and separate maintenance payments are included on this list through December 31, 2018.

SELF-STUDY QUESTION

Why should taxpayers who are using the cash method of accounting be required to include in gross income the value of property or services received?

ANSWER

If taxpayers were not required to include the value of property or services received in gross income, many taxpayers would arrange their financial affairs so that they would receive property or services instead of cash.

This definition certainly is not all-inclusive. For example, it does not indicate whether specific items of income such as property insurance settlements, gambling winnings, or illegal income are taxable. One point is apparent: The phrase *[e]xcept as otherwise provided* means that all sources of income are presumed to be taxable unless there is a specific exclusion in the income tax law. The IRS does not have to prove that an item of income is taxable. Rather, the taxpayer must prove that the item of income is excluded. Thus, gambling winnings and illegal income are taxable simply because no specific provisions in the tax law exclude such amounts from taxation. As we shall see, life insurance proceeds and certain other insurance proceeds are specifically excluded from gross income.

Form of Receipt. Gross income is not limited to amounts received in the form of cash. According to Reg. Sec. 1.61-1(a), income may be "realized in any form, whether in money, property, or services." The important question is whether the taxpayer receives an economic benefit. This rule covers barter transactions which are direct exchanges of property and services. Each party to the transaction is taxed on the value of the property or

services received in the exchange. In general, the cost basis of property given up in a barter transaction can be subtracted from the value of the property received in arriving at the taxable amount.

EXAMPLE I:3-3 ▶ King Corporation transfers 1,000 shares of its stock to its president. The stock has no restrictions and is part of the president's compensation. The president must include the value of the stock in gross income. ◀

EXAMPLE I:3-4 ▶ Ali, an attorney, performs legal services for Paul, a painter, in exchange for Paul's promise to paint Ali's residence. Each taxpayer realizes income equal to the value of services received. Thus, Ali must report income in an amount equal to the value of the painting services provided by Paul. Paul must report the value of Ali's legal services. These amounts, assuming an arm's-length transaction, should be the same. ◀

EXAMPLE I:3-5 ▶ USA Corporation distributes an automobile to Vicki, a shareholder, in lieu of a cash dividend. Vicki must report the value of the automobile as dividend income. ◀

EXAMPLE I:3-6 ▶ Len has fallen behind on loan payments due to a bank. The bank obtains a court order requiring Len's employer to pay part of Len's wages directly to the bank. Len will be taxed on the full wages even though a portion goes directly to the bank. ◀

EXAMPLE I:3-7 ▶ Wayne borrowed $3,000 from his employer. The employer awarded year-end bonuses to other employees but told Wayne that the debt was being forgiven in lieu of a bonus. Wayne must include the $3,000 in income. ◀



STOP & THINK

Question: As noted, income is taxable even if it is paid in a form other than cash. What problems does this produce for the IRS and taxpayers?

Solution: Two major problems are created: valuation and enforcement. First, it is necessary to determine the market value of property and services when income is received in a form other than cash. Determining values can be difficult. Second, enforcement by the IRS is made much more difficult because such income is not documented by canceled checks, credit card receipts, or other records. Thus, as demonstrated in Example I:3-4 above, many of these so-called traded services are not reported as income. This evasion of income represents billions of lost tax revenues to the government.

Indirect Economic Receipt. As indicated earlier, the taxability of income often depends on whether the taxpayer receives an economic benefit. In general, if a taxpayer benefits from an item, it is taxable. Frequently, employers make expenditures that incidentally or indirectly benefit employees. For example,

- Security guards patrol an employer's plant, protecting both the employer's property and the employees. The employees receive an indirect benefit for the protection provided by the security guards.
- An employer requires employees to undergo an annual checkup, the cost of which is paid by the employer.
- An employer provides protective clothing worn by employees while on the job.
- A shipping company provides sleeping accommodations to sailors while ships are at sea.
- A company requires certain employees to wear shoes manufactured by the company and provide regular reports on the quality of the shoes.

It is now well-established that taxpayers may exclude such indirect benefits from gross income. This judicially-developed rule holds that a benefit is excludible if it is made in order to serve the business needs of the employer and the benefit to the employee is secondary and incidental.

Congress also has established rules dealing with situations where expenditures are made primarily to benefit employees. While expenditures made by employers that primarily benefit employees are generally taxable, there are instances whereby such

expenditures are not taxable. These rules, which are discussed in Chapters I:4 and I:7, permit employees to exclude certain fringe benefits (such as employee discounts) from gross income.

To whom is income taxable?

OBJECTIVE 2

Explain the principles used to determine who is taxed on a particular item of income

Once it is established that income is taxable, it is necessary to determine to whom it is taxable. Although such determinations are usually easy, there are circumstances where income is not necessarily taxed to the person who receives it. If physical receipt of income was the only test, a family might reduce or eliminate its income tax by having income paid to children and other members who are in low tax brackets or have no tax liability.

ASSIGNMENT OF INCOME

KEY POINT

The law makes a clear distinction between an assignment of income and an assignment of income-producing property. The income is taxable to the assignor in the former case, but where there is a bona fide gift of property the income is taxable to the assignee.

In 1930, the Supreme Court held in a landmark case, *Lucas v. Earl,* that an individual is taxed on the earnings from his or her personal services.[1] Specifically, the Supreme Court held that a husband was taxed on the earnings from his law practice, even though he had signed a legally enforceable agreement with his wife that the earnings would be shared equally. An agreement to assign income does not permit a person to avoid being taxed on the income. The Court used the previously developed analogy that likens income to the fruit and capital to the tree.[2] Accordingly, the fruit (income) could not be attributed to a tree other than the one on which it grew.

In 1940, the Supreme Court, in *Helvering v. Horst,* extended the assignment of income doctrine to income from property.[3] In this case, the taxpayer detached interest coupons from bonds and gave the coupons to his son. The son collected the interest and reported it on his own return. The Supreme Court held that the taxpayer was taxed on the interest income because he owned the bonds. This holding leads to a basic rule that the income from property is taxed to the owner of the property. To transfer the income from property, the taxpayer must transfer ownership of the property itself.[4]

Although married couples may file joint returns today, this privilege did not become available until 1948. Assignment of income is an issue today when other individuals such as parents and children are involved, and it can still be an issue when married couples file separate returns.

ALLOCATING INCOME BETWEEN MARRIED PEOPLE

ADDITIONAL COMMENT

The community property states are generally located in the western or southwestern United States. Generally these states were settled by immigrants from France and Spain, and their state laws reflect this fact. The common law is derived from English common law.

ADDITIONAL COMMENT

Community property laws are sometimes difficult to generalize. Depending on the specific law within a community property state, one-half of estimated taxes paid by one spouse may or may not be used by the other spouse on a separate return.

How income is allocated between a husband and wife depends on the state of residence. Forty-one states follow a common law property system, whereas nine states[5] use a community property system. Under common law, income is generally taxed to the individual who earns the income, either through labor or capital. For example, if a spouse holds stock separately in his or her name, that spouse will be taxed on all of the dividends received from the separately owned stock. Generally, the only **joint income** in a common law state is income from jointly owned property.[6]

In community property states, income may be either separate or community. **Community income** is considered to belong equally to the spouses. In all community property states, the income from the personal efforts of either spouse is considered to belong

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[1] *Lucas v. Earl,* 8 AFTR 10287, 2 USTC ¶496 (USSC, 1930).

[2] The analogy had been used some ten years earlier in *Eisner v. Myrtle H. Macomber,* 3 AFTR 3020, 1 USTC ¶32 (USSC, 1920). The court originally used the analogy in efforts to distinguish income from capital.

[3] *Helvering v. Horst,* 24 AFTR 1058, 40-2 USTC ¶9787 (USSC, 1940).

[4] A series of rather specific rules allocates income between the former and current owner when income-producing property is transferred. For example, in the case of bonds transferred by gift, the IRS has ruled that interest must be allocated based on the number of days the bonds were held by each owner during the interest period (Rev. Rul. 72-312, 1972-1 C.B. 22). A similar allocation must be made if bonds are sold (Rev. Rul. 72-224, 1972-1 C.B. 30).

[5] The states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Residents of Alaska may elect to be subject to community property law.

[6] Historically, tenancy by the entirety, a form of joint ownership between spouses, allocated all income to the husband. Today, the laws of many states allocate income from property held in tenancy by the entirety equally between the spouses.

equally to the spouses. Furthermore, income from community property is considered to be community income. Thus, if a wife's salary is used to purchase stock, subsequent dividends are community income.

Couples can have separate property even in community property states. **Separate property** consists of all property owned before marriage and gifts and inheritances acquired after marriage. Whether income from separate property is community or separate depends on the state. In Idaho, Louisiana, Texas, and Wisconsin income from separate property is community income. In Arizona, California, Nevada, New Mexico, and Washington, such income is separate income.

EXAMPLE I:3-8 ▶ A husband and wife file separate returns. The husband's salary is $40,000 and the wife's salary is $48,000. The wife received $1,000 of dividends on stock she had inherited from her parents. Interest of $1,200 was received on bonds that were purchased from the husband's salary. They received $2,600 in rent from farm land that they purchased jointly. The income would be allocated, depending on the state of residence, as follows:

California (Community Property State)	*Husband*	*Wife*
Salary	$44,000	$44,000
Dividends		1,000
Interest	600	600
Rent	1,300	1,300
Total	$45,900	$46,900
Texas (Community Property State)		
Salary	$44,000	$44,000
Dividends	500	500
Interest	600	600
Rent	1,300	1,300
Total	$46,400	$46,400
Pennsylvania (Common Law State)		
Salary	$40,000	$48,000
Dividends		1,000
Interest	1,200	
Rent	1,300	1,300
Total	$42,500	$50,300 ◀

These rules are important when couples file separate returns. The community income rules can prove to be a problem if one spouse conceals income from the other. Normally, each spouse is expected to report one-half of all community income. This treatment is inequitable if one spouse is not aware that the community income was earned. Special rules excuse an innocent spouse who fails to report community income on a separate return, provided that the spouse had no knowledge or reason to know of the item and, as a result, the inclusion of the community income would be inequitable.[7] A corresponding provision permits the IRS to include the entire amount in the income of the other spouse.[8]

STOP & THINK

Question: Income in a common law state is taxed differently than a community property income. As noted, the Supreme Court, in *Lucas v. Earl,* decided that a husband was taxed on all his income even though he agreed to share that income with his wife. Nevertheless, community income in a community property state is divided equally between husbands and wives even if one spouse earned all of the income. Why the tax distinction?

Solution: *Lucas v. Earl* dealt with a case in a common law state where the husband was legally entitled to the income, but decided to divide it with his wife. In community property states, couples are legally obligated to share their incomes. The federal income tax law respects the different property law systems of the states and taxes the income

[7] Sec. 66(b).

[8] Sec. 66(c).

of persons based on state law.[9] It would be unfairly burdensome to tax individuals on income to which they never had any legal right.

INCOME OF MINOR CHILDREN

As noted earlier, whether a husband or wife is taxed on income is determined by state law. However, earnings of a minor child are taxed to the child regardless of the state's property law system. Therefore, earnings of a child from either personal services (compensation) or from property (dividends, interest, rents, etc.) are taxed to the child, not the child's parents. As noted in Chapter I:2, the unearned income of a child under age 24 may be taxed at higher rates. In the case of spouses, the spouse who has a legal right to such income determines who is taxed on it. In the case of children, however, the individual who earns the income is the individual who is taxed on it.

WHEN IS INCOME TAXABLE?

OBJECTIVE 3

Determine when a particular item of income is taxable under both the cash and accrual methods of reporting

The year in which income is taxed depends on the taxpayer's accounting method. The three primary overall accounting methods are the **cash receipts and disbursements method**, the **accrual method**, and the **hybrid method**. While taxpayers have the right to choose a method of accounting, the chosen method still must clearly reflect income as determined by the IRS. The IRS has the power to change the accounting method used by a taxpayer if, in the opinion of the IRS, the method being used does not clearly reflect income. Under this authority, the IRS determined that businesses with inventories had to use the accrual method, but created a hodgepodge of exceptions for small businesses.[10] Taxpayers (other than tax shelters) whose average gross receipts for the three prior years do not exceed $26 million ($25 million in 2018) have the option of electing the cash method.[11] Also, businesses without inventories, such as professional service partnerships, can use the cash method regardless of size. This change simplifies accounting for millions of small and medium sized businesses. Also, the tax liability coincides with cash inflow.

Once an accounting method has been adopted, it cannot be changed without permission of the IRS. See Chapter I:11.

KEY POINT

Neither the IRC nor the Regulations define the terms *accounting* and *accounting method*.

CASH METHOD

ADDITIONAL COMMENT

Taxpayers engaged in more than one trade or business may use a different method of accounting for each separate trade or business.

The **cash receipts and disbursements method** of accounting is used by most individual taxpayers and many small businesses. (See Chapter I:11 for a more complete discussion of who is permitted to use the cash method.) Under this method, income is reported in the year the taxpayer actually or constructively receives the income rather than in the year the income is earned. The income can be received by the taxpayer or the taxpayer's agent and be in the form of cash, other property, or services.[12] In the case of property or services, the amount included in income is the value of the property or services. An accounts receivable or other unsupported promise to pay is considered to have no value under the cash method and, as a result, no income is recognized until the receivable is collected. Topic Review I:3-1 summarizes when various types of income are reported.

ADDITIONAL COMMENT

The use of the cash receipts and disbursements method of accounting gives the taxpayer some control over the timing of the recognition of income and deductions. It also has the advantage of simplicity.

The fact that prepaid income is usually taxed when received, rather than when earned, often results in a mismatching of income and expenses.

EXAMPLE I:3-9 ▶ In December of the current year, Troy, who owns an apartment building, collects the first and last months' rent from a new tenant. Troy must report two months' rent in the current year. The

[9] See *Burns Poe v. H. G. Seaborn*, 9 aftr 576, 2 ustc ¶611 (ussc, 1930). In 2010, the irs Chief Counsel concluded that the rule also applies to same-sex California couples who enter into domestic partnership agreements based on the fact that California community property law applies to such couples (CCA 201021050).

[10] Taxpayers whose annual gross receipts for the three prior years did not exceed $1 million ($10 million if the taxpayer's principal business was not the sale of inventory) were allowed to use the cash method. Reg. Sec. 1.446-1(c)(2)(I) and Rev. Proc. 2002-28, 2002-1 C. B. 815 modified by Rev. Proc. 2012-20 I.R.B. 700. In addition, Sec. 448 required C corporations (and partnerships with corporate partners, tax shelters, and certain trusts) to use the accrual method of accounting, but exempted qualified personal service corporations, certain farms, and entities with average gross receipts under $5 million from the requirement.

[11] Sec. 448.

[12] An agent can be an employee, relative, or other person authorized to receive the income.

TOPIC REVIEW I:3-1

When Income Is Taxable

Item	Cash Basis	Accrual Basis
Compensation	Year actually or constructively received.	Year earned or year received if prepaid.
Interest	Year actually or constructively received.	Year accrued or year received if prepaid.
Discount on Series E or EE Bonds	Choice of reporting interest as it accrues or at maturity.	Year accrued.
Dividends	Year actually or constructively received.	Year actually or constructively received.
Rent	Year actually or constructively received (does not apply to a deposit).	Year accrued or year received if prepaid (year accrued if services are associated, e.g., in a hotel or motel) (does not apply to a deposit).
Services (maintenance contracts, dance lessons, etc.)	Year actually or constructively received.	Year accrued or year received if prepaid except that a taxpayer may report the income as it accrues if all the services are to be performed by the end of the next tax year.
Sale of goods	Year actually or constructively received.	Year of sale or year cash is received if prepaid except may elect to report in year of sale if goods are not on hand, amount received is less than cost of item, and same accounting method is used for financial accounting.
Subscriptions (newspapers, magazines, etc.)	Year actually or constructively received.	Year earned or year cash is received, if prepaid, except may elect to report income as newspaper, etc., is published.
Memberships (automobile clubs, etc.)	Year actually or constructively received.	Year earned or year received if prepaid (certain nonstock corporations may elect to report prepaid amounts over the membership period, if the period covers three years or less).
Sale of property (other than stock)	Year actually or constructively received.	Year transaction is completed (e.g., the close of escrow in case of sale of real estate).
Sale of stock	Year transaction is executed.	Year transaction is executed.

ADDITIONAL COMMENT

There is no recognized doctrine of constructive payment.

actual expenses associated with the last month's rental are not incurred until the last month. However, Troy must report two months' income this year, but may only deduct one month's expenses. ◀

REAL-WORLD EXAMPLE

Paul Hornung, a former football player with the Green Bay Packers, was awarded an automobile in 1961 for being the outstanding player in the NFL championship game, but he did not actually receive it until 1962. He attempted to invoke the constructive receipt doctrine and report the income in 1961. The court held that he could not claim constructive receipt because the car was not set aside in the year of the award. *Paul v. Hornung,* 47 T.C. 428 (1967).

Reporting prepaid income can have harsh results because it is not offset by related deductions. If the income is taxed before the expenses are incurred, the taxpayer may not have enough cash to pay the expenses when they are incurred.[13] This burden is mitigated, in part, by Treasury Regulations and Revenue Procedures discussed in this chapter (e.g., the treatment of prepaid income, page I:3-11).

Constructive Receipt. As noted, a cash-basis taxpayer must report income in the year in which it is actually or constructively received. Constructive receipt means that the income is made available to the taxpayer so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. This rule prevents taxpayers from deferring income that is otherwise available by merely "turning their backs" on it. A taxpayer cannot defer income recognition by refusing to accept payment until a later taxable year.

[13] This mismatching of income and expenses affects both cash and accrual basis taxpayers.

Examples of constructive receipt where taxpayers are required to report taxable income even though no cash is actually received include:

- A check received after banking hours[14]
- Interest credited to a bank savings account[15]
- Bond interest coupons that have matured but have not been redeemed[16]
- Salary available to an employee who does not accept payment[17]

An amount is not considered to be constructively received if:

- It is subject to substantial limitations or restrictions.
- The payer does not have the funds necessary to make payment.
- The amount is unavailable to the taxpayer.

EXAMPLE I:3-10 ▶ Beth owns an ordinary life insurance policy with a cash surrender value. She need not report any income as the cash surrender value increases because the requirement that she cancel the policy in order to collect the cash surrender value constitutes a substantial restriction. If she cancels the policy, she reports as income the difference between the cash surrender value collected and net premiums paid. ◀

EXAMPLE I:3-11 ▶ Cathy has received a paycheck from her employer but has been told to hold the check until the employer has sufficient funds to cover the payroll. Cathy need not report the amount of the check as income until funds are deposited to the employer's account. ◀

EXAMPLE I:3-12 ▶ Dan sold land for $100,000 in December with payment due the following February. During the negotiations, the buyer offered to pay cash. Because the parties did not agree to a cash transaction, there was no constructive receipt in December. Under the terms of the sale, funds were not available at the time of sale. Thus, Dan is permitted to defer the recognition of income until the funds become available the following year. ◀

Exceptions. There are exceptions to the basic rule that cash-basis taxpayers report income when it is actually or constructively received.

- The interest on Series E and Series EE U.S. savings bonds need not be reported until the final maturity date, which varies but may be as long as forty years after the date of issue, and can be deferred even longer if the bonds are exchanged within one year of the final maturity date for Series HH U.S. savings bonds.[18] Many taxpayers purchase bonds that mature after retirement when the taxpayers expect to be in a lower tax bracket.

EXAMPLE I:3-13 ▶ Tenisha purchases a Series EE U.S. savings bond for $2,500 that will mature in 10 years. The bond pays no interest until maturity when it will be worth $5,000. Tenisha is not required to report any interest income for tax purposes until the bond matures. At maturity, when Tenisha receives the $5,000, she will report $2,500 of interest income. If she desires to defer the interest further, she could exchange her Series EE bond for a Series HH bond within one year. ◀

- Special rules also apply to farmers and ranchers. Farmers may report crop insurance proceeds in the year following receipt if the crop would have ordinarily been sold in the following year. Ranchers who sell livestock on account of a drought, flood, or other weather related condition may delay reporting income until the following year if they can establish that the livestock sale would otherwise have taken place in a later tax year.[19] These rules help taxpayers avoid a bunching of income into one year.
- Small and medium taxpayer exception for inventories. As noted above, taxpayers who have average annual gross receipts of $26 million or less for the prior three years are exempt from maintaining inventories and may use the cash method. The ruling was widely interpreted to mean that small taxpayers did not need to account for inventories and could deduct

[14] *Charles F. Kahler,* 18 T.C. 31 (1952).
[15] Reg. Sec. 1.451-2(b).
[16] Ibid.
[17] *James J. Cooney,* 18 T.C. 883 (1952).
[18] Series E bonds were issued prior to 1980; Series EE bonds were issued after 1979. The interest on the Series HH bonds is taxable as received.
[19] Recognizing the volatile nature of farming and ranching, Congress established a special averaging technique for farmers and ranchers. Electing farmers and ranchers compute their tax on the average income for the current and three preceding years. Sec. 1301.

the amount of their purchases in the year of payment. However, the IRS subsequently issued Rev. Proc. 2001-10, whereby it was clarified that the small taxpayer exception will only allow small taxpayers to deduct purchases of inventory in the year of purchase if (1) the inventory purchases are paid for by the end of the year and (2) the inventory is actually sold in such year. This ruling limits the exception with respect to inventories.

EXAMPLE I:3-14 ▶ The Cheryl Corporation begins a new retail business in the current year and has sales of $400,000. The corporation has year-end accounts receivable of $15,000 and purchases $240,000 of merchandise during the year. At year-end, the corporation has not paid for $30,000 of the merchandise it had purchased and has $50,000 of inventory on hand. The corporation pays operating expenses of $140,000 during the year. The corporation's income computed under both methods is as follows:

	Accrual		*Cash*	
Sales		$400,000		$385,000
Purchases	$240,000		$210,000	
Ending inventory	50,000		20,000*	
Cost of sales		190,000		190,000
Gross profit		210,000		195,000
Expenses		140,000		140,000
Net income		$ 70,000		$ 55,000

*$50,000 – $30,000 = $20,000

The difference between the accrual and cash methods is that the sales are not reported under the cash method until such sales are actually collected. Thus, the corporation does not include year-end receivables in this year's income. The year-end receivables will be reported when the receivables are collected in later taxable years.

As can be seen above, the cost of sales under both the accrual and cash methods are the same. This is because under Rev. Proc. 2001-10, taxpayers may not deduct inventory unless it is both paid for and sold. Since $30,000 was not paid for by year-end, it is not deductible and the purchases under the cash method are $30,000 less than under the accrual method. The ending inventory under the cash method is the physical inventory of $50,000 reduced by the $30,000 of inventory on hand that has not been paid for by year-end. ◀

REAL-WORLD EXAMPLE

The Ninth Circuit Court of Appeals has held that "markers" customers gave to a gambling casino to evidence their indebtedness to the casino required accrual even though the receivables were legally unenforceable under state law. The court found that there need only be a "reasonable expectancy" that payment would be made. *Flamingo Resort, Inc. v. U.S.*, 50 AFTR 2d 82-502, 82-1 USTC ¶9136 (9th Cir., 1982).

ACCRUAL METHOD

Taxpayers using the accrual method of accounting generally report income in the year it is earned. Income is considered to have been earned when all the events have occurred that fix the right to receive the income and when the amount of income can be determined with reasonable accuracy.[20] The *Tax Cuts and Jobs Act* changed the all events test to require that income be reported no later than the year it is included on financial statements. In the case of a sale of property, income normally accrues when title passes to the buyer.[21] Income from services accrues as the services are performed.

Prepaid Income. A major exception to the normal operation of the accrual method is the rules applicable to the receipt of prepaid income. Prepaid income is generally taxable in the year of receipt. For example, if a lender receives January interest in the preceding December, it is taxable in the year received, whether the lender uses the cash or accrual method. This treatment, of course, differs from financial accounting, where the interest would be reported as it accrues.

Two important exceptions to the general rule are worth noting. Accrual-basis taxpayers may defer recognizing income in the case of certain advance payments for *goods* and in the case of certain advance payments for *services* to be rendered. A taxpayer may defer advance payments for goods (inventory) if the taxpayer's method of accounting for the sale is the same for tax and financial accounting purposes.[22]

[20] Reg. Sec. 1.451-1(a).

[21] Regulation Sec. 1.446-1(c)(1)(ii), however, does permit taxpayers the right to accrue income from the sale of inventory when the goods are shipped, when the product is delivered or accepted, or when title passes, as long as the method is consistently used.

[22] Reg. Sec. 1.451-5.

Under Rev. Proc. 2004-34, taxpayers may defer payments for future services to the year following the year in which the payment is received.[23] Revenue relating to services provided in the year payment is received is reported currently. Revenue relating to future years is reported in the year following the year of receipt even if the payments relate to multiple future years. The rule can be applied to a variety of services such as Internet service, dance lessons, maintenance contracts (but not warranties included in the sales price of a product), membership fees, and rent (if services are associated with the rent, such as a hotel or motel). The procedure is available when service and products are provided together. The procedure does not apply to rent (if services are not associated with the rent), insurance premiums, interest, or warranty contracts included in the price of a product.

EXAMPLE I:3-15 ▶

REAL-WORLD EXAMPLE

A dance studio using the accrual method was required to include in taxable income all advance payments for lessons in the form of cash and negotiable notes, plus contract installments due but remaining unpaid at year end. *Mark E. Schlude v. CIR*, 11 AFTR 2d 751, 63-1 USTC ¶9284 (USSC, 1963).

Bear Corporation, a publicly held, accrual-basis taxpayer that uses the calendar year as its tax year, sells computer courses under contracts ranging from three months to two years. When income is reported depends on the length of the contract and the month in which the contract is sold. Assume that Bear sells three contracts on July 1. One is for three months costing $90, a second is for one year costing $300, and the third for two years costing $500. The $90 charged for the three month contract is reported currently as all services are provided currently. One-half of $300 charged for the one-year contract is reported currently and one-half is reported next year as one-half of the services are provided currently and one-half will be provided next year. One-fourth of the $500 charged for the two-year contract is reported this year and the balance is reported next year. This is because Rev. Proc. 2004-34 does not permit income to be deferred beyond the end of the year following the year in which payment is received.

	Year Includible in Gross Income	
Length of Contract	*Current Year*	*Next Year*
3 months	$ 90	
12 months	150	$150
24 months	125	375

◀

HYBRID METHOD

The **hybrid method** of accounting is a combination of the cash and accrual methods. Under the hybrid method, some items of income or expense are reported under the cash basis and others are reported under the accrual method. The method is most often encountered in small businesses that maintain inventories and are required to use the accrual method of accounting for purchases and sales of goods. Such businesses often prefer to use the cash method of reporting for other items because the cash method is simpler and may provide greater flexibility for tax planning. A taxpayer using the hybrid method of accounting would use the accrual method with respect to purchases and sales of goods but would use the cash method in computing all other items of income and expenses.

STOP & THINK

Question: Taxpayers who are eligible to use the cash method often choose the cash method of reporting income over the accrual method. Why is the cash method generally more favorable for income tax purposes?

Solution: Taxpayers who have the option frequently choose the cash method over the accrual method because it is simpler, offers greater tax planning opportunity, and results in taxes being owed when income is actually received. The cash method is simpler because taxpayers are not required to make the complex accruals associated with the accrual method. Planning opportunities are greater because cash basis taxpayers can deduct expenses when paid, thereby allowing taxpayers to control their tax liability. Under the accrual method, prepaid expenses are not deductible when paid, but must be deducted over the periods benefitted. Finally, cash basis taxpayers do not have to pay taxes until they receive the money. Under the accrual method, income is reported when it is earned even if it has not been received. As a result, accrual basis taxpayers sometimes have to pay the tax before they actually receive the income they have earned.

[23] 2004-1 C.B. 991.

ITEMS OF GROSS INCOME: SEC. 61(a)

OBJECTIVE 4

Apply the rules of Sec. 61(a) to determine whether items such as compensation, dividends, alimony, and pensions are taxable

Section 61(a), quoted earlier in this chapter, states that gross income includes, but is not limited to, fifteen specifically listed types of income. Several of these items are discussed below.

COMPENSATION

Compensation is payment for personal services. It includes salaries, wages, fees, commissions, tips, bonuses, and specialized forms of compensation such as director's fees, jury fees, and marriage fees received by clergymen. What the compensation is called, how it is computed, the form and frequency of payment, and whether the compensation is subject to withholding is of little significance. Similarly, the fact that the services are part-time, one-time, seasonal, or temporary is immaterial.

ADDITIONAL COMMENT

Salaries and wages constituted 69.5% of total AGI reported in 2016.

There are exclusions, however, for a variety of employer-provided fringe benefits such as group term life insurance premiums, health and accident insurance premiums, employee discounts, contributions to retirement plans, and education benefits. In addition, there is a limited exclusion applicable to foreign-earned income. Both fringe benefits and the foreign-earned income exclusion are discussed in Chapter I:4.

BUSINESS INCOME

SELF-STUDY QUESTION

A retail company had sales of $1,000,000 and the following costs: goods sold, $400,000, salaries, $200,000, and rent and other expenses, $100,000. What is the company's gross income?

ANSWER

The gross income is $600,000. The sales figure is reduced by the cost of goods sold.

The term **gross income** usually refers to the total amount received from a particular source. In the case of businesses that provide services (e.g., accounting and law), the gross business income is the total amount received. In the case of manufacturing, merchandising, and mining, however, gross income is total sales less the cost of goods sold. Thus, gross income for tax purposes is comparable to gross profit for financial accounting purposes.

The cost of goods sold is, in effect, treated as a return of capital. Chapter I:4 discusses a well-established tax concept that a return of capital is not income and, therefore, cannot be subject to the income tax. Chapter I:11 discusses how inventories are valued.

GAINS FROM DEALINGS IN PROPERTY

Gains realized from property transactions are included in gross income unless a nonrecognition rule applies. As is true with business inventories, taxpayers may deduct the cost of property in order to arrive at the gain from a property transaction.[24] The tax law contains over 30 nonrecognition rules, which allow taxpayers to postpone the recognition of gains and losses from certain types of property transactions. In a few instances, these rules allow taxpayers to permanently exclude gains from gross income.[25]

Losses are not offset against gains in computing gross income. Rather, most losses are deductions *for* adjusted gross income. Furthermore, net capital losses for individuals are subject to provisions that limit the amount that can be deducted from other income to $3,000 per year. Losses from the sale or disposition of an asset held for personal use are not deductible.

INTEREST

TYPICAL MISCONCEPTION

It is sometimes mistakenly assumed that interest paid on federal obligations such as Treasury bonds, notes, and bills will also qualify for tax exemption.

Interest is compensation for the use of money. Taxable interest includes interest on bank deposits, corporate bonds, mortgages, life insurance policies, tax refunds, most U.S. government obligations,[26] and foreign government obligations.[27] Nontaxable interest is discussed below.

Tax-Exempt Interest. Since the inception of the federal income tax in 1913, interest on obligations of states, territories, and U.S. possessions and their political subdivisions has been tax exempt.[28] Bonds issued by school districts, port authorities, toll road commissions, counties, and fire districts have been held to be tax exempt. In addition, Sec. 501(c)(3) organizations may issue up to $225 million of tax-exempt bonds. Such organizations include private universities, hospitals, churches, and similar nonprofit organizations.

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[24] Note that *business income* and *gains from dealings in property* are overlapping terms. The gross profit from the sale of inventory is actually both business income and a gain from a property transaction. Typically, however, the phrase *gains from dealings in property* may be assumed to mean gains from dealings in property other than inventory, so as to avoid confusion.

[25] For example, Sec. 121 allows taxpayers to exclude a limited amount of gain from a sale of a personal residence.

[26] The interest on many federal obligations issued before March 1, 1942 is tax exempt.

[27] Reg. Sec. 1.61-7.

[28] Sec. 103(a)(1).

ADDITIONAL COMMENT

Many tax advisers consider the exclusion of interest on municipal bonds to be one of the few remaining tax shelters. As a result, municipal bond funds have flourished in recent years.

As noted above, this exclusion does not extend to interest paid on most U.S. government obligations or foreign government obligations, nor does the exclusion exempt from taxation gains from the sale of state or local government bonds or interest on tax refunds paid by state and municipal governments.

There has always been some uncertainty as to whether the federal government could tax interest on state and local government obligations. The basic question is whether taxing these obligations would violate the doctrine of intergovernmental immunity in that the tax would reduce the ability of state and local governments to finance their operations because taxable bonds usually pay a higher rate of interest than tax-exempt bonds. The belief that taxing state and local government interest is unconstitutional is no longer widely held. While there have been efforts to tax interest on state and local bonds, the only changes have been to limit the use of bonds for private activities,[29] federally insured loans,[30] and arbitrage.[31]

ADDITIONAL COMMENT

The doctrine of intergovernmental immunity also results in most states exempting from taxation income received from U.S. obligations.

Series EE Savings Bond Exclusion. Taxpayers may purchase and eventually redeem Series EE bonds tax-free if they use the proceeds to pay certain college expenses for themselves, a spouse, or dependents.[32]

SELF-STUDY QUESTION

Young parents, whose annual income is currently $50,000, begin a regular program of purchasing Series EE savings bonds for their 8-year-old daughter's college education. Is there any risk that when the bonds are redeemed the interest income will not be excludable?

ANSWER

Yes, the parents' income may increase over the years to such an extent that the interest exclusion will not be available.

To qualify for the exclusion:

- The bonds must be purchased after 1989 by an individual who is age 24 or older at the time of the purchase.
- The bonds must be purchased by the owner and cannot be a gift to the owner.
- The receipts from the bond redemption must be used for tuition and fees, which are first reduced by tax-exempt scholarships, veterans benefits, Hope and Lifetime Learning credits, and other similar amounts.[33]
- Married couples living together must file a joint return to obtain the exclusion.

The full amount of interest is excluded only if the combined amount of principal and interest received during the year does not exceed the net qualified educational expenses (tuition and fees reduced by exempt scholarships, etc.), and the taxpayer's 2019 modified adjusted gross income is not over $81,100 ($121,600 for married individuals filing a joint return). The exclusion is fully phased-out for taxpayers whose 2019 modified AGI is more than $96,100 ($151,600 for married individuals filing a joint return).[34]

If the net qualified education expenses are less than the total principal and interest, a portion of the interest is excluded based on the ratio of the qualified educational expenses to the total principal and interest. The tentative exclusion is equal to

$$\text{Series EE interest} \times \frac{\text{Net qualified educational expenses}}{\text{Series EE interest} + \text{Principal}}$$

EXAMPLE I:3-16 ▶ In 2019, Lois redeems Series EE bonds and receives $6,000, consisting of $1,875 of interest and $4,125 of principal. Assume that the net qualifying education expenses total $4,800. Lois's educational expenses equal 80% of the total amount received ($4,800 ÷ $6,000). Thus, her exclusion is limited to $1,500 (0.80 × $1,875). ◀

[29] Interest from state and local bonds issued for private activities such as the construction of sports facilities, convention centers, and industrial park sites is taxable. A limited amount of tax-exempt bonds can be issued each year by a state for "qualified" private activities such as airport construction, redevelopment, and student loans. The limit is the greater of $225 million or $75 per resident (Sec. 146(d)). Though exempt from regular income tax, interest from these "qualified" private activity bonds is subject to the alternative minimum tax (see Chapter I:14).

[30] Sec. 149(b).

[31] Sec. 148. Interest from state or local government bonds issued for the purpose of using the proceeds to buy higher-yield investments is taxable. Such bonds are called arbitrage bonds.

[32] Sec. 135(c).

[33] The exclusion is not permitted for amounts paid for sports, games, or hobbies unless they are part of a degree program (Sec. 135(c)(2)(B)).

[34] Each of these amounts is adjusted annually for inflation. In 2018, the phase-out started at $79,550 ($119,300 on joint returns) and ended at $94,550 ($149,300 on joint returns).

ADDITIONAL COMMENT

A child born today will require about $100,000 for a four-year college education. If interest rates are around 6%, one would have to save about $245 a month until the child entered school to be able to pay this amount.

As noted, the amount of the exclusion is further reduced if modified adjusted gross income exceeds a $81,100 threshold ($121,600 for married individuals filing a joint return). Modified adjusted gross income includes the interest from education savings bonds and certain otherwise excludable foreign income.[35] The reduction is computed as follows:

$$\text{Otherwise excludable amount} \times \frac{\text{Excess modified AGI}}{\$15{,}000\ (\$30{,}000 \text{ for joint filers})}$$

EXAMPLE I:3-17 ▶ Assume the same facts as in Example I:3-16 and that Lois is single and has other adjusted gross income of $84,225, making her total AGI $86,100 ($84,225 + $1,875). Lois's otherwise available exclusion of $1,500 is reduced by $500 to $1,000. This reduction is computed by dividing the excess modified AGI of $5,000 ($86,100 − $81,100) by $15,000 and multiplying the result by $1,500. ◀

One difficulty with the rules is that the phase-out of the exclusion is based on income in the year the bonds are redeemed, not the year they are purchased. As a result, some taxpayers who purchase bonds anticipating an exclusion find they are ineligible for the exclusion when the bonds are redeemed.

RENTS AND ROYALTIES

Amounts received as rents or royalties are included in gross income. As noted earlier, prepaid rent is taxable when received. Security deposits, which are refundable to tenants upon the expiration of a lease, are not included in gross income. The deposit is included in gross income only if it is not refunded upon the expiration of the lease.

EXAMPLE I:3-18 ▶ In December 2019, Buddy rents an apartment to Gary. Buddy receives the first and last months' rent plus a security deposit of $500. Buddy must include in 2019 gross income both the first and last months' rent. Assume that Gary moves out of the apartment in 2021 and Buddy keeps $300 of the security deposit to cover repairs costing $200 and five days' unpaid rent, which amounts to $100. In 2021, Buddy would include the $300 in gross income and could deduct $200 for repairs. ◀

Royalties from copyrights, patents, and oil, gas, and mineral rights are all taxable as ordinary income. **Royalties** are proceeds paid to an owner by others who do business under some right belonging to the owner. Amounts received by a lessor to cancel, amend, or modify a lease also are taxable.

STOP & THINK

Question: Financial accounting contains extensive rules distinguishing "operating leases" from "capital leases." The IRC has no such rules. While the tax law does require the capitalization of leases that are in substance a purchase of the asset, most authority relating to the distinction comes from court cases. Why doesn't the tax law include specific rules relating to leased property?

Solution: The financial accounting rules that require businesses to capitalize some leases were established because of concern that long-term lease commitments represented unrecorded liabilities. Unrecorded liabilities distort a company's balance sheet, but may not distort reported income. Since the tax law is concerned with the reporting of income rather than the balance sheet, neither Congress nor the Treasury Department has seen the need to adopt leasing rules like those in financial accounting.

Improvements by Lessees. Improvements made by a lessee that increase the value of leased property are included in the lessor's income only if the improvements are made in lieu of paying rent or if rent is reduced because of the improvements. In such situations, the lessor must include the fair market value (FMV) of the improvement in gross income when it is made to the property.[36]

[35] Specifically, modified adjusted gross income includes amounts that qualify for the foreign earned income exclusion (Sec. 911), the exclusion for possession's income (Sec. 931), and the exclusion for income from Puerto Rico (Sec. 933). The limitation is determined after taking the partial exclusion for Social Security benefits and railroad retirement (Sec. 86), claiming the allowable deduction for retirement contributions (Sec. 219), and applying the passive loss limitation (Sec. 469).

[36] Reg. Sec. 1.109-1.

EXAMPLE I:3-19 ▶ Rita rents an apartment to Anna. The apartment normally would rent for $1,000 per month, but Rita agrees to accept $400 per month for the first year if Anna builds a block wall around the property. Rita estimates that she would have to pay someone $6,000 to build the wall. Rita is accepting reduced rent and must report gross income of $6,000 when the wall is added to the property. The $6,000 could be added to Rita's basis in the property and should qualify as a depreciable asset. ◀

Improvements not made in lieu of rent are not income to the lessor. No adjustment is made to the lessor's basis in the property and, therefore, no depreciation is allowable. Gain or loss is recognized only when the property is disposed of.[37] Whether the improvements are in lieu of rent depends on the intent of the parties. This determination is based on the facts of the particular situation. The rental rate, the terms of the rental agreement, and whether the improvements have an estimated useful life exceeding the term of the lease may all be indications of intent.

ADDITIONAL COMMENT

Shareholders of closely held corporations generally do not want to receive dividends from their corporations. The reason? They are taxed as ordinary income and the corporation does not receive a tax deduction for the payments.

DIVIDENDS

Dividends are included in shareholder gross income. The result is a so-called double tax because corporations are taxed on income they earn, and shareholders are taxed when the income is distributed as dividends.

As noted in the previous chapter many corporations avoid the problem of "double taxation" by making S elections which result in the corporations and their shareholders being taxed much like partnerships. Other important provisions reduce the tax burden on dividends:

- C Corporation receiving dividends from other domestic C Corporations may claim a "dividends received deduction" that reduces, and in some cases eliminates, the second corporate tax on the income. The amount of the dividend received deduction is generally 50% of dividends received by a corporation owning less than 20% of the distributing domestic corporation, 65% of dividends received by a corporation owning at least 20% but less than 80% of the distributing domestic corporation, and 100% of the dividends received by a domestic corporation owning 80% or more of the distributing domestic corporation. This rule is discussed more in Chapter I:16 and in depth in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* text and the *Comprehensive* volume.
- The *Tax Cut and Jobs Act* fundamentally changes the tax treatment of foreign dividends effective in 2018. Congress adopted a territorial tax system allowing domestic corporations to claim a 100% dividend received deduction for dividends received from 10% or greater foreign subsidiaries with only foreign earnings. This change recognizes that host countries tax income earned locally. The dividend received deduction is prorated in the case of foreign subsidiaries with both domestic and foreign source earnings.

EXAMPLE I:3-20 ▶ Alpha Corp. receives a $1,000 dividend from Beta, its wholly owned domestic subsidiary, and a $1,000 dividend from Gamma, its wholly owned foreign subsidiary. The dividend from Beta qualifies for the 100% dividend received deduction because Alpha meets the 80% ownership threshold. The dividend received deduction would be 65% or $650 if Alpha owned between 20% and 80% of Beta's stock, and would be 50% or $500 if Alpha owned less than 20% of Beta's stock.

ADDITIONAL COMMENT

Beginning in 2013, higher-income taxpayers (AGI greater than $200,000 for single or $250,000 for married filing jointly) have to pay an additional 3.8% tax on net investment income. Net investment income generally includes interest, dividends, rents, and capital gains.

The deduction for the dividends from Gamma depends on the source of Gamma's accumulated earnings. The deduction is 100% or $1,000 if all of Gamma's accumulated earnings are from foreign sources, but the deduction is $400 if only 40% of Gamma's accumulated earning are from foreign sources. ◀

- Lower tax rates apply to qualified dividends received by individuals. There is no tax on qualified dividends received by single taxpayers with taxable income of less than

[37] Reg. Sec. 1.1019-1.

$39,375 in 2019 (see the Quick Reference section of the text for taxable income amounts for other filing statuses). Dividends received by single taxpayers with taxable income greater than $39,375 and less than or equal to $434,550 are taxed at 15%. Dividends received by single taxpayers with taxable income over $434,550 are taxed at 20%. These lower rates apply only to stock that meets a special 60-day holding period. In general, these rates apply to dividends received from a domestic corporation. Dividends received by individuals from foreign corporations are taxed at regular rates unless covered by treaty.

EXAMPLE I:3-21 ▶ Georgia has taxable income of $65,000 and is in the 22% tax bracket in 2019. She owns 10% of Orange Corporation, an S corporation with $20,000 of income. The corporation distributes $1,000 to Georgia. She receives a $500 dividend from Red Corporation, a U.S. corporation, and $300 from Blue Corporation, a foreign corporation. Georgia will include $2,800 in gross income. This includes her share of Orange Corporation's income or $2,000 (10% × $20,000) along with $500 she received from Red Corporation and $300 she received from Blue Corporation. As Orange Corporation made an S-election, she must include in gross income her share of the corporation's income even though only part of it is distributed. The tax rate that applies to the $2,000 depends on the nature of the income earned by Orange Corporation. For example, part or all of the income could be treated as capital gains or dividend income if Orange earned those types of income while income from operations would be taxed at Georgia's higher tax rate of 22%. The dividend from Red Corporation qualifies for the favorable 15% tax rate as Georgia's taxable income is between $39,375 and $434,550. The dividend from Blue Corporation will be taxed at Georgia's regular tax rate of 22% as it was paid by a foreign corporation. ◀

EXAMPLE I:3-22 ▶ Celeste is a single taxpayer in 2019 with a salary of $52,775, qualified dividend income of $3,000, and itemized deductions of $16,000. Her taxable income is:

Adjusted gross income	$55,775
Itemized deductions	(16,000)
Taxable income	$39,775

Her taxable income excluding dividends is $36,775 ($39,775 – $3,000), and is taxed at regular rates. The special tax rate of 0% on dividends for single taxpayers ends at $39,375. As a result, $2,600 ($39,375 – $36,775) of Celeste's dividends are tax free, and the balance of the dividends or $400 ($3,000 – $2,600) is taxed at 15%.

Tax on ordinary income of $36,775 using rate schedule	$ 4,219
$2,600 of dividend income is tax free	–0–
Tax on $400 of dividend income at 15%	60
Gross tax	$ 4,279 ▶

Dividends Defined. Distributions to shareholders are taxable as dividends only to the extent they are made from either the corporation's current earnings and profits (a concept similar, although not identical, to current year's net income for financial accounting purposes) or accumulated earnings and profits (a concept similar, although not identical, to beginning of the year retained earnings).[38] Earnings and profits are discussed in Chapter I:16 and in greater depth in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* text and the *Comprehensive* volume. Distributions in excess of current and accumulated earnings and profits are treated as a nontaxable recovery of capital. Such distributions reduce the shareholder's basis in the stock. Distributions in excess of the basis of the stock are classified as capital gains.

EXAMPLE I:3-23 ▶ Liz is the sole shareholder in Atlantic Corporation and has owned the stock for five years. The basis of her stock is $50,000. Atlantic distributes $40,000 to Liz. Accumulated earnings and profits at the beginning of the year equal $25,000, and current earnings and profits equal $10,000. Liz will report $35,000 of taxable dividend income and a nontaxable return of capital equal to $5,000. In addition, Liz must reduce her basis in the stock by $5,000. Alternatively, if the distribution to Liz were $100,000, she would report $35,000 of taxable dividend income, $50,000 as a nontaxable return of capital, and a $15,000 long-term capital gain. ◀

[38] Sec. 316(a). The federal income tax became effective on March 1, 1913. Thus, income accumulated before that date can still be distributed on a tax-exempt basis.

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Adjusted gross income	$55,775
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Taxable income	$39,775

Her taxable income excluding dividends is $36,775 ($39,775 – $3,000), and is taxed at regular rates. The special tax rate of 0% on dividends for single taxpayers ends at $39,375. As a result, $2,600 ($39,375 – $36,775) of Celeste's dividends are tax free, and the balance of the dividends or $400 ($3,000 – $2,600) is taxed at 15%.

Tax on ordinary income of $36,775 using rate schedule	$ 4,219
$2,600 of dividend income is tax free	–0–
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Dividends Defined. Distributions to shareholders are taxable as dividends only to the extent they are made from either the corporation's current earnings and profits (a concept similar, although not identical, to current year's net income for financial accounting purposes) or accumulated earnings and profits (a concept similar, although not identical, to beginning of the year retained earnings).[38] Earnings and profits are discussed in Chapter I:16 and in greater depth in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* text and the *Comprehensive* volume. Distributions in excess of current and accumulated earnings and profits are treated as a nontaxable recovery of capital. Such distributions reduce the shareholder's basis in the stock. Distributions in excess of the basis of the stock are classified as capital gains.

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[38] Sec. 316(a). The federal income tax became effective on March 1, 1913. Thus, income accumulated before that date can still be distributed on a tax-exempt basis.

Stock Dividends. A **stock dividend** is a distribution by a corporation to its shareholders of the corporation's own stock. In 1920, the Supreme Court held that simple stock dividends could not be taxed because they were not income.[39] More precisely, income had not been realized because there was no real change in the taxpayer's interest or the risks faced by the taxpayer. Over the years, however, the exclusion for stock dividends has been narrowed. If a shareholder has the option of receiving either cash or stock, the shareholder is taxed even if he or she opts to receive stock. The option to receive cash constitutes constructive receipt of the cash. Today, many other features of a stock dividend may cause it to be taxed. For example, a distribution in which preferred stock is distributed to some common shareholders and common stock is distributed to others is taxable.[40] The recipient of a taxable stock dividend includes the value of the stock received in gross income, and that amount becomes the basis of the shares received.

ADDITIONAL COMMENT

Many mutual funds do not want their shareholders to have a large tax bill on the undistributed capital gains allocated among the shareholders. Some mutual funds will sell stocks in the portfolio that can be sold at a loss to offset gains incurred earlier in the year.

A nontaxable stock dividend has no effect on a shareholder's income in the year received. The basis of the old shares is allocated between the old shares and the new shares. Furthermore, the holding period for the new shares starts on the same date as the holding period of the old.

EXAMPLE I:3-24 ▶ Carol purchases 100 shares of Mesa Corporation stock for $1,100 (or $11 per share). Carol receives 10 shares of Mesa stock as a nontaxable stock dividend. After the dividend, Carol owns 110 shares of stock with a total basis of $1,100 (or $10 per share). All of the stock is assumed to have been acquired at the time of the original purchase. ◀

Capital Gain Dividends. A **capital gain dividend** is a distribution by a regulated investment company (commonly called a *mutual fund*) of capital gains realized from the sale of investments in the fund. Such dividends also include any undistributed capital gains allocated to shareholders by such companies.[41] Capital gain dividends are long-term regardless of how long the shareholder has owned the stock of the regulated investment company.

REAL-WORLD EXAMPLE

In the 1989 trial of Leona Helmsley, the billionaire hotel queen, it was disclosed that she had billed her companies for millions of dollars in personal items. The items ranged from a $12.99 girdle to a $1 million limestone-and-marble pool enclosure at her estate. She was sentenced to four years in prison and fined $7.1 million. The amounts paid to her by her companies represented constructive dividends.

Constructive Dividends. In many corporations, the same individuals are both shareholders and employees. A corporation may not deduct dividends paid to shareholders but is permitted to deduct reasonable compensation. Questions are often raised as to whether amounts reported as compensation are really disguised dividends. If an amount called compensation is unreasonably high, it will be disallowed and reclassified as a dividend.[42] Often the reasonableness of compensation is determined by comparing the compensation paid to the employee-shareholders with amounts paid to others performing similar services.

EXAMPLE I:3-25 ▶ Carmen owns 100% of the stock in Florida Corporation and receives a $400,000 salary for serving as president. The corporation reports no taxable income and pays no dividends. Presidents of similar companies received salaries ranging from $75,000 to $160,000. The IRS probably would disallow a portion of Carmen's salary as unreasonable resulting in the corporation owing tax. The disallowed portion would be treated as a dividend. ◀

ADDITIONAL COMMENT

In one case, the taxpayer, who was also the president and principal shareholder, diverted cash from vending and pinball machines at his truck stops/restaurants to his personal use. The IRS's position was that these diverted cash amounts were a constructive dividend. *Hagaman v. CIR.*, 69 AFTR 2d 92-906 (6th Cir., 1992).

Constructive dividends are not limited to shareholder-employee compensation payments but may include situations where the shareholder also is a landlord (e.g., property is rented to the corporation at an amount greater than its fair rental value). A shareholder also may receive a constructive dividend because of a creditor or vendor relationship. It is not necessary that a dividend be formally declared or that distributions be in proportion to stock holdings. **Constructive dividends** are often distributions that are intended to result in a deduction to the corporation and taxable income (such as compensation) to the

[39] *Eisner v. Myrtle H. Macomber*, 3 AFTR 3020, 1 USTC ¶32 (USSC, 1920).
[40] Reg. Sec. 1.305-4.
[41] Sec. 852(b).
[42] Sec. 162(a)(1).

shareholder.[43] Other constructive dividends are intended to produce a nonreportable benefit to the shareholder,[44] or even result in a deduction to the corporation without income to the shareholder.[45]

ALIMONY AND SEPARATE MAINTENANCE PAYMENTS

The *Tax Cut and Jobs Act* fundamentally changes the tax treatment of divorce settlements. Alimony payments covered by new law are neither taxable nor deductible. The new rules apply to divorce and separate maintenance agreements entered into after December 31, 2018. The old rules continue to apply to earlier divorces and separations.

Payments made pursuant to a divorce or legal separation are classified as alimony, child support, and property settlements. Property settlements and child support have never been taxable to the recipient nor deductible by the payer. Alimony payments covered by prior law are taxable to the recipient and deductible for AGI by the payer.

Example I:3-26 demonstrates the significant difference in taxation that can occur when a payment is classified as either alimony or a property settlement.

EXAMPLE I:3-26 ▶ Helen earns $500,000 and, as a result of her divorce, which was finalized in 2018, she is required to pay William $250,000. If the payment is a property settlement, Helen cannot deduct any of the $250,000 payment and William is not required to include the payment in his income. However, if the $250,000 is alimony, Helen can deduct the full amount in computing her adjusted gross income. William reports the $250,000 as alimony income. ◀

ADDITIONAL COMMENT

Child-support payments are not treated as alimony and are neither deductible by the payer spouse nor includible in income of the payee spouse.

ADDITIONAL COMMENT

If any amount specified in the divorce instrument will be reduced due to the happening of a contingency relating to a child or reduced at a time that can clearly be associated with such contingency, the amount of the reduction is treated as child support.

Prior tax law had rather specific rules that distinguished alimony, child support, and property settlements. Under prior law, in order to be treated as **alimony**, payments had to meet all of the following requirements:[46]

- Be made in cash (not property)
- Be made pursuant to a divorce, separation, or a written agreement between the spouses
- Terminate at the death of the payee
- Not be designated as being other than alimony (e.g., child support)
- Be made between people who are living in separate households

These rules are summarized in Topic Review I:3-2. Certain aspects of these rules will be discussed further.



ETHICAL POINT

Tax consultants who advise divorcing couples may face an ethical dilemma because advice that benefits one spouse may be detrimental to the other, and because of the need to maintain confidential client relationships.

A **property settlement** is a division of property pursuant to a divorce. In general, each spouse is entitled to the property brought into the marriage and a share of the property accumulated during marriage.[47] A division of property does not result in any income to either spouse, nor does either spouse receive a tax deduction. The basis of property received by either spouse as a result of the divorce or separation remains unchanged.

EXAMPLE I:3-27 ▶ As a result of a divorce, Dawn receives stock that she purchased with her former husband during their marriage for $12,000. At the time of the divorce, the stock was worth $14,000. Neither Dawn nor her former husband reports income from the transfer of the stock because the stock was acquired as a property settlement. If Dawn subsequently sold the stock for $15,000, she would report a $3,000 gain. ◀

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[43] Other examples include excessive royalties (*Peterson & Pegau Baking Co.*, 2 B.T.A. 637 (1925)) and rent (*Limericks, Inc. v. CIR*, 36 AFTR 649, 48-1 USTC ¶9146 (5th Cir., 1948)).

[44] Examples include bargain sales of corporate assets to shareholders (*J. E. Timberlake v. CIR*, 30 AFTR 583, 42-2 USTC ¶9822 (4th Cir., 1942)), redemptions of a shareholder's stock (Sec. 302), and loans to shareholders that are actually dividends (*George Blood Enterprises, Inc.*, 1976 PH T.C. Memo ¶76,102, 35 TCM 436).

[45] Examples include paying an employee's personal expenses (*The Lang Chevrolet Co.*, 1967 PH T.C. Memo ¶67,212, 26 TCM 1054) and purchasing assets for an employee's use (*Joseph Morgenstern*, 1955 PH T.C. Memo ¶55,086, 14 TCM 282).

[46] Before 1942, alimony was not deductible (*Gould v. Gould*, 3 AFTR 2958, 1 USTC ¶13 (USSC, 1917)). The original rules were revised in 1984 and again in 1986. Prior rules apply to earlier divorces unless both spouses elect to apply current rules.

[47] How the property accumulated during marriage is divided may be determined by an agreement of the parties, or if they are unable to agree, on a basis of state law.

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[47] How the property accumulated during marriage is divided may be determined by an agreement of the parties, or if they are unable to agree, on a basis of state law.

TOPIC REVIEW I:3-2

Tax Rules for Alimony

TREATMENT OF RECIPIENT

The recipient of alimony covered by prior law must include the amounts received in gross income. Property settlements and child support payments are not taxable.

TREATMENT OF PAYOR

The payer of alimony covered by prior law may deduct amounts paid *for* adjusted gross income. Property settlements and child support payments are not deductible.

APPLICABLE TO

Payments must be pursuant to a divorce, separation, or a written agreement between spouses entered into prior to 2019.

REQUIREMENTS

Spouses must be living in separate households. Payments must be in the form of cash paid to (or for the benefit of) a spouse or former spouse. Payments must terminate at the death of the payee. Payments may not be designated as being other than alimony (such as child support or a property settlement).

RECAPTURE

If the amount of payments declines in the second or third year, a portion of the early payments may have to be recaptured as income by the payer. The payee may deduct the same recaptured amount.

One unusual rule found in the prior law that relates to alimony is the so-called **recapture provision.** This provision was established to prevent a large property settlement that might take place after a divorce from being disguised as alimony so as to produce a deduction for the payer. In essence, the concept of recapture in connection with a divorce means that the payer of the alimony (who has taken a deduction for such amounts in prior years) must report the recapture amount in his or her income. The payee (who has reported the income in prior years) receives a deduction for the recaptured amount. This recapture occurs because the payments that originally were reported as alimony are being reclassified as property settlements.

EXAMPLE I:3-28 ▶ As a result of their separation, Mary agrees to pay Tom $20,000 per year. The payments are to cease if Tom remarries. In the year after the agreement is reached, Tom remarries and Mary discontinues the payments. No recapture is required because the payments are contingent on the remarriage of the recipient and the payments have been discontinued because of the occurrence of this contingency. ◀

PENSIONS AND ANNUITIES

ADDITIONAL COMMENT

The three largest sources of non-wage income in 2016, in rank order, were partnership and S corporation income, pensions and annuities, and capital gains.

An **annuity** is a series of regular payments that will continue for a fixed period of time or until the death of the recipient. Taxpayers occasionally purchase annuities from insurance companies to provide a source of funds during retirement years. The insurance company may agree to make payments to the insured for the remainder of the insured's life. The retired individual is assured of a steady flow of funds for life. The price paid for the annuity represents its cost. The insured taxpayer is permitted to recover this cost tax-free.

Individuals receiving an annuity are permitted to exclude their cost, but are taxed on the remaining portion of the annuity. The following steps can be followed to determine the nontaxable portion of the annuity:

ADDITIONAL COMMENT

The expected return is limited to amounts receivable as an annuity. It does not include amounts that may be paid after death, nor does it include anticipated dividends.

- Determine the **expected return multiple.** This multiple is the number of years that the annuity is expected to continue and may be a stated term, say ten years, or it may be for the remainder of the taxpayer's life. In the latter situation, the expected return multiple (life expectancy) is determined by referring to a table (see Table I:3-1) developed by the IRS.
- Determine the **expected return.** This return is computed by multiplying the amount of the annual payment by the expected return multiple.

▼ TABLE I:3-1
Ordinary Life Annuities (One Life) Expected Return Multiple

Age	Multiple	Age	Multiple	Age	Multiple
5	76.6	42	40.6	79	10.0
6	75.6	43	39.6	80	9.5
7	74.7	44	38.7	81	8.9
8	73.7	45	37.7	82	8.4
9	72.7	46	36.8	83	7.9
10	71.7	47	35.9	84	7.4
11	70.7	48	34.9	85	6.9
12	69.7	49	34.0	86	6.5
13	68.8	50	33.1	87	6.1
14	67.8	51	32.2	88	5.7
15	66.8	52	31.3	89	5.3
16	65.8	53	30.4	90	5.0
17	64.8	54	29.5	91	4.7
18	63.9	55	28.6	92	4.4
19	62.9	56	27.7	93	4.1
20	61.9	57	26.8	94	3.9
21	60.9	58	25.9	95	3.7
22	59.9	59	25.0	96	3.4
23	59.0	60	24.2	97	3.2
24	58.0	61	23.3	98	3.0
25	57.0	62	22.5	99	2.8
26	56.0	63	21.6	100	2.7
27	55.1	64	20.8	101	2.5
28	54.1	65	20.0	102	2.3
29	53.1	66	19.2	103	2.1
30	52.2	67	18.4	104	1.9
31	51.2	68	17.6	105	1.8
32	50.2	69	16.8	106	1.6
33	49.3	70	16.0	107	1.4
34	48.3	71	15.3	108	1.3
35	47.3	72	14.6	109	1.1
36	46.4	73	13.9	110	1.0
37	45.4	74	13.2	111	.9
38	44.4	75	12.5	112	.8
39	43.5	76	11.9	113	.7
40	42.5	77	11.2	114	.6
41	41.5	78	10.6	115	.5

Source: Reg. Sec. 1.72-9, Table V.

Note: This table should be used if any or all investments were made on or after July 1, 1986. If all investments were made before July 1, 1986, use Reg. Sec. 1.72-9, Table I (not shown).

ADDITIONAL COMMENT

If payments are paid other than monthly, the number of anticipated payments is adjusted accordingly. Thus, if payments are made quarterly, the number from the table is divided by three.

- Determine the **exclusion ratio.** This ratio is computed by dividing the investment in the contract (its cost) by the expected return (from above).
- Determine the **current year's exclusion.** This exclusion is computed by multiplying the exclusion ratio (from above) times the amount received during the year.

EXAMPLE I:3-29 ▶ David, age 65, purchases an annuity for $28,800. Under the terms of the annuity, David is to receive $300 per month ($3,600 per year) for the rest of his life.

- The expected return multiple is 20.0. The multiple is obtained from Table I:3-1.
- The expected return is $72,000 (20.0 × $3,600).
- The exclusion ratio is 0.400 ($28,800 ÷ $72,000).
- The exclusion is $1,440 (0.400 × $3,600). ◀

After the entire cost of an annuity has been recovered, the full amount of all future payments is taxable. On the other hand, if an individual dies before recovering the entire cost, the remaining unrecovered cost can be deducted as an itemized deduction on that individual's final return. Insurance companies and businesses with retirement plans compute the taxable portion of annuities and report the amounts to recipients on Form 1099.

Qualified Retirement Plan Annuities. Distributions from pensions and other qualified retirement plans are commonly paid in the form of an annuity. Both the employer and the employee often contribute funds to these plans. The employee's cost is limited to after-tax amounts contributed by the employee, usually through withholding. The employee's cost does not include employer contributions or pretax contributions made by the employee to Sec. 401(k) and similar plans.

KEY POINT

The simplified method is used only for annuity distributions from qualified retirement plans. All other annuity distributions are taxed in accordance with the general rules above.

Simplified Method. A simplified method is now used to determine the taxable portion of an annuity paid from a qualified retirement plan. Under the simplified method, the nontaxable portion of each annuity payment is equal to the employee's after-tax investment in the annuity divided by the number of anticipated payments as determined from the following table:

Age of Primary Annuitant on the Start Date	*Number of Anticipated Payments*
55 and under	360
56–60	310
61–65	260
66–70	210
71 and over	160

EXAMPLE I:3-30 ▶ Jack, age 62, retires, and receives a $1,000 per month annuity from his employer's qualified pension plan. Jack contributed $65,000 to the plan prior to his retirement. Under the simplified method, Jack would exclude $250 per month as a return of capital. This is calculated by dividing $65,000 by 260 anticipated payments. ◀

ADDITIONAL COMMENT

Unlike other retirement plans, all contributions made to Roth plans are from after-tax income. When all Roth requirements are met, distributions are tax-free. See Chapter I:7.

Plan Comparison. Plans that involve a combination of pre- and after-tax contributions are taxed less favorably than plans that have only pretax or only after-tax contributions because income earned on after-tax contributions is taxed when distributed to retired employees. For that reason, many employers today have two separate plans, one with only pretax contributions and a second with only after-tax contributions (like the Roth plan). The result is that all distributions from the pretax plan are taxable, whereas no qualified distributions from the Roth plan are taxable.

KEY POINT

Under current law, a taxpayer must generally pay tax on a portion of each withdrawal made before the normal starting date of the annuity.

Advance Payments. Many pensions contain provisions that allow taxpayers to withdraw amounts before the normal starting date. Under current law, an amount withdrawn from a pension before the starting date is considered to be in part a recovery of the employee's contributions and in part a recovery of the employer's contributions.[48] After all contributions have been withdrawn, additional withdrawals are fully taxable.

EXAMPLE I:3-31 ▶ Dick, age 45 and in good health, withdrew $2,000 from a pension plan during the current year. No exception exempts Dick from the 10% penalty. Dick had made $40,000 of after-tax contributions to the plan, and his employer had contributed $60,000. Dick must include $1,200 (0.60 × $2,000) in income. Because no exception applies, Dick must also pay an additional penalty of $120 (0.10 × $1,200). The penalty is not deductible by Dick. ◀

ADDITIONAL COMMENT

In addition to being subject to the regular income tax, any amount withdrawn may also be subject to a 10% nondeductible penalty. The penalty is not applicable to taxpayers who are age 591/2 or older. Other exceptions to the early withdrawal penalty are discussed in Chapter I:7 .

INCOME FROM LIFE INSURANCE AND ENDOWMENT CONTRACTS

The face amount of life insurance received because of the death of the insured is not taxable. If the proceeds are left with the insurance company and as a result earn interest, the interest payments are taxable. (See Chapter I:4 for a detailed discussion of life insurance and endowment contracts.)

[48] Sec. 72(e).

INCOME FROM DISCHARGE OF INDEBTEDNESS

In general, the forgiveness of debt is a taxable event. The person who owed the money must report the amount forgiven as income unless one of several exceptions found in the tax law applies. These exceptions are discussed in Chapter I:4.

INCOME PASSED THROUGH TO TAXPAYER

Generally, entities are subject to income tax based on the amount of taxable income. Corporations, as an example, are subject to income taxation. As noted, certain types of entities are not subject to income taxation as their income is taxed directly to their owners rather than to the entities. Such entities are referred to as "flow-through entities." Section 61 specifically lists three such instances: the distributive share of a partnership's income, income in respect of a decedent, and income from an interest in an estate or trust. Though not mentioned in Sec. 61, similar treatment is accorded S corporations, Regulated Investment Companies, and Real Estate Investment Trusts. In each case, the income that is produced by the entities merely flows through to the owners or beneficiaries of such entities. The rules can be summarized as follows:

KEY POINT

The pass-through of income by a partnership can create a situation known as phantom income. In this situation, a partner is required to report income on his or her individual tax return, but the partner may not have received a cash distribution from the partnership.

- Each partner reports his or her share of a partnership's income and deducts his or her share of the partnership's expenses. The income and deductions are reported by the partners whether or not any amount is actually distributed by the partnership during the year. The partnership's income and deductions retain their tax status.
- S corporations are taxed much like partnerships. Each shareholder in the corporation is taxed on his or her proportionate share of the corporation's income whether or not the income is actually distributed.
- Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs) are also flow through entities. RICs, which include both mutual funds and exchange traded funds, invest in securities and are required to distribute their income to shareholders who are taxed on the distributions. REITs invest in real estate and real estate loans. They too must distribute their income to investors who are taxed on the income. The distributions (dividends, interest, rents, and gains) retain their tax status when reported by RIC and REIT investors.
- Income in respect of a decedent is income earned by an individual before death that is paid to another after the death. For example, salary earned by a husband before his death in an automobile accident may be paid to his widow. The recipient, in this case the widow, is taxed on the income if it has not been taxed to the decedent before his death.
- Income earned by estates and trusts is subject to taxation.[49] However, income distributions to beneficiaries are deductible by estates and trusts and are taxable to the beneficiaries. Thus, a trust with $20,000 of income that distributes $15,000 to its beneficiary is taxed on $5,000, while $15,000 is taxed to the beneficiary. Because of this approach estates and trusts are sometimes referred to as semi-flow-through or hybrid entities. The income taxation of estates and trusts is covered more fully in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts.*

OTHER ITEMS OF GROSS INCOME

The preceding discussions considered items of gross income specifically listed in Sec. 61(a). However, the fact that an item of income is listed in Sec. 61(a) does not necessarily cause it to be taxable. Rather, the condition that causes an item of income to be taxable is that it is not specifically excluded. Some items of gross income not mentioned in Sec. 61(a) are discussed below.

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[49] Note the distinction between income in respect of a decedent and the income of an estate. Income in respect of a decedent is the income earned before death that was never taxed to the decedent. An example would be interest that was accrued but unpaid at death. Income of an estate is income earned after death that is paid to the estate. An example would be interest that accrues after the decedent's death.

PRIZES, AWARDS, GAMBLING WINNINGS, AND TREASURE FINDS

In general, prizes, awards, gambling winnings, and treasure finds are taxable.[50] Winnings in contests, competitions, and quiz shows are taxable.[51] The amount to be included in gross income is the fair market value of the goods or services received. Total gambling winnings must be included in gross income.[52] This includes proceeds from lotteries, raffles, sweepstakes, and the like. Gambling losses (up to the amount of the current year's winnings) are allowable as an itemized deduction.[53] The Regulations state that a treasure find constitutes gross income to the extent of its value in the year in which it is reduced to undisputed possession.[54]

EXAMPLE I:3-32 ▶ Several years ago, Colleen purchased a used piano at an auction for $15. In the current year, she finds $4,500 of currency hidden in the piano. Colleen must report the $4,500 as income in the current year.[55] ◀

REAL-WORLD EXAMPLE

An accountant collected from a client money that was to be used to pay the client's taxes. Then the accountant appropriated the money for his own use. The accountant was held to have received unreported income. *Richard A. Reeves,* 1977 PH T.C. Memo ¶ 77,114, 36 TCM 500.

ILLEGAL INCOME

Income from illegal activities is taxable.[56] Some people find this part of the tax law surprising, but this fact serves as the basis for many criminal convictions given that few criminals report their illegal income. For example, Al Capone was convicted of income tax evasion, not bootlegging or other crimes. It is not necessary to prove that an individual had illegal income, but merely that the individual had income that was not reported.

Individuals have used varied defenses against this rule. One taxpayer was successful in convincing the Supreme Court that he should not be taxed on embezzlement gains because he had an unconditional obligation to repay the amount embezzled,[57] but the Supreme Court reversed this position in a later case.[58] The court concluded that although an obligation to repay existed, the taxpayer had no "consensual recognition" (intent) to repay. In addition to embezzlement of funds, the courts have held that a kidnapper's ransom was taxable,[59] along with profits from bookmaking,[60] card playing,[61] forgery,[62] stealing,[63] bank robbery,[64] sale of narcotics,[65] illegal sale of liquor,[66] and bribes.[67] (See Chapter I:6 for a discussion of related deductions.)

ADDITIONAL COMMENT

Welfare payments are not normally required to be included in gross income. However, if the welfare payments are fraudulently received under state or federal assistance programs, they must be included in the recipient's gross income.

UNEMPLOYMENT COMPENSATION

For many years, unemployment compensation was excluded from gross income. In 1978, Congress changed the law to fully tax unemployment compensation because these benefits are a substitute for taxable wages.

SOCIAL SECURITY BENEFITS

Social Security benefits were excluded from gross income until 1984. Between 1984 and 1993, up to 50% of Social Security benefits were taxable. Beginning in 1994, up to 85% of Social Security benefits may be taxable. Under Sec. 86, the portion of Social Security benefits that are taxable depends on the taxpayer's provisional income and filing status. *Provisional income* is computed using the following formula:

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[50] Exclusions for scholarships and fellowships and a limited exclusion for prizes awarded for scientific, charitable, or similar meritorious achievements are discussed in Chapter I:4.
[51] Sec. 74 and Reg. Sec. 1.74-1.
[52] *U.S. v. Manley S. Sullivan,* 6 AFTR 6753, 1 USTC ¶236 (USSC, 1927).
[53] Sec. 165(d).
[54] Reg. Sec. 1.61-14(a).
[55] *Ermenegildo Cesarini v. U.S.,* 26 AFTR 2d 5107, 70-2 USTC ¶9509 (6th Cir., 1970).
[56] Reg. 1.61-14(a).
[57] *CIR v. Laird Wilcox,* 34 AFTR 811, 46-1 USTC ¶9188 (USSC, 1946).
[58] *Eugene C. James v. U.S.,* 7 AFTR 2d 1361, 61-1 USTC ¶9449 (USSC, 1961).
[59] *Murray Humphreys v. CIR,* 28 AFTR 1030, 42-1 USTC ¶9237 (7th Cir., 1942).
[60] *James P. McKenna,* 1 B.T.A. 326 (1925).
[61] *L. Weiner,* 10 B.T.A. 905 (1928).
[62] *Cass Sunstein,* 1966 PH T.C. Memo ¶66,043, 25 TCM 247.
[63] *Mathias Schira v. CIR,* 50 AFTR 1404, 57-1 USTC ¶9413 (6th Cir., 1957).
[64] *Gary Ayers,* 1978 PH T.C. Memo ¶78,341, 37 TCM 1415.
[65] *Antonino Farina v. McMahon,* 2 AFTR 2d 5918, 58-2 USTC ¶9938 (D.C. N.Y., 1958).
[66] *U.S. v. Manley S. Sullivan,* 6 AFTR 6753, 1 USTC ¶236 (USSC, 1927).
[67] *U.S. v. Patrick Commerford,* 12 AFTR 364, 1933 CCH ¶9255 (2nd Cir., 1933).

Adjusted gross income (excluding Social Security benefits)		$xx,xxx
Plus:	Tax-exempt interest	x,xxx
	Excluded foreign income	x,xxx
	50% of Social Security benefits	x,xxx
Provisional income		$xx,xxx

REAL-WORLD EXAMPLE

The requirement that tax-exempt income be included in determining the taxable portion of Social Security benefits has been challenged on the basis that such provision is unconstitutional. However, the court held that this provision placed only an indirect burden on the governmental unit that issued the tax-exempt bonds, which was not protected by the intergovernmental immunity doctrine. *H.J. Goldin v. Baker,* 59 AFTR 2d 87-444, 87-1 USTC ¶9128, (2nd Cir., 1987).

Married Filing Separately. In the case of married couples who live together but file separately, taxable Social Security benefits are equal to the lesser of:

- 85% of Social Security benefits, or
- 85% of provisional income

Married Filing Jointly. For married couples filing jointly, the computation of the taxable portion of Social Security benefits is as follows:

- If provisional income is $32,000 or less, no Social Security benefits are taxable.
- If provisional income is over $32,000 (but not over $44,000), taxable Social Security benefits equal the lesser of:
  - 50% of the Social Security benefits, or
  - 50% of the excess of provisional income over $32,000
- If provisional income is over $44,000, taxable Social Security benefits are equal to the lesser of:
  - 85% of the Social Security benefits, or
  - 85% of provisional income over $44,000, plus the lesser of (1) $6,000 or (2) 50% of Social Security benefits

Single Taxpayers. For single taxpayers (and married persons living separately), the computation of the taxable portion of Social Security benefits is as follows:

- If provisional income is $25,000 or less, no Social Security benefits are taxable.
- If provisional income is over $25,000 (but not over $34,000), taxable Social Security benefits are equal to the lesser of:
  - 50% of the Social Security benefits, or
  - 50% of the excess of provisional income over $25,000
- If provisional income is over $34,000, taxable Social Security benefits are equal to the lesser of:
  - 85% of the Social Security benefits, or
  - 85% of provisional income over $34,000, plus the lesser of (1) $4,500 or (2) 50% of Social Security benefits

EXAMPLE I:3-33 ▶ Holly is a single taxpayer with a taxable pension of $22,000, tax-exempt interest of $10,000, and Social Security benefits of $8,000. Her provisional income is $36,000, determined as follows:

Adjusted gross income		$22,000
Plus:	Tax-exempt interest	10,000
	50% of Social Security benefits	4,000
Provisional income		$36,000

The taxable Social Security benefits are equal to $5,700, which is the lesser of $6,800 (0.85 × $8,000) or $5,700 ($1,700* + the lesser of $4,500 or $4,000**).

*($36,000 provisional income – $34,000 threshold) × 0.85.
**50% of the Social Security benefits. ◀

The result of the computation excludes from gross income the Social Security benefits received by lower-income individuals but taxes a portion (up to 85%) of the benefits received by taxpayers with higher incomes. As the thresholds are not adjusted for inflation, an increasing number of retirees are finding that a portion of their Social Security benefits is taxable.

The term **Social Security benefits** refers to basic monthly retirement and disability benefits paid under Social Security and also to tier-one railroad retirement benefits. It does

not include supplementary Medicare benefits that cover the cost of doctors' services and other medical benefits.

INSURANCE PROCEEDS AND COURT AWARDS

In general, insurance proceeds and court awards are taxable. Two exceptions are accident and health insurance benefits and the face amount of life insurance. (See Chapter I:4 for a discussion of these benefits.)

Insurance proceeds or court awards received because of the destruction of property are included in gross income only to the extent that the proceeds exceed the adjusted basis of the property. Involuntary conversion provisions permit taxpayers to avoid being taxed if they reinvest the proceeds in a qualified replacement property.[68] If the proceeds are less than the property's adjusted basis, they reduce the amount of any deductible loss. Proceeds of insurance guarding against loss of profits because of a casualty are taxable.[69] Similarly, if a taxpayer had to sue a customer to collect income owed to the taxpayer, the amount collected is taxable just as it would have been had the taxpayer collected the income without going to court.

EXAMPLE I:3-34 ▶ Gulf Corporation's factory was destroyed by fire. Gulf Corporation collected insurance of $400,000, which equaled the building's basis, and $250,000 for the profits lost during the time the company was rebuilding its factory. The $400,000 is not taxable because it constitutes a recovery of the basis of the factory. The $250,000 is taxable because it represents lost income. Recall that the income would have been taxable had it been earned by the company from regular operations. ◀

Although few exclusions are designed specifically for insurance proceeds or court awards, such amounts may be covered by other, more general exclusions. For example, Sec. 104(a)(2) excludes "damages (other than punitive damages) received... on account of personal physical injuries or sickness." Thus, amounts collected because of physical injury suffered in an automobile accident are excluded (see Chapter I:4).

RECOVERY OF PREVIOUSLY DEDUCTED AMOUNTS

On occasion, a taxpayer may deduct an amount in one year but recover the amount in a subsequent year. In general, the amount recovered must be included in the gross income in the year it is recovered. Cash-basis taxpayers encounter this situation more often than accrual-basis taxpayers because their expenses are generally deductible in the year they are paid. If the amount was overpaid, the taxpayer can anticipate a refund.

EXAMPLE I:3-35 ▶ During 2019, Cindy's employer withheld $1,000 from her wages for state income taxes. She claimed the $1,000 as an itemized deduction on her 2019 federal income tax return. Her itemized deductions totaled $20,000. On her 2019 state income tax return, her state income tax was only $800. As a result, Cindy received a $200 refund from the state in April 2020. Because Cindy deducted the full $1,000 in 2019, she must report the $200 refund as income on her 2020 federal income tax return. ◀

Tax Benefit Rule. As noted above, a taxpayer who recovers an amount deducted in a previous year must report as gross income the amount recovered. The amount recovered need not be included in income, however, if the taxpayer received no tax benefit. A tax benefit occurs only if the deduction reduced the tax for the year.[70] Chapter I:8 provides a more detailed discussion of the tax benefit rule.

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[68] The involuntary conversion provisions are discussed in Chapter I:12.

[69] *Oppenheim's Inc. v. Kavanagh*, 39 AFTR 468, 50-1 USTC ¶9249 (D.C.-Mich., 1950).

[70] Sec. 111.

EXAMPLE I:3-36 ▶ In 2019, Jack's employer withheld $1,200 from his wages for state income tax. Jack claimed the $1,200 as an itemized deduction on his 2019 federal income tax return. Because of a variety of losses incurred by Jack, he reported a negative taxable income of $32,000 during 2019. The state refunded the $1,200 during 2020. Jack will not have to report the $1,200 as gross income on his federal return. Jack received no tax benefit from the deduction, as he would have owed no federal income tax in 2019 even without the deduction. ◀

REAL-WORLD EXAMPLE

An attorney collected fees from clients of his employer. Because the attorney and his employer were engaged in a dispute over ownership of the money, he deposited the disputed amount in a trust account. The attorney was taxable on the amounts in the year received because he had control over the funds under the claim of right doctrine. *Edward J. Costello, Jr.*, 1985 PH T.C. Memo ¶85,571, 50 TCM 1463.

Taxpayers who itemize may deduct either state and local income taxes or state and local sales taxes, but not both. Taxpayers anticipating a refund of state and local income taxes may wish to consider deducting state and local sales taxes.

Note that a limitation of $10,000 ($5,000 for separate filers) applies to the itemized deduction for state and local taxes. Taxpayers do not have to report a tax refund as income to the extent the deduction is disallowed because of the limitation. The deduction for state and local taxes is discussed further in Chapter I:8.

CLAIM OF RIGHT

Sometimes taxpayers receive disputed amounts. For example, a contractor may receive payment on a job when the quality of the work is being questioned by the customer, a salesperson may receive commissions when there is a question as to whether the sales are final, or a litigant may receive a court award even though the case is on appeal. Under the claim of right doctrine, the recipient of a disputed amount must include the amount received in gross income as long as the use of the funds is unrestricted.

EXAMPLE I:3-37 ▶ Jane wins a court case against a customer requiring the customer to pay her $10,000. The customer is unhappy with the result of the case and indicates that he plans to appeal, but pays the $10,000 to avoid interest on the amount in the event he loses the appeal. Jane must include the $10,000 in gross income even though she will have to repay the amount if she loses the appeal. ◀

EXAMPLE I:3-38 ▶ Assume the same facts as in Example I:3-37 except that the $10,000 is placed in escrow by the court awaiting the outcome of the appeal. Jane does not have to report the amount as she does not have use of the funds. ◀

Of course, taxpayers may be required to repay the disputed amount in a subsequent year. Such taxpayers may deduct the previously reported amount in the year of repayment. The taxes saved from such a deduction, however, may be considerably less than the original tax. If the repayment is over $3,000, taxpayers have the option of reducing the current tax by the tax paid in the prior year or years on the repaid amount.[71]

EXAMPLE I:3-39 ▶ Assume the same facts as in Example I:3-37, except that after reporting the disputed $10,000 Jane loses the appeal and must repay the $10,000 to her customer. If Jane was in the 25% tax bracket when she reported the disputed amount, she would have paid a $2,500 (0.25 × $10,000) tax on the disputed amount. If she were in the 15% bracket when she made the repayment, she would recover only $1,500 by deducting the $10,000. Because the amount exceeds $3,000, Jane has the option of determining her current year's tax by deducting from the tax she would otherwise pay the $2,500 tax she paid in the earlier year. This credit is allowed in lieu of receiving a $10,000 deduction. ◀

TAX PLANNING CONSIDERATIONS

OBJECTIVE 5

Describe tax planning considerations for inclusions of gross income

SHIFTING INCOME

A family can reduce its taxes by shifting income from family members who are in high tax brackets (e.g., parents) to family members who are in low tax brackets (e.g., children). Assignment of income rules prevent shifting from being done by merely redirecting the

[71] Sec. 1341.

payment. Thus, a father cannot avoid a tax on his salary by ordering his employer to pay the salary to his daughter. Nevertheless, income can be shifted by transferring ownership of the property. For example, children may own stock in the family business. Dividends on the stock are taxed to the children. In the case of a child under age 24, however, the parents' (as opposed to the child's) tax rate often applies to unearned income in excess of $2,200. Series EE bonds may prove useful to avoid the kiddie tax because the interest is deferred until the bond is redeemed or matures. The maturity date, of course, may be after the child reaches age 24. Another shifting technique is for the child to work for the family business and be paid a reasonable salary. Such income is taxed at the child's tax rate, even if the child is under 24 years old, and can be offset by the child's own standard deduction.

Shifting of income is constrained by several factors. As noted, the assignment of income doctrine limits transfers. Reasonableness limitations constrain compensation and other payments. Furthermore, outright gifts of property are subject to gift taxes. Also, individuals are reluctant to transfer wealth to children for a variety of personal reasons. However, the tax saving potential of shifting income is often so great as to prompt many well-to-do families to use available shifting techniques.

DIVORCE SETTLEMENTS

Divorce settlements have significant financial implications. Alimony payments covered by prior law are deductible by the payer and taxable to the recipient.

EXAMPLE I:3-40 ▶ Tony, who is in the 37% tax bracket, makes alimony payments of $40,000 to his former wife. If prior law applies, Tony will save $14,800 (0.37 × $40,000) a year in federal income taxes. The amount of tax that his former wife must pay depends on her tax bracket. Her tax might be as high as Tony's or as little as zero if deductions offset her income. On the other hand, if the payments are covered by the new law, Tony cannot deduct the payments, and his former wife reports no income. ◀

ADDITIONAL COMMENT

In 2016, $12.6 billion of alimony paid was reported as a deduction, while only $10.5 billion was reported as taxable income. No doubt this difference is one reason Congress changed the alimony rules.

It is important that individuals paying alimony covered by the new law understand that the payments are made from after tax income.

PREPAID INCOME

As explained earlier in this chapter, prepaid income is generally taxable when received. This accelerated recognition of income may be a significant disadvantage to the taxpayer if the related expenses are incurred in a later tax year. Thus, tax planning for prepaid amounts is essential.

EXAMPLE I:3-41 ▶ Phil owns an apartment complex and requires tenants to pay the first and last months' rent before they move in. Rita, on the other hand, owns an apartment complex and requires tenants to pay the first month's rent and a refundable deposit (which equals one month's rent). Although the full amount received by Phil is taxable when it is received, only one-half of the amount received by Rita is taxable when it is received. Rita is required to refund the deposit, assuming the tenant vacates leaving the property in good condition and having paid all rent. Therefore, the deposit is not taxable. ◀

Taxpayers receiving advance payments in connection with services may be able to meet the requirements of Rev. Proc. 2004-34 (discussed earlier in the chapter); taxpayers receiving advance payments associated with the sale of merchandise may be able to meet the requirements of Reg. Sec. 1.451-5 (also discussed in this chapter). Also, special rules exist for subscription income, membership fees, crop insurance proceeds, and drought sales of livestock, all of which allow taxpayers to defer recognizing income.

TAXABLE, TAX-EXEMPT, OR TAX-DEFERRED BONDS

Which should a taxpayer choose: taxable bonds, tax-exempt bonds, or tax-deferred bonds? The answer depends on the relative interest rates and the taxpayer's current and future tax brackets. **Taxable bonds** yield the highest return, but the interest is taxable. **Tax-exempt bonds** yield a lower return. **Tax-deferred bonds** generally yield a return somewhere close to that of taxable bonds. Interest on U.S. Series EE savings bonds is tax exempt if it is used for educational purposes and if other requirements of Sec. 135 are met (see the discussion earlier in this chapter). If these conditions are not met, the tax is deferred until the bonds are redeemed. The taxpayer may be in a lower bracket when the tax is eventually paid, and in the meantime, the interest that will eventually go to pay taxes is earning additional income.

The decision between taxable and exempt bonds is a rather easy one if the risk of the investments is assumed to be approximately equal. A taxpayer should invest in exempt bonds instead of taxable bonds if the interest on the exempt bonds is greater than the interest on the taxable bonds multiplied by 1 minus the taxpayer's marginal tax bracket (expressed as a decimal). Stated in a formula, this means invest in tax-exempt bonds if

$$\text{Return on the tax-exempt bonds} > \text{Return on the taxable bonds} \times (1 - \text{Marginal tax bracket})$$

EXAMPLE I:3-42 ▶ Robert's marginal tax bracket is 37% and he is trying to decide between tax-exempt bonds, which pay 6% interest, and taxable bonds paying 8% interest. Robert should invest in the exempt bonds because 6% is greater than 5.04% [0.08 × (1 – 0.37)]. ◀

Comparison of taxable bonds or exempt bonds to tax-deferred bonds is more complicated. As noted, the advantages of the tax-deferred bonds are twofold. First, the taxpayer may be in a lower tax bracket when the tax is paid (e.g., taxpayers who plan to redeem the bonds after retirement). Second, the amount that will eventually go to pay the tax earns income until the tax must be paid. Although the computation is not covered here, it is noted that taxpayers who anticipate that they will be in lower tax brackets and who plan to leave funds invested for several years may benefit from choosing Series EE U.S. savings bonds over taxable bonds. See Chapter I:18 in the *Individuals* text for a further discussion of taxable, tax-exempt, and tax-deferred investments.

REPORTING SAVINGS BOND INTEREST

It may be desirable to purchase Series EE bonds in the child's name despite the fact that such interest is subject to the kiddie tax (see Chapter I:2). This is because there is no income tax as long as the child's annual income is less than $1,100. However, even if a child is not otherwise required to file a return, it is necessary to report interest on Series EE bonds annually by filing a tax return.[72] Taxpayers who have not been reporting savings bond interest annually may change to annual reporting, but are required to report both current and previously accrued interest in the year of the change.[73]

Taxpayers who report savings bond interest annually are allowed to change to the deferral method without IRS approval.[74] This is particularly useful where the decision to report interest currently was made before the imposition of the kiddie tax. Taxpayers who make this election are bound by it for five years.

[72] *Philip Apkin*, 86 T.C. 692 (1986).
[73] Reg. Sec. 1.454-1(a)(4), Ex. (1).
[74] Rev. Proc. 97-37, 1997-2 C.B. 455.

DEFERRED COMPENSATION ARRANGEMENTS

Deferred compensation plans can be used as a means of avoiding the constructive receipt of income. Although income is normally taxable when the funds become available to the taxpayer, an advance contractual agreement can produce different results. Corporate executives, professional athletes, and others often sign agreements providing for compensation to be paid at future dates. Such agreements can produce tax savings because the recipients expect to be in a lower tax bracket. Because the arrangements are advance contractual agreements, the deferral of income does not constitute taxpayers "turning their backs" on the income.

EXAMPLE I:3-43 ▶ Alonzo, a 35-year-old professional basketball player, signs a contract specifying that he will be paid $400,000 per year for ten years even if he does not play. Because of his age, both Alonzo and the team recognize that he will probably play for one or two more years. If the agreement had specified that he was to receive a salary of $1,300,000 per year for two years, most of the income would have been taxed at the highest rates. By spreading the amount over a longer period, Alonzo pays tax at lower rates on much of the income. Alonzo is compensated for the delayed payment by receiving a larger total amount [i.e., $4 million ($400,000 × 10 years) versus $2.6 million ($1.3 million × 2 years)]. ◀

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 6

Describe compliance and procedural considerations for gross income

Congress promised taxpayers that the 2017 Tax Cuts and Jobs Act would produce a shorter and simpler Form 1040. The revised Form 1040 is shorter. The new form is one-half the length of the old form (one-half page front and back, down from two full pages). For some, compliance is simpler because the larger standard deduction means fewer taxpayers need to itemize.

Taxpayers with only the most common types of income (wages, interest, dividends, retirement income, and social security benefits) report their income directly on the shortened Form 1040. Taxpayers with other types of income, however, must complete a new Schedule 1, Additional Income and Adjustments to Income. These taxpayers transfer the total from Schedule 1 to page 2 of Form 1040. Schedule 1 is also where adjustments to income such as IRA contributions and a self-employed person's health insurance premiums are deducted. Previously, these deductions were taken on Form 1040.

As before, a few types of income are first reported on special schedules where related deductions are taken. For example, business income and related business expenses are reported on Schedule C. The resulting net business income or loss is transferred to Schedule 1 and then to Form 1040.

Topic Review I:3-3 summarizes the procedures for reporting income and related deductions. This reporting process is illustrated in Example I:3-44.

EXAMPLE I:3-44 ▶ John J. Alexander has several items of income and related deductions for 2018:

Salary	$130,000
Taxable interest income	300
Exempt interest income	200
Dividends: Ford Motor Co.	1,150
Omaha Mutual Fund	430
Capital gain distribution: Omaha Mutual Fund	50
Rental income (depreciation, interest, repairs, and other related expenses total $9,000)	11,000
Deductible alimony payments	6,000
IRA contribution	3,000
Qualified business income deduction	400
Standard deduction	12,000
Federal income withheld from wages	20,000

John's tax computation can be summarized as follows:

Total income:	
Salary	$130,000
Taxable interest	300
Dividends	1,580
Capital gain	50
Rent (net)	2,000
Total income	$133,930
Deductions for adjusted gross income:	
Alimony	(6,000)
IRA contribution	(3,000)
Adjusted gross income	$124,930
Deductions from adjusted gross income:	
Standard deduction	(12,000)
Qualified business deduction	(400)
Taxable income	$112,530
Total tax:	
Tax on dividends and capital gains (0.15 × $1,630)	$245
Tax on remaining income of $110,900, computed using Tax Rate Schedule for Single Taxpayers	20,906
Total tax	$ 21,151

Figures I:3-1 through I:3-4 illustrate how John would report these items of income and deductions on 2018 forms. John's salary is entered directly on page 2, Form 1040 along with his interest (because the interest is less than $1,500). His dividend income, however, is first entered on Schedule B and then the total is transferred to page 2 of Form 1040 because the amount exceeds $1,500. John's capital gain distribution is entered on Schedule 1. The rental income is reported first on Schedule E (not illustrated) and then the net amount is transferred to Schedule 1. John's total income from taxable sources is $133,930. Alimony and the IRA contribution are deducted on Schedule 1 resulting in an adjusted gross income of $124,930. After subtracting the qualified business deduction and the standard deduction, John is left with taxable income of $112,530. His tax totals $21,151, consisting of a $245 tax on dividends and capital gains (0.15 × ($1,580 + $50)] and a $20,906 tax on his remaining income ($110,900), which is computed using the Tax Rate Schedule for Single Taxpayers. ◀

KEY POINT

The amount labeled "total income" on line 6 of Form 1040 is not gross income, adjusted gross income, or taxable income.

TOPIC REVIEW I:3-3

Reporting of Income

Type of Income	Reported On	Related Deductions
Wages, salaries, tips, etc.	Form 1040	Not deductible
Interest	Form 1040 (if less than $1,500), otherwise Schedule B	Schedule A (investment interest expense, for example)
Dividends	Form 1040 (if less than $1,500), otherwise Schedule B	Schedule A (investment interest expense, for example)
Retirement income (IRA distributions, pensions, etc.)	Form 1040	Not deductible
Social security benefits	Form 1040 (instructions contain a worksheet)	Not deductible
Refunds of state and local income taxes	Schedule 1	State and local taxes are deducted on Schedule A
Alimony	Schedule 1 (if covered by prior law, otherwise not taxable)	Not deductible

TOPIC REVIEW I:3-3 (Continued)

Reporting of Income

Type of Income	Reported On	Related Deductions
Business income or (loss)	Schedule C (net amount is transferred to Schedule 1)	Schedule C
Capital gain distributions	Schedule 1	Schedule A (investment interest, for example)
Other capital gains or (losses)	Schedule D (net amount is transferred to Schedule 1)	Schedule A (investment interest, for example)
Supplemental gain or (loss)	Form 4797 (net amount is transferred to Schedule 1)	Form 4797 (ordinary loss)
Rents, royalties, partnerships, S corporations, estates, trusts	Schedule E (net amount is transferred to Schedule 1)	Schedule E
Farm income or (loss)	Schedule F (net amount is transferred to Schedule 1)	Schedule F
Unemployment compensation	Schedule 1	Not deductible

Form **1040** Department of the Treasury—Internal Revenue Service (99) **U.S. Individual Income Tax Return** | **2018** | OMB No. 1545-0074 | IRS Use Only—Do not write or staple in this space.

Filing status: ☑ Single ☐ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Your first name and initial	Last name	Your social security number
John J.	Alexander	123 | 45 | 6789

Your standard deduction: ☐ Someone can claim you as a dependent ☐ You were born before January 2, 1954 ☐ You are blind

If joint return, spouse's first name and initial	Last name	Spouse's social security number

Spouse standard deduction: ☐ Someone can claim your spouse as a dependent ☐ Spouse was born before January 2, 1954 ☐ Spouse is blind ☐ Spouse itemizes on a separate return or you were dual-status alien

☑ Full-year health care coverage or exempt (see inst.)

Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	Presidential Election Campaign (see inst.) ☐ You ☐ Spouse
14 Oak Street		

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6.
Orlando, FL 32816

If more than four dependents, see inst. and ✓ here ▶ ☐

Dependents (see instructions): (1) First name Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see inst.): Child tax credit	Credit for other dependents
			☐	☐
			☐	☐
			☐	☐
			☐	☐

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
	4-15-19	Statistician	
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Preparer's name	Preparer's signature	PTIN	Firm's EIN	Check if:
				☐ 3rd Party Designee
Firm's name ▶		Phone no.		☐ Self-employed
Firm's address ▶				

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2018)

FIGURE I:3-1 ▶ FORM 1040 (Page 1)

Form 1040 (2018) Page **2**

Attach Form(s) W-2. Also attach Form(s) W-2G and 1099-R if tax was withheld.	1	Wages, salaries, tips, etc. Attach Form(s) W-2				1	130,000	
	2a	Tax-exempt interest	2a		b Taxable interest	2b	300	
	3a	Qualified dividends	3a		b Ordinary dividends	3b	1,580	
	4a	IRAs, pensions, and annuities	4a		b Taxable amount	4b		
	5a	Social security benefits	5a		b Taxable amount	5b		
	6	Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22				6	133,930	
	7	Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 36, from line 6				7	124,930	
Standard Deduction for— • Single or married filing separately, $12,000 • Married filing jointly or Qualifying widow(er), $24,000 • Head of household, $18,000 • If you checked any box under Standard deduction, see instructions.	8	**Standard deduction or itemized deductions** (from Schedule A)				8	12,000	
	9	Qualified business income deduction (see instructions)				9	400	
	10	Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-				10	112,530	
	11	a Tax (see inst.) _____ (check if any from: 1 ☐ Form(s) 8814 2 ☐ Form 4972 3 ☐ _____)						
		b Add any amount from Schedule 2 and check here ▶ ☐				11	21,151	
	12	a Child tax credit/credit for other dependents _____ **b Add** any amount from Schedule 3 and check here ▶ ☐				12		
	13	Subtract line 12 from line 11. If zero or less, enter -0-				13		
	14	Other taxes. Attach Schedule 4				14		
	15	Total tax. Add lines 13 and 14				15		
	16	Federal income tax withheld from Forms W-2 and 1099				16	20,000	
	17	Refundable credits: a EIC (see inst.) _____ b Sch. 8812 _____ c Form 8863 _____						
		Add any amount from Schedule 5 _____				17		
	18	Add lines 16 and 17. These are your total payments				18	20,000	
Refund	19	If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you **overpaid**				19		
	20a	Amount of line 19 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐				20a		
Direct deposit? See instructions.	▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings						
	▶ d	Account number						
	21	Amount of line 19 you want **applied to your 2019 estimated tax** ▶	21					
Amount You Owe	22	**Amount you owe.** Subtract line 18 from line 15. For details on how to pay, see instructions ▶				22	1,151	
	23	Estimated tax penalty (see instructions) ▶	23					

Go to *www.irs.gov/Form1040* for instructions and the latest information. Form **1040** (2018)

FIGURE I:3-2 ▶ Form 1040 (page 2)

SCHEDULE 1 (Form 1040)

Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

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

OMB No. 1545-0074

2018

Attachment Sequence No. **01**

Name(s) shown on Form 1040: John J. Alexander

Your social security number: 123-45-6789

Additional Income	1–9b	Reserved		1–9b	
	10	Taxable refunds, credits, or offsets of state and local income taxes		10	
	11	Alimony received		11	
	12	Business income or (loss). Attach Schedule C or C-EZ		12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	50
	14	Other gains or (losses). Attach Form 4797		14	
	15a	Reserved		15b	
	16a	Reserved		16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	2,000
	18	Farm income or (loss). Attach Schedule F		18	
	19	Unemployment compensation		19	
	20a	Reserved		20b	
	21	Other income. List type and amount ▶		21	
	22	Combine the amounts in the far right column. If you don't have any adjustments to income, enter here and include on Form 1040, line 6. Otherwise, go to line 23		22	2,050
Adjustments to Income	23	Educator expenses	23		
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	24		
	25	Health savings account deduction. Attach Form 8889	25		
	26	Moving expenses for members of the Armed Forces. Attach Form 3903	26		
	27	Deductible part of self-employment tax. Attach Schedule SE	27		
	28	Self-employed SEP, SIMPLE, and qualified plans	28		
	29	Self-employed health insurance deduction	29		
	30	Penalty on early withdrawal of savings	30		
	31a	Alimony paid **b** Recipient's SSN ▶ 987 65 4321	31a	6,000	
	32	IRA deduction	32	3,000	
	33	Student loan interest deduction	33		
	34	Reserved	34		
	35	Reserved	35		
	36	Add lines 23 through 35		36	9,000

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2018**

FIGURE I:3-3 ▶ Schedule 1 Additional Income and Adjustments to Income

SCHEDULE 1 (Form 1040)

Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

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

OMB No. 1545-0074

2018

Attachment Sequence No. **01**

Name(s) shown on Form 1040: John J. Alexander

Your social security number: 123-45-6789

Additional Income	1–9b	Reserved			1–9b	
	10	Taxable refunds, credits, or offsets of state and local income taxes			10	
	11	Alimony received			11	
	12	Business income or (loss). Attach Schedule C or C-EZ			12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			13	50
	14	Other gains or (losses). Attach Form 4797			14	
	15a	Reserved			15b	
	16a	Reserved			16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17	2,000
	18	Farm income or (loss). Attach Schedule F			18	
	19	Unemployment compensation			19	
	20a	Reserved			20b	
	21	Other income. List type and amount ▶			21	
	22	Combine the amounts in the far right column. If you don't have any adjustments to income, enter here and include on Form 1040, line 6. Otherwise, go to line 23			22	2,050
Adjustments to Income	23	Educator expenses	23			
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	24			
	25	Health savings account deduction. Attach Form 8889	25			
	26	Moving expenses for members of the Armed Forces. Attach Form 3903	26			
	27	Deductible part of self-employment tax. Attach Schedule SE	27			
	28	Self-employed SEP, SIMPLE, and qualified plans	28			
	29	Self-employed health insurance deduction	29			
	30	Penalty on early withdrawal	30			
	31a	Alimony paid **b** Recipient's SSN ▶ 987 65 4321	31a	6,000		
	32	IRA deduction	32	3,000		
	33	Student loan interest deduction	33			
	34	Reserved	34			
	35	Reserved	35			
	36	Add lines 23 through 35			36	9,000

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For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F Schedule 1 (Form 1040) 2018

FIGURE I:3-3 ▶ Schedule 1 Additional Income and Adjustments to Income

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:3-1 What phrase is found in both the Sixteenth Amendment to the Constitution and Sec. 61(a)? Why does the phrase appear in both locations?

I:3-2 Contrast the accounting and economic concepts of income.

I:3-3 Why does the tax concept of income more closely resemble the accounting concept of income than the economic concept?

I:3-4 Explain the meaning of the term *wherewithal to pay* as it applies to taxation.

I:3-5 If a loan is repaid, the lender does not have to include the principal portion of the payment in gross income. There is no exclusion in the tax law that permits taxpayers to omit such amounts from gross income. How can this be explained?

I:3-6 A landlord who receives prepaid rent is required to report that amount as gross income when the payment is received. Why would Congress choose to do this? What problem does this create for the taxpayer?

I:3-7 Office space is often rented without carpet, wall covering, or window covering. Furthermore, many rental agreements specify that these improvements cannot be removed by a tenant if removal causes any damage to the property. What issue does this raise?

I:3-8 Does the fact that an item of income is paid in a form other than cash mean it is nontaxable? Explain.

I:3-9 Explain the significance of *Lucas v. Earl* and *Helvering v. Horst*.

I:3-10 Under present-day tax law, community property rules are followed in allocating income between husband and wife. Is this consistent with *Lucas v. Earl*? Explain.

I:3-11 Ricardo owns a small unincorporated business. His 15-year-old daughter Jane works in the business on a part-time basis and was paid wages of $3,000 during the current year. Who is taxed on the child's earnings: Jane or her father? Explain.

I:3-12 **a.** Define the term *constructive receipt*. Explain its importance.
b. Explain three restrictions on the concept of constructive receipt.

I:3-13 What recent change was made to the tax treatment of dividends received by U. S. corporations from foreign subsidiaries?

I:3-14 When is income considered to be earned by an accrual-basis taxpayer?

I:3-15 **a.** Explain the difference between the treatment of prepaid income under the tax law and under financial accounting.
b. Why are the two treatments so different?
c. What problem does this treatment create for taxpayers?

I:3-16 Under what conditions is an accrual-basis taxpayer allowed to defer reporting amounts received in the advance of the delivery of goods?

I:3-17 Under what conditions is an accrual-basis taxpayer allowed to defer reporting advance payments received for services?

I:3-18 **a.** Is the interest received from government obligations taxable? Explain.
b. What impact does the fact that some bond interest is tax exempt have on interest rates?
c. Is an investor always better off buying tax-exempt bonds? Explain.

I:3-19 Corporations are taxed on the income they earn, and shareholders are taxed on the dividends they receive. What provisions in the tax law reduce this "double tax" burden?

I:3-20 Explain the relationship between dividends and earnings and profits.

I:3-21 On what basis did the Supreme Court in *Eisner v. Macomber* decide that stock dividends are nontaxable?

I:3-22 What is the significance of a constructive dividend?

I:3-23 What recent change has been made to the tax treatment of alimony?

I:3-24 **a.** Are items of income not listed in Sec. 61 taxable? Explain.
b. Because there is no specific exclusion for unrealized income, why is it not taxable?
c. Can income be realized even when a cash-method taxpayer does not receive cash?
d. Does a cash basis taxpayer realize income upon the receipt of a note?

I:3-25 **a.** Briefly explain the tax benefit rule.
b. Is a taxpayer required to report the reimbursement of a medical expense by insurance as income if the reimbursement is received in the year following the year of the expenditure?

I:3-26 What opportunities are available for a taxpayer to defer the recognition of certain types of prepaid income? That is, what advice could you give someone who wishes to defer the reporting of prepaid income?

I:3-27 Taxpayers who deduct an expense one year but recover it the next year are required to include the recovered amount in gross income. The tax benefit rule provides relief if the original deduction did not result in any tax savings. Does this rule provide relief to taxpayers who are in a higher tax bracket in the year they recover the previously deducted expense?

I:3-28 George, a wealthy investor, is uncertain whether he should invest in taxable or tax-exempt bonds. What tax and nontax factors should he consider?

I:3-29 Do you agree or disagree with the following statement: A taxpayer should not have to report income when debt is forgiven because the taxpayer receives nothing. Explain.

I:3-30 Jack and June are retired and receive $10,000 of social security benefits and taxable pensions totaling $25,000. They have been offered $20,000 for an automobile that they restored after they retired. They did most of the restoration work themselves and the sale will result in a gain of $12,000. What tax issues should Jack and June consider?

ISSUE IDENTIFICATION QUESTIONS

I:3-31 State Construction Company is owned equally by Andy, Bill, and Charlie. Andy works in the corporation full-time, and Bill and Charlie work elsewhere. Andy's employment contract with State specifies a $50,000 annual salary. This year, Andy felt that the company could expand if it purchased more equipment, and he offered to delay receiving $20,000 of his salary so the funds could be used to purchase the equipment. Bill and Charlie agreed, and State purchased the equipment. State is expected to have enough cash to pay Andy by early March of next year. What tax issues should Andy consider?

I:3-32 Lisa and her daughter Jane are equal shareholders in Lisa's Flooring, Inc. Lisa founded the corporation and was the sole owner for over twenty years. The company is very successful and Lisa has accumulated a fairly large estate. When Jane turned age 25 last year, Lisa gave her half of the corporation's stock. The gift was properly reported on Lisa's gift tax return. Both Lisa and Jane now work full-time for the corporation. Lisa received a salary of $55,000 per year before Jane started working for the company. After Jane started working, Lisa reduced her salary to $15,000 and started paying Jane a salary of $50,000. Lisa indicates that she still makes most major decisions in the company, but she hopes that Jane will play a more important role as she becomes more familiar with the company. What tax issues should Lisa and the corporation consider?

I:3-33 Larry's Art Gallery sells oil paintings, lithographs, and bronzes to collectors and corporations. Customers often come to Larry looking for special pieces. In order to meet customer needs, Larry often accepts orders and then travels looking for the desired item, which he purchases and delivers to the customer. The pieces are expensive, and Larry requires customers to demonstrate their sincerity by providing deposits. If it turns out that the item costs more than expected, Larry contacts the buyer and asks for additional funds. If the item costs less than expected, Larry refunds the excess amount. Also, Larry sometimes returns amounts he received in advance because he is unable to find what the customer wants. What tax issues should Larry's Art Gallery consider?

PROBLEMS

I:3-34 ***Noncash Compensation.*** For each of the following items, indicate whether the individual taxpayer must include any amount in gross income.

a. Employees of Eastside Bookstore are given their birthdays off with pay.
b. Westside Hardware, Inc., gave each employee 10 shares of Westside stock worth $100 per share in lieu of a cash bonus.
c. Employees of Northside Manufacturing were allowed to take home the company's old computers when the company purchased new ones.

I:3-35 ***Constructive Receipt.*** Which of the following constitutes constructive receipt in the current year ended December 31?

a. A salary check received at 6:00 p.m. on December 31, after all the banks have closed.
b. A rent check received on December 30 by the manager of an apartment complex. The manager normally collects the rent for the owner. The owner was out of town.
c. A paycheck received on December 29 that was not honored by the bank because the employer's account did not have sufficient funds.
d. A check received on December 30. The check was postdated January 2 of the following year by a customer who said he hoped to have the money by then.
e. A check received on January 2. The check had been mailed on December 30.

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I:3-36 ***Cash and Accrual Methods.*** Carmen opens a retail store. Her sales during the first year are $600,000, of which $30,000 has not been collected at year-end. Her purchases are $400,000. She still owes $20,000 to her suppliers, and at year-end she has $50,000 of inventory on hand. She incurred operating expenses of $160,000. At year-end she has not paid $15,000 of the expenses.

a. Compute her net income from the business assuming she elects the accrual method.
b. Compute her net income from the business assuming she elects the cash method.
c. Would paying the $15,000 she owes for operating expenses before year-end change her net income under accrual method of reporting? under the cash method?

I:3-37 ***Series EE Bond Interest.*** In 2015, Harry and Mary purchased Series EE bonds, and in 2019 redeemed the bonds, receiving $500 of interest and $1,500 of principal. Their income from other sources totaled $30,000. They paid $2,200 in tuition and fees for their dependent daughter. Their daughter is a qualified student at State University.

a. How much of the Series EE bond interest is excludable?
b. Assuming that the daughter received a $1,000 scholarship, how much of the interest is excludable? Ignore any tax credits that might be available.
c. Assuming the daughter received the $1,000 scholarship and that the parents' income from other sources is $127,100 how much of the interest is excludable?

I:3-38 ***Alimony.*** As a result of their divorce, Fred agreed to pay alimony to Tammy of $20,000 per year. The payments are to cease in the event of Fred's or Tammy's death or in the event of Tammy's remarriage. In addition, Tammy is to receive their residence, which cost them $100,000 but is worth $140,000.

a. How will the $20,000 payments be treated by Fred and Tammy if covered by prior law?
b. How will the payments be treated if the divorce is covered by new law?
c. What is Tammy's basis in the residence?
d. What role would a tax adviser play in a divorce?

I:3-39 ***Constructive Dividend.*** Brad owns a successful corporation that has substantial earnings and profits. During the year, the following payments were made by the corporation:

a. Salary of $250,000 to Brad. Officers in other corporations performing similar services receive between $50,000 and $85,000.
b. Rent of $25,000 to Brad. The rent is paid in connection with an office building owned by Brad and used by the corporation. Similar buildings rent for about the same amount.
c. Salary of $5,000 to Brad's daughter, who worked for the company full-time during the summer and part-time during the rest of the year while she attended high school.
d. Alimony of $40,000 to Brad's former wife. Although Brad was personally obligated to make the payments, he used corporation funds to make the payments.

Discuss the likelihood of these payments being treated as constructive dividends. If a payment is deemed to be a constructive dividend, indicate how such a payment will be treated.

I:3-40 ***Constructive Dividend.*** Which of the following would likely be a constructive dividend?

a. An unreasonable salary paid to a shareholder.
b. An unreasonable salary paid to the daughter of a shareholder.
c. A sale of a corporation's asset to a shareholder at fair market value.
d. A payment by a corporation of a shareholder's debts.
e. A payment by a corporation of a shareholder's personal expenses.

I:3-41 ***Prepaid Rent.*** Stan rented an office building to Clay for $3,000 per month. On December 29, 2018, Stan received a deposit of $4,000 in addition to the first and last months' rent. Occupancy began on January 2, 2019. On July 15, 2019, Clay closed his business and filed for bankruptcy. Stan had collected rent for February, March, and April on the first of each month. Stan had received May rent on May 10, but collected no payments afterwards. Stan withheld $800 from the deposit because of damage to the property and $1,500 for unpaid rent. He refunded the balance of the deposit to Clay. What amount would Stan report as gross income for 2018? for 2019?

I:3-42 ***Rental Income.*** Ed owns Oak Knoll Apartments. During the year, Fred, a tenant, moved to another state. Fred paid Ed $1,000 to cancel the two-year lease he had signed. Ed subsequently rented the unit to Wayne. Wayne paid the first and last months' rents of $800 each and a security deposit of $500. Ed also owns a building that is used as a health club. The club has signed a fifteen-year lease at an annual rental of $17,000. The owner of the club requested that Ed install a swimming pool on the property. Ed declined to do so. The

owner of the club finally constructed the pool himself at a cost of $15,000. What amount must Ed include in gross income?

I:3-43 ***Gross Income.*** Susan's salary is $44,000 and she received dividends of $600. She received a statement from SJ partnership indicating that her share of the partnership's income was $4,000. The partnership distributed $1,000 to her during the year and $600 after year-end. She won $2,000 in the state lottery and spent $50 on lottery tickets. Which amounts are taxable?

I:3-44 ***Interest Income.*** Holly inherited $10,000 of City of Atlanta bonds in February. In March, she received interest of $500, and in April she sold the bonds at a $200 gain. Holly redeemed Series EE U.S. savings bonds that she had purchased several years ago. The accumulated interest totaled $800. Holly received $300 of interest on bonds issued by the City of Quebec, Canada. What amount, if any, of gross income must Holly report?

I:3-45 ***Annuity Income.*** Tim retired during the current year at age 58. He purchased an annuity from American National Life Company for $40,000. The annuity pays Tim $500 per month for life.

a. Compute Tim's annual exclusion.
b. How much income will Tim report each year after reaching age 84?

I:3-46 ***Pension Income.*** Beth retires when she turns 65. She begins receiving a monthly pension of $300 from her employer's qualified retirement plan. While employed, Beth contributed $13,000 to the plan.

a. Beth uses the simplified method to compute her exclusion. Why?
b. Compute her monthly exclusion.
c. How much gross income does she report in the first year if she receives 12 monthly checks?

I:3-47 ***Social Security Benefits.*** Dan and Diana file a joint return. Dan earned $31,000 during the year before losing his job. Diana received Social Security benefits of $5,000.

a. Determine the taxable portion of the Social Security benefits.
b. What is the taxable portion of the Social Security benefits if Dan earned $46,000?

I:3-48 ***Social Security Benefits.*** Lucia is a 69-year-old single individual who receives a taxable pension of $10,000 per year and Social Security benefits of $7,000. Lucia is considering the possibility of selling stock she has owned for years and using the funds to purchase a summer home. She will realize a gain of $20,000 when she sells the stock, which has been paying $1,000 of dividends each year. Lucia says her brother recommended that she sell half of the stock this year and half next year because selling all of the stock at once would affect the tax treatment of her Social Security benefits.

a. Compute her AGI under the assumption she sells all of the stock now after receiving $1,000 dividends from the stock.
b. Repeat the computation under the assumption she sells only half of the stock this year and also receives $1,000 dividends from the stock.

I:3-49 ***Social Security Benefits.*** Bob is a single individual and received a salary of $27,000 before he retired in October of this year. After he retired, he received Social Security benefits of $3,000 during the year.

a. What amount, if any, of the Social Security benefits are taxable for the year?
b. Would the answer be different if Bob also had $1,000 of tax-exempt interest?
c. What if he had had $10,000 of tax-exempt interest?

I:3-50 ***Adjusted Gross Income.*** Amir, who is single, retired from his job this year. He received a salary of $25,000 for the portion of the year that he worked, tax-exempt interest of $3,000, and dividends from domestic corporations of $2,700. On September 1, he began receiving monthly pension payments of $1,000 and Social Security payments of $600. Assume an exclusion ratio of 40% for the pension. Amir owns a duplex that he rents to others. He received rent of $12,000 and incurred $17,000 of expenses related to the duplex. He continued to actively manage the property after he retired from his job. Compute Amir's adjusted gross income.

I:3-51 ***Court Awards and Insurance Settlements.*** What amount, if any, must be included in gross income by the following taxpayers?

a. Ann received $2,000 from her insurance company when her automobile which cost $3,000 was stolen.

b. Barry received $3,000 from his brother. Barry had initiated a lawsuit against his brother in an effort to recover $3,000 he had previously loaned to him. The brother paid Barry back before the case was tried, and Barry dropped the lawsuit.
c. Carry, an accountant, sued a client in order to collect her fee for doing tax work. Would Carry's accounting method make any difference?
d. Dave has incurred $6,000 of medical expenses so far this year. He paid $400 of the expenses himself. His insurance company paid $4,000 of the expenses. The hospital is suing Dave and the insurance company for the balance, $1,600.

I:3-52 ***Claim of Right.*** USA Corporation hired Jesse to install a computer system for the company and paid him $8,000 for the work. USA soon realized that there were problems with the system and asked Jesse to refund the payment. At the end of the year the dispute had not been resolved. Jesse is in the 24% tax bracket in the year he did the original work. During the next year, when he is in the 12% tax bracket, Jesse refunds the $8,000 to USA.
a. Is the original payment taxable to Jesse when he receives it?
b. What options are available to Jesse when he repays the $8,000?
c. What option would have been available to Jesse if he had been asked to repay only $2,000?

I:3-53 ***Tax Planning.*** Bart and Kesha, who are in the 37% tax bracket, are interested in reducing their taxes. They are currently considering several alternatives. For each, indicate how much tax, if any, they would save.
a. Make a gift of bonds valued at $5,000 that yield $400 per year interest to their 24-year-old daughter, who has no other income.
b. Sell the bonds from Part a rather than give them to their daughter, and buy tax-exempt bonds that pay 6%. Assume the bonds can be sold for an amount equal to their basis of $5,000.
c. Give $1,000 cash to a charity. Assume they itemize deductions and ignore any phase-out of itemized deductions.
d. Pay their daughter a salary of $10,000 for services rendered in their unincorporated business.

I:3-54 ***Series EE Bond Interest and Kiddie Tax.*** Ken and Lynn paid $5,000 to purchase Series EE bonds in the name of their 11-year-old son. The son has no other income, and they are in the 24% tax bracket. The taxable interest this year will be $400 if an election is made to accrue the interest on an annual basis.
a. Will the child owe any tax on the bond interest?
b. Does the son need to file a tax return?
c. What are the current and future tax consequences of annual gifts to their son?

COMPREHENSIVE PROBLEMS

I:3-55 Matt and Sandy reside in a community property state. Matt left home in April 2019 because of disputes with his wife, Sandy. Subsequently, Matt earned $15,000. Before leaving home in April, Matt earned $3,000. Sandy was unaware of Matt's whereabouts or his earnings after he left home. The $3,000 earned by Matt before he left home was spent on food, housing, and other items shared by Matt and Sandy. Matt and Sandy have one child, who lived with Sandy after the husband left home.
a. Is any portion of Matt's earnings after he left home taxable to Sandy?
b. What filing status is applicable to Sandy if she filed a return?
c. How much income would Sandy be required to report if she filed?
d. Is Sandy required to file?

I:3-56 Gary earned $97,000 as an executive. Gary, who is single, supported his half sister, who lives in a nursing home. His half sister had no income during the year. Gary received the following interest: $400 on City of Los Angeles bonds, $200 on a money market account, and $2,100 on a loan made to his brother.

Gary spent one week serving on a jury and received $50.

Gary received a refund of federal income taxes withheld during the prior year of $1,200 and a state income tax refund of $140. Gary had itemized deductions last year of $18,000 which included $1,000 of state income taxes.

Gary received qualified dividends from Ace Corporation of $1,000 and from Tray Corporation of $1,400. Gary's itemized deductions equal $19,000, and withholding for federal income taxes is $14,000. Compute Gary's tax due or refund due.

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:3-57 Kamal owns a restaurant that operates as an S corporation. The business earns $100,000 per year after paying Kamal a salary of $50,000. Kamal and his wife Padma report the income from the restaurant on their joint tax return. Kamal and Padma are in the process of obtaining a divorce. Kamal anticipates that he will pay Padma $30,000 per year following the divorce.

a. How will the $30,000 payments be taxed?

b. Would there be any advantage to giving Padma a 30% stock interest in the corporation in lieu of alimony?

I:3-58 Assume that it is December 31, and that Jake is considering making a $1,000 charitable contribution. Jake currently is in the 37% tax bracket, but expects that his tax bracket will be 24% next year. How much more will the deduction for the contribution be worth if it is made today compared to next year?

TAX FORM/RETURN PREPARATION PROBLEM

I:3-59 Sally W. Emanual, a teacher, had the following dividends and interest during the current year:

Acorn Corporation bond interest		$ 700
City of Boston bonds interest		1,000
Camp Bank interest		1,250
Jet Corporation dividend (qualified)		1,300
North Mutual fund		
Capital gain distribution	100	
Ordinary dividend (qualified)	150	
Nontaxable distribution	200	450
Blue Corporation foreign dividend		250

Additional information pertaining to Sally Emanual includes

Salary	$70,000
Rent income	12,000
Expenses related to rent income	14,000
Pension benefits	7,000
Taxable alimony paid to Sally	4,000

The taxable portion of the pension is $7,000. Sally actively participates in the rental activity. Other relevant information includes

Address: 430 Rumsey Place, West Falls, California 92699
Occupation: Credit manager
Social Security number: 123-45-6789
Marital status: Single

Complete Sally's Schedule 1, Schedule B and compute her taxable income on Form 1040. Assume Schedule E has already been prepared.

I:3-60 ***Short Tax Form.*** Anne Banks is a single, 60-year old retired teacher who does not itemize. Her only income is reported to her on the Form 1099-R provided by her retirement plan and the Form 1099-DIV provided by her broker. These forms are found in Figures I:3-5 and I:3-6. Complete page 2 of her Form 1040.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and phone no.	1 Gross distribution	OMB No. 1545-0119	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
Teachers Retirement Assn 500 Andrew Blvd. Atlanta, GA 30301	$ 32,000.00	2019	
	2a Taxable amount $ 32,000.00	Form 1099-R	
	2b Taxable amount not determined ☐ Total distribution ☐		Copy C For Recipient's Records

PAYER'S TIN	RECIPIENT'S TIN	3 Capital gain (included in box 2a)	4 Federal income tax withheld
13-1234567	123-45-6789	$	$ 2,500.00

RECIPIENT'S name	5 Employee contributions/ Designated Roth contributions or insurance premiums	6 Net unrealized appreciation in employer's securities
Anne Banks	$	$
Street address (including apt. no.) 306 W. Olive St.	7 Distribution code(s) 7 — IRA/SEP/SIMPLE ☐	8 Other $ %
City or town, state or province, country, and ZIP or foreign postal code East Springs, FL 32701	9a Your percentage of total distribution %	9b Total employee contributions $

10 Amount allocable to IRR within 5 years	11 1st year of desig. Roth contrib.	FATCA filing requirement	12 State tax withheld	13 State/Payer's state no.	14 State distribution
$ 0.00		☐	$		$

Account number (see instructions)	Date of payment	15 Local tax withheld	16 Name of locality	17 Local distribution
C0053312		$		$

This information is being furnished to the IRS.

Form 1099-R (keep for your records) www.irs.gov/Form1099R Department of the Treasury - Internal Revenue Service

FIGURE I:3-5 ▶ Form 1099-R Distributions from Pensions

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	1a Total ordinary dividends	OMB No. 1545-0110	**Dividends and Distributions**
TD Investment Fund P.O. Box 2 Omaha, NE 68102	$ 1,000.00	2019	
	1b Qualified dividends $ 900.00	Form **1099-DIV**	
	2a Total capital gain distr. $	2b Unrecap. Sec. 1250 gain $	**Copy B For Recipient**
PAYER'S TIN: 47-0533312 / RECIPIENT'S TIN: 123-45-6789	2c Section 1202 gain $	2d Collectibles (28%) gain $	
RECIPIENT'S name: Anne Banks	3 Nondividend distributions $	4 Federal income tax withheld $	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.): 306 W. Olive St.	5 Section 199A dividends $	6 Investment expenses $	
City or town, state or province, country, and ZIP or foreign postal code: East Springs, FL 32701	7 Foreign tax paid $	8 Foreign country or U.S. possession	
	9 Cash liquidation distributions $	10 Noncash liquidation distributions $	
FATCA filing requirement ☐	11 Exempt-interest dividends $ 5,000.00	12 Specified private activity bond interest dividends $	
Account number (see instructions): C0057777	13 State / 14 State identification no.	15 State tax withheld $	

Form **1099-DIV** (keep for your records) www.irs.gov/Form1099DIV Department of the Treasury - Internal Revenue Service

FIGURE I:3-6 ▶ Form 1099-DIV Dividends and Distributions

CASE STUDY PROBLEMS

I:3-61 Jim and Linda are your tax clients. They were divorced two years ago, and the divorce decree stated that Jim was to make monthly payments to Linda. The court designated $300 per month as alimony and $200 per month as child support, or a total of $6,000 per year. Jim has been unemployed for much of the year and paid Linda $2,000 that he said was for child support. In addition, Jim transferred the title to a three-year-old automobile with a $4,000 FMV and basis of $7,000 in exchange for her promise not to pursue any claim she has against him for the unpaid child support and alimony. Does Linda have to report any alimony and is Jim entitled to an alimony deduction? Draft a memo for the file that discusses the tax consequences for both Jim and Linda.

I:3-62 John and Mary have two small children and are looking for ways to help fund the children's college education. They have heard that Series EE bonds are a tax-favored way of saving and have requested your opinion on the tax consequences. They have asked your opinion regarding the relative advantages of purchasing Series EE bonds in their names versus the children's names. John and Mary have indicated that they expect to have a high level of income in the future and that their children may receive other income sources from future inheritances. Prepare a client memo making recommendations about the tax consequences of Series EE bond investments for John and Mary.



I:3-63 Lee and Jane have been your firm's clients for most of the twenty years they have been married. Recently Lee came to you and said that he and Jane are obtaining a divorce, and he wants you to help him with some of the tax and financial issues that may come up during the divorce. The next day, Jane called asking you for the same assistance. What ethical issues do you see in this case? What possible conflicts may arise if you represent both Lee and Jane?

TAX RESEARCH PROBLEM

I:3-64 William owns a building that is leased to Lester's Machine Shop. Lester requests that William rewire the building for new equipment Lester plans to purchase. The wiring would cost about $4,000, but would not increase the value of the building because its only use is in connection with the specialized equipment. Rather than lose Lester as a lessee, William agrees to forgo one month's rent of $1,000 if Lester will pay for the wiring. Because Lester does not want to move, he agrees. What amount, if any, must William include in gross income?

A partial list of research sources is

- Sec. 109
- Reg. Sec. 1.109-1
- *CIR v. Grace H. Cunningham*, 2 AFTR 2d 5511, 58-2 USTC ¶9771 (9th Cir., 1958)

CHAPTER

4

GROSS INCOME: EXCLUSIONS



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Determine whether an item is income
2. Determine which major statutory exclusions are available to a taxpayer
3. Describe tax planning considerations for exclusions of gross income
4. Describe compliance and procedural considerations for exclusions of gross income

CHAPTER OUTLINE

Items That Are Not Income...4-2
Major Statutory Exclusions...4-4
Tax Planning Considerations...4-23
Compliance and Procedural Considerations...4-24

Chapter I:3 discussed items that must be included in gross income. This chapter considers items excluded from gross income. Under Sec. 61(a), all items of income are taxable unless specifically excluded. Taxpayers who wish to avoid being taxed have two basic alternatives. One approach is to establish that the item is not income. If an item is not income (e.g., if it is a return of capital), it is not subject to the income tax. The second approach is to establish that a specific exclusion applies to the item of income.

EXAMPLE I:4-1 ▶ Matt borrowed $10,000 from the bank. Although Matt received $10,000, it is not income because he is obligated to repay the amount borrowed. No specific statutory authority states that borrowed funds are excluded from taxation. Presumably, the fact that borrowed funds are not income is considered to be both fundamental and obvious. ◀

KEY POINT

Given the sweeping definition of *income*, it is generally difficult to establish that an item is not income.

EXAMPLE I:4-2 ▶ Sheila enrolled in State University. The university awarded her a $1,000 tuition scholarship because of her high admission test scores and grades. Because Sec. 117 excludes such scholarships from gross income, Sheila need not report the $1,000 as gross income. ◀

The major source of exclusions are those specific items contained in the IRC. These exclusions have evolved over the years and were enacted by Congress for a variety of reasons, including social and economic objectives.

Another source of exclusions are referred to as *administrative exclusions*. Exclusions exist because specific provisions in the Internal Revenue Code allow them. While the IRS has no authority to create exclusions, the IRS does have the authority to interpret the meaning of the Code. A liberal interpretation of the statute by the IRS may result in a broad definition of what constitutes an exclusion, and such a broad definition may reasonably be termed an administrative exclusion. For example, Sec. 102 excludes gifts received from gross income. The IRS has followed the practice of excluding certain welfare benefits from gross income, presumably because such benefits may be viewed as gifts.[1] The IRS could take the position that welfare benefits are not gifts. That position would no doubt be challenged in the courts.

REAL-WORLD EXAMPLE

Grants made to Native Americans by the federal government under the Indian Financing Act of 1974 to expand Native American–owned economic enterprises are excludable from gross income. Rev. Rul. 77-77, 1977-1 C.B. 11.

The term *judicial exclusions* should be considered in the same vein. Although the courts cannot create exclusions, they can interpret the statute and decide whether a particular item is covered by a statutory exclusion.

ITEMS THAT ARE NOT INCOME

OBJECTIVE 1

Determine whether an item is income

As noted above, some items are not income and, therefore, are not subject to the income tax. In addition to amounts obtained by a loan (discussed above), four other items are not considered income:

- Unrealized income
- Self-help income
- Rental value of personal-use property
- Gross selling price of property (as opposed to the profit or gain earned on the sale)

TYPICAL MISCONCEPTION

It is sometimes erroneously assumed that severance pay, embezzlement proceeds, gambling winnings, hobby income, prizes, rewards, and tips are not taxable.

UNREALIZED INCOME

Unrealized income is not taxed. Thus, owners of appreciated property are not taxed on their unrealized gains.

This issue of the taxability of unrealized income was addressed almost 100 years ago in *Eisner v. Macomber*, where the Supreme Court held that a stock dividend cannot be

[1] For example, see Rev. Rul. 57-102, 1957-1 C.B. 26, which excludes from gross income public assistance payments to blind persons.

taxed because the taxpayer had "received nothing that answers the definition of income within the meaning of the Sixteenth Amendment."[2] An ordinary stock dividend does not alter the existing proportionate ownership interest of any stockholder, nor does it increase the value of the individual's holdings. In effect, the Court concluded that realization must occur before income is recognized. Although narrowed by subsequent legislation and litigation, ordinary stock dividends continue to be excluded from gross income even today. Perhaps more important, *Eisner v. Macomber* established realization as a criterion for the recognition of income.

SELF-HELP INCOME

TYPICAL MISCONCEPTION

When a taxpayer purchases an older house and remodels the kitchen or makes other improvements, there is a tendency to assume correctly that the taxpayer has no income from this activity, but it is often incorrectly assumed that the basis of the house can be increased by the value of the taxpayer's labor.

Although self-help income is considered as income by economists, it is not recognized as income by the IRS or by the courts. Taxpayers commonly benefit from activities such as painting their own homes or repairing their own automobiles. If a taxpayer hires someone else to do the work, the taxpayer has to earn income, pay tax on the income, and use the after-tax income to pay for the work. In either case, the taxpayer receives the same economic benefit, but the economic benefit derived from self-help is not included in the taxpayer's gross income.

This situation should be contrasted with taxable exchanges of services. A mechanic might agree to repair a painter's automobile in exchange for the painter's promise to paint the mechanic's home. In this instance, when the parties exchange services, each party realizes income equal to the value of the services received.

STOP & THINK

Question: The discussion referred to an exchange of services between two individuals, such as a painter and a mechanic. How can a taxable barter transaction be distinguished from an act of friendship which is repaid?

Solution: When one person helps another without any promise of repayment, the act of kindness does not represent an exchange and is not taxable. Friends help one another from time to time without contractual reciprocity. Such acts are not taxable. The distinction between a taxable barter exchange and acts of friendship is not always easy to make.

RENTAL VALUE OF PERSONAL-USE PROPERTY

ADDITIONAL COMMENT

The tax situation of a homeowner is quite different than that of someone who lives in an apartment. The failure to include the rental value of the home as income in addition to the deduction of mortgage interest and property taxes favors homeowners.

Taxpayers are not taxed on the rental value of personally owned property. For example, taxpayers who own their own home receive the economic benefit of occupancy without being taxed on the rental value of the property. It would be very difficult to keep records and value benefits obtained from self-help and the personal use of property. For that reason, no significant effort has ever been made to tax such benefits.[3]

SELLING PRICE OF PROPERTY

If property is sold at a gain, the gain and not the entire sales price is taxable. Because the basic principle is almost universally accepted, the Supreme Court has never had to rule directly on whether the entire sale proceeds could be taxed. The IRS and the courts seemed to accept the basic principle even before the rule became part of the statute.[4] The primary reason for this principle (often referred to as the "recovery of capital" principle) is that a portion of the selling price represents a return of capital to the seller.

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[2] 3 AFTR 3020, 1 USTC ¶32 (USSC, 1920).

[3] In 1928, the government tried unsuccessfully to tax the value of produce grown and consumed by a farmer (*Homer P. Morris,* 9 B.T.A. 1273 (1928)). The court stated, "To include the value of such products [would be to] in effect include in income something which Congress did not intend should be so regarded." The court did not explain how or why it reached this conclusion. In 1957, the IRS successfully disallowed the deduction of expenses incurred in raising such produce (*Robert L. Nowland v. CIR,* 51 AFTR 423, 57-1 USTC ¶9684 (4th Cir., 1957)).

[4] Section 202(a) of the Revenue Act of 1924 is the predecessor of current Sec. 1001(a), which states that only the gain portion of the sale proceeds is included in gross income. S. Rept. No. 398, 68th Cong., 1st Sess., p. 10 (1924) states that Sec. 202(a) sets forth general rules to be used in the computation of gain or loss. The Senate report further states that the provision "merely embodies in the law the present construction by the Department and the courts of the existing law."

MAJOR STATUTORY EXCLUSIONS

OBJECTIVE 2

Determine which major statutory exclusions are available to a taxpayer

While Congress has created statutory exclusions for a variety of reasons, most exclusions have been enacted for reasons of social policy or reasons of incentive. The concept of social policy, that is, a concept of social generosity or benevolence, has prompted the government to exclude items such as:

- Gifts and inheritances (Sec. 102)
- Life insurance proceeds (Sec. 101)
- Public assistance payments
- Qualified adoption expenses (Sec. 137)
- Payments for personal physical sickness and injury (Sec. 104)
- Discharge of indebtedness during bankruptcy or insolvency (Sec. 108)
- Gain on sale of personal residence (Sec. 121)
- Partial exclusions for Social Security benefits (Sec. 86)

ADDITIONAL COMMENT

Tax expenditure estimates measure the decreases in individual and corporate income tax liabilities that result from provisions in income tax laws and regulations that provide economic incentives or tax relief to particular kinds of taxpayers.

Other exclusions may be explained in terms of economic incentive, that is, the government's desire to encourage or reward a particular type of behavior.

- Awards for meritorious achievement (Sec. 74(b))
- Various employee fringe benefits (Secs. 79, 105, 106, 124, 125, 129, 132)
- Partial exclusion for scholarships (Sec. 117)
- Foreign-earned income (Sec. 911)
- Interest on state and local government obligations (Sec. 103)

Other reasons may exist for some of the exclusions listed above. For example, one reason income from the discharge of indebtedness during bankruptcy is excluded from gross income is the fact that such taxpayers would be unlikely to have the resources needed to pay the tax. (See Chapter I:3 for a discussion of tax-exempt interest and Social Security benefits, and Chapter I:12 for the treatment of gain on the sale of a personal residence.)

GIFTS AND INHERITANCES

TYPICAL MISCONCEPTION

Some people still believe that gifts above the gift exclusion amount of $15,000 are taxable to the donees. They are not since the Code specifically exempts all gifts, regardless of the amount. The donor may, however, depending on the circumstances, pay a gift tax.

Congress has excluded the value of gifts and inheritances received from gross income since the inception of the income tax in 1913. Section 102 excludes the value of property received during the life of the donor (***inter vivos* gifts**) and transfers at death (testamentary transfers—bequests, devises, and inheritances).[5] The recipient of such property is taxed on the income produced by the property after the transfer.[6] It should be noted that a donor, under the assignment of income doctrine, cannot avoid the income tax by making a gift of income. To avoid paying tax on income, a donor must make a gift of the underlying property.

EXAMPLE I:4-3 ▶ Stan owns stock in a corporation and orders the corporation to pay dividends on the stock to his daughter. Even though his daughter receives the dividends, Stan must include the dividends in his gross income. Stan could avoid being taxed on future dividends by giving the stock to his daughter. ◀

[5] Although excluded from gross income, such transfers may be subject to the gift tax or the estate tax which are imposed on the transferor. These separate taxes are, in part, the result of a debate over the question of whether gifts and inheritances actually are income. The answer is quite different if one defines the basic economic unit to be the family rather than the individual. Gifts (and inheritances) within a family merely move existing wealth from one person to another without changing the family's wealth. Nevertheless, the recipient of a gift does individually benefit.

[6] Reg. Sec. 1.102-1(b).

It is often difficult to distinguish gifts, which are not included in the recipient's gross income, from other transfers, which are taxable. Gifts sometimes closely resemble prizes and awards.[7]

EXAMPLE I:4-4 ▶ Tina received a free automobile for being the ten millionth paying guest at an amusement park. The automobile is not considered a gift but a prize and is taxable to Tina. ◀

Also, some payments made to employees by employers may resemble gifts.

EXAMPLE I:4-5 ▶ At Christmas, Red Corporation paid $500 cash to each employee who had been with the company for more than five years. These payments are not considered gifts for tax purposes and are taxable to the employees. ◀

REAL-WORLD EXAMPLE

Amounts received by a dealer from players in the operation of a gambling casino were not excludable as gifts even though impulsive generosity or superstition may be the dominant motive. The amounts were similar to tips, which are taxable. *Louis R. Tomburello,* 86 T.C. 540 (1986).

Whether a transfer is a gift depends on the intent of the donor. Gifts are motivated by love, affection, kindness, sympathy, generosity, admiration, or similar emotions. In the two preceding examples, the transfers were made for business motives and not necessarily for donative reasons. Thus, the automobile is a taxable prize, and the amounts paid to employees represent taxable awards for services rendered, but see the discussion of Sec. 274 later in this chapter.

Transfers of money or property between family members frequently create classification problems. For example, assume a father, who owns a business, hires his 10-year-old son to work in the business. Is the payment to the son a salary (and, therefore, deductible by the business) or is it really just a gift from the father to the son? The answer depends on the fair market value of the services performed by the son. If the son actually performs services that are commensurate with the salary paid, the payment may properly be classified as a salary. On the other hand, if the son is paid an amount that exceeds the value of the services, the excess amount will be treated as a gift.

LIFE INSURANCE PROCEEDS

Life insurance proceeds paid to a beneficiary because of the insured person's death are not taxable.[8] The exclusion applies whether the proceeds are paid in a lump sum or in installments. Amounts received in excess of the face amount of the policy usually are taxable as interest.

EXAMPLE I:4-6 ▶ Buddy is the beneficiary of a $100,000 insurance policy on his mother's life. Upon her death, he elects to receive $13,000 per year for ten years instead of the lump sum. He receives $10,000 per year tax-free ($100,000 ÷ 10), but the remaining $3,000 per year is taxable as interest. ◀

EXAMPLE I:4-7 ▶ Assume the same facts as in Example I:4-6, except that Buddy elects to receive the full $100,000 face amount upon his mother's death. None of the $100,000 is taxable. ◀

The exclusion exists because life insurance benefits closely resemble inheritances, which are not taxable.

There is one exception that may result in a portion of the face amount of a life insurance policy being included in gross income.[9] The life insurance exclusion generally is not available if the insurance policy is obtained by the beneficiary in exchange for valuable consideration from a person other than the insurance company. For example, an individual may purchase an existing life insurance policy for cash from another individual. In this situation, the exclusion for death benefits is limited to the consideration paid plus the premiums or other sums subsequently paid by the buyer.

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[7] Recall that under Sec. 74 (discussed in Chapter I:3) most prizes and awards are taxable.

[8] Sec. 101(a).

[9] Sec. 101(a)(2).

EXAMPLE I:4-8 ▶ Kwame is the owner and beneficiary of a $100,000 policy on the life of his father. Kwame sells the policy to his brother Anwar for $10,000. Anwar subsequently pays premiums of $12,000. Upon his father's death, Anwar must include $78,000 [$100,000 − ($10,000 + $12,000)] in gross income. However, if Kwame gave the policy to his brother, all of the proceeds would be excluded from gross income because the gift of the policy does not constitute valuable consideration. ◀

ADDITIONAL COMMENT

The proceeds of a life insurance policy payable to named beneficiaries can be excluded from the federal estate tax when the decedent does not possess any incidents of ownership. This provision and the exclusion from gross income of life insurance proceeds underscore the favored position of life insurance.

The proceeds are excludable under the general exclusion for life insurance proceeds if the beneficiary's basis is found by reference to the transferor's basis (as would be true in the case of a gift), or if the policy is transferred to the insured, the insured's partner, a partnership that includes the insured, or a corporation in which the insured is a shareholder or officer.

Surrender or Sale of Policy. The exclusion for life insurance is available for amounts payable by reason of the death of the insured. In general, if a life policy is sold or surrendered for a lump sum before the death of the insured, the amount received is taxable to the extent that the amount received exceeds the net premiums paid.[10] On the other hand, no loss is recognized if a life insurance policy is surrendered before maturity and premiums paid exceed the cash surrender value.[11]

"Accelerated death benefits" may be excluded from gross income. Accelerated death benefits include payments made to a terminally ill person and periodic payments made to a chronically ill person. A person is terminally ill if a physician certifies that he is reasonably likely to die within 24 months. A person is chronically ill if he has a disability requiring long-term care (e.g., nursing home care). In general, the exclusion for periodic payments made to a chronically ill person is limited to the greater of $370 per day in 2019 ($360 in 2018), or the actual cost of such care. The exclusion covers amounts received from the insurance provider or from a "viatical settlement provider" (i.e., person in the business of providing accelerated death benefits).

EXAMPLE I:4-9 ▶ Harry has been diagnosed with cancer and is expected to live less than a year. Harry is covered by a life insurance policy with a $100,000 face amount. The insurance company offers terminally ill individuals the option of receiving 75% of the policy face amount. If Harry accepts the settlement, the amount he receives is excludable from gross income because he is terminally ill. ◀

EXAMPLE I:4-10 ▶ Mary suffered a severe stroke and has been admitted to a nursing home where she is expected to remain for the rest of her life. She is certified by a licensed health care practitioner as being a "chronically ill individual." Her nursing home expenses amount to $300 per day. Mary has elected to receive $340 per day from a $1,000,000 face amount life insurance policy as accelerated death benefits. Because she is a chronically ill individual, Mary may exclude the full amount she receives as it is less than the daily limitation of $370 established by law. ◀

Dividends on Life Insurance and Endowment Policies. Dividends on life insurance and endowment policies are normally not taxable because they are considered to be a partial return of premiums paid. The dividends are taxable to the extent that the total dividends received exceed the total premiums paid. Also, if dividends are left with the insurance company and earn interest, the interest is taxable.

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[10] Sec. 72(e)(2). A 10% penalty may apply when distributions are made before the recipient reaches age 59½ (see Sec. 72(q)).

[11] *London Shoe Co. v. CIR*, 16 AFTR 1398, 35-2 USTC ¶9664 (2nd Cir., 1935).

ADDITIONAL COMMENT

Notice that to exclude awards for meritorious achievement, the award must not come into the possession of the taxpayer.

AWARDS FOR MERITORIOUS ACHIEVEMENT

As noted in Chapter I:3, prizes and awards generally are taxable. An exception is applicable to awards and prizes made for religious, charitable, scientific, educational, artistic, literary, or civic achievement if the recipient:

- Was selected without action on his or her part to enter the contest or the proceeding,
- Does not have to perform substantial future services as a condition to receiving the prize or award, and
- Designates that the payor is to pay the amount of the award to either a government unit or a charitable organization.[12]

The recipient of such an award normally would owe no tax if he or she collected the proceeds and then contributed the proceeds to a charity because the gift would qualify as a deductible charitable contribution. However, the exclusion changes AGI and thereby affects other computations. Also, this rule is beneficial in situations where the taxpayer could not deduct the full amount of the award because of the limitation on the charitable contribution deduction (generally 50% of AGI; see Chapter I:8) or in the case of a small award to a taxpayer who does not itemize.

ADDITIONAL COMMENT

Athletic scholarships for fees, books, and supplies awarded by a university to students who are expected, but not required, to participate in a particular sport can be excludable.

KEY POINT

The exclusion for scholarships does not include amounts received for room, board, and laundry.

SCHOLARSHIPS AND FELLOWSHIPS

Subject to certain limitations, scholarships are excluded from gross income.[13] A scholarship is an amount paid or allowed to a student, whether an undergraduate or graduate, to aid degree-seeking individuals.

The exclusion for scholarships is limited to the amount of the scholarship used for *qualified tuition and related expenses*. Qualified tuition and related expenses typically include tuition and fees, books, supplies, and equipment required for courses of instruction at an educational organization. The value of services and accommodations supplied such as room, board, and laundry are not excluded. The exclusion for scholarships extends to salary paid for services rendered as part of a comprehensive student work-learning-service program.[14]

EXAMPLE I:4-11 ▶ Becky is awarded a $5,000 per year scholarship by State University. Becky spends $3,000 of the scholarship for tuition, books, and supplies, and $2,000 for room and board. In addition, Becky works part-time on campus and earns $4,000, which covers the rest of her room and board and other expenses. Becky is taxed on the $2,000 of the scholarship spent for room and board and $4,000 of salary earned from her part-time job. ◀

DISTRIBUTIONS FROM QUALIFIED TUITION PROGRAMS

Congress established *qualified tuition plans*, or so-called Section 529 plans, to assist students with education costs. Amounts contributed to a qualified tuition plan (QTP) on behalf of a designated beneficiary grow tax-free. Amounts may be withdrawn tax-free by the beneficiary as long as the amounts are used for qualified education expenses.

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[12] Sec. 74.
[13] Sec. 117.
[14] Scholarships may need to be reviewed to determine whether the amount constitutes compensation. A "scholarship" awarded to the winner of a televised beauty pageant by a profit-making corporation was ruled to be compensation for performing subsequent services for the corporation (Rev. Rul. 68-20, 1968-1 C.B. 55). An employer-paid "scholarship" was held to be compensation in a situation where the employee was on leave and was required to return to work after finishing the degree (*Richard E. Johnson v. Bingler*, 23 AFTR 2d 69-1212, 69-1 USTC ¶9348 (USSC, 1969)). However, in Ltr. Rul. 9526020 (September 10, 1995) the IRS ruled that grants to law students are not taxable even if they are conditioned upon the students agreeing to practice upon graduation in public, nonprofit, or other low paying sectors.

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Athletic scholarships for fees, books, and supplies awarded by a university to students who are expected, but not required, to participate in a particular sport can be excludable.

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Qualified higher education costs include tuition, books, fees, supplies, equipment, expenses incurred to meet the student's special needs, and room and board.[15] In the case of elementary and secondary education, the exclusion is limited to $10,000 per student per year and only covers tuition. Wealthy individuals may fund QTPs as there is no income limitation. Although parents and grandparents are the most frequent donors, anyone can fund a QTP.

A QTP must be maintained either by a state government or by a private educational institution. Plans may acquire mutual funds and similar investments. State plans (but not private plans) may provide for the purchase of credit for future tuition in lieu of investments.

Contributions to a QTP may be distributed tax-free. The portion of a distribution that is treated as a contribution is determined under annuity rules discussed in Chapter I:3. The income portion of a QTP distribution may be excluded to the extent it is used for qualified higher education expenses. The amount of the QTP exclusion is reduced by American Opportunity and lifetime learning tax credits claimed by the beneficiary.[16] Any additional distributed income is included to the beneficiary's gross income and is subject to a 10% penalty.

Donors can change the designated beneficiary to another member of the original beneficiary's family without tax consequences. Family members include relatives, as defined for dependency exemption purposes, plus first cousins.

EXAMPLE I:4-12 ▶ For each of his two young children, David contributes $10,000 to a state-established Qualified Tuition Program. There is no gift tax as the amounts are less than the $15,000 annual per donee gift tax exclusion. Current and future qualified contributions grow tax-free. Future distributions of income are tax exempt as long as the amounts do not exceed the beneficiary's qualified higher education expenses. Excess distributions are taxable and subject to a 10% penalty. ◀

PAYMENTS FOR INJURY AND SICKNESS

Sec. 104(a) excludes from gross income the "amount of any damages (other than punitive damages)...received...on account of personal physical injuries or physical sickness." Thus, for example, a taxpayer may exclude an insurance settlement for physical injury that resulted from an automobile accident. Section 104(a) does not cover amounts awarded for nonphysical injuries (such as a damaged reputation or libel) except that taxpayers may exclude reimbursements for medical expenses related to nonphysical injuries.

An attempt to challenge the constitutionality of this provision in the Court of Appeals of the District of Columbia was successful initially, but the court subsequently reversed itself.[17]

EXAMPLE I:4-13 ▶ After she was denied a promotion, Jane sued her employer claiming sex discrimination. She was awarded $5,000 to cover the medical bills she incurred because of the related emotional distress, $20,000 to punish her employer for discrimination, and $10,000 to compensate her for lost wages. The $5,000 awarded to cover medical bills is excluded from gross income, but not the amounts awarded as punitive damages or lost wages. ◀

The exclusion under Sec. 104(a) applies to damages received because of emotional distress in only two situations: (1) when the payments are for medical expenses related to the emotional distress, and (2) when the payments are for emotional distress *attributable* to a physical injury (including physical injury suffered by another person).

[15] Room and board is a qualified higher education expense only if the beneficiary is at least a half-time student.

[16] Sec. 529(c)(3)(B)(v). These credits are discussed in Chapter I:14 of this textbook.

[17] *Marrita Murphy v. CIR*, 100 AFTR2d 2007-5075, 2007-2 USTC ¶50,531, (DC Cir., 2007) reversing *Marrita Murphy v. CIR*, 98 AFTR2d 2006-6088, 2006-2 USTC ¶50,476, (DC Cir., 2006).

Sometimes, victims are awarded amounts that are intended to punish the guilty party. These so-called punitive damages are taxable even when they are awarded for physical injuries.

EXAMPLE I:4-14 ▶ Mary was injured in an automobile accident caused by another driver. Mary's daughter, Sarah, was in the automobile, but she was not physically injured. The other driver's insurance company was required by a court to pay Mary $10,000 to cover medical bills relating to her injuries, $5,000 to compensate her for emotional distress caused by the injuries, and $15,000 of punitive damages. Sarah was paid $3,000 to compensate her for distress caused by her witnessing her mother's injuries. Only the $15,000 of punitive damages are taxable to Mary as the other amounts are compensatory damages related to her physical injuries. Sarah's damage award of $3,000 is also excludable. ◀

Sec. 104(a)(3) excludes from gross income amounts collected under an accident and health insurance policy purchased by the taxpayer, even if the benefits are a substitute for lost income. In addition, Sec. 101 specifies that benefits received under a qualified long-term care insurance contract may be excluded from gross income, but limits the exclusion to the greater of $370 per day in 2019 ($360 in 2018) or the actual cost of such care. Such policies pay for nursing home and other types of long-term care. If the benefits exceed the actual cost of such care but are less than $370 per day, no portion of the benefits is taxable.

EXAMPLE I:4-15 ▶ Chuck purchased a disability income policy from an insurance company. Chuck subsequently suffered a heart attack. Under the terms of the policy, Chuck received $2,500 per month for the five months he was unable to work. The amounts received are not taxable, even though the payments are a substitute for the wages lost due to the illness. ◀

This exclusion is not applicable if the accident and health benefits are provided by the taxpayer's employer.[18]

EXAMPLE I:4-16 ▶ Assume the same facts as in Example I:4-15 except that Chuck's employer paid the premiums on the policy. The amounts received by Chuck are taxable. ◀

EXAMPLE I:4-17 ▶ After a serious stroke, Ruth moved into a nursing home. She was in the nursing home for 140 days. Nursing home charges, physician fees, and other related expenses totaled $46,000.

Under her long-term care insurance contract, Ruth received reimbursements of $48,000. The reimbursements are not includible in Ruth's gross income because the amounts are less than the allowed exclusion amount of $51,800 (140 days × $370). This exclusion applies even though she was reimbursed more than her actual costs. Alternatively, if the reimbursements had been $54,400, she would be required to report $2,600 ($54,400 − $51,800) as gross income. ◀

If the cost of the coverage is shared by the employer and the taxpayer, a portion of the benefits is taxable. For example, if the employer paid one-half of the premiums, one-half of the benefits would be taxable. The principal reason for the different tax treatment is that employer-paid coverage represents a tax-free employee fringe benefit, whereas employee-paid premiums are from after-tax dollars.

[18] A limited credit is available to taxpayers who receive such benefits. See Chapter I:14 for a discussion of the credit for the elderly and disabled.

In the case of an award intended to reimburse the taxpayer for medical expenses, it follows that the taxpayer cannot deduct the reimbursed medical expenses.[19] If the award exceeds the actual expense, it is not taxable except in the case of employer-financed accident and health insurance and in the case of excess long-term care discussed above.[20]

State worker's compensation laws establish fixed amounts to be paid to employees suffering specific job-related injuries. Section 104(a)(1) specifically excludes worker's compensation from gross income, even though the payments are intended, in part, to reimburse injured workers for loss of future income and even if the injuries are nonphysical.

EMPLOYEE FRINGE BENEFITS

In general, employee compensation is taxable regardless of the form it takes. Nevertheless, the tax law encourages certain types of fringe benefits by allowing an employer to deduct the cost of the benefit, by permitting the employee to exclude the benefit from gross income, or by permitting both the employer deduction and an employee exclusion. Employee fringe benefits subject to special rules include employee insurance, Sec. 132 benefits, meals and lodging, dependent care, and cafeteria plans. These fringe benefits are discussed below.

ADDITIONAL COMMENT

Many companies provide health care benefits to retired employees. However, due to mounting medical insurance bills, a rising retiree population, and an FASB rule that requires firms to recognize the associated liability, a number of companies are requiring retired workers to pick up a larger portion of their medical costs.

Employer-Paid Insurance. Employers commonly provide group insurance coverage for employees. In general, employers may deduct the premiums paid for life, health, accident, and disability insurance. Normally an employee does not have to include in gross income premiums paid on his or her behalf for health, accident, and disability insurance. Special rules applicable to life insurance premiums are discussed below.

Benefits received from medical, health, and group term life insurance coverage generally are excluded from an employee's gross income. Benefits received from a disability policy are normally taxable, but may qualify for the credit for the elderly and disabled (see Chapter I:14). The tax treatments of employer-financed and taxpayer-financed insurance coverage are compared in Topic Review I:4-1.

The rules relating to accident and health insurance are more generous than those for some other types of benefits. Under Sec. 106, employers can deduct insurance premiums and employees need not include the premiums in gross income.



STOP & THINK

Question: How does the *Affordable Care Act* (commonly called ObamaCare) impact employer provided health insurance?

Answer: The law made a number of changes in the tax rules affecting employee health insurance. The rules penalize larger employers who fail to provide adequate employee health benefits. The penalty applicable to individuals who do not obtain coverage was repealed effective for tax years after 2018. The act created several new taxes and changed others.

The act mandates that employers report the cost of health insurance benefits provided to employees on employee W-2's. The amount of the benefit is *not* included in employee gross income, but the reporting serves as a basis for imposing a variety of penalties that are part of the law. The law limits the amount that can be contributed to a flexible spending plan for health care ($2,700 in 2019). A credit will help small employers with the cost of providing employees with health insurance coverage.

Industry specific taxes apply to tanning salons, medical device manufacturers, insurance companies, and pharmaceutical companies. Other taxes apply to high income individuals and large employers who do not provide employee coverage.[21]

These and a number of other taxes will help subsidize health insurance costs for lower and middle income individuals.

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[19] See Chapter I:3 for a discussion of the reimbursement of an expense deducted in a preceding year.

[20] Sec. 105(a).

[21] A payroll tax of 0.9% applies to earned income over $200,000 ($250,000 for married couples). High income taxpayers also face a 3.8% tax on investment income, such as interest, capital gains, and dividends. Employers with 50 or more employees who do not provide adequate health insurance coverage must pay a tax of $2,500 in 2019 ($2,320 in 2018) for each employee over 30.

TOPIC REVIEW I:4-1

Treatment of Insurance

	Premiums Paid by	
	Employer	*Employee*
Medical and health Premiums	Premiums not included in employee's gross income. Premiums deductible by employer.	Premiums deductible as medical expense subject to 10% of AGI limitation (7.5% in 2018).
Benefits	Excluded from employee's gross income except when benefits exceed actual expenses.	Excluded from gross income.
Disability Premiums	Premiums not included in employee's gross income. Premiums deductible by employer.	Not deductible.
Benefits	Included in employee's gross income. May qualify for credit for elderly and disabled.	Excluded from gross income.
Life insurance Premiums	Included in employee's gross income (except for limited exclusion applicable to group term life insurance). Premiums deductible by employer (assuming employer is not the beneficiary).	Not deductible.
Benefits	Excluded from gross income.	Excluded from gross income.

Some employers provide self-insured accident and health plans to employees. Under such plans the employer pays employee medical expenses directly. Such plans are called Health Reimbursement Arrangements and often supplement health insurance.

Both insured and self-insured plans are subject to nondiscrimination requirements. *Discrimination* is defined in terms of an eligibility test (whether a sufficient number of non-highly compensated employees are covered) and benefits (whether non-highly compensated employees receive benefits comparable to highly compensated employees). Highly compensated employees include the five highest-paid officers, greater-than-10% shareholders, and highest-paid 25% of other employees. If a plan discriminates in favor of highly compensated employees, these employees must include in gross income any medical reimbursements they receive that are not available to other employees.

KEY POINT

The nondiscrimination requirements for self-insured accident and health plans are designed to ensure that such plans do not discriminate against rank-and-file workers.

In general, life insurance premiums paid by an employer on an employee's behalf are deductible by the employer and are includable in the employee's gross income.[22] A limited exception is applicable to group term life insurance coverage. In general, premiums attributable to the first $50,000 of group term life insurance coverage may be excluded from an employee's gross income.[23] To qualify group term life insurance premiums for the exclusion, broad coverage of employees is required. Though somewhat different, the rules may be compared to those associated with self-insurance coverage.[24] The amount of coverage can vary between employees as long as the coverage bears a uniform relationship to each employee's compensation.

[22] If the employer is the beneficiary of the policy, the employee receives no economic benefit and, as a result, need not include the premiums in gross income. Such premium payments are not deductible by the employer. Subsequent benefits are not included in the employer's gross income.

[23] Sec. 79(a).

[24] For example, the rules refer to "key employees" as opposed to highly compensated employees. The term *key employee* is somewhat narrower in scope.

▼ TABLE I:4-1
Uniform One-Month Group Term Premiums for $1,000 of Life Insurance Coverage

Employee's age	Premiums
Under 25	$0.05
25 to 29	.06
30 to 34	.08
35 to 39	.09
40 to 44	.10
45 to 49	.15
50 to 54	.23
55 to 59	.43
60 to 64	.66
65 to 69	1.27
70 and above	2.06

EXAMPLE I:4-18 ▶ Data Corporation provides group term life insurance coverage for each full-time employee. The coverage is equal to one year's compensation. The arrangement constitutes a qualified group term life insurance plan. ◀

TYPICAL MISCONCEPTION
Many individuals erroneously believe that all life insurance coverage provided by employers is tax exempt.

In the case of coverage that exceeds $50,000, employees must include in gross income the amount established by the Regulations. (See Table I:4-1.)

EXAMPLE I:4-19 ▶ USA Corporation provides Joy, age 61, with $150,000 of group term life insurance coverage. Joy must include in gross income $792, an amount determined by reference to Table I:4-1 [($100,000/$1,000 × $.66) × 12 = $792]. ◀

The amount that must otherwise be included in an employee's gross income is reduced by any premiums paid by the employee.

If group term life insurance coverage discriminates in favor of key employees, each key employee must include in gross income the greater of the premiums paid on his or her behalf or the amount determined based on Table I:4-1 without any exclusion for the first $50,000 of coverage.

STOP & THINK

Question: Does the fact that employers can provide health insurance and group term life insurance to employees on a tax-favored basis mean that such benefits should be provided to all employees? Explain.

Solution: No. Providing such benefits to all employees may be inefficient. Some employees have other health coverage (e.g., coverage through a spouse's employer). Employees with no dependents may not want life insurance coverage. As a result, employers who provide all employees with such benefits may be spending money on coverage that some employees neither want nor need. A cafeteria plan, discussed later in this chapter, is often a more efficient option. Such plans permit employees to choose either cash or tax-favored benefits from a list. This does have significant social and economic implications. As the cost of health insurance increases, more employees, especially those with lower incomes, choose cash salary over health insurance coverage. This contributes to the number of individuals who do not have health insurance. Further, under the Affordable Care Act, larger employers face penalties if employees are not covered by health insurance.

TOPIC REVIEW I:4-2

Summary of Sec. 132 Fringe Benefits

Section	Benefit	May Be Made Available to	Comments
132(b)	No-additional-cost (e.g., telephone, unused hotel rooms for hotel employees, unused airline seats for airline employees)	Employees, spouses, dependents, and retirees	The services must be of the same types that are sold to customers and in the line of business in which the employee works. Discrimination is prohibited.
132(c)	Qualified employee discounts	Employees, spouses, dependents, and retirees	Discounts on services limited to 20%. Discounts on merchandise are limited to the employer's gross profit percentage. No discount is permitted on real estate, stock, or other investment type property. Discrimination is prohibited.
132(d)	Working condition (e.g., outplacement and professional memberships)	Employees	Discrimination is permitted. Special rules apply to tuition reductions for employees of educational institutions and to an auto salesperson's demonstrator.
132(e)	De minimis (e.g., free coffee, holiday turkeys, or use of company eating facilities)	Employees	Eating facilities must be made available on a nondiscriminatory basis. Employer deduction only for 50% of the net cost.
132(f)	Qualified transportation fringes (e.g., transit passes, tokens, and parking)	Employees	Limited exclusion for parking and transportation fringes. Discrimination is permitted. No employer deduction for the net cost.
132(j)(4)	Recreation and athletic facilities (e.g., gyms, pools, saunas, and tennis courts)	Employees, spouses, dependents, and retirees	No employer deduction for the net cost.
132(j)(8)	Educational assistance	Employees and former employees	Discrimination is prohibited. Only covers job-related education and training.

ADDITIONAL COMMENT

The nondiscrimination rules do not apply to working condition fringe benefits. For example, if a corporation makes bodyguards available only to key officers, the working condition fringe benefit exclusion would still apply.

Section 132 Fringe Benefits. It has become common for employers to provide employees with such diverse benefits as free parking, membership in professional organizations, and small discounts on products sold by the employer. Section 132 was added to the IRC in 1984 to clarify whether certain types of benefits are taxable. Section 132 lists six types of fringe benefits that may be excluded from an employee's gross income (see Topic Review I:4-2). Benefits covered by Sec. 132 include:

- No-additional-cost benefits (e.g., a hotel employee's use of a vacant hotel room)
- Qualified employee discounts (e.g., discounts on merchandise sold by the employer)
- Working condition benefits (e.g., membership fees in professional organizations paid by an employer)
- De minimis benefits (e.g., coffee provided by the employer)
- An exclusion of $265 per month in 2019 ($260 in 2018) is available for employer-financed public transportation, use of commuter highway vehicles, and parking.
- Athletic facilities (e.g., employer-owned exercise equipment used by employees)
- Job-related education and training. See Chapter I:7 for a discussion of what constitutes "job-related" education and training. Chapter I:7 also discusses the possible deduction by employees of unreimbursed job-related education costs.

One reason some benefits are exempt is that taxing each individual employee would require keeping records of what would often be small amounts. Instead, Congress has chosen to limit employer deductions for some benefits beginning in 2018. Employers can

no longer deduct expenses associated with employee transportation, parking, recreational facilities, and de minimis benefits except that employers can deduct one-half of the net cost of operating employee eating facilities.

No-additional-cost benefits are limited to services, as opposed to property. Common examples of no-additional-cost benefits include the use of vacant hotel rooms by hotel employees and standby tickets provided to airline employees. The employer may not incur substantial additional costs, including forgone revenue, in providing the services to the employee. Thus, a hotel may allow employees to stay in vacant hotel rooms even though the hotel incurs additional utility and laundry costs as a result of the stay. However, the hotel cannot allow the employees to stay in lieu of paying guests. No-additional-cost benefits are limited to services provided to employees, their spouses, dependent children, and to retired and disabled employees. The term employee includes partners who perform services for a partnership. In addition, the benefits may be extended, on a reciprocal basis, to employees of other companies in the same line of business.

Employers may permit employees to purchase goods and services at a discount from the price charged regular customers. In the case of services, the discount is limited to 20% of the price charged regular customers. In the case of property, the discount is limited to the company's gross profit percent. No discounts are permitted on real property or investment property (e.g., houses or stocks). Further, the discounts must be from the same line of business in which the employee works. The discounts may be provided to the same persons as no-additional-cost benefits except that the discounts may not be provided on a reciprocal basis to employees of companies in the same line of business.

Discrimination is prohibited with respect to certain benefits. The benefits must be made available to employees in general rather than to highly compensated employees only. (See Topic Review I:4-2 for specific rules.)

SELF-STUDY QUESTION

Western Airlines and Central Airlines have a reciprocal agreement that permits employees of the other airline to travel for free on a standby basis. Stan, an employee of Western Airlines, takes a free flight on Central Airlines that would have cost $800. What is Stan's income?

ANSWER

None, reciprocal agreements with regard to no-additional-cost services are permitted.

Employee Awards. As noted earlier, it is often difficult to distinguish between gifts and awards. The de minimis rule mentioned above permits employers to make small gifts such as a holiday turkey or a watch at retirement without the employee having to include the value of the gift in gross income. The employer is entitled to a deduction for the cost of such gifts.

Section 74 provides a similar rule for **employee achievement awards** and **qualified plan awards.**[25] Such awards must be in the form of tangible personal property other than cash and must be based on safety records or length of service. Employee achievement awards are limited to $400 for any one employee during the year. Furthermore, the awards must be presented as part of a meaningful presentation and awarded under circumstances that do not create a significant likelihood of the payment being disguised compensation. Qualified plan awards must be granted under a written plan and may not discriminate in favor of highly compensated employees. The average cost of qualified plan awards is limited to $400, but individual awards can be as large as $1,600.

- An award for length of service cannot qualify under the IRC if it is received during the employee's first five years of employment or if the employee has received a length-of-service award during the year or any of the preceding four years.
- No more than 10% of an employer's eligible employees may receive an excludable safety achievement award during any year. Eligible employees are employees whose positions involve significant safety concerns.

EXAMPLE I:4-20 ▶ Each year, USA Corporation presents length-of-service awards to employees who have been with the company five, ten, fifteen, or twenty years. The presentations are made at a luncheon sponsored by the company and include gifts such as desk clocks, briefcases, and watches, none of which cost more than $400. The awards, which qualify as employee achievement awards, are deductible by USA Corporation and are not taxable as income to USA's employees. ◀

[25] Sec. 74(c). The definitions and requirements for employee achievement awards and qualified plan awards are contained in Sec. 274(j). It provides that tangible personal property shall not include cash, cash equivalents, gift cards, gift coupons or gift certificates (other than arrangements conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer), or vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items.

Gifts to employees that do not qualify as employee achievement awards or qualified plan awards can be excluded by the employee only if the awards can be excluded as de minimis amounts under Sec. 132(e).

Meals and Lodging. Section 119 provides a limited exclusion for the value of meals and lodging that are provided to employees at either no cost or a reduced cost.

- Meals provided by an employer may be excluded from an employee's gross income if they are furnished on the employer's premises and for the convenience of the employer.
- Lodging provided by an employer may be excluded from an employee's gross income if it is furnished on the employer's premises and for the convenience of the employer, and the employee is required to accept the lodging as a condition of employment.

REAL-WORLD EXAMPLE

Many university presidents are furnished with personal residences, the value of which they can generally exclude from gross income.

The requirement that meals and lodging be furnished on the premises of the employer refers to the employee's place of employment.[26]

REAL-WORLD EXAMPLE

A brewery provided houses on the business premises to officers. The value of the houses was excludable because it was important to have the officers available for around-the-clock operations of the business. *Adolph Coors Co.*, 1968 PH T.C. Memo ¶68, 256, 27 TCM 1351.

The convenience of the employer test considers whether a substantial noncompensatory business reason exists for providing the meals or lodging. Thus, the test is met if the owner of an apartment complex furnishes a unit to the manager of the complex because it is necessary to have the manager present on the premises even when he or she is off duty.

The value of lodging cannot be excluded from gross income unless the employee is required to accept the lodging as a condition of employment. This requirement is not met if the employee has a choice of accepting the lodging or receiving a cash allowance. Furthermore, meal allowances do not qualify for the exclusion if the employer does not actually provide the meal.[27] Section 132 (discussed earlier in this chapter) provides a de minimis exception. Some employers provide supper money to employees who must work overtime. If such benefits are occasionally provided to employees, the amount is excludable from the employees' gross income.

EXAMPLE I:4-21 ▶ A hospital maintains a cafeteria that is used by employees, patients, and visitors. Employees are provided free meals while on duty in order to be available for emergency calls. Since the meals are provided on the employer's premises and for the convenience of the employer, the value of the meals is excluded from the employees' gross income. ◀

EXAMPLE I:4-22 ▶ A state highway patrol organization provides its officers with a daily meal allowance to compensate them for meals eaten while they are on duty. Officers typically eat their meals at the restaurant of their choice. Because the officers receive cash instead of meals, the amount provided must be included in the officers' gross income. ◀

EXAMPLE I:4-23 ▶ A large corporation requires five of its employees to work overtime two evenings each year when the company takes inventory. The corporation gives each of the employees a small amount to cover the cost of the dinner for the two evenings. The amounts constitute supper money and are excluded from the employees' gross income. ◀

Section 119 provides that if employees can exclude the value of meals from gross income, the employer can deduct one-half the cost of the meal.[28] Further, if more than half of the employees who receive meals meet the "convenience of the employer" test, then all employees who receive meals can exclude the value from gross income.

Meals and Entertainment. As noted previously employees can exclude from gross income the value of certain meals consumed on the employer's premises. That leaves open the question of whether an employee must include in gross income the value of meals consumed elsewhere if the employer either pays for the meal or reimburses the employee. If an employer pays for employee entertainment or reimburses an employee for the cost of entertainment, must the employee include the value of the entertainment in gross income?

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[26] Reg. Sec. 1.119-1(c)(1).

[27] *CIR v. Robert J. Kowalski*, 40 AFTR 2d 77-6128, 77-2 USTC ¶9748 (USSC, 1977).

[28] Prior to 2018, employers could deduct the full cost of such meals. Effective 2026, none of the cost of such meals will be deductible.

EXAMPLE I:4-24 ▶ Joe is a sales representative for Eagle Corporation. Joe treats Wayne to lunch and a round of golf. Joe and Wayne discuss the possibility of Wayne opening an Eagle retail outlet during lunch and while playing golf. Wayne subsequently signs a contract and opens an Eagle Corporation store. Joe is not entitled to any deduction for meals and entertainment even though the expenses are employment related. Eagle can deduct none of the cost of golf and only one-half of the cost of the meal if it reimburses Joe. ◀

In general, an employee is not required to include a reimbursement in gross income if the expenses are job related and the employee is required to provide an accounting to the employer. The amounts are taxable to the employee, however, if they represent compensation for services.

EXAMPLE I:4-25 ▶ To reward Joe (from Example I:4-24) for his success, Eagle Corporation gives him four concert tickets worth a total of $250 and a $200 gift card. The $450 is compensation for services and is taxable to Joe. ◀

Employee Death Benefits. Employers sometimes may make payments to the family or friends of deceased employees. In some instances, the payments might be viewed as a gift made for reasons such as the financial need of the family, kindness, or charity. Alternatively, the amount might constitute a payment of compensation based on the past services of the deceased employee. Gifts are, of course, excluded from gross income, whereas compensation is taxable. The treatment of payments made to the family or other beneficiaries of the employee's estate is determined by the following rules:

- Payments for past services (such as bonuses, accrued wages, and unused vacation pay) are taxable as income to the family and are deductible by the employer. The important issue is whether the employee would have received this amount had he or she lived. If the employer was legally obligated to make the payment at the time of the employee's death, the payments are taxable to the recipient.
- Other amounts may be either taxable compensation or excludable gifts depending on the facts and circumstances. If the amount is a gift, it is not deductible by the employer. If the amount is taxable income to the deceased employee's family, it is deductible by the employer.

In determining whether the amount is taxable, the courts have considered factors such as whether the employer derived benefit from the payment, whether the employee had been fully compensated, and whether the payment was made to the family and not to the estate. The Supreme Court stated, "The most critical consideration [in determining whether a transfer is a gift] is the transferor's 'intention'."[29] Although the case did not deal with death benefits, it did establish the importance of motive in determining whether a payment is a gift. Thus, the transfer should be made for reasons such as kindness, sympathy, generosity, affection, or admiration.

It should be noted that it is more difficult to establish that a payment is a gift in situations where the payments are made to persons owning stock in the corporation making the payment. Such payments may be construed as constructive dividends, which are not deductible by the corporation but are taxable income to the recipients.[30]

ADDITIONAL COMMENT

The $5,000 limit was placed on the exclusion for dependent care assistance programs because it was thought to be inequitable to provide an unlimited dependent care exclusion but a limited child care credit for people who pay their own child care expenses.

Dependent Care. **Dependent care assistance programs** are employer-financed programs that provide care for an employee's children or other dependents. An employee may exclude up to $5,000 of assistance each year ($2,500 for a married individual filing a separate return). The care must be of a type that, if paid by the employee, would qualify for the dependent care credit. Furthermore, the credit is scaled down if the employee receives

[29] *CIR v. Mose Duberstein*, 5 AFTR 2d 1626, 60-2 USTC ¶9515 (USSC, 1960).

[30] *Ernest L. Poyner v. CIR*, 9 AFTR 2d 1151, 62-1 USTC ¶9387 (4th Cir., 1962).

WHAT WOULD YOU DO IN THIS SITUATION?



FRINGE BENEFIT

National Boats manufactures pleasure boats sold to consumers. The boats range in price from $40,000 to $1,500,000. Jake is the president of National Boats. The company provides Jake with one of its more expensive boats. The company pays for fuel, insurance, and other costs and deducts these expenses along with depreciation on the boat. The company states that Jake is responsible for testing and for demonstrating the boat to possible customers. Jake has had the same boat for two years, and the company plans to provide him with a new boat next month.

You asked Jake how often he uses the boat. He indicated that he uses it once or twice each month on weekends, except during the winter. You asked him who accompanies him, and what types of testing he conducts. He seemed reluctant to answer the question, but acknowledged that his family often accompanies him on the boat, and said that he tests it during ordinary operations to determine how it performs. He added that potential customers who have also accompanied him included neighbors and friends. What tax issues do you see?

KEY POINT

The classification of an employee as highly compensated is made on the basis of the facts and circumstances of each case. Any officers and shareholders owning more than 5% of the stock are classified as highly compensated employees.

benefits under the employer's plan. (See Chapter I:14 for a discussion of the child and dependent care rules.) The program cannot discriminate in favor of highly compensated employees or their dependents.[31]

Adoption Expenses. Congress provides tax benefits for qualified adoption expenses in the form of a tax credit (see Chapter I:14) or an exclusion for amounts paid pursuant to the employer's written adoption assistance plan. In 2019, an employee may exclude from gross income up to $14,080 ($13,810 in 2018) of qualified expenses paid by an employer in connection with the adoption of a child under age 18.[32] The exclusion is phased out for employees with modified adjusted gross income between $211,160 and $251,160 (between $207,140 and $247,140 in 2018).

ADDITIONAL COMMENT

The Sec. 132 education exclusion discussed earlier is not subject to a dollar limitation, but covers only training related to the employee's work.

Educational Assistance. Under Sec. 127 educational assistance plans, employers pay employee education expenses. Employees may exclude from gross income annual payments of up to $5,250. The exclusion applies to payments for tuition, fees, books, supplies, and equipment for undergraduate courses or graduate courses as well as other training.

ADDITIONAL COMMENT

About half of the large employers in the United States offer flexible spending accounts.

Cafeteria Plans. **Cafeteria plans** are plans that offer employees the option of choosing cash or statutory nontaxable fringe benefits (such as group term life insurance, medical insurance, adoption expenses, child care, etc.). If the employee chooses cash, the cash is taxable. However, if the employee chooses a statutory nontaxable fringe benefit, the value of the benefit is excluded from gross income.[33] In other words, the fact that the employee could have chosen cash does not cause the fringe benefit to be taxed. The plan cannot discriminate in favor of highly compensated employees or their dependents or spouses.[34] Employer plans may specify what benefits are offered and may limit the amount of benefits individual employees may receive.

ADDITIONAL COMMENT

While the main benefit of a cafeteria plan is to offer tax-free choices to employees, the plan must also offer at least one taxable benefit.

Cafeteria plans that allow employees to use funds to pay medical expenses are called Flexible Spending Accounts. Typically, the plans supplement medical insurance, and funds are used to pay dental bills and other medical expenses not covered by regular insurance. In general, employees annually elect to set aside funds to pay medical expenses, and the employer pays the expenses using the set-aside funds. One problem with the agreements is that they are binding for one year. As a result, the employee loses the funds if the actual medical expenses are less than the amount set aside. Rules permit employees to carry over up to $500 from one year to the next. Employers, on the other hand, are obligated to pay expenses up to the agreed

ADDITIONAL COMMENT

Some plans supplement wages; others are wage reduction plans. In supplemental wage plans, employer funds are used to pay fringe benefits. In the case of wage reduction plans, employees elect to receive reduced wages in exchange for the fringe benefits. In both cases, employees receive benefits without being taxed on them.

[31] Sec. 129.
[32] Sec. 137.
[33] Long-term care insurance (sometimes called nursing home insurance) can be offered to employees on a tax-favored basis, but that benefit cannot be offered as part of a flexible spending account.
[34] Sec. 125.

ADDITIONAL COMMENT

One benefit that was often used in the past was interest-free loans to employees. Under present law, interest must generally be imputed on interest-free loans. (See Chapter I:11 for a detailed discussion of rules applicable to interest-free loans.)

amount even if the full amount has not yet been withheld from the employee's wages. Thus, the employer may lose money if an employee terminates employment after incurring the designated amount of medical expenses but before the full amount is withheld.

Advantage of Fringe Benefits. The major advantage of taking fringe benefits (such as those described above) in lieu of a cash payment is the fact that employees do not have to use after-tax income to obtain the product or service.

EXAMPLE I:4-26 ▶ Dan, an employee of Central Corporation, has a $40,000 life insurance policy and pays the premiums out of his salary. Since his salary is taxable, the premiums are paid on an after-tax basis. Kay, an employee for Western Corporation, is covered by a $40,000 group term life insurance policy financed by Western Corporation. Western Corporation pays the premiums on the policy. Because the premiums are excludable, Kay does not have to report the premiums as income. ◀

EXAMPLE I:4-27 ▶ John's employer establishes a cafeteria plan which allows each employee to set aside up to $5,000 for health insurance premiums and medical reimbursements. John, whose salary has been $30,000, agrees to a salary reduction of $4,000, of which $2,600 is to cover his health insurance premiums and $1,400 is available to reimburse his medical expenses. Under the arrangement, John's salary is reduced to $26,000 for tax purposes. Neither the health insurance coverage nor the medical expense reimbursement is taxable. During the year, John incurs $1,300 of medical expenses not covered by insurance. He receives a reimbursement for all of the expenses, and the $100 balance carries over. Alternatively, if the medical expenses were $1,800, John would receive a reimbursement of $1,400 and he must pay the remaining $400 of expenses out of after-tax salary dollars. ◀

In 2019, the maximum amount that employees can elect to contribute tax-free to a flexible spending account for health care benefits is $2,700 ($2,650 in 2018). The limitation does not apply to an elective wage reduction for an employee's share of medical insurance premiums, but does apply to reimbursements for dental bills, co-pays, and other medical expenses paid directly by an employee.

STOP & THINK

Question: Employers and employees both pay FICA taxes on salaries. Fringe benefits such as health insurance are exempt from both income taxes and FICA taxes. What is the tax effect of an employee's decision to elect health insurance coverage in exchange for a reduced salary?

Solution: The employee's income and FICA taxes are both lowered. The employer is permitted an income tax deduction for either the salary payment or the payment of the health insurance premium. The employer's FICA tax is reduced because the health insurance benefit also is exempt from that tax.

ADDITIONAL COMMENT

The estimated cost of excluding employer provided health insurance and medical care from income taxes for 2017 is $220 billion. This is the largest tax expenditure in the federal budget.

Availability of Tax-Favored Fringe Benefits to Business Owners. The exclusion for many fringe benefits is only available to employees (and in some cases spouses, dependents, and retirees). Many tax-favored fringe benefits are unavailable to proprietors and partners. As a result, a partnership can provide $50,000 of group-term life insurance to employees on a tax-favored basis, but cannot provide the benefit on a tax-favored basis to its partners. Other fringe benefits that cannot be offered to proprietors or partners on a tax-favored basis include cafeteria plans, disability insurance, medical reimbursements, achievement awards, adoptions assistance, on-premises lodging, moving expense, and commuting and parking benefits (other than de minimis).[35]

Special rules apply to health insurance premiums and retirement plan contributions for proprietors and partners. The owners deduct these payments for AGI. This results in a self-employment tax on the amounts, but no income tax.

[35] Benefits that can be offered to proprietors and partners on a tax-favored basis include de minimis benefits, no additional cost fringe benefits, dependent care assistance, educational assistance, discounts, on-premises meals, and working condition fringes.

Shareholders, as such, are ineligible for tax-favored fringe benefits. In most cases employees of C corporations are eligible for tax-favored fringe benefits based on their wages even if they own stock. This is not true, however, for S corporation employees who own more than 2% of the corporation's stock. They are treated much like partners and proprietors with respect to fringe benefits. Health insurance premiums and retirement plan contributions made for these S corporation employee-shareholders are wages for income tax purposes. Like partners and proprietors, these S corporation employees-shareholders can deduct the amounts for AGI. Unlike partners and proprietors, the amounts are not subject to FICA or self-employment taxes.

The fact that fringe benefits provided to employee-shareholders of C corporations are treated more favorably than benefits provided to the owners of other businesses is an incentive for businesses to operate as C corporations.

FOREIGN-EARNED INCOME EXCLUSION

ADDITIONAL COMMENT

Many U.S. embassies and consulates in foreign countries provide income tax assistance.

ADDITIONAL COMMENT

Foreign-earned income does not include amounts paid to an employee of the U.S. government or any U.S. government agency or instrumentality.

The income of U.S. citizens is generally subject to the U.S. income tax even if the income is derived from sources outside the United States. The foreign income of U.S. citizens often is taxed by the host country potentially leading to a substantial double tax on the same income. The double tax is mitigated by a **foreign tax credit**. Subject to limitations, U.S. citizens may subtract from their U.S. income tax liability the income taxes they pay to foreign countries. (See Chapter I:14 for a discussion of foreign tax credit.)

In the case of foreign-earned income, individuals have available the alternative option of excluding the first $105,900 in 2019 ($103,900 in 2018) of foreign-earned income from gross income.[36] The *exclusion* is available in lieu of the foreign tax credit. If both a husband and wife have foreign-earned income, each may claim an exclusion. Community property rules are ignored in determining the amount of the exclusion. Thus, if only one spouse has foreign-earned income, only one exclusion is available. The principal reasons for the exclusion are to encourage U.S. businesses to operate in foreign countries and to hire U.S. citizens and resident aliens to manage the businesses. The hope is that such operations will improve the balance of payments. Taxpayers who elect the exclusion in one year may switch to the foreign tax credit in any subsequent year. Taxpayers who change from the exclusion to the credit may not reelect the exclusion before the sixth tax year after the tax year in which the change was made.[37] The IRS can waive the six-year limitation in special situations (such as an individual employee changing the location of his or her foreign employment).

TYPICAL MISCONCEPTION

A taxpayer must be present in one or more foreign countries for 330 days during a period of twelve consecutive months, rather than 330 days during a calendar year.

Foreign-earned income includes an individual's earnings from personal services rendered in a foreign country. The place where the services are performed determines whether earned income is foreign or U.S. source income. If an individual is engaged in a trade or business in which both personal services and capital are material income-producing factors, no more than 30% of the net profits from the business may be excluded.[38] Furthermore, pensions, annuities, salary paid by the U.S. government, and deferred compensation do not qualify for the exclusion.[39]

To qualify for the foreign-earned income exclusion, the taxpayer must either be a bona fide resident of one or more foreign countries for an entire taxable year, or be present in one or more foreign countries for 330 days during a period of 12 consecutive months.[40] The exclusion limitation for a year must be prorated if the taxpayer is not present in, or a resident of, a foreign country or countries for the entire year.

EXAMPLE I:4-28 ▶ Sondra is given a temporary assignment to work in foreign country T. She arrives in T on October 19, 2019, and leaves on October 1, 2020. Although Sondra does not establish a permanent residence in T, she is present in T for at least 330 days out of a twelve-month period beginning on October 20, 2019. Thus, 73 days fall in 2019 and the rest in 2020. Sondra's exclusion for 2019 is limited to $21,180 [(73 ÷ 365) × $105,900]. She may exclude $21,180 or the income she earns in foreign country T during 2019, whichever is less. Sondra also may claim the foreign earned income exclusion in 2020 for the number of qualified days during the year. ◀

[36] Sec. 911(b)(2).
[37] Sec. 911(e)(2).
[38] Sec. 911(d)(2)(B).
[39] Sec. 911(b)(1)(B).
[40] Sec. 911(d).

In the past, employees claiming the foreign earned exclusion could deduct a portion of their employment related expenses. The deduction for employment related expenses was repealed for all employees effective 2018.

Housing costs in foreign countries are often higher than in the United States. In such situations, employees may be able to increase their exclusion while self-employed individuals may be able to deduct a portion of their housing costs. Specifically, the exclusion (deduction) is available for housing costs that exceed 16% of the foreign earned income exclusion limitation or $16,944 (0.16 × $105,900) in 2019 ($16,624 in 2018). Because the maximum housing cost exclusion is 30%, the amount that can be excluded for housing costs under this rule generally is limited to $14,826 (0.14 × $105,900) in 2019 ($14,546 in 2018). The IRS provides higher amounts for cities with high cost-of-living. Further, the housing exclusion must be reduced if the taxpayer does not incur cost for the entire year.

EXAMPLE I:4-29 ▶ Wayne is employed in Quebec City, Canada, and earns a salary of $120,000. His housing costs are $38,000 for the year. Wayne can exclude $120,726 ($105,900 + $14,826) from gross income. If the housing costs had been $24,000, Wayne's foreign earned income exclusion would have totaled $112,956 [$105,900 + ($24,000 − $16,944)]. ◀

Taxpayers who exclude a portion, but not all foreign earned income, are subject to a special tax computation. The result of the computation is to apply higher tax rates to the taxable portion of the foreign earned income. (See *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*, Chapter 16.) Americans employed abroad are often subject to income and payroll taxes imposed by the host country. Americans employed abroad by foreign companies are generally exempt from FICA taxes while Americans employed abroad by American companies remain subject to FICA taxes except in instances where a tax treaty between the U.S. and the host country subjects Americans to comparable host country taxes.

INCOME FROM THE DISCHARGE OF A DEBT

If debt of a taxpayer is cancelled or forgiven, the taxpayer may have to include the cancelled amount in gross income. It is important to distinguish a debt cancellation from a gift, a bequest, or a renegotiation of the purchase price.

EXAMPLE I:4-30 ▶ Farouk loaned his daughter $4,000 to help her purchase an automobile. Several months after she purchased the automobile, but before she repaid the $4,000, Farouk's daughter married. Farouk told his daughter that he was "tearing up" the $4,000 note as a wedding present. In this instance, the amount forgiven would constitute an excludable gift and would not be taxable as income to the daughter. ◀

EXAMPLE I:4-31 ▶ Clay purchased a used automobile from a dealer for $6,000. He paid $2,000 down and agreed to pay the balance of $4,000 over three years. After Clay purchased the automobile, he determined that it was defective. Clay tried to return the automobile, but the automobile dealer refused. Clay threatened to sue the dealer. To resolve the problem, the dealer offered to reduce the balance due on the purchase-money debt from $4,000 to $2,500. Clay agreed. The transaction constitutes a reduction in the purchase price of the automobile. Clay will not recognize any income, but must reduce the basis in his automobile from $6,000 to $4,500. ◀

EXAMPLE I:4-32 ▶ Blue Corporation issued bonds for $1,000 when interest rates were low. After a few years, interest rates increased and the bond value declined to $850. Blue Corporation purchased the bonds on the open market. Blue will recognize $150 of income from the discharge of indebtedness. ◀

EXAMPLE I:4-33 ▶ Indy Coal Company has seen its business decline during the past two years. The Company has a significant amount of bank debt that was incurred over the years to fund its coal operations. In order to maintain its operations, Indy entered into an agreement with the bank whereby the bank agreed to cancel 50% of Indy's debt. Assuming Indy was solvent at the time of the cancellation, Indy must report the discharge of indebtedness as gross income. ◀

STOP & THINK

Question: In Example I:4-33, the bank agreed to cancel 50% of Indy Coal Company's debt. Why would a lender agree to unilaterally cancel a borrower's debt?

Solution: A bank might cancel a portion of a borrower's debt in order to protect the remaining portion of the debt. If the debt forced the company into bankruptcy, the bank may collect little or none of the debt. If the cancellation would help stabilize Indy, the bank may be able to collect at least 50% of the debt. Further, if Indy becomes a viable company in the years ahead, the bank will have a good customer to earn profits in the future.

REAL-WORLD EXAMPLE

A taxpayer purchased and retired its own bonds. The purchase resulted in a gain because the bonds were payable in British pounds, which had been devalued. The gain was excludable. *Kentucky & Indiana Terminal Railroad Co. v. U.S.*, 13 AFTR 2d 1148, 64-1 USTC ¶9374 (6th Cir., 1964).

The enforceability of a debt under state law may also determine whether the forgiveness results in income. For example, one case held that the forgiveness of a gambling debt was not included in gross income where the debt was unenforceable under state law.[41]

Discharge in Bankruptcy and Insolvency. Section 61(a)(12) indicates that gross income includes income from the discharge of an indebtedness. Section 108, on the other hand, provides for the following exceptions where the discharge of an indebtedness is not taxable:

- The discharge occurs in bankruptcy.
- The discharge occurs when the taxpayer is insolvent.

These exceptions are intended to allow a "fresh start" for bankrupt and other financially troubled taxpayers. Since a taxpayer is not required to include the discharge in gross income, he is required to reduce certain tax attributes. For example, if the taxpayer has a net operating loss carryover, the NOL carryover must be reduced by the excluded discharge.

If a debt is reduced during bankruptcy proceedings, the taxpayer recognizes no income even if the reduction in debt exceeds the available tax attributes. In the case of an insolvent taxpayer, no income is recognized as long as the taxpayer is insolvent after the reduction in debt takes place. A taxpayer is insolvent if the debts owed by the taxpayer exceed the FMV of assets owned. Thus, an insolvent taxpayer reduces the tax attributes to the point of solvency. From that point on, any reduction in debt results in the recognition of income even if all tax attributes have not been offset.

ADDITIONAL COMMENT

Also excludable is the income from the cancellation of a student loan pursuant to a provision under which part of the debt is discharged due to working for a period of time in certain professions for a broad class of employers.

Student Loan Forgiveness. Under Sec. 108(f)(2), the discharge of certain student loans is excluded from gross income if the discharge is contingent on the individual's performing certain public services. The loans must have been made by governmental, educational, or charitable organizations, and the loan proceeds must have been used to pay the cost of attending an educational institution or used to refinance outstanding student loans. Further, the loan forgiveness must be contingent upon the individual's working for a specified time period in certain professions, and the services must normally be performed for someone other than the lender.

EXAMPLE I:4-34 ▶ Lee borrowed $60,000 from the federal government to attend medical school. Under the terms of the loan, $20,000 of debt is forgiven for each year she practices medicine in designated low-income neighborhoods. Lee does not have to include the debt forgiveness in gross income. ◀

The discharge of student loans on account of the student's death is not taxable.

Home Mortgage Forgiveness. Through 2016, homeowners could exclude debt forgiveness on their principal residence of up to $2 million under Sec. 108(a)(1)(E). This provision applied only to mortgages acquired in connection with the acquisition or improvement of a taxpayer's principal residence. Taxpayers were required to reduce the basis of their residence by the amount of the exclusion.

[41] *David Zarin v. CIR*, 66 AFTR 2d 90-5679, 90-2 USTC ¶50,530 (3rd Cir., 1990).

EXCLUSION FOR GAIN FROM SMALL BUSINESS STOCK

Investing in small businesses is risky. To encourage investment, Congress enacted a 100% exclusion for gains realized by noncorporate taxpayers on the sale or exchange of small business stock held over five years.[42]

For each issuer of qualified small business stock, there is a limit on the amount of gain a taxpayer may exclude. The amount of gain eligible for the exclusion may not exceed the greater of $10 million, reduced by amounts previously excluded for gains on the company's stock, or ten times the taxpayer's aggregate adjusted basis of the stock disposed of during the year.[43] When measuring the taxpayer's aggregate basis for the stock to determine the maximum amount of gain to exclude, the fair market value of the assets contributed to the corporation is used.

EXAMPLE I:4-35 ▶ In February 2011, Dennis contributed property with a basis of $1,000,000 and a value of $4,000,000 to a qualified small business corporation for common stock. After holding the stock over five years, Dennis sells it for $14,000,000. He can exclude 100% of the $13,000,000 ($14,000,000 − $1,000,000) realized gain, as that amount is less than the maximum gain eligible for the exclusion $40,000,000 [the greater of $10,000,000 or $40,000,000 (10 times $4,000,000)]. ◀

A corporation may issue qualified small business stock only if the corporation is a C corporation that is not an excluded corporation with an aggregate adjusted basis of not more than $50 million of gross assets, and at least 80% of the value of its assets must be used in the active conduct of one or more qualified trades or businesses.[44]

The 100% exclusion only applies to stock acquired after September 27, 2010. The small business stock exclusion is 50% (60% for certain empowerment zone businesses) for stock acquired after August 10, 1993 and before February 18, 2009 and is 75% for stock acquired after February 17, 2009 and before September 28, 2010. Any gain remaining after the 50% and 75% exclusions is taxed at a rate not greater than 28%.

EXAMPLE I:4-36 ▶ Assume the same facts as in Example I:4-35 except that Dennis acquired the stock in February 2005. Dennis can exclude one-half of his gain or $6,500,000. Dennis' exclusion would be 75% of his gain or $9,750,000 if he had acquired the stock in February 2010. ◀

Taxpayers do not have to recognize any gain if they reinvest the proceeds from the sale of small business stock in stock in another small business corporation within 60 days. The stock must have been held for over six months. This is important for investors who do not meet the five-year holding period requirement and for investors who acquired stock during the periods covered by the 50% and 75% exclusions. The basis of the stock must be reduced by the amount of the unrecognized gain.

OTHER EXCLUSIONS

The tax law contains other exclusions that are either covered elsewhere in the text or are of limited application. Table I:4-2 lists several such exclusions.

[42] §1202(a).
[43] Sec. 1202(b)(1).

[44] Secs. 1202(d) and (e). Excluded corporations are those engaged in providing professional services (e.g., law and health), financial services (e.g., banking and insurance), hospitality (e.g., hotels and restaurants), farming, and mining and oil and gas production.

▼ TABLE I:4-2
Other Exclusions

Section	Applies to	Comments
121	Gain from sale of personal residence	Taxpayers may exclude up to $250,000 ($500,000 in the case of a married couple filing a joint return) of gain from the sale of a personal residence. (See Chapter I:12 for a detailed discussion of this provision.)
101(h)	Annuities paid to survivors of public safety officers	Annuities paid to survivors of public safety officers, such as firefighters and police officers, killed in the line of duty are excluded.
104(a)	Military disability pay	Military personnel may exclude disability pay, combat pay (noncommissioned personnel only), and housing allowances.
112	Combat pay	
134	Military housing allowance	
107	Housing allowance for ministers	Ministers may exclude either the rental value of their homes or a rental allowance if provided in connection with their religious duties.
119	Campus housing	A limited exclusion is provided to employees of educational institutions when they are provided with on-campus housing.
108(a)(1)(D)	Qualified real property business debt discharge	A limited exclusion of income related to the cancellation of real property business indebtedness by taxpayers other than C corporations.
131	Foster care payments	Certain allowances received by foster care providers are excluded from gross income.
139F	Wrongful incarceration	Former prisoners may exclude monetary awards received for wrongful incarceration.
162(o)	Rural letter carrier's allowance	Rural letter carriers may exclude the "equipment maintenance allowance" they receive for the use of their personal automobiles in delivering the mail. They receive no deduction for the use of their automobiles.
408A(d)	Roth IRA distributions	Qualified distributions from Roth IRAs are excluded from gross income (see Chapter I:7 for a detailed discussion of the provisions).
530(d)	Education IRA distributions	Qualified distributions from Coverdell Education Savings Account IRAs are excluded from gross income (see Chapter I:7 for a detailed discussion of this provision).
988(e)	Personal foreign currency gains	Individuals are excused from recognizing gain on the disposition of foreign currency in any personal transaction, provided that the gain does not exceed $200.

TAX PLANNING CONSIDERATIONS

OBJECTIVE 3

Describe tax planning considerations for exclusions of gross income

EMPLOYEE FRINGE BENEFITS

The tax law encourages certain forms of fringe benefits by allowing an employer to deduct the cost of the benefit while permitting the employee to exclude the benefit from gross income. This deduction does not represent an income tax advantage to the employer because compensation, whether in the form of cash or nontaxable fringe benefits, is deductible if reasonable in amount. (Under new provisions, there are minor exceptions that are not deductible by the employer such as employee transportation and athletic facilities.) While employees receive the greatest income tax benefit from the exclusion of fringe benefits from gross income, employers receive a small benefit from the fact that fringe benefits are not subject to Social Security and Medicare taxes.

EXAMPLE I:4-37 ▶

USA Company has decided to offer $20,000 of group term life insurance coverage for each of its employees at an average annual premium cost of $100 per employee. Tim, an employee of USA Corporation, is in the 22% tax bracket. Because USA is offering a nontaxable fringe benefit, Tim will owe no additional income tax. If Tim had received a salary increase of $100, he would have had to pay an additional income tax of $22 (0.22 × $100). The remaining $78 of after-tax income would probably not have been sufficient to obtain the same amount of life insurance coverage. ◀

ADDITIONAL COMMENT

A case can be made for the desirability of encouraging employers to provide health insurance and other fringe benefits. However, these provisions may contribute to increases in the cost of insurance and medical care.

Excluding fringe benefits from gross income favors employees who are subject to higher tax rates.

EXAMPLE I:4-38 ▶ Assume the same facts as in Example I:4-37 except that Tim is in the 37% tax rate. Tim would save $37 (0.37 × $100) of taxes by receiving the group term life insurance coverage instead of the $100 salary increase. ◀

ADDITIONAL COMMENT

Fringe benefits offered by potential employers are important consideration factors when weighing total compensation packages.

It is not always desirable for employers to offer nontaxable fringe benefits. Some employees are not interested in certain benefits. For example, in the case of married couples where both spouses are employed, it is not necessary for both employers to provide medical insurance coverage for both spouses. Alternatively, single employees may not feel the need for group term life insurance and employees with no children are uninterested in employer-provided child care.

To avoid providing fringe benefits that are unneeded or unwanted, many employers have turned to cafeteria plans. Under cafeteria plans, employees may select from a list of nontaxable fringe benefits. On the other hand, employees who so choose may receive cash in lieu of some or all of the nontaxable benefits. Thus, each employee selects what he or she wants most. One common result is that high-tax-rate employees select the nontaxable fringe benefits, whereas other employees choose to receive cash.

SELF-HELP INCOME AND USE OF PERSONALLY OWNED PROPERTY

As noted earlier in this chapter, self-help income and income derived from the use of personal property are not taxable. Thus, self-help income and personal ownership of property are favored by the tax system. Taxpayers who rent their personal residences cannot deduct rental payments, but taxpayers who own their residences do not pay rent and may deduct interest and real estate taxes as itemized deductions. Thus, the tax law encourages ownership of personal residences.

Effective tax planning necessitates weighing the tax incentives with other nontax factors. Taxpayers with little accumulated funds may find it difficult to purchase a residence despite the availability of tax incentives. Taxpayers who move frequently may find that transaction costs such as real estate commissions and other closing costs are greater than the tax benefits obtained from home ownership. Other factors such as the personal preference of the taxpayer and anticipated inflation rates must also be considered.

Self-help income must be viewed in the same way. Taxpayers who are deciding whether to paint their own residences or hire someone else to do it must consider factors such as personal preference and the amount of income that could be produced if the time were spent working at an activity that produces taxable income.

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 4

Describe compliance and procedural considerations for exclusions of gross income

Taxpayers are usually not required to disclose excluded income on their tax returns. For example, a taxpayer who receives a tax-exempt scholarship need not disclose that income on his or her tax return. An exception is provided for tax-exempt interest and Social Security benefits, which must be disclosed on the tax return. If a taxpayer's only income is from tax-exempt sources, the taxpayer need not file a tax return. Whether an individual must file a return is based on the amount of the individual's gross income for the year (see Chapter I:2).

This chapter considers the taxability of various fringe benefits. The rules regarding the need for an employer to withhold federal income taxes or to report a payment on an employee's Form W-2 (Statement of Income Tax Withheld on Wages) closely parallel the gross income rules. (See Chapter I:14 for a discussion of these reporting requirements.) In general, if a fringe benefit is nontaxable, employers do not withhold from the benefit, nor do they report the benefit on the employee's W-2 at year-end. On the other hand, if the

ADDITIONAL COMMENT

Taxpayers filing Form 1040 are asked to report any tax-exempt interest income on line 2a.

benefit is taxable, it is subject to withholding and is reported on the employee's W-2 at year-end. Thus, employers do not withhold for nontaxable meals and lodging provided to employees.[45] Similarly, no withholding is required for the following fringe benefits if they are nontaxable: scholarships and fellowships covered by Sec. 117, dependent care covered by Sec. 129, and miscellaneous fringes covered by Sec. 132.[46]

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:4-1 What is meant by the terms *administrative exclusion* and *judicial exclusion*?

I:4-2 There is no specific statutory exclusion for welfare benefits. Nevertheless, the IRS has ruled that such benefits are not taxable. Is this within the authority of the IRS?

I:4-3 What was the issue in the tax case *Eisner v. Macomber*? Why is the case important?

I:4-4 Most exclusions exist for one of two reasons. What are those reasons? Give examples of exclusions that exist for each.

I:4-5
a. If a gift of property is made, who is taxed on income produced by the property?
b. How can interfamily gifts reduce a family's total tax liability?

I:4-6
a. What role does intent play in determining whether a transfer is a gift and therefore not subject to the income tax?
b. Are tips received by employees from customers excludable from gross income as gifts? Explain.

I:4-7 What is the tax significance of the face amount of a life insurance policy?

I:4-8 What conditions must be met for an award to qualify for an exclusion under Sec. 74?

I:4-9 Which of the requirements for the Sec. 74 awards exclusion most severely limits its use? Does the exclusion benefit taxpayers more if they itemize their deductions or use the standard deduction?

I:4-10
a. Define the term *scholarship* as it is used in Sec. 117.
b. If a scholarship covers room and board, is it excludable?
c. If an employer provides a scholarship to an employee who is on leave of absence, is that scholarship taxable?
d. Is the amount paid by a university to students for services excludable from the students' gross income?

I:4-11 What special rules are applicable to non-degree candidates who receive scholarships?

I:4-12 Is the personal injury exclusion found in Sec. 104 limited to physical injury? Explain.

I:4-13 Answer the following questions relative to employer-financed medical and health, disability, and life insurance plans.
a. May employers deduct premiums paid on employee insurance?
b. Do employees have to include such premiums in gross income?
c. Are benefits paid to the employee included in the employee's gross income?

I:4-14 Special rules are applicable in situations where group term life insurance coverage exceeds $50,000. How are key employees treated?

I:4-15
a. What are the seven major types of fringe benefits covered by Sec. 132?
b. What tax advantage is offered relative to such benefits?
c. Are such benefits available to employees only or may the benefits also be offered to spouses, dependents, and retirees?
d. Is discrimination prohibited relative to Sec. 132 benefits?
e. What is the tax impact on the employer and employees if an employer's plan is discriminatory?

I:4-16 What conditions must be met if an employee is to exclude meals and lodging furnished by an employer?

I:4-17 The president and vice president of USA Corporation receive benefits that are unavailable to other employees. These benefits include free parking, payment of monthly expenses in a local club, discounts on products sold by the corporation, and payment of premiums on a whole life insurance policy. Which of the benefits must be

[45] Reg. Sec. 31.3401(a)-1(b)(9).

[46] See Sec. 3401 for withholding requirements for numerous special situations.

included in the gross income of the president and vice president?

I:4-18 Are the same fringe benefits that are available to employees also available to self-employed individuals?

I:4-19 If an employee takes a customer to lunch and discusses business, can the employee deduct the cost of the meal? Explain.

I:4-20 Are income distributions from a qualified state tuition program taxable?

I:4-21 What types of income qualify for the foreign-earned income exclusion?

I:4-22 Are taxpayers who claim the foreign-earned income exclusion entitled to deduct expenses incurred in producing that income? Explain.

I:4-23 **a.** Why is it important to distinguish debt cancellation from a gift, bequest, or renegotiation of a purchase price?
b. What happens to the basis of an asset if the taxpayer renegotiates its purchase price?

I:4-24 **a.** Under what conditions is the discharge of indebtedness not taxable?
b. If a father forgives a daughter's debt to him, is she required to include such amount in her gross income?

I:4-25 Bankrupt and insolvent taxpayers do not recognize income if debt is discharged. They must, however, reduce specified tax attributes. What is involved?

I:4-26 Are partners and proprietors at a disadvantage with respect to fringe benefits? Explain.

I:4-27 Why are cafeteria plans helpful in the design of an employee benefit plan that provides nontaxable fringe benefits?

I:4-28 Both high-income and low-income employees are covered by cafeteria plans. Under such plans, all employees may select from a list of nontaxable fringe benefits or they may elect to receive cash in lieu of these benefits.
a. Which group of employees is more likely to choose nontaxable fringe benefits in lieu of cash? Explain.
b. Is this result desirable from a social or economic point of view? Explain.

ISSUE IDENTIFICATION QUESTIONS

I:4-29 Luke, who retired this year, lives in a four-plex owned by Julie. Luke's income decreased when he retired, and he now has difficulty paying his rent. Julie offered to reduce Luke's rent if he would agree to mow the lawn, wash windows, and provide other maintenance services. Luke accepted, and Julie reduced the monthly rental from $650 to $300. What are the tax issues that should be considered by Luke and Julie?

I:4-30 Mildred worked as a maid for 27 years in the home of Larry and Kay. When she retired, they presented her with a check for $25,000, indicating that it was a way of showing their appreciation for her years of loyal service. What tax issues should Mildred and her employer consider?

I:4-31 Troy Department Stores offers employees discounts on merchandise carried in the store. Newly hired employees receive a 10% discount. The discount rate increases 1% each year until employees have 20 years of service when the discount rate is capped at 30%. What tax issues should Troy and the employees consider?

I:4-32 Jerry works in the human resources department of Ajax Corporation. One of his responsibilities is to interview prospective employees. Two or three days each week, Jerry takes a prospective employee and fellow employees to lunch, and Ajax reimburses him for the cost of the meals. What tax issues should Jerry and Ajax Corporation consider?

PROBLEMS

I:4-33 ***Self-Help Income.*** In which of the following situations would the taxpayer realize taxable income?
a. A mechanic performs work on his own automobile. The mechanic would have charged a customer $400 for doing the same work.
b. A mechanic repairs his neighbor's personal automobile. In exchange, the neighbor, an accountant, agrees to prepare the mechanic's tax return. The services performed are each worth $200.
c. A mechanic repairs his daughter's automobile without any charge.

I:4-34 ***Excludable Gifts.*** Which of the following would be includable in gross income?

a. Alice appeared on a TV quiz show and received a prize of $5,000.

b. Bart received $500 from his employer because he developed an idea that reduced the employer's production costs.

c. Chuck borrowed $500 from his mother in order to finance his last year in college. Upon his graduation, Chuck's mother told him he did not have to repay the $500. She intended the $500 to be a graduation present.

I:4-35 ***Life Insurance Proceeds.*** Don is the beneficiary of a $50,000 insurance policy on the life of his mother, Anna. To date, Anna has paid premiums of $16,000. What amount of gross income must be reported in each of the following cases?

a. Anna elects to cancel the policy and receives $20,000, the cash surrender value of the policy.

b. Anna dies and Don receives the face amount of the policy, $50,000.

c. Anna dies and Don elects to receive $15,000 per year for four years.

I:4-36 ***Transfer of Life Insurance.*** Ed is the beneficiary of a $20,000 insurance policy on the life of his mother. Because Ed needs funds, he sells the policy to his sister, Amy, for $6,000. Amy subsequently pays premiums of $9,000.

a. How much income must Amy report if she collects the face value of the policy upon the death of her mother?

b. Would Amy have to report any income if her brother had given her the policy? Assume the only payment she made was $9,000 for the premiums.

I:4-37 ***Settlement of Life Insurance Policy.*** Sue is age 73 and has a great deal of difficulty living independently as she suffers from severe rheumatoid arthritis. She is covered by a $400,000 life insurance policy, and her children are named as her beneficiaries. Because of her health, Sue decides to live in a nursing home, but she does not have enough income to pay her nursing home bills which are expected to total $42,000 per year. The insurance company offers disabled individuals the option of either a reduced settlement on their policies or an annuity. Given Sue's age and health she has the option of receiving $3,200 per month or a lump sum payment of $225,000. To date, Sue has paid $80,000 in premiums on the policy.

a. How much income must Sue report if she chooses the lump sum settlement?

b. How much income must Sue report if she elects the annuity?

c. How much income would Sue have to report if her nursing home bills amounted to only $36,000 per year?

I:4-38 ***Insurance Policy Dividends.*** Hank carries a $100,000 insurance policy on his life. Premiums paid over the years total $8,000. Dividends on the policy have totaled $6,000. Hank has left the dividends on the policy with the insurance company. During the current year, the insurance company credited $600 of interest on the accumulated dividends to Hank's account.

a. How much income is Hank obligated to report in connection with the policy?

b. Would it make any difference if the accumulated dividends equaled $9,000 instead of $6,000?

I:4-39 ***Prizes and Awards.*** For each of the following, indicate whether the amount is taxable:

a. Peggy won $4,000 in the state lottery.

b. Jane won a $500 prize for her entry in a poetry contest.

c. Linda was awarded $2,000 when she was selected as "Teacher of the Year" by the local school district.

I:4-40 ***Scholarships.*** For each of the following, indicate the amount that must be included in the taxpayer's gross income:

a. Larry was given a $1,500 tuition scholarship to attend Eastern Law School. In addition, Eastern paid Larry $4,000 per year to work part-time in the campus bookstore.

b. Marty received a $10,000 football scholarship for attending Northern University. The scholarship covered tuition, room and board, laundry, and books. Four thousand dollars of the scholarship was designated for room and board and laundry. It was understood that Marty would participate in the school's intercollegiate football program, but Marty was not required to do so.

c. Western School of Nursing requires all third-year students to work twenty hours per week at an affiliated hospital. Each student is paid $10 per hour. Nancy, a third-year student, earned $10,000 during the year.

I:4-41 ***Research Grant.*** Otto is a biology professor at State University. The university gave Otto a sabbatical leave to study the surface of the flatworm. During the year he received a salary of $50,000, which is less than his regular salary of $56,000. Otto also received a grant to cover expenses associated with the study. The grant was $2,000, as were his related expenses. Otto also incurred memberships and other employment related expenses totaling $1,000. How much must Otto include in gross income?

I:4-42 ***Payments for Personal Injury.*** Determine which of the following payments for sickness and injury must be included in the taxpayer's gross income.

a. Pat was injured in an automobile accident. The other driver's insurance company paid him $2,000 to cover medical expenses and a compensatory amount of $4,000 for pain and suffering.

b. A newspaper article stated that Quincy had been convicted of tax evasion. Quincy, in fact, had never been accused of tax evasion. He sued and won a compensatory settlement of $4,000 from the newspaper.

c. Rob, who pays the cost of a commercial disability income policy, fell and injured his back. He was unable to work for six months. The insurance company paid him $1,800 per month during the time he was unable to work.

d. Steve fell and injured his knee. He was unable to work for four months. His employer-financed disability income policy paid Steve $1,600 per month during the time he was unable to work.

e. Ted suffered a stroke. He was unable to work for five months. His employer continued to pay Ted his salary of $1,700 per month during the time he was unable to work.

I:4-43 ***Employee Benefits.*** Ursula is employed by USA Corporation. USA Corporation provides medical and health, disability, and group term life insurance coverage for its employees. Premiums attributable to Ursula were as follows:

Medical and health	$3,600
Disability	300
Group term life (face amount is $40,000)	200

During the year, Ursula suffered a heart attack and subsequently died. Before her death, Ursula collected $14,000 as a reimbursement for medical expenses and $5,000 of disability income. Upon her death, Ursula's husband collected the $40,000 face value of the life insurance policy.

a. What amount can USA Corporation deduct for premiums attributable to Ursula?

b. How much must Ursula include in income relative to the premiums paid?

c. How much must Ursula include in income relative to the insurance benefits?

d. How much must Ursula's widower include in income?

I:4-44 ***Group Term Life Insurance.*** Data Corporation has four employees and provides group term life insurance coverage for all four employees. Coverage is nondiscriminatory and is as follows:

Employee	*Age*	*Key Employee*	*Coverage*	*Actual Premiums*
Andy	62	yes	$200,000	$4,000
Bob	52	yes	40,000	700
Cindy	33	no	80,000	600
Damitria	33	no	40,000	300

a. How much may Data Corporation deduct for group term life insurance premiums?

b. How much income must be reported by each employee?

I:4-45 ***Life Insurance Proceeds.*** Joe is the beneficiary of a life insurance policy taken out by his father several years ago. Joe's father dies, and Joe has the option of receiving the $100,000 face value of the policy in cash or receiving annual payments of $1,000 per month for the rest of his life. Joe is now 65. Joe's father paid $32,000 in premiums over the years.

a. How much must Joe include in gross income this year if he accepts the $100,000 face amount?

b. Assume Joe elects to receive the annual payments. What is his life expectancy?

c. What is his annual exclusion?

d. How much must he report as income each year?

I:4-46 ***Employee Benefits.*** Al flies for AAA Airlines. AAA provides its employees with several fringe benefits. Al and his family are allowed to fly on a space-available basis on AAA Airline. Tickets used by Al and his family during the year are worth $2,000. AAA paid for a subscription to two magazines published for pilots. The subscriptions totaled $80. The

airline paid for Al's meals and lodging while he was away from home overnight in connection with his job. Such meals and lodging cost AAA $10,000. Although Al could not eat while flying, he was allowed to drink coffee provided by the airline. The coffee was worth about $50. AAA provided Al with free parking, which is valued at $100 per month. The airline treated Al and his family to a one-week all-expenses-paid vacation at a resort near his home. This benefit was awarded because of Al's outstanding safety record. The value of the vacation was $2,300. Which of these benefits are taxable to Al?

I:4-47 ***Employee Benefits.*** Jet Corporation is involved in the purchase and rental of several large apartment complexes. Questions have been raised about the treatment of several items pertaining to Jet Corporation and its employees. Jet Corporation employs a manager for each complex. The manager is required to occupy a unit in the complex in order to be available at all hours. The average rental value of the units is $12,000 per year. The corporation's president finds that it is beneficial to the corporation if he entertains bankers and others with whom Jet does business. He does such entertaining about once each month and the corporation pays the cost. Business is discussed at the meals. The cost for the year of such entertaining was $1,500, and about one-third of the cost was attributable to meals consumed by the president.

Each year as the company closes its books, the controller and certain other members of the accounting staff must work overtime. The company pays each employee supper money totaling $25 during this period.

The corporation's vice president is expected to travel on business-related matters to visit various properties owned by the corporation. Because of the distances involved, the vice president must stay away from home several nights. Total meals and lodging incurred on the trips total $3,000, most of which is attributable to the vice president himself.

Which amounts are deductible by the corporation? Which are taxable to the employee?

I:4-48 ***Death Benefits.*** After a brief illness, Bill died. Bill's employer paid $20,000 to his widow. The corporation sent along a letter with the check indicating that $5,000 represented payment for Bill's accrued vacation days and back wages. The balance was being awarded in recognition of Bill's many years of loyal service. The company was obligated to pay the accrued vacation days and back wages, but the balance was discretionary.

a. Is the employer entitled to deduct the $20,000 paid to Bill's widow?
b. Is Bill's widow required to include the $20,000 in her gross income?

I:4-49 ***Foreign-Earned Income Exclusion.*** For each of the following cases, indicate the amount of the foreign-earned income exclusion. (Disregard the effect of exemptions for certain allowances under Sec. 912.)

a. Sam, a U.S. citizen, is an assistant to the ambassador to Spain. Sam lives and works in Spain. His salary of $90,000 is paid by the U.S. government.
b. Jim, a U.S. citizen, owns an unincorporated oil drilling company that operates in Argentina, where he resides. The business is heavily dependent on equipment owned by Jim. His profit for the year totaled $100,000.
c. Ken, a U.S. citizen, works for a large Japanese corporation. Ken is employed in the United States, but must travel to Japan several times each year. During the current year he spent sixty days in Japan. This is typical of most years. His salary is $95,000.

I:4-50 ***Foreign-Earned Income Exclusion.*** On January 5, 2019 Rita left the United States for Germany, where she had accepted an appointment as vice president of foreign operations. Her employer, USA Corporation, told her the assignment would last about two years. Rita decided not to establish a permanent residence in Germany because her assignment was for only two years. Her salary for the year is $306,300. Rita incurred travel, transportation, and other related expenses totaling $6,000, none of which are reimbursed.

a. What is Rita's foreign-earned income exclusion?
b. How much may she deduct for travel and transportation?

I:4-51 ***Discharge of Debt.*** During bankruptcy, USA Corporation debt was reduced from $780,000 to $400,000. USA Corporation's assets are valued at $500,000. USA's NOL carryover was $400,000.

a. Is USA Corporation required to report any income from the discharge of its debts?
b. Which tax attributes are reduced and by how much? Assume USA does not make any special elections when reducing its attributes.

I:4-52 ***Discharge of Debt.*** Old Corporation has suffered losses for several years, and its debts total $500,000; Old's assets are valued at only $380,000. Old's creditors agree to reduce

Old's debts by one-half in order to permit the corporation to continue to operate. Old's NOL carryover is $150,000.

a. What impact does the reduction in debt have on Old's NOL?
b. Is Old required to report any income?

I:4-53 *Court and Insurance Awards.* Determine whether the following items represent taxable income.

a. As the result of an age discrimination suit, Pat received a cash settlement of $40,000. One-half of the settlement represented wages lost by Pat as a result of the discrimination and the balance represented an award based on personal injury.
b. Matt sued the local newspaper for a story that reported he was affiliated with organized crime. The court awarded him $50,000 of libel damages.
c. Pam was injured in an automobile accident and received $10,000 from an employer-sponsored disability policy. In addition, her employer-financed medical insurance policy reimbursed her for $15,000 of medical expenses.

I:4-54 *Cafeteria Plan.* Jangyoun is a married taxpayer with a dependent 4-year-old daughter. His employer offers a cafeteria plan under which he can choose to receive cash or, alternatively, choose from certain fringe benefits. These benefits include health insurance that costs $9,000 and child care that costs $2,600. Assume Jangyoun is in the 32% tax bracket.

a. How much income tax will Jangyoun save if he chooses to participate in the employer's health insurance plan? Assume that he does not have sufficient medical expenses to itemize his deductions.
b. Would you recommend that Jangyoun participate in the employer's health insurance plan if his wife's employer already provides comparable health insurance coverage for the family?
c. Would you recommend that Jangyoun participate in the employer-provided child care option if he has the alternative option of claiming a child care credit of $480?

I:4-55 *Exclusion of Gain from Small Business Stock.* In October 2010, Jose acquired 100% of Acorn Corporation common stock by transferring property with an adjusted basis of $1,000,000 and fair market value of $4,000,000. Acorn is a qualified small business corporation. On April 1, 2019, Jose sells all of the Acorn Corporation common stock for $16,000,000.

a. What is the amount of gain that may be excluded from Jose's gross income?
b. What would your answer be if the fair market value of the Acorn stock were only $800,000 upon its issue?
c. What would your answer be if the stock were sold after two years?
d. Can Jose avoid recognizing gain by purchasing replacement stock?

COMPREHENSIVE PROBLEM

I:4-56 Pat was divorced from her husband in 2012. During the current year she received alimony of $18,000 and child support of $4,000 for her 11-year-old son, who lives with her. Her former husband had asked her to sign an agreement giving him the dependency exemption for the child but she declined to do so. After the divorce she accepted a position as a teacher in the local school district. During the current year she received a salary of $32,000. The school district paid her medical insurance premiums of $6,900 and provided her with group term life insurance coverage of $40,000. The premiums attributable to her coverage equaled $160. During her marriage, Pat's parents loaned her $8,000 to help with the down payment on her home. Her parents told her this year that they understand her financial problems and that they were cancelling the balance on the loan, which was $5,000. They did so because they wanted to help their only daughter.

Pat received dividends from National Motor Company of $4,600 and interest on State of California bonds of $2,850.

Pat had itemized deductions of $9,600. Compute her taxable income for 2019.

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:4-57 Sally owns a small C corporation that has provided health insurance coverage for Sally and the company's three other employees. The insurance coverage for Sally and the three employees is individual coverage, not family coverage. Sally's own family coverage is through

a separate private policy. She pays the premiums out of after-tax dollars. Sally's salary is $40,000 and the salary for the other three employees averages $30,000. The premiums on the health insurance policy average $5,000 per employee per year. The provider recently informed Sally that the premiums will increase to $8,000 per employee. The spouses of her two married employees have coverage through their employers. The third employee has announced that he will marry soon and would very much like to have family health insurance coverage. The insurance provider says that family coverage will approximately double the premiums. Sally is finding the cost of providing medical insurance coverage particularly burdensome for her small business. What planning suggestions can you offer?

I:4-58 Maria was planning to paint the interior of her apartment over a three-day weekend. Her employer asked her to work all three days and will pay her $600 overtime. She called a professional painter who offered to do the job for $500. He is willing to use the paint she has already purchased. Maria is in the 32% tax bracket. Will she be better off financially to work the overtime and pay the painter or to turn down the overtime and do the work herself? What other factors should she consider?

I:4-59 Ellen is a single taxpayer who is considering two job offers. Ellen considers both accounting firms to be equally desirable in terms of the opportunities for long-term career growth. But the companies have significantly different compensation and benefits packages. She has come to you for a recommendation. Below is a summary of the benefits packages offered by each firm.

In addition to salary, Mahindra and Associates (a well-established public accounting firm with several offices and high-profile clients) also offers several additional fringe benefits to its employees. In particular, Ellen believes that the high-quality health insurance coverage is an attractive benefit. In addition, she believes that she will also take advantage of the educational assistance that the firm provides, as she hopes to pursue an additional graduate degree. Below are the specifics of the compensation and benefits:

Salary	$65,000
Health insurance coverage	
Annual estimated premiums	3,700
(Employer pays 100% of premiums)	
Educational assistance:	
Maximum benefit	8,000

The other firm that Ellen is considering, Glenmark and Associates (a relatively new firm with one office that focuses on new technology companies), offers a higher salary, but their fringe benefits are not as attractive. Below are the specifics of their compensation and benefits:

Salary	$72,000
Health insurance coverage	
Annual estimated premiums	4,100
(Employer pays 70% of premiums/employee pays 30% of premiums)	
Educational assistance:	
Maximum benefit	3,500

The health insurance plans offered by Mahindra and Glenmark are similar in terms of coverage, out-of-pocket costs, etc. (In other words, the quality of coverage is the same under each plan.)

Ellen believes that her actual tuition costs for the graduate classes will be $9,500.

Determine which offer is best for Ellen to accept, assuming that she will be in the 25% marginal tax bracket.

TAX FORM/RETURN PREPARATION PROBLEMS

I:4-60 ***Short Tax Form.*** A. J. Paige, Social Security number 111-22-3333, is the vice president of marketing (Australia) for International Industries, Inc. (III). III is headquartered at 123 Main Street, Los Angeles, California 92601. A. J., who is single, accepted the position and became a resident of Australia on July 8 of last year. Her busines3s address is 242 Main, Westview, Australia. Westview is not designated as a high housing cost city. A. J.'s visa permits her to stay in Australia indefinitely. Her only trips to the United States in the current year were for vacations (August 2 to 16 and December 21 to 28). A. J.'s contract specifies that her

appointment is to last indefinitely, but states that III is to pay her $4,000 per year to cover the cost of two vacation trips to the United States. Her salary is $140,000, out of which she pays rent on an apartment of $34,000 per year. A. J. has no family or residence in the United States. She paid an income tax in Australia of $23,500. Complete a Form 2555 for 2018.

I:4-61 Alice Johnson, Social Security number 222-23-3334, is a single taxpayer and is employed as a secretary by State University of Florida. She has the following items pertaining to her income tax return for the current year:

- Received a $30,000 salary from her employer, who withheld $4,200 federal income tax.
- Received a gift of 1,000 shares of Ace Corporation stock with a $100,000 FMV from her mother. She also received $4,000 of cash dividends from the Ace Corporation. The dividends are qualified dividends.
- Received $1,000 of interest income on bonds issued by the City of Tampa.
- Received a regular stock dividend (nontaxable under Sec. 305) of 50 shares of Ace Corporation stock with a $5,000 FMV.
- Alice's employer paid $2,000 of medical and health insurance premiums on her behalf.
- Received $13,000 alimony from her ex-husband. They divorced in 2014.
- State University provided $60,000 of group term life insurance. Alice is 42 years old and is not a key employee. The table in the text is applicable.
- Received a $1,000 cash award from her employer for being designated the Secretary of the Year.
- Total itemized deductions are $10,000.

Complete Form 1040 and accompanying schedules for Alice Johnson's 2018 return.

CASE STUDY PROBLEMS

I:4-62 Able Corporation is a closely held company engaged in the manufacture and retail sales of automotive parts. Able maintains a qualified pension plan for its employees but has not offered nontaxable fringe benefits.

You are a tax consultant for the company who has been asked to prepare suggestions for the adoption of an employee fringe benefit plan. Your discussions with the client's chief financial officer reveal the following:

- Employees currently pay their own premiums for medical and health insurance.
- No group term life insurance is provided.
- The company owns a vacant building that could easily be converted to a parking garage.
- Many of the employees purchase automobile parts from the company's retail outlets and pay retail price.
- The president of the corporation would like to provide a dependent care assistance program under Sec. 129 for its employees.

Required: Prepare a client memo that recommends the adoption of an employee fringe benefit program. Your recommendations should discuss the pros and cons of different types of nontaxable fringe benefits.



I:4-63 Jay Corporation owns several automobile dealerships. This year, the corporation initiated a policy of giving the top salesperson at each dealership a free vacation trip to Florida. The president believes that this is an effective sales incentive. The cost of the vacations is deductible by the corporation as compensation paid to employees, and is taxable to the recipients. Nevertheless, the president objects to reporting the value of the vacations as income on the W-2s of the recipients and to withholding taxes from wages for the value of the trips. He feels that this undermines the effectiveness of the incentive. What are the implications of this behavior for the corporation and the president?

TAX RESEARCH PROBLEMS

I:4-64 Ann is a graduate economics student at State University. State University awarded her a $1,000 scholarship. In addition, Ann works as a half-time teaching assistant in the Economics Department at State University. She is paid $7,000 per year and her tuition is waived. The salary is equal to that paid other part-time instructors. Her tuition would

be $8,000 were it not for the waiver. Ann paid $500 for her books and supplies and she incurred living expenses of $7,400. Determine how much gross income Ann must report.

A partial list of research sources is

- Sec. 117(d)
- Prop. Reg. 1.117-6(d)(5)

I:4-65 Kim leased an office building to USA Corporation under a ten-year lease specifying that at the end of the lease USA had to return the building to its original condition if any modifications were made. USA changed the interior of the building, and at the end of the lease USA paid Kim $30,000 instead of making the required repairs. Does Kim have to include the payment in gross income?

A partial list of research sources is

- Sec. 109
- *Boston Fish Market Corp.,* 57 T.C. 884 (1972)
- *Sirbo Holdings Inc. v. CIR,* 31 AFTR 2d 73-1005, 73-1 USTC ¶9312 (2nd Cir., 1973)

I:4-66 As a result of a fire damaging their residence, the Taylors must stay in a motel for three weeks while their home is being restored. They pay $2,000 for the room and $500 for meals. Their homeowner's policy pays $2,500 to reimburse them for the cost. They estimate that during the five-week period they would normally spend $300 for meals. Is the reimbursement taxable?

A partial list of research sources is

- Sec. 123
- Reg. Sec. 1.123-1

I:4-67 Bold Corporation paid $25 to each full-time employee at year-end in recognition of the holidays. Bold Corporation is interested in whether the amounts are taxable income to its employees, and whether the company can deduct the amounts.

A partial list of research sources is

- Secs. 74(c), 102, 132(c), and 274(b)
- Reg. Sec. 1.132-6(e)(1)
- *Hallmark Cards, Inc. v. U.S.,* 9 AFTR 2d 391, 62-1 USTC ¶9162 (DC-Mo, 1961).
- Rev. Rul. 59-58, 1959-1 CB 17.

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CHAPTER

5

PROPERTY TRANSACTIONS: CAPITAL GAINS AND LOSSES



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Determine the realized gain or loss from the sale or other disposition of property
2. Determine the basis of property
3. Distinguish between capital assets and other assets
4. Understand how capital gains are taxed for noncorporate taxpayers
5. Understand how capital gains are taxed for corporate taxpayers
6. Recognize when a sale or exchange has occurred
7. Determine the holding period for an asset when a sale or disposition occurs
8. Describe tax planning opportunities for property transactions
9. Describe compliance and procedural considerations for property transactions

CHAPTER OUTLINE

Determination of Gain or Loss...5-3
Basis Considerations...5-5
Definition of a Capital Asset...5-13
Tax Treatment for Capital Gains and Losses of Noncorporate Taxpayers...5-16
Tax Treatment of Capital Gains and Losses: Corporate Taxpayers...5-22
Sale or Exchange...5-22
Holding Period...5-29
Tax Planning Considerations...5-32
Compliance and Procedural Considerations...5-33

Gross income includes "gains derived from dealings in property,"[1] and certain "losses from sale or exchange of property"[2] are allowed as deductions from gross income to determine adjusted gross income. All recognized gains and losses must eventually be classified either as *capital* or *ordinary*. Except for a brief time in the mid-to-late 1980s, long-term capital gains (LTCGs) of individual taxpayers have consistently been taxed at lower rates than ordinary gains or short-term capital gains (STCGs).[3] This preferential treatment of capital gains, more precisely LTCGs, has been a much debated topic for many years. A discussion of the reasoning for imposing lower tax rates on LTCGs is provided near the end of this chapter.

The preferential treatment of capital gains has fluctuated widely over the years. For example, in the early 1980s, taxpayers were allowed to deduct 60% of the gain. In 1991, net capital gains were taxed at a maximum rate of 28%, then reduced to 20% for most taxpayers in 1997. Congress started applying different rates to different types of LTCG in 2001, i.e., an LTCG due to the sale of a collectible has a maximum rate of 28% while an LTCG due to the sale of stock has a maximum rate of 15% or 20%. Thus, depending on the political persuasion of the government, tax rates on net capital gains have yo-yoed up and down. A significant change in the rates for adjusted net capital gains occurred in 2003 when the rates were reduced from 20% to 15% for most taxpayers (5% for lower income taxpayers). For tax years beginning after 2007, the rate is zero instead of 5%.[4] With the maximum ordinary tax rate for individuals being 37% today, individuals can benefit by having a gain classified as LTCG rather than as ordinary gain or STCG. Thus, much planning is performed to attempt to arrange one's affairs to take advantage of the lower capital gain rates.

HISTORICAL NOTE

A preferential tax rate on capital gains was included in the tax law from 1921 until 1987. A modest preferential rate was reintroduced in 1991, with capital gains for noncorporate taxpayers being subject to a maximum 28% tax rate and ordinary income being subject to a maximum tax rate of 31%. The rates were reduced in 1997 and reduced again in 2003.

As explained later, LTCG may be subject to one of five different rates [0%, 15%, 20%, 25%, or 28%] depending on what type of asset is sold and the taxpayer's regular tax rate.

Capital losses must be offset against capital gains, and net capital losses are subjected to restrictions on their deductibility. Thus, most taxpayers prefer to have losses classified as ordinary instead of capital.

ADDITIONAL COMMENT

For a discussion of the justification of preferential tax rates for LTCGs (see page I:5-30).

Most property transactions have tax consequences to the taxpayer. For example, when a sale, exchange, or abandonment occurs, the taxpayer must determine the realized gain or loss, the portion of the realized gain or loss that must be recognized (if any), and the character of the gain or loss. This chapter focuses on determining the realized gain or loss and the portion of the recognized gain or loss classified as capital or ordinary. When classifying a recognized gain or loss (i.e., the gain or loss actually reported on the taxpayer's tax return), three important questions must be considered:

ADDITIONAL COMMENT

During 2010, many taxpayers sold capital assets to recognize LTCG taxed at 15% because the rates were expected to increase to 20% or even higher.

- ▶ What type of property has been sold or exchanged?
- ▶ When has a sale or exchange occurred?
- ▶ What is the holding period for the property?

In this chapter, these three questions are considered as well as difficulties associated with determining the basis of the property sold or exchanged and the amount of realized gains or losses.

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[1] Sec. 61(a)(3).
[2] Sec. 62(a)(3).
[3] See page I:5-29 and below for a discussion of the holding period for capital assets. A capital gain or loss is long-term or short-term depending on the length of time the asset has been held by the taxpayer.
[4] Sec. 1(h)(1)(B).

DETERMINATION OF GAIN OR LOSS

OBJECTIVE 1

Determine the realized gain or loss from the sale or other disposition of property

REALIZED GAIN OR LOSS

To determine the **realized gain or loss**, the amount realized from the sale or exchange of property is compared with the adjusted basis of that property. A gain is realized when the amount realized is greater than the basis, and a loss is realized when the amount realized is less than the basis of the property.[5]

EXAMPLE I:5-1 ▶ Jack sells an asset with an adjusted basis of $10,000 to Judy for $14,000. Because the amount realized is greater than the basis, Jack has a realized gain of $4,000 ($14,000 – $10,000). ◀

Despite the fact that most transfers of property involve a sale, gains and losses may also be realized on certain other types of dispositions of property, such as exchanges, condemnations, casualties, thefts, bond retirements, and corporate distributions. However, gains and losses are generally not realized when property is disposed of by gift or bequest.

EXAMPLE I:5-2 ▶ Alice owns land held for investment with a basis of $20,000. The land is taken by the city by right of eminent domain, and she receives a payment of $30,000 for the land. This condemnation is treated as a sale or disposition for income tax purposes, and Alice's realized gain is $10,000 ($30,000 – $20,000). ◀

EXAMPLE I:5-3 ▶ Two years ago, Bob purchased stock of a newly formed corporation for $10,000. During the current year, he receives a $12,000 distribution, constituting a return of capital, from the corporation. This distribution is treated as a sale. Therefore, Bob has a realized gain of $2,000 ($12,000 – $10,000). Bob's basis for the stock is now zero because his basis of $10,000 has been recovered. ◀

There must be an identifiable event for a sale or other disposition to occur. Mere changes in the value of property are not normally recognized as a disposition for purposes of determining a realized gain or loss.

STUDY AID

Students should pay close attention to the technical terms used in tax law. For example, the similar sounding terms of "realized gain" and "recognized gain" are often different dollar amounts for the sale of an asset.

Many reasons exist for not taxing unrealized gains and losses that arise due to a mere change in value. The Treasury Regulations state that "A loss is not ordinarily sustained prior to the sale or other disposition of the property, for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup the adjusted basis of the property."[6] Because of administrative difficulties associated with determining fair market value (FMV), disputes with the Internal Revenue Service (IRS) would be greatly increased if unrealized gains were taxed and unrealized losses were allowed as deductions. In addition, payment of tax on income is generally required only when a taxpayer has the wherewithal to pay the tax (e.g., the taxpayer has received cash from the sale or other disposition of property and can therefore pay the tax on the gain).

Amount Realized. The **amount realized** from a sale or other disposition of property is the sum of any money received, the FMV of all other property received, and any debt assumed by the buyer.

EXAMPLE I:5-4 ▶ Tony sells land to Rita for $15,000 in cash and a machine having a $3,000 FMV. Tony's amount realized is $18,000 ($15,000 + $3,000). ◀

[5] Sec. 1001(a).

[6] Reg. Sec. 1.1001-1(c)(1).

The determination of FMV is a question of fact and often creates considerable controversy between taxpayers and the IRS. **Fair market value (FMV)** is "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell."[7] The FMV of the asset given in the exchange may be easier to determine than the FMV of the property received. In those cases, the FMV of the property given may be used to measure the amount realized. If a buyer assumes the seller's liability or takes the property subject to the debt, the courts have included the amount of the liability when determining the amount realized.[8]

EXAMPLE I:5-5 ▶ Anna exchanges land subject to a liability of $20,000 for $35,000 of stock owned by Mario. Mario takes the property subject to the liability. The amount realized by Anna is $55,000 ($35,000 + $20,000 liability assumed by Mario). If Anna's adjusted basis for the land exchanged is $42,000, her realized gain is $13,000 ($55,000 − $42,000). ◀

In the above example, Anna receives stock with a $35,000 FMV and is relieved of a $20,000 debt. Mario's taking the property subject to the debt is equivalent to providing Anna with cash of $20,000. Thus, the amount realized by Anna is $55,000.

Generally, selling expenses such as sales commissions and advertising incurred in order to sell or dispose of the property reduce the amount realized.

EXAMPLE I:5-6 ▶ Doug sells stock of Briggs Corporation, with a basis of $10,000, for $17,000. Doug pays a sales commission of $300. The amount realized by Doug is $16,700 ($17,000 − $300), and his realized gain is $6,700 ($16,700 − $10,000). ◀

TYPICAL MISCONCEPTION

The difference between the assumption of a liability and the taking of the property subject to the debt is sometimes confusing. The latter means that the lender can satisfy the debt only by repossessing the property. In the former case, where the buyer assumes the debt, the lender can satisfy the debt by repossessing the property and by going after other assets of the buyer.

Adjusted Basis. The initial basis of property depends on how the property is acquired (e.g., by purchase, gift, or inheritance). Most property is acquired by purchase and therefore its initial basis is the cost of the property. However, if property is acquired from a decedent, its basis to the estate or heir is its FMV either at the date of death or, if the alternate valuation date is elected, six months from the date of death. The rules for determining the adjusted basis are discussed in subsequent sections of this chapter. Once the initial basis is determined, it may be adjusted upward or downward. Capital additions (also called capital expenditures) are expenditures that add to the value or prolong the life of property or adapt the property to a new or different use. Capital additions increase the basis. Capital recoveries, such as the deductions for casualty losses, cost recovery, and depreciation, reduce the basis. A property's adjusted basis can be determined by the following equation:

Initial basis
+ Capital additions (e.g., new porch for a building)
− Capital recoveries (e.g., depreciation deduction)
= Adjusted basis



ETHICAL POINT

The taxpayer may have lost records relating to the basis of the assets acquired many years earlier. In that case, the CPA can accept estimates of the missing data made by the taxpayer.

Capital expenditures are distinguished from expenditures that are deductible as ordinary and necessary business expenses. For example, the cost of repairing a roof may be a deductible expense, whereas the cost of replacing a roof is a capital addition. It is sometimes difficult to determine whether an item is a capital expenditure or a business expense. Because of the preference for an immediate tax deduction, taxpayers normally prefer to classify expenditures as expenses rather than capital expenditures.

EXAMPLE I:5-7 ▶ Ellen pays $2,500 for a major overhaul of an automobile used in her trade or business. The $2,500 is capitalized as part of the automobile's cost rather than deducted as a repair expense. ◀

Capital recoveries reduce the adjusted basis. The most common form of capital recovery is the deduction for depreciation or cost recovery. As discussed in Chapter I:10, the

[7] *CIR v. Homer H. Marshman*, 5 AFTR 2d 1528, 60-2 USTC ¶9484 (6th Cir., 1960).

[8] *Beulah B. Crane v. CIR*, 35 AFTR 776, 47-1 USTC ¶9217 (USSC, 1947).

modified accelerated cost recovery system (MACRS) is mandatory for most tangible depreciable property placed in service after 1986, although "100% expensing" is available for many assets placed in service after September 27, 2017 and before January 1, 2024. The accelerated cost recovery system (ACRS) applies to most property placed in service after December 31, 1980, and before 1987.

EXAMPLE I:5-8 ▶ Jeremy paid $100,000 for equipment two years ago and has claimed depreciation deductions of $37,000 for the two years. The cost of repairs during the same period was $6,000. At the end of the two-year period, the property's adjusted basis is $63,000 ($100,000 − $37,000). The amount spent for repairs does not affect the basis. ◀

ADDITIONAL COMMENT

In addition to depreciation, other capital recoveries that reduce the adjusted basis of property include depletion, amortization, corporate distributions that are a return of basis, compensation or awards for involuntary conversions, deductible casualty losses, insurance reimbursements, and cash rebates received by a purchaser.

Recovery of Basis Doctrine. The **recovery of basis doctrine** states that taxpayers are allowed to recover the basis of an asset without being taxed because such amounts are a return of capital that the taxpayer has invested in the property. If a taxpayer receives a $12,000 return of capital distribution from a corporation when the taxpayer's basis for its investment in the corporation's stock is $10,000, the first $10,000 received represents a recovery of basis and the $2,000 excess amount is treated as a gain realized on a sale or exchange of the stock investment. In many cases, basis is recovered in the form of a deduction for depreciation, cost recovery, or a casualty loss.

RECOGNIZED GAIN OR LOSS

TYPICAL MISCONCEPTION

It is sometimes incorrectly believed that all realized gains and losses are recognized for tax purposes. Although most realized gains are recognized, some realized losses are not. For example, losses on the sale or exchange of property held for personal use are not recognized.

Realized gain or loss represents the difference between the amount realized and the adjusted basis when a sale or exchange occurs. The amount of gain or loss actually reported on the tax return is the **recognized gain or loss**. In some instances, gain or loss is not recognized due to special provisions in the tax law (e.g., a gain or loss may be deferred or a loss may be disallowed).

Losses are generally deductible if they are incurred in carrying on a trade or business, incurred in an activity engaged in for profit, and casualty and theft losses. Realized losses on the sale or exchange of assets held for personal use are not recognized for tax purposes. Therefore, a taxpayer who incurs a loss on the sale or exchange of a personal-use asset does not fully recover the basis. As explained in Chapter I:9, realized losses on personal-use assets may be recognized to some extent if the property is disposed of by casualty or theft.

EXAMPLE I:5-9 ▶ Ralph purchases a personal residence for $60,000. Deductions for depreciation are not allowed because the asset is not used in a trade or business or held for the production of income. If Ralph sells the house for $55,000, the realized loss of $5,000 is a capital loss but not deductible. He recovers only $55,000 of his original $60,000 basis. ◀

BASIS CONSIDERATIONS

OBJECTIVE 2

Determine the basis of property

COST OF ACQUIRED PROPERTY

In most cases, the basis of property is its cost. **Cost** is the amount paid for the property in cash or the FMV of other property given in the exchange. Any costs of acquiring the property and preparing the property for use are included in the cost of the property.

EXAMPLE I:5-10 ▶ Penny purchases equipment for $15,000, pays delivery costs of $300, and installation costs of $250. The cost of the equipment is $15,550. ◀

Funds borrowed and used to pay for an asset are included in the cost. Obligations of the seller that are assumed by the buyer increase the asset's cost.

EXAMPLE I:5-11 ▶ Peggy purchases an asset by paying cash of $40,000 and signs a note payable to the seller for $60,000. She also assumes a $2,000 lien against the property. Her basis for the asset is $102,000 and the amount realized by the seller is $102,000. ◀

Uniform Capitalization Rules. For financial accounting purposes, businesses must capitalize certain costs in connection with inventory, such as direct materials, direct labor, and overhead. For many years, businesses had a degree of flexibility with respect to capitalizing or expensing certain costs for tax purposes. However, the tax law now mandates one set of capitalization rules applicable to all taxpayers and all types of activities. These uniform capitalization rules, which apply principally to inventory, are provided in Sec. 263A and discussed in Chapter I:11.

ADDITIONAL COMMENT

The sales tax is a good example of a tax that would be paid in connection with the acquisition of property.

The uniform capitalization rules also affect property other than inventory if the property is used in a taxpayer's trade or business or in an activity engaged in for profit. Taxes paid or accrued in connection with the acquisition of property are included as part of the cost of the acquired property. Taxes paid or accrued in connection with the disposition of property reduce the amount realized on the disposition.[9]

EXAMPLE I:5-12 ▶ The Compact Corporation owns and operates a funeral home. The corporation purchases a hearse for $90,000 and pays sales taxes of $8,600. The cost basis for the hearse is $98,600. ◀

Capitalization of Interest. Interest on debt paid or incurred during the production period to finance production expenditures incurred to construct, build, install, manufacture, develop, or improve real or tangible personal property must be capitalized.[10] The real or tangible personal property must have "a long useful life, an estimated production period exceeding two years, or an estimated production period exceeding one year and a cost exceeding $1,000,000."[11] Property has a long useful life if it is real property or property with a class life of at least 20 years. The production period starts when "production of the property begins and ends when the property is ready to be placed in service or is ready to be held for sale."[12]

EXAMPLE I:5-13 ▶ The Indiana Corporation started construction of an $8 million motel on July 1, 2018, and borrowed an amount equal to the motel's construction costs. The motel is completed and ready for service on October 1, 2019. Interest incurred for the construction loan for the period from July 1, 2018, through October 1, 2019, is included in the motel's cost. The capitalized interest cost is depreciated over the motel's thirty-nine year recovery period (see Chapter I:10). ◀

ADDITIONAL COMMENT

If a stockholder leaves his or her stock with a broker in street name, the stockholder can specifically identify the shares sold by simply informing the broker which shares he or she wishes to sell. The date basis of the shares sold should appear on the confirmation from the broker.

Identification Problems. In most cases, the adjusted basis of property sold is easily identified. However, problems arise when property is homogenous in nature such as when an investor owns several blocks of common stock of the same corporation purchased on different dates at different prices. The Regulations require the taxpayer to adequately identify the particular stock sold or exchanged.[13] Many investors allow brokers to hold their stock in street name (i.e., the brokerage firm holds title to the stock certificates) and thus do not make a physical transfer of securities. Such investors need to provide specific instructions to the broker as to which securities should be sold. If the stock sold or exchanged is not adequately identified, the first-in, first-out (FIFO) method must be used to identify the stock. With the FIFO method, the stock sold or exchanged is presumed to come from the first lot or lots acquired.

EXAMPLE I:5-14 ▶ Judy purchased 300 shares of the Gustavel Corporation stock last year:

Month Acquired	*Size of Block*	*Basis*
January	100 shares	$4,000
May	100	5,000
October	100	6,000

In March of the current year, Judy sells 120 shares of the stock for $5,160. If Judy specifically identifies the stock sold as being all of the stock purchased in October and 20 shares purchased in May, her realized loss is $1,840 [$5,160 − ($6,000 + $1,000)]. ◀

ADDITIONAL COMMENT

It appeared that Congress was going to disallow the use of the specific identification method and require use of only FIFO, but the change was not included in the final version of the Tax Cuts and Jobs Act. The change was viewed as being a source of revenue for the government.

[9] Sec. 164(a).
[10] Sec. 263A(f).
[11] Sec. 263A(f)(1)(B).
[12] Sec. 263A(f)(4)(B).
[13] Reg. Sec. 1.1012-1(c)(1).

If Judy does not specifically identify the stock sold, the FIFO method is used, and her realized gain is $160 [$5,160 − ($4,000 + $1,000)].

Owners of shares of mutual funds have more choices when determining the basis of shares sold. In addition to FIFO and specific identification, they may use an average cost method.[14]

EXAMPLE I:5-15 ▶ Colin purchased 100 shares of Bluejay Mutual Fund on May 10, 2017, for $1,000, and has been reinvesting dividends. On December 20, 2018, he sells 115 shares.

ADDITIONAL COMMENT

Because of the difficulty and complexity of tracking basis of shares in a mutual fund, the average cost method is widely used by taxpayers.

	Amount	*No. of Shares*
Purchase May 10, 2017	$1,000	100
Reinvested Dividend Nov. 1, 2017	125	10
Reinvested Dividends Nov. 1, 2018	140	7
Reinvested Dividends Nov. 1, 2019	185	8
	1,450	125
		$11.60 Average Cost

His basis for the 115 shares sold is $1,225 with FIFO, $1,334 (115 × $11.60) with average cost and could be as high as $1,350 with specific identification. Note that if he sells the shares obtained with the reinvested dividends in 2019, part of the gain or loss is short-term. ◀

PROPERTY RECEIVED AS A GIFT: GIFTS AFTER 1921

The basis of property received as a gift is generally the same as the donor's basis.[15] If the FMV of the property at time of the gift is less than the donor's basis, the donee may have to use one basis if the property is subsequently disposed of at a gain and another if the property is disposed of at a loss. As discussed later in this chapter, the basis may be increased by a portion or all of the gift tax paid because of the transfer.

ADDITIONAL COMMENT

Upon receipt of property from a relative, one should inquire as to its basis at that time. It might be years later that the asset is sold and the information about the donor's basis may be lost or forgotten.

Current rules for determining the donee's basis for property received as a gift are a function of the relationship between the FMV of the property at the time the gift is made and the donor's basis. If the FMV is equal to or greater than the donor's basis, the donee's basis is the same as the donor's basis for all purposes. However, if the FMV is less than the donor's basis, the donee has a dual basis for the property, that is, a basis for loss and a basis for gain. If the donee later transfers the property at a loss, the donee's basis is the property's FMV at the time of the gift (basis for loss). However, if the donee transfers the property at a gain, the donee's basis is the same as the donor's basis (basis for gain).

EXAMPLE I:5-16 ▶ Kevin makes a gift of property held for investment with a basis of $350 to Janet when it has a $425 FMV. If Janet sells the property for $450, she has a realized gain of $100 ($450 − $350). If Janet sells the property for $330, she has a realized loss of $20 ($330 − $350). Because the FMV of the property at the time of the gift is more than the donor's basis, the donee's basis is $350 for determining both gain and loss. ◀

The following example illustrates the scenario when a taxpayer has a dual basis. The property is received as a gift when the FMV is less than the donor's basis, so the basis for determining a gain is different from the basis for determining a loss.

EXAMPLE I:5-17 ▶ Chuck makes a gift of property held for investment with a basis of $600 to Maggie when the property has a $500 FMV. Maggie's basis for the property is $600 if the property is sold at a gain (i.e., for more than $600), but the basis is $500 if the property is sold at a loss (i.e., for less than $500). If the property is sold for $500 or more but not more than $600, no gain or loss is recognized. ◀

The dual basis rules were designed to prevent tax-avoidance schemes. Taxpayers are prevented from shifting unrealized losses to another taxpayer by making gifts of such "loss" property. For example, a low-income taxpayer who owns property that has depreciated in value might transfer the property by gift to a high-income taxpayer who would receive greater tax benefit from the deduction of the loss upon the subsequent sale of the

[14] For mutual fund investors, the IRS has authorized the use of FIFO, specific identification, or two average cost basis methods if only a portion of the fund shares is redeemed or sold. (See Reg. Sec. 1.1012-1(e) and Chapter I:17.)

[15] Sec. 1015(a).

ADDITIONAL COMMENT

If Maggie in Example I:5-17 sells the land for $750, she has a $150 gain. If she sells the land for $400, she has a $100 loss, and there is no gain or loss if she sells the land for $560.

TAX STRATEGY TIP

Donors generally should not make gifts of property that have declined in value below original cost. Since the donee's basis will be the property's FMV, the loss will never be recognized.

KEY POINT

No gift tax can be added to the basis of the property if the donor's basis is greater than the FMV of the property.

property. The loss basis rules prevent the donee from recognizing a loss on the sale of the property because the basis for loss is the lesser of the donor's basis or FMV on the date of the gift.

Effect of Gift Tax on Basis. If the donor pays a gift tax on the transfer of property, the donee's basis may be increased. This increase occurs only if the FMV of the property exceeds the donor's basis on the date of the gift. For taxable gifts after 1976, the increase in the donee's basis is equal to a pro rata portion of the gift tax attributable to the unrealized appreciation in the property. The amount of the addition to the donee's basis is determined as follows:[16]

$$\text{Gift tax paid} \times \frac{\text{FMV at time of the gift} - \text{Donor's basis}}{\text{Amount of the gift}}$$

The amount of the gift is the FMV of the property less the amount of the annual exclusion which is $15,000 in 2019.[17]

EXAMPLE I:5-18 ▶ During the current year, Cindy makes one gift of property with a $25,000 basis to Jessie when the property has a $65,000 FMV. Cindy pays a gift tax of $18,500. The amount of the gift is $50,000 ($65,000 − $15,000). Thus, 80% [($65,000 − $25,000)/$50,000] of the gift tax is added to Jessie's basis. Jessie's basis for the property for determining both gain and loss is $39,800 [$25,000 + (0.80 × $18,500)]. ◀

EXAMPLE I:5-19 ▶ During the current year, Sally makes a gift of property with a basis of $50,000 to Troy when the property has a $40,000 FMV. Sally pays a gift tax of $9,000. Troy's basis for the property is not affected by the gift tax paid by Sally because the FMV is less than the donor's basis at the time of the gift. Troy's basis for the property is $50,000 to determine gain and $40,000 to determine loss. ◀

STOP & THINK

Question: Pete wants to make a gift of either ABC common stock (basis of $44,000 and FMV of $50,000) or XYZ common stock (basis of $73,000 and FMV of $50,000) to his nephew. Pete and his nephew have the same tax rate. Which stock should he give to his nephew?

Solution: Pete should give the ABC stock to his nephew because the nephew's basis for determining a gain or loss is $44,000 plus a portion of any gift tax Pete pays. The nephew's basis for XYZ common stock is $50,000 to determine a loss and $73,000 to determine a gain. If the nephew sells XYZ stock for less than $73,000, no loss is recognized and thus some of the basis is not used. Note that Pete would have a $23,000 loss if he sells the XYZ stock for $50,000. Furthermore, the nephew's basis for the XYZ stock is not increased if Pete has to pay a gift tax on the $35,000 taxable gift ($50,000 − $15,000).

PROPERTY RECEIVED FROM A DECEDENT

The basis of property received from a decedent who died in a year other than 2010 is the FMV of the property at the date of the decedent's death or an alternate valuation date (AVD).[18] This provision can result in either a step up (increase) or step down (decrease) in basis, but it is frequently described as the stepped-up basis rule. For decedents dying in 2010, the estate tax was repealed (see the discussion of Carryover Basis Rules below).

EXAMPLE I:5-20 ▶ Patrick inherited property having an $8 million FMV on the date of his sister's death in 2019. The decedent's basis in the property is $3.6 million. The executor of the estate does not elect the AVD. Patrick's basis for the property is $8 million. ◀

EXAMPLE I:5-21 ▶ Dianna inherited property having an $8 million FMV at the date of the decedent's death in 2019. The decedent's basis in the property is $9.2 million. The AVD is not elected. Dianna's basis for the property is $8 million. ◀

[16] Sec. 1015(d)(6).

[17] Sec. 1015(d)(2) and Sec. 2503(b). The annual exclusion allowed for each donee was increased from $14,000 to $15,000 in 2018. See Chapter I:1 for a limited discussion of the annual exclusion and Chapter C:12 of the *Corporations, Partnerships, Estates & Trusts* and *Comprehensive* volumes for a more detailed discussion.

[18] Sec. 1014(a).

REAL-WORLD EXAMPLE

The alternate valuation date was used in valuing the estates of many individuals owning large portfolios of common stocks who died shortly before the stock market crash in October 1987.

Instead of using the FMV on the date of death to determine the estate tax, the executor of the estate may elect to use the FMV on the AVD. The AVD is generally six months after the date of death. If the AVD is elected, the basis for all of the assets in the estate is their FMV on that date unless the property is distributed by the estate to the heirs or is sold before the AVD. If the AVD is used, property distributed or sold after the date of the decedent's death and before the AVD has a basis equal to its FMV on the date of distribution or the date of disposal.[19]

If the estate is small enough that an estate tax return is not required, the value of the property on the AVD may not be used.[20] An estate tax return must be filed if an individual dies in 2019 and the gross estate plus any previous taxable gifts exceeds $11.4 million.

EXAMPLE I:5-22 ▶ Marilyn inherited all of the property owned by an individual who died in April 2019, when the property had a $100,000 FMV. The value of the property six months later was $90,000. Because of the size of the estate, no estate tax was due. The AVD may not be used, and Marilyn's basis for the property is $100,000. Note that Marilyn does not want the AVD to be used because her basis would be $90,000 instead of $100,000. ◀

As noted above, the basis of the property to the estate and the heirs can be affected if the AVD is used to value the estate's assets. The AVD may be elected only if the value of the gross estate and the amount of estate tax after credits are reduced as a result of using the AVD.[21] This means that the aggregate value of the assets determined by using the AVD may be used only if the total value of the assets decreased during the six-month period.

EXAMPLE I:5-23 ▶ Helmut inherited all of the property owned by an individual who died in March 2019 when the FMV of the property was $5.8 million. Six months after the date of death, the property had a $5.95 million FMV. The property is distributed to Helmut in December. Use of the AVD is not permitted because the value of the gross estate has increased. Therefore, his basis in the property is $5.8 million, the FMV on the date of death. ◀

An executor may elect to use the AVD to reduce the estate taxes owed by the estate. However, the income tax basis of the property included in the estate is also reduced for heirs who inherit the property.

EXAMPLE I:5-24 ▶ Michelle inherited property with a $6.2 million FMV at the date of the decedent's death in 2019. The FMV of the property on the AVD (six months after the date of the decedent's death) is $5.74 million. The executor of the estate elects to use $5.74 million to value the property for estate tax purposes, and Michelle's basis for the property is thus $5.74 million instead of $6.2 million. ◀

Carryover Basis Rules-Special Rule for 2010. In 2001, Congress eliminated the estate tax for individuals dying in 2010; however, the estate tax was scheduled to return in 2011 and be higher than the estate tax in 2009. Most tax professionals did not expect the estate tax to actually be repealed for the year 2010, but Congress did not take action to reinstate the estate tax retroactively until December of 2010. Congress reinstated the estate tax for 2010 and future years, but estates of individuals dying in 2010 may elect to use the provisions in effect for 2010 and not have the estate tax apply.

ADDITIONAL COMMENT

At least five billionaires, including George Steinbrenner of the New York Yankees, died in 2010, and their estates were probably not subject to the estate tax.

The existence of the estate tax has implications for the basis of property transferred to others when one dies. For 2010, a modified carryover basis rule applies if the estate elects to not have the estate tax apply. A taxpayer who inherits the property will take the lesser of the decedent's basis or FMV at time of death, but the basis may be increased if the asset is appreciated. The basis may not be increased to more than the FMV, and the total amount of increase is limited to $1.3 million plus any unused built-in loss or NOL carryover. A surviving spouse may receive an additional $3 million adjustment.

If Patrick's sister in Example 5-20 died in 2010, an estate tax is due unless the estate elected to have the estate tax not apply. Because the exemption equivalent in 2010 was $5 million or less, the estate would probably have elected to pay no estate tax. If so, Patrick's basis is $4.9 million ($3,600,000 + $1,300,000). Patrick's basis is $7.9 million if the decedent was his spouse ($3,600,000 + $1,300,000 + $3,000,000). If the election is not made and the estate tax applies, Patrick's basis is the $8,000,000 FMV.

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[19] Sec. 2032(a).

[20] Rev. Rul. 56-60, 1956-1 C.B. 443. For a decedent dying in 2011 and 2012, Sec. 6018(a) requires an estate tax return to be filed if the gross estate exceeds $5 million ($3.5 million in 2009, $2 million in 2006–2008 and $1.5 million for decedents dying in 2004 or 2005).

[21] Credits available include the unified transfer tax credit and possibly credits for gift taxes, foreign death taxes, and the credit for taxes on prior transfers.

Dianna's basis in Example 5-21 is $8 million even if the death occurred in 2010. The estate would elect to have the estate tax not apply and avoid any estate tax liability, but the basis is the same under the stepped-up basis rules and the carryover basis rules because the decedent's basis in the property is greater than its FMV.

Community Property. If the decedent and the decedent's spouse own property under community property laws,[22] one-half of the property is included in the decedent's gross estate and its basis to the surviving spouse is its FMV.[23] The surviving spouse's one-half share of the community property is also adjusted to FMV.[24] In effect, the surviving spouse's share of the community property is considered to have passed from the decedent.

EXAMPLE I:5-25 ▶ Matt and Jane, a married couple, live in Texas, a community property state, and jointly own land as community property that cost $110,000. The land has an $800,000 FMV when Jane dies, leaving all of her property to Matt. His basis for the entire property is $800,000. ◀

In a common law state, one-half of the jointly owned property is included in the decedent's estate and is adjusted to its FMV. The survivor's share of the jointly held property is not adjusted.

EXAMPLE I:5-26 ▶ Barry and Maria, a married couple, live in Iowa, a common law state, and jointly own land that cost $200,000. The property has a $700,000 FMV when Barry dies, leaving all of his property to Maria. Her basis for the land is $450,000 [$100,000 + (0.50 × $700,000)]. ◀

PROPERTY CONVERTED FROM PERSONAL USE TO BUSINESS USE

ADDITIONAL COMMENT

It is important to estimate the FMV of property at the time the property is converted from personal use to business use.

Often, taxpayers who own personal-use assets convert these assets to an income-producing use or for use in a trade or business. When this conversion occurs, the property's basis must be determined. The basis for computing depreciation is the lower of FMV or the adjusted basis of the property when the asset is transferred from personal use to an income-producing use or for use in a trade or business.[25] This rule prevents taxpayers from obtaining the benefits of depreciation to the extent that the property has declined in value during the period that it is held for personal use.

EXAMPLE I:5-27 ▶ Olga owns a boat that cost $2,000 and is used for personal enjoyment. At a time when the boat has a $1,400 FMV, Olga transfers the boat to her business of operating a marina. The basis for depreciation is $1,400 because the FMV is less than Olga's adjusted basis at the time of conversion to business use. The $600 decline ($2,000 – $1,400) that occurred while Olga used the boat for personal use may not be deducted as depreciation. ◀

REAL-WORLD EXAMPLE

A taxpayer sold a personal residence to a purchaser, and the purchaser rented the property from the taxpayer until financing could be secured. The rental agreement was executed simultaneously with the sales agreement and was incidental to the sale. The taxpayer was not permitted to recognize any loss on the sale because the property was never converted to rental property. *Henry B. Dawson,* 1972 PH T.C. Memo 31 TCM 5.

If the boat's FMV in Example I:5-27 is more than $2,000, the basis for depreciation is $2,000 because the FMV is higher than its adjusted basis at the time the asset is transferred to business use.

If a personal-use asset is transferred to business use when its FMV is less than its adjusted basis, the basis for determining a loss on a subsequent sale or disposition of the property is its FMV on the date of the conversion to business use less any depreciation taken after the transfer to business use.[26]

EXAMPLE I:5-28 ▶ Susanna purchased a personal residence in 2005 for $100,000 and converted the property to rental property in 2009 when its FMV was $96,000. Assume depreciation of $20,700 has been deducted after the conversion in 2009, and the property is sold for $71,000. The basis of the property is $75,300 ($96,000 – $20,700), and her loss on the sale is $4,300 ($71,000 – $75,300). ◀

The rule for determining basis, that is, lower of adjusted basis or FMV, applies only to the sale of converted property at a loss. The basis for determining gain is its adjusted basis when converted less depreciation taken after the transfer to business use.

EXAMPLE I:5-29 ▶ Assume the same facts as in Example I:5-28, except the property is sold for $81,000 instead of $71,000. The basis of the property is $79,300 ($100,000 – $20,700) and her gain is $1,700 ($81,000 – $79,300). ◀

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[22] Community property states are Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, and Washington. Wisconsin has a marital property law that is basically the same as community property.

[23] Sec. 1014(a).

[24] Sec. 1014(b)(6).

[25] Reg. Sec. 1.167(g)-1.

[26] Reg. Sec. 1.165-9(b)(2).

Without the rule for determining basis of personal-use property converted to business property, taxpayers would have an incentive to convert nonbusiness assets that have declined in value to business use before selling the asset to convert nondeductible losses into deductible losses.

EXAMPLE I:5-30 ▶ Craig owns a personal-use asset with a basis of $80,000 and a $50,000 FMV. If he sells the asset for its FMV, the $30,000 loss ($50,000 − $80,000) is not deductible because losses on the sale of personal-use assets are not deductible. If Craig converts the asset to business use and then immediately sells the asset for $50,000, no loss is realized because the basis of the asset for purposes of determining loss is $50,000, the FMV when property was converted. ◀

REAL-WORLD EXAMPLE

A taxpayer purchased a group of lots and allocated the total cost evenly among the lots. The court, however, held that more cost should be allocated to the waterfront lots than to the interior lots. *Biscayne Bay Islands Co.*, 23 B.T.A. 731 (1931).

ALLOCATION OF BASIS

When property is obtained in one transaction and portions of the property are subsequently disposed of at different times, the basis of the property is allocated to the different portions of the property. Gain or loss is computed at the time of disposal for each portion. If a taxpayer purchases a 20-acre tract of land and later sells the entire tract, an allocation of basis is not needed. However, if the taxpayer divides the property into smaller tracts of land for resale, the cost of the 20-acre tract must be allocated among the smaller tracts of land.

Basket Purchase. If more than one asset is acquired in a single purchase transaction (i.e., a basket purchase), the cost must be apportioned to the various assets acquired. The allocation is based on the relative FMVs of the assets.

EXAMPLE I:5-31 ▶ Kelly purchases a duplex for $400,000 to use as a rental property. The land has a $75,000 FMV, and the building has a $325,000 FMV. Kelly's bases for the land and the building are $75,000 and $325,000, respectively. ◀

SELF-STUDY QUESTION

If Kelly in Example I:5-31 paid $2,000 for the cost of a title search and other costs that must be capitalized, what is the basis of the land and building?

ANSWER

Land $75,375
Building $326,625

Because no depreciation deduction is allowed for land, taxpayers tend to favor a liberal allocation of the total purchase price to the building. Appraisals or other measures of FMV may be used to make the allocation.

Common Costs. As in the case of financial accounting, common costs incurred to obtain or prepare an asset for service must be capitalized and allocated to the basis of the individual assets.

EXAMPLE I:5-32 ▶ Priscilla acquires three machines for $60,000, which have FMVs of $30,000, $20,000, and $10,000, respectively. Costs of delivery amount to $2,000, and costs to install the three machines amount to $1,000. The total installation and delivery costs of $3,000 are allocated to the three machines based on their FMVs.

The allocation of the $3,000 of common costs occurs as follows:

$$\text{Machine No. 1: } \frac{\$30{,}000 \text{ FMV}}{\$30{,}000 + \$20{,}000 + \$10{,}000} \times \$3{,}000 = \$1{,}500$$

$$\text{Machine No. 2: } \frac{\$20{,}000 \text{ FMV}}{\$30{,}000 + \$20{,}000 + \$10{,}000} \times \$3{,}000 = \$1{,}000$$

$$\text{Machine No. 3: } \frac{\$30{,}000 \text{ FMV}}{\$30{,}000 + \$20{,}000 + \$10{,}000} \times \$3{,}000 = \$500$$

The bases for each of the three machines are $31,500, $21,000, and $10,500, respectively. ◀

Nontaxable Stock Dividends Received. If a nontaxable stock dividend is received, a portion of the basis of the stock on which the stock dividend is received is allocated to the new shares received from the stock dividend.[27] The cost basis of the previously acquired shares is reduced by the amount of basis allocated to the stock dividend shares. If the stock received as a stock dividend is the same type as the stock owned before the dividend, the total basis of the stock owned before the dividend is allocated equally to all shares now owned.

[27] Sec. 307(a).

Without the rule for determining basis of personal-use property converted to business property, taxpayers would have an incentive to convert nonbusiness assets that have declined in value to business use before selling the asset to convert nondeductible losses into deductible losses.

EXAMPLE I:5-30 ▶ Craig owns a personal-use asset with a basis of $80,000 and a $50,000 FMV. If he sells the asset for its FMV, the $30,000 loss ($50,000 − $80,000) is not deductible because losses on the sale of personal-use assets are not deductible. If Craig converts the asset to business use and then immediately sells the asset for $50,000, no loss is realized because the basis of the asset for purposes of determining loss is $50,000, the FMV when property was converted. ◀

REAL-WORLD EXAMPLE

A taxpayer purchased a group of lots and allocated the total cost evenly among the lots. The court, however, held that more cost should be allocated to the waterfront lots than to the interior lots. *Biscayne Bay Islands Co.*, 23 B.T.A. 731 (1931).

ALLOCATION OF BASIS

When property is obtained in one transaction and portions of the property are subsequently disposed of at different times, the basis of the property is allocated to the different portions of the property. Gain or loss is computed at the time of disposal for each portion. If a taxpayer purchases a 20-acre tract of land and later sells the entire tract, an allocation of basis is not needed. However, if the taxpayer divides the property into smaller tracts of land for resale, the cost of the 20-acre tract must be allocated among the smaller tracts of land.

Basket Purchase. If more than one asset is acquired in a single purchase transaction (i.e., a basket purchase), the cost must be apportioned to the various assets acquired. The allocation is based on the relative FMVs of the assets.

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SELF-STUDY QUESTION

If Kelly in Example I:5-31 paid $2,000 for the cost of a title search and other costs that must be capitalized, what is the basis of the land and building?

ANSWER

Land $75,375
Building $326,625

Because no depreciation deduction is allowed for land, taxpayers tend to favor a liberal allocation of the total purchase price to the building. Appraisals or other measures of FMV may be used to make the allocation.

Common Costs. As in the case of financial accounting, common costs incurred to obtain or prepare an asset for service must be capitalized and allocated to the basis of the individual assets.

EXAMPLE I:5-32 ▶ Priscilla acquires three machines for $60,000, which have FMVs of $30,000, $20,000, and $10,000, respectively. Costs of delivery amount to $2,000, and costs to install the three machines amount to $1,000. The total installation and delivery costs of $3,000 are allocated to the three machines based on their FMVs.

The allocation of the $3,000 of common costs occurs as follows:

$$\text{Machine No. 1: } \frac{\$30{,}000 \text{ FMV}}{\$30{,}000 + \$20{,}000 + \$10{,}000} \times \$3{,}000 = \$1{,}500$$

$$\text{Machine No. 2: } \frac{\$20{,}000 \text{ FMV}}{\$30{,}000 + \$20{,}000 + \$10{,}000} \times \$3{,}000 = \$1{,}000$$

$$\text{Machine No. 3: } \frac{\$30{,}000 \text{ FMV}}{\$30{,}000 + \$20{,}000 + \$10{,}000} \times \$3{,}000 = \$500$$

The bases for each of the three machines are $31,500, $21,000, and $10,500, respectively. ◀

Nontaxable Stock Dividends Received. If a nontaxable stock dividend is received, a portion of the basis of the stock on which the stock dividend is received is allocated to the new shares received from the stock dividend.[27] The cost basis of the previously acquired shares is reduced by the amount of basis allocated to the stock dividend shares. If the stock received as a stock dividend is the same type as the stock owned before the dividend, the total basis of the stock owned before the dividend is allocated equally to all shares now owned.

[27] Sec. 307(a).

EXAMPLE I:5-33 ▶ Wayne owns 1,000 shares of Bell Corporation common stock with a $44,000 basis. Wayne receives a nontaxable 10% common stock dividend and now owns 1,100 shares of common stock. The basis for each share of common stock is now $40 ($44,000 ÷ 1,100). ◀

If the stock received as a stock dividend is not the same type as the stock owned before the dividend, the allocation is based on relative FMVs.

EXAMPLE I:5-34 ▶ Stacey owns 500 shares of Montana Corporation common stock with a $60,000 basis. She receives a nontaxable stock dividend payable in 50 shares of preferred stock. At time of the distribution, the common stock has a $40,000 FMV ($80 × 500 shares), and the preferred stock has a $10,000 FMV ($200 × 50 shares). After the distribution, Stacey owns 50 shares of preferred stock with a basis of $12,000 [($10,000 ÷ $50,000) × $60,000]. Thus, $12,000 of the basis of the common stock is allocated to the preferred stock and the basis of the common stock is reduced from $60,000 to $48,000. ◀

KEY POINT

Corporations issue stock rights to shareholders so that the shareholders will be able to maintain their same proportional ownership in the corporation. This is called the preemptive right.

Nontaxable Stock Rights Received. Stock rights represent rights to acquire shares of a specified corporation's stock at a specific exercise price when certain conditions are met. The exercise price is usually less than the market price when the stock rights are issued. Stock rights may be distributed to employees as compensation, and they are often issued to shareholders to encourage them to purchase more stock, thereby providing more capital for the corporation.

If the FMV of nontaxable stock rights received is less than 15% of the FMV of the stock, the basis of the stock rights is zero unless the taxpayer elects to allocate the basis between the stock rights and the stock owned before distribution of the stock rights.[28]

EXAMPLE I:5-35 ▶ Tina owns 100 shares of Bear Corporation common stock with a $27,000 basis and a $50,000 FMV. She receives 100 nontaxable stock rights with a total FMV of $4,000. Because the FMV of the stock rights is less than 15% of the FMV of the stock (0.15 × $50,000 = $7,500), the basis of the stock rights is zero unless Tina elects to make an allocation. ◀

REAL-WORLD EXAMPLE

In 1993, United States Cellular Corporation issued one right for each common share held. Each whole right entitled the holder to buy one common share for $33.

If, Tina, in the example above, elects to allocate the basis of $27,000 between the stock rights and the stock, the basis of the rights is $2,000 ([$4,000 ÷ $54,000] × $27,000) and the basis of the stock is $25,000 ([$50,000 ÷ $54,000] × $27,000).

The decision to allocate the basis affects the gain or loss realized on the sale or disposition of the stock rights because the basis of the rights is zero unless an allocation is made. Furthermore, the basis of any stock acquired by exercising the rights is affected by whether or not a portion of the basis is allocated to the rights. The basis of stock acquired by exercising the stock rights is the amount paid plus the basis of the stock rights exercised.

EXAMPLE I:5-36 ▶ George receives 10 stock rights as a nontaxable distribution, and no basis is allocated to the stock rights. With each stock right, George may acquire one share of stock for $20. If he exercises all 10 stock rights, the new stock acquired has a basis of $200 ($20 × 10 shares). If George sells all 10 stock rights for $135, he has a realized gain of $135 ($135 − $0). ◀

If the FMV of a nontaxable stock right received is equal to or greater than 15% of the FMV of the stock, the basis of the stock owned before the distribution must be allocated between the stock and the stock rights.

EXAMPLE I:5-37 ▶ Helen owns 100 shares of NMO common stock with a $14,000 basis and a $30,000 FMV. She receives 100 stock rights with a total FMV of $5,000. Because the FMV of the stock rights is at least 15% of the FMV of the stock, the $14,000 basis must be allocated between the stock rights and the stock. The basis of the stock rights is $2,000 [($5,000 ÷ $35,000) × $14,000] and the basis of the stock is $12,000 [($30,000 ÷ $35,000) × $14,000]. ◀

A recipient of stock rights generally has three courses of action. The stock rights can be sold or exchanged, in which case the basis allocated to the stock rights, if any, is used to determine gain or loss. The stock rights may be exercised, and any basis allocated to the rights is added to the purchase price of the acquired stock. The stock rights may be allowed to expire, in which case no loss is recognized, and any basis allocated to the rights is reallocated back to the stock. If the stock rights received in the above example expire without being exercised, Helen does not recognize a loss and the basis of her 100 shares of common stock is $14,000.

Property basis rules are highlighted in Topic Review I:5-1.

[28] Sec. 307(b)(1).

TOPIC REVIEW I:5-1

Property Basis Rules

Method Acquired	Basis of the Acquired Property
1. Acquired by direct purchase	1. Basis includes the amount paid for the property, costs of preparing the property for use, obligations of the seller assumed by the buyer, and liabilities to which the property is subject.
2. Acquired as a gift. (a) FMV on the date of the gift is equal to or greater than the donor's basis (b) FMV on the date of the gift is less than the donor's basis	2. (a) The donee's basis is the same as the donor's basis plus a pro rata portion of the gift tax attributable to the property's unrealized appreciation at the time of the gift. (b) The donee's gain basis is the donor's basis and the loss basis is FMV. No increase for any gift tax paid.
3. Received from a decedent* (a) AVD is not elected (b) AVD is elected	3. (a) The basis is its FMV on the date of death. (b) The basis of nondistributed property is its FMV on the AVD. If the property is distributed or sold before this date, its basis is FMV on the date of sale or distribution.
4. Converted from personal to business use	4. The basis for a loss (as well as for depreciation) is the lesser of its adjusted basis or FMV at date of conversion. The basis for a gain is its adjusted basis at date of conversion.
5. Nontaxable stock dividend	5. Basis of the stock dividend shares includes a pro rata portion of the adjusted basis of the underlying shares owned.
6. Nontaxable stock right	6. If the FMV of the rights is less than 15% of the stock's FMV, the basis of the rights is zero unless an election is made to allocate basis. Basis of the underlying stock is allocated to the rights based on the respective FMVs of the stock and rights.

* Special rules apply to decedents dying in 2010.

Definition of a Capital Asset

OBJECTIVE 3

Distinguish between capital assets and other assets

TYPICAL MISCONCEPTION

It is common in financial accounting classes to include property used in a trade or business in the definition of a capital asset. For example, factory buildings, machinery, trucks, and office buildings would be defined as capital assets. However, such items are not capital assets for tax purposes.

Instead of defining capital assets, Sec. 1221 provides a list of properties that are **not** capital assets. Thus, a capital asset is any property owned by a taxpayer *other* than the types of property specified in Sec. 1221. Property that is not a capital asset includes the following:

1. Inventory or property held primarily for sale to customers in the ordinary course of a trade or business.
2. Property used in the trade or business and subject to the allowance for depreciation provided in Sec. 167 or real property used in a trade or business. (As explained in Chapter I:13, these properties are referred to as *Sec. 1231 assets* if held by the taxpayer more than one year.)
3. Accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of property described in item 1.
4. Supplies of a type regularly used or consumed in the ordinary course of a trade or business.
5. Other assets including
   a. A letter, memorandum, or similar property held by a taxpayer for whom such property was prepared or produced.
   b. A patent, invention, model or design, secret formula or process, copyright; a literary, musical, or artistic composition; a letter or memorandum; or similar property held by a taxpayer whose personal efforts created such property or whose basis in the property for determining a gain is determined by reference to the basis of such property in the hands of one who created the property or one for whom such property was prepared or produced.
   c. A U.S. government publication held by a taxpayer who receives the publication by any means other than a purchase at the price the publication is offered for sale to the public.

d. A U.S. government publication held by a taxpayer whose basis in the property for determining a gain is determined by reference to the basis of such property in the hands of a taxpayer in item 5c (e.g., certain property received by gift).

6. Any hedging transaction clearly identified as a hedge before the close of the day it was acquired, originated, or entered into.

EXAMPLE I:5-38 ▶ Maxine owns a building used in her business. Other business assets include equipment, inventory, and accounts receivable. None of the assets are classified as capital assets. ◀

Chapter I:13 provides an in-depth discussion of business assets such as buildings, land, and equipment. Although these items are not capital assets, Sec. 1231 provides in many cases that the gain on the sale or exchange of such an asset is eventually taxed as LTCG.

EXAMPLE I:5-39 ▶ Eric owns an automobile held for personal use and also owns a copyright for a book he has written. Because the copyright is held by the taxpayer whose personal efforts created the property, it is not a capital asset. The automobile held for personal use is a capital asset. ◀

SELF-STUDY QUESTION

Doug owns a personal residence, an automobile, 100 shares of Ford Motor Company, and a poem he wrote for his girlfriend. Which of these assets are capital assets?

ANSWER

All of the items are capital assets except the poem, which is a literary composition that Doug created. If Doug gives the poem to his girlfriend, the poem is still not a capital asset.

By analyzing Examples I:5-38 and I:5-39, one can conclude that the classification of an asset is often determined by its use. An automobile used in a trade or business is not a capital asset but is a capital asset when held for personal use. Examples of assets that qualify as capital assets include a personal residence, land held for personal use, and investments in stocks and bonds. In addition, certain types of assets are specifically given capital asset status, such as patents, franchises, etc. These and other special assets are discussed later in this chapter.

Recently, Congress made a major change for self-created musical works. Pursuant to Sec. 1221(b)(3), a taxpayer whose personal efforts created such property may now make an election to treat the sale or exchange of musical compositions or copyrights in self- created musical works as a sale or exchange of a capital asset.

INFLUENCE OF THE COURTS

In *Corn Products Refining Co.*, the Supreme Court rendered a landmark decision when it determined that the sale of futures contracts related to the purchase of raw materials resulted in ordinary rather than capital gains and losses.[29] The Corn Products Company, a manufacturer of products made from grain corn, purchased futures contracts for corn to ensure an adequate supply of raw materials. Delivery of the corn was accepted when needed for manufacturing operations, and unneeded contracts were later sold. Corn Products contended that any gains or losses on the sale of the unneeded contracts should be capital gains and losses because futures contracts are customarily viewed as security investments, which qualify as capital assets. The Supreme Court held that these transactions represented an integral part of the business for the purpose of protecting the company's manufacturing operations and the gains and losses should, therefore, be ordinary in nature.

ADDITIONAL COMMENT

If an asset such as an automobile is used in part in a trade or business and in part for personal use, then the business part of the car is not a capital asset, but the other part is a capital asset.

Although the *Corn Products* doctrine has been interpreted as creating a nonstatutory exception to the definition of a capital asset when the asset is purchased for business purposes, the Supreme Court ruled in the 1988 *Arkansas Best Corporation* case that the motivation for acquiring assets is irrelevant to the question of whether assets are capital assets. Arkansas Best, a bank holding company, sold shares of a bank's stock that had been acquired for the purpose of protecting its business reputation. Relying on the *Corn Products* doctrine, the company deducted the loss as ordinary. The Supreme Court ruled that the loss was a capital loss because the stock is within the broad definition of the term **capital asset** in Sec. 1221 and is outside the classes of property that are excluded from capital-asset status.[30] *Arkansas Best* apparently limits the application of *Corn Products* to hedging transactions that are an integral part of a taxpayer's system of acquiring inventory.



ETHICAL POINT

A CPA should not prepare or sign a tax return for a client unless the position or issue has (1) a realistic possibility of being sustained on its merits or (2) is not frivolous and is adequately disclosed in the return.

OTHER IRC PROVISIONS RELEVANT TO CAPITAL GAINS AND LOSSES

A number of IRC sections provide special treatment for certain types of assets and transactions. For example, loss on the sale or exchange of certain small business stock that

[29] *Corn Products Refining Co. v. CIR*, 47 AFTR 1789, 55-2 USTC ¶9746 (USSC, 1955).

[30] *Arkansas Best Corporation v. CIR*, 61 AFTR 2d 88-655, 88-1 USTC ¶9210 (USSC, 1988).

qualifies as Sec. 1244 stock is treated as an ordinary loss rather than a capital loss to the extent of $50,000 per year ($100,000 if the taxpayer is married and files a joint return).[31]

ADDITIONAL COMMENT

For purposes of Sec. 1236, a security is defined as any share of stock in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the above.

Dealers in Securities. Normally, a security dealer's gain on the sale or exchange of securities is ordinary income. Section 1236 provides an exception for dealers in securities if the dealer clearly identifies that the property is held for investment. This act of identification must occur before the close of the day on which the security is acquired, and the security must not be held primarily for sale to customers in the ordinary course of the dealer's trade or business at any time after the close of the day of purchase.

EXAMPLE I:5-40 ▶ Allyson, a dealer in securities, purchases Cook Corporation stock on April 8, and identifies the stock as being held for investment on that date. Four months later, Allyson sells the stock. Any gain or loss recognized due to the sale is capital gain or loss. ◀

Once a dealer clearly identifies a security as being held for investment, any loss on the sale or exchange of the security is treated as a capital loss.

EXAMPLE I:5-41 ▶ Kris, a dealer in securities, purchases Boston Corporation stock and clearly identifies the stock as being held for investment on the date of purchase. Eight months later, the security is removed from the investment account and held as inventory. If the security is later sold at a gain, the gain is an ordinary gain. However, if the stock is sold at a loss, the loss is a capital loss. ◀

Securities dealers must use the mark-to-market method for their inventory of securities. This method requires that securities be valued at FMV at the end of each taxable year. Dealers in securities recognize gain or loss each year as if the security is sold on the last day of the tax year. Gains and losses are generally treated as ordinary rather than capital. Gains or losses due to adjustments in subsequent years or resulting from the sale of the security must be adjusted to reflect gains and losses already taken into account when determining taxable income.[32]

EXAMPLE I:5-42 ▶ Jim Spikes, a dealer in securities and calendar-year taxpayer, purchases a security for inventory on October 10, 2019, for $10,000 and sells the security for $18,000 on July 1, 2020. The security's FMV on December 31, 2019, is $15,000. Jim recognizes $5,000 of ordinary income in 2019 and $3,000 of ordinary income in 2020. ◀

Real Property Subdivided for Sale. A taxpayer who engages in regular sales of real estate is considered to be a dealer, and any gain or loss recognized is ordinary gain or loss rather than capital gain or loss. A special relief provision is provided in Sec. 1237 for nondealer, noncorporate taxpayers who subdivide a tract of real property into lots (two or more pieces of real property are considered to be a tract if they are contiguous). Part or all of the gain on the sale of the lots may be treated as a capital gain if the following provisions of Sec. 1237 are satisfied:

ADDITIONAL COMMENT

The conversion of an apartment building into condominiums does not qualify under Sec. 1237, even if the property has been held for five years and no substantial improvements have been made.

- During the year of sale, the noncorporate taxpayer must not hold any other real property primarily for sale in the ordinary course of business.
- Unless the property is acquired by inheritance or devise, the lots sold must be held by the taxpayer for a period of at least five years.
- No substantial improvement may be made by the taxpayer while holding the lots if the improvement substantially enhances the value of the lot.[33]
- The tract or any lot may not have been previously held primarily for sale to customers in the ordinary course of the taxpayer's trade or business unless such tract at that time was covered by Sec. 1237.

The primary advantage of Sec. 1237 is that potential controversy with the IRS is avoided as to whether a taxpayer who subdivides investment property is a dealer. Section 1237 does not apply to losses. Such losses are capital losses if the property is held for investment purposes, or ordinary losses if the taxpayer is a dealer.

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[31] Secs. 1244(a) and (b). (See Chapter I:9 for additional discussion on small business corporation stock losses.)

[32] Sec. 475. The mark-to-market rule also applies to some securities that are not inventory, but does not apply to any security that is held for investment and certain other transactions (see Sec. 475(b)).

[33] Certain improvements are not treated as substantial under Sec. 1237(b)(3) if the lot is held for at least ten years.

If the Sec. 1237 requirements are satisfied, all gain on the sale of the first five lots may be capital gain. Starting in the tax year during which the sixth lot is sold, 5% of the selling price for all lots sold in that year and succeeding years is ordinary income.

EXAMPLE I:5-43 ▶ Jean subdivided a tract of land held as an investment into seven lots, and all requirements of Sec. 1237 were satisfied. The lots have a FMV of $10,000 each and a basis of $4,000. Jean incurred no selling expenses and sold four lots in 2018 and three lots in 2019. In 2018, all of the $24,000 [four lots × ($10,000 − $4,000)] gain was capital gain. In 2019, the year in which the sixth lot is sold, $1,500 of the gain is ordinary income [0.05 × ($10,000 × three lots)], and the remaining $16,500 {[three lots × ($10,000 − $4,000)] − $1,500} gain is capital gain. ◀

EXAMPLE I:5-44 ▶ Assume the same facts as in the above example, except that all seven lots are sold in 2019. The amount of ordinary income recognized is $3,500 [0.05 × ($10,000 × seven lots)], and the remaining $38,500 {[seven lots × ($10,000 − $4,000)] − $3,500} gain is capital gain. ◀

ADDITIONAL COMMENT

If a taxpayer sells any lots from a tract and does not sell any others for a period of five years, the remaining property is considered a new tract.

Based on Examples I:5-43 and I:5-44, the advantage of selling no more than five lots in the first year should be apparent. Expenditures incurred to sell or exchange the lots are also treated favorably because they are first applied against the portion of the gain treated as ordinary income. Because selling expenses (e.g., commissions) are often equal to or greater than 5% of the selling price, this offset against ordinary income may result in the elimination of the ordinary income portion of the gain. Selling expenses in excess of the gain taxed as ordinary income reduce the amount realized on the sale or exchange.

Nonbusiness Bad Debt. Bad debt losses from nonbusiness debts are deductible only as short-term capital losses (STCLs),[34] regardless of when the debt occurred. A nonbusiness bad debt is deductible only in the year in which the debt becomes totally worthless.

EXAMPLE I:5-45 ▶ Two years ago, Alice loaned $4,000 to a friend. During the current year, the friend declares bankruptcy and the debt is entirely worthless. Assuming that Alice has no other gains and losses from the sale or exchange of capital assets during the year, she deducts $3,000 in determining adjusted gross income (AGI) and has an STCL carry forward of $1,000. ◀

TAX TREATMENT FOR CAPITAL GAINS AND LOSSES OF NONCORPORATE TAXPAYERS

OBJECTIVE 4

Understand how capital gains are taxed for noncorporate taxpayers

To recognize capital gain or loss, it is necessary to have a sale or exchange of a capital asset. Once it is determined that a capital gain or loss has been realized and is to be recognized, it is necessary to classify the gains and losses as either short-term or long-term. If the asset is held for one year or less, the gain or loss is classified as a short-term capital gain (STCG) or a short-term capital loss (STCL). If the capital asset is held for more than one year, the gain or loss is classified as a long-term capital gain (LTCG) or long-term capital loss (LTCL).[35]

CAPITAL GAINS

ADDITIONAL COMMENT

The rates for long-term capital gains have been lower than rates for ordinary income for many years. However, preferential rates for qualified dividends were enacted in 2003. Qualified dividends are now taxed at a maximum 15% or 20% rate, the same as for long-term capital gains which are ANCG.

The first step in determining the taxability of capital gains is to calculate *net capital gains* (NCG), which is defined as the excess of net long-term capital gain over net short-term capital loss.[36] All capital gains are not taxed at the same rate. So, depending on the type of property, NCG could be taxed at zero, 15%, 20%, 25%, or 28%. Once NCG has been determined, a portion or all of NCG may be classified as *adjusted net capital gain* (ANCG) which is subject to the lower rates of zero, 15%, or 20%.

[34] Sec. 166(d)(1)(B). Also, see discussion of bad debts in Chapter I:9.

[35] While the Taxpayer Relief Act of 1997 reduced the rates for most LTCGs, it increased the required holding period to more than 18 months to be eligible for the lower rates of 10% and 20%. During the last few months of 1997, gain resulting from the sale of a capital asset might be taxed at many different rates depending on whether or not the holding period is one year or less, more than one year but not more than 18 months, or more than 18 months. These changes in the law dramatically increased the complexity associated with the taxation of capital gains. The 1998 Restructuring and Reform Act eliminated the more than 18-month holding period requirement for tax years ending after 1997 and returned to the more-than-one-year requirement to be LTCG.

[36] Sec. 1222(11).

To compute NCG, first determine all STCGs, STCLs, LTCGs, LTCLs, and then net gains and losses as described below.

Net Short-Term Capital Gain. If total STCGs for the tax year exceed total STCLs for that year, the excess is defined as net short-term capital gain (NSTCG). As discussed later, NSTCG may be offset by net long-term capital loss (NLTCL).

EXAMPLE I:5-46 ▶ Hal has two transactions involving the sale of capital assets during the year. As a result of those transactions, he has an STCG of $4,000 and an STCL of $3,000. Hal's NSTCG is $1,000 and his AGI increases by $1,000. His gross income increases by $4,000, and he is entitled to a $3,000 deduction for AGI. ◀

Net Long-Term Capital Gain. If the total LTCGs for the tax year exceed the total LTCLs for that year, the excess is defined as net long-term capital gain (NLTCG). As indicated earlier, a NCG exists when NLTCG exceeds net short-term capital loss (NSTCL).

EXAMPLE I:5-47 ▶ Clay has two transactions involving the sale of capital assets during the year. As a result of the transactions, he has an LTCG of $5,000 and an LTCL of $3,000. Clay has an NLTCG and a net capital gain of $2,000. His AGI increases by $2,000. ◀

EXAMPLE I:5-48 ▶ Linda has four transactions involving the sale of capital assets during the year. As a result of the transactions, she has an STCG of $5,000, an STCL of $7,000, an LTCG of $10,000, and an LTCL of $2,000. After the initial netting of short-term and long-term gains and losses, Linda has an NSTCL of $2,000 ($7,000 − $5,000) and an NLTCG of $8,000 ($10,000 − $2,000). Because the NLTCG exceeds the NSTCL by $6,000 ($8,000 − $2,000), her NCG is $6,000. ◀

Lower Rates for Adjusted Net Capital Gain (ANCG). The tax rate that applies to a noncorporate taxpayer's ANCG can be zero, 15% or 20%. Prior to the Tax Cuts and Jobs Act effective for 2018, it was easy to determine when the different rates applied. Taxpayers with a rate of 15% or less used a zero rate while taxpayers whose rate was greater than 15% but less than 39.6% used 15%. Taxpayers with a 39.6% rate used 20%.

Congress now uses seven different percentage rates (10, 12, 22, 24, 32, 35 and 37) with the Tax Cuts and Jobs Act but wanted to retain the maximum preferential rates on ANCG and qualified dividends. Breakpoints comparable to income which would have been taxed at less than 25% before the Tax Cuts and Jobs Act are determined. Refer to Table I:5-1 below and note that the preferential rate is zero for taxpayers filing a joint return (and a surviving spouse) with taxable income equal to or less than $78,750. When the taxable income is more than $78,750 but not more than $488,850, the preferential rate is 15%. The preferential rate becomes 20% when taxable income exceeds $488,850.[37]

EXAMPLE I:5-49 ▶ Carolina is single with taxable income of $150,000 without considering the sale of Micron common stock during 2019 for $25,000. The stock was purchased three years ago for $14,000 and is her only sale of a capital asset during the year. Her NCG which is ANCG is $11,000 taxed at 15%. To compute her total tax for 2019, ordinary rates are applied to the $150,000, and then the tax on ANCG (15% × $11,000) is added. ◀

EXAMPLE I:5-50 ▶ Assume the same facts as in Example I:5-49 except Carolina's taxable income without the capital gain is $20,000. The $11,000 ANCG is taxed at a rate of zero because her $31,000 taxable income is less than $39,375.

▼ **TABLE I:5-1**

Preferential Rates for Adjusted Net Capital Gain (ANCG) and Qualified Dividends

LTCG Rate	Single	Filing Jointly*	Head of Household
0%	Up to $39,375	Up to $78,750	Up to $52,750
15%	> $39,375 but ≤ $434,550	> $78,750 but ≤ $488,850	> $52,750 but ≤ $461,700
20%	Over $434,550	Over $488,850	Over $461,700

*The corresponding amounts if married filing separately are half of the amounts for filing jointly. The preferential rate is zero for taxable income up to $39,375 if married filing separately.

The breakpoint amounts in Table I:5-1 will be adjusted annually for inflation.

[37] Sec. 1(h).

LEGISLATIVE UPDATE

The American Tax Relief Act of 2012 retained tax relief of the zero and 15% rates provided by the Bush administration but increased the preferential tax rate to 20% of ANCG for those taxpayers with the highest marginal tax rate, 39.6%.

This change was a compromise between President Obama and most Democrats in Congress who advocated for higher tax rates on taxpayers with higher incomes and most Republicans who opposed any income tax increases

Computation of the tax for Carolina becomes more complicated if the ANCG causes the taxable income to exceed $39,375. If her taxable income is $44,000 including $11,000 of ANCG, her tax is determined as follows:

Tax on $33,000 (taxable income without the ANCG)	$3,766.00	[$970 + ($23,300 × 12%)]
+ Tax on $6,375 ($39,375 − $33,000) of the ANCG at zero	0	($6,375 × 0%)
+ Tax on $4,625 ($11,000 − $6,375) at 15% because taxable income is > $39,375	$ 693.75	($4,625 × 15%)
Total tax	$4,459.75	

◀

EXAMPLE I:5-51 ▶ The Danecks file a joint return with taxable income of $800,000 which includes ANCG of $100,000 and no other investment income. Their tax is determined by adding the tax on $700,000 where marginal tax rate is 37% to $20,000 (20% × $100,000). They are also subject to the 3.8% Medicare tax of $3,800 (3.8% × $100,000) on investment income discussed later in the chapter. ◀

SELF-STUDY QUESTION

Mary sells common stock for a gain of $10,000 on December 29, 2019. The settlement date, or date that Mary will receive the proceeds from the stockbroker, is January 2, 2020. Will Mary report the gain on her 2019 or 2020 tax return?

ANSWER

Mary is required to report the gain in the year of the sale (2019). Losses are also recognized in the year of sale.

ADJUSTED NET CAPITAL GAINS (ANCG)

When computing ANCG, one has to consider that four different types of LTCGs may exist:

1. Collectibles gain
2. Part of the gain (generally 50%) resulting from the sale or exchange of qualified small business stock as defined in Sec. 1202
3. Unrecaptured Sec. 1250 gain[38]

All other LTCGs

KEY POINT

Collectibles gain, as explained below, is the net of LTCG and LTCL from the sale of collectibles. Sec. 1202 stock is qualified small business stock designed to encourage investment in small businesses.

It is the fourth group of LTCGs that receives the preferential rates of zero, 15%, or 20%. The other three groups receive preferential treatment but not at the zero, 15%, or 20% rate. The first two gains above are referred to as 28% rate gain because the maximum rate for those gains is 28%; the maximum rate for unrecaptured Sec. 1250 gain is 25%. Unrecaptured Sec. 1250 gain, which is taxed at a maximum 25% rate, generally occurs when a building is sold. For the second and third types of LTCG, the special provisions only apply to gains. Net losses from sale of Sec. 1202 stock are treated as normal LTCLs, and one cannot have a loss connected with an unrecaptured Sec. 1250 gain.

ANCG is defined as NCG less the first three gains listed above. However, the computation of ANCG is tricky because one has to consider the impact of net capital losses, both short-term and long-term. Taxpayers are permitted to offset capital losses against capital gains. But, as discussed above, there are four different types of LTCG. So, if a taxpayer has both LTCG and capital losses, the capital losses are first offset within the category (collectibles, Sec. 1202 stock, etc.), then any excess loss is offset against the highest rate LTCG category first and works down to the lowest rate category (i.e., 28% rate gain first, then 25%, then 20% or 15%). This topic is discussed in more detail on the next page.

When a taxpayer has no capital losses and no qualified dividends, ANCG is NCG reduced by the first three types of LTCG listed above. Many taxpayers will not have the first three types of LTCG and therefore, NCG and ANCG will often be the same amount.

EXAMPLE I:5-52 ▶ During 2019, Charles, who is single and his tax rate exceeds 12% and is less than 35%, sold two publicly-traded stocks. The first stock resulted in an LTCG of $10,000 while the second stock resulted in an LTCG of $15,000. These were his only transactions involving capital assets during the year. Charles' NCG and ANCG is $25,000 and this gain is subject to a maximum tax rate of 15%. ◀

Given the information about Charles' tax rate, one can determine that his taxable income is more than $39,475 and less than $204,100, so Table I:5-1 can be used to find the preferential rate is 15%. Note that he could have taxable income of $434,550, and his preferential rate is still 15%.

EXAMPLE I:5-53 ▶ Assume in the example above that Charles also had a gain on the sale of a building that resulted in an unrecaptured Sec. 1250 gain of $50,000. Charles has NCG of $75,000 and ANCG of $25,000. The $50,000 gain is taxed at a maximum rate of 25% while the $25,000 of ANCG is taxed at a maximum rate of 15%. ◀

Collectibles Gain. Gains resulting from the sale of collectibles such as artwork, rugs, antiques, stamps and most coins are taxed at a maximum rate of 28%.

[38] Sec. 1(h)(4).

EXAMPLE I:5-54 ▶ Danny, who is single and has a tax rate of 32% purchased Bowling common stock and antique chairs three years ago for investment. He sells the assets during the current year and has a gain of $8,000 on the sale of the stock and $10,000 on the sale of the antique chairs. His NLTCG is $18,000, and his NCG is $18,000. His ANCG is $8,000 since $10,000 of the NCG is a collectibles gain. His tax on the capital gains is $4,000 [(15% × $8,000) + (28% × $10,000)]. ◀

SELF-STUDY QUESTION

Eliza, who is single, has taxable income of $60,000 including a $1,200 LTCG due to the sale of her baseball card collection. Does she receive preferential tax treatment?

ANSWER

No. Her marginal tax rate is 22% which is less than the maximum 28% rate that applies to collectibles gain. If her taxable income is $225,000, she saves $84 [(35% − 28%)($1,200)].

Sec. 1202 Gain. Sec. 1202 provides that noncorporate taxpayers may exclude a portion of the gain resulting from the sale or exchange of qualified small business stock (QSBS) issued after August 10, 1993, if the stock is held for more than five years. The exclusion depends on when the stock was acquired, as follows:

Date QSBS Acquired	*Exclusion Percentage*
Prior to February 18, 2009	50%
February 18, 2009–September 27, 2010	75%
After September 27, 2010	100%

Since the QSBS must be held for five years, the 100% exclusion did not apply to any sales of Sec. 1202 stock before 2015. A corporation may have QSBS only if the corporation is a C corporation and at least 80% of the value of its assets must be used in the active conduct of one or more qualified trades or businesses.[39]

If the excluded gain on QSBS is either 50% or 75%, the remaining gain is generally taxed at a maximum rate of 28%. However, the amount of any gain eligible for the exclusion may not exceed the greater of $10,000,000 or ten times the aggregate basis of the qualified stock. Thus, if gain on the sale of QSBS is $11.4 million and $5 million of the gain is excluded, $5 million of the gain is taxed at 28% and the remaining $1.4 million gain is taxed at 15% or 20%.

EXAMPLE I:5-55 ▶ Raef purchased $200,000 of newly issued Monona common stock on October 1, 2008. On December 15, 2019, he sells the stock for $4 million, resulting in a $3.8 million gain. He excludes $1.9 million of the gain, and the remaining $1.9 million of gain is Sec. 1202 gain taxed at 28%. Alternatively, if Raef purchased the Monona stock on July 11, 2010 and sold it in 2019, he could exclude $2.85 million ($3.8 × 0.75) of the gain. ◀

EXAMPLE I:5-56 ▶ Matthew, whose tax rate is 35% and 15% for ANCG, has the following capital gains in 2019:

STCG	$10,000
LTCG (artwork)	12,000
LTCG (stock of AT&T)	17,000
LTCG (QSBS acquired in 2006)	200,000

Matthew may exclude $100,000 of the $200,000 Sec. 1202 gain. His NCG is $129,000 ($12,000 + $17,000 + $100,000). His ANCG is $17,000. The increase in his tax is $37,410 [35%($10,000) + 28%($12,000) + 15%($17,000) + 28%($100,000)]. ◀

ADDITIONAL COMMENT

If Raef's gain in Example I:5-55 is $12 million, he excludes $5 million, $5 million of the gain is taxed at 28%, and $2 million is taxed at 20%, given that Raef's tax rate would probably be 37%.

CAPITAL LOSSES

To have a capital loss, one must sell or exchange the capital asset for an amount less than its adjusted basis. As in the case of capital gains, the one-year period is used to determine whether the capital loss is short-term or long-term.

Net Short-Term Capital Loss. If total STCLs exceed total STCGs for the tax year, the excess is defined as a net short-term capital loss (NSTCL). As indicated above, the NSTCL is first offset against any NLTCG to determine net capital gain. If NSTCL exceeds NLTCG, the capital loss may be offset, on a dollar-for-dollar basis, against a noncorporate taxpayer's ordinary income for amounts up to $3,000 in any one year.[40]

EXAMPLE I:5-57 ▶ Bob has gross income of $60,000 before considering capital gains and losses. If Bob has an NLTCG of $10,000 and an NSTCL of $15,000, he has $5,000 of NSTCL in excess of NLTCG and may deduct $3,000 of the losses from gross income. Assuming no other deductions for AGI, Bob's AGI is $57,000 ($60,000 − $3,000). ◀

ADDITIONAL COMMENT

A husband and wife filing a joint return may use capital losses carried forward from years when they were single. Also, a divorced couple may use capital losses carried forward from a joint return year to their single returns.

In the above example, $10,000 of Bob's NSTCL is used to offset the $10,000 of NLTCG, and $3,000 of the NSTCL is used to reduce ordinary income. However, $2,000

[39] Sec. 1202.

[40] Sec. 1211(b). A $1,500 limitation applies to a married individual filing a separate return.

of the loss is not used. This net capital loss is carried forward for an indefinite number of years.[41] The loss retains its original character and will be treated as an STCL occurring in the subsequent year. If a taxpayer dies with an unused capital loss carryover, it expires.

EXAMPLE I:5-58 ▶ Last year, Milt had an NSTCL of $8,000 and an NLTCG of $2,600. The netting of short-term and long-term gains and losses resulted in a $5,400 excess of NSTCL over NLTCG, and $3,000 of this amount was offset against ordinary income. Milt's NSTCL carryforward is $2,400. During the current year he sells a capital asset and generates an STCG of $800. His NSTCL is $1,600 ($2,400 – $800), and the loss is less than $3,000 and offset against $1,600 of ordinary income. ◀

Net Long-Term Capital Loss. If total LTCLs for the tax year exceed total LTCGs for the year, the excess is defined as net long-term capital loss (NLTCL). If there is both an NSTCG and an NLTCL, the NLTCL is initially offset against the NSTCG on a dollar- for-dollar basis. If the NLTCL exceeds the NSTCG, the excess is offset against ordinary income on a dollar-for-dollar basis up to $3,000 per year.

EXAMPLE I:5-59 ▶ In the current year, Gordon has an NLTCL of $9,000 and an NSTCG of $2,000. He must use $2,000 of the NLTCL to offset the $2,000 NSTCG, and then use $3,000 of the $7,000 ($9,000 – $2,000) NLTCL to offset $3,000 of ordinary income. Gordon's carryforward of NLTCL is $4,000 [$9,000 – ($2,000 + $3,000)]. This amount is treated as an LTCL in subsequent years. ◀

If an individual has both NSTCL and NLTCL, the NSTCL is offset against ordinary income first, regardless of when the transactions occur during the year.

EXAMPLE I:5-60 ▶ In the current year, Beth has an NSTCL of $2,800 and an NLTCL of $2,000. The entire NSTCL is offset initially against $2,800 of ordinary income. Because capital losses may offset only $3,000 of ordinary income, $200 of NLTCL is used to offset $200 ($3,000 – $2,800) of ordinary income. The NLTCL carryover to the next year is $1,800 ($2,000 – $200). ◀

TAX STRATEGY TIP

Taxpayers who have realized capital gains during the tax year should consider selling securities with a loss during the same year. The losses can be offset against the gains and tax savings result.

Capital Losses Applied to Capital Gains by Groups. Taxpayers separate their LTCGs and LTCLs into three tax rate groups: (1) 28% group, (2) 25% group, and (3) the 15% or 20% group. The 28% group includes capital gains and losses when the capital asset is a collectible held more than one year and part of the gain from the sale of QSBS held for more than five years. The 25% group consists of unrecaptured Sec. 1250 gain discussed in Chapter I:13, and there are no losses for this group. The 15% or 20% group includes capital gains and losses when the holding period is more than one year and the capital asset is not a collectible or Sec. 1202 small business stock.

When a taxpayer has NSTCL and NLTCG, the NSTCL is first offset against NLTCG from the 28% group, then the 25% group, and finally the 15% or 20% group. This treatment of NSTCL is favorable for taxpayers. Note that a taxpayer could have NLTCLs in one group, except the 25% group, and NLTCGs in another group. A net loss from the 28% group is first offset against gains in the 25% group then net gains in the 15% or 20% group. A net loss from the 15% or 20% group is first offset against net gains in the 28% group and then gains in the 25% group.[42]

EXAMPLE I:5-61 ▶ Leroy, whose tax rate is 32%, has NSTCL of $20,000, a $25,000 LTCG from the sale of a rare stamp held 16 months and an $18,000 LTCG from the sale of stock held for three years. The $20,000 NSTCL is offset against $20,000 of the collectibles gain in the 28% group. Leroy's NCG is $23,000 and his ANCG is $18,000. Leroy's tax liability increases by $4,100 [($5,000 × 28%) + ($18,000 × 15%)]. ◀

EXAMPLE I:5-62 ▶ Elizabeth, whose tax rate is 32%, has a $32,000 LTCL from the sale of stock held for four years and the following capital gains:

NSTCG	$40,000
LTCG from sale of collectible	$30,000
LTCG in the 25% group (unrecaptured Sec. 1250 gain)	$10,000

ADDITIONAL COMMENT

If Elizabeth in Example I:5-62 also had a $9,000 LTCG from the sale of stock held for two years, she would only be able to offset $23,000 of the LTCG in the 28% group.

The $32,000 LTCL is offset first against all of the $30,000 LTCG in the 28% group (collectibles) and then $2,000 against the unrecaptured Sec. 1250 gain. Her NLTCG is $8,000 taxed at 25% while her $40,000 NSTCG is taxed at her ordinary income rate of 32%. ◀

[41] Sec. 1212(b) and Reg. Sec. 1.1212-1(b).

[42] Notice 97-59, I.R.B. 1997-45.

STOP & THINK

Question: Srinija has a salary of $100,000. If she sells a non-personal use asset during the year and has a $40,000 loss, why is it important that the asset not be a capital asset?

Solution: Only $3,000 of a $40,000 capital loss is used as a deduction to reduce her gross income each year. Her AGI is $97,000 if the asset is a capital asset, and she has a $37,000 capital loss carryforward. All of the $40,000 loss is used to reduce her gross income if the asset is not a capital asset, lowering her AGI to $60,000. It is possible that Srinija might not care whether or not the asset is a capital asset if she has capital gains that could be reduced by capital losses. If the asset is a personal-use asset, the loss is not deductible regardless of whether or not it is a capital asset.

KEY POINT

The lower rates made taxpayers more interested in having capital gain income instead of ordinary income. Investors preferences for growth stocks as opposed to stocks with high dividends increased.

Tax Treatment for Net Capital Gain and Qualified Dividends. Congress eliminated preferential tax rates on NCG in 1986 by making the maximum ordinary income rate equal to the rate on net capital gains at 28%. However, this equality was short-lived as Congress, in 1991, increased the maximum ordinary income rate to 31% but left the NCG rate at 28%.[43] This newly-created preferential treatment for NCG's only applied to taxpayers whose tax rate exceeded 28%. The change in 1997 to rates as low as 10% benefited all noncorporate taxpayers if they held the capital asset for more than one year.

LEGISLATIVE UPDATE

The lower rates on long-term capital gains and qualified dividends were scheduled to expire after December 31, 2012 under the so-called sunset provisions. These provisions would have increased maximum rates on long-term capital gains to 20% and subject dividends to ordinary income rates. Instead, only noncorporate taxpayers with a tax rate of 39.6% experienced an increase to 20%. The maximum tax rate starting in 2018 is 37%, but the maximum income tax rate on ANCG is still 20%.

Legislation in 2003 which reduced the tax rate on qualified dividends to 5% (**zero** after 2007) and 15% as of January 1, 2003 dramatically changed investor preferences.[44] The current rate on qualified dividends is zero, 15% or 20%, following the same taxable income breakpoints for ANCG provided in Table I:5-1. This significant reduction of tax rates for dividend income has resulted in an increased interest in stocks with high dividends.

Taxpayers who own mutual funds must recognize their share of capital gains even if no distributions are received. Many mutual fund shareholders reinvest their distributions instead of withdrawing assets from the mutual fund. Mutual funds must classify the gains as short-term or long-term, and long-term gains will need to be separated by rate groups. When shareholders of a mutual fund recognize their share of capital gains when no distribution is actually received, the basis for their shares is increased.

EXAMPLE I:5-63 ▶ Eunice, whose tax rate is 32%, is a shareholder of Canyon Mutual Fund. The basis for her shares is $23,000. At the end of the current year, she received a statement from Canyon indicating her share of the following: qualified dividend income, $200; STCG, $300; 28-percent rate gain, $1,000; and ANCG of $1,500. The increase in her taxes as a result of her ownership of the mutual shares is $631 [($200 × 15%) + ($300 × 32%) + ($1,000 × 28%) + ($1,500 × 15%)]. The basis for her shares of Canyon Mutual Fund is increased to $26,000. ◀

ADDITIONAL COMMENT

Prior to 2003, noncorporate taxpayers preferred to have LTCG instead of dividend income.

The 3.8% Net Investment Income Tax (NIIT). The Affordable Care Act, which requires most U.S. citizens and legal residents to have health insurance, added a new Medicare tax on certain taxpayers' net investment income. Investment income includes interest, dividends, NSTCG, NLTCG, rental, and royalty income. Starting in 2013, individuals are subject to a 3.8% surtax on the lesser of net investment income (NII) or the excess of modified AGI (MAGI) over a certain threshold amount.

MAGI is the sum of AGI plus the net foreign earned income excluded, and NII is gross investment income less allocable investment expenses. The threshold amount is $200,000 for individuals (single or head of household) or $250,000 for married couples (and surviving spouse). The threshold amounts are not indexed for inflation.

EXAMPLE I:5-64 ▶ The Robinsons file a joint return in 2019 with $325,000 of MAGI which includes $100,000 of net investment income. They must pay the new 3.8% Medicare tax on $75,000 (net investment income of $325,000 less $250,000 threshold). ◀

EXAMPLE I:5-65 ▶ Pablo is single and a dentist with MAGI of $800,000 and taxable income of $730,000. MAGI includes LTCG of $220,000 from sale of Google stock and qualified dividend income of $60,000. Pablo's NIIT is $10,640 (3.8% × $280,000). Because his taxable income is more than $434,550 his income tax rate on the LTCG and dividend income is 20%, however, his total tax rate is 23.8% after considering the new Medicare tax. ◀

ADDITIONAL COMMENT

Estates and certain trusts may be required to pay the new 3.8% Medicare tax on NII.

[43] For years prior to 1990, a myriad of rules have applied. Prior to 1987, noncorporate taxpayers received a deduction from gross income equal to 60% of the taxpayer's net capital gain. For years 1987–1990, net capital gains were subject to tax at ordinary income rates.

[44] Sec. 1(h)(11).

Tax Treatment of Capital Gains and Losses: Corporate Taxpayers

OBJECTIVE 5

Understand how capital gains are taxed for corporate taxpayers

Most topics covered in this chapter concerning capital gains and losses, including the classification of an asset as a capital asset, rules for determining holding periods, and the procedure for offsetting capital losses against capital gains, apply to both corporate and noncorporate taxpayers. However, a major difference is that the lower tax rates of zero, 15%, 20%, 25%, and 28% on net capital gain for noncorporate taxpayers do not apply to corporations. A second significant difference relates to the treatment of capital losses: Unlike the noncorporate taxpayer who may deduct up to $3,000 of capital losses from ordinary income, corporations may offset capital losses only against capital gains. Corporate taxpayers may carry capital losses back to each of the three preceding tax years (the earliest of the three tax years first and then to the next two years) and forward for five years to offset capital gains in such years. When a corporate taxpayer carries a loss back to a preceding year or forward to a following year, the loss is treated as an STCL.[45]

EXAMPLE I:5-66 ▶

The Peach Corporation has income from operations of $200,000, a NSTCG of $40,000, and a NLTCL of $56,000 during the current year. The $40,000 NSTCG is offset by $40,000 NLTCL. The remaining $16,000 of NSTCL may not be offset against the $200,000 of other income but may be carried back three years and then forward five years to offset capital gains arising in these years. If Peach has NLTCG and/or NSTCG in the previous three years, a refund of taxes paid during those years will be received during the current year. ◀

HISTORICAL NOTE

The House of Representatives proposed a reduction in corporate net capital gains in 1997, but the proposal was rejected.

TYPICAL MISCONCEPTION

Because the carryover for net operating losses is 20 years, it is sometimes erroneously assumed that the carryover for corporate capital losses is also 20 years instead of five years.

Unlike individual taxpayers, corporations do not receive any preferential rate reductions for net capital gains. Corporations are taxed on ordinary income and LTCG at a flat rate of 21% starting in 2018.

Topic Review I:5-2 summarizes the principal differences in the tax treatment of capital gains and losses for corporate and noncorporate taxpayers.

TOPIC REVIEW I:5-2

Comparison of Corporate and Noncorporate Taxpayers: Capital Gains and Losses

	Noncorporate	Corporate
A statutory maximum tax rate applicable to net capital gain	Yes, 0%, 15%, 20%, 25%, and 28%	No
Offset of net capital losses against ordinary income	Yes, up to $3,000	No
Carryback of capital losses	No	Yes, three years as STCLs
Carryforward of capital losses	Yes, indefinitely	Yes, five years as STCLs

Sale or Exchange

OBJECTIVE 6

Recognize when a sale or exchange has occurred

As previously indicated, capital gains and losses result from the sale or exchange of capital assets. Although Sec. 1222 does not define a sale or an exchange, a **sale** is generally considered to be a transaction where one receives cash or the equivalent of cash, including the assumption of one's debt. An **exchange** is a transaction where one receives a reciprocal transfer of property, as distinguished from a transaction where one receives only cash or a cash equivalent.[46]

EXAMPLE I:5-67 ▶

Two years ago, Bart acquired 100 shares of Alaska Corporation common stock for $12,000 to hold as an investment. Bart sells 50 shares of the stock to Sandy for $10,000 and transfers the other 50 shares to Gail in exchange for land that has a $10,000 FMV. In each transaction, Bart realizes a $4,000 ($10,000 − $6,000) LTCG due to the sale or exchange of a capital asset. The transfer to Sandy qualifies as a sale, and the transfer to Gail qualifies as an exchange. ◀

To qualify as a sale or exchange, the transaction must be bona fide. Transactions between related parties such as family members are closely scrutinized. For example, a sale

[45] Sec. 1212(a).

[46] Reg. Sec. 1.1002-1(d).

of property on credit to a relative may be a disguised gift if there is no intention of collecting the debt. If this is the case, a subsequent bad debt deduction due to the debt's worthlessness is disallowed. In some instances, the Code specifically states that a particular transaction or event either qualifies or does not qualify for sale or exchange treatment. For example, the holder of an option who fails to exercise such an option treats the lapse of the option as a sale or exchange.[47] However, abandonment of property is generally not deemed to be a sale or exchange.[48]

WORTHLESS SECURITIES

ADDITIONAL COMMENT

The worthlessness of a security is treated as a sale or exchange so that the taxpayer is not forced to arrange for someone to buy the security for a token amount.

If a security that is a capital asset becomes worthless during the year, Sec. 165(g)(1) specifies that any loss is treated as a loss from the sale or exchange of a capital asset on the last day of the tax year. The term includes stock, a stock option, and "a bond, debenture, note or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political division thereof, with interest coupons or in registered form."[49] Whether a security has become worthless during the year is a question of fact, and the taxpayer has the burden of proof to show evidence of worthlessness.[50]

EXAMPLE I:5-68 ▶ Charlotte purchased $40,000 of bonds issued by the Jet Corporation in March 2018. In February 2019, Jet is declared bankrupt, and its bonds are worthless. Charlotte has an LTCL of $40,000 because the bonds have become worthless and are deemed to have been sold on the last day of 2019. The more-than-one-year holding period requirement is satisfied by the last day of 2019. ◀

REAL-WORLD EXAMPLE

A corporation owned 76% of the stock of another company. The corporation later acquired the remaining 24% of the stock, allegedly for the purpose of avoiding interference by minority shareholders. Later the corporation claimed an ordinary loss on the worthless stock because it owned at least 80% of the stock. The Court treated the loss as a capital loss because the acquisition of the remaining stock was without a business purpose. *Hunter Mfg. Co.*, 21 T.C. 424 (1953).

Securities in Affiliated Corporations. If the security that becomes worthless is a security in a domestic affiliated corporation owned by a corporate taxpayer, the worthless security is not considered a capital asset. Thus, a corporate taxpayer's loss due to owning worthless securities in an affiliated corporation is treated as an ordinary loss. Because capital losses are of only limited benefit to corporate taxpayers, the classification of the loss as ordinary is preferable.

To qualify as an affiliated corporation, the parent corporation must own at least 80% of the voting power of all classes of stock and at least 80% of each class of nonvoting stock. The subsidiary corporation must be engaged in the active conduct of an operating business as opposed to being a passive investment company (i.e., more than 90% of its aggregate gross receipts must be from sources other than passive types of income such as royalties, dividends, and interest).[51]

EXAMPLE I:5-69 ▶ Ace Corporation owns 80% of all classes of stock issued by the same Jet Corporation described in Example I:5-68. Jet Corporation is actively engaged in an operating business and has no income from passive investments before being declared bankrupt. Ace's loss from its worthless stock investment is an ordinary loss instead of a capital loss because Jet is an affiliated corporation. Ace owns at least 80% of all classes of Jet's stock and more than 90% of Jet's gross receipts are from sources other than passive types of income. ◀

RETIREMENT OF DEBT INSTRUMENTS

Generally, the collection of a debt is not a sale or an exchange. However, if a debt instrument is retired, amounts received by the holder are treated as being received in an exchange.[52] Debt instruments include bonds, debentures, notes, certificates, and other evidences of indebtedness.

EXAMPLE I:5-70 ▶ In 2014 the Rocket Corporation issued $50,000 of five-year, interest-bearing bonds that were purchased by Elaine as an investment for $49,800. Elaine receives $50,000 at maturity in 2019. Retirement of the debt instrument is an exchange, and the $200 gain is an LTCG.[53] ◀

Although Congress has provided that retirements of debt instruments are treated as exchanges, Congress is not willing to allow taxpayers to convert large amounts of potential ordinary interest income into capital gain by purchasing debt instruments at a substantial

[47] Sec. 1234(b) and Reg. Sec. 1.1234-1(b).
[48] Reg. Secs. 1.165-2 and 1.167(a)-8.
[49] Sec. 165(g)(2).
[50] *Minnie K. Young v. CIR*, 28 AFTR 365, 41-2 USTC ¶9744 (2nd Cir., 1941).
[51] Sec. 165(g)(3).
[52] Sec. 1271(a).
[53] If Rocket Corporation issued the bonds with the intention of calling the bonds before maturity, Sec. 1271(a)(2) treats the gain as ordinary income.

discount. As illustrated in Example I:5-70, a small amount of bond discount is sometimes converted to capital gain. However, if the discount is large enough to be classified as original issue discount, the discount must be amortized and included in gross income for each day the debt instrument is held for both cash and accrual method taxpayers. Original issue discount (OID) is defined as "the excess (if any) of the stated redemption price at maturity over the issue price."[54]

EXAMPLE I:5-71 ▶ On January 1, 2019, Connie purchases $100,000 of the City Corporation's newly issued bonds for $85,000. The bonds mature in 20 years. In 2019 and in subsequent years Connie must annually recognize as interest income a portion of the $15,000 of OID. ◀

The OID is considered to be zero if the amount of discount "is less than ¼ of 1% of the stated redemption price at maturity, multiplied by the number of complete years to maturity."[55] In Example I:5-70, the $200 discount is not OID because it is less than $625 (0.0025 × $50,000 × 5 years). If Connie pays more than $95,000 for the bonds in Example I:5-71, the OID is zero.

ADDITIONAL COMMENT

Two different types of bonds are sold at a discount: original issue discount (OID) bonds and market discount bonds. OID bonds are issued at a discount, whereas market discount bonds have market discount resulting from a rise in interest rates after the issuance of the bonds.

Original Issue Discount. Instead of spreading the OID ratably over the life of the bond, amortization of the discount is based on an interest amortization method called the **constant interest rate method.** The total amount of interest income is determined by multiplying the interest yield to maturity by the adjusted issue price. With this method of amortizing discount, the amount of OID amortized increases for each year the bond is held. In the above example, Connie recognizes a larger amount of interest income in 2020 than in 2019 due to amortization of the OID.

The daily portion of the OID for any accrual period is "determined by allocating to each day in any accrual period its ratable portion to the increase during such accrual period in the adjusted issue price of the debt instrument."[56] The increase in the adjusted issue price for any accrual period is shown below.

$$\text{increase in the adjusted issue price} = \left[\begin{array}{l}\text{Adjusted issue price at the begining of the accrual period}\end{array} \times \begin{array}{l}\text{Yield to maturity}\end{array}\right] - \begin{array}{l}\text{Interest payments during the accrual period}\end{array}$$

EXAMPLE I:5-72 ▶ On June 30, 2019, Fred purchases a 10%, $10,000 corporate bond for $9,264. The bond is issued on June 30, 2019, and matures in five years. Interest is paid semiannually, and the effective yield to maturity is 12% compounded semiannually. In 2019, Fred recognizes interest income of $556, as illustrated in Table I:5-2. The adjusted issue price as of January 1, 2020, is $9,320. This is the sum of the issue price plus any amounts of OID includible in the income of any holder since the date of issue. ◀

KEY POINT

The owner of an OID bond is normally required to accrue interest income each year regardless of the owner's method of accounting.

If a debt instrument is sold or exchanged before maturity, part of the OID is included in the seller's income. The amount to be included depends on the number of days the debt instrument is owned by the seller within the accrual period.

EXAMPLE I:5-73 ▶ Assume the same facts as in the above example, except that Fred sells the corporate bond to Carolyn on February 24, 2022 (the 55th day in the accrual period). Fred must include $23 [(55 days ÷ 181 days in the accrual period) × $75] of accrued interest for the period of January 1, 2022, to February 24, 2022, in income for 2022. Fred's basis for the bond increases by $23. Thus, his basis for determining a gain or loss is $9,603 ($9,580 + $23). (For simplification, ignore the impact of leap years.) ◀

Market Discount Bonds Purchased After April 30, 1993. The sale or exchange of a market discount bond may result in part or all of the gain being classified as ordinary

[54] Sec. 1273(a)(1).
[55] Sec. 1273(a)(3).
[56] Sec. 1272(a)(3).

▼ TABLE I:5-2
Computation for Interest Income in Examples I:5-72 and I:5-73

	Interest Received (1)	Amortization of Original Issue Discount (2)	Interest Income (3) = (1) + (2)	Taxpayer's Basis for the Bond
6-30-19				$ 9,264
12-31-19	$ 500	$ 56[a]	$ 556	9,320[b]
6-30-20	500	59	559	9,379
12-31-20	500	63	563	9,442
6-30-21	500	67	567	9,509
12-31-21	500	71	571	9,580
6-30-22	500	75	575	9,655
12-31-22	500	79	579	9,734
6-30-23	500	84	584	9,818
12-31-23	500	89	589	9,907
6-30-24	500	93[c]	593	10,000
	$5,000	$736	$5,736	

[a] 6% × $9,264 − $500 = $56.
[b] $9,264 + $56 = $9,320.
[c] This figure is adjusted for rounding.

income.[57] A market discount bond is a bond that is acquired in the bond market at a discount. Market discount is the excess of the stated redemption price of the bond at maturity over the taxpayer's basis for such bond immediately after it is acquired.

EXAMPLE I:5-74 ▶ On January 1, Stephanie purchased $100,000 of 8%, 20-year bonds for $82,000. The bonds were issued at par by the Solar Corporation two years ago on January 1. The bonds are market discount bonds. ◀

Similar to OID, there is a de minimis rule for determining market discount. Market discount is zero if the discount is less than ¼ of 1% of the stated redemption price of the bond at maturity multiplied by the number of complete years to maturity.[58] If Stephanie paid $95,500 or more for the Solar Corporation bonds in Example I:5-74, the bonds would not be market discount bonds.[59]

Gain realized on disposition of the market discount bond is ordinary income to the extent of the accrued market discount.[60] The ratable accrual method (straight line method computed on a daily basis) is used to determine the amount of the accrued market discount recognized as ordinary income.[61] The market discount is allocated on the basis of the number of days the taxpayer held the bond relative to the number of days between the acquisition date and maturity date.

EXAMPLE I:5-75 ▶ Assume the same facts as in the above example except Stephanie sells the bonds to Smith three years later for $86,400 on January 1st. $3,000 (3/18 × $18,000) of the $4,400 ($86,400 − $82,000) gain is ordinary income and the remaining gain is LTCG. If Stephanie sold the bond for more than $82,000 but less than $85,000, all of the gain is ordinary income. The entire $18,000 gain is ordinary income if the bond is held to maturity. ◀

[57] Ordinary income treatment for accrued market discount does not apply to owners of taxable market discount bonds issued on or before July 18, 1984, if the bonds were acquired before May 1, 1993. Owners of tax-exempt bonds are not required to accrue market discount if the bonds were acquired before May 1, 1993 (regardless of the issue date).

[58] Sec. 1278(a)(2)(C).
[59] $100,000 × .25% × 18 years = $4,500.
[60] Sec. 1276(a)(1).
[61] Sec. 1276(b)(1). A taxpayer may elect to use the constant interest rate method (see Sec. 1276(b)(2)).

OPTIONS

The owner of an option to buy property may sell the option, exercise the option, or allow the option to expire. If the option is exercised, the amount paid for the option is added to the purchase price of the property acquired.[62]

EXAMPLE I:5-76 ▶ On August 5, 2019, Len pays $600 for an option to acquire 100 shares of O-Joy Corporation common stock for $80 per share at any time before December 20, 2019. Len exercises the option on November 15, 2019, and pays $8,000 for the stock. Len's basis for the 100 shares of O-Joy is $8,600 ($8,000 + $600), and the stock's holding period begins on November 15, 2019. ◀

ADDITIONAL COMMENT

An option is a contract in which the owner of property agrees with a potential buyer that the potential buyer has the right to buy the property at a fixed price within a certain period of time.

When an option is sold or allowed to expire, a sale or exchange has occurred and gain or loss is therefore recognized.[63] The character of the underlying property determines whether the gain or loss from the sale or expiration of the option is capital or ordinary in nature. If the optioned property is a capital asset, the option is treated as a capital asset and capital gain or loss is recognized on the sale or exchange.

EXAMPLE I:5-77 ▶ On March 2, 2019, Holly pays $270 for an option to acquire 100 shares of Arkansas Corporation stock for $30 per share at any time before December 10, 2019. As a result of an increase in the market value of the Arkansas stock, the market price of the option increases and Holly sells the option for $600 on August 2, 2019. Because the Arkansas stock is a capital asset in the hands of Holly, the option is a capital asset and she must recognize an STCG of $330 ($600 − $270). ◀

EXAMPLE I:5-78 ▶ On October 12, 2018, Mary paid $400 for an option to acquire 100 shares of Portland Corporation stock for $50 per share at any time before February 19, 2019. The price never exceeds $50 before February 19, 2019, and Mary does not exercise the option. Because the option expires, Mary recognizes an STCL of $400 in 2019. ◀

SELF-STUDY QUESTION

Marc writes a call option on stock owned by him and receives $800 on November 1, Y2. The value of the stock declines and the option is allowed to expire on February 15, Y3. When does Marc recognize the $800 gain?

ANSWER

Marc recognizes the STCG in Y3 when the transaction is completed.

Transactions in which taxpayers purchase or write options to buy (calls) are quite common today. An investor who anticipates that the market value of a stock or security (e.g., common stock) will increase during the next few months may purchase a call option instead of actually buying the stock. As indicated above, the tax treatment for the option depends on whether the call is exercised, sold, or expires. Someone, however, must be willing to write a call on the stock. Typically an owner of the same stock will write a call option. The writer of the call receives a payment for granting the right to purchase the stock at a fixed price within a given period of time.

If the call is exercised, the writer of the call adds the amount received for the call to the sales price to determine the amount realized.[64] If the call is not exercised within the given time period and thus expires, the writer retains the amount received for the option and recognizes an STCG in the year the call expires. The gain is short-term even if the option is written and held for more than a year.

EXAMPLE I:5-79 ▶ Sam owns 100 shares of Madison Corporation common stock, which he purchased on May 1, 2012, for $4,000. On November 8, 2019, Sam writes a call that gives Joan, an investor, the option to purchase Sam's 100 shares of Madison stock at $60 per share any time before April 19, 2020. The current market price of Madison stock is $56 per share, and Sam receives $520 for writing the call. If the call is exercised, Sam has an LTCG of $2,520 [($6,000 + $520) − $4,000] in the year the call is exercised. If the call is not exercised and expires on April 19, 2020, Sam must recognize an STCG of $520 in 2020. ◀

EXAMPLE I:5-80 ▶ Assume the same facts as in Example I:5-79, and consider the tax treatment for Joan, the holder of the call. If Joan exercises the call, the basis of the stock is $6,520 ($6,000 + $520). If she does not exercise the call, an STCL of $520 is recognized. If Joan sells the call, the amount received is compared with her basis in the call ($520) to compute Joan's gain or loss. ◀

KEY POINT

Note that Sam in Example I:5-79 did not have to recognize gross income when he received $520 on November 8.

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[62] Rev. Rul. 58-234, 1958-1 C.B. 279.

[63] Sec. 1234(a).

[64] Rev. Rul. 58-234, 1958-1 C.B. 279.

PATENTS

To encourage technological progress and to clarify whether a transfer of rights to a patent is capital gain or ordinary income, Congress created Sec. 1235, which allows the holder of a patent to treat the gain resulting from the transfer of all substantial rights in a patent as LTCG. This tax treatment is more favorable than that accorded to producers of artistic and literary works, who receive ordinary rather than capital gain from the sale of their works.

KEY POINT

A copyright held by a taxpayer whose personal efforts created it is omitted from the definition of a capital asset. However, a patent can be considered a capital asset. In effect, the tax law could be said to favor individuals whose efforts lead to scientific or technological advancement.

Requirements for Capital Gain Treatment. Section 1235 provides that the transfer of all substantial rights to a patent by the holder of the patent is treated as a sale or exchange of a capital asset that has been held long-term. Thus, LTCG is recognized on the transfer of a patent regardless of its holding period or the character of the asset. Favorable long-term capital gain treatment applies even if the transferor of the patent receives periodic payments contingent on the productivity, use, or disposition of the property transferred.[65]

EXAMPLE I:5-81 ▶ Clay purchased a patent for a small utensil used to peel shrimp earlier this year. He transfers all rights to the patent to a manufacturing company. Clay receives $100,000 plus 40 cents per utensil sold. Because Sec. 1235 applies, the total of the lump-sum payment and the royalty payments received less his cost basis for the patent is recognized as an LTCG. ◀

Substantial Rights. The principal requirement in Sec. 1235 is that the holder must transfer all substantial rights to the patent. The Regulations state that the circumstances of the whole transaction should be considered in determining whether all substantial rights to a patent have been transferred.[66] All substantial rights have not been transferred if the patent rights of the purchaser are limited geographically within the country of issuance or the rights are for a period less than a patent's remaining life.

EXAMPLE I:5-82 ▶ Bruce, an inventor, transfers one of his U.S. patents on a manufacturing process to a manufacturer located in Utah. The manufacturer's rights to use the patent are limited to the state of Utah. Because the use of the patent is limited to a geographical area, all substantial rights have not been transferred, and Sec. 1235 does not apply. Payments received for the use of the patent are royalties and taxed as ordinary income. ◀

Definition of a Holder. Long-term capital gain treatment applies only to a holder of the patent rights. For purposes of Sec. 1235, a holder is an individual whose efforts created the property or an individual who acquires the patent rights from the creator for valuable consideration before the property covered by the patent is placed in service or used. Furthermore, the acquiring individual may not be related to the creator or be the creator's employer.

Prior to the Tax Cuts and Jobs Act, Congress had a clear distinction between a patent and other intangible assets held by their creators. Most intangible assets such as a copyright were not capital assets in the hands of their creator or a taxpayer who obtained his or her basis from the creator. Starting in 2018, patents have been added to the list of self-created intangible assets that are not capital assets; thus the benefits of Section 1235 may be more limited today.

Section 1235 may not be used by corporate taxpayers because corporations are not permitted to be classified as holders. Although a partnership is not permitted to be a holder, individual partners may qualify as holders to the extent of the partner's interest in the patent owned by the partnership.

EXAMPLE I:5-83 ▶ Joy purchases a patent from Martin, whose efforts created the patent. The purchase occurs before the property is placed in service or used. Joy and Martin are unrelated individuals, and Joy is not Martin's employer. For purposes of Sec. 1235, both Joy and Martin qualify as holders. ◀

ADDITIONAL COMMENT

The scope of Sec. 1253 is very broad. A franchise "includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities within a specified area."

FRANCHISES, TRADEMARKS, AND TRADE NAMES

Before the enactment of Sec. 1253, significant uncertainty existed as to whether the transfer of a franchise, trademark, or trade name should be treated as a sale or exchange or as a licensing agreement. If the transfer is tantamount to a sale of the property, payments received should be treated by the transferor as a return of capital and capital gain, and the transferee should be required to capitalize and amortize such payments. However, if the

[65] Sec. 1235(a).

[66] Reg. Sec. 1.1235-2(b).

transfer represents a licensing agreement, the transferor should recognize ordinary income and the transferee should receive an ordinary deduction for such payments.

REAL-WORLD EXAMPLE

Shaquille O'Neal, a well-known former professional basketball player, has obtained a trademark on his nickname, Shaq. The trademark covers products such as athletic shoes, cake decorations, bathroom tissue, bathtub toys, and kites.

Section 1253, which applies to the granting of a franchise, trademark, or trade name, as well as renewals and transfers to third parties, attempts to resolve the uncertainty by stating, "A transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name."[67]

Examples of some rights that are to be considered a "significant power, right, or continuing interest"[68] include the right to:

- Disapprove of any assignment.
- Terminate the agreement at will.
- Prescribe standards of quality for products, product services, and facilities.
- Require the exclusive selling or advertising of the transferor's products or services.
- Require the transferee to purchase substantially all of its supplies and equipment from the transferor.

If the transferor does not retain any significant power, right, or continuing interest in the property, the transferor treats the transfer as a sale of the franchise and has the benefits of capital gain treatment. However, any amounts received that are contingent on the productivity, use, or disposition of such property must be treated as ordinary income by the transferor.

EXAMPLE I:5-84 ▶ Rose, who owns a franchise with a basis of $100,000, transfers the franchise to Ruth and retains no significant power, right, or continuing interest. Rose receives a $250,000 down payment when the agreement is signed and annual payments for five years equal to 10% of all sales in excess of $2,000,000. Rose has a capital gain of $150,000 with respect to the initial payment, but all of the payments received during the next five years will be ordinary income because they are contingent payments. ◀

Under Sec. 1253, the transferee may deduct payments that are contingent on the productivity, use, or disposition of such property as business expenses. Generally, other payments are capitalized and amortized over a period of 15 years.[69] In practice, payments received for the transfer of a franchise are generally treated as ordinary income to the transferor and are deductible by the transferee because in most franchise agreements the transferor desires to maintain significant powers, rights, or continuing interests in the franchise operation. Also, in many instances the payments are, in part, predicated on the success of the franchised business and are, therefore, established as contingent payments.

LEASE CANCELLATION PAYMENTS

REAL-WORLD EXAMPLE

A taxpayer sold a building with the purchaser paying $500,000 and the lessee of the building paying $60,000 under a separate agreement to cancel the lease. The $60,000 was treated as ordinary income because no "sale or exchange" of the property occurred with respect to the lessee's $60,000 payment. *Gary Gurvey v. U.S.*, 57 AFTR 2d 86-1062, 86-1 USTC ¶9260 (D.C. Ill., 1986).

A lease arrangement may be terminated before the lease period expires, and a lease cancellation payment may be made as consideration for the other party's agreement to terminate the lease. Either a lessor or a lessee may receive such a payment because the payment is normally made by the person who wants to cancel the lease. The tax treatment may differ significantly depending on which party is the recipient.

Payments Received by Lessor. The Supreme Court has ruled that lease cancellation payments received by a lessor are treated as ordinary income on the basis that the payments represent a substitute for rent.[70] Lease cancellation payments are included in the lessor's income in the year received, even if the lessor uses an accrual method.[71]

Payments Received by Lessee. Payments received by a lessee for canceling a lease are considered amounts received in exchange for the lease.[72] If the lease is a capital asset, any gain or loss is a capital gain or loss.

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[67] Sec. 1253(a). Section 1253(e) prevents the basic Sec. 1253 rules from applying to the transfer of a professional sports franchise.
[68] Sec. 1253(b)(2).
[69] Sec. 197(a).
[70] *Walter M. Hort v. CIR*, 25 AFTR 1207, 41-1 USTC ¶9354 (USSC, 1941).
[71] *Farrelly-Walsh, Inc.*, 13 B.T.A. 923 (1928).
[72] Sec. 1241.

EXAMPLE I:5-85 ▶ Jim has a three-year lease on a house used as his personal residence. The lessor has an opportunity to sell the house and has agreed to pay $1,000 to Jim to cancel the lease. Assuming that Jim has no basis in the lease, the gain of $1,000 is capital gain because the lease is a capital asset. ◀

Holding period

OBJECTIVE 7

Determine the holding period for an asset when a sale or disposition occurs

The length of time an asset is held before it is disposed of (i.e., the **holding period**) is an important factor in determining whether any gain or loss resulting from the disposition of a capital asset is treated as long-term or short-term. To be classified as a long-term capital gain or loss, the capital asset must be held more than one year.[73] To determine the holding period, the day of acquisition is excluded and the disposal date is included.[74]

If the date of disposition is the same date as the date of acquisition, but a year later, the asset is considered to have been held for only one year. If the property is held for an additional day, the holding period is more than one year.

EXAMPLE I:5-86 ▶ Arnie purchased a capital asset on April 20, 2018, and sells the asset at a gain on April 21, 2019. The gain is classified as an LTCG. If the asset is sold on or before April 20, 2019, the gain is an STCG. ◀

ADDITIONAL COMMENT

When determining the holding period for marketable securities, it is important to use the "trade" dates, not the "settlement" dates.

The fact that all months do not have the same number of days is not a factor in determining the one-year period. Acquisitions made on the last day of any month must be held until the first day of the thirteenth subsequent month in order to have been held for more than one year.

EXAMPLE I:5-87 ▶ Alford sells stock held as an investment and recognizes a gain. If the capital asset was purchased on May 31, 2018, the gain is LTCG if the asset is sold on or after June 1, 2019. If sold on or before May 31, 2019, the gain is STCG and the lower preferential rates do not apply. ◀

ADDITIONAL COMMENT

The Securities and Exchange Commission requires investors who purchase or sell securities to deliver the funds to pay for the securities or deliver the certificates to be sold within two days of when the order is placed.

PROPERTY RECEIVED AS A GIFT

If a person receives property as a gift and uses the donor's basis to determine the gain or loss from a sale or exchange, the donor's holding period is added to the donee's holding period.[75] In other words, the donee's holding period includes the donor's holding period. If, however, the donee's basis is the FMV of the property on the date of the gift, the donee's holding period starts on the day after the date of the gift. This situation occurs when the FMV is less than the donor's basis on the date of the gift and the property is subsequently sold at a loss.

EXAMPLE I:5-88 ▶ Cindy receives a capital asset as a gift from Marc on July 4, 2019, when the asset has a $4,000 FMV. Marc acquired the property on April 12, 2019, for $3,400. If Cindy sells the asset after April 12, 2020, any gain or loss is LTCG or LTCL. Cindy's basis is the donor's cost because the FMV of the property is higher than the donor's basis on the date of the gift. Because Cindy takes Marc's basis, Marc's holding period is included. ◀

EXAMPLE I:5-89 ▶ Roy receives a capital asset as a gift from Diane on September 12, 2019, when the asset has a $6,000 FMV. Diane acquired the asset on July 1, 2018, for $6,500. If the asset is sold at a gain (i.e., for more than $6,500), Roy's holding period starts on July 1, 2018, the date when Diane acquired the property, because the donor's basis of $6,500 is used by Roy to compute the gain. If the asset is sold at a loss (i.e., for less than $6,000), Roy's holding period does not start until the day after the date of the gift, September 13, 2019, because Roy's basis is the $6,000 FMV. The FMV is used to compute the loss because it is less than the donor's basis on the date of the gift. ◀

ADDITIONAL COMMENT

The provision permitting the holding period of property received from a decedent to be deemed to be long-term is a rule of convenience. It is not necessary to try to determine when the decedent actually acquired the property.

PROPERTY RECEIVED FROM A DECEDENT

The holding period of property received from a decedent is always deemed to be long-term. If the person who receives the property from the decedent sells the property within one

[73] Sec. 1222. A six-month holding period was applied to property acquired after June 27, 1984 and before January 1, 1988.

[74] *H. M. Hooper*, 26 B.T.A. 758 (1932), and Rev. Rul. 70-598, 1970-2 C.B. 168.

[75] Sec. 1223(1) and Reg. Sec. 1.1223-1(b).

year after the decedent's death, the property is considered to be held for more than one year regardless of how long the property is actually held.[76]

EXAMPLE I:5-90 ▶ The executor of Paul's estate sells certain securities for $41,000 on September 2, 2019, which were valued in the estate at their FMV of $40,000 on June 5, 2019, the date of Paul's death. The estate has an LTCG of $1,000 because the securities are considered to have been held long-term. ◀

NONTAXABLE EXCHANGES

ADDITIONAL COMMENT

The like-kind exchange rules under Sec. 1031 allow taxpayers to trade certain types of business and investment properties with no tax consequences arising from the exchange. Like-kind exchanges are discussed in Chapter I:12.

In a nontaxable exchange, the basis of the property received is determined by taking into account the basis of the property given in the exchange. If the properties are capital assets or Sec. 1231 assets, the holding period of the property received includes the holding period of the surrendered property.[77] In essence, the holding period of the property given up in a tax-free exchange is tacked on to the holding period of the property received in the exchange.

RECEIPT OF NONTAXABLE STOCK DIVIDENDS AND STOCK RIGHTS

If a shareholder receives nontaxable stock dividends or stock rights, the holding period of the stock received as a dividend or the stock rights received includes the holding period for the stock owned by the shareholder.[78] However, if the stock rights are exercised, the holding period for the stock purchased begins with the date of exercise.

EXAMPLE I:5-91 ▶ As a result of owning Circle Corporation stock acquired three years ago, Paula receives nontaxable stock rights on June 5, 2019. Any gain or loss on the sale of the rights is long-term, regardless of whether any basis is allocated to the rights, because the holding period of the rights includes the holding period of the stock. ◀

EXAMPLE I:5-92 ▶ Assume the same facts as in the example above, except that the stock rights are exercised on August 20, 2019. The holding period for the newly acquired Circle stock begins on the date of exercise. ◀

STOP & THINK

Question: Carter owns 500 shares of Okoboji, Inc. (current market price of $310) with a basis of $101,500 acquired three years ago. In May of the current year, she receives 500 stock rights and exercises those rights that entitle her to purchase 500 shares of Okoboji at $300 per share. The current market price of the stock right is $40 per right. She plans to sell the 500 shares obtained by exercising the stock rights in January when she expects the market price to be $400 per share. Why should she elect to allocate basis to the stock rights?

Solution: If she does not allocate basis, her STCG will be $50,000 ($200,000 − $150,000). If she allocates basis to the stock rights, the basis of the 500 shares obtained when she exercises the rights is $161,600 ($150,000 + $11,600), and her STCG will be $38,400 ($200,000 − $161,600). Note that Carter might benefit by waiting a few months before selling because the gain might then be LTCG. She could sell the original 500 shares and have an LTCG.

JUSTIFICATION FOR PREFERENTIAL TREATMENT OF NET CAPITAL GAINS

Preferential treatment for capital gains was first created by the Revenue Act of 1921, which became effective on January 1, 1922. Despite almost continuous controversy concerning the need for preferential treatment, some form of preferential treatment for capital gains has existed since 1922. The range of controversy concerning the need for preferential tax treatment for capital gains is wide. Some maintain that capital gains do

[76] Sec. 1223(11).
[77] Sec. 1223(1).
[78] Sec. 1223(5) and Reg. Sec. 1.1223-1(e).

HISTORICAL NOTE

In part the preferential treatment of net capital gains was repealed in the Tax Reform Act of 1986 because Congress believed that the reduction of individual tax rates on such forms of capital income as business profits, interest, dividends, and short-term capital gains eliminated the need for a reduced rate for net capital gains.

not represent income and should not be taxed, whereas others maintain that capital gains are no different from any other type of income and should be taxed accordingly.[79] A few of the most common arguments are discussed below.

MOBILITY OF CAPITAL

Without some form of preferential treatment, taxpayers who own appreciated capital assets may be unwilling to sell or exchange the asset if high tax rates exist, despite the presence of more attractive investment opportunities. In essence, the taxpayer may be "locked in" to holding an appreciated capital asset instead of shifting resources to more profitable investments.

EXAMPLE I:5-93 ▶ Carmen owns Missouri Corporation stock with a $4,000 basis and a $20,000 FMV. She anticipates that the future after-tax annual return will be 10% on the Missouri stock and 12% on Kansas Corporation stock that has a similar level of risk. Assume her marginal tax rate is 35% (without consideration of favorable capital gain rates). Without preferential treatment of capital gains, Carmen will have to pay a tax of $5,600 ($16,000 × 0.35) on the sale of the Missouri stock and will have only $14,400 ($20,000 − $5,600) to invest in the Kansas stock. With a 12% return, she will receive an investment return of only $1,728 ($14,400 × 0.12), as compared with $2,000 ($20,000 × 0.10) if she maintains the investment in the Missouri stock. ◀

ADDITIONAL COMMENT

According to *The Wall Street Journal*, twelve industrialized nations impose a zero capital gains rate (10-15-07, p. A22).

While the payment of any tax due to the sale of an asset creates somewhat of a "locked-in" effect, the effect can be reduced by lowering the tax rate. The "locked-in" effect is even stronger for older taxpayers if the basis of inherited property is FMV at time of death. A lower tax rate on net capital gain should reduce the taxpayers unwillingness to sell the asset and allow for more mobility of capital. For a brief period in the 1990s, both the top ordinary income rate and the rate on net capital gain were 28%. Today, the top rate on ordinary income is 37% and 20% on adjusted net capital gain.

MITIGATION OF THE EFFECTS OF INFLATION AND THE PROGRESSIVE TAX SYSTEM

Because the tax laws do not generally reflect the effect of changes in purchasing power due to inflation, the sale or exchange of a capital asset may produce inequitable results. In fact, taxes may have to be paid even where a transaction results in an inflation-adjusted loss.

EXAMPLE I:5-94 ▶ Beverly purchased a capital asset nine years ago for $100,000. If the asset is sold today for $180,000 and the general price level has increased by 100% during the nine-year period, Beverly will have a taxable gain of $80,000, despite suffering an inflation-adjusted loss of $20,000 [$180,000 sale price − ($100,000 × 200%)]. ◀

ADDITIONAL COMMENT

The American Assembly at Columbia University, in its final report on *Reforming and Simplifying the Federal Tax System* issued in 1985, recommends that capital gains be taxed as ordinary income if they are adjusted for inflation.

With a progressive tax system, the failure to adjust for inflation creates an even greater distortion. However, it should be noted that this distortion applies to all assets, not just capital assets.

LOWERS THE COST OF CAPITAL

By reducing the tax rate on capital gains, investors are more willing to provide businesses with capital and the cost of capital is reduced. A lower cost of capital encourages capital formation to create more jobs and improve our competitive position in the global economy. Reducing the cost of capital is particularly important for the formation and growth of small business.

[79] Walter J. Blum, "A Handy Summary of the Capital Gains Argument," *Taxes—The Tax Magazine*, 35 (April 1957), pp. 247–66.

Tax planning considerations

OBJECTIVE 8

Describe tax planning opportunities for property transactions

SELECTION OF PROPERTY TO TRANSFER BY GIFT

Many tax reasons exist for making gifts of property, although the donor may incur a gift tax liability if the gift is a taxable gift. For example, taxpayers may give income-producing property to a taxpayer subject to a lower tax rate, or property expected to appreciate in the future may be given away to reduce estate taxes. Individuals may annually give property of $15,000[80] or less to a donee without making a taxable gift.[81]

EXAMPLE I:5-95 ▶ Maya, who is single, owns marketable securities with a $6,200 basis and $10,400 FMV. She makes gifts of the marketable securities to Phil and cash of $15,000 to Roy. Because of the $15,000 annual exclusion per donee, Maya's gifts are not taxable gifts. ◀

EXAMPLE I:5-96 ▶ Harry, who is single and has never made a taxable gift, makes a gift of land in 2019 with a $1,635,000 basis and a $16,215,000 FMV to Rita. Harry's taxable gift is $16,200,000 ($16,215,000 − $15,000), and he incurs a gift tax liability. Rita's basis is $1,635,000 + 90% of the gift tax paid by Harry [($16,215,000 − $1,635,000)/$16,200,000 = 90%]. ◀

Individuals often reduce future estate taxes by making gifts. By using the annual exclusion, an individual may reduce future estate taxes and avoid the gift tax.

EXAMPLE I:5-97 ▶ Christine owns only one asset in 2019—cash of $16.2 million—and has no liabilities. In December of 2019, she gifted $15,000 to each of her five grandchildren. Because of the $15,000 annual exclusion per donee, Christine's gifts were not taxable gifts. By making the gifts, she reduced her potential gross estate by $75,000 (5 × $15,000). ◀

ADDITIONAL COMMENT

A husband and wife can each make a $15,000 gift to their daughter in 2019, enabling her to receive a total of $30,000 annually without the parents having a taxable gift.

The selection of which property to give is important if one is attempting to reduce future estate taxes. It is generally preferable to make gifts of properties that are expected to significantly increase in value during the postgift period before the donor's death. Any increases in value after the date of the gift are not included in the donor's gross estate.

EXAMPLE I:5-98 ▶ In 1999, Hal owned Sun Corporation stock with a $100,000 FMV and Union Corporation stock with a $100,000 FMV. Hal expected the Sun stock to increase in value at a moderate rate and the Union stock to increase at a substantial rate. In 1999, Hal made a gift of the Union stock to Dana. Hal's taxable gift in 1999 was $90,000 ($100,000 − $10,000 annual exclusion in 1999). Hal dies in the current year when the FMVs of the Sun and Union stocks are $180,000 and $425,000, respectively. The postgift appreciation of $325,000 ($425,000 − $100,000) is not included in Hal's gross estate. By giving the Union stock instead of the Sun stock in 1999, Hal reduces his gross estate by $245,000. ◀

Gifts are often made for income tax purposes to shift income to other family members who are in a lower income tax bracket than the donor.

EXAMPLE I:5-99 ▶ In 2019, Anne has a marginal tax rate of 32% and owns Atlantic Corporation bonds, which have a $5,000 basis and $8,000 FMV. The bonds pay interest of $1,400 per year. If Anne gives the bonds to her dependent child, the interest income is shifted to the child. If the child has no other income, the child's taxable income is $300 ($1,400 − $1,100 standard deduction), and the child's marginal tax rate is 10%. The gift results in an annual income tax savings to the family unit of $418 [(0.32 × $1,400) − (0.10 × $300)]. The rate of tax that is imposed may be a special higher rate (see Chapter I:2) if the child is less than 18 years old (possibly less than 24 years old after 2007) and has net unearned income in excess of $2,200.

In addition to shifting the interest income, Anne has also shifted a potential gain of $3,000. The child's basis for the bonds is $5,000 because the donee takes the donor's basis when the FMV of the property at the time of the gift is greater than the donor's basis. No gain is

[80] The annual exclusion was $13,000 in 2009–2012 and $14,000 in 2013–2017. [81] Sec. 2503(b).

ADDITIONAL COMMENT

In Example I:5-99, Anne may also reduce the new 3.8% Medicare tax on net investment income.

recognized by Anne when the gift is made, and a future sale of the property by the child may be taxed at a lower income tax rate. ◀

Although gifts of appreciated property may generate desirable income tax benefits, it is not usually advantageous to make a gift of property that has a basis greater than its FMV because the donee's basis for determining a loss is the FMV. The excess of the donor's basis over the FMV at the time of the gift may never generate any tax benefit for the donor or the donee. Therefore, the donor should sell the asset and make a gift of the proceeds if the loss on the sale is deductible.

EXAMPLE I:5-100 ▶ Bob owns Red Corporation stock with an $8,000 basis and $6,000 FMV, which is held as an investment. Bob wishes to make a graduation gift of the marketable securities to Angela, although he expects her to sell the stock and purchase a car. If Angela sells the stock for $6,000, no gain or loss is recognized because her loss basis for the stock is $6,000. In addition, no loss is recognized by Bob on the gift of the stock to Angela. Instead of giving the stock, Bob should sell it to recognize a $2,000 capital loss and then give the proceeds from the sale to Angela. ◀

SELF-STUDY QUESTION

Doug owns IBM Corporation shares, which have a $50,000 FMV and basis of $75,000. Doug makes a deathbed telephone call to his stockbroker and sells the IBM shares. Assuming that Doug is in the 35% bracket and had no other capital gains or losses, calculate the tax savings associated with the sale.

ANSWER

Doug saves $1,050 ($3,000 × 0.35) unless he has capital gain income that may be offset with the capital loss. It should be noted that the loss is limited to $3,000; if Doug dies, the unused capital loss of $22,000 is lost.

The effect of gift taxes paid by the donor on the donee's basis for property received is another reason why it may be more advantageous to give appreciated property rather than property with a basis greater than its FMV. A portion of the gift taxes paid as a result of giving appreciated property is added to the property's basis. However, payment of gift taxes due to the gift of property that has a basis greater than its FMV does not result in an increase in the donee's basis.

SELECTION OF PROPERTY TO TRANSFER AT TIME OF DEATH

An integral part of gift and estate planning is the selection of property to be transferred to family members and others both during the taxpayer's lifetime and upon death. Usually, taxpayers find it advantageous to retain highly appreciated property in their estates and transfer such property at death to the taxpayer's heirs because the basis of the inherited property will be increased to its FMV at the date of death (or six months from the date of death if the alternate valuation date is elected). Of course, the impact of gift and estate taxes also play a major role in this planning process.

Investment and business assets that have declined in value (i.e., the FMV is less than the basis) should normally be sold before death to obtain an income tax deduction for the loss. If the property is not sold or otherwise disposed of before death, the basis of the inherited property is reduced to its FMV.

EXAMPLE I:5-101 ▶ Paul owns two farms of similar size and quality. Each farm has a $500,000 FMV. Paul's basis for the first farm is $100,000, and his basis for the second farm is $430,000. Eventually, Paul plans for both farms to be owned by Amy. However, he would like to transfer ownership of one farm now and retain the other farm until his death. Paul should make a gift of the second farm and transfer the first farm to Amy upon his death because the second farm has appreciated less in value. When Paul dies and devises the first farm to Amy, she will have a basis for the property equal to its FMV at the date of death even though Paul's basis is only $100,000. ◀

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 9

Describe compliance and procedural considerations for property transactions

DOCUMENTATION OF BASIS

The importance of being able to determine and document the basis of assets acquired by a taxpayer cannot be overemphasized. Accurate records of asset acquisitions, dispositions, and adjustments to basis are essential. When more than one asset is acquired at the same time, the amount paid must be allocated among the assets acquired based on their relative FMVs. Subsequent adjustments to basis, such as those due to capital improvements and depreciation deductions, must be documented.

KEY POINT

Many taxpayers do not maintain adequate records that can be used to document the basis of their most important asset, their personal residence. For example, taxpayers can increase the basis of their residence if they have the driveway paved or add a new room or porch.

Because the basis of property can be determined by reference to another person's basis for that asset (e.g., gifts), taxpayers should be particularly aware of obtaining documentation for that basis at the time of the transfer. In the case of a gift, the taxpayer's basis may be affected by any gift tax paid by the donor. A copy of the donor's gift tax return is useful in documenting the upward adjustment to the donor's basis in determining the donee's basis.

Taxpayers who inherit property may use the decedent's federal Estate Tax Return (Form 706) to determine the FMV at the time of the decedent's death or FMV as of the alternate valuation date. There have always been issues when the one who inherits the property wants to use a basis higher than the fair market value used to determine the estate tax. Taxpayers have had some success using a different value than the value used for the estate tax, but Congress recently added a requirement that the basis used must be consistent with the value used for determining the estate tax.[82]

Brokerage firms must report an investor's cost basis in any shares purchased after January 1, 2011 to the IRS when securities are sold. Brokers have been required for many years to report the amount of sales proceeds but must now also provide the basis. The broker will apply a FIFO rule when selecting the securities sold unless the taxpayer notifies the broker that other securities are being sold. If a taxpayer owns securities purchased at different prices and on different dates, the taxpayer may specifically identify those stocks deemed to be sold and thus may affect the amount of the gain or loss and if the gain or loss in ST or LT.

REPORTING OF CAPITAL GAINS AND LOSSES ON SCHEDULE D

KEY POINT

Schedule D refers to 28% gain which is NCG taxed at a maximum rate of 28% (collectible gain and part of the Sec. 1202 gain).

Capital gains and losses are reported by individuals on Schedule D, which is then attached to Form 1040. Part I is used to report short-term capital gains and losses, and Part II is used to report long-term capital gains and losses. Part III is a summary of Parts I and II.

Capital gains due to installment sales are first reported on a separate form before being included on Schedule D. The taxpayer's share of capital gains and losses from partnerships, S corporations, and fiduciaries is reported in Parts I and II on lines 5 and 12. The carryover of capital losses is also included in Parts I and II on lines 6 and 14.

EXAMPLE I:5-102 ▶

REAL-WORLD EXAMPLE

Artwork inherited by a married couple was originally valued at $12 million for estate taxes based on a blockage discount. The IRS determined that the undiscounted value was $36 million and the discounted value was $14 million. The taxpayers consented to the $14 million value but later used $36 million as the basis for the artwork after the statute of limitations had expired for the estate tax. The 9th Circuit Court of Appeals agreed with the IRS that the correct basis should be $14 million. *Janis v. Commissioner* 461 F.3d 1080 (CA-9, 2006)

Virgil Brady, a single taxpayer, uses the following information to prepare his Schedule D for 2018. Virgil received $8,000 of qualified dividends during the year. He sold 200 shares of Tennis Corporation stock for $13,000 on June 20, 2018. The shares were purchased on October 2, 2017, for $8,700. He has an STCL carryforward from 2017 of $8,200. He sold a piano for $4,000 on May 30, 2018. The piano was purchased on April 12, 2008, for $2,500 and used by his two sons. Virgil also sold 500 shares of Golf Corporation stock for $18,000 on November 30, 2018. He had purchased the stock on April 1, 2014, for $10,000.

Virgil has STCG of $4,300 that is offset by $8,200 of STCL carryforward on line 6. His NSTCL of $3,900 ($8,200 – $4,300) is shown on line 7. His $1,500 LTCG as a result of the sale of the piano (not a collectible) and his $8,000 LTCG from the sale of the Golf Corporation stock are on lines 8b and 10. Thus, Virgil has an NLTCG of $9,500. He has ANCG of $5,600 ($9,500 – $3,900).

Because Virgil has ANCG of $5,600 and no 28% rate gains or unrecaptured Sec. 1250 gains, he computes his tax on the Qualified Dividends and Capital Gain Tax Worksheet. The preferential treatment for dividends and capital gains saves Virgil $1,224 of federal income taxes in 2018.

Virgil's taxable income including the above dividends and capital gains is $120,000. ◀

The following pages include the Schedule D (Figure I:5-1), Form 8949 (Figure I:5-2), and a worksheet that taxayers use to compute their tax if they have no 28% rate gains or unrecaptured Section 1250 gains (Figure I:5-3). For Virgil in the above example, both stock transactions were reported on Form 1099-B with basis reported to the IRS.

Taxpayers such as Virgil use the Qualified Dividends and Capital Gain Tax Worksheet if they either have qualified dividends or ANCG *and* do not have any 28% rate gain property or unrecaptured Section 1250 gain. This worksheet applies the lower preferential tax rates of zero, 15%, or 20% for qualified dividends and ANCG. The following series of forms includes the completed worksheet for Virgil for 2018.

[82] Sec. 1014(f).

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

► Attach to Form 1040 or Form 1040NR.
► Go to *www.irs.gov/ScheduleD* for instructions and the latest information.
► Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074

2018

Attachment Sequence No. 12

Name(s) shown on return: Virgil Brady

Your social security number:

Part I Short-Term Capital Gains and Losses—Generally Assets Held One Year or Less (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked	13,000	8,700		4,300
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	6	(8,200)
7 **Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back	7	(3,900)

Part II Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked	18,000	(10,000)		8,000
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked	4,000	(2,500)		1,500

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13 Capital gain distributions. See the instructions	13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15 **Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Then go to Part III on the back	15	9,500

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H **Schedule D (Form 1040) 2018**

FIGURE I:5-1 ► PART I–II OF SCHEDULE D FOR EXAMPLE I:5-102

Part III Summary

16	Combine lines 7 and 15 and enter the result	16	5,600
	• If line 16 is a **gain,** enter the amount from line 16 on Schedule 1 (Form 1040), line 13, or Form 1040NR, line 14. Then go to line 17 below. • If line 16 is a **loss,** skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22. • If line 16 is **zero,** skip lines 17 through 21 below and enter -0- on Schedule 1 (Form 1040), line 13, or Form 1040NR, line 14. Then go to line 22.		
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 . . . . . ▶	18	
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 . . . . . ▶	19	
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 11a (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 Schedule 1 (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.	21	( )
22	Do you have qualified dividends on Form 1040, line 3a, or Form 1040NR, line 10b? ☐ **Yes.** Complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the instructions for Form 1040, line 11a (or in the instructions for Form 1040NR, line 42). ☐ **No.** Complete the rest of Form 1040 or Form 1040NR.		

FIGURE I:5-1 ▶ PART III OF SCHEDULE D FOR EXAMPLE I:5-102

Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

▶ Go to *www.irs.gov/Form8949* for instructions and the latest information.

▶ File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074

2018

Attachment Sequence No. **12A**

Name(s) shown on return: Virgil Brady

Social security number or taxpayer identification number

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are generally short term (see instructions). For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- ☑ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- ☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
- ☐ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
800 sh. Tennis Corp.	10-2-17	6-20-18	13,000	8,700			4,300
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 1b** (if **Box A** above is checked), **line 2** (if **Box B** above is checked), or **line 3** (if **Box C** above is checked) ▶			13,000	8,700			4,300

Note: If you checked Box A above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37768Z Form **8949** (2018)

FIGURE I:5-2 ▶ PART I OF FORM 8949 FOR EXAMPLE I:5-102

Form 8949 (2018) Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side | **Social security number or taxpayer identification number**

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part II **Long-Term.** Transactions involving capital assets you held more than 1 year are generally long term (see instructions). For short-term transactions, see page 1.

Note: You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 8a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box D, E, *or* F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- ☑ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- ☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
- ☐ **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
500 sh. Golf Corp Stock	4-1-14	11-30-18	18,000	10,000			8,000
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked) ▶			18,000	10,000			8,000

Note: If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949** (2018)

FIGURE I:5-2 ▶ PART II OF FORM 8949 FOR EXAMPLE I:5-102

Form 8949 (2018) Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side	**Social security number or taxpayer identification number**

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part II **Long-Term.** Transactions involving capital assets you held more than 1 year are generally long term (see instructions). For short-term transactions, see page 1.

Note: You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the total directly on Schedule D, line 8a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box D, E, *or* F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- ☐ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- ☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
- ☑ **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss).** Subtract column (e) from column (d) and combine the result with column (g)
Piano	4-12-08	5-3-18	4,000	2,500			1,500
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked) ▶			4,000	2,500			1,500

Note: If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949** (2018)

FIGURE I:5-2 ▶ PART II (CONT'D) OF FORM 8949 FOR EXAMPLE I:5-102

2018 Form 1040—Line 11a

Qualified Dividends and Capital Gain Tax Worksheet—Line 11a

Keep for Your Records

Before you begin:
- ✓ See the earlier instructions for line 11a to see if you can use this worksheet to figure your tax.
- ✓ Before completing this worksheet, complete Form 1040 through line 10.
- ✓ If you don't have to file Schedule D and you received capital gain distributions, be sure you checked the box on line 13 of Schedule 1.

1.	Enter the amount from Form 1040, line 10. However, if you are filing Form 2555 or 2555-EZ (relating to foreign earned income), enter the amount from line 3 of the Foreign Earned Income Tax Worksheet	1.	120,000		
2.	Enter the amount from Form 1040, line 3a*	2.	8,000		
3.	Are you filing Schedule D?* ☑ **Yes.** Enter the **smaller** of line 15 or 16 of Schedule D. If either line 15 or line 16 is blank or a loss, enter -0-. ☐ **No.** Enter the amount from Schedule 1, line 13	3.	5,600		
4.	Add lines 2 and 3	4.	13,600		
5.	If filing Form 4952 (used to figure investment interest expense deduction), enter any amount from line 4g of that form. Otherwise, enter -0-	5.	-0-		
6.	Subtract line 5 from line 4. If zero or less, enter -0-	6.	13,600		
7.	Subtract line 6 from line 1. If zero or less, enter -0-	7.	106,400		
8.	Enter: $38,600 if single or married filing separately, $77,200 if married filing jointly or qualifying widow(er), $51,700 if head of household.	8.	38,600		
9.	Enter the smaller of line 1 or line 8	9.	38,600		
10.	Enter the smaller of line 7 or line 9	10.	38,600		
11.	Subtract line 10 from line 9. This amount is taxed at 0%	11.	-0-		
12.	Enter the smaller of line 1 or line 6	12.	13,600		
13.	Enter the amount from line 11	13.	-0-		
14.	Subtract line 13 from line 12	14.	13,600		
15.	Enter: $425,800 if single, $239,500 if married filing separately, $479,000 if married filing jointly or qualifying widow(er), $452,400 if head of household.	15.	425,800		
16.	Enter the smaller of line 1 or line 15	16.	120,000		
17.	Add lines 7 and 11	17.	106,400		
18.	Subtract line 17 from line 16. If zero or less, enter -0-	18.	13,600		
19.	Enter the smaller of line 14 or line 18	19.	13,600		
20.	Multiply line 19 by 15% (0.15)			20.	2,040
21.	Add lines 11 and 19	21.	13,600		
22.	Subtract line 21 from line 12	22.	-0-		
23.	Multiply line 22 by 20% (0.20)			23.	-0-
24.	Figure the tax on the amount on line 7. If the amount on line 7 is less than $100,000, use the Tax Table to figure the tax. If the amount on line 7 is $100,000 or more, use the Tax Computation Worksheet	24.			19,826*
25.	Add lines 20, 23, and 24	25.			21,866
26.	Figure the tax on the amount on line 1. If the amount on line 1 is less than $100,000, use the Tax Table to figure the tax. If the amount on line 1 is $100,000 or more, use the Tax Computation Worksheet	26.			23,090*
27.	**Tax on all taxable income.** Enter the **smaller** of line 25 or 26. Also include this amount on the entry space on Form 1040, line 11a. If you are filing Form 2555 or 2555-EZ, don't enter this amount on the entry space on Form 1040, line 11a. Instead, enter it on line 4 of the Foreign Earned Income Tax Worksheet	27.			21,866

*Using 2018 tax rate schedule.

FIGURE I:5-3 ▶ QUALIFIED DIVIDENDS AND CAPITAL GAIN TAX WORKSHEET FOR EXAMPLE I:5-102

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:5-1 What problem may exist in determining the amount realized for an investor who exchanges common stock of a publicly traded corporation for a used building? How is the problem likely to be resolved?

I:5-2 In 2009, Ellen purchased a house for $150,000 to use as her personal residence. She paid $30,000 and borrowed $120,000 from the local savings and loan company. In 2011 she paid $20,000 to add a room to the house. In 2013 she paid $2,400 to have the house painted and $1,200 for built-in bookshelves. As of January 1 of the current year, she has reduced the $120,000 mortgage to $108,300. What is her basis for the house?

I:5-3 Vincent pays $20,000 for equipment to use in his trade or business. He pays sales tax of $800 as a result of the purchase. Must the $800 sales tax be capitalized as part of the purchase price?

I:5-4 Sergio owns 200 shares of Palm Corporation common stock, purchased during the prior year: 100 shares on July 5, for $9,000; and 100 shares on October 15, for $12,000. When Sergio sells 50 shares for $8,000 on July 18 of the current year, he does not identify the particular shares sold. Determine the amount and character of the gain.

I:5-5 On October 21 of the current year, David receives stock of Western Corporation as a gift from his grandfather, who acquired the stock on January 20, 1995. Under what conditions would David's holding period start on?
a. October 22 of the current year?
b. January 20, 1995?

I:5-6 Jim inherits stock (a capital asset) from his brother, who died in March of 2019, when the property had a $15.3 million FMV. This property is the only property included in his brother's gross estate and there is a taxable estate. The FMV of the property as of the alternate valuation date was $14.9 million.
a. Why might the executor of the brother's estate elect to use the alternate valuation date to value the property?
b. Why might Jim prefer the executor to use FMV at time of the death to value the property?
c. If the marginal estate tax rate is 40% and Jim's marginal income tax rate is 24% and his rate on ANCG is 15%, which value should the executor use?

I:5-7 Martha owns 500 shares of Columbus Corporation common stock at the beginning of the year with a basis of $82,500. During the year, Columbus declares and pays a 10% nontaxable stock dividend. What is her basis for each of the 50 shares received?

I:5-8 Mario owns 2,000 shares of Nevada Corporation common stock at the beginning of the year. His basis for the stock is $38,880. During the year, Nevada declares and pays a stock dividend. After the dividend, Mario's basis for each share of stock owned is $18. What is the percentage dividend paid by Nevada?

I:5-9 A corporate taxpayer plans to build a $6 million office building during the next 18 months. How must the corporation treat the interest on debt paid or incurred during the production period?

I:5-10 Andy owns an appliance store where he has merchandise such as refrigerators for sale. Roger, a bachelor, owns a refrigerator, which he uses in his apartment for personal use. For which individual is the refrigerator a capital asset?

I:5-11 Why did the Supreme Court rule in the *Corn Products* case that a gain due to the sale of futures contracts is ordinary income instead of capital gain?

I:5-12 When is the gain on the sale or exchange of securities by a dealer in securities classified as capital gain?

I:5-13 In 2002, Florence purchased 30 acres of land. She has not used the land for business purposes or made any substantial improvements to the property. During the current year, she subdivides the land into 15 lots and advertises the lots for sale. She sells four lots at a gain.
a. What is the character of the gain on the sale of the four lots?
b. Explain how the basis of each lot would be determined.

I:5-14 Amy has LTCGs taxed at different tax rates, 15%, 25% and 28%. She also has NSTCLs that amount to less than her NLTCG. The procedure for offsetting the NSTCL against the LTCGs is favorable to her. Explain.

I:5-15 Four years ago, Susan loaned $7,000 to her friend Joe. During the current year, the $7,000 loan is considered worthless. Explain how Susan should treat the worthless debt for tax purposes.

I:5-16 Why did the Supreme Court rule in *Arkansas Best* that the stock of a corporation purchased by the taxpayer to protect the taxpayer's business reputation was a capital asset?

I:5-17 The effective income tax rate on gain of $1 million resulting from the sale of qualified small business stock obtained in 2005 in an initial public offering and held more than five years is 14%. Do you agree or disagree? Explain.

I:5-18 Nancy and the Minor Corporation own bonds of the East Corporation. Minor Corporation owns 80% of the stock of East Corporation. East Corporation has declared bankruptcy this year, and bondholders will receive only 26% of the face value of the debt. Explain why the loss is a capital loss for Nancy but an ordinary loss for the Minor Corporation.

I:5-19 On January 1 of the current year, the Orange Corporation issues $500,000 of 11%, 20-year bonds for $480,000. Determine the amount of original issue discount, if any.

I:5-20 Today, Juanita purchases a 15-year, 7% bond of the Sunflower Corporation issued four years ago at par. She purchases the bond as an investment at a discount from the par value. If she sells the bonds two years from now, explain why some or all of the gain may be ordinary income.

I:5-21 Judy just obtained a patent on a new product she has developed. Bell Corporation wishes to market the product and will pay 12% of all future sales of the product to Judy. How can she be sure that the payments received will be treated as a long-term capital gain?

I:5-22 When is the transferor of a franchise unable to treat the transfer as a sale or an exchange of a capital asset?

I:5-23 How does a lessor treat payments received for canceling a lease?

I:5-24 What is the first day that an individual could sell a capital asset purchased on March 31, 2019 and have a holding period of more than one year?

I:5-25 Phil, a cash-basis taxpayer, sells the following marketable securities, which are capital assets during 2019. Determine whether the gains or losses are long-term or short-term. Also determine the net capital gain and adjusted net capital gain for 2019.

Capital Asset	*Basis*	*Date Acquired*	*Trade Date in 2019*	*Sales Price*
A	$40,000	Feb. 10, 2018	Aug. 12	$52,000
B	20,000	Dec. 5, 2018	May 2	17,000
C	30,000	Apr. 9, 2017	Dec. 10	37,400

I:5-26 How might the current treatment of capital losses discourage an individual investor from purchasing stock of a high-risk, start-up company?

I:5-27 An individual taxpayer has realized a $40,000 loss on the sale of an asset that had a holding period of eight months. Explain why the taxpayer may be indifferent as to whether the asset is a capital asset.

I:5-28 If Pam transfers an asset to Fred and the asset is subject to a liability that is assumed by Fred, how does Fred's assumption of the liability affect the amount realized by Pam? How does Fred's assumption of the liability affect his basis for the property?

ISSUE IDENTIFICATION QUESTIONS

I:5-29 Mr. and Mrs. Pickens purchased a used piano in Y1 for their young son who had started taking piano lessons. In Y8 while cleaning the piano, Mrs. Pickens discovered $4,800 of old currency. They exchanged the old currency for new currency.

I:5-30 Lisa and John are in the business of breeding beavers to produce fur for sale. They recently purchased a pair of breeding beavers for $30,000 from XUN, Inc., and agreed to pay interest at 10% each year for five years. After the five-year period, they could pay the debt by delivering seven beavers to XUN, Inc., provided that each beaver was at least nine months old. Identify the tax issues involved in this situation.

I:5-31 Mike, a real estate broker in California, recently inherited a farm from his deceased uncle and plans to sell the farm to the first available buyer. His uncle purchased the property 12 years ago for $600,000. The FMV of the farm on the date of the uncle's death was $500,000. Mike sells the farm for $520,000 seven months after his uncle's death. What tax issues should Mike consider?

I:5-32 Sylvia, a dentist with excellent skills as a carpenter, started the construction of a house that she planned to give to her son as a surprise when he returned from Afghanistan, where he is serving in the military. She began construction on March 23, 2018, and finished the house on July 10, 2019, at a total cost of $70,000. Her son is expected to be home on September 1, 2019.

On July 30, 2019, Roscoe offered Sylvia $245,000 for the house and Sylvia considered the offer to be so attractive that she accepted it. She decided that she could purchase a suitable home for her son for about $200,000. What tax issues should Sylvia consider?

PROBLEMS

I:5-33 ***Amount Realized.*** Tracy owns a nondepreciable capital asset held for investment. The asset was purchased for $250,000 six years earlier and is now subject to a $75,000 liability. During the current year, Tracy transfers the asset to Tim in exchange for $94,000 cash and a new automobile with a $50,000 FMV to be used by Tracy for personal use; Tim assumes the $75,000 liability. Determine the amount of Tracy's LTCG or LTCL.

I:5-34 ***Basis of Property Received as a Gift.*** Doug receives a duplex as a gift from his uncle. The uncle's basis for the duplex and land is $90,000. At the time of the gift, the land and building have FMVs of $40,000 and $80,000, respectively. No gift tax is paid by Doug's uncle at the time of the gift.

a. To determine gain, what is Doug's basis for the land?
b. To determine gain, what is Doug's basis for the building?
c. Will the basis of the land and building be the same as in Parts a and b for purposes of determining a loss?

I:5-35 ***Sale of Property Received as a Gift.*** During the current year, Stan sells a tract of land for $800,000. The property was received as a gift from Maxine on March 10, 1995, when the property had a $310,000 FMV. The taxable gift was $300,000 because the annual exclusion was $10,000 in 1995. Maxine purchased the property on April 12, 1980, for $110,000. At the time of the gift, Maxine paid a gift tax of $12,000. In order to sell the property, Stan paid a sales commission of $16,000.

a. What is Stan's realized gain on the sale?
b. How would your answer to Part a change, if at all, if the FMV of the gift property was $85,000 as of the date of the gift?

I:5-36 ***Sale of Asset Received as a Gift.*** Bud received 200 shares of Georgia Corporation stock from his uncle as a gift on July 20, 2018, when the stock had a $45,000 FMV. His uncle paid $30,000 for the stock on April 12, 2002. The taxable gift was $45,000, because his uncle made another gift to Bud for $20,000 in January and used the annual exclusion. The uncle paid a gift tax of $1,500.

Without considering the transactions below, Bud's AGI is $45,000 in 2019. No other transactions involving capital assets occur during the year. Analyze each transaction below, independent of the others, and determine Bud's AGI in each case.

a. He sells the stock on October 12, 2019, for $48,000.
b. He sells the stock on October 12, 2019, for $28,000.
c. He sells the stock on December 16, 2019, for $42,000.

I:5-37 ***Basis of Property Converted from Personal Use.*** Irene owns a truck costing $15,000 and used for personal activities. The truck has a $9,600 FMV when it is transferred to her business, which is operated as a sole proprietorship.

a. What is the basis of the truck for determining depreciation?
b. What is Irene's realized gain or loss if the truck is sold for $5,000 after claiming depreciation of $4,000?

I:5-38 ***Sale of Assets Received as a Gift and Inherited.*** Daniel receives 400 shares of A&M Corporation stock from his aunt on May 20, 2019, as a gift when the stock has a $60,000 FMV. His aunt purchased the stock in 2009 for $42,000. The taxable gift is $60,000 because she made earlier gifts to Daniel during 2019 and used the annual exclusion. She paid a gift tax of $9,300 on the gift of A&M stock to Daniel.

Daniel also inherited 300 shares of Longhorn Corporation preferred stock when his uncle died on November 12, 2018, when the stock's FMV was $30,000. His uncle purchased the stock in 1997 for $27,600. Determine the gain or loss on the sale of A&M and Longhorn stock on December 15, 2019, under each alternative situation below.

a. A&M stock was sold for $62,600, and Longhorn stock was sold for $30,750.
b. A&M stock was sold for $58,200, and Longhorn stock was sold for $28,650.
c. Assume the same as in Part a except his aunt purchased A&M stock for $71,000 and his uncle purchased Longhorn stock for $31,200.

I:5-39 ***Personal-Use Property Converted to Rental Property.*** Tally owns a house that she has been living in for eight years. She purchased the house for $245,000 and the FMV today is $200,000. She is moving into her friend's house and has decided to convert her residence to rental property. Assume 20% of the property's value is allocated to land.

a. What is the basis of the house for depreciation?
b. If she claims depreciation of $15,000 and sells the property six years later for $260,000 (20% allocated to land), determine the gain on the sale of the building and gain on the sale of the land.
c. How much of the gain is due to depreciation?
d. If the FMV is $290,000 when she converts the house to rental property instead of $200,000, what is the basis of the house for depreciation?

I:5-40 ***Stock Rights.*** Kathleen owns 500 shares of Buda Corporation common stock which was purchased on March 20, 2000, for $48,000. On October 10 of the current year, she receives a distribution of 500 stock rights. Each stock right has a $20 FMV and the FMV

of the Buda common stock is $100 per share. With each stock right, she may acquire one share of Buda common stock for $95.

a. How much gross income must Kathleen recognize?
b. What is the basis of each stock right received?
c. If she sells the 500 stock rights for $10,600, what is her gain?
d. If she exercises the 500 stock rights on November 10, what is the basis of the 500 shares she receives and when does the holding period for those shares start?

I:5-41 ***Stock Rights.*** Martha Lou owns 100 shares of Blain Corporation common stock. She purchased the stock on July 25, 1998, for $4,000. On May 2 of the current year, she receives a nontaxable distribution of 100 stock rights. Each stock right has a $10 FMV, and the FMV of the Blain common stock is $70 per share. With each stock right, Martha Lou may acquire one share of Blain common for $68 per share. Assuming that she elects to allocate basis to the stock rights, answer the following:

a. What is the basis allocated to the stock rights?
b. If she sells the stock rights on June 10 for $1,080, determine the amount and character of the recognized gain?
c. If she exercises the stock rights on May 14, what is the basis of the 100 shares purchased and when does the holding period start?
d. If she does not elect to allocate basis to the stock rights, determine the amount and character of the gain if she sells the stock rights on June 10 for $1,080?

I:5-42 ***Real Property Subdivided for Sale.*** Beth acquired only one tract of land seven years ago as an investment. In order to sell the land at a higher price, she decides to subdivide it into 20 lots. She pays for improvements such as clearing and leveling, but the improvements are not considered to be substantial. Each lot has a basis of $2,000, and a selling price of $6,000. Selling expenses of $480 were incurred to sell two lots last year. This year, ten lots are sold, and selling expenses amount to $1,900. How much ordinary income and capital gain must be recognized in the prior and current year?

I:5-43 ***Marginal Tax Rates.*** Mr. and Mrs. Dunbar have taxable income of $260,000 without considering the following sales. Consider the following independent cases where capital gains are recognized and determine the marginal tax rate for the capital gain in each case. Ignore the effect of increasing AGI on deductions.

CASE A: $10,000 gain from sale of Storm Lake common stock held for seven months.
CASE B: $10,000 gain from sale of antique clock held for six years.
CASE C: $10,000 gain from sale of Ames preferred stock held for three years.

I:5-44 ***Netting Gains and Losses.*** Trisha, who is single and has taxable income of $300,000, sells the following capital assets in 2019 with gains and losses as shown:

Asset	*Gain or (Loss)*	*Holding Period*
A	$15,000	15 months
B	7,000	20 months
C	(3,000)	14 months

a. Determine Trisha's increase in income tax liability as a result of the three sales. All assets are stock held for investment. Ignore the effect of increasing AGI on deductions and phase-out amounts.
b. Determine her increase in income tax liability if the holding period for asset B is 8 months.
c. Determine her increase in income tax liability if the holding periods are the same as in Part a but asset B is an antique clock.
d. Determine her increase in income tax liability if her taxable income is $700,000.

I:5-45 ***Computing the Tax.*** Donna files as a head of household in 2019 and has taxable income of $110,000, including the sale of a stock held as an investment for two years at a gain of $20,000. Only one asset was sold during the year and Donna does not have any capital loss carryovers.

a. What is the amount of Donna's tax liability?
b. What is the amount of Donna's tax liability if the stock is held for 11 months?

I:5-46 ***Computing the Tax.*** Mr. and Mrs. Sedlock file a joint return and have taxable income of $370,000 without considering the following information below. Determine the increase in their tax liability for the following independent fact situations.

a. They have a STCG of $20,000 and a LTCL of $12,000.

b. They have a LTCG of $30,000 due to the sale of a collectible and a LTCG of $9,000 due to the sale of General Motors stock.
c. Same as Part b except they also have a STCL of $4,400.

I:5-47 ***Computing the Sales Price.*** An investor in a 32% tax bracket and a 15% rate on ANCG owns land that is a capital asset with a $50,000 basis and a holding period of three years. The investor who is single wishes to sell the asset at a price high enough so that he will have $120,000 in cash after paying the income taxes.
a. What is the minimum price the investor could accept?
b. What is the minimum price the investor could accept if all the gain is subject to the Medicare tax on net investment income?

I:5-48 ***Capital Gains and Losses.*** Consider the four independent situations below for an unmarried individual, and analyze the effects of the capital gains and losses on the individual's AGI. For each case, determine AGI after considering the capital gains and losses.

	Situation 1	*Situation 2*	*Situation 3*	*Situation 4*
AGI (excluding property transactions)	$40,000	$50,000	$60,000	$70,000
STCG	6,000	2,000	5,000	6,000
STCL	2,000	5,000	4,000	15,000
LTCG	3,500	15,000	10,000	9,000
LTCL	2,500	4,000	12,000	4,000

I:5-49 ***Capital Losses.*** To better understand the rules for offsetting capital losses and how to treat capital losses carried forward, analyze the following data for an unmarried individual for the period 2016 through 2019. No capital loss carryforwards are included in the figures. For each year, determine AGI and the capital losses to be carried forward to a later tax year.

	2016	*2017*	*2018*	*2019*
AGI (excluding property transactions)	$40,000	$50,000	$60,000	$70,000
STCG	4,000	5,000	7,000	10,000
STCL	9,000	3,000	5,000	12,000
LTCG	6,000	10,000	2,200	6,000
LTCL	5,000	21,000	1,000	9,500
AGI (including property transactions)	_____	_____	_____	_____
STCL to be carried forward	_____	_____	_____	_____
LTCL to be carried forward	_____	_____	_____	_____

I:5-50 ***Character of Loss.*** The Michigan Corporation owns 20% of the Wolverine Corporation. The Wolverine stock was acquired eight years ago to ensure a steady supply of raw materials. Michigan also owns 30% of Spartan Corporation and 85% of Huron Corporation. Stock in both corporations was acquired more than ten years ago for investment purposes. During the current year, Wolverine, Spartan, and Huron are deemed bankrupt, and the stocks are considered worthless. Describe how Michigan should treat its losses.

I:5-51 ***Original Issue Discount.*** On December 31, 2018, Phil purchased $20,000 of newly issued bonds of Texas Corporation for $16,568. The bonds are dated December 31, 2018. The bonds are 9%, 10-year bonds paying interest semiannually on June 30 and December 31. The bonds are priced to yield 12% compounded semiannually.
a. What is the amount of the original issue discount?
b. For the first semiannual period, what is the amount of the original issue discount Phil must recognize as ordinary income?
c. What is the total amount of interest income Phil must recognize in 2019?
d. What is Phil's basis for the bonds as of December 31, 2019?

I:5-52 On January 1, 2017, Swen paid $184,000 for $200,000 of the 8%, 20-year bonds of Penn Corporation, issued on January 1, 2013, at par. The bonds are held as an investment. Determine the gain and the character of the gain if the bonds are sold on January 1, 2019, for
a. $191,000
b. $185,750
c. $183,000

I:5-53 *Capital Gains and Losses.* During 2019, Gary receives a $90,000 salary and has no deductions for AGI. In 2018, Gary had a $5,000 STCL and no other capital losses or capital gains. Consider the following sales and determine Gary's AGI for 2019.

- An automobile purchased in 2014 for $20,500 and held for personal use is sold for $7,000.
- On April 10, 2019, stock held for investment is sold for $21,000. The stock was acquired on November 20, 2018, for $9,300.

I:5-54 *Call Options.* On February 10, 2019, Gail purchases 20 calls on Red Corporation for $250 per call. Each call represents an option to buy 100 shares of Red stock at $42 per share any time before November 25, 2019. Compute the gain or loss recognized, and determine whether the gain or loss is long-term or short-term for Gail in the following situations:

a. The 20 calls are sold on May 15, 2019, for $310 per call.
b. The calls are not exercised but allowed to expire.
c. The calls are exercised on July 15, 2019, and the 2,000 shares of Red Corporation stock are sold on July 20, 2020, for $50 per share.

I:5-55 *Call Writing.* Dan owns 500 shares of Rocket Corporation common stock. The stock was acquired two years ago for $30 per share. On October 2, 2019, Dan writes five calls on the stock, which represent options to buy the 500 shares of Rocket at $75 per share. For each call, Dan receives $210. The calls expire on June 22, 2020. Consider the following transactions and describe the tax treatment for Dan:

a. The five calls are exercised on December 4, 2019.
b. The calls are not exercised and allowed to expire.

I:5-56 *Corporate Capital Gains and Losses.* Determine the taxable income for the Columbia Corporation for the following independent cases:

Case	*Income from Operations*	*STCG (NSTCL)*	*NLTCG (NLTCL)*
A	$110,000	$30,000	$44,000
B	100,000	(50,000)	65,000
C	80,000	(37,000)	30,000
D	90,000	(15,000)	(9,000)

I:5-57 *Original Issue Discount.* On January 1, 2018, Sean purchased an 8%, $100,000 corporate bond for $92,277. The bond was issued on January 1, 2018, and matures on January 1, 2023. Interest is paid semiannually, and the effective yield to maturity is 10% compounded semiannually. On July 1, 2019, Sean sells the bond for $95,949. A schedule of interest amortization for the bond is shown in Table I:5-3.

a. How much interest income must Sean recognize in 2018?
b. How much interest income must Sean recognize in 2019?
c. How much gain must Sean recognize in 2019 on the sale of the bond?

▼ **TABLE I:5-3**
Interest Amortization for Problem I:5-57

	Interest Received (1)	Amortization of Discount (2)	Interest Income (3) = (1) + (2)
6-30-18	$4,000	$614	$4,614
12-31-18	4,000	645	4,645
6-30-19	4,000	677	4,677
12-31-19	4,000	711	4,711
6-30-20	4,000	747	4,747
12-31-20	4,000	783	4,783
6-30-21	4,000	823	4,823
12-31-21	4,000	864	4,864
6-30-22	4,000	907	4,907
12-31-22	4,000	952	4,952

I:5-58 *Capital Gains and Losses.* Martha has $40,000 AGI without considering the following information. During the year, she incurs an LTCL of $10,000 and has a gain of $14,000 due to the sale of a capital asset held for more than a year.

a. If the $14,000 gain is not properly classified as an LTCG (i.e., is improperly treated as an ordinary gain), determine Martha's AGI.

b. If the $14,000 gain is properly classified as an LTCG, determine her AGI.

c. If Martha has a $2,500 STCL carryover from earlier years, how would the answers to Parts a and b be affected?

I:5-59 *Capital Gains and Losses.* Without considering the following capital gains and losses, Charlene, who is single, has taxable income of $660,000 and a marginal tax rate of 37%. During the year, she sold stock held for nine months at a gain of $10,000; stock held for three years at a gain of $15,000; and a collectible asset held for six years at a gain of $20,000. Ignore the effect of the gains on any threshold amounts.

a. What is her taxable income and the increase in her income tax liability after considering the three gains?

b. In addition to the above three sales, assume that she sells another asset and has an STCL of $14,000. What is her taxable income and the increase in her tax liability after considering the four transactions?

c. In addition to the above three sales in Part a, assume that she sells another collectible asset held seven years as an investment and has a $27,000 capital loss. What is her taxable income and the increase in her tax liability after considering the four transactions?

d. Determine her Medicare tax on net investment income in (a) if all of the $660,000 of taxable income is due to salary.

I:5-60 *Corporate Capital Gains and Losses.* In 2014, the Ryan Corporation sold a capital asset and incurred a $40,000 LTCL that was carried forward to subsequent years. That sale was the only sale of a capital asset that Ryan made until 2019, when Ryan sells a capital asset and recognizes an STCG of $53,000. Without considering the STCG from the sale, Ryan's taxable income is $250,000.

a. Determine the corporation's NSTCG for 2019.

b. Determine the corporation's 2019 taxable income.

c. If the sale of the asset in 2014 had occurred in 2013, determine the corporation's 2019 taxable income.

COMPREHENSIVE PROBLEM

I:5-61 Betty incurs the following transactions during the current year. Without considering the transactions, her 2019 AGI is $92,000. Analyze the transactions and answer the following questions:

- On March 10, 2019, she sells a painting for $2,000. Betty is the artist, and she completed the painting in 2014. Her basis for the painting is $50.
- On June 18, 2019, she receives $28,500 from the sale of stock purchased by her uncle in 2004 for $10,000, which she inherited on February 20, 2019, as a result of her uncle's death. The stock's FMV on that date is $30,000.
- On July 30, 2019, she sells land for $25,000 that was received as a gift from her brother on April 8, 2019, when the land's FMV was $30,000. Her brother purchased the land for $43,000 on October 12, 2011. No gift tax was paid.

a. What is her NSTCL or NSTCG?

b. What is her NLTCL or NLTCG?

c. What is Betty's AGI?

d. What is her capital loss carryforward to the next year?

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:5-62 Dale, who files a joint return, purchased Blue Corporation stock four years ago for $1,000 as an investment. He intended to hold the stock until funds were needed to help pay for his daughter's college education. Today the stock has a $6,500 FMV and Dale decides to sell the stock and give the proceeds, less any taxes paid on the sale, to Tammy, his 22-year-old daughter. Dale's marginal tax rate is 32%. Tammy has no other gross income and receives more than half of her support from Dale.

a. What advice would you give to Dale?
b. What is the cash savings if Dale follows your advice?

I:5-63 Calvin, whose tax rate is 35% and 15% for ANCG, is considering two alternative investments on January 1, 20Y1. He can purchase $100,000 of 10% bonds due in five years or purchase $100,000 of Hobbes, Inc. common stock. The bonds are issued at par, pay interest annually on December 31, and mature at the end of five years. Interest received can be reinvested at 10%. Assume that he knows with relative certainty that the value of the stock will increase 8% each year (i.e., the value of the Hobbes stock will be $108,000 at the end of 20Y1) and the interest and principal for the bonds will be paid as scheduled. On December 31, 20Y5, he will sell the stock or receive the bond principal plus the last interest payment. Which alternative should Calvin select if he wants to have the greater amount of money as of January 1, 20Y6? Provide supporting information for your answer.

I:5-64 On December 20 of the current year, Winneld has decided to sell all of the stock that she owns and reinvest the proceeds in state of Minnesota bonds. Without considering the sales, her taxable income is expected to exceed $550,000 this year and in future years. Information about the stocks are provided below:

Corporation	*FMV*	*Basis*	*Holding Period*
Viking, Inc.	$190,000	$140,000	7 months
Twins, Inc.	200,000	255,000	4 years
Timberwolves, Inc.	382,000	300,000	3 years

She is willing to sell some of the stock this year and the remaining stock next year if it is more advantageous to spread the sales over two years. Assume that the FMV of the stock will not change during the next 30 days, and ignore the effect of a sale on threshold amounts.

Determine the increase in her income tax for each of the following alternatives (a, b, & c) and advise Winneld, who is single.

a. Sell all stock this year.
b. Sell Twins and Timberwolves this year and Viking in March of next year.
c. Sell Viking and Twins this year and Timberwolves in March of next year.
d. Determine her Medicare tax on net investment income in Part a if she has no investment income before selling all the stock.

I:5-65 Dallas, whose tax rate is 35% and 15% for ANCG, has recognized an STCL of $11,000 and an LTCG of $10,200 due to the sale of stock. In late December, he is considering the sale of an antique chair held for investment that would result in an LTCG of $5,000. If he sells the chair this year, what is the increase in his tax liability as a result of the sale? Ignore the phase out rules.

I:5-66 It is August 20, 2019, and Andy, whose tax rate is 32%, owns stock of Wendys and stock of Dublin. The FMV of each stock is $10,000, and the commission to sell either stock is $15.

Andy has no other sales or exchanges during the year, and he wants to sell either his stock of Wendys or Dublin. His expectation about future price increases is the same for either company. Under what circumstances will it make a difference which stock he sells?

	Basis	*Date of Purchase*
Wendys	$12,800	February 7, 2017
Dublin	12,798	March 8, 2019

TAX FORM/RETURN PREPARATION PROBLEMS

I:5-67 ***Short Tax Form.*** Given the following information for Jane Cole, complete Schedule D of Form 1040 through Part III.

- Stock options, which she purchases on February 14 of the current year for $850, expire on October 1.
- On July 1, she sells for $4,500 her personal-use automobile acquired on March 31, 2011, for $18,000.
- On August 16, she sells for $3,100 her stock of York Corporation purchased as an investment on February 16, for $1,600.
- On March 15, she sells for $5,600 an antique ring, a gift from her grandmother on January 10, 2005, when its FMV was $1,600. The ring was purchased by her grandmother on April 2, 1979, for $1,800.
- She has an STCL carryover of $250 from last year.

a. What advice would you give to Dale?
b. What is the cash savings if Dale follows your advice?

I:5-63 Calvin, whose tax rate is 35% and 15% for ANCG, is considering two alternative investments on January 1, 20Y1. He can purchase $100,000 of 10% bonds due in five years or purchase $100,000 of Hobbes, Inc. common stock. The bonds are issued at par, pay interest annually on December 31, and mature at the end of five years. Interest received can be reinvested at 10%. Assume that he knows with relative certainty that the value of the stock will increase 8% each year (i.e., the value of the Hobbes stock will be $108,000 at the end of 20Y1) and the interest and principal for the bonds will be paid as scheduled. On December 31, 20Y5, he will sell the stock or receive the bond principal plus the last interest payment. Which alternative should Calvin select if he wants to have the greater amount of money as of January 1, 20Y6? Provide supporting information for your answer.

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Corporation	*FMV*	*Basis*	*Holding Period*
Viking, Inc.	$190,000	$140,000	7 months
Twins, Inc.	200,000	255,000	4 years
Timberwolves, Inc.	382,000	300,000	3 years

She is willing to sell some of the stock this year and the remaining stock next year if it is more advantageous to spread the sales over two years. Assume that the FMV of the stock will not change during the next 30 days, and ignore the effect of a sale on threshold amounts.

Determine the increase in her income tax for each of the following alternatives (a, b, & c) and advise Winneld, who is single.

a. Sell all stock this year.
b. Sell Twins and Timberwolves this year and Viking in March of next year.
c. Sell Viking and Twins this year and Timberwolves in March of next year.
d. Determine her Medicare tax on net investment income in Part a if she has no investment income before selling all the stock.

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Andy has no other sales or exchanges during the year, and he wants to sell either his stock of Wendys or Dublin. His expectation about future price increases is the same for either company. Under what circumstances will it make a difference which stock he sells?

	Basis	*Date of Purchase*
Wendys	$12,800	February 7, 2017
Dublin	12,798	March 8, 2019

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- Stock options, which she purchases on February 14 of the current year for $850, expire on October 1.
- On July 1, she sells for $4,500 her personal-use automobile acquired on March 31, 2011, for $18,000.
- On August 16, she sells for $3,100 her stock of York Corporation purchased as an investment on February 16, for $1,600.
- On March 15, she sells for $5,600 an antique ring, a gift from her grandmother on January 10, 2005, when its FMV was $1,600. The ring was purchased by her grandmother on April 2, 1979, for $1,800.
- She has an STCL carryover of $250 from last year.

I:5-68 Spencer Duck (SSN 000-22-1111) is single and his eight-year-old son, Mitch, lives with him nine months of the year in a rented condominium at 321 Hickory Drive in Ames, Iowa. Mitch lives with his mother, Spencer's ex-wife, during the summer months. His mother provides more than half of Mitch's support and Spencer has agreed to allow her to claim Mitch as her dependent. Spencer has a salary of $39,000 and itemized deductions of $4,000. Taxes withheld during the year amount to $3,221. On July 14 of the current year, he sold the following assets:

- Spencer received a K-1 from a partnership indicating that his share of the partnership STCL is $200.
- Land was sold for $35,000. The land was received as a property settlement on January 10, 2009, when the land's FMV amounted to $30,000. His ex-wife's basis for the land, purchased on January 10, 2001, was $18,600.
- A personal-use computer acquired on March 2 last year for $4,000 was sold for $2,480.
- A membership card for a prestigious country club was sold for $8,500. The card was acquired on October 10, 2003, for $6,000.
- Marketable securities held as an investment were sold for $20,000. The securities were inherited from his uncle, who died on March 10 of the current year when FMV of the securities was $21,000. The uncle purchased the securities on May 10, 1990, for $10,700.

In addition to the above sales, Spencer received a $100 refund of state income taxes paid last year. Spencer used the standard deduction last year to compute his tax liability. Prepare Form 1040 and Schedule D for the current year.

CASE STUDY PROBLEMS

I:5-69 As a political consultant for an aspiring politician, you have been hired to evaluate the following statements that pertain to capital gains and losses. Evaluate the statement and provide at least a one-paragraph explanation of each statement. As you prepare your answer, consider the fact that the aspiring politician does not have much knowledge about taxation.



a. The tax on capital gains is considered a voluntary tax.
b. High-income taxpayers receive the most benefit from preferential treatment for capital gains.

I:5-70 Your client, Apex Corporation, entered into an agreement with an executive to purchase his personal residence at its current FMV in the event that his employment is terminated by the company during a five-year period. The executive's job was terminated before the end of the five-year period and Apex acquired the house for $500,000. Due to a downturn in the real estate market, a $200,000 loss was incurred by the company upon the resale of the house. The chief financial officer of Apex insists that the loss be characterized as ordinary, based on the *Corn Products* doctrine. Your research into this matter reveals that the weight of authority heavily favors capital loss treatment (i.e., case law based on facts identical to the above issue held that the loss was capital rather than ordinary). You therefore conclude that the client's position does not have a realistic possibility of being sustained administratively or judicially on its merits if challenged by the IRS. What responsibility do you have as a tax practitioner relative to preparing the client's tax return and rendering continuing tax consulting services to the client? (See the Section *Statements on Standards for Tax Services* in Chapter I:1 for a discussion of these issues.)

TAX RESEARCH PROBLEMS

I:5-71 Tom Williams is an equal partner in a partnership with the Kansas Corporation. Williams, an inventor, produced a new process while working for the partnership, which has been patented by the partnership. Before making any use of the patent, the partnership entered into a contract granting all rights to use the process for the life of the patent to the Mason Manufacturing Co.

The time between receiving the patent and entering into the contract with Mason amounted to eight months. Mason agreed to pay 0.3% of all sales revenue generated by products produced as a result of the process. If Mason fails to make payments on a timely

basis, Mason's right to use the process is forfeited and the agreement between the partnership and Mason is canceled. Will any of the proceeds collected qualify as LTCG under Sec. 1235?

A partial list of research sources is

- Reg. Sec. 1.1235-2
- *George N. Soffron,* 35 T.C. 787 (1961)

I:5-72 Lynette, a famous basketball player, is considering the possibility of transferring the sole right to use her name to promote basketball shoes produced and sold by the NIK Corporation. NIK will pay $2 million to obtain the right to use Lynette's name for the next 40 years. NIK may use the name on the shoes and as a part of any of the company's advertisements for basketball shoes. If Lynette signs the contract and receives the $2 million payment, will she have to recognize capital gain or ordinary income?

A partial list of research sources is

- Sec. 1221
- Rev. Rul. 65-261, 1965-2 C.B. 281

I:5-73 Jack, a tenured university professor, has been a malcontent for many years at Rockport University. The university has recently offered to pay $200,000 to Jack if he will relinquish his tenure position and resign. Jack is of the opinion that tenure is an intangible capital asset and the $200,000 received for release of the tenure should be a long-term capital gain. Explain why you agree or disagree.

A partial list of research sources is

- *Harry M. Flower,* 61 T.C. 140 (1973)
- *Estelle Goldman,* 1975 PH T.C. Memo ¶75,138, 34 TCM 639

I:5-74 Web Baker was hired three years ago by the Berry Corporation to serve as CEO for the company. As part of his employment contract, the corporation had agreed to purchase his residence at FMV in the event the company decided to fire him. Last year, Berry, unsatisfied with Web's performance, fired him and purchased the residence for $350,000. Berry immediately listed the house with a real estate agency. Soon after the purchase, the real estate market in the area experienced a serious decline, especially in higher-priced homes. Berry sold the house this year for $270,000 and paid selling expenses of $12,000. How should the Berry Corporation treat the $92,000 loss?

A partial list of research sources is

- Sec. 1221
- Rev. Rul. 82-204, 1982-2 C.B. 192
- *Azar Nut Co. v. CIR,* 67 AFTR 2d 91-987, 91-1 USTC ¶50,257 (5th Cir., 1991)

CHAPTER

6

DEDUCTIONS AND LOSSES



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Distinguish between deductions *for* and *from* AGI
2. Discuss the criteria for deducting business and investment expenses
3. Examine the restrictions for deducting expenses
4. List the substantiation requirements for deducting travel and entertainment expenses
5. Explain the timing of deductions under both the cash and accrual methods of accounting
6. Discuss special disallowance rules for certain deductions
7. Describe tax planning considerations for deductions and losses
8. Describe compliance and procedural considerations for deductions and losses

CHAPTER OUTLINE

Classifying Deductions as For Versus From Adjusted Gross Income (AGI)...6-3
Criteria for Deducting Business and Investment Expenses...6-4
General Restrictions on the Deductibility of Expenses...6-9
Proper Substantiation Requirement...6-17
When an Expense Is Deductible...6-18
Special Disallowance Rules...6-23
Tax Planning Considerations...6-35
Compliance and Procedural Considerations...6-37

The next five chapters deal with deductions. As you recall from Chapters I:3 and I:4, the IRC uses the "all-inclusive" approach when dealing with items of income; that is, gross income includes all items of income unless the income item is specifically excluded by statute. In contrast, unless the IRC specifically provides a deduction, a taxpayer may not deduct an expenditure or expense. For example, a taxpayer who makes a donation to a charity during the year may deduct the donation only because the IRC specifically allows the deduction of charitable contributions under Sec. 170.

Chapter I:6 discusses the general requirements for the deductibility of taxpayer expenditures and losses. Some of these requirements apply to all taxpayers while others apply only to individuals. Chapter I:7 discusses business expenses and employee compensation. Chapter I:8 deals with itemized deductions for individual taxpayers. Chapter I:9 covers two major areas that apply to all taxpayers: the deductibility of losses and bad debts. Chapter I:10 discusses tax depreciation, amortization, and depletion.

As mentioned above, a taxpayer can only deduct an expenditure if the IRC specifically allows the deduction. However, the IRC cannot possibly specify *every* deductible expense that a taxpayer might incur. Therefore, the IRC contains a framework for analyzing the nature of an expenditure. If the expenditure meets the criteria developed in the framework, the taxpayer generally can deduct the item unless specific disallowance or limitation provisions apply. This framework provides three general categories of deductions:

(1) Expenses incurred in connection with a **trade or business** (Sec. 162);
(2) Expenses incurred by an individual in connection with the **production of income** (Sec. 212);
(3) Other types of expenses that fall within specific provisions of the IRC, such as certain types of interest expense, taxes, bad debts, and other expenditures by individuals for personal items.

The first two categories of deductions (business expenses and production of income expenses) are for expenditures the taxpayer incurs in connection with a profit-motivated activity. Here again, the IRC does not attempt to specify every conceivable type of deductible business or investment expense. Instead, the IRC establishes general guidelines that a taxpayer must meet in order to deduct an expense as either a business or investment deduction. In this case, a taxpayer may deduct any expense incurred in connection with a trade or business or for the production of income if the expense (1) falls within the general guidelines and (2) the tax law does not specifically exclude or limit the expense from deductibility. For example, although the law does not specifically state that a taxpayer can deduct expenditures for utilities or salaries that the taxpayer incurs in a profit-motivated business, the taxpayer can deduct these business expenses under Sec. 162 as long as the expenses meet the general guidelines of Sec. 162 and they are not subject to a specifically stated limitation or exclusion from deductibility. These general guidelines are discussed later in this chapter.

Section 212, which applies only to individuals, allows an individual to deduct expenses that the individual incurs for the:

- ▶ Production or collection of income
- ▶ Management, conservation, or maintenance of property held for the production of income
- ▶ Determination, collection, or refund of any tax

As explained later in this chapter, the general guidelines that the taxpayer must meet in order to deduct expenses incurred in both of these types of activities require that the expenses must be ordinary, necessary, and reasonable in the context of the activity in which they are incurred. Furthermore, if the taxpayer incurs a loss in either of these types of activities, the amount of the deduction may be limited.

Section 262 also provides a general rule that prohibits individuals from deducting personal, living, or family expenses. However, the tax law does specifically allow individuals to deduct certain personal expenditures or losses. For example, an individual taxpayer may deduct losses incurred in a federally declared disaster on personal use assets (subject to certain limitations). Individual taxpayers may also deduct personal

expenditures for certain types of interest, taxes, and retirement savings if the expenditures meet strict requirements. Chapters I:7, I:8, and I:9 discuss deductions and losses for personal expenditures.

Classifying Deductions as For versus From Adjusted Gross Income (AGI)

OBJECTIVE 1

Distinguish between deductions for and from AGI

TAX LAW UPDATE

New Sec. 199A, also mentioned in Chapter I:2, was enacted in late 2017 as part of the Tax Cuts and Jobs Act, and it established a new kind of deduction from AGI. The Sec. 199A qualified business income deduction is a deduction from AGI, but it is not an itemized deduction.

KEY POINT

Most *for* AGI deductions are either expenses the taxpayer incurs in a trade or business or certain investment activities. Most of the deductible personal expenses are deductible *from* AGI.

ADDITIONAL COMMENT

While reimbursed employee business expenses are listed in Sec. 62 as a deduction for AGI, in cases where the employee needs to account to their employer for the expenses, neither the reimbursement nor the expenses are typically reported on the income tax return. See Chapter I:7 for additional details.

As mentioned in Chapter I:2, the tax formula for individuals divides allowable business, investment, and personal deductions into the following two categories:

- Deductions subtracted from gross income in order to calculate adjusted gross income (*for* AGI deductions); and
- Deductions subtracted from AGI to calculate taxable income (*from* AGI deductions).

Section 62 specifically identifies deductions *for* AGI. All other deductions for individuals are deductions *from* AGI. The more common *for* AGI deductions include the following, subject to certain limitations:

- All allowable expenses incurred in an individual's trade or business, but not including an employee's unreimbursed business expenses
- Reimbursed employee business expenses
- Certain business expenses incurred by performing artists as well as employees of a state or a political subdivision thereof
- Losses from the sale or exchange of trade, business, or investment property
- Expenses attributable to the production of rent or royalty income
- Contributions to certain pension, profit-sharing, or retirement plan arrangements
- Penalties paid to a bank or other savings institution because of the early withdrawal of funds from a certificate of deposit or time savings account
- Cash payments made to a qualified Health Savings Account or Archer Medical Savings Account
- Up to $2,500 of interest paid on qualified educational loans (student loan interest).
- Professional fees and out-of-pocket expenses ($250 indexed for inflation) incurred by elementary and high school teachers
- One-half of the self-employment tax imposed on self-employed individuals and 100% of health insurance costs paid by such individuals.[1]

For individuals, the distinction between deductions *for* AGI and *from* AGI is critical for two reasons. First, as explained in Chapter I:2, the tax formula allows individuals to deduct the greater of the standard deduction or the total of the *from* AGI (itemized) deductions in arriving at taxable income. Thus, an individual does not benefit from deductions *from* AGI if the total deductible amount for the year does not exceed the standard deduction. Deductions *for* AGI, on the other hand, reduce AGI (and consequently taxable income) even if the taxpayer uses the standard deduction in computing taxable income.

[1] Sections 62, 162(l) and 164(f). Other deductions *for* AGI include deductions for depreciation and depletion for life tenants and income beneficiaries of property, reforestation expenses, required repayments of supplemental unemployment compensation benefits, certain expenses incurred for clean-fuel vehicles and refueling property, jury duty pay the taxpayer remits to an employer, attorney's fees the taxpayer pays out of awards in certain types of lawsuits, and certain trade or business expenses incurred by members of an Armed Forces unit. Two *for* AGI deductions, broadly allowed before the Tax Cuts and Jobs Act (2017), continue to be allowed under more restricted circumstances. The deduction for the amount of alimony paid continues for alimony paid under divorce agreements finalized before 2019 (Section 215, Public Law 115-97, Section 11051(c)). The deduction for moving expenses, after 2017 and through 2025, is limited to taxpayers who are active duty Armed Forces members who move under military orders (Section 217(k)).

EXAMPLE I:6-1 ▶ Brad, a single individual with no dependents, incurs $6,000 of deductible expenses and earns $75,000 in gross income during 2019. If the expenses are all deductions from AGI, Brad will report taxable income of $63,000 (i.e., Brad receives a $12,200 standard deduction). Brad receives no direct tax benefit from the expenses because they do not exceed the standard deduction. However, if the $6,000 of expenses are all deductions for AGI, Brad reports taxable income of $57,000 (a $6,000 for AGI deduction in addition to the $12,200 standard deduction).

	Deductions from AGI	*Deductions for AGI*
Gross income	$75,000	$75,000
Minus: For AGI deductions	0	(6,000)
AGI	$75,000	$69,000
Minus: Standard deduction	(12,200)	(12,200)
Taxable income	$62,800	$56,800 ◀

The second important reason for the proper classification of deductions is that AGI acts as a limit on the amount of *from* AGI itemized deductions that can be taken. This limitation operates in various ways:

- Individuals may deduct certain itemized deductions such as medical expenses and certain, casualty losses only to the extent the particular expense exceeds a prescribed percentage of AGI. For example, a taxpayer may deduct medical expenses only to the extent the medical expenses exceed 10% of the individual's AGI for the year. Individual taxpayers must first reduce allowable casualty losses on personal-use property by $100 per casualty event. After this reduction, an individual may deduct casualty losses only to the extent that the sum exceeds 10% of the individual's AGI.
- AGI also acts as a limit on the deductibility of certain itemized deductions by placing a limit on the total amount of the deduction. For example, in general the deduction for charitable contributions may not exceed 50% of the taxpayer's AGI although cash contributions are limited to 60% of the taxpayer's AGI.

Deductions *for* AGI are reported in two places on the tax return. First, some deductions *for* AGI appear on lines 23–35 of Schedule 1 of Form 1040. These deductions include such items as individual retirement account contributions, one-half of self-employment taxes, and student loan interest. Second, other deductions appear on separate schedules, including Schedule C (Profit or Loss from Business), Schedule E (Supplemental Income or Loss), or Schedule F (Profit or Loss from Farming). The net profit or loss from these schedules carries over to the front page of Form 1040 as part of gross income. Thus, the deductions on these schedules are deductions *for* AGI. Figure I:2-1 in Chapter I:2, contains the front page of Form 1040 and Schedule 1.

CRITERIA FOR DEDUCTING BUSINESS AND INVESTMENT EXPENSES

OBJECTIVE 2

Discuss the criteria for deducting business and investment expenses

A taxpayer may deduct business and investment expenses only if certain requirements are met. Under these requirements, deductible business or investment expenses must be:

- Related to a profit-motivated activity of the taxpayer (i.e., a business or investment activity rather than a personal expenditure),
- Ordinary,
- Necessary,
- Reasonable in amount,
- Properly documented (discussed later in the chapter under the heading Proper Substantiation Requirement), and
- An expense of the taxpayer (not someone else's expense).

Furthermore, as discussed later in this chapter under the heading General Restrictions on the Deductibility of Expenses, even if the expense meets the requirements for deductibility

above, taxpayers may not deduct expenditures meeting certain other criteria. Thus, generally, a taxpayer cannot deduct an expenditure if it is:

- A capital expenditure,
- An expense related to tax-exempt income,
- Illegal or in violation of public policy, or
- Specifically disallowed by the tax law.

Further discussion of these criteria and related matters follows.

BUSINESS OR INVESTMENT ACTIVITY

Deductible expenditures generally originate from a profit-motivated activity. Section 162 provides all taxpayers with a deduction for their business expenses. Additionally, under Sec. 212, individuals can deduct expenses they incur for the production of income or for the maintenance and conservation of income-producing property (an investment activity). Thus, the requirement of an activity being profit-motivated is really two-pronged: (1) a determination of whether an expenditure originates from an activity engaged in for profit and (2) for individuals, a distinction between a trade or business and an investment activity.

REAL-WORLD EXAMPLE

A taxpayer attempted to deduct competitive bass fishing costs as a business expense, but the court concluded that there was no profit motive. Although the taxpayer maintained adequate business records, the taxpayer had a history of promptly ending unprofitable business ventures. His unwillingness to cease tournament bass fishing despite continued losses over several years suggested the lack of a profit motive. Moreover, the taxpayer's lifelong love of fishing suggested that the taxpayer engaged in the activity for personal pleasure rather than for profit. *Thomas W. and Pamela A. Hill,* T.C. Summary Opinion 2006-120.

Activity Engaged in for Profit. This first part of the test classifies the expense as resulting from either a profit-motivated activity or a personal activity. For individuals, classifying expenses as either profit-motivated or personal can be quite difficult. For example, is the activity of coin collecting a hobby that is personal in nature, a profit-motivated business, or an investment activity? No single objective test is available. Rather, a tax advisor must examine all the facts and circumstances surrounding the activity in which the taxpayer incurs expenses in order to make this distinction. The section in this chapter entitled Hobby Losses discusses these factors in more detail, as well as other issues dealing with the determination of whether or not a particular activity is profit-motivated.

Trade or Business Versus Investment Classification. The second part of the profit-motive test involves the determination of whether a particular activity is a trade or business of the taxpayer or only an investment. This distinction generally is important only to individuals since corporations are assumed to be engaged in a business. It is important to individuals for several reasons. First, if an individual realizes a loss on the sale of an asset that the individual used in a business, the individual may be able to deduct the loss as an ordinary loss.[2] On the other hand, if the taxpayer realizes a loss on the sale of an investment asset, the loss is treated as a capital loss which, as explained in Chapter I:5, receives different treatment. Second, this distinction may control whether an expense of the activity is a deduction *for* AGI or a deduction *from* AGI. In general, expenses incurred in a trade or business are deductions *for* AGI whereas investment expenses, other than those incurred to produce rents and royalties, are not deductible.[3] Additionally, under Sec. 179, taxpayers may elect to currently deduct a specified amount of capital expenditures for certain qualified tangible personal property. The maximum amount that a taxpayer can deduct under Sec. 179 is $1,020,000 for 2019. This deductible amount begins to phase out if the taxpayer places into service more than $2,550,000 of qualified property during 2019. (See Chapter I:10 for a discussion of the Sec. 179 expense election for capital expenditures.)

EXAMPLE I:6-2 ▶ Robin is a self-employed financial consultant. She meets daily with a variety of clients to discuss their investments. Because she must keep abreast of the latest market quotes and strategies, Robin subscribes to several trade publications and quote services. During the year, Robin purchased a $4,000 computer to be used exclusively in her consulting business. Robin may deduct the expenses incurred for the publications and services as deductions for AGI because she incurred them in her consulting business. Furthermore, she can currently deduct the $4,000 paid for the computer under the special rules of Sec. 179 because it is a business asset, rather than an investment asset. ◀

[2] Under Sec. 1231, the exact treatment depends on the total gains and losses from such property for the year. See Chapter I:13 for a discussion of Sec. 1231.

[3] The Tax Cuts and Jobs Act of 2017 repealed any deductions considered miscellaneous itemized deductions subject to the 2% floor for years 2018–2025.

Expenses incurred by an individual in an investment activity, other than those incurred to produce rents and royalties, are not deductible (see Chapter I:8).

EXAMPLE I:6-3 ▶ Steve is a wealthy attorney who invests in the stock market and keeps abreast of the latest market quotes and strategies by subscribing to several trade publications. This year he purchased a computer he will use exclusively for tracking his investments. Steve generally spends an hour or two each day studying this information and analyzing his portfolio. The subscription expenses are not deductible because Steve incurred the expenses in an investment (rather than a business) activity and the expenses do not relate to the production of rents and royalties. Similarly, Steve cannot currently deduct the cost of the computer. ◀

ADDITIONAL COMMENT

A trade or business is an activity with a profit motive and some type of economic activity. An investment activity requires a profit motive but does not require economic activity.

Despite these important differences in treatment, the distinction between an investment activity and a trade or business is not always clear. The IRC and the Treasury Regulations do not provide a precise definition of what constitutes a trade or business. Judicial law, however, does provide some guidelines. In one of the first cases dealing with the issue, the Supreme Court stated that a trade or business involves "holding one's self out to others as engaged in the selling of goods or services."[4]

Later, another Supreme Court case emphasized that one must examine all the surrounding facts and circumstances to determine the underlying nature of an activity.[5] In that case, the taxpayer owned a large portfolio of stocks, bonds, and real estate. The taxpayer's holdings were so large that he rented offices and hired employees to help him manage the properties. The Court, however, regarded these activities as investment activities despite the size of the holdings and the amount of work and effort involved because the taxpayer merely kept records and collected interest and dividends from his securities. Other cases, however, indicate that a taxpayer who invests in stocks and bonds may be considered to be in a business if he or she frequently buys and sells securities in order to make a short-term profit on the daily swings in the market.

Legal and Accounting Fees. Taxpayers may generally deduct legal and accounting fees incurred in the regular conduct of a trade or business or for the production of rent or royalty income. These deductions are *for* AGI. Legal and accounting fees incurred in the determination or collection of taxes are also *for* AGI deductions if paid to prepare a taxpayer's Schedule C (Profit or Loss from Business), Part I of Schedule E (Supplemental Income and Loss, which is used to report rental and royalty income), and Schedule F (Farm Income and Expenses).[6] All other legal and accounting fees incurred by an individual are not deductible. A filled-in Schedule C and copies of Schedule E and Schedule F are provided in Appendix B.

Taxpayers may not deduct legal fees they incur in connection with the purchase of property. Instead, taxpayers must capitalize these expenses by adding them to the cost of the property. Likewise, taxpayers generally may not deduct legal expenses they incur for personal purposes.

EXAMPLE I:6-4 ▶ During the current year, Lia pays legal and accounting fees for the following:

Services rendered with regard to a contract dispute in Lia's business	$ 8,000
Services rendered in resolving a federal tax deficiency relating to Lia's business	2,500
Tax return preparation fees:	
Allocable to preparation of Schedule C	1,600
Allocable to preparation of Schedules A and B and to the remainder of Form 1040	400
Legal fees incident to a divorce	1,200
Total	$13,700

Lia may deduct $12,100 ($8,000 + $2,500 + $1,600) *for* AGI because these legal expenses are associated with Lia's business. Lia may not deduct the remaining $400 of tax preparation fees. The legal fees incident to the divorce are not deductible. ◀

[4] *Deputy v. Pierre S. DuPont*, 23 AFTR 808, 40-1 USTC ¶9161 (USSC, 1940).

[5] *Eugene Higgins v. CIR*, 25 AFTR 1160, 41-1 USTC ¶9233 (USSC, 1941). See also *Chang H. Liang*, 23 T.C. 1040 (1955), and *Ralph E. Purvis v. CIR*, 37 AFTR 2d 76-968, 76-1 USTC ¶9270 (9th Cir., 1976); and *Samuel B. Levin v. U.S.*, 43 AFTR 2d 79-612, 79-1 USTC ¶9331 (Ct. Cls., 1979).

[6] Rev. Rul. 92-29, 1992-1 C.B. 20.

ORDINARY EXPENSE

A business or investment expense must also be "ordinary" in order for a taxpayer to be able to deduct the expense. Although neither Sec. 162 nor Sec. 212 provides either a definition or an application of this requirement, the Treasury Regulations under Sec. 212 indicate that for an expense to be ordinary it must be reasonable in amount and it must bear a reasonable and proximate relationship to the income-producing activity or property. Also, case law has held that for an expense to be ordinary it must be customary or usual in the context of a particular industry or business community.[7] Thus, an expenditure may be ordinary in the context of one type of business, but not in the context of another.

EXAMPLE I:6-5 ▶ Ahmed purchases a plot of land, on which there is an old vacant warehouse. In the long run, Ahmed anticipates making a long-term profit from the investment because the value of the land is expected to appreciate eventually due to commercial development in the area. In the short run, Ahmed plans to rent storage space in the warehouse. During the current year (first year of ownership), although he is unable to rent the warehouse, Ahmed incurs the following expenses:

Expenses	*Amount*
Property taxes	$1,000
Interest	4,000
Insurance	800
Utilities	200

All of these expenditures qualify as ordinary deductible rental expenses under Sec. 212 because they bear a reasonable and proximate relationship to the rental income Ahmed expects to obtain. However, Ahmed might not be able to deduct them all in the current year because of the passive loss limitations explained in Chapter I:9. ◀

ADDITIONAL COMMENT

A General Accounting Office report finds that tax cheating is widespread among self-employed taxpayers. These workers represent only 13% of all taxpayers, but account for approximately 40% of all underreported individual income. The report identified truckers as one of the least compliant groups.

EXAMPLE I:6-6 ▶ For many years, Hank has been an officer in Green Corporation, which is engaged in the grain business. Green Corporation purchases its grain from various suppliers. Last year, Green Corporation went bankrupt and was relieved from having to pay off its debts to its suppliers. In the current year, Hank enters into a contract to act as a commissioned agent to purchase grain for Green Corporation. To reestablish a relationship with suppliers whom Hank knew previously, Hank decides to pay off as many of Green Corporation's debts as he can. Hank is under no legal obligation to do so. Hank's payments are not ordinary. Rather, they are extraordinary expenditures made for goodwill to establish Hank in a new trade or business, and they must be capitalized. ◀

An expense may be ordinary with respect to a taxpayer even though that taxpayer encounters it only once.

EXAMPLE I:6-7 ▶ For several years, Health for You, Inc., has been engaged in the business of making and selling dietary supplements. Health for You, Inc., does most of the advertisements, orders, and deliveries of the supplements through the mail. During the current year, the post office judged that some of the advertisements were false. As a result, a fraud order is issued under which the post office stamps "Fraudulent" on all letters addressed to or from Health for You, Inc., and then returns them to the senders. In an unsuccessful suit to prevent the post office from continuing this practice, Health for You, Inc. expends $50,000 in lawyer's fees. These fees are ordinary business expenses because Health For You, Inc. incurred them in an action that a taxpayer normally or ordinarily would have taken under these circumstances. ◀

REAL-WORLD EXAMPLE

A corporation made payments to an individual who was a 50% shareholder in the corporation. The corporation made these payments to the individual to prevent him from interfering in the management of the business and damaging the corporation's reputation. The Tax Court held that these payments were necessary business expenses. *Fairmont Homes, Inc.*, 1983 PH T.C. Memo ¶83,209, 45 TCM 1340.

The Supreme Court has also indicated that the term *ordinary* in this context refers to an expenditure that is currently deductible rather than an expenditure that must be capitalized.[8]

NECESSARY EXPENSE

In addition to being ordinary, a deductible investment or business expense must also be **necessary**. The Supreme Court has indicated that an expense is considered necessary if it

[7] *Thomas H. Welch v. Helvering*, 12 AFTR 1456, 3 USTC ¶1164 (USSC, 1933) and *Deputy v. Pierre S. DuPont*, 23 AFTR 808, 40-1 USTC ¶9161 (USSC, 1940).

[8] *CIR v. S. B. Heininger*, 31 AFTR 783, 44-1 USTC ¶9109 (USSC, 1943). See also *CIR v. Walter F. Tellier*, 17 AFTR 2d 633, 66-1 USTC ¶9319 (USSC, 1966).

is "appropriate and helpful" in the taxpayer's business.[9] To meet this appropriate or helpful standard, an expenditure need not be necessary in the sense that it is indispensable. Rather, the test is whether a reasonable or prudent businessperson would incur the same expenditure under similar circumstances.

EXAMPLE I:6-8 ▶ The expenditures in Example I:6-6 (the payment of debts from a former business) and Example I:6-7 (the payment of legal fees) are both necessary because they are appropriate and helpful in each case. However, the expenditure in Example I:6-6 is not ordinary and, therefore, is not deductible. The expenditure in Example I:6-7 is deductible because it meets both tests. ◀

REASONABLE EXPENSE

Section 162 and case law provide that in order to be deductible the business or investment expense must be reasonable.[10] Problems with meeting the reasonable standard can arise when a closely-held C corporation pays a salary to an individual who is both a shareholder and an employee. In this situation, a controlling shareholder of a C corporation may receive a payment, characterized as salary, that the IRS asserts is too large for the services the individual employee rendered.

EXAMPLE I:6-9 ▶ Central Corporation pays Brian, the controlling shareholder and an employee of Central Corporation, an annual salary of $650,000. Based on several factors, such as the size of Central Corporation's total operations, Brian's duties as an employee, and a comparison of salary received by officers of comparably sized corporations, the IRS contends that Brian's salary should be no higher than $300,000. If Central successfully defends the $650,000 salary, the corporation is able to deduct the full amount as salary expense. If Central Corporation's defense is not successful, the IRS will treat the excess over $300,000 as a dividend (not deductible) to the extent of Central Corporation's earnings and profits. In either event, Brian must take the full $650,000 into income. (See the Tax Planning Considerations section in this chapter for a discussion of the use of a payback agreement in these situations.) ◀

KEY POINT

The IRS also applies the reasonable standard in determining whether a salary paid to the owner of an S corporation is too low. This may occur if the owner is attempting to avoid the payment of employment taxes.

KEY POINT

Since the Sec. 162(m) compensation deduction limit applies only to publicly-held corporations, privately-held corporations are faced with the general reasonable standard which looks at the particular facts and circumstances.

The reasonable standard for compensation expense in Section 162(a)(1) was expanded in 1993 with the addition of Sec. 162(m), which limited to $1,000,000, the deduction for compensation paid by public corporations to "covered employees." The addition of this bright-line standard was linked to public awareness of substantial growth in executive pay in ways not always aligned with observed executive performance.

The Tax Cuts and Jobs Act of 2017 changed provisions in Sec. 162(m) in three ways:

- For years after 2017, covered employees include the principal executive officer (CEO), principal financial officer (CFO), and the three officers (other than the CEO and CFO) included in the group of the five highest compensated officers for the tax year.
- Before 2018, the Sec. 162(m) deduction limit did not apply to performance-based compensation. After 2017, the "$1 million limit" is more stringent in that it includes performance-based compensation (Sec. 162(m)(4)).
- After 2018, the definition of "publicly held corporation" is defined to include any corporation a) considered an issuer required to register its securities with the Securities and Exchange Commission or b) required to comply with the reporting requirements imposed by the Securities and Exchange Commission.

The tests for determining whether a business or investment expense is deductible are summarized in Topic Review I:6-1.

EXPENSES AND LOSSES INCURRED DIRECTLY BY THE TAXPAYER

Generally, taxpayers may not take a deduction for a loss or expense of another person. This requirement attempts to prevent taxpayers from engaging in manipulative schemes.

[9] *Thomas H. Welch v. Helvering*, 12 AFTR 1456, 3 USTC ¶1164 (USSC, 1933). [10] *Botany Worsted Mills v. United States*, 49 S. Ct.. 129 (1929).

TOPIC REVIEW I:6-1

Tests for Deductibility as a Business or Investment Expense

Test	Application
Ordinary	▶ Based on the facts and circumstances. ▶ Reasonable and proximate relationship to the activity. ▶ Customary or usual in context of the industry. ▶ Need not be encountered by the taxpayer more than once.
Necessary	▶ Based on the facts and circumstances. ▶ Appropriate and helpful. ▶ Need not be indispensable. ▶ Would a reasonable or prudent businessperson incur the same expense?
Reasonable	▶ Based on the facts and circumstances. ▶ Applies to all business and investment expenses. ▶ Compensation paid to an owner-employee of a small corporation is the most commonly contested area. ▶ Compensation in excess of $1 million payable by a publicly-held corporation to its key executives is not deductible.

EXAMPLE I:6-10 ▶ Juanita owns 60% of Hot Clothes, Inc. As CEO of Hot Clothes, Juanita travels extensively. This year Hot Clothes purchases a business jet to facilitate Juanita's travel. In addition to her business travel, Juanita also uses the jet to take several family vacations. In general, Hot Clothes may not take a deduction for Juanita's personal expenses. In order for the business to deduct these amounts, Juanita and the corporation must follow one of two procedures: (1) Juanita must report as additional compensation an amount that represents the use of the jet for her vacations, or (2) Juanita must reimburse Hot Clothes for the use of the jet for her vacations. However, even if Juanita does follow one of these procedures, the amount Hot Clothes, Inc. may deduct for Juanita's private use of the jet may be limited. ◀

This general rule requiring the taxpayer to directly incur the expense applies to all types of expenditures, whether incurred in a trade or business, an investment activity, or a personal activity for which deductions are allowed. There is one exception: under Sec. 213 taxpayers may take a deduction for medical expenses paid on behalf of a dependent. Individuals may also deduct medical expenses that they pay for a person who would qualify as a dependent except for failing to meet certain other tests (see Chapter I:2). For example, under Sec. 152, the dependent's gross income must be less than the exemption amount to qualify as a qualifying relative, but for Sec. 213 this requirement is disregarded.

EXAMPLE I:6-11 ▶ In June 2019, Terry Thompson, a newly minted nurse practitioner, accepted a position to work for 24 months as a contractor with a large medical practice in Nashville, TN. The practice requires him to have his own malpractice insurance coverage for the first 60 days, though afterwards, the practice will obtain coverage for Terry with a policy rider on their own malpractice policy. Terry is unable to afford the 60 day premium of $448, and his brother Malcolm paid the premium for him. Terry's Form 1099 reports he earned $39,075 in 2019 working for the medical practice. Because he did not bear the $448 premium cost, Terry cannot deduct the $448 in premiums against the income he earned. ◀

General Restrictions on the Deductibility of Expenses

OBJECTIVE 3

Examine the restrictions for deducting expenses

As mentioned earlier on page I:6-5, certain types of expenditures are not deductible. These types of expenditures fall within various categories discussed below.

CAPITALIZATION VERSUS EXPENSE DEDUCTION

General Capitalization Requirements. Under Sec. 162 a taxpayer may currently deduct ordinary, necessary, and reasonable business expenses that the taxpayer incurs for the operation and maintenance of tangible property the taxpayer uses in a business. However, under Sec. 263, expenditures that (1) provide a permanent improvement or "betterment" that increases the value of any property, or (2) "restore" the property are considered **capital expenditures**, which generally must be capitalized and depreciated over an appropriate number of years. Taxpayers must also capitalize the cost of goodwill purchased in connection with the acquisition of the assets of a going concern.[11] (See Chapter I:10 for a discussion of the amortization of goodwill.)

Although taxpayers may depreciate or amortize certain business assets, such as buildings, machinery, equipment, furniture and fixtures, purchased goodwill, and customer lists, other assets, such as land, stock, and partnership interests, are neither depreciable nor amortizable and taxpayers must wait until they sell these assets to recover the cost of the assets. In some instances, it is difficult to ascertain whether an asset is eligible for depreciation or amortization. For example, the Tax Court has held that antique violin bows and an antique bass violin are depreciable property, overriding the IRS's arguments that they should not be depreciable because they were actually appreciating in value and it was impossible to determine their useful life.[12]

As mentioned above, expenditures that only keep an asset in a normal operating condition are deductible as repair expense if they do not provide a permanent improvement that increases the value of the property or restore the property to its normal usage. Distinguishing between a currently deductible expenditure and a capital expenditure that must be capitalized and depreciated over time can be very difficult. This difficulty has caused a lot of uncertainty and controversy for taxpayers. For example, in an old Tax Court case, the court held that expenditures incurred in replacing support beams and floor joists to shore up a sagging floor were deductible, whereas the court held that the cost of placing a new floor over an old one was a capital expenditure.[13] Recently issued Regulations under Sec. 162 and Sec. 263 provide more clear guidance for taxpayers. These new regulations contain many examples that can help taxpayers and their advisors distinguish the proper tax treatment of these expenditures. In any event, a tax advisor must examine all of the facts and circumstances in light of the guidance contained in these new regulations in order to determine whether any particular expenditure constitutes a deductible repair expense or an asset that should be capitalized.

ADDITIONAL COMMENT

Some provisions permit taxpayers to depreciate or amortize capital expenditures over a relatively short period of time. For example, there is a rapid write-off available for pollution control facilities under Sec. 169 and for organization costs of corporations under Sec. 248.

Election to Deduct Currently. Taxpayers sometimes may elect a current deduction for certain capital expenditures. Taxpayers often prefer a current deduction over capitalizing and depreciating an asset because of the time value of money. Some expenditures that taxpayers may elect to deduct currently[14] include: cost of fertilizers incurred by farmers, cost of soil and water conservation incurred by farmers, intangible drilling costs incurred in drilling oil and gas wells, costs for tertiary injectants, costs for certain mining development projects, costs incurred to remove architectural and transportation barriers to the handicapped and elderly, and costs for certain qualified research and experimental expenditures.

BOOK-TAX COMPARISON

Although for tax purposes a taxpayer may elect to deduct these capital expenditures, for book purposes capital expenditures must still be capitalized and depreciated or amortized. This difference in treatment gives rise to a book-tax adjustment on Schedule M-1 or M-3 of a corporation's Form 1120 or a partnership's Form 1065.

As mentioned previously, under Sec. 179 a taxpayer may also elect to currently deduct a limited amount of capital expenditures for tangible property the taxpayer purchases to use in a trade or business. Additionally, for property placed in service after September 27, 2017 taxpayers can elect to currently take a "100% bonus depreciation deduction" for certain qualified property the taxpayer purchases and places into service during the year instead of depreciating the full cost of the property over its depreciable life. This 100% bonus depreciation deduction is phased out between 2023–2026. See Chapter I:10 for a discussion of the rules and limitations of these deductions.

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[11] Reg. Sec. 1.263(a)-2(h). See also *Indopco, Inc., v. CIR*, 69 AFTR 2d 92-694, 92-1 USTC ¶50,113 (USSC, 1992), where expenses incurred by a corporation that was the target of a "friendly" takeover were held to be nondeductible capital expenditures because they provided long- term benefits to the corporation. In this case, the Supreme Court held that these long-term benefits do not need to be associated with a specific identifiable asset.

[12] *Richard L. Simon*, 103 T.C. 247 (1994) and *Brian P. Liddle*, 76 AFTR 2d 95-6255, 95-2 USTC ¶50,488 (3rd Cir., 1959). The IRS has stated it will not follow these decisions. See AOD 96-9, 7/15/96.

[13] *Standard Fruit Product Co.*, 1949 PH T.C. Memo ¶49,207, 8 TCM 733.

[14] See Secs. 180, 175, 263(c), 193, 616, 190, and 174 respectively.

Capitalization of Deduction Items. The exceptions mentioned above provide a current deduction for expenditures that are normally capital in nature. Conversely, Section 266 provides for the capitalization of certain expenses that are normally deductible. Section 266 is elective and applies to the following items:

- Interest and employment taxes incurred in transporting and installing personalty (as opposed to realty) up to the time when the taxpayer first puts the property into use.
- Annual property taxes, interest on a mortgage, and other carrying charges incurred on unimproved and unproductive real estate.
- Annual property taxes, interest, employment taxes, and other necessary expenses incurred for the development, improvement, or construction of real property, prior to the time construction is completed. For these expenses to be capitalized, the real property may be either improved or unimproved, productive or unproductive. After construction is completed, these types of expenses are deductible when incurred.

A taxpayer may make a new election each year to capitalize the expenses on unimproved and unproductive real estate each year.

EXAMPLE I:6-12 ▶ During 2018 and 2019, Nancy pays property taxes of $5,000 on a plot of land. During 2018, the land is vacant and unproductive. In 2019, Nancy uses the land as a parking lot, generating $7,000 in income. Nancy can elect to capitalize the taxes in 2018 because the property is both unimproved and unproductive. In 2019, however, the land is productive, and Nancy cannot elect to capitalize the taxes. Because the expenses relate to the production of rental income, Nancy can deduct them *for* AGI. ◀

For the development or construction of real property, if the taxpayer makes the election to capitalize the other expenses incurred during the development or construction period the election remains in effect for that year and for all subsequent years until the end of the construction period. However, a taxpayer may make the election on each new project separately.

EXAMPLE I:6-13 ▶ During the current year, Development, Inc. begins construction of an office building and a hotel. Development, Inc. incurs $20,000 in property taxes during the construction of the office building and $12,000 for the hotel. The election to capitalize the taxes on the office building does not bind Development, Inc. to make the same election with respect to the taxes on the hotel. ◀

If a taxpayer elects to capitalize this type of expense under Sec. 266, the expense increases the taxpayer's basis in the property to which the election pertains. If the property is depreciable, the taxpayer may deduct the expenses as depreciation deductions over a certain period. Taxpayers would want to make this election if they have large net operating loss (NOL) carryovers, or if they expect to be in a significantly higher tax bracket in future years and thus estimate that the benefit of the deduction will be greater in the future.

Under Sec. 263A, certain taxpayers must capitalize certain costs into inventory instead of taking a current deduction. (See Chapter I:11 for a discussion of inventories.)

SELF-STUDY QUESTION

Alpha, Inc., borrows $100,000 at a 10% rate of interest and invests the $100,000 in exempt bonds yielding 8%. Alpha is in the 35% tax bracket. Calculate what Alpha's cash flow on these transactions would be on an after-tax basis if Alpha could deduct these expenses.

ANSWER

Alpha, Inc., has $8,000 of exempt income and $10,000 of interest expense. Cash flows would be equal to ($2,000) since there is no tax benefit for the interest. If the interest expense were deductible, its after-tax cost would be $6,500 ($10,000 – $3,500). Alpha's cash flow would be $1,500 ($8,000 – $6,500), allowing Alpha to make money on an unsound investment.

EXPENSES RELATED TO EXEMPT INCOME

Under Sec. 265, taxpayers may not deduct any expense allocated or related to tax-exempt income. The purpose of this disallowance is to prevent the taxpayer from receiving a double tax benefit.

The IRC specifically disallows interest expense on debt the taxpayer incurs in order to purchase or hold tax-exempt securities. Thus, the disallowance depends on the taxpayer's intended use of the loan proceeds. Intent is generally determined by an examination of all the facts and circumstances surrounding the transaction rather than a mere statement of intent. Intent to hold tax-exempt securities is shown if the tax-exempt securities are used as collateral in securing a loan.[15] If an individual who holds tax-exempt securities later incurs some debt, no disallowance will occur if the debt is incurred to finance personal items for which an interest deduction may be taken (e.g., a mortgage on a personal residence). However, if a

[15] Rev. Proc. 72-18, 1972-1 C.B. 740 and Rev. Proc. 87-53, 1987-2 C.B. 669. See also *Wisconsin Cheeseman, Inc. v. U.S.*, 21 AFTR 2d 383, 68-1 USTC ¶9145 (7th Cir., 1968).

taxpayer incurs the debt to finance an investment, a deduction for a portion of the interest is generally disallowed. Even though the debt is not incurred to hold tax-exempt securities, the deductibility of interest may still be limited. For example, if a taxpayer incurs interest on personal debt, this interest is not deductible unless the loan qualifies as home acquisition indebtedness. (See Chapter I:8 for a discussion of limitations on the deductibility of personal interest.)

EXAMPLE I:6-14 ▶

BOOK-TAX COMPARISON

For a corporation, tax-exempt income and related expenses are included in the calculation of net income. For tax purposes, they are excluded from gross income resulting in a permanent book-tax difference that must be reported on schedule M-1 or M-3.

Asian, Inc. has invested $80,000 in Gold Corporation stock, $120,000 in real estate, and $50,000 in tax-exempt municipal bonds. During the current year, Asian borrows $70,000 for the purpose of investing in a limited partnership. For the year, the company pays $6,000 interest on the loan. Under these circumstances, the IRS will presume that Asian, Inc. has incurred a portion of the debt in order to hold the tax-exempt securities and will disallow a portion of the deduction for interest expense. Asian may overcome that presumption if it can show that it could not have sold the tax-exempt securities. Merely showing that the sale of the bonds would result in a loss will not overcome this presumption. ◀

EXPENDITURES CONTRARY TO PUBLIC POLICY

Taxpayers may not deduct certain expenditures, if the payment itself is illegal or if the payment is a penalty or fine resulting from an illegal act. These nondeductible expenses generally fall within one of the following categories: illegal payments to government officials or employees; other illegal payments; kickbacks, rebates, and bribes under Medicare and Medicaid; payments of fines and penalties; and payment of treble damages under the federal antitrust laws.

REAL-WORLD EXAMPLE

A subcontractor involved with the construction of a new shopping mall made kickbacks to the supervisor of the primary contractor. The kickbacks were deductible because they were not illegal, and the kickbacks were also ordinary and necessary because the subcontractor would not have been able to continue to work if the kickbacks had not been made. *Raymond Bertolini Trucking Co. v. CIR*, 54 AFTR 2d 84-5413, 1984-2 USTC ¶9591 (6th Cir., 1984).

Bribes and Kickbacks. Under Sec. 162(c)(1), any illegal bribe or kickback made to any official or employee of a government is not deductible. This applies to payments made to: federal officials and employees; state, local, and foreign government officials and employees; and officials and employees of an agency of a government.

EXAMPLE I:6-15 ▶

During February of the current year, Road Corporation enters into a contract with the State of Iowa to construct a five-mile stretch of a new highway. Under the terms of the contract, Road Corporation must complete the project by October 22 of the current year. If it is not completed and accepted by Iowa on or before that date, Iowa will fine Road Corporation $5,000 per day for every day after October 22 until the project is accepted. By October 20, the project foreman realizes that the company will not make the deadline if it complies with all the requirements imposed by the state inspector assigned to the project. To avoid the fine, the foreman arranges for the inspector to "look the other way" on several of the requirements in exchange for a payment of $8,000. Because this payment constitutes an illegal bribe to a government official, the payment is not deductible. On the other hand, assume Road Corporation does not pay the bribe and that it finishes the project four days after the deadline. In this case Road Corporation must pay $20,000 in fines. These fines are not imposed because of an illegal act. Thus, Road Corporation can deduct the $20,000 as an ordinary and necessary business expense. ◀

Taxpayers may not deduct illegal payments to officials or employees of a foreign government if the payment is unlawful under the Foreign Corrupt Practices Act of 1977, unless such payments constitute a normal way of doing business in that country. In all cases, the burden rests on the government to prove the illegality of the payment.

If a taxpayer makes illegal bribes, kickbacks, and other illegal payments to people other than a government official or employee, the payments are nondeductible if they are illegal under a federal law that subjects the payor to a criminal penalty or loss of the privilege of doing business. In addition, illegal payments under a state law imposing the same penalties are nondeductible, but only if the state generally enforces its law. Here, the definition of a kickback includes a payment for referring a client, patient, or customer.

[16] Rev. Rul. 82-149, 1982-2 C.B. 56.



ETHICAL POINT

A CPA discovers that a client included fines and penalties in a miscellaneous expense section of a previously filed tax return. The CPA should recommend the filing of an amended return. However, the CPA is not obligated to inform the IRS, and the CPA may not do so without the client's permission, except where required by law.

The courts and the IRS have made a distinction between a nondeductible illegal kickback and a rebate on the purchase of an item. If the seller pays a rebate directly to the purchaser, it is an adjustment to the selling price and, as such, is an ***exclusion*** (rather than a deduction) from gross income.[16] The distinction between the two payments seems to be that the seller and purchaser negotiate the rebate as part of the selling price.

Section 162(c)(3) specifically disallows a deduction for any kickback, rebate, or bribe under Medicare and Medicaid. Disallowed amounts include payments made by physicians or by suppliers and providers of goods and services who receive payment under the Social Security Act or a federally funded state plan. Unlike payments to foreign government or nongovernment employees and officials, these payments need not be illegal under federal or state law.



STOP & THINK

Question: Queen, Inc., is engaged in the ship and boat repair business. Since competition in this industry is very tough, Queen generally kicks back approximately 10% of any repair bill to any ship captain who brings the ship to Queen for repairs. Queen's customers include individual owners of large ocean-going yachts and fishing boats, as well as government vessels owned by state, federal, and foreign governments. During the current year, Queen paid $80,000 in kickbacks to the captains of privately-owned yachts and boats, $40,000 to the owners of privately-owned commercial ships, and $100,000 to the captains of state, federal, and foreign government vessels. The crews of these government vessels are government employees. What is the proper tax treatment of these payments?

Solution: The $80,000 in kickbacks paid directly to the owners of the privately-owned yachts and boats are treated as merely a rebate in the price of the services and reduces Queen's gross income, unless the payments could result in the imposition of a criminal penalty or loss of the privilege of doing business. The kickbacks paid to the captains of the state and federal vessels are not deductible because they are paid to employees of state and federal governments. The $40,000 paid to the captains of the privately-owned vessels are not deductible if they are illegal and subject the payor to a criminal penalty or loss of the privilege to do business. Likewise, any portion of the $40,000 paid to the captains of the foreign vessels are not deductible if the payments are unlawful under the Foreign Corrupt Practices Act.

Fines and Penalties. Section 162(f) of the IRC also disallows a deduction for the payment of any fine or penalty paid to a government because of the violation of a law. After 2017, Sec. 162(f) expands in three ways. First, the category of nondeductible fines and penalties is broadened to include amounts paid to or at the direction of a government or governmental entity because of a law violation or investigation into law violation. Exceptions (deductible) include payments made as restitution for damages, made to become compliant with the law violated, ordered by a court in a setting in which the government is not a party, and which are otherwise deductible as taxes. Second, fines and penalties are defined to include payments to nongovernmental entities that have regulatory powers or that perform an essential government function. Finally, a reporting requirement exists after 2017, so that payments made as a result of a suit or agreement must be reported by the controlling employee with the total amount segregated into any amount paid for restitution and any amount paid to become compliant with the law.

Furthermore, the IRC disallows a deduction for two-thirds of any payment the taxpayer makes for damages resulting from a conviction (or a guilty or no-contest plea) in an action regarding a criminal violation of the federal antitrust laws.[17]

While settlement payments to avoid litigation are deductible if related to the taxpayer's business, Sec. 162(q) prohibits deduction of payments or settlements (including associated legal fees) if subject to nondisclosure and based on sexual harassment or sexual abuse.

[17] Sec. 162(g).

EXAMPLE I:6-16 ▶ During the current year, the United States files criminal and civil actions against Allen, the president of Able Corporation, and Betty, the president of Bell Corporation, for conspiring to fix and maintain prices of electrical transformers. Both Allen and Betty enter pleas of no contest, and the appropriate judgments are entered. Subsequent to this action, Circle Corporation sues both Able and Bell Corporations for treble damages of $3,000,000. In settlement, Able and Bell Corporations each pay Circle Corporation $750,000. For these damage settlements, Able and Bell Corporations may each deduct $250,000 ($500,000 or $\frac{2}{3} \times \$750,000$ is disallowed). ◀

Expenses Relating to an Illegal Activity. Interestingly, although the payment of an illegal bribe or kickback and the payment of a fine or penalty as the result of an illegal act are both nondeductible, other expenses incurred in an illegal business activity are generally deductible if they are ordinary, necessary, and reasonable and the taxpayer reports the income from the illegal activity.[18]

EXAMPLE I:6-17 ▶ Acme, Inc., owns and operates a small financial services business involved in the sale of securities and the lending of money. Acme often sells securities to customers in other states. However, because Acme has not registered the business with the appropriate state or federal authorities, the operation of the business is illegal. During the current year, Acme incurs the following expenses:

Interest	$ 20,000
Salaries	140,000
Depreciation	7,000
Printing	5,000
Bribe to employee of state securities commission	12,000
Total	$184,000

If Acme reports the income from this activity, the deductible expenses for the year total $172,000. The illegal bribe paid of $12,000 to the government employee is not deductible. ◀

One exception to this general rule exists. Section 280E disallows a deduction for expenses incurred in an illegal business of trafficking or dealing in drugs.

OTHER EXPENDITURES SPECIFICALLY DISALLOWED

The IRC also specifically disallows deductions for certain other expenses, even though they might meet all the requirements mentioned previously. These include political contributions and lobbying expenses and, in certain situations, business start-up expenses.

Political Contributions and Lobbying Expenses. Political contributions and lobbying expenses constitute one general category of disallowed expenses. Taxpayers may not deduct expenditures made in connection with the following:

- Influencing legislation
- Participating or intervening in any political campaign of any candidate for public office
- Attempting to influence the general public with respect to elections, legislative matters, or referendums
- Communicating directly with the President, Vice President, and certain other federal employees and officials

Sec. 162(e) also denies a deduction for contributions to tax-exempt organizations that carry on lobbying activities if a principal purpose of the contribution is to obtain a deduction for what otherwise would have been disallowed. Furthermore, the IRC disallows payments made for advertising in a convention or any other program if any part of the proceeds of the publication will directly or indirectly benefit a specific political party or candidate.[19]

[18] *CIR v. Neil Sullivan, et al.*, 1 AFTR 2d 1158, 58-1 USTC ¶9368 (USSC, 1958).

[19] Sec. 276(a). Nondeductible political contributions also include payments for admission to a dinner or program where the proceeds will benefit a party or candidate, or admission to an inaugural ball, party, or concert if the activity is identified with a political party or candidate.

For payments before December 22, 2017, taxpayers may deduct lobbying expenses incurred to influence legislation on a local level if the legislation is of direct interest to the taxpayer's business. After December 21, 2017, lobbying expenses related to local legislation are included in the general category [Sec. 162(e)(1)] of disallowed lobbying and political expenses. For administrative convenience, the deduction disallowance does not apply to any in-house expenditure attributable to such activities as long as the total of such expenditures for the taxable year does not exceed $2,000. In-house expenditures are expenses incurred directly by the taxpayer and do not include amounts paid to a professional lobbyist or dues that are allocable to lobbying. Additionally, the deduction disallowance does not apply to taxpayers engaged in the business of lobbying.

EXAMPLE I:6-18 ▶ Kensey & Associates is a large New York law firm. It is not in the lobbying business. During the year, the firm spends $6,000 to send some of its employees to Washington, D.C., to testify before a Congressional subcommittee with regard to proposed changes in the Social Security taxes imposed on employers. Such changes directly affect the firm's business because they affect the amount of taxes it must pay on behalf of its employees. The firm's ordinary and necessary expenses incurred with respect to the trip are not deductible because the expenses were incurred to influence legislation. ◀

Business Interest Expense Limitation. In general, business interest expense is allowed as a deduction for AGI. However, after 2017, new Sec. 163(j) limits this deduction.[20] The deduction cannot exceed the following:

1. business interest income, plus
2. 30 percent of adjusted taxable income (must not be negative).

Adjusted taxable income is measured as taxable income excluding:

- business interest income,
- business interest expense,
- nonbusiness income and gains,
- nonbusiness deductions and losses,
- cost recovery deductions, and
- net operating losses.

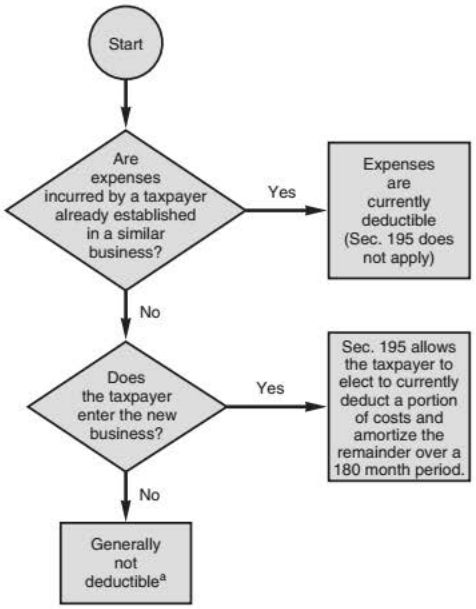
Business interest expense disallowed by this limit is carried forward (indefinitely). In the next tax year, the disallowed amount is treated as if an expense in that tax year.

Notably, this limit does not apply to small businesses as determined by the gross receipts test (Sec. 448(c) average annual gross receipts do not exceed $26,000,000 for the prior 3 year period).

EXAMPLE I:6-19 ▶ Robin Martin operates a successful business in which he works as an energy property developer. In the three preceding years, average gross receipts for this business were $28,000,000. His 2019 net taxable profit from this business equals $58,000, including deductions for $39,000 of interest expense on a business loan and $8,000 of depreciation expense. Robin's adjusted taxable income equals $105,000 ($58,000 + $39,000 + $8,000). The 2019 interest expense deduction is limited to $31,500 ($105,000 × 30%), with the excess $7,500 carried forward to 2020. ◀

Business Investigation and Preopening Expenses. Generally, business start-up expenses are capitalized and not deducted. However, unless the taxpayer chooses to avoid it, an election [Sec. 195(b)] allows a current deduction for business start-up expenditures in the year in which the business starts. The current deduction amounts to the lesser of the amount of the start-up expenditures or $5,000, with a dollar for dollar phase-out for amounts incurred over $50,000. Taxpayers must capitalize and amortize the remaining portion of start-up

[20] This limitation does not apply to floor plan financing interest expense (Sec. 163(j)(1)(C)).



[a] Rev. Rul. 57-418, 1957-2 C.B. 143 and Rev. Rul. 77-254, 1977-2 C.B. 63; *Morton Frank*, 20 T.C. 511 (1953).

FIGURE I:6-1 ▶ DEDUCTIBILITY OF BUSINESS INVESTIGATION AND START-UP COSTS

expenditures over a period of 180 months starting with the month in which the new business begins. Start-up expenditures specifically include three types of expenditures:

- *Business investigation expenses.* These expenses are costs a taxpayer incurs in reviewing and analyzing a prospective business before deciding whether to acquire or create it. The key here is that the taxpayer incurs the expenses before making a decision. These expenses include such items as analyses and surveys of markets, traffic patterns, products, labor supplies, and distribution facilities.

ADDITIONAL COMMENT

Costs incurred in connection with the issuance of stock or securities do not qualify as start-up costs. These costs are capitalized as Paid-in Capital.

- *Preopening or start-up costs.* Preopening or start-up costs are expenses incurred after a taxpayer decides to acquire or create a business but before the business activity itself has started. These costs include expenditures for training employees; advertising; securing supplies, distributors, and potential customers; and professional services in setting up the business' books and records. These costs must be incurred by a taxpayer not engaged in any existing business or engaged in a business unrelated to the business the taxpayer is acquiring or creating.
- *Expenses incurred in connection with an investment activity.* These expenses are costs the taxpayer incurs in connection with an investment activity that the taxpayer anticipates will become an active trade or business.

As defined by Sec. 195, start-up expenditures do not include these same types of expenses when incurred by a taxpayer already engaged in a business similar to the new one being created or acquired. In this case, the taxpayer may deduct these expenditures currently because the expenses originate in the taxpayer's existing business. Figure I:6-1 provides a flowchart to assist in properly classifying these types of expenditures.

STOP & THINK

Question: Shauna works in an automobile manufacturing plant in Detroit, Michigan. In January of the current year, she took a two-week vacation in order to fly to Orlando, Florida. While in Orlando, she spent some time investigating the possibility of opening a store in nearby Coco Beach. In total, she spent $800 on airfare, $1,500 on hotels and food, $300 on equipment rentals, and $300 on a car rental. In addition to spending time on the beach talking to people and checking out the rental equipment, she also spent some time

talking to shop owners and real estate agents. After some analysis, however, Shauna decides to keep her job in Detroit. What is the proper tax treatment for these expenditures?

Solution: In general, Sec. 162 of the IRC allows a deduction for expenses incurred in a business. Expenses incurred before the business starts are not incurred in a business and thus are not deductible under Sec. 162. However, under Sec. 195 a portion of certain expenditures such as business investigation expenses and start-up costs can be deducted currently while the remainder is capitalized and amortized over a 180-month period, beginning with the month in which the new business begins. Unfortunately Shauna did not open the new business. Thus, she may not deduct or amortize any of these expenses.

Topic Review I:6-2 summarizes the restrictions on the deductibility of these items.

TOPIC REVIEW I:6-2

Restrictions on the Deductibility of Expense Items

Item	Restrictions Imposed
1. Capital expenditures	The general rule is that the expenditure is not currently deductible if its life extends beyond the end of the year. Special elections are available to currently deduct certain capital expenditures (e.g., research and experimental costs under Sec. 174; and limited amounts per year for acquisitions of tangible personal property used in a trade or business under Sec. 179).
2. Carrying charges	An election may be made under Sec. 266 to capitalize certain expenses that are normally deductible such as property and employment taxes, interest, and carrying charges on unimproved unproductive real estate.
3. Expenses related to tax-exempt income	Expenses such as interest incurred on debt used to purchase or carry tax-exempt securities are disallowed under Sec. 265.
4. Expenditures contrary to public policy	Such expenditures are generally not deductible. Examples include bribes and kickbacks, fines and penalties, and expenses of an illegal activity involved with trafficking or dealing in drugs.
5. Political contributions and lobby expenses	Such items are not deductible (e.g., costs of influencing public opinion), but there exists a convenience exception where in-house expenses do not exceed $2,000.
6. Business investigation and preopening expenses	The following rules apply: a. Currently deductible if the taxpayer is already engaged in a similar business. b. Not deductible if the taxpayer is not currently engaged in a similar business and does not enter the new business. c. If the taxpayer enters the new business, a current deduction is allowed at an amount equal to the lesser of the amount of the expenses or $5,000 (reduced by amounts incurred over $50,000) with the remainder to be capitalized and amortized over a 180 month period. d. Deductible if expenditures constitute specific items such as legal expenses incurred in drafting purchase documents in an unsuccessful attempt to acquire a specific business. However, general investigation expenditures in search of a new business are not deductible.

Proper Substantiation Requirement

OBJECTIVE 4

List the substantiation requirements for deducting travel and entertainment expenses

Generally, the burden of proving the existence of a deduction or loss falls on the taxpayer. Thus, a taxpayer must properly substantiate all deductible expenses. Because the IRS may request proof, taxpayers should retain items such as receipts, cancelled checks, and paid bills. Occasionally, the courts will allow a deduction that is not properly substantiated by the taxpayer if an expenditure clearly has been made. In these cases, the court estimates the amount of the deduction based on all the facts and circumstances. This procedure is known as the *Cohan* rule and derives its name from a court case in which the judge allowed a deduction for an estimated amount of certain expenses.[21] The most prudent course of action, of course, is to retain proper documentation rather than to rely upon the *Cohan* rule.

[21] *George M. Cohan v. CIR*, 8 AFTR 10552, 2 USTC ¶489 (2nd Cir., 1930). Interestingly, the *Cohan* case dealt with travel and entertainment expenses. Because of the subsequent enactment of Sec. 274(d), the *Cohan* rule may not be used to deduct entertainment expenses. It is still effective for other types of expenses.

EXAMPLE I:6-20 ▶ In April of the current year, Terry took his tax records to a CPA to have his prior year's income tax return prepared. As part of the return, the CPA attached a supplemental schedule listing all of Terry's items of income and expense. After the return was prepared and filed, Terry's records were stolen. Upon audit two years later, the IRS disallowed Terry's deductions because he had no records to substantiate the expenses. When the case was litigated, the court allowed deductions for an estimated amount of expenses under the *Cohan* rule because of the list that was attached to Terry's return and because the court believed that Terry had testified honestly in his own behalf.[22] ◀

HISTORICAL NOTE

Judge Learned Hand, in permitting a deduction for unsubstantiated amounts in *George M. Cohan v. CIR,* 8 AFTR 10552, 2 USTC ¶1489 (2nd Cir, 1930), wrote "absolute certainty in such matters is usually impossible and it is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses on the taxpayer whose inexactitude is of his own making."

Additionally, Sections 274 and 280F provide specific and more stringent recordkeeping requirements for travel, entertainment, business gifts, computers, and vehicles used for transportation. In these cases, the taxpayer may not take a deduction unless the taxpayer substantiates the expenditure by either an adequate record or sufficient evidence that corroborates the taxpayer's statement. This substantiation may take the form of account books, diaries, logs, receipts and paid bills, trip sheets, expense reports, and statements of witnesses. The information that requires substantiation includes the following:

- Amount of the expense
- Time and place of the travel or entertainment
- Date and description of the gift
- Business purpose of the expenditure
- Business relationship to the taxpayer of the person entertained or of the person who received the gift

The *Cohan* rule does not apply to these types of expenses. (See Chapter I:7 for a more complete discussion regarding the deductibility of these types of expenses.)

WHEN AN EXPENSE IS DEDUCTIBLE

OBJECTIVE 5

Explain the timing of deductions under both the cash and accrual methods of accounting

Because the tax law generally requires calculating taxable income annually, the question of when a particular expense is deductible is especially important. The answer to this question largely depends on the taxpayer's method of accounting.[23] The most common methods include the following:

- Cash receipts and disbursements method (cash method)
- Accrual method
- Hybrid method (a combination of the cash and accrual methods where some items are accounted for on the cash method and other items are accounted for on the accrual method)

ADDITIONAL COMMENT

Section 446(b) provides that in cases where no method of accounting has been regularly used or if the method used does not clearly reflect income, then the computation of taxable income is to be made under a method that, in the opinion of the IRS, does clearly reflect income.

Taxpayers normally use the same method for computing taxable income that they use in keeping their financial accounting records. However, except for the use of the last-in, first-out (LIFO) method of accounting for inventory, the tax law does not generally require conformity. For example, many companies use the straight-line depreciation method for financial accounting purposes and the modified accelerated cost recovery system (MACRS) for tax purposes. This difference in depreciation methods, of course, results in a book-tax adjustment in the reconciliation of book income to taxable income.

CASH METHOD

Under the **cash method** of accounting, expenses are generally deductible when actually paid. The cash method considers payment by check equivalent to a cash payment as long as the bank subsequently honors the check. This is the case even if the payee receives the check so late on the last day of the year that the payee could not have cashed it.[24] If the taxpayer mails the check near the end of the year, the taxpayer must have evidence that the mailing took place in the year for which the taxpayer claims a deduction. Furthermore, the cash method treats payment by

[22] *Layard M. White,* 1980 PH T.C. Memo ¶80,582, 41 TCM 671.

[23] Methods of accounting as they relate to the reporting of income are discussed in Chapter I:3. Methods of accounting as they relate to deductibility of expenses and losses are covered in this chapter. For an overall discussion of accounting methods, see Chapter I:11.

[24] *CIR v. Estate of M. A. Bradley,* 10 AFTR 1405, 3 USTC ¶904 (6th Cir., 1932) and *Charles F. Kahler,* 18 T.C. 31 (1952).

credit card as a cash payment at the time of the charge rather than at the time the taxpayer pays the credit card bill.

A mere promise to pay, or the issuance of a note payable, does not constitute a payment under the cash method. Thus, a charge on an open account with a creditor is not deductible until an actual payment of cash satisfies the charge.

EXAMPLE I:6-21 ▶ Fox, Inc., a calendar-year taxpayer, is in the plumbing repair business. The business uses the cash method of accounting. Under an arrangement with one of its suppliers, Fox and its employees can pick up supplies at any time during the month by merely signing for them. At the end of the month, the supplier sends Fox a bill for the charges. Fox always pays the bill in full during the following month. In December of the current year, Fox charges $1,500 for supplies. During the same month Fox purchases a plumbing fixture for $250 from another supplier. Fox uses its charge card at the time of purchase. Fox may deduct the $250 during the current year. However, the $1,500 charged on the open account is deductible when paid in the following year. ◀

Prepaid Expenses. In general, a capital expenditure or the prepayment of expenses by a cash method taxpayer does not result in a current deduction if the expenditure creates an asset having a useful life that extends substantially beyond the close of the tax year. This can occur when a taxpayer makes expenditures for prepaid rent, services, or interest. However, in the case of prepaid rent, a circuit court of appeals decision has held that a taxpayer may take a current deduction for the entire amount of an expenditure if the period covered by the prepayment does not exceed one year and the rent agreement obligates the taxpayer to make the prepayment.[25] This one year rule also applies to other prepaid expenses (insurance).

EXAMPLE I:6-22 ▶ On November 1 of the current year, Twyla Corporation enters into a lease arrangement with Rashad to rent Rashad's office space for the following 36 months.

a. Assume Twyla prepays rent of $64,800 to cover the next 36 months of rent. This prepayment creates an asset (a leasehold) with a useful life that extends substantially beyond the end of the taxable year. Thus, only $3,600 ($1,800 × 2 months) of the total payment is deductible in the current year. The rest must be capitalized and amortized over the life of the lease.
b. However, assume instead that under the terms of the lease, Twyla Inc. is obligated to make three annual payments of $21,600 each November 1 for the subsequent 12 months. On November 1 of the current year, Twyla pays Rashad $21,600 for the first 12-month period. Because Twyla is obligated to make the prepayment and the period covered by the prepayment does not exceed one year, the entire $21,600 is deductible in the current year. ◀

Prepaid Interest. The IRC requires taxpayers to deduct prepaid interest expense over the period of the loan to which the interest charge is allocated.[26] Receipt of a discounted loan does not represent prepaid interest expense. Instead, the IRC deems the interest paid when the taxpayer repays the loan.

EXAMPLE I:6-23 ▶ In November of the current year, Richelle borrows $1,000 from the bank for use in her business. Richelle uses the cash method of accounting in her business. Under the terms of the loan, the bank discounts the loan by $80, issuing Richelle $920. When the loan comes due in October of the following year, Richelle is to repay the full $1,000. Richelle cannot deduct the $80 of interest expense until she repays the loan in the following year. ◀

REAL-WORLD EXAMPLE

A taxpayer made an overpayment of the federal income tax in 1975. In 1979, the IRS offset the overpayment against interest the taxpayer owed to the IRS. The Tax Court held that the interest expense was deductible in 1979 rather than in 1975. *Saverio Eboli*, 93 T.C. 123 (1989).

Taxpayers often prepay interest in the form of points. A point is one percent of the loan amount. Thus, the payment of two points on a $100,000 loan amounts to $2,000. While tax law generally requires the amortization of points over the life of the loan, if a taxpayer pays points in connection with the purchase or improvement of a principal residence, the taxpayer may deduct the points when they are paid. Points that a taxpayer pays in connection with the

[25] *Martin J. Zaninovich v. CIR*, 45 AFTR 2d 80-1442, 80-1 USTC ¶9342 (9th Cir., 1980) and *Bonaire Development Co. v. CIR*, 50 AFTR 2d 82-5167, 82-2 USTC ¶9428 (9th Cir., 1982). See also *Stephen A. Keller v. CIR*, 53 AFTR 2d 84-663, 84-1 USTC ¶9194 (8th Cir., 1984).

[26] Sec. 461(g).

purchase (but not the improvement) of a principal residence are automatically deductible in the year paid if they satisfy the following four requirements:

- the closing agreement clearly designates the amount as points,
- the amount involves a computation as a percentage of the amount borrowed,
- the charging of points is an established business practice in the geographic area, and
- the points are paid in connection with the purchase of the taxpayer's principal residence which is used to secure the loan.[27]

REAL-WORLD EXAMPLE

The mortgage company will, at the end of the year, mail to the taxpayer a Form 1098 which shows the amount of interest and points paid.

Although points paid on loans incurred to *improve* the taxpayer's principal residence do not fall under this safe harbor rule, they still are currently deductible if the residence is collateral for the loan, the payment of points is an established business practice in the geographic area in which it is incurred, and the amount of the prepayment does not exceed the amount generally charged.

A taxpayer may not currently deduct points paid to refinance a mortgage on a principal residence because the points are not paid in connection with the purchase or improvement of the taxpayer's residence.[28] Refinancing points are deducted over the life of the loan.

EXAMPLE I:6-24 ▶ During the current year, Pam purchases a principal residence for $150,000, paying $50,000 down and financing the remainder with a 30-year mortgage secured by the property. Pam must make monthly payments on the mortgage. At the closing, Pam must pay three points ($100,000 × 0.03) as a loan origination fee. Because these points are paid in connection with the purchase of a principal residence, Pam may deduct $3,000 as interest expense during the current year. In addition, Pam may also deduct the interest portion of each monthly payment made during the year.

On the other hand, assume that Pam takes out the $100,000 loan in order to refinance her home at a lower interest rate. The $3,000 prepaid interest is not currently deductible. Instead, Pam must deduct the interest ratably over the term of the loan. Thus, Pam may deduct an additional $8.33 ($3,000 ÷ 360 payments) interest expense for each payment that she makes during the year. ◀

The cash method of accounting provides some degree of flexibility to taxpayers because, under this method, taxpayers can generally deduct expenses when paid rather than when accrued. Subject to the limitations mentioned above with regard to prepaid expenses, taxpayers may to some degree accelerate or defer deductions from one year to another by merely accelerating or deferring payment. However, tax law imposes limitations on the use of the cash method. Tax shelters are not allowed to use the cash method in any circumstances. Under Sec. 448, most C corporations and partnerships with C corporation partners are not allowed to use the cash method. However, if the business is small (has gross receipts averaging less than $26 million in the three preceding years), the cash method is allowed (Sec. 448(c)). Generally, a business in which inventory is an income-producing factor may not use the cash method.[29] However, after 2017, even a business with inventory may qualify to use the cash method if they qualify as small (see above gross receipts test), and their use of the cash method either treats inventory as non-incidental supplies or the business uses the cash method in their financial statements (Sec. 471(c)). (See Chapter I:11 for a complete discussion of the different accounting methods a taxpayer may use for computing taxable income.)

ACCRUAL METHOD

An **accrual method** taxpayer deducts expenses in the period in which they accrue. Generally, items accrue when the transaction meets both an **all-events test** and an **economic performance test.**[30]

[27] Rev. Proc. 94-27, I.R.B. 94-15, 17. As explained in Chapter I:8, acquisition indebtedness incurred to acquire a personal residence is limited to $1,000,000. Hence, points that are allocated to the loan principal in excess of this limit are not deductible either.

[28] Rev. Proc. 94-27, I.R.B. 94-15, 17.

[29] Reg. §1.446-1(e)(2).

All-Events Test. The all-events test is met when both of the following occur:

- The existence of a liability is established.
- The amount of the liability is determined with reasonable accuracy.

EXAMPLE I:6-25 ▶ During the current year, Phil provides services for Granite, Inc. Granite uses the accrual method of accounting. Phil claims that Granite owes $10,000 for the services. Granite admits owing Phil $6,000, but contests the remaining $4,000. Because the amount of the liability can be accurately established only with respect to $6,000, Granite can deduct only that amount. If Granite pays the full $10,000, it may deduct the full amount in the year of payment, even though the contested amount ($4,000) is not resolved until a subsequent taxable year.[31] If Phil loses the lawsuit and repays Granite the $4,000, Granite will include that amount in income in the year of repayment under the tax benefit rule (see Chapter I:11). ◀

Taxpayers may not deduct additions to reserves for estimated expenses such as warranty expenses. The all-events test is not met because the liability is not fixed until the work is provided. Instead, the taxpayer deducts the expenses in the year in which such work is actually performed.

EXAMPLE I:6-26 ▶ Best Corporation uses the accrual method of accounting and is engaged in the business of painting and rustproofing automobiles. Best Corporation provides a 5-year warranty for new vehicles and a 2-year warranty for used vehicles. Best Corporation extends the warranty only to the person who owns the car at the time the car is painted. Furthermore, in order to keep the warranty in force, the customer must present the vehicle to Best Corporation for inspection each year. The warranty is void if the vehicle is involved in an accident. Even though for financial accounting purposes Best Corporation may provide a reserve for estimated warranty expenses and deduct a reasonable addition to the reserve on an annual basis, no income tax deduction is allowed until the warranty work is actually done. ◀

ADDITIONAL COMMENT

Because of this difference between the tax treatment and the financial accounting treatment, an adjustment must be made on a corporation's reconciliation of book income and taxable income.

Economic Performance Test. To be currently deductible under the accrual method, an expense must also meet an economic performance test. Exactly when economic performance occurs depends on the type of transaction. Table I:6-1 contains a listing of various types of transactions that may arise and identifies when economic performance is deemed to have occurred under Sec. 461(h).

EXAMPLE I:6-27 ▶ On December 20 of the current year, Pit Rentals, an accrual method taxpayer, enters into a binding contract with Pat to have Pat do a deep cleaning of its offices. Under the terms of the contract, Pat is to do the work in March of the following year. The total cost of the job is $5,000. Pit pays Pat 10% down at the time the contract is signed. Because the job is not to be done until the following year, economic performance has not occurred in the current year and Pit Rentals may not deduct any portion of the expense in the current year. ◀

HISTORICAL NOTE

The economic performance test was added by Congress in the Tax Reform Act of 1984. Congress was concerned that in some situations taxpayers could deduct expenses currently, but the actual cash expenditure might not be made for several years. Taking a current deduction in such situations overstated the real cost because the time value of money was ignored.

An exception to the economic performance test provides that taxpayers may take a current deduction for recurring liabilities if all of the following occur:

- The item meets the all-events test during the year.
- Economic performance of the item occurs within the shorter of 8½ months after the close of the tax year or a reasonable period after the close of the tax year.
- The expense is recurring and the taxpayer consistently treats the item as incurred in the tax year.
- Either the item is not material or the accrual of the item in the tax year results in a more proper matching against income than accruing the item in the tax year in which economic performance occurs.

[30] Reg. Sec. 1.461-1(a)(2) and Sec. 461(h).

[31] Reg. Sec. 1.461-2(a)(1).

▼ TABLE I:6-1
When Economic Performance Is Deemed to Have Occurred

Event That Gives Rise to Liability	When Economic Performance Is Deemed to Have Occurred
Another person provides the taxpayer with property or services	When the person actually provides the services[a]
Taxpayer uses property	As the taxpayer uses the property[a]
Taxpayer must provide property or services to another person	As the taxpayer provides property or services to the other person[b]
Taxpayer must make payments to another, including payments for rebates and refunds, awards or prizes, insurance or service contracts, and taxes	As the taxpayer makes payments to the other person
Taxpayer must make payments to another person because of a tort, breach of contract, violation of law, or injury claim under a worker's compensation act	As the taxpayer makes payments to the other person

[a] Economic performance may be deemed to have occurred at the earlier date of payment if the taxpayer reasonably expects the property or services to be provided within 3½ months after the payment is made. Reg. Sec. 1.461-4(d)(6)(ii).
[b] Economic performance may also occur as the taxpayer incurs costs in connection with the obligation to provide the property or services. Reg. Sec. 1.461-4(d)(4)(i).

The recurring liability exception is available for the first four types of transactions identified in Table I:6-1, but it is not available for the last type of transaction in the table.

EXAMPLE I:6-28 ▶ Beta Inc. is a calendar-year, accrual method taxpayer. Every year at the end of October, Beta enters into a contract with Sam to provide snow removal services for the parking lots at Beta corporate offices. This contract extends for five months through the end of March of the following year. Because the all-events test is met (the liability is fixed), the expense recurs every year, economic performance occurs within the requisite period of time, and the item is not material, Beta may deduct the entire expense in the year in which Beta and Sam enter into the contract. ◀

A special rule under Sec. 461(c) applies to real property taxes. Under this provision, a taxpayer may elect to accrue real property taxes ratably over the period to which the taxes relate. Once made, this election is irrevocable unless the taxpayer obtains permission from the IRS.

EXAMPLE I:6-29 ▶ Under the laws of State X, the lien date for real property taxes for the calendar year 2019 is January 1, 2019. The tax is payable in full on December 15, 2019. Alpha Holdings is an accrual-method taxpayer that has a January 31 fiscal year-end. On January 1, 2019, real property taxes of $100,000 are assessed against a building Alpha owns. Alpha pays the taxes on December 15, 2019. If Alpha does not make the election to use the ratable accrual method, Alpha cannot deduct any of the payment in its fiscal year ending January 31, 2019, because the payment date (December 15, 2019) is more than 8½ months after Alpha's January 31, 2019, year end.

On the other hand, if Alpha makes the election, it may deduct $8,333 ($100,000 × $^{1}/_{12}$) in its fiscal year that ends January 31, 2019, and $91,667 ($100,000 × $^{11}/_{12}$) in its fiscal year that ends January 31, 2020.

If the taxes are paid on September 30, 2019, Alpha would be better off not making the ratable accrual election. In this case, the recurring item exception applies because Alpha makes the payment within 8½ months of its January 31, 2019, fiscal year end. Thus, if Alpha does not make the election, all of the $100,000 is deductible in its fiscal year ending on January 31, 2019. ◀

Topic Review I:6-3 presents the rules for determining when an expense is deductible.

TOPIC REVIEW I:6-3

When an Expense Is Deductible

Cash Method: Deductible When Paid

Payment Is Made When

- Cash or other property is transferred.
- A check is delivered or mailed.
- An item is charged on a credit card.

  Note: A mere promise to pay or delivery of a note payable is not deductible under the cash method.

Prepaid Expenses

- Generally are deductible over the period covered.
- Deductible when paid if the period covered does not exceed one year.
- Prepaid interest is generally deductible ratably over the period covered by the loan.
- Points are deductible when paid if:
  - The loan is used to purchase or improve the taxpayer's principal residence.
  - The loan is secured by the residence.
  - Points are established business practice in the geographical area.
  - The points do not exceed the amount generally charged.
  - For points paid to purchase a principal residence, the closing agreement clearly designates the amount as points and the amount must be computed as a percentage of the amount borrowed.

Accrual Method: Deductible When Accrued

In General

- Accrual occurs when the item satisfies both the all-events test and economic performance.

All-Events Test

- The existence of a liability is established and
- The amount of the liability is determined.

Economic Performance

- When economic performance occurs depends on the transaction involved (see Table I:6-1).
- Occurs in the year the item meets the all-events test and all of the following tests:
  - Actual economic performance occurs within the shorter of:
    8½ months after the taxable year or a reasonable period after the taxable year.
  - The expense is recurring and receives consistent treatment from year to year.
  - Either:
    The item is immaterial or
    Deducting the expense in the year it meets the all-events test results in a more proper matching of income and deductions.

Special Disallowance Rules

OBJECTIVE 6

Discuss special disallowance rules for certain deductions

In addition to the general rules mentioned above, certain types of transactions are subject to further limitations and disallowances. These include wash sales, transactions between related persons, gambling losses, losses associated with an activity determined to be a hobby, expenses of renting a vacation home, and expenses of an office in the taxpayer's home. Further discussion of these special disallowance rules follows.

WASH SALES

Section 1091 disallows losses incurred on wash sales of stock or securities in the year of sale. For purposes of Sec. 1091, a **wash sale** occurs when:

- A taxpayer realizes a loss on the sale of stock or securities, and

- The taxpayer acquires "substantially identical" stock or securities within a 61-day period of time that extends from 30 days before the date of sale to 30 days after the date of sale.[32]

The purpose of the wash sale rule is to prevent taxpayers from generating artificial tax losses in situations where taxpayers do not intend to reduce their holdings in the stock or securities sold.

EXAMPLE I:6-30 ▶ Leslie realizes $10,000 in short-term capital gains (STCGs) through dealings in the stock market during the current year. Realizing that STCGs are fully includible in gross income and are taxed at ordinary rates unless they are offset against realized capital losses, Leslie analyzes her portfolio to determine whether she owns any stocks that have declined in value. She finds that the FMV of her Edison Corporation common stock is only $7,500, even though she originally purchased it for $16,000. Despite the $8,500 paper loss on the stock, Leslie wants to retain the stock because she feels that Edison Corporation is still a good investment. If Leslie attempts to take advantage of the paper loss on the Edison stock by selling the stock she owns and repurchasing a similar number of shares of Edison common stock within the 61-day period, Sec. 1091 disallows the loss. ◀

SELF-STUDY QUESTION

During 2018, you bought 100 shares of X stock on each of three occasions. You paid $158 a share for the first block of 100 shares, $100 a share for the second block, and $95 a share for the third block. On December 21, 2019, you sold 300 shares of X stock for $125 a share. On January 6, 2020, you bought 250 shares of identical X stock. Can you deduct the loss realized on the first block of stock?

ANSWER

You cannot deduct the loss of $33 a share on the first block because within 30 days after the date of sale you bought 250 identical shares of X stock. In addition, you cannot reduce the gain realized on the sale of the second and third blocks of stock by this loss.

At times, taxpayers may attempt to circumvent the wash sale provisions through either a sham transaction or an indirect repurchase of the securities. If this is the case, the wash sale provisions still prevent the recognition of the loss. The Supreme Court has held that losses on sales of stock by a husband were disallowed when the stockbroker was instructed to purchase the same number of shares in his wife's name.[33]

In some instances a taxpayer may attempt to circumvent the wash sale provisions by merely delaying the repurchase of the substantially identical stock. This tactic should work as long as a written agreement to repurchase the stock does not exist at the time of the sale or at any time within the 61-day period mandated by the Sec. 1091 wash sale provisions. If such an agreement exists, the courts will disallow the loss, even though the actual purchase does not occur within the 61-day period.[34]

In certain cases, taxpayers may still recognize losses on transactions that literally fall within the wash sale requirements. For example, a taxpayer may purchase stock and then sell a portion of those shares within 30 days where the intent is merely to reduce the stock holdings. Taken together, these two transactions meet the tests of Sec. 1091. However, because the purpose of the sale is to reduce the taxpayer's holdings rather than to generate an artificial tax loss, Sec. 1091 does not disallow the loss.[35] Section 1091 also does not apply to losses that a dealer in stock or securities realizes in the ordinary course of business.

If the taxpayer acquires fewer shares of stock within the 61-day period than the number of shares disposed of, Sec. 1091 disallows only a proportionate amount of the total loss.

EXAMPLE I:6-31 ▶ Several years ago, Henry purchased 100 shares of New Corporation common stock for $2,000 ($20 per share). On July 2 of the current year, Henry sells all 100 shares for $1,000. On July 30 of the current year, Henry purchases 75 shares (three-fourths of the original shares) of New Corporation common stock. As a result of the reacquisition, three-fourths of the total loss ($750) is disallowed. Henry recognizes the remaining $250 loss. ◀

Substantially Identical Stock or Securities. Only the acquisition of substantially identical stock or securities will cause a loss to be disallowed. The IRC and the Treasury Regulations do not define the term *substantially identical*. Judicial and administrative rulings have held that bonds issued by the same corporation generally are not substantially identical if they differ in terms (e.g., interest rate and term to maturity). However,

[32] Here the term *acquire* includes an acquisition of the stock either by purchase or in a taxable exchange. The term *stock or securities* includes contracts or options to acquire or sell stock or securities (see Sec. 1091(a)). The wash sale rules also apply to losses realized on the closing of a short sale of stock or securities if, within the 61-day period, substantially identical stock or securities were sold or another short sale of (or a securities futures contract to sell) substantially identical stock or securities was entered into.

[33] *John P. McWilliams v. CIR*, 35 AFTR 1184, 47-1 USTC ¶9289 (USSC, 1947).

[34] Rev. Rul. 72-225, 1972-1 C.B. 59, and *Frank Stein*, 1977 PH T.C. Memo ¶77,241, 36 TCM 992.

[35] Rev. Rul. 56-602, 1956-2 C.B. 527.

bonds of the same corporation that differ only in their maturity dates (e.g., the bonds do not come due for 16 years and mature within a few months of each other) have been held to be substantially identical. Generally, courts have not considered the preferred stock of a corporation to be substantially identical to the common stock of the same corporation.[36]

Basis of Stock. If the wash sale provisions disallow a loss, then the disallowed loss increases the basis of the recently acquired stock. This increase in basis merely causes the disallowed loss to be deferred. The taxpayer will eventually recognize the loss upon the subsequent sale or disposition of the stock that causes the loss disallowance. If there has been more than one purchase of replacement stock and the amount of stock purchased within the 61-day period exceeds the stock that is sold, the stock that is deemed to have caused the loss to be disallowed is accounted for chronologically. The holding period of the replacement stock includes the period of time the taxpayer held the stock sold.

EXAMPLE I:6-32 ▶ Ingrid enters into the following transactions with regard to Pacific Corp. common stock:

Date	*Transaction*	*Amount*
January 4, 2012	Purchases 600 shares	$30,000
October 2, 2019	Purchases 400 shares	10,000
October 12, 2019	Sells original 600 shares	12,000
October 20, 2019	Purchases 200 shares	5,000
October 25, 2019	Purchases 300 shares	8,400

Because Ingrid purchases more than 600 shares within the 61-day period before and after the date of sale (the purchases made on October 2, 20, and 25), the recognition of the entire loss of $18,000 ($30,000 – $12,000) from the October 12, 2019 sale is postponed. Four hundred shares (two-thirds of the number of shares sold) are purchased on October 2 and 200 shares (one-third) are purchased on October 20. Thus, the basis of the 400 shares of stock purchased on October 2 is $22,000 [$10,000 purchase price + ($18,000 disallowed loss × 0.667)]. The basis of the 200 shares of stock purchased on October 20 is $11,000 [$5,000 + ($18,000 × 0.333)]. Both of these blocks of stock have a holding period that starts on January 4, 2012.[37] The basis of the 300 shares of stock purchased on October 25 is its purchase price of $8,400. Its holding period begins on October 25, 2019. ◀

STOP & THINK

Question: With regard to his investments in the stock market, the current year has been like a roller coaster ride for Doug. He now wants to do some year-end tax planning. For the year to date, he has realized a net gain of $12,000 on his stock investments. Although some of his current stock holdings have unrealized losses, he feels that they are excellent investments that will provide excellent returns in the next year or two. His stock broker has suggested that he sell enough of his holdings to realize a $12,000 loss (to offset the $12,000 capital gain) and then simply repurchase some of the stock. What advice would you give Doug as he discusses this strategy with his broker?

Solution: By realizing $12,000 in capital losses this year, Doug may be able to offset the capital gains he has already recognized. In order to recognize these losses, however, he must make sure that the wash sale provisions do not apply. Thus, he must either (1) purchase stock of different corporations or (2) delay the repurchase of the same issue of stock for at least 31 days after the date of sale. Because Doug is happy with his current investments, perhaps the second strategy is the best. Of course, other non-tax issues must also be considered. For example, does Doug think that the prices will go up quickly within the next 30 days? If so, he may lose out on some significant gains while he is waiting to repurchase the stock. Additionally, he must also consider the transaction costs (such as commissions).

[36] *Marie Hanlin, Executrix v. CIR*, 39-2 USTC ¶9783 (3d Cir., 1939). However, the IRS held in Rev. Rul. 77-201, 1977-1 C.B. 250, that the convertible preferred stock of a corporation is substantially identical to its common stock if the preferred stock has the same voting rights and is subject to the same dividend restrictions as the common stock, is unrestricted as to its convertibility, and sells at relatively the same price (taking into consideration the conversion ratio).

[37] An asset's holding period is important in determining whether subsequent gain or loss on the asset is long-term or short-term gain or loss. This is explained further in Chapter I:5.

TRANSACTIONS BETWEEN RELATED PARTIES

Section 267 places transactions between certain related parties under special scrutiny because of the potential for tax abuse. For example, a taxpayer could sell a piece of property at a loss to a wholly owned corporation. Without any restrictions on the deductibility of the loss, the individual could recognize the loss while still retaining effective control of the property. Under Sec. 267, related taxpayers may not take current deductions on two specific types of transactions. These transactions are:

- Losses on sales of property
- Accrued expenses that remain unpaid to the related cash method taxpayer at the end of the tax year

ADDITIONAL COMMENT

Section 267 does not define the word property, but the IRS and the courts have given it a broad meaning.

Related Parties Defined. Section 267 defines the following relationships as related parties:

- Individuals and their families. The term family includes an individual's spouse, brothers and sisters (including half-brothers and half-sisters), ancestors, and lineal descendants.
- An individual and a corporation in which the individual owns more than 50% of the value of the outstanding stock.
- Various relationships between grantors, beneficiaries, and fiduciaries of a trust or trusts, or between the fiduciary of a trust and a corporation if they meet certain ownership requirements.
- A corporation and a partnership if the same persons own more than 50% in value of the stock of the corporation and more than 50% of the partnership.
- Two corporations if the same persons own more than 50% in value of the outstanding stock of both corporations and at least one of the corporations is an S corporation.
- Other complex relationships involving trusts, corporations, and individuals.

TAX STRATEGY TIP

The related party rules many times cause the tax consequences to be different than what was expected. Be sure that your clients provide all details to you ahead of time when related parties are involved in the transaction. You might be able to help structure the transaction in a way that meets your clients' expectations.

Several of these relationships depend on an individual's ownership of a corporation. For example, if a taxpayer does not own more than 50% of a corporation's stock, the individual and the corporation are not related and a loss on the sale of business or investment property between the two is deductible. Occasionally, individuals might attempt to circumvent the related party rules by dispersing the ownership of a corporation (e.g., among close family members) while retaining economic control. To prevent these tactics, Sec. 267 contains constructive ownership rules whereby a taxpayer is deemed to own stock owned by certain other persons. These constructive ownership rules are as follows:

- Stock owned by an individual's family is treated as owned by the individual. Here the definition of *family* is the same as that of *related parties* (i.e., spouse, brothers and sisters, ancestors, and lineal descendants).
- Stock owned by a corporation, partnership, estate, or trust is treated as owned proportionately by the entity's shareholders, partners, or beneficiaries.
- If an individual partner in a partnership owns (or is treated as owning) stock in a corporation, the individual is treated as owning any stock of that corporation owned by any other partner in the partnership. This does not occur, however, if the only stock the individual owns (or is considered to own) is through family attribution.[38]
- Stock ownership that is attributed to a shareholder or partner from an entity can be reattributed to another taxpayer under any of the constructive ownership rules. In other words, the same stock can be constructively owned by more than one person. However, stock ownership attributed to a taxpayer under the family or partner rules cannot be reattributed.

[38] Reg. Sec. 1.267(c)-1(b), Exs. (2) and (3).

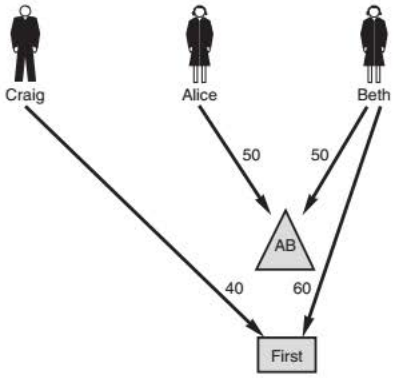


FIGURE I:6-2 ▶ ILLUSTRATION FOR EXAMPLE I:6-33

The following examples illustrate these rules.

EXAMPLE I:6-33 ▶ Alice and Beth are equal partners in the AB Partnership. Beth owns 60% of First Corporation's stock, and Craig, Alice's husband, owns the other 40%. The ownership of the partnership and the corporation is demonstrated in Figure I:6-2. Under the constructive ownership rules, Alice is considered to own Craig's 40% of the First Corporation stock. Alice is not considered to own the First Corporation stock owned by her partner, Beth, because the only First Corporation stock Alice owns (or is considered to own) is the stock owned by her husband. If Alice sells property at a loss to First Corporation, the loss is recognized because Alice does not directly or constructively own more than 50% of the First Corporation stock. ◀

EXAMPLE I:6-34 ▶ Assume the same facts as in Example I:6-33, except that the First Corporation stock is owned 50% by the AB Partnership and 25% each by Beth and Craig. The ownership of the partnership and the corporation is shown in Figure I:6-3. In addition to Craig's 25%, Alice is considered to own 50% of the stock owned by the AB Partnership because of her 50% ownership in AB. The other half of AB's stock ownership is attributed to her partner, Beth. However, Alice is also treated as owning the First Corporation stock Beth owns both actually and constructively (50%). Thus, Alice is treated as owning 100% of the First Corporation stock. In this case, Alice will not be able to recognize a loss on the sale of property to First Corporation. ◀

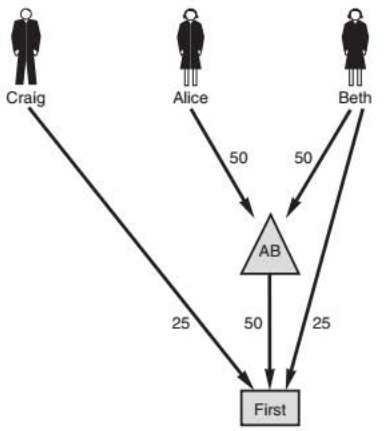


FIGURE I:6-3 ▶ ILLUSTRATION FOR EXAMPLE I:6-34

Disallowed Losses. If Sec. 267 disallows the loss, the original seller of the property receives no tax deduction. The disallowed loss has no effect on the purchaser's basis. The cost basis to the purchaser is equal to the amount paid for the property. However, Sec. 267 provides partial relief because, on a subsequent sale of the property, the related purchaser may reduce any recognized gain by the amount of the disallowed loss. This offsetting of a subsequent gain is available only to the related person who originally purchased the property. If the disallowed loss is larger than the subsequent gain, or if the purchaser sells the property at a loss, the taxpayer may not take a deduction for the unused loss. This may result in a partial disallowance of an overall economic loss for the related parties because there is no upward basis adjustment for the previously disallowed loss (as is the case for a wash sale).

EXAMPLE I:6-35 ▶ Assume three separate scenarios in which Sam sells a tract of land during the current year. In each case assume that Sam purchased the land from his father, Frank, for $10,000. Frank's basis at the time of the original sale was $15,000 in each case. Thus, Frank's $5,000 loss on each land sale was disallowed.

KEY POINT

The loss disallowance rule for related parties is more severe compared to the loss disallowance rule on wash sales. In a related party transaction, it is possible to lose the tax benefit of all or a portion of the economic loss.

	Scenario		
	1	2	3
Selling price	$17,000	$ 12,000	$ 8,000
Minus: Sam's basis	(10,000)	(10,000)	(10,000)
Sam's realized gain (loss)	$ 7,000	$ 2,000	$ (2,000)
Minus: Frank's disallowed loss (up to Sam's gain)	(5,000)	(2,000)	—0—
Sam's recognized gain (loss)	$2,000	—0—	($2,000)

In Scenario 1, Sam and Frank together have incurred an aggregate gain of $2,000 ($17,000 – $15,000). Thus, Frank's full disallowed loss reduces Sam's subsequent gain. In Scenario 2, the aggregate economic loss incurred by Sam and Frank is actually $3,000 ($12,000 – $15,000). However, the actual amount of the tax loss recognized by Sam and Frank is zero. In Scenario 3, the actual tax loss would have been $7,000 ($8,000 – $15,000) instead of $2,000 if Frank had held the land until its eventual sale. ◀

A similar rule found in Sec. 707(b)(1) disallows losses between a partner and a partnership in which the partner owns directly or indirectly over 50% of the partnership and between two partnerships in which the same people own directly or indirectly over 50% in each partnership. The constructive ownership rules of Sec. 267 apply here in determining ownership (see *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* text or the *Comprehensive* volume).

KEY POINT

The effect of Sec. 267 with respect to unpaid expenses is to place an accrual method taxpayer on the cash method for amounts owed to a related cash method taxpayer.

Unpaid Expenses. Sec 267(a)(2) requires time period matching for an accrual method taxpayer's expense owed but unpaid at year end to a cash method taxpayer. The accrual method taxpayer's expense is deductible only in the year in which the cash method taxpayer reports the receipt of payment as income. In effect, this rule prevents an accrual-method taxpayer (the payer) from taking a deduction for an unpaid expense in the earlier year of accrual while the related cash-method taxpayer (the payee) recognizes the payment as income in the subsequent year.

For unpaid expenses, Sec. 267 expands the definition of related parties to include a personal-service corporation and any employee-owner.[39] A personal-service corporation is one whose principal activity is the performance of personal services substantially performed by employee-owners. An employee-owner is an employee who owns any of the outstanding stock of the personal-service corporation.[40]

EXAMPLE I:6-36 ▶ Michelle owns 100% of the outstanding stock of Hill Corporation. Michelle is a cash-method taxpayer and Hill Corporation is an accrual-method taxpayer. Both taxpayers are calendar-year taxpayers. In a bona fide transaction, Hill borrows some funds from Michelle. By the end of the current year, $8,000 interest expense had accrued on the loan. However, Hill Corporation does not pay the interest to Michelle until February of the following year. Because Michelle is a cash-method

[39] Sec. 267(a)(2).

[40] Secs. 269A(b) and 441(i)(2). In determining the ownership of an employee-owner, the constructive ownership rules of Sec. 318 as modified by Sec. 441(i)(2) are used. These rules differ substantially from the constructive ownership rules of Sec. 267.

taxpayer, she reports the interest income when she receives it in the following year. Although Hill is an accrual-method taxpayer, it must deduct the interest expense when paid, in February of the following year. The results are the same if Hill Corporation is a personal service corporation and Michelle is an employee and owns any amount of the Hill stock. ◀

For purposes of these unpaid expenses, the definition of *related parties* also includes various relationships involving partnerships or S corporations and any person who owns (either actually or constructively) any interest in these entities.[41]

HOBBY ACTIVITIES

Certain activities have both profit-motivated and personal attributes. In these cases, one must examine all the relevant factors to determine the tax status of the activity. The distinction is important because, in general, expenses incurred in a profit-motivated activity are deductible, but most expenses associated with personal activities (hobbies) are not deductible. Reg. Sec. 1.183-2(b) lists the factors the IRS uses to determine whether an activity is profit-motivated. These factors include the following:

- Whether the taxpayer conducts the activity in a businesslike manner.
- The expertise of the taxpayer or the taxpayer's advisors.
- The time and effort expended by the taxpayer in carrying on the activity.
- Whether the assets used in the activity are expected to appreciate in value.
- The taxpayer's success in carrying on other similar activities.
- The taxpayer's history of profits or losses with respect to the activity.
- The amount of occasional profits earned, if any.
- The taxpayer's financial status.
- Any elements of personal pleasure or recreation the activity might involve.

ADDITIONAL COMMENT

Many of the court cases dealing with profit motive under Sec. 183 are ranch and farm cases. In fact, Sec. 183, now titled "Activities Not Engaged in for Profit" was originally titled "Farm Losses, etc." in the Tax Reform Act of 1969.

No one of these factors is determinative, and the IRS also may consider other factors not listed. Furthermore, the IRS does not make a determination by merely counting the number of factors that are present. Instead, the decision depends on an examination of all the factors together. The IRS can, therefore, make the decision on a more subjective basis than the taxpayer might like. If the IRS asserts that an activity is a personal one (i.e., a hobby) rather than a business or investment, the burden of proof rests on the taxpayer to prove otherwise.

EXAMPLE I:6-37 ▶ Paula, a successful attorney with an annual income of $300,000, also enjoys raising and training quarter horses. She generally spends five to six hours each week training, showing, or racing the horses. Over the last four years her winnings from shows and races have amounted to $16,000. Over that same period, she has generated an additional $8,000 of income from stud fees and the sale of colts. Often Paula uses the horses to take her family or friends riding. In addition, Paula often participates in equestrian clinics and demonstrations for 4-H Clubs and other similar groups. Paula employs a high school student to feed the horses each day and clean the stalls weekly. Paula also hires a professional horse trainer for 4 hours each week to help her train the horses.

In this case, several factors such as the level of earnings, the hiring of professional help, and the amount of time spent in the activity suggest that Paula is engaged in a business. Other factors, such as the time spent riding with family and friends, the voluntary clinics and demonstrations, and the small amount of revenue generated as compared with Paula's other income, support the position that Paula merely has a hobby of raising horses. ◀

In cases where a clear profit motive cannot be shown under the factors mentioned above, the Code provides a presumptive test whereby an activity may be presumed to be engaged in for profit. The activity meets the test if it shows a profit for any three years during a consecutive five-year period. The five-year period consists of the year in question plus the previous four years.[42] This presumption is rebuttable (i.e., if the taxpayer meets

[41] Sec. 267(e). A discussion of these modifications is beyond the scope of this book.

[42] Sec. 183(d). If the major part of the activity involves breeding, training, showing, or racing horses, the five-year period is extended to a seven-year period, and a profit must be shown in only two, rather than three, of the years covered by that seven-year period.

the test, the IRS has the burden of proof to show that the activity *is not* profit motivated). However, if the taxpayer fails to meet this test, the taxpayer must prove that the activity *is* profit motivated.

KEY POINT

Section 183(d) primarily serves to shift the burden of proof from the taxpayer to the IRS.

If the examination of the factors leads to the determination that the activity is a business, the taxpayer generally may deduct all qualified business expenses from the gross income, even if a net loss results.[43] However, if the factors lead to a determination that the activity is a hobby, after 2017, the taxpayer may not deduct the related expenses (Sec. 67(g) in the Tax Cuts and Jobs Act).[44]

EXAMPLE I:6-38 ▶

Lorenzo, a stockbroker, enjoys raising pedigreed poodles. Although he mainly raises them for recreation and relaxation after work, Lorenzo periodically sells some of his poodles. Lorenzo realizes $850 in income and $2,900 in expenses from the activity in the current year.

ADDITIONAL COMMENT

The hobby expense is one that is deductible whether or not incurred in a profit-motivated activity, such as real property taxes on a home, the taxpayer can include the expense in his/her itemized deductions.

If Lorenzo's poodle-raising activity is a business, Lorenzo will report a net loss of $2,050 ($2,900 expenses − $850). If the activity is determined to be a hobby, however, Lorenzo will report $850 in income but can deduct none of the $2,900 of expenses. ◀

EXAMPLE I:6-39 ▶

Lynn raises various plants and flowers in a small greenhouse constructed specifically for that purpose. During the current year, Lynn reports gross income from the greenhouse activities of $1,700. Lynn also incurs the following expenses:

Property taxes on the greenhouse	$1,150
Utilities	300
Depreciation (assuming the activity is considered a business)	800

If the greenhouse activity is considered to be a hobby rather than a business, the only deduction Lynn may take is an itemized deduction of $1,150 in property taxes. ◀

REAL-WORLD EXAMPLE

Good records are very important in establishing the existence of a business rather than a hobby. A taxpayer, who owned and operated an apple orchard, asserted that he maintained sufficient business records, consisting of bank deposit slips, check stubs, and tax forms. A separate bank account was also maintained. But the taxpayer did not present any production records for the apple orchard. In fact, at trial, the taxpayer was not even certain of the exact number of trees in the orchard. Thus, the court found that due to the limited records, the taxpayer's activity was considered to be a hobby rather than a business. *Zdun,* TC Memo 1998-296 (1998).

VACATION HOME

Because owning a home may have both personal and profit-motivated attributes, Sec. 280A may disallow or limit deductions for expenses related to the rental of a home that is also used as a residence by the taxpayer.

Residence Defined. For the restrictive rules of Sec. 280A to apply, the property must be a dwelling unit that qualifies as the taxpayer's residence. As used in this context, the term *dwelling unit* is expansive and may include property such as boats and mobile homes. The determining factor is whether the property provides shelter and accommodations for eating and sleeping.[45] Thus, a mini-motorhome that contains the appropriate accommodations has been held to be a dwelling unit subject to the rules and limitations of Sec. 280A.

The tax treatment of income and expenses associated with a taxpayer's rental of a home depends on the extent to which the taxpayer uses it (personal use) and the extent to which the home is rented at its fair value. Three categories capture these dimensions and tax law treatment:

SELF-STUDY QUESTION

What is the maximum number of days during a year that a taxpayer may use a property for personal use and not have it considered to be used as a residence?

1. The home is rented for fewer than 15 days. *Primarily personal*

   In these circumstances, the taxpayer may exclude from gross income the rental income received, but may not deduct expenses related to the home, other than the itemized deductions allowed for property tax and mortgage interest expense (Sec. 280A(g)).

2. The home is rented for more than 14 days and the taxpayer's personal use of the home exceeded the larger of i) 14 days or ii) 10% of rented days. *Mixed personal and rental*

   For a home in this category, the taxpayer must report in gross income all of the rental income and may offset allocated rental expenses against that income, but only to the

[43] If the activity is a passive activity, however, the loss may be deferred or suspended. See Chapter I:9 for a discussion of the passive loss rules.

[44] Before 2018, the taxpayer could generally deduct the expenses as a miscellaneous itemized deduction but only to the extent of the gross income from the activity.

[45] *Ronald L. Haberkorn,* 75 T.C. 259 (1980), and *John O. Loughlin v. U.S.,* 50 AFTR 2d 82-5827, 82-2 USTC ¶9543 (D.C. Minn., 1982).

extent of income. A rental loss is not allowed. Allocated expenses not deductible in one year because of this limit are carried forward, and are deductible against the subsequent year's rental income.

3. The home is rented for more than 14 days and the taxpayer's personal use of the home did not exceed the larger of i) 14 days or ii) 10% of rented days. *Primarily rental*

   In these circumstances, the taxpayer must report in gross income all of the rental income and may offset allocated rental expenses against that income, even to the extent that the allocated expenses generate a rental loss.

EXAMPLE I:6-40 ▶

Sarah owns a houseboat on Lake Powell that she personally uses for 21 days out of the year. During the year she also rents out the boat for a total of 300 days. Even though Sarah's personal use exceeds 14 days during the year, the houseboat is considered primarily a rental activity because Sarah's personal use does not exceed 30 days during the year (10% of the 300 rental days for the year). ◀

ANSWER

If a property was rented for 332 days it could be used by the taxpayer for 33 days and not be considered a residence.

For purposes of the residence test, a day of personal use includes all of the following:

- Any day the taxpayer or the taxpayer's family uses the property for personal purposes. Family is defined here as including the taxpayer's spouse, brothers and sisters, ancestors, and lineal descendants.[46]
- Any day any individual uses the property under a reciprocal-use arrangement.[47]
- Any day any individual uses the property and does not pay a fair rental for its use.[48]

Despite the family-use rule, if a taxpayer rents property at a fair rental to a family member who uses the property as a principal residence, such use does not constitute personal use by the taxpayer.

EXAMPLE I:6-41 ▶

During the current year, Peggy purchases a small house as an investment and rents the property to Stan, her married son, who uses the property as his principal residence. Stan pays his mom a fair rental for the property. Because Stan uses the property as his principal residence and pays Peggy a fair rental for the property, Peggy is not treated as personally using the house for any days during the year. Thus Peggy's personal use does not exceed the greater of 14 days or 10% of the rental days during the year, and the rules of Sec. 280A do not apply to limit the expenses that Peggy may deduct (although the passive loss rules may limit the deduction). ◀

KEY POINT

A second home is classified as either rental property, a residence, or some combination of the two. If it is classified as some combination of rental property and a residence, the expenses of the property must be allocated between the two categories.

Allocation of Expenses. When a taxpayer uses a home personally as well as for rental purposes, the tax law requires the taxpayer to allocate the expenses between the taxpayer's personal use and rental use. The reason for this required allocation of the expenses is that the IRC generally allows individuals to deduct expenses attributable to the rental of property (subject to various limitations), whereas individuals generally cannot deduct expenses allocated to personal use property.

Sec. 280A uses the following formula to allocate expenses between the personal use and the rental use of the property:[49]

$$\text{Rental use expenses} = \frac{\text{Number of rental days}}{\text{Total number of days used}} \times \text{Total expenses for the year}$$

The denominator of the allocation fraction is the sum of the days the property is rented plus the days the taxpayer uses it for personal purposes. The formula does not include the days that no one uses the property.

Some courts have modified the allocation formula by using the total number of days in the year as the denominator for qualified residential interest and property taxes instead

[46] Sec. 280A(d)(2). A day during which the taxpayer spends substantially full time on repairs and maintenance does not count as a personal-use day.

[47] Sec. 280A(d)(2)(B). A reciprocal-use arrangement is one whereby another person uses the taxpayer's property in exchange for the taxpayer's use of the other person's property.

[48] Sec. 280A(d)(2)(C). Exactly what constitutes a fair rental must be determined by an examination of all the associated facts and circumstances.

[49] Sec. 280A(e)(1).

of the number of days the property was used.[50] Use of this ratio allocates less interest and taxes to the rental use, allowing more of the other expenses to be deducted against the rental income. Expenses allocated to personal use of the home generally are not deductible. However, as explained in Chapter I:8, individuals may take a *from* AGI deduction for real estate taxes paid on personal use property such as a home or vacation home. In addition an individual may also include as a *from* AGI deduction certain interest expenses incurred on a "qualified residence" of the taxpayer. In order for the vacation home to qualify as a "qualified residence" the taxpayer's personal usage must exceed the greater of (1) 14 days or (2) 10% of the rental days during the year.[51] Example I:6-42 and I:6-43 use the allocation formula for the interest and taxes that is sanctioned by the courts.

Order of the Deductions. To the extent the allocated expenses exceed the gross rental income, the deductions are allowed in the following order.

- Tier 1: Expenses that are deductible even though not incurred in a trade or business (e.g., itemized deductions such as property taxes and qualified mortgage interest expense)
- Tier 2: Other expenses that would be deductible in a trade or business context but which do not affect the property's basis
- Tier 3: Expenses deductible in a trade or business context which reduce the basis of the property (e.g. depreciation)

EXAMPLE I:6-42 ▶ Joan owns a cabin near a ski resort. During the year, Joan and her family use the cabin a total of 25 days. Joan also rents the cabin to out-of-state skiers for a total of 50 days during the year, generating rental income of $10,000. Joan incurs the following expenses:

Expense	*Amount*
Property taxes	$1,500
Mortgage interest expense	3,000
Utilities	2,000
Insurance	1,500
Security and snow removal	2,500
Depreciation	12,000

SELF-STUDY QUESTION

Assume that a taxpayer rents his cabin to an individual who occupies it on a Saturday afternoon. Two weeks later the tenant leaves the cabin on a Saturday morning. Has the cabin been rented for more than 14 days?

ANSWER

No. Although the tenant was on the premises for 15 calendar days, he is treated as having rented the property for only 14 days.

Because the cabin is rented for more than 14 days and Joan's personal use of the cabin exceeds 14 days (larger of 10% of 50 rental days and 14 days), the cabin is reported using the limits on mixed personal and rental activities. The activity cannot generate a net rental loss. The amount of deductions (for AGI) Joan may take with respect to the property during the year is as follows:

Item	*Calculation*	*Allocated to Rental*	*Allocated to Personal*	*Treatment of Personal Amounts*
Rental income		$10,000		
Tier 1:				
Interest expense	$\$3,000 \times \frac{50}{365}$	(411)*	($2,589)	Deductible from AGI**
Property taxes	$\$1,500 \times \frac{50}{365}$	(205)*	(1,295)	Deductible from AGI***
Tier 2:				
Other expenses	$\$6,000 \times \frac{50}{75}$	(4,000)	(2,000)	Not deductible
Tier 3:				
Depreciation	$\$12,000 \times \frac{50}{75}$	(5,384)	(4,000)	Not deductible
Net Rental Income from Property		$0		

[50] *Dorance D. Bolton v. CIR*, 51 AFTR 2d 83-305, 82-2 USTC ¶9699 (9th Cir., 1982). See also *Edith G. McKinney v. CIR*, 52 AFTR 2d 83-6281, 83-2 USTC ¶9655 (10th Cir., 1983).

[51] No deduction is allowed for interest incurred with respect to a personal residence if the debt on which the interest is paid is not secured by the property or the taxpayer has not chosen the property as a second residence for purposes of deducting the interest as qualified residential interest (see Chapter I:8). For purposes of the discussion and examples used here, the assumption is made that the interest qualifies as qualified residential interest.

Because a rental loss is not allowed for this activity, deductible allocable expenses are limited to the property's income of $10,000. All of Tier 1 and Tier 2 expenses allocated to the rental activity ($4,616) are deductible, but the remainder, $5,384, is the limit on further deductions.

The income and expenses allocated to the rental use are reported on Schedule E. Thus, the expenses allocated to the rental use are *for* AGI deductions. The deductible interest and taxes allocated to the personal use are *from* AGI deductions (itemized deductions).

* Under the approach favored by the IRS, $2,000 of the interest and $1,000 of the taxes would be allocated to the rental use (50/75 or 2/3 or each expense), leaving only $3,000 of the depreciation to be deducted against the gross income.
** Joan can include the interest allocated to her personal use as an itemized *from* AGI deduction because her personal usage of the cabin (25 days) exceeds 14 days (the greater of 14 days or 10% of the rental days). See Chapter I:8 and Sec. 163(h)(2) and (h)(4)(A).
*** Deductible under Sec. 164(a)(1) as an itemized *from* AGI deduction. ◀

EXAMPLE I:6-43 ▶ Assume all the same facts in Example I:6-42 except that during the year Joan uses the cabin for 16 days and rents the cabin out for 170 days. Pursuant to the court's approved method, Joan chooses to calculate the allocation and deductibility of the interest and taxes using the full year. The allocation of expenses is as follows:

Item	*Calculation*	*Allocated to Rental*	*Allocated to Personal*	*Treatment of Personal Amounts*
Rental income		$10,000		
Tier 1:				
Interest expense	$ 3,000 × 170/365	(1,397)	($1,603)	Not deductible
Property Taxes	$ 1,500 × 170/365	(699)	(801)	Deductible from AGI
Tier 2:				
Other expenses	$ 6,000 × 170/186	(5,484)	(516)	Not deductible
Tier 3				
Depreciation	$ 12,000 × 170/186	(10,968)	(1,932)	Not deductible
		($8,548)		

Because the cabin was rented for more than 14 days but Joan's personal use (16 days) did not exceed the larger of 14 days or 10% of rented days (17 days), the cabin's use is primarily rental (category 3). A rental loss is allowed, and for this property, it totals ($8,548). However, note that the personal portion of mortgage interest expense, $1,603, is not eligible as an itemized deduction because Joan's use of the cabin is insufficient to qualify it as a personal residence (Sec. 163(h)(2) and (h)(4)(A)). ◀

EXAMPLE I:6-44 ▶ Assume the same facts as in Example I:6-42, except that during the year Joan rents the cabin out for only 12 days and the amount of rental income is $2,400. The cabin qualifies as Joan's residence because her personal use (25 days) exceeds 14 days. Because the cabin is rented for less than 15 days during the year, Joan may only take itemized deductions of $4,500 for the qualified residential interest and taxes. She may not deduct the other expenses. In addition, she does not include the $2,400 in gross income. ◀

Finally, any net income or loss from rental property is subject to the Sec. 469 passive loss rules, which may limit the deductibility of any losses from the property (see Chapter I:9).

EXAMPLE I:6-45 ▶ Assume the same facts as in Example I:6-43 except that Joan chooses to use the IRS's method of allocating the interest and taxes between the personal use and the rental use of the cabin based upon the total number of days used during the year rather than on the total 365 days in the year.

Item	*Total*	*Allocation*	*Allocated to Rental*	*Allocated to Personal*	*Treatment of Personal Amounts*
Rental income	$10,000		$10,000		
Tier 1:					
Interest expense	(3,000)	170/186	(2,742)	(258)	Not deductible
Property taxes	(1,500)	170/186	(1,371)	(129)	Deductible from AGI
Tier 2:					
Other expenses	(6,000)	170/186	(5,484)	(516)	Not deductible
Tier 3:					
Depreciation	(12,000)	170/186	(10,968)	(1,032)	Not deductible
			(10,565)		

Relative to Example I:6-43, the above allocation yields a larger rental loss, ($10,665), and less ($258 versus $1,603) of the interest expense is allocated to the non-deductible personal portion. Though it seems a better result, note that the choice of allocation method must be consistent over time and that the passive activity loss rules (Sec. 469) may limit the deductibility of the rental loss. ◀

The rule of Sec. 280A regarding the rental of residential property is summarized in Figure I:6-4.

EXPENSES OF AN OFFICE IN THE HOME

Unless the taxpayer meets certain strictly imposed requirements, Sec. 280A disallows any deduction for home office expenses. In general, for a taxpayer to deduct office-in-home expenses, the taxpayer must use the office regularly and exclusively as either of the following:

- ▶ The principal place of business for a trade or business of the taxpayer, or
- ▶ A place where the taxpayer meets or deals with clients in the normal course of business.

WHAT WOULD YOU DO IN THIS SITUATION?

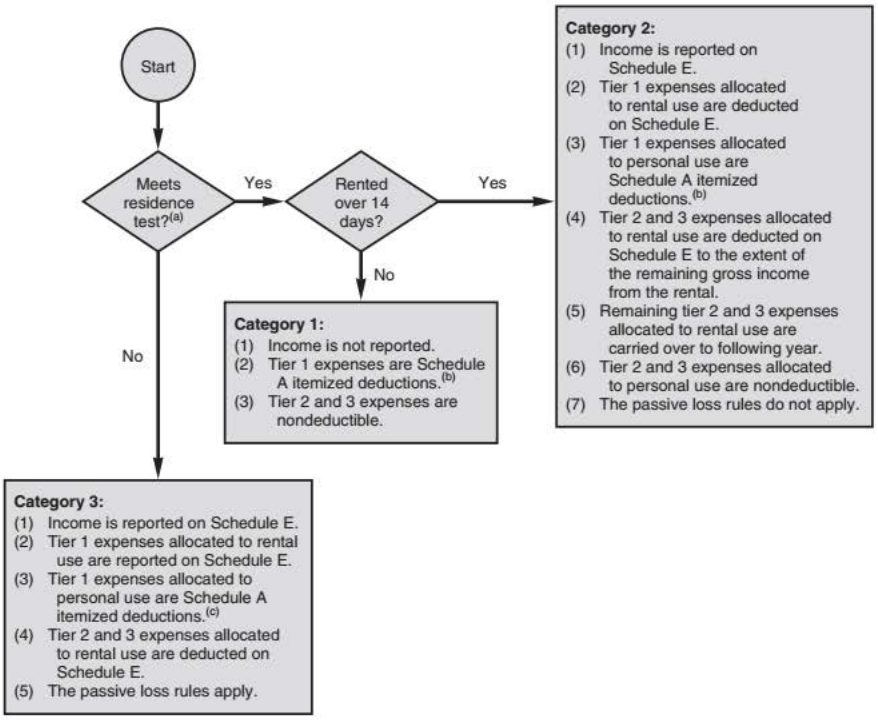
Serious Wine or Hobby Loss?

Mr. Bouteilles Gerbeuses has been your long-time tax client. He has amassed an impressive portfolio of real estate, securities, and joint venture investments. His net worth is substantial.

Despite all his material well-being, Mr. Gerbeuses wants to take on a new challenge—that of producing fine wines. He has not had any formal wine training but he has decided to start his own winery, named Cuvée de Prestige. He will pattern it after the great wine houses of Europe.

He already owns several hundred acres of agriculturally zoned land in the wine producing region of the Noir Valley. It happens to adjoin his home in the Wemadeit Country Club and Retirement Resort subdivision. He anticipates a life of semi-retirement by engaging in the art of malolactic fermentation and blending of his blanc de blancs and pinot noir grapes into his own estate wine. He expects his start-up capital investment to be over $5 million and does not expect the first harvest to take place for at least seven years after the initial planting of grape vines. He expects to offset any losses by his other income.

Assuming Mr. Gerbeuses comes to you for tax advice on his new wine venture, what tax and ethical issues should be considered?



(a) Personal use is more than the larger of (1) 14 days or (2) 10% of rental days.
(b) In order for the interest to be deductible, it must be "qualified residence interest" (see Chapter I:8).
(c) In order for the interest to be deductible as qualified residence interest, the property must not have been rented at all during the year. If the property has been rented out, the interest allocated to personal use is not deductible (see Chapter I:8).

FIGURE I:6-4 ▶ SECTION 280A: LIMITATION OF DEDUCTIONS ON RENTAL OF RESIDENTIAL PROPERTY

The term "principal place of business" includes a home office used by the taxpayer for administrative or management activities of the business if no other fixed location exists where the taxpayer conducts these administrative or managerial activities. In addition, a separate structure not attached to the taxpayer's house may qualify if regularly and exclusively used in connection with the taxpayer's business. (See Chapter I:7 for a comprehensive discussion of these rules.)

TAX PLANNING CONSIDERATIONS

OBJECTIVE 7

Describe tax planning considerations for deductions and losses

HOBBY LOSSES

Deductions for expenses incurred in a hobby activity may not exceed the gross income generated by the hobby for the year. However, if the gross income exceeds the deductions from the activity in at least three out of five consecutive years (two out of seven for activities involving the breeding, training, showing, or racing of horses), tax law presumes the activity is a business, and the limits on the deductibility of expenses do not apply. Thus, if possible, taxpayers should use care in timing the realization of items of income and expense. For example, if an activity has shown a profit in only two out of the previous four

years, a taxpayer may consider accelerating some of the income into the fifth year or deferring some of the expenses of the activity into the following year. Under the cash method of accounting, this can be done by delaying payment for some of the expenses or accelerating income-generating transactions. Note that meeting the three-out-of-five-year test does not automatically ensure the activity will be treated as a business. It merely compels the IRS to prove the activity is *not* a business. Under these circumstances, the IRS is less likely to challenge the deductions.



ETHICAL POINT

In some cases it is difficult to ascertain whether an activity is a trade or business or a hobby. A CPA should not prepare or sign a tax return unless he or she in good faith believes that the return takes a position that has substantial authority.

UNREASONABLE COMPENSATION

If the IRS feels that a salary payment to an officer of a corporation is excessive, it may recharacterize the excess portion as a dividend. If that happens, the corporation cannot deduct the full amount of the salary payment. To prevent a potential future disallowance, the parties may enter into a payback or hedge agreement, which provides that the employee must return to the corporation any payment held to be excessive. Under such an agreement, the employee receives a *for* AGI deduction for any amount he or she repays to the corporation. This deduction is available in the year of repayment. A payback agreement must meet the following requirements to be effective:

- The parties must enter into the agreement before actually making the payment.
- It must legally obligate the employee to repay the excess amount.[52]

The IRS may take the position that the existence of the payback agreement itself is evidence that the compensation is excessive. The corporation and employees can avoid this situation if they include the agreement in the general corporate bylaws rather than in a specific contract with a particular employee.[53]

TIMING OF DEDUCTIONS

Because of the time value of money, taxpayers generally prefer to deduct an expenditure as a current expense rather than capitalize it and spread the deductions over the next several years as depreciation or amortization. In addition, some capital expenditures (e.g., land) are not subject to depreciation or amortization. In some situations, however, the taxpayer may prefer to capitalize rather than expense a particular item. For example, if a taxpayer has net operating losses (NOLs) that are about to expire, a current deduction may prevent the use of these losses.[54]

In some cases it is difficult to determine whether an item should be treated as a capital expenditure or a deduction item (e.g., certain repairs may require capitalization). Because of this conflict, the Treasury has issued some new regulations that provide very detailed guidance on when an expenditure is to be capitalized and when it may be currently deducted. In addition, the taxpayer may elect to either capitalize or expense certain types of expenditures—such as those for research and experimentation. A tax practitioner should give consideration to the taxpayer's tax situation when making this decision. In making this decision, taxpayers and their advisors should consider any pre-2018 NOL carryovers that might be expiring. They should also compare the taxpayer's current marginal tax rate with their anticipated future marginal tax rate.

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[52] *Vincent E. Oswald,* 49 T.C. 645 (1968) and *J. G. Pahl,* 67 T.C. 286 (1976). See also *Ernest H. Berger,* 37 T.C. 1026 (1962).

[53] *Charles Schneider and Co. v. CIR,* 34 AFTR 2d 74-5422, 74-2 USTC ¶9563 (8th Cir., 1974). See also *Plastics Universal Corp.,* 1979 PH T.C. Memo ¶79,355, 39 TCM 32. Additionally, some taxpayers have been successful in defending their current level of compensation where they proved that they had been undercompensated in prior years. See *Acme Construction Co., Inc.,* 1995 RIA T.C. Memo ¶95,600, 69 TCM 1596.

[54] A NOL arises when business expenses exceed business income for a year. NOLs generated in years before 2018 may be carried back two years and forward up to twenty years. NOLs generated after 2017 may be carried forward (only) without limitation. See Chapter I:9 for a discussion of NOLs.

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 8

Describe compliance and procedural considerations for deductions and losses

PROPER CLASSIFICATION OF DEDUCTIONS

Individuals report trade or business expenses on Schedule C (Profit or Loss from Business or Profession). It is similar to an income statement for business-related income and expenses. Income reported on Form 1040 includes the net income computed on Schedule C, because the process of arriving at the taxable income from the business involves deducting business-related expenses. Thus, these expenses are deductions *for* AGI. Similar treatment is given to expenses attributable to the production of rental and royalty income reported on Schedule E, which is an income statement. The other deductions *for* AGI are reported on Schedule 1 for Form 1040 as "Adjustments to Income."[55]

Deductions *from* AGI are reported on Schedule A.

A filled-in Schedule C is provided in Appendix B.

SELF-STUDY QUESTION

A professor in the Department of Accounting also teaches continuing education courses for the state CPA society as a sole proprietor. If she is a member of the state CPA society, are her dues deductible on Schedule C?

ANSWER

Certainly, she would prefer to have the dues deductible on Schedule C so that they will be deductible. This question demonstrates the difficulty of classifying some deductions, and the answer probably depends on the primary reason for membership in the organization.

PROPER SUBSTANTIATION

The burden of proving the deductibility of any expense generally rests on the taxpayer. This has always been the case. However, in recent years Congress and the IRS have become increasingly concerned about the propriety of many deductions. In the case of travel and entertainment expenses, the Code states that taxpayers may not take a deduction for an improperly documented expense. This documentation must include the amount of the expense, the time and place of the travel or entertainment activity, the business purpose, and the business relationship of the people entertained.

BUSINESS VERSUS HOBBY

Self-employed individuals who claim a home office deduction on Schedule C must attach a Form 8829, used to allocate direct and indirect expenses to the appropriate use.

When an activity has both profit-making and personal attributes, the burden is normally on the taxpayer to prove that the activity is a business. However, if a taxpayer can show that the activity has generated a profit in at least three out of five consecutive years (two out of seven for activities involving the breeding, training, showing, and racing of horses), the burden of proof shifts to the IRS. Because the statute of limitations generally runs three years after a return is filed for any particular year (i.e., for audit purposes the year closes and the IRS cannot assess any tax deficiency for that year), a potential problem exists for taxpayers who want to rely on this presumption during the first year or two of an activity's life. In these cases, the taxpayer may elect to defer the determination of whether the presumption applies until the fifth (seventh) year of operation. The election keeps the year in question open with respect to that activity until sufficient years have passed to allow for application of the presumptive test. If the taxpayer subsequently does not meet the presumptive test, the IRS can still assess a deficiency for that activity for the prior year, because the year is still open. A taxpayer makes the election by filing Form 5213 (Election to Postpone Determination as to Whether the Presumption That an Activity Is Engaged In for Profit Applies) within three years after the due date for the year in which the taxpayer first engages in the activity.

ADDITIONAL COMMENT

When a taxpayer elects to defer the determination of whether a particular activity is engaged in for profit, the statute of limitations is automatically extended for all years in the postponement period. However, the automatic extension applies only to items that might be disallowed under the hobby loss rules.

[55] Some of these expenses, such as moving expenses (Form 3903), are summarized on separate forms. These separate forms, however, are not net income statements in the same sense as Schedules C and E.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:6-1 Why is the distinction between deductions *for* AGI and deductions *from* AGI important for individuals?

I:6-2 Sam owns a small house that he rents out to students attending the local university. Are the expenses associated with the rental unit deductions *for* or *from* AGI?

I:6-3 During the year, Sara sold a capital asset at a loss of $2,000. She had held the asset as an investment. This is the only capital asset she sold during the year. Is her deduction for this capital loss a deduction *for* or a deduction *from* AGI?

I:6-4 Joe is a single, self-employed individual who owns his own business. During 2019, Joe reported $200,000 gross income and $60,000 of business expenses. He also paid $30,000 in alimony to his former spouse, $4,000 mortgage interest on his personal home, $6,000 for health insurance premiums, and $2,000 for medicine and doctors. Ignoring any self-employment tax on the business income, what is Joe's AGI?

I:6-5 For 2019, Mario, a single individual with no dependents, receives income of $55,000 and incurs deductible expenses of $9,000.

a. What is Mario's taxable income assuming that the expenses are deductions *for* AGI?
b. What is Mario's taxable income assuming that the expenses are itemized deductions *from* AGI?

I:6-6 Deductible business or investment expenses must be related to a profit-motivated activity.

a. What are the factors used in determining whether an activity is profit-motivated?
b. Why are these factors so important in making this determination?

I:6-7 If an activity does not generate a profit in three out of five consecutive years, is it automatically deemed to be a hobby? Why or why not?

I:6-8 Because expenses incurred both in a business and for the production of investment income are deductible, why is it important to determine in which category a particular activity falls?

I:6-9 In order for a business expense to be deductible it must be *ordinary, necessary,* and *reasonable.* Explain what these terms mean.

I:6-10 What are the criteria for distinguishing between a deductible expense and a capital expenditure?

I:6-11 Why are expenses related to tax-exempt income disallowed?

I:6-12 Under what circumstances may a taxpayer deduct an illegal bribe or kickback?

I:6-13 Michelle pays a CPA $400 in 2019 for the preparation of her federal income tax return. Michelle's only sources of income are her salary from employment and interest and dividends from her investments.

a. Is this a deductible expense? If so, is it a deduction *for* or *from* AGI?
b. Assume the same facts as in Part a except that in addition to her salary and investment and dividend income, Michelle also owns a small business. Of the $400 fee paid to the CPA, $250 is for the preparation of her Schedule C (Profit or Loss from Business). How much, if any, of the $400 is a deductible expense? Identify it as either *for* or *from* AGI.

I:6-14 In March 2019, Otter Corporation sends people to the state capital to lobby the legislature to build a proposed highway that is planned to run through the area where its business is located.

a. If Otter Corp. incurs $3,200 of expenses, what part, if any, of its expenses are deductible?
b. Would it make a difference if the proposed road were a city road rather than a state highway, and Otter lobbied its local government?
c. Assume the same facts in Part a except that Otter's total in-house expenses are $1,500. Are these expenses deductible?

I:6-15 During November and December of last year, Tommy's, Inc., incurred the following expenses in investigating the feasibility of opening a new restaurant in town:

Expenses to do a market survey	$3,800
Expenses to identify potential suppliers of goods	$2,000
Expenses to identify a proper location	$1,000

Explain the proper treatment of these expenses under the following scenarios:

a. Tommy's, Inc., already owns another restaurant in town and is wanting to expand. Tommy's, Inc. opens the new restaurant in February of the current year.
b. Assume that Tommy's, Inc. is in the book selling business and feels that its bookstore business is not making a high enough return and it wants to move into the restaurant business. It opens the restaurant in February of the current year.
c. Same as Part b except Tommy's decides against opening a restaurant after the investigation.

I:6-16 What documentation is required in order for a travel or entertainment expense to be deductible?

I:6-17 Under what circumstances can prepaid expenses be deducted in the year of payment by a taxpayer using the cash method of accounting?

I:6-18 Under what circumstances would a taxpayer use both the cash method and the accrual method of accounting at the same time?

I:6-19 The timing of when the economic performance test is satisfied depends on the type of transaction and whether the transaction is recurring.
- **a.** When does economic performance occur for a taxpayer who must provide property or services to another person?
- **b.** When does economic performance occur when another person provides the taxpayer with property or services?
- **c.** Explain the exception to the economic performance test for recurring liabilities.

I:6-20 Why did Congress enact the wash sale provisions?

I:6-21 The wash sale rules disallow a loss in the year of sale when substantially identical stock or securities are acquired by the taxpayer within a 61-day period. What types of stock or securities are considered substantially identical?

I:6-22 Under Sec. 267, current deductions may not be taken for certain transactions between related parties.
- **a.** Who is considered a member of a taxpayer's family under the related party transaction rules of Sec. 267?
- **b.** Identify some of the other relationships that are considered related parties for purposes of Sec. 267. Why are these other relationships included in the definition?

I:6-23 Under the related party rules of Sec. 267, why has Congress imposed the concept of constructive ownership?

I:6-24 If property is sold at a loss to a related taxpayer, under what circumstances can at least partial benefit be derived from the disallowed loss?

I:6-25 Assume that Jill is engaged in painting as a hobby. During the year, she earns $1,000 from sales of her paintings and incurs $1,300 expenses for supplies and lessons. Jill's salary from her job is $70,000. What is the tax treatment of the hobby income and expenses?

I:6-26 Under Sec. 280A, what constitutes personal use of a vacation home by the taxpayer?

I:6-27 Under Sec. 280A, how are expenses allocated to the rental use of a vacation home? In what order must the expenses be deducted against the gross income of the property?

I:6-28 Under Sec. 280A, how will a taxpayer report the income and expenses of a vacation home if it is rented out for only 12 days during the year?

ISSUE IDENTIFICATION QUESTIONS

I:6-29 David, a CPA for a large accounting firm, often works 10- to 12-hour days. As a requirement for his position, he must attend social events to recruit new clients. In addition to his job with the accounting firm, he also has private clients in his unincorporated marketing business. David purchased exercise equipment for $3,000. He works out on the equipment to maintain his stamina and good health that enable him to carry such a heavy workload. What tax issues should David consider?

I:6-30 Gus coaches several developing professional tennis players as an employee of the Central Tennis Training Camp (CTTC). In May 2019, his ex-girlfriend Teresa, (a tennis player former client), alleged sexual abuse by Gus and made a complaint against him. When Gus informed them of the situation, CTTC was disillusioned and concerned over the risk to the camp's reputation. In September 2019, CTTC paid Teresa $50,000 to drop the complaint and to keep the entire matter confidential. CTTC incurred legal costs of $7,800 related to the matter. CTTC required Gus to acknowledge (sign) their intention to terminate his employment if the complaint and its settlement became public. Will the settlement payment be allowed as a tax deduction to CTTC?

I:6-31 Kathleen pays $3,000 mortgage interest on the home that she and her husband live in. Kathleen and her husband live with Molly, Kathleen's mother. The title to the home is in Kathleen's name. However, the mortgage is Molly's obligation. What tax issues should Kathleen consider?

I:6-32 Katie and Alan are avid boaters and water skiers. They also enjoy parasailing. This year, they started a new parasailing venture to provide rides to patrons. Katie and Alan are both employed full-time in other pursuits, but they take patrons out during the summer months, on weekends and holidays. Alan has attended classes on boat operation and parasailing instruction. Katie and Alan have owned a boat for four years, but because of the heavy usage this summer, they replaced their old boat in July. They plan on replacing their boat with a new one every two years now. They use their boat in the parasailing activity and for recreational purposes. This year, Katie and Alan earned $5,400 from chartering activities and incurred $11,600 of expenses associated with their boating and parasailing. What tax issues should Katie and Alan consider?

PROBLEMS

I:6-33 ***For or From AGI Deductions.*** Roberta is a self-employed accountant. During the year, Roberta incurs the following unreimbursed expenses:

Item	*Amount*
Travel to client locations	$750
Subscriptions to professional journals	215
Taking potential clients to lunch	400
Photocopying	60
	$1,425

Identify which of these expenses are deductible and the amount that is deductible by Roberta. Indicate whether they are deductible *for* or *from* AGI.

I:6-34 ***For vs. From AGI.*** During 2019, Kent, a 40-year-old single taxpayer, reports the following items of income and expense:

Income:	
Salary	$150,000
Dividends from Alta Corporation	800
Interest income from a savings account	1,500
Rental income from a small apartment he owns	8,000
Expenses:	
Medical	6,000
Interest on a principal residence	7,000
Real property taxes on the principal residence	4,300
Charitable contributions	4,000
Loss from the sale of Delta Corporation stock (held for two years)	2,000
Expenses incurred on the rental apartment:	
Maintenance	500
Property taxes	1,000
Utilities	2,400
Depreciation	1,700
Insurance	800
Alimony payments to former wife (divorced July 21, 2018)	10,000

The amounts above are before any limitations. What is Kent's taxable income for the year?

I:6-35 ***Capitalization vs. Expense.*** Sam owns a small apartment building (this is the only rental building Sam owns). During the year Sam incurs the following expenditures:

Item	*Amount*
Replace roof and roof underlying structure because of building code requirements	$30,000
Repaint the interior	3,000
Repair door handles and door locks	1,000
Replace broken windows	1,500
Replace crumbling sidewalks and stairs because of building code requirements	25,000

Discuss the proper tax treatment for these expenditures.

I:6-36 ***Political Contributions and Lobbying Expenses.*** Eljay, LLP owns several apartment complexes and office buildings. The leasing and management of these buildings constitutes Eljay's only business activity. During 2019, Eljay incurred the following:

- $900 in airfare and lodging for a trip to Washington, D.C. The purpose of the trip was to protest proposed tax rate increases for individuals and corporations.
- $700 for renting space on billboards along the highway. The billboards express its concern regarding pending legislation that would significantly increase property taxes.
- $500 in airfare and hotel bills incurred on a trip to the state capital. The purpose of the trip was to meet with the legislative subcommittee on property taxation.
- $50 for a subscription to a political newsletter published by a national political party.
- $150 in making a presentation to the county council protesting a proposed increase in the property tax levy.

a. What is the total amount Eljay may deduct because of these expenditures?
b. Assume instead that Eljay did not travel to Washington, DC or to the state capital. Costs incurred were for billboard rental ($700), newsletter ($50), and presentation to the county council ($150). What amount may Eljay deduct because of these expenditures?

I:6-37 ***Legal and Accounting Expenses.*** Sam is a sole proprietor who owns, leases, and manages several apartment complexes and office buildings. During the current year, Sam incurs the following expenses. Which of these expenditures are deductible? Are they *for* or *from* AGI deductions?

a. $200 in attorney's fees for title searches on a new property Sam has acquired.
b. $450 in legal fees in an action brought to collect back rents.
c. $500 to his CPA for the preparation of his federal income tax return. $400 is for the preparation of Schedule C (Profit or Loss from Business).
d. $300 in attorney's fees for drafting a will.
e. $250 in attorney's fees in an unsuccessful attempt to prevent the city from rezoning the area of the city where several of his office buildings are located.

I:6-38 ***Illegal Payments.*** Damian Corporation is engaged in the business of purchasing and importing carpets. The carpets are imported from a country from which the U.S. has banned imports. Following is a list of income and expense items for the year:

Item	*Amount*
Sales	$750,000
Cost of goods sold	270,000
Salaries	75,000
Freight	22,500
Bribes to customs officials	30,000
Lease payments on warehouses	15,000
Interest expense	12,000

a. What is the taxable income of Damian Corporation from the illegal business activity?
b. Assume the same facts as in Part a except that Damian's business consists of buying and selling illegal drugs. What is Damian's taxable income from this illegal business activity?

I:6-39 ***Illegal Payments.*** Indicate whether Glenda can deduct the $5,000 payment in each of the following independent situations.

a. Glenda is a supplier of medical supplies. In order to secure a large sales contract to the regional Veterans Affairs Hospital, Glenda makes a gift of $5,000 to the hospital's purchasing agent. The payment is illegal under state law.
b. Assume the same facts as in Part a, except that the payment is made to the purchasing agent of a government-owned hospital in Brazil.
c. Assume the same facts in Part a, except that the payment is made to the purchasing agent of a privately owned hospital in Idaho.

I:6-40 ***Business Investigation Expenditures.*** During January and February of the current year, Big Bang LLC incurs $13,000 in travel, feasibility studies, and legal expenses to investigate the feasibility of opening a new entertainment gallery in one of the new suburban malls in town. Big Bang already owns two other entertainment galleries in other malls in the area.

a. What is the proper tax treatment of these expenses if Big Bang decides not to open the new gallery?
b. What is the proper tax treatment of these expenses if Big Bang decides to open the new gallery?

I:6-41 ***Business Investigation Expenditures.*** Assume the same facts as in Problem I:6-40, except that Big Bang LLC incurs $51,000 in expenses, and it does *not* already own the other entertainment galleries and it does not own anything similar.

a. What is the proper tax treatment of these expenses if Big Bang does not open the new gallery?
b. What is the proper tax treatment of these expenses if Big Bang decides to open the new gallery on May 1 of the current year and makes the appropriate election under Sec. 195?

I:6-42 ***Timing of Expense Recognition.*** Solutions Corporation, a computer vendor and consulting company, uses the accrual method of accounting. Its tax year is the calendar year. The following are three of the corporation's transactions during the current year:

1. Solutions Corporation hired a contractor to remodel its sales floor. The contractor completed the remodeling on November 30. On December 15, Solutions received a $5,000 bill from the contractor. Solutions immediately contacted the contractor to contest $1,000 of the total charges, arguing that it exceeded the price that was agreed upon. Solutions made no payment on the bill during its current tax year.
2. Solutions offers a 2-year warranty on all of its computer systems. For sales of computers in the current year, it paid $11,500 to service warranties during the current tax year, and it expects to pay $12,000 to fulfill the remaining warranty obligations next year.
3. Every year, Solutions offers a series of six trade seminars from November 1 through April 30. It receives all registration fees from participants by October 1, before the seminars begin. As of December 31, two of the six seminars are completed, and the next seminar is scheduled for January 14–15. The expenses incurred in performing the seminars are routine each year. On the first of each month from November through April, Solutions pays the $625 monthly rent for the seminar location. On September 16, Solutions signs a contract with the seminar teacher, a computers expert and excellent public speaker. The contract requires Solutions to pay the teacher $900 after each seminar, a total of $5,400. On October 3, Solutions signs a contract with a local printing company, which will provide text materials for the seminars. Solutions pays the printer $350 after each seminar's materials are delivered the day before the seminar.

Required:

a. How should Solutions Corporation treat these transactions? What rules apply?
b. How would your answers change for each of the transactions if Solutions Corporation were a cash-method taxpayer?

I:6-43 ***Prepaid Expenses.*** Pamello, Inc., an engineering consulting firm, uses the cash method of accounting and is a calendar year taxpayer. Compute the amount of Pamello's current year deductions for the following transactions:

a. On November 1 of the current year, it entered into a lease to rent some office space for five years. The lease agreement states that the lease payments are $12,000 per year, payable in advance each November 1 for the following 12-month period. Under the terms of the lease, Pamello is required to pay a $5,000 deposit, refundable upon the termination of the lease.
b. On December 1 of the current year, Pamello also renewed its malpractice insurance, paying $18,000 for the three-year contract.
c. On December 31 of the current year, Pamello mailed out a check for $5,000 for drafting services performed for it during the current year by an individual who lives in another city.
d. On December 31, the firm received a shipment of $700 worth of stationery and other office supplies. Pamello has an open charge account with the office supply company, which bills the firm monthly for charges made during the year.
e. On December 31, Pamello picked up some work that a local printing company had done for it, which amounted to $1,000. The firm charged the $1,000 with its corporate credit card.

I:6-44 ***Prepaid Interest.*** During the current year, Richard and Alisha, a married couple who use the cash method of accounting, purchased a principal residence for $320,000. They paid $40,000 down and financed the remaining $280,000 of the purchase price with a 30-year mortgage. At the closing, they also paid $500 for an appraisal, $500 for a title search, and 1.5 points representing additional interest over the term of the loan. At the end of the year, Richard and Alisha received a statement from the mortgage company indicating that $12,000 of their total monthly payments made during the year represents interest and $1,000 is a reduction of the principal balance.

a. What is the total amount Richard and Alisha may deduct in the current year arising from the purchase and ownership of their home?
b. What is the treatment of the other items that are not deductible?

I:6-45 ***Wash Sales.*** John Broward owns 1,500 shares of Silver Fox Corporation common stock. John purchased the 1,500 shares on April 17, 2011, for $21,000. On December 8, 2018, John sells 750 shares for $5,000. On January 2, 2019, John buys 250 shares of Silver Fox Corporation common stock for $1,750 and 50 shares of Silver Fox Corporation preferred stock for $1,000. The preferred stock is nonvoting, nonconvertible.

a. What is John's realized and recognized loss on the December 8 sale of stock?
b. What is his basis and the holding periods of the shares purchased in 2011 and in 2018?

I:6-46 ***Wash Sales.*** Mr. Cougar owns 1,000 shares of Western Corporation common stock, which it purchased on March 8, 2011, for $12,000. On October 3, 2019, Cougar purchases an

additional 300 shares for $3,000. On October 12, 2019, he sells the original 1,000 shares for $8,500. On November 1, 2019, he purchases an additional 500 shares for $4,000.

a. What is Mr. Cougar's recognized gain or loss as a result of the sale on October 12, 2019?
b. What are the basis and the holding period of the stock he continues to hold?
c. How would your answers to Parts a and b change if the stock Cougar purchases during 2019 is Western nonvoting, nonconvertible, preferred stock instead of Western common stock?

I:6-47 ***Constructive Ownership.*** During the current year, Troy sells land to Berry Corporation for $165,000. Troy purchased the land for investment in 2002 for $170,000. Berry Corporation is owned as follows:

Owner	*Percentage Ownership*
Tom (Troy's son)	20%
Jimmy (Troy's cousin)	15%
Jimmy's father (Troy's uncle)	30%
Angie (Troy's wife)	10%
Nicole (Angie's Sister)	25%

Troy and Jimmy are equal partners in a separate entity, TJ Partnership.

a. What is Troy's constructive ownership in Berry Corporation?
b. What is the amount of loss Troy may recognize?
c. How would your answers to Parts a and b change if TJ Partnership owned 25%, instead of Nicole?

I:6-48 ***Constructive Ownership.*** PIB Partnership is owned 20% by Sara, 40% by Steve, and 40% by Thann. Burnham, Inc. is owned 70% by PIB Partnership, 10% by Ralph, 10% by Thann, and 10% by Sara. Ralph and Thann are brothers. All other individuals are unrelated. During the current year, Ralph sold a piece of land to Burnham, Inc., for $90,000. Ralph originally purchased the land as an investment a few years ago for $100,000.

a. How much of the loss may Ralph recognize?
b. Now assume all the same facts except that the sale occurred between Thann and Burnham, Inc. How much of the loss may Thann recognize?
c. Now assume the same facts as in b except that Burnham, Inc., is owned 60% by Sara and 40% by Ralph. Thann sells the land to Burnham, Inc. How much of the loss may Thann recognize?

I:6-49 ***Related Party Transactions.*** Sally is an attorney who computes her taxable income using the cash method of accounting. Sage Corporation, owned 40% by Sally's brother, 40% by her cousin, and 20% by her grandmother, uses the accrual method of accounting. Sally is a calendar-year taxpayer, whereas Sage Corporation's fiscal year ends on January 31. During 2019, Sally does some consulting work for Sage Corporation for a fee of $10,000. The work is completed on December 15 and Sage receives Sally's invoice on that date. For each of the following assumptions, answer the following questions: During which tax year must Sally report the income? During which tax year must Sage Corporation deduct the expense?

a. The payment to Sally is made on December 27, 2019.
b. The payment to Sally is made on January 12, 2020.
c. The payment to Sally is made on February 3, 2020.

I:6-50 ***Related Party Transactions.*** During the current year, CVI Corporation sells a tract of land for $75,000. The sale is made to Sandi, CVI Corporation's sole shareholder. CVI Corporation originally purchased the land five years earlier for $98,000.

a. What is the amount of gain or loss that CVI Corporation will recognize on the sale during the current year?
b. Assume that in the following year, Sandi sells the land for $85,000. What is the amount of gain or loss Sandi will recognize? What are the tax consequences to CVI Corporation upon the subsequent sale by Sandi?
c. Assume that in the following year, Sandi sells the land for $70,000. What is the amount of gain or loss Sandi will recognize?
d. Assume that in the following year, Sandi sells the land for $105,000. What is the amount of gain or loss Sandi will recognize?

I:6-51 ***Hobby Loss Presumptive Rule.*** Rachel Schurtz is a high school English teacher. In her spare time, she likes to make her own body lotion, lip gloss, and bath and shower gel. She uses the bath products herself and gives them to her friends and relatives as gifts. Two years ago, Rachel started attending arts and crafts festivals three or four times a year to sell her

products. She hands out her business card so her customers can buy directly from her via phone, email, or internet. In 2017 (the first year), Rachel reported a net loss of $375 from the activity. In 2018, she reported a loss of $460. Rachel is audited for the year 2018, and the agent disallows the $460 loss. Rachel is confident she will make a profit on her sales in 2019, and she assumes she will continue to make a profit in future years. Rachel is not sure that she can prove that her activity is a business right now. What can she do to delay or avoid having to prove to the IRS that her loss is not a hobby loss?

I:6-52 ***Hobby Loss Presumptive Rule.*** Emily is an interior decorator who does consulting work for several furniture stores. Additionally, she has been designing and creating rubber stamps for the past several years. She sells the stamps to local stationary and novelty shops. Emily has reported the following net income or loss from the rubber stamp activity:

Year	*Net Income (Loss)*
2014	$ 300
2015	(900)
2016	(400)
2017	600
2018	(550)
2019	(800)

Emily is audited for the year 2019, and the agent disallows the $800 loss. Can Emily make an election for 2019 to keep the year open in anticipation of meeting the presumptive rule for the year? Why or why not?

I:6-53 ***Hobby Losses.*** Chuck, a dentist, raises prize rabbits for breeding and showing purposes. Assume that the activity is determined to be a hobby. During 2019, the activity generates the following items of income and expense:

Item	*Amount*
Sale of rabbits for breeding stock	$800
Prizes and awards	(300)
Property taxes on rabbit hutches	(200)
Feed	(600)
Veterinary fees	(500)
Depreciation on rabbit hutches	(250)

a. What is the total amount of income and deductions Chuck should report for 2019 with respect to the rabbit raising activities?
b. Identify which expenses may be deducted and indicate whether they are deductions *for* or *from* AGI.
c. By what amount is the cost basis of the rabbit hutches to be reduced for the year?

I:6-54 ***Rental of Vacation Home.*** During 2019, Kim incurs the following expenses with respect to her beachfront condominium in Hawaii:

Expense Items	*Amount*
Insurance	$ 500
Repairs and maintenance	700
Interest on mortgage	3,000
Property taxes	1,000
Utilities	800
Depreciation	$8,000

During 2019, Kim used the condominium 20 days for vacation. She rented it out for a total of 60 days, generating a total gross income of $9,100.
a. What are the total amounts of deductions for and from AGI that Kim may take during 2019 with respect to the condominium using the IRS allocation method?
b. What is the effect on the basis of the condominium?

I:6-55 ***Rental of Vacation Home.*** Assume all of the same facts as in Problem I:6-54, except that during the year Kim rents the condominium a total of 14 days. How does Kim report the income and deductions from the property?

COMPREHENSIVE PROBLEMS

I:6-56 Bryce, a bank official, is 40 years old, unmarried and has no dependents. During 2019 he engages in the following activities and transactions:

a. Being an avid fisherman, Bryce develops an expertise in tying flies. At times during the year, he is asked to conduct fly-tying demonstrations, for which he is paid a small fee. He also periodically sells flies that he makes. Income generated from these activities during the year is $2,500. The expenses for the year associated with Bryce's fly-tying activity include $125 personal property taxes on a small trailer that he uses exclusively for this purpose, $2,900 in supplies, $270 in repairs on the trailer, and $200 in gasoline for traveling to the demonstrations.

b. Bryce sells a small building lot to his brother for $40,000. Bryce purchased the lot four years ago for $47,000, hoping to make a profit.

c. Bryce enters into the following stock transactions: (None of the stock qualifies as small business stock.)

Date	*Transaction*
March 22	Purchases 100 shares of Silver Corporation common stock for $2,800.
April 5	Sells 200 shares of Gold Corporation common stock for $8,000. The stock was originally purchased two years ago for $5,000.
April 15	Sells 200 shares of Silver Corporation common stock for $5,400. The stock was originally purchased three years ago for $9,400.
May 20	Sells 100 shares of United Corporation common stock for $12,000. The stock was originally purchased five years ago for $7,000.

d. Bryce's salary for the year is $100,000. In addition to the items above, he makes $5,000 charitable contributions and pays $4,800 of state income tax.

Determine the following:

1. Bryce's taxable income for 2019.

2. Bryce's basis in the Silver stock he continues to own.

I:6-57 Using the following facts, determine Jaron's 2019 taxable income.

1. In November 2017, when his wife died, Jaron left the CPA firm he was working for and started his own practice so he could have more time to spend with his four children (ages 14, 16, 19, and 24 years old). The three younger children live at home with their father. Danny, Jaron's 19-year-old son, graduated from high school a year ago and is currently working at a local golf course. Danny earned $17,000 in the current year. Jaron's oldest daughter, Laura, is married and lives in town with her husband, Chad. Laura graduated from college two years ago and now works for a local advertising agency.

2. Jaron rents a small office downtown where he meets with clients and conducts business. He keeps all his client files and business records in this office. In the evening, he uses a converted bedroom in his home as his office. The following expenses are allocated to his home office (by square feet):

Depreciation	$2,150
Taxes	$1,500 ($3,600 for non-office portion of his home)
Utilities	$75

3. Jaron owns a condominium downtown. He rented it out 270 days during the year. He also allowed Laura and her husband to stay in the home rent-free for 24 days while they were looking for a home. Fortunately, the condominium was not rented during the time they needed it. The following items of annual income and expense relate to the condominium:

Rental income	$18,000
Mortgage interest	($3,150)
Taxes	($1,700)
Other expenses	($6,000)
Depreciation	($7,090)

4. On April 6, Jaron sold a parcel of land he had held for investment to a real estate development firm for $75,000. He purchased the land three years earlier from his brother for $70,000. His brother had originally purchased the land for $74,000.

5. On May 1, Jaron purchased 1,000 shares in Genomics Ltd. for $10 per share. In December he was forced to sell all 1,000 shares at $8 per share to avoid a conflict of interest.

6. Jaron reported the following items of income and expense from his consulting practice:

Consulting fees received	$185,000
Wages expense	$47,400
Rent expense	$20,000
Depreciation	$2,100
Other expenses	$17,000

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:6-58 Danielle Anderson, your client and a cash method taxpayer, works full-time at a music store located in a mall. She assists the manager in buying decisions, serves customers on the sales floor, and plays music to draw in customers. On the weekends, she plays in various orchestras, working as an independent contractor. She does not work under a business name, maintain an office, or maintain a separate bank account for her performing activities. She always pays her bills as soon as possible, well before the bill due date. In prior years, she has taken every allowable deduction related to the performing activities. Prior year returns show the following on her Schedule C:

2015	$(5,000)
2016	2,100
2017	3,000
2018	(1,800)

Danielle has come to you on December 12, 2019. She understands that the IRS can deny losses generated by her performing business if it determines the business is actually a hobby. Because of the uncertainty of the entertainment industry, she will likely continue to generate profits in some years and losses in others. Still, she continues the activities with the intent to earn a profit.

Danielle routinely sends bills to orchestra clients at the end of the month for work she performed during the month. Most of her clients, including the Springville Orchestra, send payment within ten days of when they receive her bill.

The following is a summary of the financial position of the business as of December 12, 2019:

Income received to date	$9,000
General expenses paid to date	(9,200)
Other items:	
Bill for refurbishing work on cello, due in January 2020	($ 300)
Newspaper bill for monthly advertisement, due in January 2020	(200)
Printer bill for business cards, due in January 2020	(500)
Meals eaten while in transit to performance locations	(150)
Income receivable for December 2019 performance with the Springville Orchestra	1,000

What will you recommend to your client? What issues must you address? What actions will you take to ensure the most favorable tax outcome possible? What advice, if any, will you give your client for the future?

I:6-59 Peter Baumann, your client, wants to sell a printing press to Chamberlain Corporation for $50,000. Pete has used the press in his business for two years and its adjusted basis is $90,000. The Coxmann Partnership; Chloe International, Inc.; Watts, Inc., and Raleigh Corporation own Chamberlain Corporation equally. Pete and Emily Cox each own 50% of the Coxmann Partnership. Emily owns 70% of Chloe International, Inc., and Pete's sister Susan owns the other 30%. Pete's brother, Brian, owns 100% of Watts, Inc. Wade and Catherine Chamberlain, friends of Pete, own Raleigh Corporation equally. Peter wants to know what the tax consequences will be if he sells the printing press to Chamberlain Corporation. In a memo to Pete, explain any tax consequences of the proposed sale and any alternatives that would provide a better result.

TAX FORM/RETURN PREPARATION PROBLEMS

I:6-60 Dave Stevens, age 34, is a self-employed physical therapist. His wife Sarah, age 31, teaches English as a Second Language at a local language school. Dave's Social Security number is 111-11-1111. Sarah's Social Security number is 222-22-2222. Sarah and Dave have three

children—Andrew, age 8; Isaac, age 6; and Mira, age 3. The children's Social Security numbers are, respectively, 333-33-3333, 444-44-4444, and 555-55-5555. They live at 12637 Pheasant Run, West Bend, Oregon 74658. They paid $8,900 in qualified residence interest and $2,400 in property taxes on their home. They had cash charitable contributions of $14,000. They also paid $180 to a CPA for preparing their federal and state income tax returns for the prior year, $100 of which was for the preparation of Dave's Schedule C. Sarah and Dave earned interest on CDs of $3,200. Sarah's salary for the year is $32,000, from which $9,600 in federal income tax and $1,400 in state income tax were withheld. Dave's office is located at Suite 402, 942 Woodview Drive, Portland, Oregon 74624, and his employer ID number is 11-1111111. Dave has been practicing for four years, and he uses the cash method of accounting. During 2018, Dave recorded the following items of income:

Revenue from patient visits	$300,000
Interest earned on the office checking balance	225

The following expenses were recorded for the office:

Property taxes	$ 4,500
Mortgage interest	12,000
Depreciation	4,500
Malpractice insurance	37,500
Utilities	3,750
Office staff salaries	51,000
Rent payments on equipment	15,000
Office magazine subscriptions	150
Office supplies	24,000
Medical journals	330

Dave pays $50 annually for use of a safety deposit box to store certain confidential documents related to his business. In addition to his medical practice, Dave spends 15 hours every week managing his real estate investments. To make sure he is aware of all current investment strategies and best practices, he subscribes to the following journals:

Wall Street Journal	$150
U.S. News & World Report	55
Money Magazine	45

Dave also prepaid $33,000 in estimated federal income taxes. Prepare Dave and Sarah's 2018 tax return (Form 1040, Schedules 1, A, B, C, and SE). Disregard any tax credits for which they may be eligible.

I:6-61 Lyle and Kaye James are married, have two minor children, Jessica, age 8 and Jerron, age 4, and are filing a joint tax return in the current year. They are both employed. Lyle and Kaye, ages 38 and 37, respectively, have combined salaries of $240,000, from which $48,000 of federal income tax and $10,000 of state income tax are withheld. Lyle and Kaye own two homes. Their primary residence is located at 11620 N. Mount Ave., New Haven, Connecticut 22222, and their vacation home is on the beach in Fort Lauderdale, Florida. They often rent their vacation home to supplement their income. The following items are related to the James' ownership of the two homes:

Item	*New Haven*	*Fort Lauderdale*
Rental income	$ —	$15,000
Qualified residence interest	7,200	5,000
Property taxes	1,400	1,000
Utilities	1,000	1,300
Repairs	200	300
Depreciation	0	3,500
Advertising	0	200
Insurance	1,500	1,500

The James family used their Fort Lauderdale home 20 days during the year. They rented the vacation home 60 days during the year. Lyle and Kaye jointly purchase stock in various corporations and make the following transactions in the current year. (None of the stock qualifies as small business stock.)

Date	*Transaction*	*Price Paid/Sold*
2/15	Bought 50 shares of Lake common stock (they own no other Lake stock)	$1,000
5/14	Bought 100 shares of Bass common stock (they own no other Bass stock)	3,000
5/24	Sold 25 shares of Lake common stock	250
5/27	Bought 50 shares of Lake common stock	900
	Sold 50 shares of Bass common stock	1,750
7/12	Bought 100 shares of Bass common stock	2,800

The James' have no other income or expense items. Lyle and Kaye's Social Security numbers are 111-22-3333 and 444-55-6666, respectively. Jessica and Jerron's Social Security numbers are 123-45-6789 and 888-99-1010. They use the IRS method of allocating all expenses between personal and rental use.

Prepare the James' income tax return Form 1040, Schedules 1, A, C, D, and SE for 2018 using the currently available forms and rates. Disregard the alternative minimum tax and any tax credits for which they may be eligible.

I:6-62 Scarlet Furniture Corporation, an accrual-method taxpayer, retails custom office furniture. On January 1 of the current year, Peter Marlin and John Tanner incorporated Scarlet Furniture Corporation. Peter transferred $350,000 cash for 70% of Scarlet's outstanding stock, and John transferred $150,000 cash for 30% of the outstanding stock. Scarlet generated the following financial statements at the end of its first year of operations:

Scarlet Corporation's Balance Sheet

Assets	
Cash	$ 91,400
Inventory	48,000
Other Current Assets	50,000
Office Equipment	170,000
Building	250,000
Accumulated Depreciation	(20,000)
Land	550,000
Total Assets	$1,139,400
Liabilities and Owner's Equity	
Accrued Expenses	$ 100,000
Long Term Debt	400,000
Common Stock	500,000
Retained Earnings	139,400
Total Liabilities and Owners' Equity	$1,139,400

Scarlet Corporation's Income Statement

Revenues	$650,000
Costs of Goods Sold	100,000
Gross Income	$550,000
Advertising Expense	40,000
Depreciation Expense	20,000*
Miscellaneous Expense	10,600**
Office Supplies	5,000
Property Tax Expense	60,000
Wages & Salaries Expense	135,000***
Warranty Expense	10,000****
Operating Income	$269,400
Interest Expense	30,000
Federal Income Tax Expense	100,000
Net Income	$139,400

*Depreciation expense for tax purposes was $120,441 because Scarlet made a Sec. 179 election to expense $105,000 of the cost of the equipment purchased this year.
**Miscellaneous expense relates to a $600 penalty fee as a result of a breached customer contract and a $10,000 fine assessed by OSHA for hazardous conditions in its storage facility.
***Wages and salary expense includes Peter's salary of $40,000 and the accrual of $15,000 of bonuses payable to Peter which Scarlet actually paid on February 10 of the following year.
****The actual expenditure paid for warranty repairs during the year is $2,000.

Scarlet does not make any sales or purchases on account. Scarlet's employer identification number is 12-3456789. Its address is 789 Presidential Way, Seattle, Washington 54789. Peter Marlin's Social Security number is 555-66-8888. During the current year, the Corporation made federal estimated income tax payments of $50,000.

Prepare a Form 1120 for the initial return for Scarlet.

CASE STUDY PROBLEM

I:6-63 John and Kathy Brown have just been audited and the IRS agent disallowed the business loss they claimed in 2016. The agent asserted that the activity was a hobby, not a business.

John and Kathy live in Rochester, New York, near Lake Ontario. Kathy is a CPA, and John was formerly employed by an insurance firm. John's firm moved in 2011 and John resolved not to move to the firm's new location. Instead of seeking other employment, John felt he could supplement his income by using his fishing expertise. He had been an avid fisherman for 15 years, and he owned a large Chris-Craft fly-bridge that he chartered to paying parties.

In 2012, Kathy and John developed a business plan, established a bank account for the charter activities, developed a bookkeeping system, and acquired insurance to cover the boat and the passengers. John fulfilled all the requirements to receive a U.S. Coast Guard operating license, a New York sport trolling license, and a seller's permit. These licenses and permits were necessary to legally operate a charter boat. The first year of their activity was 2012.

John advertised in local papers and regional sport fishing magazines. He usually had three or four half-day paying parties each week. John spent at least one day per week maintaining and repairing his boat. Kathy usually accompanied John on charters three or four times each year.

John's charter activity was unprofitable the first two years. In 2014, John and Kathy restructured the activity to improve profitability. The restructuring included increasing advertising, participating in outdoor shows, and negotiating small contracts with local businesses. After the restructuring, the activity provided a small profit in 2014 and 2015.

In 2016, John started working with another insurance company in the area on a full-time basis. Even though he returned to the insurance business, John normally took two paying parties and one nonpaying, promotional party each week throughout the fishing season. John's costs unexpectedly increased and he lost $8,000 in the activity during 2016. John and Kathy deducted the entire loss on Schedule C of their 2016 tax return.

Required: Prepare a memo to the Browns recommending what position they should take and why. Show the logic used in arriving at your recommendation.

TAX RESEARCH PROBLEMS

I:6-64 Richard Penn lives in Harrisburg, Pennsylvania. Richard is the president of an architectural firm. Richard has become known throughout the community for excellent work and honesty in his business dealings. Richard believes his reputation is an integral part of the success of the firm.

Oil was found recently in the area around Harrisburg and some geologists believed the reserves were large. A few well-respected businesspeople organized Oil Company to develop a few wells. Although some oil was being extracted, the oil corporation lacked capital to develop the oil fields to their expected potential. After reading the geologists' report, Richard felt that Oil Company was a good investment; therefore, he acquired 25% of the company. A short time after Richard's acquisition, the price of foreign oil decreased sharply. The drop in foreign oil prices caused Oil Company to be unprofitable due to its high production costs. Three months later Oil Company filed bankruptcy.

The bankruptcy proceedings were reported in the local newspaper. Many of Oil Company's creditors were real estate developers that engaged Richard's architectural firm

to provide designs. After Oil Company declared bankruptcy the architectural firm's business noticeably decreased.

Richard felt the decline in business was related to the bankruptcy of Oil Company. Richard convinced his partner to use the accumulated earnings of the firm to repay all the creditors of Oil Company.

Richard has asked you whether his firm can deduct the expenses of repaying Oil Company's creditors. After completing your research explain to Richard why the expenses are or are not deductible.

A partial list of research sources is as follows:

- Sec. 162
- *Thomas H. Welch v. Helvering,* 12 AFTR 1456, 3 USTC ¶1164 (USSC, 1933)
- *William A. Thompson, Jr.,* 1983 PH T.C. Memo ¶83,487, 46 TCM 1109

I:6-65 Three years ago, Paul Wilde exercised all his stock options in the start up company he helped establish and walked away with over $100 million. Since that time, he has spent all his energy, time, and effort in managing his portfolio. His investment philosophy is one of steady, careful investment in a well-balanced portfolio. Thus, although each year he engages in several sales and purchases, he generally buys and holds the securities for both the dividends and the growth potential. Consequently, most of the stock sales he makes are of securities he has held for over one year. Because his investment activities have grown so large, this year he rented a suite of offices and hired two investment advisors and five secretaries to help him. He also purchased several new computers and some new office furniture for the office.

Paul has now come to you for some tax help. Specifically, he would like to know if his activities are considered a business or an investment activity. In your explanation, please include whether the expenses incurred in the activity are deductions *for* or *from* AGI.

A partial list of research sources is as follows:

- *Higgins v. CIR,* 25 AFTR 1160, 41-1 USTC §9233 (USSC, 1941)
- *Estate of Louis Yaeger, Deceased, Judith Winters, Ralph Meisels, Abraham J. Weber and the Bank of New York,* 889 F2d 29, 89-2 USTC ¶9633 (CA-2)
- *Frederick Mayer and Jan Perry Mayer,* 67 TCM 2949 (1994)
- *Rudolph W. and Abbie A. Steffler,* 69 TCM 2940 (1995)
- Sec. 179

CHAPTER

7

BUSINESS EXPENSES AND DEFERRED COMPENSATION



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Understand the deductibility of business and rental real estate activities
2. Distinguish the classifications of employees and independent contractors
3. Determine the proper deductible amount for travel expenses
4. Understand the deductibility of transportation expenses
5. Understand the deductibility of business meals and the 50% disallowance rule
6. Identify deductible moving expenses
7. Describe the requirements for deducting education expenses
8. Determine whether the expenses of an office in home meet the requirements for deductibility and apply the gross income limitations
9. Discuss the tax treatment and requirements for various deferred compensation arrangements
10. Describe tax planning considerations for business expenses and deferred compensation
11. Describe compliance and procedural considerations for business and deferred compensation expenses

CHAPTER OUTLINE

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This chapter discusses the tax consequences of two types of individual and business expenses:

- Part I: Expenditures incurred by individual taxpayers in connection with his or her business or certain expenses that are classified as Adjustments to Income.
- Part II: Deferred compensation payments made to employees, including retirement plans.

As discussed in Chapter I:6, all tax-deductible expenses incurred by an individual taxpayer must be classified as either (1) *for* AGI deductions, or (2) *from* AGI deductions (itemized deductions). *For* AGI deductions are discussed in this chapter, and itemized deductions are covered in Chapter I:8.

Deferred compensation refers to methods of compensating employees or self-employed persons that are based on their current service, but the actual payments are deferred until future periods. Deferred compensation arrangements are very popular and widely used in business. The two principal types of deferred compensation arrangements are qualified plans and nonqualified plans. Qualified plans, such as pension and profit-sharing plans, have very favorable tax benefits but also impose strict eligibility and coverage requirements. Nonqualified plans, while not as tax advantageous as qualified plans, are very useful for highly compensated employees. Both of these types of deferred compensation arrangements are discussed later in this chapter.

PART I: SELF-EMPLOYED EXPENSES

Part I of this chapter (through page I:7-20) deals with expenses classified as *for* AGI deductions. These deductions are reported on Schedule 1 of Form 1040.

For AGI deductions can be classified into two principal categories: (1) expenses connected with a trade or business and reported on Schedule C, expenses connected with rental real estate or royalties and reported on Schedule E, and expenses connected with farm income and reported on Schedule F; and (2) various types of expenses of individuals referred to as "adjustments to income" as shown on Schedule 1 of Form 1040. Schedule 1 of Form 1040 is presented in Figure I:7-2 near the end of this chapter.

As will be discussed in more detail in Chapter I:8, substantial changes to itemized deductions were made for the taxable years 2018–2025. The two most important changes were (1) a limitation on the deductibility of taxes paid to a maximum of $10,000, and (2) the elimination of miscellaneous itemized deductions. Most important for this chapter is the non-deductibility of employee business expenses as a miscellaneous itemized deduction.

BUSINESS AND RENTAL REAL ESTATE EXPENSES

OBJECTIVE 1

Understand the deductibility of business and rental real estate activities

As mentioned above, expenses connected with a business or rental real estate generally are tax-deductible if they are ordinary, necessary, and reasonable in amount under Sec. 162 of the IRC. These expenses are netted against the income from the activity and reported as Additional Income on Schedule 1 of Form 1040. Many individual taxpayers work as consultants or independent contractors and are commonly referred to as *self-employed individuals*. These taxpayers are not employees, but they work directly with their own customers and clients; their activity is considered a trade or business and is reported on Schedule C of Form 1040. Similarly, expenses connected with rental real estate property are also tax deductible and reported as a *for* AGI deduction under Sec. 62(a)(4) of the IRC. While any expense connected with a business or rental real estate activity is deductible if ordinary, necessary, and reasonable in amount, some of the more frequently encountered expenses discussed in this chapter include:

- Travel
- Transportation

ADDITIONAL COMMENT

"The income tax has made more liars out of the American people than golf has. Even when you make a tax form on the level, you don't know when it's through if you are a crook or a martyr."
—Will Rogers

- Meals and entertainment
- Moving
- Education
- Office in home

Each of these types of expenses are discussed in this chapter. Other *for* AGI deductions referred to as Adjustments to Income on Schedule 1 of Form 1040, including Individual Retirement Accounts (IRAs), self-employed retirement plans, and Health Savings Accounts are covered in Part II of this chapter.

SELF-EMPLOYED INDIVIDUAL VERSUS EMPLOYEE

OBJECTIVE 2

Distinguish the classifications of employees and independent contractors

An individual who provides services for another person or entity may be classified either as an employee or as a self-employed individual (also referred to as an independent contractor). If the individual is classified as self-employed, expenses are deductible *for* AGI under Sec. 162, and are reported on Schedule C of Form 1040. Expenses of employees are not deductible. In addition to the deductibility of expenses, the proper classification is also important due to employment taxes, such as Social Security and Medicare taxes. As is discussed below, self-employed taxpayers must pay both the employee and employer shares of Social Security and Medicare taxes.

EMPLOYEE EXPENSES

The TCJA 2017 made major changes to employee expenses, referred to as employee business expenses. For 2018 and future years through 2025, employee business expenses are no longer deductible. Under prior law, such expenses were deductible as miscellaneous itemized deductions. Most provisions of the TCJA 2017 pertaining to individual taxpayers are effective after December 31, 2017 and before January 1, 2026. So the miscellaneous itemized deductions for individuals are suspended rather than repealed and are scheduled to return in 2026. In contrast, the new tax law had little impact to self-employed individuals. Deductions continue to be allowed as a *for* AGI deduction.

Employer–Employee Relationship Defined. The Treasury Regulations provide that an employer–employee relationship generally exists where the employer has the right to control and direct the individual who provides services with regard to the end result and the means by which the result is accomplished.[1]

EXAMPLE I:7-1 ▶ Carmen is a nurse who assists a group of doctors in a clinic. Carmen is under the direct supervision of the doctors and is told what procedures to perform and when to perform them. Therefore, Carmen is classified as an employee. ◀

EXAMPLE I:7-2 ▶ Carol is a registered nurse who provides in-home services to several elderly patients. She receives instructions from the patients' doctors regarding such items as medications and diet, but Carol is directly responsible for the delivery of nursing care and is in control of the end result. Thus, Carol is self-employed. ◀

ADDITIONAL COMMENT

Anyone in a trade or business making payments of $600 or more to an independent contractor during a year must file Form 1099-MISC.

Importance of Proper Classification. As mentioned above, proper classification is important both to employers and employees. If an individual is classified as an employee, the employer must match the Social Security and Medicare taxes that are paid by the employee. In addition, employers are generally liable for unemployment taxes for their employees. Thus, an employer must pay these employment taxes to the federal and/or state governments in addition to the wages, which means that the cost of an employee generally is higher than for a non-employee.

[1] Reg. Sec. 31.3401(c)-1(b).

ADDITIONAL COMMENT

The maximum limit for OASDI ($132,900 for 2019) continues to increase rapidly. There is some support to eliminate the OASDI limit, thereby imposing the 6.2% rate to all earned income.

If an individual is *not* considered to be an employee, the individual is classified as self-employed (also called an independent contractor). Amounts paid to a self-employed individual are not considered to be wages and the payor is not responsible for any employment taxes. However, the self-employed individual must pay both the employee and employer portions *of Social* Security and Medicare taxes. This tax is referred to as the *self-employment tax*. As can be seen from the above discussion, employment taxes are shifted from the employer to the self-employed individual if the individual is not considered to be an employee.

Individuals may prefer to be classified as employees because the employee portion of the Social Security and Medicare taxes (7.65%) is only one-half of the self-employment tax rate (15.3%). Of the 7.65%, 6.2% (12.4% for self-employed individuals) is for the old age, survivors and disability insurance (OASDI) portion of the FICA tax and is assessed on a maximum income amount of $132,900 for 2019 ($128,400 for 2018). The remaining 1.45% (2.9% for self-employed individuals) portion of the FICA tax is for hospital insurance and has no ceiling limitation.

Litigation Issues and Administrative Enforcement. The determination as to whether an individual who performs services is either an employee or an independent contractor has been a major ongoing area of contention between the IRS and taxpayers. In determining whether a worker is an employee or independent contractor, the facts of the situation must be analyzed and divided into three main categories: behavioral control, financial control, and relationship of the parties. No one factor is necessarily determinative, the totality of the situation must be considered. The first category, behavioral control, entails whether the payor has the right to control how the individual does the work. *Behavioral control* is characterized by the amount of instruction as to how the work is to be done as well as the level of training that is provided to the individual. As to *financial control*, an independent contractor has a significant investment in his or her work, is not reimbursed for expenses, and has the opportunity for profit or loss. An employee generally would not have these characteristics in their role as an employee. The third category is that the *relationship of the parties* and looks at employee benefits and explicit written contracts that show the type of relationship intended. These three categories of tests are an outgrowth of the so-called "20 factor test" that was used for many years to determine whether an individual was considered an employee or independent contractor. Under either system, the determination is still a very difficult and uncertain process.

Substantial litigation has occurred in the interpretation of these factors. For example, truck drivers who were owner-operators and were engaged under contract by an interstate trucking company were considered independent contractors because they selected their own routes and were paid a percentage of the company's receipts for shipment.[2] However, drivers for a moving van company were considered employees because the company exercised control over their assignments.[3] The Tax Court held that cosmetologists, nail technicians, and massage therapists who performed services at a spa were not employees but rather independent contractors.[4] The individuals paid weekly rent, set their own hours and fees, and generally provided their own supplies.

TRAVEL EXPENSES

OBJECTIVE 3

Determine the proper deductible amount for travel expenses

DEDUCTIBILITY OF TRAVEL EXPENSES

The deductibility of travel expenses depends on the nature of the expenditure. The following rules apply to the deductibility of travel expenses.

- If the taxpayer is engaged in a trade or business as a self-employed individual or is engaged in an activity for the production of rental and royalty income, the travel-related expenditures are deductible *for* AGI. The specific requirements for deducting travel expenses are discussed below.

[2] Rev. Rul. 76-226, 1976-1 CB 332
[3] *Richard N. Smith v. U.S.*, 78-1 USTC ¶9263 (CA-5, 1978).
[4] *Cheryl A. Mayfield Therapy Center*, TC Memo 2010–239.

HISTORICAL NOTE

The partial disallowance of business meals and entertainment of 50% was enacted because Congress believed that prior law had not focused sufficiently on the personal consumption element of deductible business meal and entertainment expenses. Congress felt that taxpayers who could arrange business settings for personal consumption were unfairly receiving a federal tax subsidy for such consumption.

- Travel expenses for employees in connection with his or her job are not deductible after December 31, 2017 through the year 2025. If an employee is reimbursed for travel expenses by his employer, the reimbursement is excludible by the employee if paid under an accountable plan. Accountable plans are expense reimbursement plans whereby the employee must account for his expenses to his employer in order to receive a reimbursement. This accounting is typically done via an expense report. If the reimbursement is less than the actual travel expenses incurred by the employee, the excess travel expenses are not deductible.
- Personal travel expenses are not deductible.

DEFINITION OF TRAVEL EXPENSES

Travel expenses include transportation, meals, lodging, and other reasonable and necessary expenses incurred by a taxpayer while "away from home" in the pursuit of a trade or business. The term **travel expense** is more broadly defined in the IRC than is the term **transportation expense.** If an individual is not away from home, expenses related to local transportation are classified as transportation expenses rather than travel expenses. Table I:7-1 illustrates how travel expenses are reported. Transportation expenses for self-employed individuals are deductible under certain conditions and are discussed later in this chapter.

EXAMPLE I:7-3 ▶ Ahmed is away from home overnight on a business-related trip and incurs airfare, hotel, and taxi fares amounting to $800. Because Ahmed is away from home, the $800 is treated as travel expenses for tax purposes. ◀

EXAMPLE I:7-4 ▶ Charlotte uses her personal automobile to make deliveries of products to customers in the same local area of her place of business. Charlotte's automobile expenses are classified as transportation expenses (rather than travel expenses) because she was not away from home when they were incurred. As is discussed later in this chapter, transportation expenses are deductible but are subject to strict recordkeeping rules. If Charlotte stopped to eat lunch alone during her delivery activities, the meals are not deductible as they are neither travel nor transportation expenses. ◀

▼ **TABLE I:7-1**
Classification of Travel Expenses

Situation Facts	TAX TREATMENT		
	Deductible *for* AGI	Deductible *from* AGI	Not Deductible
1. Cindy is a self-employed attorney who incurs travel expenses related to her business.	X		
2. Jose, who lives in Dallas, is the owner of several apartment buildings in Denver. Periodically he travels to Denver to inspect and manage the properties.	X		
3. Clay is an employee who is required to travel to company facilities throughout the U.S. in the conduct of his management responsibilities. Clay is not reimbursed by his employer.			X
4. Same as Situation 3, except that Clay is fully reimbursed by his employer.	X[a]		
5. Colleen works in New York City and travels to her parents' home in Dallas during the holidays.			X

[a] Clay would not include the reimbursement in his gross income and is not allowed any deduction. In this case, since the expense equals the reimbursement, it is considered a "wash." Technically, Clay is required to report reimbursements as income and is allowed a deduction *for* AGI, but the IRS permits this "wash" treatment.

GENERAL QUALIFICATION REQUIREMENTS

To qualify as a travel expense deduction, the following requirements must be met:

- The purpose of the trip must be connected with a trade, business, or rental real estate activity. (Personal vacation trips or commuting to and from a work office are nondeductible personal expenses.)
- The taxpayer must be away from his tax home overnight or for a sufficient duration to require sleep or rest before returning home.

Away-from-Tax-Home Requirement. Travel expenses are deductible if the taxpayer is temporarily away from his tax home overnight. While this seems simple enough, there has been considerable controversy as to what the words actually mean. There are three important aspects of this requirement: (1) where the taxpayer's home is, (2) how *temporarily* is distinguished from *indefinite* or *permanent,* and (3) how the term *overnight* is interpreted.

TYPICAL MISCONCEPTION

There is a tendency to erroneously assume that a taxpayer's tax home is the location of his or her primary personal residence.

Taxpayer's home: The IRS's position is that a person's tax home is the location of his principal place of business regardless of where the family residence is maintained. Thus, a taxpayer who works permanently or for an indefinite period of time away from his or her family residence is *not* considered to be away from home and, therefore, travel expenses are not deductible. In this situation, the taxpayer's *tax home* is considered to be his work location.

Temporary vs. Indefinite: To meet the away from home requirement, a taxpayer must be away from home on a temporary basis. Thus, a self-employed individual who travels out of town on a three-day business trip clearly meets this requirement. However, a self-employed individual whose primary residence is in one location but works on a permanent basis during the week at another location, and possibly has an apartment at the work location, is not considered away from home at the *work location*. In this case, the work location is considered his tax home for income tax purposes, and he is not considered to be away from home.

REAL-WORLD EXAMPLE

A taxpayer was employed by a traveling circus with headquarters in Chicago. The Tax Court held that the taxpayer's home was wherever he happened to be with the circus. Therefore, the cost of his meals and lodging was not deductible. *Nat Lewis,* 1954 PH T.C. Memo ¶54,233, 13 TCM 1167.

The determination of whether a taxpayer is away from home temporarily or indefinitely is based upon the length of time the taxpayer is at such location. Work assignments of more than one year are treated as indefinite.[5] Work assignments for one year or less are classified as either temporary or indefinite depending on the facts and circumstances of each case. If a self-employed individual works away from home only for a temporary period, then his tax home does not change and the travel expenses are deductible. However, if the assignment is for an indefinite period, the individual's tax home shifts to the new location. The following bulleted items and examples are adapted from Rev. Rul. 93-86[6] and are used to illustrate the IRS's position concerning whether a taxpayer is away from home temporarily for purposes of deducting travel expenses:

- An independent contractor accepts an away from home assignment where it is realistically expected that the work will be completed in six months. The actual assignment period lasts ten months. Because the assignment period is realistically expected to last (and does in fact last) for one year or less, the IRS's position is that the assignment is temporary and the taxpayer's travel expenses are deductible.
- An independent contractor accepts an away from home assignment where it is realistically expected that the work will be completed in 18 months but the work is actually completed in ten months. In such case the IRS's position is that the assignment is treated as indefinite, regardless of whether it actually exceeds one year or not.
- An independent contractor accepts an away from home assignment where it is realistically expected that the work will be completed in nine months. After eight months the taxpayer is asked to remain for seven more months or a total period of more than one year. Based on these facts, the IRS's position is that the assignment is temporary for eight months and the travel expenses are deductible for the eight-month period. The assignment is considered indefinite for the remaining seven months and no travel expense deduction is allowed for the travel expenses during this period.

[5] Sec. 162(a). See also Rev. Rul. 99-7, 1999-1 C.B. 361.

[6] Rev. Rul. 93-86, 1993-2 C.B. 71.

Overnight test: To satisfy the overnight test, a taxpayer must show that it was reasonable for him to need to obtain sleep or rest during release time on such trips in order to meet the demands of his job.[7] Generally, costs of meals on one-day business trips are not deductible since the taxpayer was not away from home overnight. The Supreme Court held that a taxpayer who took short rest stops on long one-day business trips was not allowed to deduct his meals.[8] However, whether it is reasonable to need sleep or rest depends on the specific circumstances. A railroad conductor was allowed to deduct lodging, meals, and tips incurred during a six-hour layover on a total trip of 16 hours.[9]

EXAMPLE I:7-5 ▶ Roberto lives and works in Baltimore. He occasionally travels to New York City on business and stays overnight for two or three days at a time. Roberto clearly meets the away from home test and all of his travel expenses, including airfare, lodging, tips, taxi, and food (subject to the 50% disallowance) are deductible as travel expenses. ◀

EXAMPLE I:7-6 ▶ Tom lives with his family in Baltimore. In 2019, Tom, an independent contractor, accepts a new assignment in New York City. However, he decides not to move his family to New York but to rent an apartment and stay there during the week and return home on weekends. Tom's work assignment would be considered indefinite and the cost of his apartment, food, and other incidental expenses would not be deductible travel expenses because his tax home is New York and he is not considered to be away from home. ◀

EXAMPLE I:7-7 ▶ Gunther lives and works in Baltimore. Gunther, an independent contractor, accepts an assignment in New York City that is expected to last approximately seven months. Gunther rents an apartment in New York for the seven months, then returns to his regular office in Baltimore. Gunther's work assignment in New York is considered temporary because it is less than one year, and therefore, all of his apartment rent, food, laundry, and other incidental costs are deductible as travel expenses. Because apartments and food are expensive in New York, his travel expense deduction will be substantial. Good records to substantiate the work assignment and the expenses are very important in this case. ◀

BUSINESS VERSUS PLEASURE

Travel expenses are deductible only if they are incurred in the pursuit of a trade or business activity or connected with a rental real estate activity. Thus, if a taxpayer takes a trip that is primarily personal in nature but some business is transacted, the only deductions allowed are those that are directly related to the business activity.[10] In such event, all of the traveling expenses to and from the destination are treated as nondeductible personal expenditures. However, if the trip is *primarily related* to business, all of the traveling expenses to and from the destination are deductible, and meals and lodging, local transportation, and incidental expenses are allocated to the business and personal activities, respectively. In effect, an all-or-nothing approach is applied to the deductibility of traveling expenses to and from the destination depending upon the primary purpose for making the trip, i.e., no proration of expenses.

In determining the primary purpose for a trip, the amount of time spent on personal activities compared to the time spent on business activities generally is the most important factor. However, the fact that a taxpayer may spend slightly more time on personal activities than business activities will not automatically prohibit the deductibility of the transportation expenses to and from the destination. The taxpayer must clearly show that the purpose of the trip was *primarily business*.

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[7] Rev. Rul. 75-168, 1975-1 C.B. 58.

[8] *Correll v. U.S.*, 389 U.S. 299 (1968).

[9] *Williams v. Patterson*, 286 F2d 333 (5th Cir. 1961) and Rev. Rul. 75-170, 1975-1 C.B. 60. See also *Marc G. Bissonnette*, 127 T.C. 124 (October 23, 2006), where a six-hour layover on 15–17 hour days for a ferry boat captain was held to be "away from home."

[10] Reg. Sec. 1.162-2(b)(1).

EXAMPLE I:7-8 ▶ Dana, an independent contractor, travels to New York on a business trip and spends $500 for a roundtrip airline ticket and $200 per day for hotel, meals, and incidental expenses. Dana spends three days in business meetings and vacations for two days. Because the trip is primarily business, the traveling expenses to and from the destination (e.g., airfare) of $500 are fully deductible by Dana. Dana's meals, lodging, and incidental expenses amount to $1,000 (5 days × $200), but only $600 ($200 × 3 business days) of such travel expenses is deductible. The deductible business meal expenses are reduced by 50%. A proration of the meals, lodging, and incidental expenses based on the number of days may not be appropriate if the expenses are uneven or are directly related to either business or personal activities. ◀

EXAMPLE I:7-9 ▶ Assume that the facts in Example I:7-8 are reversed (i.e., that two days are business-related and three days are personal). Because more time was spent on personal activities, the general rule would hold that the trip is primarily personal and the traveling expenses to and from the destination of $500 are not deductible. Thus, only $400 ($200 × two business days) of travel expenses related to meals, lodging, and incidental expenses are deductible (subject to the limitations previously discussed). ◀

EXAMPLE I:7-10 ▶ Carroll is an independent contractor who lives and works in St. Louis, and he attends a business meeting in San Francisco. The meeting lasts two days. Carroll decides to take three days of vacation and sightsee in the San Francisco area. Even though Carroll spent more days on personal activities than business activities, Carroll's airfare would be deductible if he can clearly show that the primary purpose of the trip was business. ◀

REAL-WORLD EXAMPLE

It is very difficult to deduct expenses of a spouse who accompanies his or her spouse to a business meeting or convention. The accompanying spouse not only must work in the business but the reason for accompanying his or her spouse must be for bona fide business purpose.

Stringent rules are applied if the taxpayer is accompanied by family members because of the likelihood that the trip is primarily for personal reasons. No deduction is permitted for travel expenses of a spouse or a child (or other person accompanying the taxpayer) unless the person works in the business, the travel is for a bona fide business purpose, and the expenses would be otherwise deductible.[11]

FOREIGN TRAVEL

Due to the potential for abuse, special rules apply to foreign travel and foreign convention expenses.[12] Travel expenses related to foreign conventions, seminars, or similar types of meetings are disallowed unless it can be shown that the meeting is directly related to the taxpayer's trade or business activity and that it is reasonable for the meeting to be held outside North America. In addition, complex expense allocation rules are applied to business trips made outside the United States.[13]

SELF-STUDY QUESTION

Would the cost of going on a safari in Africa be deductible if the taxpayer were in the business of selling guns?

ANSWER

In an actual case, the Court held that the safari expenses were not sufficiently connected to the taxpayer's gun-selling business. Therefore, the safari costs were not deductible. *Vincent W. Eckel*, T.C. Memo 1974-33.

ADDITIONAL LIMITATIONS ON TRAVEL EXPENSES

IRC Section 274 also provides several limitations on the deductibility of certain types of travel expenses, including the following:

- Travel deductions are disallowed if the expenses are deductible only as a form of education. For example, a French language professor cannot deduct travel expenses to France if the purpose of the trip is to maintain a general familiarity with the French language and customs.
- Deductions allowed for luxury water travel (i.e., ocean liners, cruise ships, or other forms of water transportation) are limited to twice the highest per diem amount allowable for a day of domestic travel by employees in the executive branch of the federal government.
- Travel deductions to attend a convention, seminar, or meeting are not allowed if they are related to investment activities coming under Sec. 212. Expenses to attend a convention, seminar, or meeting are deductible if directly connected with a taxpayer's trade or business. However, expenses to attend such meetings on a U.S. cruise ship are deductible but only to a maximum amount of $2,000.

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[11] Sec. 274(m)(3).
[12] Secs. 274(c) and (h).
[13] Reg. Sec. 1.274-4. No allocation of total expenses is made to the personal-use (nondeductible) element if an individual is away from home for seven days or less or if less than 25% of the time is devoted to personal purposes. In all other cases, all of the foreign travel expenses (including transportation costs) must be apportioned between business and personal activities based on the relative percentage of time devoted to each activity.

EXAMPLE I:7-11 ▶ Dawn travels from Miami on a cruise ship to attend a business meeting in Bermuda. The round-trip cost of the cruise is $6,000, and the travel is for a period of four days. If the highest daily per diem amount is $400 for a government employee, the travel expenses related to the cruise ship are limited to $3,200 ($800 per day × 4 days travel). ◀

EXAMPLE I:7-12 ▶ Assume that Dawn in Example I:7-11 went on the cruise to attend a business seminar held on the cruise ship. In this case, Dawn's deductible expenses are limited to a maximum of $2,000. ◀

EXAMPLE I:7-13 ▶ Danielle is an investor in the stock market who attends investment counseling seminars. During the current year, she incurs $4,000 in travel expenses and $1,000 in registration fees to attend the seminars. None of the travel expenses are deductible because the expenses are related to income-producing activities coming under Sec. 212. The registration fees are not deductible as an investment expense because miscellaneous itemized deductions are not allowed after December 31, 2017. If Danielle was employed as a stockbroker (rather than an investor) and attended investment seminars, her travel expenses would be deductible as well as the registration fee. ◀

TRANSPORTATION EXPENSES

OBJECTIVE 4

Understand the deductibility of transportation expenses

The deductibility and classification of transportation expenses also depends on the nature of the expenditure, as follows:

- Transportation expenses related to a trade or business are deductible *for* AGI and are not subject to specific limitations.
- Transportation expenses related to rental real estate and royalty income (e.g., an owner-investor in rental properties) are deductible *for* AGI and are not subject to specific limitations.
- *Unreimbursed* employee transportation expenses are not deductible, as miscellaneous itemized deductions are not allowed.
- Commuting expenses are nondeductible personal expenses.

KEY POINT

The primary difference between travel expenses and transportation expenses for tax purposes is that travel expenses are broad in nature and include transportation, lodging, meals, and other necessary expenses, whereas transportation expenses include only the cost of transportation.

DEFINITION AND CLASSIFICATION

Transportation expenses include such items as taxi fares, automobile expenses, airline tickets, tolls, and parking fees incurred in a trade, business, or rental real estate activity. Generally speaking, transportation expenses are those incurred for "local transportation" and are not treated as travel expenses because the away from home requirements have not been met. The cost of commuting to and from a business location are non-deductible personal expenditures regardless of the length of the trip.

EXAMPLE I:7-14 ▶ Eurie, an independent contractor, calls on several customers at different locations in the metropolitan area during the course of the workday. Her transportation expenses (e.g., auto expenses, tolls, and parking) are deductible as transportation expenses because they are related to providing services in her business. She would deduct these expenses against her business income on Schedule C of Form 1040. If Eurie is required to travel away from home overnight, the transportation costs are included with meals and lodging and deducted as a travel expense. ◀

EXAMPLE I:7-15 ▶ David, an independent contractor, obtains a major new client located 80 miles from his principal residence. The new client will require David to spend at least four days a week at the client's office. He decides not to move to the new location and drives the 160-mile roundtrip each day. None of David's transportation expenses are deductible because they are personal commuting expenses. (Note: Because the job is a permanent assignment, it is for an indefinite period rather than a temporary period and the transportation expenses are not deductible as travel expenses.) ◀

ADDITIONAL COMMENT

The IRS takes the position that the hauling of equipment, tools, etc., in an automobile for business purposes does not make the commuting expenses deductible. This position is based on the Supreme Court's decision in *Donald W. Fausner v. CIR*, 32 AFTR 2d 73-5202, 73-2 USTC ¶9515 (USSC, 1973). The Court held that it was not possible to allocate the automobile expenses between nondeductible commuting expenses and deductible business expenses. However, if the taxpayer incurs additional costs, such as in renting a trailer, these additional costs are deductible.

The following exceptions or unusual circumstances should be noted:

- Transportation expenses incurred to go from one work location to another are deductible in 2019. If the self-employed individual goes home between jobs, the deduction is only the amount it would have cost him to go directly from the first location to the second.[14]
- Expenses are deductible *for* AGI if they are related to the production of rental or royalty income. Expenses connected with other investment-related activities are not deductible after 2017.
- Transportation expenses related to medical treatment may be deductible from AGI as a medical expense (subject to the limitations on the deductibility of medical expenses discussed in Chapter I:8).
- Transportation expenses related to charitable activities may be deductible as a charitable contribution (subject to the limitations on the deductibility of charitable contributions discussed in Chapter I:8).

EXAMPLE I:7-16 ▶ As shown in Figure I:7-1, Dick has two work locations that are 10 miles apart. Dick lives 5 miles from the first job site and 8 miles from the second job site. If Dick drives directly from Job 1 to Job 2, he may deduct the automobile costs associated with the 10-mile trip. If he goes home from the first job before driving to the second job, the deduction is still limited to 10 miles, even though he actually travels 13 miles. ◀

EXAMPLE I:7-17 ▶ Diana owns a duplex, which she rents to tenants. She periodically drives from her place of business to this income-producing property to collect the rents and to inspect the property. The transportation expenses are deductible *for* AGI as an expense related to the production of rental income. ◀

TREATMENT OF AUTOMOBILE EXPENSES

An employee or self-employed person may use either of two methods to deduct allowable automobile expenses. First, actual automobile expenses, including gas, oil, repairs, depreciation, interest, property taxes, license fees, and insurance are deductible based on the percentage of business miles to total miles. Detailed records to support the expenses are necessary in order to properly claim the deduction. To help reduce the burden of detailed recordkeeping, a second method, the standard mileage rate method, is available to taxpayers.

The standard mileage rate for business travel for the year 2019 is 58 cents per mile.[15] Parking and tolls for business purposes are allowed as an addition to this

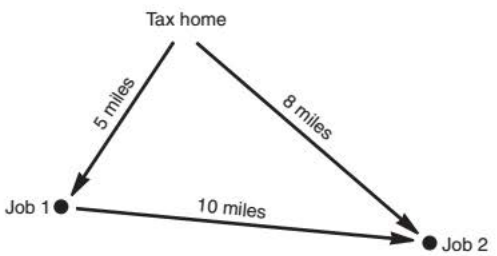


FIGURE I:7-1 ▶ ILLUSTRATION FOR EXAMPLE I:7-16

[14] IRS, *Publication No. 463* (Travel, Entertainment, Gift, and Car Expenses), 2019.

[15] IRS Notice 2019-2. The rate for 2018 was 54.5 cents per mile.

deduction as well as interest expense on an automobile loan and personal property taxes on the automobile. The following restrictions apply when the standard mileage rate is used:

- The standard mileage rate method cannot be used for automobiles used for hire, such as taxicabs, or for five or more automobiles used simultaneously by a taxpayer.
- If a taxpayer changes from the standard mileage rate method in one year to the actual expense method in a later year, the basis of the used automobile must be reduced by 26 cents per mile for 2019, by 25 cents per mile for 2018 and 2017, and by 24 cents for 2016 and 2015.[16] The modified accelerated cost-recovery system (MACRS) rules (discussed in Chapter I:10) cannot be used for computing depreciation in the year of the change and for the remaining useful life of the automobile. In such case, only the straight-line method under the alternative depreciation system (ADS) may be used (see Chapter I:10).
- A change to the standard mileage rate method is not allowed for an automobile that was previously depreciated under the MACRS rules or where an election was made under Sec. 179 to expense part or all of the automobile's cost in the year of acquisition. (See Chapter I:10 for a discussion of the Sec. 179 election.)
- The actual expense method is based on the ratio of business miles to total miles. (See Chapter I:10 for a discussion of specific restrictions on the computation of depreciation where mixed business- and personal-use automobiles are acquired.)

ADDITIONAL COMMENT

It should be remembered that in many cases the taxpayer can choose between the automatic mileage method and calculating the actual costs of operating the car. Although the automatic mileage method has the advantage of convenience, a calculation of the actual costs might produce a larger deduction.

STOP & THINK

Question: Assume a taxpayer uses her car (original cost, $20,000) in her business, drives a total of 15,000 miles per year, and can substantiate 80% of the mileage as business use. In general, will the taxpayer benefit more from the standard mileage method of deducting automobile expenses or from the actual expenses method?

Solution: In general, the actual expenses method will yield a slightly higher deduction. The AAA (American Automobile Association) estimates that it costs approximately 60.8 cents per mile to operate a medium-sized car in the United States based on driving 15,000 miles per year. Therefore, the actual cost of operating the automobile would be approximately $9,120 (15,000 miles × $0.608). The deductible amount for tax purposes would be 80% of $9,120, or $7,296 for the actual expense method. Compare this amount with the standard mileage amount of $6,960 (15,000 miles × 80% business usage × 0.58/mile) and the actual expenses method yields a slightly higher deduction. Of course, each individual situation is different and the actual results can vary based on circumstances, such as the amount of repairs, depreciation, and so on.

HISTORICAL NOTE

Congress enacted a "contemporaneous" records test for substantiating expenses for automobiles and certain other activities. Public outcry caused Congress to repeal this requirement. Currently, the business use of an automobile can be substantiated either by keeping adequate records or by sufficient corroborating evidence, oral or written.

EXAMPLE I:7-18 ▶ Danny owns and operates a taxicab in New York City and drives 90,000 miles per year. In deducting his automobile expenses, Danny must use the actual cost method. He is not permitted to use the standard mileage method as the taxicab is an automobile for hire. ◀

EXAMPLE I:7-19 ▶ Doug acquired an automobile for use in his unincorporated business in 2016 and used the standard mileage rate method in 2016–2018. If Doug switches to the actual expense method for 2019 and later years, the automobile's adjusted basis (for depreciation purposes) must be reduced by 25 cents for 2018 and 2017 and 24 cents for 2016. Thus, if the automobile originally cost $20,000 in 2016 and was used 10,000 miles for business purposes during the initial year and 15,000 miles each in 2017 and 2018, the adjusted basis for computing depreciation in 2019 is reduced to $10,100 {$20,000 − [(0.24 × 10,000) + (0.25 × 15,000) + (0.25 × 15,000)]}. The remaining $10,100 basis must be depreciated using straight-line depreciation over the automobile's estimated useful life if the actual expense method is used. ◀

[16] The depreciation component of the mileage rate for earlier years was 22 cents per mile for 2014 and 23 cents per mile for 2013 and 2012.

EXAMPLE I:7-20 ▶ Edith uses her automobile 60% of the time for business use and 40% for personal use. These percentages are substantiated by records that document the total usage for the automobile. During 2019, Edith drives 3,000 miles per month or a total of 36,000 miles for the year. If the standard mileage rate method is used, she can deduct $12,528 [(0.58 × 36,000 miles) × 60%] for the business and employment-related use. Additionally, Edith may deduct any business-related parking fees and tolls. ◀

ADDITIONAL COMMENT

The kind of written record that could corroborate the business use of an automobile would include account books, diaries, logs, trip sheets, expense reports, or written statements from witnesses.

MEALS AND ENTERTAINMENT EXPENSES

OBJECTIVE 5

Understand the deductibility of business meals and the 50% disallowance rule

The deduction for meals and entertainment has been severely curtailed for expenses incurred after December 31, 2017 through the year 2025. First of all, entertainment expenses of any type are disallowed. This disallowance has had a major effect on many businesses for which entertainment of customers is an important part of their businesses. Second, business meals continue to be deductible for businesses, although only 50% of the meals are deductible. So, a self-employed individual, as well as other types of businesses such as corporations, LLCs, etc., can deduct 50% of business meals. However, any portion of a meal that is considered entertainment is not deductible. Additional details on business meals are discussed below.

REAL-WORLD EXAMPLE

One common way business people document a business meal is to write on the back of the credit card receipt the other person(s) at the meal and the topic discussed. Then all of the necessary substantiation requirements are present on the one piece of paper: date, time, place, amount, people present, and business discussed.

BUSINESS MEALS

Business meals continue to be deductible under Sec. 162, subject to the 50% limit, and are also subject to the recordkeeping requirements under Sec. 274. Sec. 274 imposes stringent substantiation rules, such as the purpose of the meal, the persons that attended the meal, the amount of the meal, and the date of the meal. Each expenditure must contain this information; lack of documentation alone will cause the disallowance of a deduction. Because meals are so closely associated with entertainment, the Treasury Department intends to issue proposed income tax regulations to clarify when business meals are nondeductible entertainment expenses under Sec. 274 and when they are tax-deductible. Until proposed regulations are issued, the IRS has issued Notice 2018-76,[17] which taxpayers may rely on for guidance in this area until the proposed regulations are issued. The Notice is discussed below, but it should be noted that the Sec. 274 requirements do not apply to a business meal associated with travel where the taxpayer is away from home overnight and claims a deduction only for his or her own expenses.

Notice 2018-76 sets forth five requirements for a taxpayer to deduct 50% of a business meal expense:

1. The expense is an ordinary and necessary expense incurred in carrying on a trade or business.
2. The expense is not lavish or extravagant under the circumstances.
3. The taxpayer, or an employee of the taxpayer, is present in the furnishing of the food or beverages.
4. The food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact.
5. If food and beverages are provided during or at an entertainment activity, a deduction is only allowed if the food and beverages are either paid for separately or are stated separately from the cost of the entertainment.

The Notice provides a number of illustrations concerning how these rules apply. Basically, if the meal is provided to a bona fide business customer or client and the meal is not merely social or personal, the cost of the meal would be 50% deductible as long as the taxpayer maintains sufficient records to meet the Sec. 274 substantiation rules. Further, if food and beverages

[17] Notice 2018-76, 2018-42 IRB 599, 10/03/2018

WHAT WOULD YOU DO IN THIS SITUATION?

You have recently acquired a new individual tax client, Joe Windsack, who is a manufacturer's representative for a local tool and die company. You have been engaged by Windsack to prepare his individual income tax return for the current year. Before the current tax year is over, you are at a party where Windsack is also a guest. You overhear Windsack bragging to a group of people that he substantially reduces his income tax liability by overstating meal expenses. He indicated that he overstates the deductions in several ways: (1) when he goes out to lunch or dinner that is personal in nature, such as with his family, he always uses a credit card and fictitiously writes the name of a client or prospective client on the charge card receipt, and (2) when he goes out to lunch with several colleagues from his office (not business related), he charges the entire amount on his credit card (for everyone at the table), collects the cash from his colleagues for the cost of their meals, and then writes the entire amount off as a business-related meal. When Windsack brings his tax information to you a couple of months later and you see a substantial amount of meal expenses, what should you do?

are consumed before, during, or after an entertainment event, the cost of the meals must be separately paid for or separated from the cost of the entertainment.

EXAMPLE I:7-21 ▶ Toby, a CPA, invites an important client in the insurance business to a basketball game. Toby purchases the tickets to attend the game in a suite where they have access to food and beverages that are not lavish or extravagant in the circumstances. The cost of the tickets, as stated on the invoice, includes the food and beverages. Because the basketball game is considered entertainment and the food and beverage cost is not separately-stated, Toby is not allowed a deduction for the cost of the tickets. Alternatively, if the invoice for the tickets separately-stated the cost of the food and beverages, Toby could deduct the cost of the food and beverages but not the basketball game. ◀

EXAMPLE I:7-22 ▶ Hank is a salesman for a manufacturing supply company. Hank meets Harold, a purchasing agent who is an important customer, for lunch during a normal business day. Business is actually conducted during the lunch, and the lunch expenses are not lavish or extravagant under the circumstances. Hank spends $50 and maintains documentation of the details of the lunch. The business meal qualifies as a deduction because the meal involved the actual conduct of business where some business benefit is reasonably expected and a business discussion was conducted during the meal. Hank may deduct $25 ($50 × 0.50) of business meal expenses. ◀

EXAMPLE I:7-23 ▶ Susan is a self-employed individual and lives in Louisville, Kentucky. She travels to Las Vegas to attend a business conference for three days. During the three-day conference, Susan eats alone, and the cost of her meals was $450. Since Susan meets the away from home test, she can deduct $225 ($450 × 50%). ◀

PER DIEM ALLOWANCES FOR MEALS AND LODGING

The IRS permits businesses and self-employed individuals to use optional "per diem allowances" for meals and lodging expenses in lieu of actual expenses. The use of per diem allowances is intended to simplify the burden of keeping detailed records for taxpayers who incur significant travel expenses. Special tables have been issued by the IRS that provide fixed per diem amounts for lodging as well as meals and incidental expenses (M&IE). The per diem allowances vary in amount depending on the city in which the travel took place. The tables list many cities in the United States as well as many cities in foreign countries. Thus, a taxpayer must only substantiate the time, place, and business purpose of the trip and then is permitted to use the per diem allowances. Under the per diem system, the expenses must be reasonably expected to be incurred, and the amount of expenses should be in reasonable proximity to the expected actual expense amount.[18] A full discussion of this topic is outside the scope of this text.

[18] The IRS tables for per diem allowances paid on or after October 1, 2018, may be found in Notice 2018-77, 2018-42 IRB, or IRS Publication 1542, which is periodically updated. The rate for travel on or after October 1, 2018 for high-cost localities (specifically identified by the IRS) is $287 per day (consisting of $216 for lodging and $71 for M&IE); all other localities are $195 per day (including $60 for M&IE). Further, self-employed individuals who are not reimbursed for their travel expenses may use the M&IE rate, but must substantiate lodging with actual receipts.

EXAMPLE I:7-24 ▶ Peyton Boying is a self-employed individual and travels extensively in the United States for business purposes. Instead of keeping actual records of his travel expenses, Peyton uses the per diem amounts as allowed by the IRS. Assuming Peyton traveled exclusively in high-cost localities (see footnote 18) and was away from home for 100 days, Peyton could deduct $28,700 (100 days × $287) without the necessity of Peyton keeping detailed receipts of his actual travel expenses. The amount that Peyton actually spent is irrelevant as the IRS will accept the per diem amounts. However, Peyton is required to keep records of the time, place, and business purpose of each trip. ◀

BUSINESS GIFTS

Business gifts are deductible but are subject to an annual ceiling amount of $25 per donee.[19] Amounts in excess of the $25 limit per donee are disallowed. The following rules and exceptions apply to determine the business gift deduction:

- Multiple gifts to each donee are aggregated for purposes of applying the $25 per donee annual limitation. Husbands and wives and other family members are treated as a single donee.
- Employee achievement awards made for length of service or safety that are under $400 per individual are excluded.[20]
- A gift from an employee to his or her supervisor does not qualify as a business gift because such gifts are personal rather than business related and are, therefore, not deductible.
- Business gifts are not subject to the 50% reduction for meals and entertainment.

EXAMPLE I:7-25 ▶ Jack, an employee, makes the following gifts during the year, none of which are reimbursed by his employer:

Jack's immediate supervisor	$20
Jack's secretary	15
Jeff (a customer of Jack's)	24
Jeff's wife (a noncustomer)	26
Total	$85

Jack's total deduction for business gifts is $40 ($15 + $25) and is classified as a miscellaneous itemized deduction subject to the 2% nondeductible floor as an employee business expense. The $20 gift to Jack's immediate supervisor is not deductible. The gifts of $24 and $26 to Jeff and Jeff's wife must be aggregated and are limited to $25. ◀

REAL-WORLD EXAMPLE

A taxpayer who had deducted the full cost of two wedding gifts, both of which were in excess of $25 apiece, was able to deduct only $25 for each gift. *Jack R. Howard,* 1981 PH T.C. Memo ¶81,250, 41 TCM 1554.

MOVING EXPENSES

OBJECTIVE 6

Identify deductible moving expenses

Prior to enactment of the TCJA 2017, employees and self-employed individuals were allowed to deduct moving expenses in connection with their job or business. There were distance and time requirements, and only direct moving costs were deductible. The moving expense deduction was a *for* AGI deduction. For years 2018–2025, moving expenses are allowed only for members of the Armed Forces of the United States on active duty who move pursuant to a military order and incident to a permanent change of station. The distance and time requirements are not applicable to moves of members of the Armed Forces, and reimbursements for the move are not included in the member's gross income. Unless legislative changes are made in the interim, moving expenses for employees and self-employed individuals will again be deductible beginning in 2026.

[19] Sec. 274(b)(1).

[20] Sec. 274(j). The total limit including both qualified and nonqualified plan awards is $1,600 per individual (see Chapter I:4).

EDUCATION EXPENSES

OBJECTIVE 7

Describe the requirements for deducting education expenses

Most of the education provisions that existed prior to 2018 were not affected by the TCJA 2017. Two changes were made: (1) education expenses allowed to a taxpayer in pursuit of an employment-related activity were deductible prior to 2018 as a miscellaneous itemized deduction subject to the 2% of AGI floor. Since miscellaneous itemized deductions have been suspended, these education expenses are not deductible for employees in 2018. They continue to be deductible for self-employed taxpayers. (2) Section 529 plans have always only applied to post-secondary education expenses (college expenses). Beginning in 2018, Sec. 529 plans are now allowed to be for Kindergarten–12th grade school expenses up to $10,000 per year per student.

Generally, education expenses are considered personal expenses and, therefore, are not deductible despite the obvious benefits that accrue to society from the pursuit of such activities. However, education expenses that are necessary in the pursuit of a trade or business activity are deductible. It would be inequitable if such educational expenditures were not deductible because they are incurred to produce income from business activities. The education expenses discussed in this chapter pertain to expenses that are related to a trade or business of a self-employed individual. However, there are a number of other provisions in the tax law that provide favorable tax advantages for education expenses. Most of these rules are covered elsewhere in this textbook; however, the major tax provisions dealing with education are summarized below.

ADDITIONAL COMMENT

Attendance at a convention or professional meeting is one of the most common deductible education expenses. Almost every profession or occupation has its own society or association. Often these organizations sponsor local, regional, or national meetings. Training sessions or other types of educational activities are normally included on the program.

- Tax credits—two important provisions benefiting education are the American Opportunity Tax Credit and the Lifetime Learning Credit. Both of these items are credits and are available for the taxpayer and his dependents and are discussed in Chapter I:14.
- Exclusion for scholarships—scholarships received by students are generally excludable from gross income under Sec. 117. See the discussion of scholarships in Chapter I:4.
- Educational assistance for employees—if an employer maintains an educational assistance plan, amounts received by the employee for tuition and other expenses are excludable from the employee's gross income under Sec. 127. This exclusion is also discussed in Chapter I:4.
- Student loan interest—a *for* AGI deduction is permitted for certain student loan interest under Sec. 221. (See Chapter I:6 for a further discussion of this topic.)
- Qualified state tuition programs—a very popular program for higher income taxpayers is the use of so-called Section 529 plans. These plans allow taxpayers to invest funds to be used for education and the income earned on such funds is not subject to tax. When amounts are withdrawn from the plan, the amounts are also not taxable if used for qualified education expenses. As mentioned earlier, Sec. 529 plans have only been available for post-secondary expenses prior to 2018. Pursuant to the TCJA 2017, Sec. 529 plans can now make qualified distributions for K–12 school expenses up to $10,000 per year. These plans are discussed in Chapter I:4.
- Coverdell Education IRA—these special IRAs are discussed later in this chapter and enable a taxpayer to invest up to $2,000 per year in a tax-deferred IRA.

CLASSIFICATION OF EDUCATION EXPENSES

Depending on the nature of the education-related activity, educational expenses may be either personal and nondeductible or deductible *for* AGI. Education expenses for a taxpayer that are not related to a trade or business are not deductible under Reg. Sec. 1.162-5. Such amounts may be eligible for the American Opportunity Tax Credit or the Lifetime Learning Credit as discussed in Chapter I:14. Self-employed individuals may deduct education expenses on Schedule C if they meet the requirements discussed below. Table I:7-2 illustrates the implications of education expenses for some common scenarios.

▼ TABLE I:7-2
Classification and Tax Treatment of Educational Expenses Under Reg. Sec. 1.162-5 and Sec. 127

Situation Facts	Classification and Tax Treatment
▶ Jeremy is a college student and is pursuing a general course of study.	▶ The expenses are nondeductible personal expenditures regardless of whether Jeremy or his parents pay them.
▶ Irene is an employee who incurs certain employment-related educational expenses including travel, transportation, tuition, and books.	▶ The expenses are nondeductible personal expenditures, regardless of who pays for them.
▶ Jesse is an employee who receives educational assistance payments from his employer to reimburse him for certain educational expenses incurred in attending college at the undergraduate level.	▶ Educational assistance payments up to $5,250 per excluded from Jesse's gross income and are deductible by the employer as trade or business expenses if the requirements of Sec. 127 are met.[21]
▶ Jackie is a self-employed CPA who incurs education expenses including travel, transportation, books, registration fees, and so on to attend a continuing education conference.	▶ All of the education expenses are deductible *for* AGI as trade or business expenses.

GENERAL REQUIREMENTS FOR A DEDUCTION

TYPICAL MISCONCEPTION

Education costs include the cost of books, tuition, registration fees, and supplies. Transportation costs and travel costs are also included.

An employee generally may deduct education expenses if either of the following two requirements are met:[22]

- The expenditure is incurred to maintain or improve skills required by the individual in his or her trade or business; or
- The expenditure is incurred to meet requirements imposed by law for retention of business, rank, or compensation rate.

Even if one of the two requirements above are met, education expenses are not deductible if:

- The education is required to meet minimum educational requirements for qualification in the taxpayer's trade or business; or
- The education qualifies the taxpayer for a new trade or business.



ETHICAL POINT

A client asks advice from his CPA as to whether certain educational expenses are deductible. The CPA should inform the client that the advice reflects professional judgment based on an existing situation. The CPA should use cautionary language to the effect that the advice is based on facts as stated and authorities that are subject to change.

The above income tax regulation applies to both employees and self-employed individuals. Because the education expenses for employees are treated as a miscellaneous itemized deduction, such expenses are not deductible for the years 2018–2025. Self-employed individuals, however, can continue to deduct these expenses if they meet the tests contained in Reg. Sec. 162-5 as discussed below.

The deductibility of education expenses has been a frequent source of controversy and litigation because of the uncertainty in interpreting the above Regulations. The principal area of disagreement has been the interpretation of the term "qualifies the taxpayer for a new trade or business." If a taxpayer undertakes education and that education will *qualify* her for a new trade or business, then her expenses will not be deductible. For example, several courts have disallowed deductions to IRS agents and accountants for educational expenses incurred in obtaining a law degree, even though such training would be helpful in the taxpayer's employment.[23] The courts reasoned that the taxpayers were qualifying for a new profession (i.e., the practice of law). However, the IRS has ruled that a practicing dentist may deduct educational expenses in becoming an orthodontist under the theory that a dentist becoming an orthodontist is not entering a new trade or business.[24]

[21] The Sec. 127 exclusion is applicable for expenses paid by an employer for courses taken by employees. Qualified expenses include tuition, fees, and related expenses. Both undergraduate and graduate-level courses qualify for the exclusion.

[22] Reg. Sec. 1.162-5.
[23] *Jeffry L. Weiler,* 54 T.C. 398 (1970).
[24] Rev. Rul. 74-78, 1974-1 C.B. 44.

STOP & THINK

Question: The Regulations clearly provide that if the education "qualifies" a taxpayer for a new trade or business, the cost of such education is not deductible. If taken to the extreme, could the IRS argue that *any* course would qualify an individual for a new trade or business? For example, if a person took a basket weaving course, could not the IRS argue that the person is now qualified for the new trade or business of basket weaving? How can a taxpayer support his position that the education does not qualify him for a new trade or business in order to meet the deductibility requirements?

Solution: This is a difficult question and many commentators have written that the Regulations are unfairly harsh toward taxpayers. The courts have required that the IRS be "reasonable" in its interpretations of qualification of a new trade or business. The best way for a taxpayer to support his position is to find a case where the facts are approximately the same as the taxpayer's and where the court has upheld the taxpayer's position in that case.

ADDITIONAL COMMENT

The same course could be deductible as a qualified educational expense or not depending on the particular situation of the student. For example, a CPA enrolled in a taxation course to update his or her tax knowledge could deduct the expense. On the other hand, a non-CPA taking the course as part of a series of courses meeting the requirements to sit for the CPA exam could not deduct the expense. The CPA has already met the minimum education requirements for the profession and the non-CPA has not.

EXAMPLE I:7-26 ▶ Jane is a self-employed dentist who incurs education expenses attending a continuing education conference on new techniques in her field. Such expenditures are incurred to maintain or improve her skills as a practicing dentist (a trade or business activity). All of her educational expenses are deductible *for* AGI because Jane is currently engaged in a trade or business activity. ◀

EXAMPLE I:7-27 ▶ Juan is a business executive who incurs education expenses in the pursuit of an MBA degree in management. None of the expenses are reimbursed by Juan's employer. Under prior law, the expenses would have been deductible because they were incurred to maintain or improve Juan's skills as a manager and do not qualify Juan for a new trade or business. An MBA degree has been held to not qualify a taxpayer for a new trade or business. Since the deduction was a miscellaneous itemized deduction, it is not deductible in years 2018–2025. ◀

EXAMPLE I:7-28 ▶ Jean is self-employed and operates her own bookkeeping firm. She incurs expenses in connection with taking the CPA examination (e.g., CPA review course fees, travel, and transportation). Even though the expenditures may improve her business-related skills, they are not deductible because they are incurred to meet the minimum educational standards for qualification in Jean's accounting position.[25] ◀

EXAMPLE I:7-29 ▶ Joy is self-employed and a tax accountant who incurs expenses to obtain a law degree. Despite the fact that the law school courses may be helpful to Joy to maintain or improve her skills as a tax practitioner, such expenses are not deductible because the taxpayer is qualifying for a new trade or business. If Joy were not a degree candidate at the law school and merely took a few tax law courses for continuing education, the educational expenses would be deductible because they are incurred to maintain or improve Joy's skills as a tax specialist and do not qualify her for a new trade or business. In such a case, the expenses are deductible *for* AGI as Joy is self-employed. ◀

KEY POINT

The deduction for travel expenses is not permitted if the travel itself is the educational activity. Therefore, a high school teacher who teaches Spanish cannot deduct expenses incurred in living in Madrid during the summer.

OFFICE IN HOME EXPENSES

OBJECTIVE 8

Determine whether the expenses of an office in home meet the requirements for deductibility and apply the gross income limitations

Prior to 2018, office in home expenses for employees were classified as miscellaneous itemized deductions subject to the 2% of AGI floor. The TCJA 2017 suspended the deductibility of miscellaneous itemized deductions for 2018. Therefore, for employees, the office in home deductions are not allowed for years 2018–2025. Self-employed individuals who claim office in home expenses are unaffected by the TCJA 2017. Qualified office in home expenses can be claimed as a *for* AGI deduction by these taxpayers.

Qualified self-employed individuals who use a portion of their home for trade or business activities should be entitled to a deduction because the property is used for trade or business activities. When a self-employed taxpayer's only office is located in his home, the office in

[25] Rev. Rul. 69-292, 1969-1 C.B. 84.

home deduction should be straightforward and allowed for tax purposes. However, where a self-employed taxpayer has a separate office at a location outside his home as well as a home office, it is often difficult to determine whether the taxpayer is using the home office for business or personal use.

For many years, there has been an ongoing controversy in the tax law as to the deductibility of office in home expenses. Because of the possibility of abuse by taxpayers, the IRC, Treasury Regulations, and the courts[26] have been extremely strict as to who qualifies to deduct office in home expenses. In order to promote fairness and consistency in the tax law, the definition of an office in home that qualifies for a tax deduction was expanded in 1998.

ADDITIONAL COMMENT

Approximately 27 million individuals, or 19% of the work force, work at least part-time at home.

GENERAL REQUIREMENTS FOR A DEDUCTION

Self-employed individuals are permitted to deduct office in home expenses only if the office is exclusively used on a regular basis under any of the following conditions:

- The office is used as the principal place of business for *any* trade or business of the taxpayer;
- The office is used as a place for meeting or dealing with patients, clients, or customers in the normal course of business; or
- If the office in home is located in a separate structure which is not attached to the dwelling unit, the office is used exclusively and regularly in connection with the taxpayer's trade or business.[27]

The first condition above has caused the major controversy in this area. Taxpayers are required to prove that the office is used exclusively as the "principal place of business." Under prior law, the principal place of business was interpreted to mean the "most important or significant place for the business," or more precisely, where the primary services were performed.

EXAMPLE I:7-30 ▶ In the *Soliman* case, Dr. Soliman was a self-employed anesthesiologist who performed medical services at three hospitals, none of which provided him with an office. He spent approximately two hours per day in his office in home where he maintained patient records and correspondence and he performed billing procedures. The office was not used as a place for meeting with or dealing with patients, clients, or customers in the normal course of his business. The U.S. Supreme Court denied a deduction for Dr. Soliman's office in home because it concluded that the essence of professional service rendered by the doctor was the actual medical treatment in the hospitals. A second factor considered by the court was the amount of time spent at the office relative to the total work effort. The effect of this case was to deny a deduction for an office in home for any type of taxpayer in a trade or business where the primary services were performed outside of the office (such as plumbers, electricians). This case was highly criticized. ◀

To combat the perceived unfairness of the *Soliman* case, Congress expanded the definition of "principal place of business." An office in home now qualifies as a taxpayer's principal place of business if:

1. the office is used by the taxpayer for *administrative or management* activities of the taxpayer's trade or business, and
2. there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.[28]

KEY POINT

The office-in-home deduction is available only where the office is being used for trade or business purposes. No deduction is permitted if the office is used to carry on investment activities.

Thus, the law essentially allows a deduction for an office in home even though the taxpayer provides his primary service away from the office. The above tests are clearly intended for self-employed taxpayers.

EXAMPLE I:7-31 ▶ David is a self-employed electrician who performs his electrical services at the location of his customers. He also maintains an office where he does his administrative and management duties. David is permitted a deduction for an office in home even though his primary duties of providing electrical services are performed away from his office. ◀

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[26] See, for example, *CIR v. Nader E. Soliman*, 71 AFTR 2d 93-463, 93-1 USTC 50,014 (USSC, 1993).

[27] Sec. 280A(c)(1).

[28] Ibid. For years before 1999, this new definition of principal place of business does not apply. Thus, the restrictive rules promulgated by *Soliman* apply to these years.

DEDUCTIONS AND LIMITATIONS

The deduction for home office expenses is computed using the following two categories of expenses: (1) Expenses directly related to the office, and (2) Expenses indirectly related to the office.

Direct expenses include expenses that relate solely to the office, such as painting and decorating just the office. Indirect expenses are the pro rata share of expenses that benefit the entire house or apartment, such as mortgage interest (or rent), real estate taxes, insurance, utilities, and maintenance. The office in the home expense is the sum of the direct expenses plus the pro rata share (generally based on square footage) of indirect expenses.

To compute the office in home deduction, taxpayers first subtract all expenses not connected with the office from the income generated by the business. Then, 100% of the direct expenses of the office and the percentage of indirect expenses based on the pro rata share of the house are deducted. The total of the office in home expenses cannot create a loss.

EXAMPLE I:7-32 ▶

Julie, a self-employed individual, operates a mail order business out of her home and maintains an office in her home that is used exclusively for business. The size of her home in total is 2,400 square feet and her office is 300 square feet. During the current year, she generated gross income of $18,000 and had $6,000 of direct business expenses, supplies, and shipping charges. She also had the following expenses in connection with the office in her home:

Painting of office	$ 600
Decorations in office	900
Mortgage interest (total)	3,200
Real estate taxes (total)	1,800
Insurance (total)	600
Utilities (total)	2,400
Depreciation (total)	800

Julie's home office expense for the current year would be computed as follows:

Direct expenses:		
Painting	$ 600	
Decorations	900	$1,500
Indirect expenses:		
Mortgage interest	3,200	
Real estate taxes	1,800	
Insurance	600	
Utilities	2,400	
Depreciation	800	
	8,800	
Business percentage (300/2,400)	×12.5%	1,100
Total expense for office in home		$2,600

Julie would be allowed to deduct the $2,600 of office in home expenses as they do not exceed the $12,000 ($18,000 – $6,000) of income from the business. If Julie only had $8,000 of gross income and $6,000 of business expenses, her office in home expenses of $2,600 would be limited to $2,000. ◀

TAX STRATEGY TIP

When a taxpayer depreciates his office in the home, the office becomes business property. Upon the sale of the residence, the portion of the sale price attributable to the office will not be eligible for the sale of principal residence exclusion. Therefore, taxpayers might consider only deducting direct expenses of an in-home office to preserve the exclusion.

TYPICAL MISCONCEPTION

Where a taxpayer is not entitled to an office-in-home deduction, the taxpayer can still deduct directly related business expenses (e.g., the cost of office supplies, and a MACRS deduction on filing cabinets and other equipment).

As mentioned above, the total allowable office in home expenses may not exceed the taxpayer's net income from the business (or rental) activity.[29] This ceiling limitation on office in home deductions is intended to prevent taxpayers from recognizing tax losses if the business (or rental) activity does not produce sufficient amounts of gross income. Expenses disallowed because of the gross income limitation can be carried forward but are subject to the gross income limitation in the later year and are subject to specific ordering rules.[30]

[29] Sec. 280A(c)(5). Technically, the limitation is gross income less deductions not connected with the home office.

[30] See Prop. Reg. Sec. 1.280A-2 for the ordering rules. These rules are similar, but not identical to the ordering rules for hobby losses under Sec. 183, as follows: (1) mortgage interest and real estate taxes; (2) other deductions related to the office, such as insurance and utilities; and (3) depreciation.

In 2013, the IRS issued rules that provide for an optional safe harbor that individuals can use to determine the amount of their deductible home office expenses. This safe harbor is effective for tax years beginning on or after January 1, 2013, and the same strict rules as to eligibility for a home office deduction, as discussed previously, will continue to apply. The safe harbor allows taxpayers the option of claiming as their home office deduction $5 times the square feet of qualified use (300 square feet maximum), for a maximum total deduction of $1,500. Taxpayers can alternate the use of the actual expenses or the safe harbor amount each year. So, taxpayers will need to analyze each year which method to use and claim the greater amount.

PART II: DEFERRED COMPENSATION

OBJECTIVE 9

Discuss the tax treatment and requirements for various deferred compensation arrangements

Various types of benefit plans providing favorable tax treatment are available to employees and self-employed individuals. These tax benefits are provided to stimulate savings accumulations necessary for retirement. Private retirement plans should be the primary source of retirement with the Social Security system as a supplement, although in recent years, more and more retirees rely increasingly on Social Security. Favorable tax consequences generally include the following benefits:

- Deferral of taxes on amounts contributed to retirement plans until the individual retires or receives a distribution from the plan
- An immediate deduction for contributions to qualified retirement plans for the employer or self-employed individual
- Deferral of taxation on income earned on retirement plan assets
- Tax-free distributions from certain types of plans (Roth-type plans)

This section discusses *deferred compensation arrangements* including qualified pension and profit sharing plans, nonqualified deferred compensation arrangements, and self-employed retirement plans and individual retirement accounts (IRAs).

QUALIFIED PENSION AND PROFIT-SHARING PLANS

ADDITIONAL COMMENT

The Staff of the Joint Committee on Taxation estimates the revenue loss resulting from the deferral of taxes on contributions and earnings for qualified employer plans, individual retirement plans, and Keogh plans for 2012 will approximate $138 billion. This provision represents one of the largest tax expenditures of the federal government and is designed to encourage employers to establish retirement plans for their employees.

The federal tax law provides favorable tax benefits for *qualified* pension and profit- sharing plans. A **qualified plan** is one that must meet strict requirements, such as not discriminating in favor of highly compensated individuals, be formed and operated for the exclusive benefit of employees, and meet specified vesting and funding requirements. In a qualified plan, both the employer and employee receive significant tax benefits, as follows:

Employer: receives an immediate tax deduction for pension and profit-sharing contributions made on behalf of employees.

Employee: is not taxed on either employer or employee contributions or earnings of the plan assets until funds are withdrawn from the plan at retirement.[31] Thus, funds invested in a qualified plan grow tax-free during an employee's working years. Alternatively, in recent years, Roth-type plans do not allow a deduction for the employee, but all distributions at retirement age can be withdrawn completely tax free.

Types of Plans. Qualified plans[32] include:

- Pension plans
- Profit-sharing plans (including Sec. 401(k) plans)
- Stock bonus plans, including employee stock ownership plans (ESOPs)

[31] An employee may not be liable for federal income taxes but may be subject to Social Security taxes and possibly local or city income taxes.

[32] Qualified plans are generally covered in Secs. 401-417 of the IRC.

Pension Plans. The features that distinguish a **qualified pension plan** *include the following:*

- Systematic and definite payments are made to a pension trust (without regard to profits) based on formulas or actuarial methods.
- A pension plan may provide for incidental benefits such as disability, death, or medical insurance benefits.

A pension plan may be either contributory or noncontributory. Under a **noncontributory pension plan**, the contributions are made solely by the employer. Under a **contributory pension plan**, the employee makes voluntary contributions into the plan that supplement any contributions made by the employer.

Pension plans also may be either defined contribution plans or defined benefit plans. In a **defined contribution pension plan**, a separate account is established for each participant and certain amounts are contributed based on a specific formula (e.g., a specified percentage of compensation). The benefits payable to the participant at retirement are based on the value of the participant's account (including the amount of earnings that accrue to the account) at the time of retirement.

EXAMPLE I:7-33 ▶ Alabama Corporation establishes a qualified pension plan for its employees that provides for employer contributions equal to 8% of each participant's salary. Retirement payments to each participant are based on the amount of accumulated benefits in the employee's account at the retirement date. The pension plan is a defined contribution plan, because the contribution rate is based on a specific and fixed percentage of compensation. ◀

KEY POINT

The trend for most companies in the U.S. is away from defined benefit plans and toward defined contribution plans. Defined contribution plans usually are less costly and the employer liability is fixed at the date of contribution rather than at some future date.

Defined benefit plans establish a contribution formula based on actuarial techniques that are sufficient to fund a fixed benefit amount to be paid upon retirement. For example, a defined benefit plan might provide fixed retirement benefits equal to 40% of an employee's average salary for the five years before retirement.

A distinguishing feature of a defined benefit plan is that forfeitures of unvested amounts (e.g., due to employee resignations) must be used to reduce the employer contributions that would otherwise be made under the plan. In a defined contribution plan, however, the forfeitures related to unvested amounts may either be reallocated to the other participants in a nondiscriminatory manner or used to reduce future employer contributions.

Profit-Sharing Plans. A qualified **profit-sharing plan** also may be established by an employer in addition to, or in lieu of, a qualified pension plan arrangement. Profit-sharing plans include the following distinguishing features:

- A definite, predetermined formula must be used to allocate employer contributions to individual employees and to establish benefit payments.
- Annual employer contributions are not required, but substantial and recurring contributions must be made to satisfy the requirement that the plan be permanent.
- Employees may be given the option to receive cash that is fully taxable as current compensation or to defer taxation on employer contributions by having such amounts contributed to the profit-sharing trust. Plans of this type are called Sec. 401(k) plans.[33]
- Forfeitures arising under the plan may be reallocated to the remaining participants to increase their profit-sharing benefits, provided that certain nondiscrimination requirements are met.
- Lump-sum payments made to an employee before retirement may be provided following a prescribed period for the vesting of such amounts.
- Incidental benefits such as disability, death, or medical insurance may also be provided in a profit-sharing arrangement.

Roth-Type Plans. **Roth-type plans** are a special type of back-loaded plan. Under such a plan, a taxpayer does not receive a current deduction for any current contribution to the plan, but does not include any qualified distribution from the plan in gross income. The best known of this type of plan is a Roth IRA which was first enacted in 1998 and very

[33] Sec. 401(k).

popular today. A discussion of Roth IRAs is presented later in this chapter. More recently, in 2006, Congress extended the Roth concept to Sec. 401(k) plans where employees can contribute funds to a Roth 401(k) plan.[34] Similar to Roth IRAs, the employee receives no current tax deduction, but all contributions plus all earnings in the plan grow tax-free. Thus, any qualified distributions (generally, distributions after age 59½) are received tax-free by taxpayer. Participants in 401(k), 403(b), or 457 plans are permitted to roll over amounts in the plan to a "qualified Roth contribution program" for tax years after December 31, 2012.

Stock Bonus Plan. A **stock bonus plan** is a special type of defined contribution plan whereby the investments of the plan are in the employer-company's own stock. The employer makes its contribution to the trust either in cash or in stock. If in cash, the amounts are invested in the company's stock. The stock is allocated and subsequently distributed to the participants. Stock bonus plan requirements are similar to profit-sharing plans. An **employee stock ownership plan (ESOP)** is a type of qualified stock bonus plan.[35] An ESOP, funded by a combination of employer and employee contributions and plan loans, invests primarily in employer stock. The stock is held for the benefit of the employees. ESOPs are attractive because the employer is allowed to reduce taxable income by deducting any dividends that are paid to the participants (or their beneficiaries) in the year such amounts are paid and are taxable to the participant. For employer securities acquired by the ESOP, the dividends-paid deduction is limited to dividends paid on employer stock acquired with an ESOP loan.

ADDITIONAL COMMENT

The tax law with respect to qualified pension and profit-sharing plans is extremely complex. A detailed study of these provisions is beyond the scope of this text.

QUALIFICATION REQUIREMENTS FOR A QUALIFIED PLAN

Qualified pension, profit-sharing, and stock bonus plans must meet complex qualification rules and requirements to achieve and maintain their favored qualifying status. A summary of the important requirements are discussed below.

- Section 401(a) requires that the plan must be for the employee's exclusive benefit. For example, the trust must follow prudent investment rules to ensure that the pension benefits will accrue for the employees' benefit.
- The plan may not discriminate in favor of highly compensated employees. Highly compensated employees are employees who meet either of two tests: (1) own more than 5% of the corporation's stock in either the current or prior year or (2) receive compensation of greater than $125,000 in the prior year.[36]
- Contributions and plan benefits must bear a uniform relationship to the compensation payments made to covered employees. For example, if contributions for the benefit of the participants are based on a fixed percentage of the employee's compensation (e.g., 4%), the plan should not be disqualified despite the fact that the contributions for highly-compensated employees are greater on an actual dollar basis than those for lower-paid individuals.
- Certain coverage requirements that are expressed in terms of a portion of the employees covered by the plan must be met.
- An employee's right to receive benefits from the employer's contributions must vest (i.e., become nonforfeitable) after a certain period or number of years of employment. The vesting requirement is intended to ensure that a significant percentage of employees will eventually receive retirement benefits. Employer-provided benefits must be 100% vested after 5 years of service.[37] In all cases, any employee contributions to the plan must vest immediately.

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[34] Sec. 402A. For 2016 and 2017, the maximum contribution limit to Roth 401(k) plans is $18,000 ($24,000 for taxpayers 50 years and older).

[35] Secs. 409(a) and 4975(e)(7).

[36] Sec. 414(q). The $125,000 applicable in 2019 is subject to annual indexing for inflation. The amount for 2015–2018 was $120,000. Alternatively, an employer may elect to define a highly-compensated group as employees earning more than $125,000 *and* the top 20% group of employees based on compensation.

[37] Sec. 411(a)(2)(A). An alternative vesting schedule may also be used that provides for 20% vesting each year beginning in the third year of service, Sec. 411(a)(2)(B). Thus, after a total of seven years of service, an employee would be 100% vested. In addition, a faster vesting schedule is provided in Sec. 411(a)(2)(B) whereby the vesting begins after two years of service and increases at a rate of 20% per year to 100% after six years.

EXAMPLE I:7-34 ▶ Ken is a participant in a noncontributory qualified pension plan that provides for no vesting until an employee completes three years of service. Ken terminates his employment with the company after two years of service. Because Ken has not met the minimum vesting requirements, he is not entitled to receive any of the employer contributions that are made on his behalf. ◀

ADDITIONAL COMMENT

Most employees choose to contribute amounts to their qualified retirement plans on a pre-tax basis because of the time value of money. A current deduction (and the related tax savings) is more valuable than a deduction at retirement.

TAX TREATMENT TO EMPLOYEES AND EMPLOYERS

Employer contributions to a qualified plan are immediately deductible (subject to specific limitations on contribution amounts), and earnings on pension fund investments are tax-exempt to the plan. Amounts paid into a plan by or for an employee are not taxable until the pension payments are received, normally at retirement. At the election of the employee, amounts may be treated as having been made from either pre-tax or after-tax earnings. If amounts contributed to a qualified plan by an employee are made on a pre-tax basis, the taxable portion of the employee's earnings is reduced by the contribution amount. This has the effect of permitting a deduction for the contribution amount. When amounts are withdrawn at retirement, the entire distribution is subject to taxation.

EXAMPLE I:7-35 ▶ Larry is an employee of Cisco Corporation, which maintains a Sec. 401(k) plan. Larry contributes 5% of his gross salary into the plan on a pre-tax basis. During the current year, Larry's gross salary is $80,000 so his Sec. 401(k) contribution is $4,000. Since Larry's contribution is made on a pre-tax basis, his taxable salary for the current year will be $76,000. In effect, Larry is able to deduct the $4,000 from his salary in the current year. When Larry retires and begins withdrawing amounts from the plan, the entire amount withdrawn will be subject to income taxation. ◀

Conversely, an employee may elect to contribute to a qualified plan on an after-tax basis. If, in Example I:7-35, Larry contributed to the Sec. 401(k) plan on an after-tax basis, his taxable salary would have been $80,000. The $4,000 contributed to the plan is treated as an investment in the plan and is considered a tax-free return of capital when this amount is withdrawn at retirement.[38]

Employee Retirement Payments. An employee's retirement benefits, other than from Roth-type plans, are generally taxed under the Sec. 72 annuity rules (see Chapter I:3). If the plan is noncontributory (i.e., no employee contributions are made to the plan), all of the pension benefits when received by the employee are fully taxable. If the plan is contributory, the taxability depends on whether the employee's contributions were made on a pre-tax or after-tax basis. If the contributions were made on a pre-tax basis, *all* retirement payments received by the employee are taxable. Alternatively, if the contributions were made on an after-tax basis, each payment is treated, in part, as a tax-free return of the employee's contributions and the remainder is taxable. The excluded portion is based on the ratio of the employee's investment in the contract to the expected return under the contract. However, the total amount that may be excluded is limited to the amount of the employee's contributions to the plan. If the employee dies before the entire investment in the contract is recovered, the unrecovered amount is allowed as an itemized deduction in the year of death.

As mentioned earlier, qualified distributions from a Roth-type plan, such as a Roth 401(k), are not subject to taxation. Qualified distributions are those that have been invested in the plan for at least five years and the employee is at least age 59½.

EXAMPLE I:7-36 ▶ Kevin retires in 2019 at age 64 and will receive monthly annuity payments of $2,000 for life from his employer's qualified pension plan beginning in January 2019. Kevin's investment in the contract (represented by his contributions made on an after-tax basis) is $100,000. Kevin's life expectancy per Sec. 72 is 260 months from the annuity starting date. So, for the next 260 months, Kevin can exclude $384.62 ($100,000/260 months). In 2019, Kevin would exclude $4,615.44 ($384.62 × 12 months) and $19,384.56 ($24,000.00 − $4,615.44) would be taxable. After Kevin receives payments for 260 months and his $100,000 investment in the contract is recovered, all subsequent payments are fully taxable. (See Chapter I:3 for a discussion of the annuity formula and related rules.) ◀

[38] Amounts contributed to a qualified plan on an after-tax basis are treated as an investment in the contract under the annuity rules of Sec. 72. Amounts withdrawn during retirement are taxed under the general rules of Sec. 72. (See Chapter I:3 for a discussion of taxation of annuities.)

EXAMPLE I:7-37 ▶ Assume the same facts as in Example I:7-36 except that Kevin made all of his contributions to the plan on a pre-tax basis. In other words, the amount that he contributed to the plan was subtracted from his salary each year. When Kevin starts receiving payments from the plan, all amounts received will be taxable. Therefore, in 2019, Kevin will include $24,000 in his gross income. Most employees elect to "tax defer" their contributions into retirement plans in order to reduce their current year taxable income and take advantage of the time value of money principle. ◀

EXAMPLE I:7-38 ▶ Keith, age 61 and still employed, has maintained a Roth 401(k) plan for 10 years. All of his contributions into the plan, therefore, have been made on a post-tax basis. Keith may contribute $25,000 into his Roth 401(k) for 2019. The maximum contribution is $19,000, but Keith is allowed an additional $6,000 catch-up contribution as he is 50 years old or older. ◀

KEY POINT

For purposes of the limitation on employer contributions, all defined contribution plans maintained by one employer are treated as a single defined contribution plan. Furthermore, under some circumstances a group of employers can be treated as a single employer.

Limitation on Employer Contributions. The Code places limitations on (1) amounts an employer may contribute to qualified pension, profit-sharing, and stock bonus plans and (2) amounts that the employer may deduct:

- Defined contribution plan contributions in 2019 are limited to the lesser of $56,000 or 100% of the employee's compensation.[39]
- Defined benefit plans are restricted to an annual benefit to an employee equal to the lesser of $225,000 for 2019 or 100% of the participant's average compensation for the highest three years.[40]
- An overall maximum annual employer deduction of 25% of compensation paid or accrued to plan participants is placed on defined contribution, profit-sharing, and stock bonus plans.[41] If an employer has more than one type of qualified plan (e.g., a defined benefit pension plan and a profit-sharing plan), a maximum deduction of 25% of compensation is allowed.

ADDITIONAL COMMENT

Many individuals have the option of taking their retirement savings from traditional pensions, profit-sharing plans, and 401(k)s as a lump sum or an annuity. Those who want to take a lump-sum distribution can delay taxes by transferring the money directly into a tax-deferred IRA.

The distinguishing features and major requirements for qualified pension and profit-sharing plans are summarized in Topic Review I:7-1.

TOPIC REVIEW I:7-1

Qualified Pension and Profit-Sharing Plans

Distinguishing Features and Major Requirements

- Employer contributions and earnings on contributed amounts are not taxed to employees until distributed or made available. The contributions are immediately deductible by the employer.
- Pension plans can be established as either defined contribution or defined benefit plans in which systematic and definite payments are made to a pension trust. Incidental benefits (e.g., death and disability payments) can be provided under the plan.
- Profit-sharing plans require the use of a predetermined allocation formula and substantial and recurring contributions must be made although annual employer contributions are not required and the contributions need not be based on profits. Section 401(k) plans can be established where employees have the option to receive cash or to have such amounts contributed to the profit-sharing trust. The employer may also establish an ESOP where the plan is funded by a contribution of the employer's stock.
- Qualified plans must be created for the employees' exclusive benefit.
- The plans may not discriminate in favor of highly compensated employees.
- Contributions and plan benefits must bear a uniform relationship to the compensation of covered employees.
- Minimum vesting requirements must be met (e.g., 100% vesting after five years).
- Employee benefits are taxed under the Sec. 72 annuity rules.
- Total employer contributions to the plan are subject to specific ceiling limitations.

[39] Sec. 415(c). The deduction limit for 2018 was $55,000. In addition, individuals over 50 years of age are eligible to contribute extra amounts into their plans. The amount of the so-called catch-up contributions depend on the type of plan.

[40] Sec. 415(b)(1). The benefit amount for 2018 was $220,000. These amounts are subject to indexing each year.

[41] Sec. 404(a)(3)(A).

KEY POINT

Because nonqualified plans are not subject to the same restrictions as imposed upon qualified plans, they do not receive the same tax benefits that are available under qualified plans. For example, the employer may not be able to deduct amounts that are set aside for employees.

NONQUALIFIED PLANS

Nonqualified deferred compensation plans are often used by employers to provide incentives or supplementary retirement benefits for executives. Common forms of nonqualified plans include the following:

- An unfunded, nonforfeitable promise to pay fixed amounts of compensation in future periods.[42]
- Restricted property plans involving property transfers (usually in the form of the employer-company stock), where the property transferred is subject to a substantial risk of forfeiture and is nontransferable.[43]

Distinguishing Characteristics of Nonqualified Plans. Nonqualified plans are not subject to the same restrictions imposed on qualified plans (such as the nondiscrimination and vesting rules), although nonqualified plans may have some vesting rules. Thus, such plans are particularly suitable for use in executive compensation planning. In general, nonqualified plans impose certain restrictions on the outright transfer of the plan's benefits to the employee. This avoids immediate taxation under the constructive receipt doctrine, which does not apply if the benefits are not yet credited, set apart, or made available so that the employee may draw on them. The amount is taxed to the employee upon the lapse of such restrictions, and the employer receives a corresponding deduction in the same year.

Unfunded Deferred Compensation Plans. **Unfunded deferred compensation plans** are often used to compensate highly compensated employees who desire to defer the recognition of income until future periods (e.g., a professional athlete or a business executive who receives a signing bonus may prefer to defer the recognition of income from the bonus). In general, if the promise to make the compensation payment in a future period is nonforfeitable, the agreement must not be funded (e.g., the transfer of assets to a trust for the employee's benefit) or evidenced by a negotiable note. The employer, however, may establish an *escrow account* on behalf of the employee. Such an account is used to accumulate and invest the deferred compensation amounts. If the requirements for deferral are met, the employee is taxed when the amounts are actually paid or made available, and the employer receives a corresponding deduction in the same year.[44]

EXAMPLE I:7-39 ▶ In 2019, Kelly signs an employment contract to play professional football for the Chicago Skyhawks. The contract includes a $2,000,000 signing bonus that is payable in five annual installments beginning in 2020. The bonus agreement is nonforfeitable and is unfunded. The Skyhawks have agreed to place sufficient amounts of money into an escrow account to fund the future payments to Kelly. None of the $2,000,000 bonus is deductible by the employer or taxable to Kelly when the agreement is signed in 2019. The Skyhawks do not receive a deduction for any amounts that are deposited into the escrow account during the 2019–2023 period. In 2020, Kelly receives $400,000 taxable compensation (plus interest, if any, that accrued and was paid to Kelly is also taxable) upon receipt of the initial payment, and the Skyhawks receive a corresponding tax deduction. ◀

Requirements were enacted several years ago for nonqualified deferred compensation plans.[45] While a detailed examination of these new rules is outside the scope of this textbook, some major features of the law are as follows:

- The rules apply to any plan by which executive employees are permitted to defer the receipt and taxability of compensation from the current year to a future year. In prior years, the tax laws in this area were a wide range of cases and rulings.
- If deferred amounts under a plan fail to satisfy the requirements at any time during the tax year, the recipient must pay the tax on the deferred compensation plus interest and an additional 20% excise tax.

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[42] Rev. Rul. 60-31, 1960-1 C.B. 174, modified by Rev. Rul. 64-279, 1964-2 C.B. 121 and Rev. Rul. 70-435, 1970-2 C.B. 100.

[43] Sec. 83.

[44] Reg. Sec. 1.451-2(a).

[45] Sec. 409A.

- Distributions from the plan to recipients are subject to strict rules. Deferrals may be distributed to participants no earlier than the time of separation of service, pursuant to a fixed schedule in the plan, death, disability, an unforeseeable emergency, or upon a change in control of the company. Thus, early distributions are not generally permitted. In addition, acceleration of payment amounts are severely curtailed.
- Funding rules essentially have remained the same except that employers generally may no longer use offshore trusts.

Because of the complexity of the rules in this area, taxpayers are strongly urged to look closely at their nonqualified deferred compensation plans to ensure that they comply with the rules.

Restricted Property Plans. Restricted property plans are used to attract and retain key executives. Under such arrangements, the executive generally obtains an ownership interest (i.e., stock) in the corporation. Restricted property plans are governed by the income recognition rules contained in Sec. 83. Under these rules, the receipt of restricted property in exchange for services rendered is not taxable if the property is nontransferable and subject to a substantial risk of forfeiture.

The employee is treated as receiving taxable compensation based on the amount of the property's fair market value (FMV) (less any amount paid for the property) at the earlier of the time the property is no longer subject to a substantial risk of forfeiture or is transferable. The employer receives a corresponding compensation deduction at the same time the income is taxed to the employee.

EXAMPLE I:7-40 ▶ In 2019, Allied Corporation transfers 1,000 shares of its common stock to employee Karen as compensation pursuant to a restricted property plan. The FMV of the Allied stock is $10 per share on the transfer date. The restricted property agreement provides that the stock is nontransferable by Karen until the year 2021 (i.e., Karen cannot sell the stock to outsiders until year 2021). The stock is also subject to the restriction that if Karen voluntarily leaves the company before the year 2021, she must transfer the shares back to the company and will receive no benefit from the stock other than from the receipt of dividends. The FMV of the stock is $100 per share in year 2021 when the forfeiture and nontransferability restrictions lapse. Because the stock is both nontransferable and subject to a substantial risk of forfeiture from the issue date to year 2021, the tax consequences from the stock transfer are deferred for both Karen and Allied Corporation until the lapse of the nontransferability or forfeiture restrictions in year 2021. Thus, no tax consequences result in 2019 or 2020. In year 2021, Karen must report ordinary (compensation) income of $100,000 ($100 × 1,000 shares), and Allied Corporation is entitled to a corresponding compensation deduction of the same amount. Karen is taxed currently on the dividends she receives because they are not subject to any restrictions. ◀

KEY POINT

If an employee makes the election to be taxed immediately, he or she should be aware of the adverse consequences of leaving the company before the forfeiture restrictions lapse. The employee will not receive the property, and no deduction is allowed on the forfeiture.

Election to Be Taxed Immediately. An exception which permits an employee to elect (within 30 days after the receipt of restricted property) to recognize income immediately upon receipt of the restricted property is provided in Sec. 83(b). If the election is made, the employer is entitled to a corresponding deduction at the time the income is taxed to the employee. This election is frequently made when the fair market value of the restricted property is expected to increase significantly in the future and the future gain would be taxed as long-term capital gain.

EXAMPLE I:7-41 ▶ Assume the same facts as Example I:7-40, except that Karen elects to recognize income in 2019 (i.e., the transfer date). Karen must include $10,000 ($10 × 1,000 shares) in gross income as compensation in the current year and Allied Corporation is entitled to a corresponding deduction in the same year. Karen will report no income in 2021 when the restrictions lapse and her basis in the Allied Corporation stock remains at $10,000. If Karen sells the stock for $100,000 in the year 2021, or a later year after the restrictions lapse, Karen reports a $90,000 ($100,000 – $10,000) long-term capital gain on the sale.[46] If Karen voluntarily leaves the company before the forfeiture restrictions lapse, no deduction is allowed when the forfeiture occurs, despite the fact that Karen is previously taxed on the stock's value on the transfer date (i.e., $10,000 of income is recognized by Karen in the current year). In such event, Allied Corporation must

[46] Sec. 1223. The holding period originates on the day following the transfer date because Karen made the election to be taxed immediately under Sec. 83(b).

TOPIC REVIEW I:7-2

Nonqualified Plans

Distinguishing Features and Major Requirements

1. The employee is taxed upon the lapse of restrictions imposed on the availability or withdrawal of funds and the employer receives a corresponding deduction in the same year.
2. Nonqualified plans may discriminate in favor of highly compensated employees and no minimum vesting rules are required.
3. Restricted property (usually employer stock) may be offered to executives where the incidents of taxation are deferred if the property is nontransferable and subject to a substantial risk of forfeiture. An election may be made under Sec. 83(b) to recognize income immediately upon the receipt of the restricted property.
4. Restrictions must be imposed to avoid immediate taxation to the employee under the constructive receipt doctrine.
5. To avoid immediate taxation, restricted property plans must be both nonforfeitable and subject to a substantial risk of forfeiture.

include $10,000 in gross income in the year of the forfeiture (i.e., the amount of the deduction that is taken in the year of the transfer to the extent of any previous tax benefit). ◀

Nonqualified plan features and requirements are summarized in Topic Review I:7-2.

EMPLOYEE STOCK OPTIONS

Stock option plans are used by corporate employers to attract and retain key management employees. Both stock option and restricted property arrangements using the employer's stock permit the executive to receive a proprietary interest in the corporation. Thus, an executive may identify more closely with shareholder interests and the firm's long-run profit-maximization goals. The tax law currently includes two types of stock-option arrangements: the incentive stock option and the nonqualified stock option.[47] Each type is treated differently for tax purposes.

REAL-WORLD EXAMPLE

The use of employee stock options has come under criticism recently in the financial press. The pressure to increase earnings has been a major issue in recent corporate scandals. Further, the Financial Accounting Standards Board has issued a statement requiring the current expensing of stock options in certain circumstances.

As will be seen in the discussions below, both types of plans have their respective advantages and disadvantages. Incentive stock option arrangements generally are preferred when long-term capital gain rates are low as compared to ordinary income rates. Thus, because long-term capital gain rates are 15% or 20% and marginal tax rates for ordinary income are rather high (37%), interest should continue in incentive stock option arrangements. However, an employer is more favorably treated under the nonqualified stock-option rules (i.e., the employer receives a tax deduction for the compensation related to a nonqualified stock option but does not receive a corresponding deduction if an incentive stock-option plan is adopted) and may therefore still prefer to continue to use nonqualified stock options.

Incentive Stock Option Plans.

Employer Requirements. ***An*** **incentive stock option (ISO) must meet the following plan or employer requirements:**[48]

KEY POINT

Incentive stock options have the disadvantage of not providing a compensation deduction for the employer.

KEY POINT

Incentive stock options can be a valuable tax planning tool because the earliest that they are generally taxed is when they are exercised. Also, when an employee realizes profits from stock options, those profits in certain cases may qualify as capital gains.

- The option price must be equal to or greater than the stock's FMV on the option's grant date.
- The option must be granted within ten years of the date the plan is adopted, and the employee must exercise the option within ten years of the grant date.
- The option must be both exercisable only by the employee and nontransferable except in the event of death.
- The employee cannot own more than 10% of the voting power of the employer corporation's stock immediately before the option's grant date.
- The total FMV of the stock options that become exercisable to an employee in any given year may not exceed $100,000 (e.g., an employee can be granted ISOs to acquire $200,000 of stock in one year, provided that no more than $100,000 is exercisable in any given year).
- Other procedural requirements must be met (e.g., shareholder approval of the plan).

[47] The incentive stock option rules are provided in Sec. 422, whereas the rules governing nonqualified stock options are contained in Reg. Sec. 1.83-7.

[48] Sec. 422.

Employee Requirements. In addition to the above plan requirements, the employee must meet the following requirements:

- The employee must not dispose of the stock within two years of the option's grant date nor within one year after the option's exercise date.
- The employee must be employed by the issuing company on the grant date and continue such employment until within three months before the exercise date.

If an employee meets the requirements listed above, no tax consequences occur on the grant date or the exercise date. However, the excess of the FMV over the option price on the exercise date is an adjustment for purposes of the alternative minimum tax (see Chapter I:14). When the employee sells the optioned stock, a long-term capital gain or loss is recognized. If the employee meets the two requirements, the employer does not receive a corresponding compensation deduction. If the requirements are not met, the option is treated as a nonqualified stock option.

EXAMPLE I:7-42 ▶ American Corporation grants an incentive stock option to Kay, an employee, on January 1, 2019. The option price is $100, and the FMV of the American stock is also $100 on the grant date. The option permits Kay to purchase 100 shares of American stock. Kay exercises the option on June 30, 2021, when the stock's FMV is $400. Kay sells the 100 shares of American stock on January 1, 2023, for $500 per share. Because Kay holds the stock for the required period (at least two years from the grant date and one year from the exercise date) and because Kay is employed by American Corporation on the grant date and within three months before the exercise date, all of the requirements for an ISO have been met. No income is recognized on the grant date or the exercise date, although $30,000 [($400 − $100) × 100 shares] is a tax adjustment item for the alternative minimum tax in 2021. Kay recognizes a $40,000 [($500 − $100) × 100 shares] long-term capital gain on the sale date in 2023. American Corporation is not entitled to a compensation deduction in any year. ◀

EXAMPLE I:7-43 ▶ Assume the same facts as Example I:7-42, except that Kay disposes of the stock on August 1, 2021, thus violating the one-year minimum holding period requirement after the exercise date. Kay must recognize ordinary income on the sale date equal to the spread between the option price and the exercise price, or $30,000 [($400 − $100) × 100 shares]. The $30,000 spread between the FMV and the option price is no longer a tax adjustment item because the option ceases to qualify as an ISO. American Corporation can claim a $30,000 compensation deduction in 2021. Kay also recognizes a $10,000 [($500 − $400 adjusted basis) × 100 shares] short-term capital gain on the sale date, which represents the appreciation of the stock from the exercise date to the sale date. The gain is short-term because the holding period from the exercise date to the sale date does not exceed one year. ◀

KEY POINT

With ISOs, the employee does not recognize income when the option is exercised; income is recognized only when the stock is sold. With nonqualified stock options, income is recognized when the option is exercised or on the grant date and when the stock is sold at a gain.

Nonqualified Stock Option Plans. Stock options that do not meet the plan requirements for incentive stock options are referred to as **nonqualified stock options**. The tax treatment of nonqualified stock options depends on whether the option has a **readily ascertainable fair market value** (e.g., whether the option is traded on an established options exchange).

Readily Ascertainable Fair Market Value. If a nonqualified stock option has a readily ascertainable FMV (e.g., the option is traded on an established options exchange), the employee recognizes ordinary income on the grant date equal to the difference between the fair market value of the option and the amount paid (if any) for such property. The employer receives a compensation deduction on the grant date equal to the same amount of income that is recognized by the employee. In such case, no tax consequences occur on the date the option is exercised, and the employee recognizes capital gain or loss upon the sale or disposition of the stock.

No Readily Ascertainable Fair Market Value. If a nonqualified stock option has no readily ascertainable FMV, no tax consequences occur on the grant date. On the exercise date the employee recognizes ordinary income equal to the spread between the FMV of the stock and the option price, and the employer receives a corresponding compensation deduction. When the stock option is exercised, the employee's basis in the stock is equal to the option price plus the amount reported as ordinary income on the exercise date. Capital gain or loss is recognized upon the subsequent sale of the stock by the employee.

The alternative minimum tax does not apply to nonqualified stock options regardless of whether the option has a readily ascertainable FMV. Table I:7-3 illustrates the tax consequences to employees and employers for such options.

As illustrated in Table I:7-3, Kim reports a total gain of $11,000 from the nonqualified stock option transaction under both circumstances. However, the character of her profit (i.e., ordinary income or capital gain) and the timing of the profit recognition (i.e., grant date or exercise date) depends on whether the option's FMV is readily ascertainable.

The distinguishing features and major requirements for employee stock options are summarized in Topic Review I:7-3.

▼ TABLE I:7-3
Taxation of Nonqualified Stock Options

Situation Facts	Readily Ascertainable FMV	No Readily Ascertainable FMV
Grant date: On January 1, 2017, Kim is granted a nonqualified stock option to purchase 100 shares of stock from Apple Corporation (Kim's employer) at $90 per share. The stock's FMV is $100 on the grant date.	Ordinary income of $1,000 is recognized [($100 – $90) × 100 shares] by Kim in 2017. Apple Corporation receives a corresponding $1,000 compensation deduction in 2017.	No tax consequences to Kim or Apple Corporation.
Exercise date: On January 31, 2019, Kim exercises the option and acquires the 100 shares of Apple Corporation stock for the $90 option price when the FMV is $190.	No tax consequences to Kim or Apple Corporation.	Kim recognizes ordinary income in 2019 of $10,000 [($190 – $90) × 100 shares], and Apple Corporation receives a $10,000 compensation deduction.
Sale date: On February 1, 2020, Kim sells the stock for $200 per share and realizes $20,000 ($200 × 100 shares).	Kim recognizes a $10,000 ($20,000 – $10,000 basis) long-term capital gain.[a]	Kim recognizes a $1,000 ($20,000 – $19,000 basis) long-term capital gain on the sale.[b]

[a] Kim's basis includes the amount paid for the optioned stock of $9,000 plus ordinary income of $1,000 recognized on the grant date. Kim's holding period commences on the January 1, 2017, grant date for determining whether the gain is long-term.

[b] Kim's basis includes the $9,000 paid for the option stock plus the $10,000 ordinary income recognized on the exercise date. Kim's holding period commences on the January 31, 2019, exercise date for determining whether the gain is long-term.

TOPIC REVIEW I:7-3

Employee Stock Options

Distinguishing Features and Major Requirements

- For an incentive stock option (ISO) plan no tax consequences occur on the grant or the exercise date (except for the recognition of a tax preference item under the AMT provisions on the exercise date). Capital gain or loss is recognized by the employee upon the sale or exchange of the stock. No deduction is allowed to the employer.
- ISOs and nonqualified stock options may be issued to highly-compensated employees without regard to nondiscrimination rules.
- If a nonqualified stock option has a readily ascertainable FMV, the employee recognizes ordinary income equal to the spread between the FMV of the stock and the option price on the grant date and the employer receives a corresponding deduction. If the option has no readily ascertainable FMV, income is recognized on the exercise date equal to the spread between the FMV of the stock and the option price and a corresponding deduction is available to the employer.
- For an ISO, the option price must be equal to or greater than the FMV of the stock on the grant date, employees cannot own more than 10% of the voting power of the employer's stock, and restrictions are placed on the total FMV of stock options that may be issued.
- To qualify under the ISO rules, a two-year holding period from the grant date is required (and at least one year after the exercise date) and the employee must continue to be employed by the company until within three months of the exercise date.

PLANS FOR SELF-EMPLOYED INDIVIDUALS

ADDITIONAL COMMENT

If you are self-employed and establish a Keogh plan, you must include any full-time employees in the plan.

Self-employed individuals, such as sole proprietors or partners who practice as a trade or business, are not considered as employees and are not eligible for the retirement plans offered to employees. However, self-employed individuals have their own special types of retirement plans. Retirement plans of self-employed people are generally subject to the same contribution and benefit limitations as other qualified corporate plans. An individual who is an employee and also has a self-employed business generally is able to be covered under an employer-sponsored plan and a self-employed plan. There are overall limitations that apply in these circumstances.

The principal types of retirement plans for self-employed individuals include the following:

- H.R. 10 plan—this plan, also referred to as a Keogh plan, was the original self-employed plan and, although still a viable and important type of plan, is not used as much now because of the annual paperwork requirements.
- SEP IRA—this plan, a Simplified Employee Pension plan, is similar to an H.R. 10 plan but is easier to set up and administer. SEP IRAs are discussed in more detail below.
- SIMPLE plan—SIMPLE plans are relatively easy to use and administer but the contribution limits are lower than those for H.R. 10 or SEP IRA plans. SIMPLE plans are discussed in more detail below.
- Solo 401(k) plan—this plan is for solo business owners with no other employees. Solo 401(k) plans provide for a $19,000 deferral for the business owner plus a 25% of salary match by the company. The total contribution limit (including both the deferral plus the company match) in 2019 is $56,000.

KEY POINT

Keogh plans can be either defined benefit or defined contribution plans. Many individuals avoid the defined benefit type of Keogh plan due to the extra paperwork and administrative costs.

For a **defined contribution H.R. 10 plan or SEP IRA**, a self-employed individual in 2019 may contribute the smaller of $56,000 or 25% of earned income from the self-employment activity.[49] *Earned income* refers to net earnings from self-employment. However, for purposes of computing the maximum amount that may be contributed to a Keogh or SEP IRA plan by a self-employed individual, earned income must be reduced by two amounts: (1) the 50% deduction for self-employment taxes and (2) the contribution itself. Since the contribution is based on earned income *after* the contribution, the 25% contribution percentage must be reduced to 20%.[50] To compute the limitations for 2019, a maximum of $280,000 of earned income may be taken into account for any one individual.[51]

EXAMPLE I:7-44 ▶ Larry is a self-employed CPA whose 2019 net earnings from his trade or business (before the H.R. 10 or SEP IRA plan contribution but after the deduction for one-half of the self-employment taxes paid under Sec. 164(f) [see Chapter I:14]) is $100,000. Larry may contribute $20,000 to the plan for 2019. Larry must also provide coverage for all of his eligible full-time employees under the general rules provided in the law for qualified plans (e.g., nondiscrimination, vesting, and so on).[52] ◀

EXAMPLE I:7-45 ▶ Assume the same facts as in Example I:7-44 except that Larry's earnings from his trade or business (before the plan contribution but after the deduction for one-half of the self-employment taxes) is $300,000. The maximum contribution that Larry can make on his behalf in 2019 is $56,000 ($280,000 × 0.20). Even though his earnings were $300,000, the maximum compensation that can be used to calculate the H.R. 10 or SEP IRA plan contribution in 2019 is $280,000. ◀

KEY POINT

A Keogh plan must be created no later than the last day of your tax year. However, a SEP IRA may be created by the due date of the return.

An H.R. 10 plan must be established before the end of the tax year, but contributions may be made up to the due date for the tax return (including extensions). SEP IRA plans can be setup and funded by the due date of the return, including extensions. Thus, for the tax year 2019, a taxpayer is permitted to establish a SEP IRA by April 15, 2020 (or October 15, 2020, if the return is extended). All pension contributions made by a self-employed individual for *employees* are deductible for AGI on Schedule C. The H.R. 10 or SEP IRA contribution for the self-employed individual is deductible *for* AGI on page 1 of Form 1040.

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[49] Sec. 415(c)(1). The limitations are indexed annually for inflation.

[50] This reduction in contribution percentage is computed as follows: 0.25/1.00 + 0.25 = 0.20. If the Keogh or SEP IRA contribution rate is 15% rather than 25%, the deductible percentage would be 13.0435%, computed as above, 0.15/1.00 + 0.15 = 0.130435. Other percentages can be calculated accordingly.

[51] Secs. 401(a)(17) and 404(l). The ceiling in 2018 was $275,000.

[52] Sec. 401(d).

SIMPLIFIED EMPLOYEE PENSIONS (SEP IRAS)

Due to the administrative complexity associated with qualified pension and profit-sharing plans, small businesses often establish simplified employee pension (SEP IRA) plans for their employees. In a SEP, the employer makes contributions to the IRAs of its employees.[53] The following is a summary of the tax rules that apply to SEP IRAs:

ADDITIONAL COMMENT

A self-employed person (i.e., a partner or sole proprietor) may establish a SEP rather than using an H.R. 10 plan arrangement because of reduced administrative complexity associated with a SEP.

- The employer receives an immediate tax deduction for contributions made under the plan. The annual deductible contributions for each participant are limited to the lesser of 25% of the participant's compensation (up to a ceiling of $280,000 for 2019) and the dollar limitations for defined contribution plans.[54] The maximum amount for 2019 is $56,000.
- Contributions are treated as being made on the last day of the tax year if they are made by the due date of the tax return (including extensions).
- Employer contributions must be nondiscriminatory.
- Distributions from a SEP are subject to taxation based on the IRA rules (previously discussed) including the penalty tax for premature distributions.

SIMPLE RETIREMENT PLANS

Another more recent type of retirement savings plan for small businesses is called the savings incentive match plan for employees (SIMPLE).[55] This type of plan can be adopted by employers who have 100 or fewer employees who received at least $5,000 in compensation from the employer in either of the two preceding years. A SIMPLE plan may be set up either as an IRA for each employee or part of a qualified cash or deferred arrangement (401(k) plan). Essentially, employees are allowed to make elective contributions in 2019 of up to $13,000 per year and employers are required to make matching contributions.

The unique features of the SIMPLE plans are (1) that elective contributions by employees must be matched by the employer or the employer has the option of making nonelective contributions, (2) that all contributions to an employee's SIMPLE account must be fully vested, and (3) the SIMPLE plans are not subject to the special nondiscrimination rules generally applicable to qualified plans. This last feature is important in that there is no requirement that a set number of employees *participate* in the plan, the only requirement is that all employees who had $5,000 in compensation in the previous year and are reasonably expected to have $5,000 in compensation in the current year must be eligible to participate.

INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)

HISTORICAL NOTE

The IRA savings provisions were originally enacted in 1974 to provide a tax-favored retirement savings arrangement to individuals who were not covered under a qualified plan. Beginning in 1982, Congress extended IRA availability to all taxpayers. It was hoped that the extended availability would increase the level of savings and provide a discretionary retirement savings plan that was uniformly available. However, Congress in the Tax Reform Act of 1986 restricted the availability of IRAs because there was no discernible impact on aggregate personal savings.

Under current law, there are three types of IRAs that are available to taxpayers: traditional IRA, Roth IRA, and Coverdell Education Savings Account IRA.[56] Each of these three types of IRAs is discussed below.

TRADITIONAL IRA

Traditional IRAs have been in the law for over 45 years and taxpayers may make either deductible or nondeductible contributions to the IRA. A contribution to a traditional IRA that is deductible has two principal benefits: (1) the amount contributed to the IRA (maximum $6,000 per year for 2019) is deductible on the taxpayer's return[57] and (2) the income earned on the investments in the IRA is not subject to current taxation. However, when amounts are withdrawn from the IRA at retirement, such amounts are fully subject to taxation. Nondeductible contributions to a traditional IRA may not be deducted on the taxpayer's return, but such contributions are not subject to taxation when withdrawn from the IRA. While contributions are not subject to taxation, any earnings are subject to taxation when withdrawn.

In order to make a deductible contribution to a traditional IRA, certain requirements must be met. First, the individual must have compensation (or earned income) equal to the lesser of $6,000 or the amount of the contribution. Second, either of the following conditions must exist:

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[53] Sec. 408(k).
[54] Sec. 404(h)(1).
[55] Sec. 408(p).
[56] The Coverdell Education Savings Account was named after the late Senator Paul Coverdell of Georgia.
[57] The deductible amount to an IRA was increased from $2,000 prior to 2002 to $3,000 for 2002–2004, $4,000 for 2005–2007, $5,000 for 2008–2012, and 5,500 for 2013–2018. See Sec. 219 (b)(5). The deductible amount is indexed for inflation. Prior to 2002, the deductible amount was $2,000. In addition, individuals over 50 years of age are now eligible to contribute an extra $1,000 into their IRA. These extra amounts are referred to as "catch-up contributions."

- The individual is *not* an active participant in an employer-sponsored retirement plan, including tax-sheltered annuities, government plans, simplified employee pension plans, and H.R. 10 plans; or
- Individuals who are active participants in an employer-sponsored retirement plan must have an AGI equal to or below the following applicable dollar limits for 2019:[58] $64,000 for an unmarried taxpayer; $103,000 for a married couple filing a joint return; zero for a married individual filing separately. If an individual has AGI above these amounts, the deductible IRA contribution amounts are phased out on a pro rata basis as AGI increases from $64,000 to $74,000 for unmarried taxpayers and from $103,000 to $123,000 for married taxpayers filing a joint return.

EXAMPLE I:7-46 ▶ Laura is an unmarried taxpayer who is not an active participant in an employer-sponsored retirement plan or other qualified plan. In 2019, Laura's AGI is $90,000, consisting of earned income from wages. Laura is not subject to the dollar limitation because she is not an active participant in a qualified plan and may, therefore, contribute and deduct up to $6,000 to a traditional IRA. Laura's AGI is reduced to $84,000 ($90,000 – $6,000) because the amount is deductible *for* AGI. ◀

EXAMPLE I:7-47 ▶ Judy is an unmarried taxpayer and an active participant in her employer's qualified retirement plan. In 2019, Judy's AGI is $68,000, consisting of earned income from wages of $65,000 and interest and dividends of $3,000. Since she is an active participant in a qualified plan and her AGI is over $64,000, her deductible contribution to a traditional IRA is subject to the phaseout. Since the ceiling amount is exceeded by $4,000 ($68,000 – $64,000), the maximum IRA contribution is reduced by 40% ($4,000/$10,000), or $2,400. Thus, the maximum that Judy can contribute *and* deduct to her IRA in 2019 is $3,600 ($6,000 – $2,400). ◀

ADDITIONAL COMMENT

Banks, savings and loan associations, insurance companies, and stock brokerage firms make IRAs available to taxpayers. Usually, the amounts are invested in long-term investment accounts. However, self-directed plans are offered by some stock brokerage firms. In this type of IRA, the taxpayer can specify how the contributions will be invested.

If a taxpayer's AGI exceeds the above limits, the taxpayer may make a nondeductible contribution of up to $6,000 to a traditional IRA. The benefit of making a nondeductible contribution to an IRA is that the earnings of the IRA investments grow tax-free. Thus, even though the *earnings* of the nondeductible IRA will be taxed when distributed, the ability to allow investments to compound before-tax is a major advantage for taxpayers. However, as will be seen in the discussion of Roth IRAs below, if a taxpayer can qualify for a Roth IRA rather than a traditional nondeductible IRA, the choice clearly favors a Roth IRA. The maximum amount of a nondeductible contribution that may be made to a traditional IRA is $6,000 minus the amount that is allowed as a deduction. Also, a taxpayer may elect for all of his contributions to be nondeductible even though the contributions are otherwise eligible to be deducted.

EXAMPLE I:7-48 ▶ Using the same facts as in Example I:7-47, Judy is permitted to make a nondeductible contribution to her IRA of $2,400 ($6,000 – $3,600). She also could elect to designate all $6,000 as a nondeductible contribution even though she is eligible to deduct the $3,600. ◀

Two special rules apply to married couples relative to traditional IRAs:

1) If only one spouse is employed and this working spouse is otherwise eligible to make IRA contributions, the nonworking spouse may contribute up to $6,000 per year to an IRA (a so-called spousal IRA). Thus, a total of $12,000 may be deductible by a married couple ($6,000 to each spouse's IRA) even though only one spouse has earned income. It should be noted that even though only the working spouse must have earned income, such working spouse must have at least $12,000 of earned income in order to contribute $12,000 to the two IRAs.

2) If one spouse is covered under a qualified retirement plan but the other spouse is not covered, the non-covered spouse may contribute to a traditional deductible IRA. However, for 2019, the contribution to a traditional deductible IRA is phased out at adjusted gross incomes between $193,000 and $203,000.

EXAMPLE I:7-49 ▶ Gary and Babs are a married couple. Gary is covered under a qualified retirement plan at his job and earned $176,000 in 2019. Babs is employed as a secretary and earned $26,000 but is not covered under a qualified retirement plan. They file a joint return, have interest and dividend income of $16,000, and their AGI, therefore, is $218,000. Neither Gary nor Babs is entitled to

[58] Sec. 219(g).

deduct contributions to a traditional IRA. Gary cannot contribute and deduct any amount to an IRA because he is covered under another qualified plan and their AGI exceeds $123,000. Babs is also not eligible because their AGI exceeds $203,000. However, both Gary and Babs are allowed to make nondeductible contributions of $6,000 each to the IRA. ◀

EXAMPLE I:7-50 ▶ Assume the same facts as in Example I:7-49 but that Gary's income is $100,000 and their AGI is $130,000. Babs may contribute and deduct $6,000 to a traditional IRA because their AGI is less than $193,000. However, Gary may not make a deductible contribution because he is covered under a qualified plan and their AGI exceeds $123,000. Gary is permitted to make a $6,000 contribution to a nondeductible IRA. ◀

ADDITIONAL COMMENT

A contribution to an IRA for the tax year 2019 can be made as late as the due date for filing the 2019 return, or April 15, 2020.

The following significant tax rules apply to traditional IRAs:

- An IRA plan may be established between the end of the tax year and the due date for the tax return (not including any extensions that are permitted). Any deductible contributions made during this time are treated as a deduction for the prior year. Contributions are deductible if made by the due date for the tax return (i.e., contributions for 2019 must be made no later than April 15, 2020). Contributions to nondeductible IRAs also must be made by the tax return due date of the following year.
- Taxpayers who are 50 years of age or older by the end of the taxable year may contribute an additional $1,000 per year (or a total of $7,000 in 2019). These additional IRA contributions are referred to as catch-up contributions.
- Distributions from a traditional IRA are taxed under the annuity rules in Sec. 72. Normally distributions from an IRA are fully subject to taxation. However, if nondeductible contributions are made to an IRA, these amounts would represent the investment in the contract in calculating the exclusion ratio.
- Withdrawals by a participant before age 59½ are both includible in income and subject to a nondeductible 10% penalty tax.[59]

ADDITIONAL COMMENT

Some financial advisors recommend the following approach when someone can only afford to have limited amounts set aside for retirement. Have pre-tax dollars withheld from salary up to the employer-matching amount in 401(k) plans, then place $5,500 in a Roth IRA. This maximizes employer contributions and places the maximum amount allowable into the much favored Roth IRA.

- Withdrawals must begin no later than April 1 of the year following the end of the tax year in which the individual reaches age 70½. IRA contributions that were deducted over the years on the taxpayer's returns are fully taxable as ordinary income when the amounts are distributed.
- A nondeductible 6% penalty is levied on excess contributions to an IRA.[60]

ROTH IRA

The Roth IRA[61] is a relatively new type of IRA that is a so-called "backloaded IRA" because the tax benefits come at the end, not at the beginning, of the IRA. Contributions to a Roth IRA are nondeductible but all distributions from the IRA, including earnings, are nontaxable. The maximum amount that may be contributed to a Roth IRA is $6,000. However, taxpayers who are eligible for both a Roth IRA and a traditional IRA may only contribute a total of $6,000 to both types of IRAs. As with traditional IRAs, Roth IRAs are also subject to AGI phaseout limitations, although the limitation amounts are higher than with traditional IRAs.

ADDITIONAL COMMENT

Employers may now offer their employees a Roth 401(k) option. Under a Roth 401(k), employees can contribute up to $19,000 in 2019. The Roth 401(k) plan operates in the same basic way as a regular Roth IRA.

All taxpayers may contribute up to the lesser of (1) $6,000 or (2) 100% of the taxpayer's compensation, to a Roth IRA; however, for 2019, this amount is phased-out for single taxpayers if their AGI is between $122,000 and $137,000 ($193,000 and $203,000 for married couples filing a joint return and $0 for married individuals filing separate returns). The principal advantage of the Roth IRA is the nontaxability of qualified distributions. One requirement of a qualified distribution is that the distribution must meet a five-year holding period. More specifically, the distribution may not be made before the end of the five-tax-year period beginning with the first tax year for which a contribution was made to the Roth IRA. The first tax year begins on the first day of the tax year

[59] Sec. 72(t). The amount subject to the 10% penalty is the portion of the amount that must be included in gross income. Exceptions to the 10% penalty are provided in the event of death, disability, and certain non-lump-sum distributions. Two additional exceptions also apply: (1) withdrawals used to pay qualified higher education costs for taxpayer, spouse, children or grandchildren and (2) up to $10,000 to buy or build the principal residence for a "first time homebuyer."

[60] Sec. 4973(b).

[61] Sec. 408A.

(i.e., January 1 in most cases) in which a contribution was made even though such contribution may have been made later in such tax year. In addition to satisfying the five-year test, a qualifying distribution must also meet one of the following:

- made on or after the date on which the individual attains age 59½,
- made to a beneficiary (or the individual's estate) on or after the individual's death,
- attributable to the individual being disabled, or
- a distribution for first-time homebuyer expenses (maximum of $10,000).

An important aspect of distributions from a Roth IRA is a special ordering rule for determining the taxability of nonqualifying withdrawals. Under this rule, distributions are treated as being made from contributions first and, thus, are nontaxable. After all contributions have been withdrawn, any remaining amounts are considered taxable and subject to the 10% penalty.

EXAMPLE I:7-51 ▶ Ray and Sandy are married and Ray is covered under his employer's qualified retirement plan. Their AGI on a joint return is $130,000. Ray can contribute $6,000 to a Roth IRA. Alternatively, however, if their AGI was $197,000, Ray would be limited to a maximum contribution of $3,600. Since their AGI exceeds the threshold of $193,000 by $4,000, the $5,500 contribution is reduced by $2,400 [($4,000/$10,000) × $6,000]. ◀

EXAMPLE I:7-52 ▶ Bob, age 60 in 2019, contributes $6,000 each year to a Roth IRA in 2019, 2020, and 2021. On November 30, 2024, the value of the Roth IRA is $20,000. Bob has experienced some financial setbacks and needs to withdraw the money from the Roth IRA. If Bob withdraws $18,000 in 2024 and waits until January 2025 to withdraw the remaining $2,000, none of the distributions are taxable. This result occurs because the first $18,000 is treated as coming from contributions. The remaining $2,000 is nontaxable because Bob has met the five-year test and is over age 59½. Conversely, if Bob withdraws the entire $20,000 in 2024, $2,000 must be included in his income because the five-year test was not met. No penalty will be imposed because he is over age 59½. ◀

TAX STRATEGY TIP

Because of the tax-deferral of income within a Roth IRA and the ability to withdraw amounts at retirement tax-free, the Roth IRA generally is superior to a traditional IRA for younger taxpayers. Once a taxpayer reaches 50 years of age, the two types of IRAs become more equal.

A final aspect of Roth IRAs is the ability to "rollover" funds from an existing traditional IRA into a Roth IRA. Since the taxpayer received a deduction for the contribution into the traditional IRA, any rollover amount must be included in gross income in the year the rollover occurred, but is not subject to the 10% penalty for early withdrawals. This rollover option also has been extended to existing 401(k), 403(b), or 457 plans for years beginning after 2012. There is considerable interest in this rollover option for taxpayers. The essential question is whether a taxpayer should convert his or her traditional IRA to a Roth IRA and pay the tax currently or keep the traditional IRA and pay the tax on a current basis as the amounts are withdrawn. The key variable in this analysis is the taxpayer's age. Younger taxpayers would definitely benefit with a Roth IRA as the amounts in the Roth IRA have years to accumulate and compound and such amounts will never be subject to taxation. Other important variables include the taxpayer's assessment of his or her future marginal tax rate and the ability to pay the tax on the rollover out of private funds.

EXAMPLE I:7-53 ▶ John is single and has a traditional IRA that has a balance of $250,000 on June 30, 2019. John would like to rollover the $250,000 to a Roth IRA. John is permitted to rollover the $250,000 from his traditional IRA to a Roth IRA in 2019. He must include the $250,000 in his gross income in 2019 but no penalty is imposed. This treatment is now also available for 401(k), 403(b), or 457 plans in addition to traditional IRAs. ◀

Below is a discussion of some of the important tax rules for Roth IRAs:

- Like traditional IRAs, Roth IRAs must be established by the due date of the tax return (not including extensions). Similarly, contributions to a Roth IRA also must be made by the due date of the return (i.e., April 15, 2020, for 2019 contributions).
- Contributions to a Roth IRA are never deductible.
- Contributions to a Roth IRA are subject to special modified AGI limitations.
- Contributions to a Roth IRA can be made after the owner has reached age 70½. Similarly, no distributions are required at any age from a Roth IRA. (Remember: owners of traditional IRAs must begin taking distributions in the year after the taxpayer has reached age 70½).

- Taxpayers who are 50 years or older by the end of the taxable year may contribute an additional $1,000 per year (or a total of $7,000 in 2019).
- Withdrawals from a Roth IRA are not taxable if such withdrawals are "qualified distributions." If a withdrawal is not a qualified distribution, the amount is taxed under special ordering rules and subject to the 10% penalty.

STOP & THINK

Question: Both nondeductible contributions to a traditional IRA and contributions to a Roth IRA are similar in the sense that neither provides a tax deduction at the date of contribution. Which of the two types would be most advantageous to taxpayers?

Solution: Clearly, if a taxpayer qualifies for a Roth IRA, that type of IRA is superior to a nondeductible contribution to a traditional IRA. The reason is that distributions from a Roth IRA are totally excluded from gross income while only the principal portion of nondeductible contributions to a traditional IRA are excludable. In other words, the earnings generated in a Roth IRA are excluded from gross income whereas earnings associated with nondeductible contributions to a traditional IRA are subject to taxation. Generally, a nondeductible contribution to a traditional IRA will not be advantageous unless the taxpayer's AGI exceeds $203,000.

For a discussion of the decision whether to invest in a traditional deductible IRA or a Roth IRA, see the Tax Planning Considerations later in this chapter. Also, for a more detailed analysis including computations, see Chapter I:18 of the *Individuals* textbook.

Topic Review I:7-4 contains a table which summarizes the eligibility rules for traditional and Roth IRAs.

COVERDELL EDUCATION SAVINGS ACCOUNT

A special type of IRA, referred to as an Education IRA, was established to specifically assist low- and middle-income taxpayers with higher education expenses. The Education IRA was renamed the Coverdell Education Savings Account (CESA) in 2001. CESAs have a number of attractive features:

ADDITIONAL COMMENT

Any number of people may contribute funds to a Coverdell Education Savings Account for one child, but all of the contributions may not total more than $2,000 for that child.

- The maximum annual contribution into such plan is $2,000.[62]
- CESAs may be used for elementary and secondary education expenses as well as for higher education expenses, and
- Taxpayers can claim either the HOPE scholarship credit or Lifetime Learning Credit as well as excluding distributions from a CESA in the same year.

TOPIC REVIEW I:7-4

Traditional and Roth IRAs—Eligibility

If 2019 AGI Is	Eligible for IRA (Joint Returns)				
	Traditional IRA (Deductible)			Roth IRA	Traditional IRA (Nondeductible)*
	A	B	C		
Up to $103,000	Yes	Yes	Yes	Yes	Yes
$103,000–$123,000	Yes	Partially	Yes	Yes	Yes
$123,000–$193,000	Yes	No	Yes	Yes	Yes
$193,000–$203,000	Yes	No	Partially	Partially	Yes
Over $203,000	Yes	No	No	No	Yes

A If neither spouse is an active participant in an employer-sponsored plan
B For the IRA of a spouse who is an active participant in an employer-sponsored plan
C For the IRA of a spouse who is not an active participant in an employer-sponsored plan

* If AGI is not above $203,000, a nondeductible IRA will not be advantageous.

[62] Pursuant to the American Taxpayer Relief Act of 2012 (ATRA 2012), the contribution limit of $2,000 and other enhancements that were enacted in 2001 were made permanent for 2013 and future years.

A contributor can make a *nondeductible* contribution of up to $2,000 per year into a CESA for a designated beneficiary until the beneficiary reaches age 18.[63] The contributor need not be related to the beneficiary and there is no limit on the number of CESAs that can be set up by a contributor. Distributions to the beneficiary are excluded from gross income provided the distribution does not exceed the *qualified education expenses* of the designated beneficiary during the taxable year. Qualified education expenses include tuition, fees, books, supplies, equipment, and room and board. In the case of elementary and secondary education expenses, qualified education expenses include academic tutoring and Internet access fees. Distributions in any tax year in excess of qualified education expenses are includible in the gross income of the beneficiary and subject to a 10% penalty.

Similar to other IRA-type accounts, there are phaseout limits based on the contributor's AGI. The $2,000 annual contribution is phased out for married taxpayers filing joint returns with AGI from $190,000 to $220,000 ($95,000 to $110,000 for other taxpayers). In addition, if the taxpayer claims either the HOPE scholarship credit or the Lifetime Learning Credit, the education expenses used for these credits must reduce the qualified expenses for exclusion from a CESA.

EXAMPLE I:7-54 ▶ Lee and Patsy are married and have two young grandchildren. To assist the grandchildren with their future education expenses, they set up a CESA for each child in 2019 and plan to deposit $2,000 in both accounts. Their AGI for 2019 is $202,000. Because their AGI exceeds $190,000, they are limited to putting $1,200 [$2,000 – $2,000(($202,000 – $190,000)/$30,000)] into the accounts in 2019. In the future, the children can withdraw amounts tax-free from their CESA to pay for qualified education expenses for elementary, secondary, or higher education. ◀

EXAMPLE I:7-55 ▶ Craig Shaw is about to enter State University as a freshman and plans to withdraw amounts from his CESA to help pay his expenses. His expenses for the Fall Semester 2019 are as follows:

Tuition and fees	$2,200
Books	500
Supplies	300
Room and board	2,400
Total	$5,400

Craig's parents plan on paying Craig's tuition and fees, and Craig will pay the remaining $3,200 from his CESA. Craig qualifies as a dependent of his parents for the tax year. Craig's parents plan on claiming the American Opportunity Tax Credit. Craig is not required to include the $3,200 in his gross income in 2019 as his qualified education expenses are at least $3,200. Craig's parents will use $2,200 to claim the AOTC credit. ◀

HEALTH SAVINGS ACCOUNTS

Health Savings Accounts (HSAs) were established by Congress to enable individuals to accumulate funds on a tax-free basis to pay qualified medical expenses currently or in the future.[64] In summary, HSAs operate as follows:

- The individual must be covered by a high-deductible health plan and not covered under any other health plan that is not a high-deductible health plan.
- Taxpayer contributes money into an HSA with a qualified trustee or custodian (much like an IRA). The taxpayer must be an eligible individual and the contributions are subject to limitations. These detailed issues are discussed below.
- The taxpayer is allowed a *for* AGI deduction in the year the contributions are made.
- Distributions from the HSA that are used exclusively to pay for qualified medical expenses (medical expenses as defined in Sec. 213(d), but not health insurance premiums)

[63] Sec. 530. Contributions are allowed to continue past age 18 for a special-needs beneficiary.

[64] Sec. 223. Archer Medical Savings Accounts are similar to HSAs but cannot be established after 12/31/05. MSAs have a more restrictive definition of HDHP so there is little incentive to use them.

are excludable from gross income. However, any amount of the distribution that is not used to pay for qualified medical expenses is includable in the gross income of the taxpayer and subject to an additional 10% penalty. The 10% penalty is waived if the beneficiary/taxpayer is age 65 or older.

HSAs are only available to eligible individuals. An eligible individual is any individual who (1) is covered under a high-deductible health plan (HDHP), (2) is not also covered by any other health plan that is not an HDHP, (3) is not entitled to benefits under Medicare (i.e., generally, has not reached age 65), and (4) may not be claimed as a dependent on another person's tax return. An HDHP is a plan for an individual with an annual deductible in 2019 of at least $1,350 and annual out-of-pocket expenses (other than premiums) required to be paid not exceeding $6,750. For family coverage, these amounts are $2,700 and $13,500, respectively.

Annual contributions to an HSA are determined separately for each month the plan is in effect and is of the *lesser* of (1) 100% of the annual deductible under the HDHP (minimum of $1,350) or (2) $3,500. For individuals with family coverage under an HDHP, the amounts are (1) 100% of the annual deductible under the HDHP (minimum of $2,700) or (2) $7,000. Catch-up contributions are permitted for individuals age 55 to 64.

EXAMPLE I:7-56 ▶ Roy, age 45, established an HDHP for his family with a $3,600 annual deductible on May 1, 2019. Roy is eligible to put $2,400 (8 months × $300) into an HSA for the calendar year 2019. The purpose of the fund is to pay for medical expenses for himself and his family. In 2019, Roy is allowed to deduct the $2,400 as a deduction for AGI. Any earnings of the fund investments are not subject to tax if the distribution is used to pay qualified medical expenses. ◀

EXAMPLE I:7-57 ▶ In 2022, Roy takes a $5,000 distribution from the HSA to make a down payment on a new automobile. Since the distribution was not used to pay qualified medical expenses, Roy must include the $5,000 in his income and pay a $500 ($5,000 × 10%) penalty in 2022. ◀

TAX PLANNING CONSIDERATIONS

OBJECTIVE 10

Describe tax planning considerations for business expenses and deferred compensation

PROVIDING NONTAXABLE COMPENSATION TO EMPLOYEES

Employers should consider the tax consequences to employees when changes in fringe benefit and deferred compensation arrangements are evaluated. For example, it is preferable for an employer to pay for fringe benefit items such as group term life insurance (up to $50,000 in coverage), health and accident insurance, employee parking, and so on rather than to give cash raises of a comparable amount. Such payments are nontaxable to the employee up to certain limits, whereas a comparable salary increase is fully taxable. Both types of payments are deductible by the employer.

REAL-WORLD EXAMPLE

Banks and other financial institutions in their ads sometimes compare the accumulated wealth in an IRA to the accumulated wealth in a fully taxable investment. Although the IRA is generally advantageous, the ads sometimes overstate the advantages because they fail to deduct the tax that will be paid when amounts are withdrawn from the IRA.

Consideration should also be given to increased deferred compensation benefit programs for employees, particularly highly-compensated individuals. The use of nonqualified deferred compensation plans, restricted property, and stock options result in tax deferrals and may result in the eventual recognition of capital gains that may be used to offset capital losses or that are taxed at preferential tax rates.

All eligible employees should consider establishing an individual retirement account (IRA) because of the available tax deferral benefits. Even if a premature withdrawal (i.e., before age 59½ occurs), the time value of the deferred benefits for the plan contributions and the earnings may be greater than the penalty tax imposed.

ROLLOVERS TO ROTH IRA

Taxpayers have the ability to rollover amounts from traditional IRAs as well as 401(k), 403(b), or 457 plan to a Roth IRA.[65] However, if such a rollover is made, the taxpayer

[65] 401(k), 403(b), and 457 plans must have a separate "designated Roth account" for each participant in the plan.

must include the rollover amount in gross income in the year of the rollover. The principal benefit of the rollover is that once the amounts are in the Roth IRA, no further taxes are due on these amounts upon distribution (assuming the five-year test is met). The essential question, therefore, is whether it is advantageous to rollover amounts to a Roth IRA and pay the tax now or keep the original plan intact and pay the tax when regular distributions are made.

The decision rests on several factors, including (1) the marginal tax rate at retirement, (2) age of taxpayer, and (3) payment of tax from rollover from post-tax funds. First, if a taxpayer's marginal tax rate at retirement is expected to be lower than the current tax rate, a rollover may not be advantageous. Second, younger taxpayers are more likely to benefit from a rollover because they have more years to accumulate earnings tax-free and may be in a lower tax bracket today than at retirement. Finally, if the taxes that accrue from the rollover must be paid from the rollover funds, a rollover will probably not be in the taxpayer's favor. In other words, taxpayers should have sufficient funds from other sources to pay the tax, then the entire amount of rollover into the Roth IRA will have maximum ability to grow on a tax-free basis.

Each case must be analyzed based on the unique factors of that particular situation. However, for most taxpayers, it is generally advantageous to rollover funds from a traditional type of plan to a Roth IRA. The desirability of Roth conversions is increased if the taxpayer believes tax rates will go higher in the future.

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 11

Describe compliance and procedural considerations for business and deferred compensation expenses

SUBSTANTIATING TRAVEL AND BUSINESS MEAL EXPENSES

Travel and entertainment expenses are disallowed if the taxpayer does not maintain adequate records or documentary proof of the expenditures.[66] Normally, documentation includes expense statements (diary or account book) and proof of the amount, time, place, and business purpose. Strict substantiation rules are enacted in the law to curb widespread abuses in the so-called expense account living practices engaged in by some taxpayers.

To make compliance easier, the IRS formulated the following administrative procedural rules:

- The standard mileage rate may be used to compute automobile expenses in lieu of actual expenses and is reported on Form 2106 (Employee Business Expenses).
- Taxpayers may elect an optional method for computing deductions for business travel and meal expenses in lieu of using actual costs. If a per diem allowance is paid by a self-employed individual in lieu of actual expenses, the expense is deemed to be substantiated if it does not exceed a federal per diem rate for the travel locality. In lieu of using actual expenses a self-employed individual may use the applicable federal per diem rate. The taxpayer must still provide documentation of time, place, and business purpose for the expenditures.

KEY POINT

It is extremely important to be able to substantiate travel and entertainment expenses. The *Cohan* Rule permits a reasonable deduction when substantiation is lacking but does not apply to travel and entertainment expenses (see Chapter I:6).



ETHICAL POINT

The CPA has a responsibility to make sure that proper documentation has been furnished by the taxpayer to substantiate travel and entertainment expenses according to the provisions in Sec. 274(d). The CPA cannot rely on the use of estimates for these expenses despite the fact that the *AICPA's Statements on Standards for Tax Services No. 4* (see Appendix E) permits the use of estimates if it is impractical to obtain exact data and the estimated amounts appear to be reasonable.

REPORTING OFFICE IN HOME EXPENSES

Form 8829 (Expenses for Business Use of Your Home) must be used to figure the allowable expenses for business use that are reported on Schedule C (Profit or Loss from Business) and the carryover of any nondeductible amounts from prior years. Form 4562 (Depreciation and Amortization) must also be used to compute depreciation on the office portion of the residence.

[66] Sec. 274(d).

QUALIFICATION OF PENSION AND PROFIT-SHARING PLANS

The reporting requirements to establish and maintain a qualified pension or profit-sharing plan are too complex for this text. However, it should be noted that it is generally advisable for a taxpayer to obtain advance approval of the plan from the district director of the IRS by requesting a determination letter that all requirements for qualification have been met. A new determination letter should generally be requested when any material (e.g., substantial) modification is made to a plan. Material changes are frequently required when major tax legislation is enacted. In addition, several reports must be filed with the IRS and the U.S. Department of Labor.

Taxpayers who make deductible contributions to an IRA report the deduction on Schedule 1 of Form 1040 (see Figure I:7-2).

SCHEDULE 1 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

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

OMB No. 1545-0074
2018
Attachment Sequence No. **01**

Name(s) shown on Form 1040 | **Your social security number**

Additional Income	1–9b	Reserved			1–9b	
	10	Taxable refunds, credits, or offsets of state and local income taxes			10	
	11	Alimony received			11	
	12	Business income or (loss). Attach Schedule C or C-EZ			12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ► ☐			13	
	14	Other gains or (losses). Attach Form 4797			14	
	15a	Reserved			15b	
	16a	Reserved			16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17	
	18	Farm income or (loss). Attach Schedule F			18	
	19	Unemployment compensation			19	
	20a	Reserved			20b	
	21	Other income. List type and amount ►			21	
	22	Combine the amounts in the far right column. If you don't have any adjustments to income, enter here and include on Form 1040, line 6. Otherwise, go to line 23			22	
Adjustments to Income	23	Educator expenses	23			
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	24			
	25	Health savings account deduction. Attach Form 8889	25			
	26	Moving expenses for members of the Armed Forces. Attach Form 3903	26			
	27	Deductible part of self-employment tax. Attach Schedule SE	27			
	28	Self-employed SEP, SIMPLE, and qualified plans	28			
	29	Self-employed health insurance deduction	29			
	30	Penalty on early withdrawal of savings	30			
	31a	Alimony paid **b** Recipient's SSN ►	31a			
	32	IRA deduction	32			
	33	Student loan interest deduction	33			
	34	Reserved	34			
	35	Reserved	35			
	36	Add lines 23 through 35			36	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2018**

FIGURE I:7-2 ▶ SCHEDULE 1 OF FORM 1040

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:7-1 Why is it important to distinguish whether an individual is an employee or an independent contractor (self-employed)?

I:7-2 Deductions for individual taxpayers are classified as either *for* AGI or *from* AGI. Discuss the two categories of *for* AGI deductions.

I:7-3 *For* AGI deductions of individual taxpayers that are connected with either a trade or business or a rental activity are reported differently than other *for* AGI deductions reported as Adjustments to Income on Schedule 1 of Form 1040. Explain the difference as to how the two groups are reported for tax purposes.

I:7-4 In each of the following cases involving travel expenses, indicate how each item is reported on the taxpayer's tax return for 2019. Include any limitations that might affect its deductibility.

a. Marilyn lives in Houston and owns several rental properties in Denver. To supervise the management of these properties, Marilyn incurs travel expenses including airfare, lodging, and meals while traveling to and from the location of the rental properties.

b. Marc is an employee who incurs travel expenses as a salesperson. The expenses are fully reimbursed by his employer after an adequate accounting has been made.

c. Assume the same facts as in Part b, except that the expenses are not reimbursed.

d. Kay is a self-employed attorney who incurs travel expenses (including meals) to prepare a court case in a nearby city where she spends the night.

I:7-5 Kelly is self-employed and incurs $2,200 of business meal expenses in connection with business travel. $500 of the business meal costs are considered to be lavish or extravagant. How much can Kelly deduct in 2019?

I:7-6 Latoya is an independent contractor and operates her own successful consulting business in Milwaukee. She has just signed a large contract with a new client that will require her to spend nine months in Cincinnati. Latoya leaves her husband and children in Milwaukee and incurs the following expenses in connection with the temporary assignment:

Airfare to and from the temporary assignment in Cincinnati	$ 1,000
Living expenses in the new location (including meals of $1,000)	8,000
Personal clothing	1,500
Total	$10,500

a. Which (if any) of these items can Latoya deduct in 2019?

b. Would your answer to Part a change if Latoya, after completing the nine month assignment, needed to spend an additional six months in Cincinnati?

I:7-7 Louie is a self-employed taxpayer and also an investor in the stock market in his spare time. In the current year, Louie incurs $2,500 of travel expenses and $1,000 in registration fees related to attending investment seminars. Can Louie deduct the expenses for attending an investment seminar?

I:7-8 A self-employed individual travels in connection with her business. She travels in the city where she lives and works and also in several surrounding states. What is the criteria for her to deduct her travel expenses?

I:7-9 If a self-employed individual uses the standard mileage rate method for the year in which an automobile is acquired, may the actual expense method be used in a subsequent year? If so, what restrictions are imposed (if any) on depreciation methods? What adjustments to basis are required?

I:7-10 If a self-employed individual uses the actual method of deducting automobile expenses and claims depreciation for the first two years of business use, can the individual switch to the standard mileage rate method for the third year and beyond?

I:7-11 When a self-employed individual travels for business but mixes in some pleasure days, such as sightseeing, how does the taxpayer deduct expenses connected with the travel expenses to and from the destination as well as expenses while at the destination (such as hotel, meals, etc.)?

I:7-12 Robert is an independent contractor who lives and works in Philadelphia, PA. Robert rarely travels out-of-town but travels extensively in the Philadelphia area meeting with customers. He is home every evening after work. Is Robert permitted to deduct any of the expenses below?

Automobile expenses (not including commuting expenses)	$2,470
Automobile expenses for commuting to his office	620
Business lunches with his customers	580
Lunch by himself in Philadelphia	750

I:7-13 What taxpayers are eligible to deduct qualified moving expenses in years 2018–2025?

I:7-14 What are the two methods of computing automobile expenses of self-employed taxpayers?

I:7-15 Are deductions allowed for entertainment expenses in 2019?

I:7-16 If an individual belongs to a country club and uses the facility primarily for business entertainment of customers, what portion of the club dues is deductible?

I:7-17 Bass Corporation purchases 10 tickets to the Super Bowl in February 2019 for entertaining its customers. Due to unusually high demand, the tickets have to be purchased for $25,000 (10 × $2,500). The face value of the tickets is only $2,000 (10 × $200). The $2,500 cost per ticket includes a $500 charge for food and beverages and is separately stated on the invoice. What amount is deductible by Bass in 2019?

I:7-18 Would education expenses incurred by a self-employed individual be allowed in 2019 for the following expenses?

Cost of a CPA review course	$ 2,500
Accounting continuing education expenses (including travel, conference fees, and meals of $200)	1,000
Law school tuition and books	9,000
Total	$12,500

I:7-19 Discuss whether either of the following individuals are entitled to an office-in-home deduction:

a. Maggie is a self-employed management consultant who maintains an office in her home exclusively used for client meetings and other business-related activities. Maggie has no other place of business and her office is the most significant place for her business. She has substantial income from the consulting practice.

b. Bobby operates his own sole proprietorship as an electrician. He maintains an office at home where he keeps his books, takes phone calls from customers, and does the payroll for his five employees. All of his electrical work is done at the location of his customers.

I:7-20 Compare and contrast the tax advantages accruing to employers and employees from the establishment of a qualified pension or profit-sharing plan versus a nonqualified deferred compensation arrangement (e.g., a restricted property plan).

I:7-21 What is the difference between a defined benefit pension plan and a defined contribution pension plan?

I:7-22 Austin Corporation is proposing the establishment of a pension plan that will cover only employees with salaries in excess of $150,000. No other employees are covered under comparable qualified plans. What problems (if any) do you envision regarding the plan's qualification with the IRS?

I:7-23 Babson Corporation is proposing the creation of a qualified profit-sharing plan for its employees. The proposed plan provides for vesting of employer contributions after 20 years because the company wants to discourage employee turnover and does not feel that short-term employees should qualify for benefits. Will this plan qualify? Why or why not?

I:7-24 Explain how distributions from a qualified pension plan, which are made in the form of annuity payments, are reported by an employee under the following circumstances:

a. No employee contributions are made to the plan.

b. The pension plan provides for matching employee contributions.

I:7-25 Discuss the limitations and restrictions that the Internal Revenue Code places on employer contributions to qualified pension and profit-sharing plans.

I:7-26 Why are nonqualified deferred compensation plans particularly well-suited for use in executive compensation arrangements?

I:7-27 A recently-formed corporation is considering going public and anticipates substantial future appreciation in its stock. Would it be advisable for an executive/employee receiving stock (restricted property) to elect to recognize income immediately under Sec. 83(b)? Contrast the tax consequences of a restricted property arrangement for both the employer and employee when this election is made versus when it is not made. Consider the effect of the subsequent lapsing of the restrictions and the employee's sale of the stock.

I:7-28 List and discuss the qualification requirements for an incentive stock option plan (ISO). Describe the advantages and disadvantages of ISOs compared to nonqualified stock option plans.

I:7-29 What difference does it make if a nonqualified stock option has a readily ascertainable FMV on the grant date?

I:7-30 Is a self-employed individual, who is also employed and covered by an employer's qualified pension plan, eligible to establish an H.R. 10 or a SEP plan on his or her self-employment income?

I:7-31 What limitations are placed on self-employed individuals for contributions made to defined contribution H.R. 10 plans? Must self-employed individuals cover their full-time employees if an H.R. 10 plan is established?

I:7-32 Discuss the essential differences between a traditional IRA and a Roth IRA.

I:7-33 Would you be more favorably inclined to advise a 30-year-old individual to establish a traditional deductible IRA or a Roth IRA? Explain. Consider any tax problems involved if the IRA funds are needed before age 59½. Would your answer change for a 55-year-old individual?

I:7-34 Your client, Charley Long, age 40, has requested your advice with respect to his IRA. He has a traditional IRA with a balance of $250,000 and his current AGI is $150,000. He expects his income to increase slightly when he retires at age 65. Charley has been reading about Roth IRAs and wants your advice as to whether he should rollover the $250,000 from his traditional IRA into a Roth IRA. He has sufficient outside money to pay any taxes due on the rollover. What advice would you give Charley?

I:7-35 Sally, who is single and age 40, made deductible IRA contributions in several early years, but has not been eligible to make deductible IRA contributions for the last 5 years because she is covered under her employer's plan. Her AGI is $100,000. She is interested in making IRA contributions in the current year. What advice would you give her?

I:7-36 Discuss the major features of a Coverdell Education Savings Account (CESA).

I:7-37 The owner of an unincorporated small business is considering whether to establish a simplified employee pension (SEP) plan for its employees.

a. What nontax factors might make a SEP attractive as an alternative to establishing a qualified pension or profit-sharing plan?

b. Is the owner of the small business eligible to make contributions on his or her behalf to the SEP?

ISSUE IDENTIFICATION QUESTIONS

I:7-38 Georgia is self-employed and recently completed a consulting assignment at an away-from-home location. It was realistically expected that the assignment would be completed in 15 months but the actual time period was only 11 months. Georgia incurred $15,000 of away-from-home expenses during the 11-month period. What tax issues should Georgia consider?

I:7-39 Juan, a self-employed medical doctor, maintains an office in his home where he maintains patient records and performs billing procedures. Most of his time is spent visiting patients and performing surgical procedures in the operating room at several local hospitals. Juan intends to deduct his expenses of his office in his home. What tax issues should Juan consider?

I:7-40 David is an independent contractor who has been in the consulting business for several years. David has applied and been accepted into a prestigious MBA program. The program is two years in duration. David has decided to suspend his consulting activities to complete the MBA degree. David plans to resume his consulting business in two years. David wants to deduct his education expenses. What are the relevant tax issues in this case?

PROBLEMS

I:7-41 ***Business-Related Expenses.*** Mike, a self-employed consultant, incurs the following business-related expenses in 2019:

Actual automobile expenses	$ 2,500
Moving expenses	4,000
Entertainment expenses	1,500
Travel expenses (including $500 of business meals)	2,500
Professional dues and subscriptions	500
Total	$ 11,000

Mike earned $130,000 of gross income from his consulting business and had $12,000 of interest and dividend income in 2019 before any of the above expenses are deducted. He has $20,000 of itemized deductions. Mike is married and files a joint return with his wife, Ann, who has no income.

a. What is the amount of Mike's deduction for business-related expenses for 2019?

b. What is Mike and Ann's AGI and taxable income in 2019, assuming he is married and files a joint return, and ignoring the self-employment tax?

I:7-42 ***Travel and Entertainment.*** Monique is a self-employed manufacturer's representative (i.e., an independent contractor) who solicits business for numerous clients and

receives a commission based on sales. She incurs the following expenditures during the current year:

Airfare and lodging while away from home overnight	$ 4,000
Business meals while traveling at which business is discussed	1,000
Local transportation costs for automobile, parking, tolls, etc. (business-related)	2,000
Commuting expenses	1,000
Local entertainment of customers	2,000
Total	$10,000

a. Which of the expenditures listed above (if any) are deductible by Monique for 2019?
b. Are each of these items classified as *for* AGI or *from* AGI deductions?
c. How would your answers to Parts a and b change if Monique were an employee rather than self-employed and none of the expenses were reimbursed by her employer?

I:7-43 ***Business-Related Expenses.*** Mary is self-employed and incurs $3,600 of business-related travel and entertainment expenses during 2019 in which she was away from home overnight. These business expenses include the following:

Airfare	$1,500
Taxi fare	100
Meals eaten alone while away from home on business	300
Laundry	50
Lodging	650
Business meals with customers at which business is discussed	500
Entertainment of customers	500
Total	$3,600

Mary also pays $1,000 of investment counseling fees and $500 of tax return preparation fees in the current year.
a. What is the total amount of Mary's deductible expenses for 2019?
b. Are the deductible expenses classified as *for* AGI or *from* AGI?

I:7-44 ***Travel Expenses.*** Marilyn, an independent contractor who lives and works in Cleveland, obtains a large contract that will require her to live and work in Atlanta for a period of ten months. Marilyn leaves her husband and children in Cleveland and rents an apartment in Atlanta during the ten-month period. Marilyn incurs the following expenses:

Airfare to and from Atlanta	$ 800
Airfare for weekend trips to visit her family	8,000
Apartment rent	10,000
Meals in Atlanta	8,500
Entertainment of customers	2,000
Total	$29,300

a. What are Marilyn's total deductions for 2019?
b. Are the expenditures classified as *for* AGI or *from* AGI deductions?
c. Do the tax consequences change if Marilyn's assignment is for a period of more than one year?
d. Do the tax consequences in Parts a through c change if it was realistically expected that the work would be completed in ten months but after the ten-month period Marilyn is asked to continue for seven more months and if an additional $10,000 of travel expenses are incurred during the extended period?

I:7-45 ***Business/Personal Travel Expenses.*** Mike is an independent contractor in 2019. Mike attends a professional trade association convention in Los Angeles. He spends three days at the meeting and two days vacationing before the meeting. Mike's total expenses include the following:

Airfare	$ 450
Meals ($50 per day)	250
Hotel ($100 per day)	500
Entertainment of customers (business is discussed)	500
Total	$1,700

a. How much can Mike deduct for business-related expenses for 2019?
b. How would your answers change if Mike spent two days at the meeting and three days vacationing?

I:7-46 ***Auto Expenses.*** Michelle is self-employed and uses her personal automobile for business trips. During 2019, Michelle drives her car 60% for business use and incurs the following total expenses (based on 100% use of car):

Gas and oil	$12,000
Repairs	2,800
Depreciation	4,700
Insurance and license fees	2,600
Parking and tolls (business related)	400
Total	$22,500

Michelle drives her car a total of 40,000 miles (24,000 business miles) during 2019.
a. What amount is deductible if Michelle uses the standard mileage method?
b. What amount is deductible if Michelle uses the actual cost method?
c. Can taxpayers switch back and forth between the mileage and actual methods each year?

I:7-47 ***Auto Expenses.*** Amelie is self-employed and uses her personal automobile in connection with her business. During 2019, Amelie drove her car a total of 28,000 miles. Her business log shows that she drove 22,400 miles for business purposes. During 2019, Amelie incurred the following actual expenses based on 100% use, that is, 28,000 total miles:

Gas and oil	$ 7,800
Repairs and maintenance	1,200
Depreciation	5,800
Insurance	1,440
Licenses and fees	300
	$16,540

a. Compute Amelie's deduction if she uses the actual cost method.
b. Compute Amelie's deduction if she uses the standard mileage method.
c. Assume Amelie used the standard mileage method in 2019. In addition to the automobile expenses, she made several business trips and incurred the following travel expenses while away from home overnight:

Airfare	$ 4,600
Hotel	1,860
Meals	720
Taxi fees and tips	280
	$7,460

None of the above expenses were personal in nature. What are Amelie's deductions in 2019 after all limitations?
d. Would Amelie's deduction in 2019 be *for* AGI or *from* AGI?

I:7-48 ***Meal and Entertainment Expenses.*** Milt, a self-employed attorney, incurs the following expenses in 2019:

Business lunches for clients and prospective clients	$4,000
Entertainment of professional associates in his home (immediately following business meetings)	2,000
Country club dues (the club is used exclusively for business)	2,500
Total	$8,500

Which of the expenditures listed above (if any) are deductible in 2019 by Milt?

I:7-49 ***Entertainment Expenses.*** Beach Corporation purchases tickets to sporting events and uses them to entertain customers. In 2019 Beach Corporation purchases the following tickets:

100 tickets to football games (face value of the tickets is $7,000)	$10,000
A skybox rented for six NFL football games (seating capacity of the skybox is 20, and the highest price of a nonluxury box seat is $100; included in the price was a separate charge for food and beverages in the amount of $5,000)	30,000

a. What amount of the above expenses are deductible in 2019?
b. Would your answer change if the amount for food and beverages was not separately stated in the $30,000 price?

I:7-50 ***Education Expenses.*** For each of the following independent situations, determine whether any of the expenditures qualify as deductible education expenses in connection with a trade or business (Reg. Sec. 1.162-5). Are the expenditures classified as *for* AGI or *from* AGI deductions?

a. Law school tuition and books for a self-employed individual who works in the income tax business and is pursuing a law degree: $8,000.
b. Continuing professional accounting education expenses of $1,900 for a self-employed CPA: travel, $1,000 (including $200 meals); registration fees, $800; books, $100.
c. MBA education expenses for a self-employed individual totaling $25,000: tuition, $23,000; transportation, $800; and books, $1,200.
d. Bar review courses for a recent law school graduate: $3,000.

I:7-51 ***Office in Home.*** Nancy is a self-employed consultant who uses 10% of her residence as an office. The office is used exclusively for business and is frequented by customers on a regular basis. Nancy also uses her den as an office (10% of the total floor space of her home) to prepare bills and keep records. However, the den is also used by her children as a TV room. In 2019, Nancy's net income from the consulting business (other than her home office expenses) amounts to $40,000 in 2019. She also incurs $1,400 of expenses directly related to the office (e.g., painting of the office, window blinds). Nancy incurs the following expenses in 2019 related to her residence:

Real estate taxes	$ 2,000
Mortgage interest	5,000
Insurance	500
Depreciation	3,500
Repairs and utilities	1,000
Total	$12,000

a. Which of the expenditures above (if any) are deductible for 2019? Are they *for* AGI or *from* AGI deductions?
b. Would your answer to Part a change if Nancy's net income from consulting were only $2,500 for the year?

I:7-52 ***Deferred Compensation Plan Requirements.*** Identify whether each of the following plan features is associated with a qualified pension plan, a qualified profit-sharing plan, an employee stock ownership plan, a nonqualifed plan, or none of these plans.

a. Annual employer contributions are not required, but substantial and recurring contributions must be made based on a predetermined formula.
b. Annual, systematic, and definite employer contributions are required without regard to profits but based on actuarial methods.
c. Forfeitures must be used to reduce contributions that would otherwise be made under the plan.

d. The plan may discriminate in favor of highly compensated individuals.
e. The trust is funded with the contribution of employer stock, which is subsequently distributed to employees.

I:7-53 ***Taxability of Pension Payments.*** Pat is a participant in a qualified pension plan. She retires on January 1, 2019, at age 63, and receives pension payments beginning in January 2019. Her pension payments, which will be received monthly for life, amount to $1,000 per month. Pat contributed $30,000 to the pension plan on a pre-tax (or tax-deferred) basis, and the number of anticipated payments based on Pat's age of 63 years is 260 months (see IRS table in Chapter I:3) from the date she starts receiving payments.
a. What gross income will Pat recognize in 2019 and each year thereafter?
b. How would your answer to Part a change if Pat made contributions to the plan on an after-tax basis?
c. If, in Part b, Pat dies in December 2020 after receiving pension payments for two full years, what tax consequences occur in the year of death?

I:7-54 ***Restricted Property.*** In 2019, Bear Corporation transfers 100 shares of its stock to its employee Patrick. The stock is valued at $10 per share on the issue date. The stock is subject to the following restrictions:

- Patrick cannot transfer the stock by sale or other disposition (except in the event of death) for a five-year period.
- The stock must be forfeited to Bear Corporation if Patrick voluntarily terminates his employment with the company within a five-year period.

In the year 2024, the Bear stock is worth $100 per share when the restrictions expire.
a. Assuming that no Sec. 83(b) election is made, what are the tax consequences to Patrick and Bear Corporation in 2019?
b. What are the tax consequences to Patrick and Bear Corporation if Patrick makes a valid Sec. 83(b) election in 2019?
c. What are the tax consequences to Patrick and Bear Corporation if Patrick forfeits the stock back to the company in 2020 when the stock is worth $20 per share if an election was made under Sec. 83(b)? What would happen if no Sec. 83(b) election were made?
d. What are the tax consequences to Patrick and Bear Corporation upon the lapse of the restrictions in the year 2024 if an election has been made under Sec. 83(b)? What would the results be if no Sec. 83(b) election were made?
e. What are the tax consequences to Patrick and Bear Corporation if Patrick sells the Bear stock in the year 2025 for $120 per share if a Sec. 83(b) election is made? if no Sec. 83(b) election is made?

I:7-55 ***IRAs.*** On February 14, 2020, Jamal, who is single and age 30, establishes a traditional IRA and contributes $6,000 to the account. Jamal's adjusted gross income is $70,000 in 2019 and $60,000 in 2020. Jamal is an active participant in an employer-sponsored retirement plan.
a. What amount of the contribution is deductible? In what year is it deductible?
b. How is the deduction (if any) reported (i.e., *for* AGI or *from* AGI)?
c. How would your answer to Part a change, if at all, if Jamal were not an active participant in an employer-sponsored retirement plan?
d. How would your answer to Part a change if Jamal were married and files a joint return with his spouse, who has no earned income? (Assume their combined AGI is $85,000.)

I:7-56 ***IRAs.*** Phil, age 30, is married and files a joint return with his spouse. On February 15, 2020, Phil establishes a traditional IRA for himself and a spousal IRA for his spouse with a $12,000 contribution, $6,000 for himself and $6,000 for his wife. Phil's spouse earned $4,000 in 2019 from a part-time job, and their combined AGI is $75,000. Neither Phil nor his spouse is an active participant in an employer-sponsored retirement plan.
a. What amount of the contribution is deductible?
b. To what year does the contribution apply? (Assume that an election is made to treat Phil's spouse as having no compensation.)
c. Is the deduction reported as *for* AGI or *from* AGI?
d. How would your answer to Part a change, if at all, if Phil and his spouse were active participants in an employer-sponsored retirement plan?
e. If a portion of the contribution is nondeductible in Part d, is it possible for Phil to make a deductible and a nondeductible contribution in the same year? Explain.
f. How would your answer to Part a change if Phil and his spouse's combined AGI were $125,000 in 2019 and Phil was an active participant in an employer-sponsored retirement plan?

I:7-57 ***Roth IRA.*** Chatham Mae is single, age 35, and wants to make a contribution to an IRA for the year ended December 31, 2019. She is an active participant in a qualified retirement plan sponsored by her employer. Her AGI for 2019 is $128,000 before considering any IRA contribution.

a. What type of IRA, if any, is Chatham Mae eligible to make a contribution to for 2019? If she is eligible to contribute to an IRA, what is the maximum amount that she can contribute to the IRA?

b. Assume Chatham Mae contributes a total of $12,000 over six years to a Roth IRA. In 2025, she withdraws $15,000 to pay off her car loan. Her financial advisor suggested she withdraw the money from the IRA for two major reasons: (1) to eliminate her debt and (2) no tax would be due on distributions from a Roth IRA after five years. Chatham Mae wants to verify the accuracy of her advisor's advice. What would be the tax consequences of this withdrawal? Alternatively, what if Chatham Mae withdrew the $15,000 to purchase a house (she is a first-time homebuyer)?

c. Alternatively to Part b above, assume Chatham Mae has a traditional deductible IRA that has a balance of $50,000. She has been able to deduct all of her contributions to the IRA in prior years. Her financial advisor has recommended that she rollover the funds from her traditional IRA to a Roth IRA in 2019. What are the tax consequences of this rollover in 2019?

I:7-58 ***Coverdell Education Savings Accounts.*** Jack and Katie have five grandchildren, ages 19, 16, 15, 12, and 10. They have established Coverdell Education Savings Accounts (CESA) for each of the grandchildren and would like to contribute the maximum amount allowable to each CESA for the 2019 taxable year. Jack and Katie's AGI for 2019 is $196,000.

a. How much can Jack and Katie contribute to each grandchild's CESA in 2019?

b. Assume that the 19-year-old granddaughter is a freshman in college and makes a withdrawal of $7,000 from her CESA during the year 2019. Her college expenses for 2019 were as follows:

Tuition	$3,000
Room and board	2,000
Books and supplies	500

The extra amount withdrawn was used as a down payment on a car that the granddaughter purchased during the year. She needed the car in order to drive to school rather than having to either ride the bus or ride with a friend. What are the tax consequences of the $7,000 distribution to the granddaughter?

I:7-59 ***H.R. 10 Plans.*** Paula is a self-employed doctor and is considering whether to establish a defined contribution H.R. 10 plan. Paula's only employee is a full-time nurse who has been employed by Paula for seven years. Paula's net earnings from self-employment (before the H.R. 10 plan contribution but after the deduction for one-half of self- employment taxes paid) is expected to be $200,000 during the current year and increase slightly in future years.

a. If the H.R. 10 plan is established, what is the maximum amount Paula can contribute for the nurse's benefit?

b. What is the maximum amount Paula can contribute for herself? Is the amount reported as a *for* AGI or *from* AGI deduction?

c. Is Paula's nurse required to be included in the plan?

d. What are the tax consequences if Paula makes a premature withdrawal from the plan before reaching age 59½?

I:7-60 ***Stock Options.*** Bell Corporation grants an incentive stock option to Peggy, an employee, on January 1, 2019, when the option price and FMV of the Bell stock is $80. The option entitles Peggy to buy 10 shares of Bell stock. Peggy exercises the option and acquires the stock on April 1, 2021, when the stock's FMV is $100. Peggy, while still employed by the Bell Corporation, sells the stock on May 1, 2023, for $120 per share.

a. What are the tax consequences to Peggy and Bell Corporation on the following dates: January 1, 2019; April 1, 2021; and May 1, 2023? (Assume all incentive stock option qualification requirements are met.)

b. How would your answer to Part a change if Peggy instead sold the Bell stock for $130 per share on May 1, 2021?

I:7-61 ***Stock Options.*** Bender Corporation grants a nonqualified stock option to Penny, an employee, on January 1, 2019, that entitled Penny to acquire 1,000 shares of Bender stock

at $80 per share. On this date, the stock has a $100 FMV and the option has a readily ascertainable FMV of $20 per share. Penny exercises the option on January 1, 2020 (when the FMV of the stock is $150), and acquires 1,000 shares of the stock for $80 per share. Penny later sells the Bender stock on January 1, 2022, for $200 per share.

a. What are the tax consequences to Penny and Bender Corporation on the following dates: January 1, 2019; January 1, 2020; and January 1, 2022?

b. How would your answer to Part a change if the Bender stock were instead closely-held and the option had no readily ascertainable FMV?

COMPREHENSIVE PROBLEM

I:7-62 Dan and Cheryl are married, file a joint return, and have no children. Dan, age 45, is an independent contractor working in pharmaceutical sales and Cheryl, age 42, is a nurse at a local hospital. Dan's SSN is 400-20-1000 and Cheryl's SSN is 200-40-8000 and they reside at 2033 Palmetto Drive, Atlanta, GA 30304. Dan is paid according to commissions from sales, and he has no income tax or payroll tax withholdings. Dan operates his business from his home office. During 2018, Dan earned total commissions in his business of $125,000. Cheryl earned a salary during 2018 of $45,400, with the following withholdings: $6,000 federal taxes, $1,800 state taxes, $2,815 OASDI, and $658 Medicare taxes.

During 2018, Dan and Cheryl had interest income from corporate bonds and bank accounts of $1,450 and qualified dividends from stocks of $5,950. Dan also actively trades stocks and had the following results for 2018:

LTCG	$4,900
LTCL	(3,200)
STCG	0
STCL	(7,800)

He had no capital loss carryovers from previous years.

Dan does a considerable amount of travel in connection with his business and uses his own car. During 2018, Dan drove his car a total of 38,000 miles, of which 32,000 were business related. He also had business-related parking fees and tolls during the year of $280. Dan uses the mileage method for deducting auto expenses. Dan also had the following travel expenses while away from home during the year:

Hotel	$4,200
Meals	820
Entertainment of customers	1,080
Tips	100
Laundry and cleaning	150
Total	$6,350

Dan uses the simplified method to deduct expenses for his office-in-home. His office measures 15 feet by 12 feet in size.

Cheryl incurred several expenses in connection with her nursing job. She paid $450 in professional dues, $200 in professional journals, and $350 for uniforms.

Dan and Cheryl had the following other expenditures during the year:

Health insurance premiums (after-tax)	$ 4,400
Doctor bills	470
Real estate taxes on home	6,800
Personal property taxes	1,400
Mortgage interest—all deductible	7,400
Charitable contributions—cash	9,000
Charitable contributions—GE stock owned for 5 years:	
FMV	$8,000
Adjusted basis	2,000
Tax preparation fees	750

During 2018, Dan and Cheryl paid federal and state estimated tax payments on a quarterly basis. Federal payments for the year amounted to $24,000. State estimated payments for the year amounted to $2,200. Compute Dan and Cheryl's income tax liability for 2018. Disregard the alternative minimum tax.

TAX STRATEGY AND CRITICAL THINKING PROBLEM

I:7-63 Paul Price is self-employed and operates Lightmore Communications as a sole proprietorship. Lightmore has been extremely successful over the past 20 years. Paul travels extensively in connection with the business to meet with existing and prospective clients. Paul's wife, Laura, would be helpful to Paul in his business entertaining if she could accompany him on many of his business trips and, furthermore, she was unable to go on these trips in the past because of their children at home. Their youngest child is now in college, and Laura's duties at home have diminished. During the current year, Laura has made a number of trips with Paul, but after conferring with the company's tax advisor, had been informed that Laura's expenses would not be deductible for tax purposes. The tax advisor suggested the possibility of putting Laura on the Lightmore payroll as an employee.

a. Would Laura's travel expenses be deductible if she was an employee of the corporation?

b. What other benefits would be available to Laura if she was an employee of the corporation?

c. Are there any detriments to putting Laura on the payroll?

TAX FORM/RETURN PREPARATION PROBLEM

I:7-64 Using the information in Problem I:7-62 for Dan and Cheryl, prepare a Form 1040, including Schedule 1 and 4, Schedule A, C, D, and SE, and Form 8829 for 2018.

CASE STUDY PROBLEMS

I:7-65 Ajax Corporation is a young high-growth company engaged in the manufacture and distribution of automotive parts. Its common stock has doubled in value since the company was listed on the NASDAQ exchange about two years ago. Ajax currently has a high debt/equity ratio due to the issuance of debt to finance its capital expansion needs. Despite rapid growth in assets and profitability, Ajax has severe cash flow problems and a poor working capital ratio. The company urgently needs to attract new executives to the organization and to provide financial incentives to existing top management because of recent turnover and high growth. Approximately 55% of the common stock is owned by Andrew Ajax, who is the CEO, and his immediate family. None of the other officers own stock in the company.

You are a tax consultant for the company who has been asked to prepare suggestions after reviewing the compensation system. Your discussions with several top management individuals reveal the following aspects of corporate strategy and philosophy:

- The company needs to expand the equity capital base because of its concern for the high risk caused by large amounts of debt.
- Improvement in cash flow and liquidity would enhance its stock price and enable the company to continue its high growth rate.
- Top management feels that employee loyalty and productivity would be improved if all employees owned some stock in the company. The company currently offers a qualified pension plan to its employees and executives that provides only minimal pension benefits. No other deferred compensation or bonus arrangements are currently being offered.
- Andrew Ajax feels that the top management group should own a substantial amount of Ajax stock to ensure that the interests of management correspond with the shareholder interests (i.e., the maximization of shareholder wealth).

The following four types of executive compensation arrangements have been discussed:

- Sec. 401(k) and ESOP plans for employees.
- Encourage all employees and executives to independently fund their retirement needs beyond any Social Security benefits by establishing IRA plans.
- Provide restricted property arrangements (using Ajax stock) to attract new top level executives and to retain existing executives.
- Offer nonqualified or incentive stock options to existing and new executives.

Required: Prepare a client memo that recommends revisions to Ajax Corporation's existing compensation system for both its employee and executive groups. Your recommendations should discuss the pros and cons of different deferred compensation arrangements and should consider both tax and nontax factors.



I:7-66 Steve is part owner and manager of a small manufacturing company that makes keypads for alarm systems. The keypads are sold to several different alarm companies throughout the country. Steve must travel to several cities each year to meet with current customers and to attract new business. When you meet with Steve to obtain information to prepare his current year tax return, he tells you that he has spent about $5,000 during the current year on airfare and taking his customers out to dinner to discuss business. Because he took most of his trips in the summer and fall, and it is now April of the following year, Steve cannot remember the exact time and places of the business dinners and did not retain any receipts for the cash used to pay the bills. However, he remembers the names of the customers he went to see, the business topics that were discussed, and the restaurants where he had his meals. As Steve's tax consultant, what is your responsibility regarding the treatment of the travel and entertainment expenses under the mandates of the AICPA's *Statements on Standards for Tax Services*? Prepare a client letter explaining to Steve the requirements under Sec. 274(d) for sufficient substantiation of travel and entertainment expenses. (See the *Statements on Standards for Tax Services* section in Chapter I:15 for a discussion of these issues and Appendix E.)

TAX RESEARCH PROBLEM

I:7-67 Charley Long is a truck driver, the 18-wheeler variety. He lives in Mobile, Alabama, owns his own truck, and operates as an independent contractor. Charley's route entails leaving Mobile at 4:00 PM each day (five days per week) and delivering fresh fish to restaurants and wholesale fish distributors in Mississippi and Louisiana. His last stop, in Lafayette, Louisiana, is generally around 12:00 midnight. It normally takes Charley about five hours to get back to Mobile.

Charley's routine is varied. Sometimes, he drives straight back to Mobile from Lafayette. On other occasions, he will pull off at a truck stop and sleep in his cab before returning to Mobile. His cab is equipped with sleeping facilities, although small and sparse. Finally, on other occasions, Charley will spend the night in a motel along the road.

When Charley drives straight back to Mobile, Charley will eat one meal. When he sleeps overnight (either in his cab or in a motel), he will eat two meals, a late dinner and breakfast. He spends an average of $10.00 for dinner and $6.00 for breakfast. The cost of his motel averages $70.00 per night. When Charley sleeps in the cab, he generally sleeps about 4–5 hours and then drives on to Mobile.

During the current year, Charley incurred the following expenses:

Meals incurred on nonstop trips	$1,000
Meals incurred when: slept in cab	800
slept in motel	600
Lodging	2,800
Total	$5,200

The IRS has disallowed all of the above expenses on the grounds that they are not bona fide travel expenses but personal expenses, as they contend that Charley was not away from home overnight. Would you advise Charley to contest this issue?

A partial list of research sources is:

- Sec. 162(a)(2) and Reg. Sec. 1.162-2(a)
- *U.S. v. Correll*, 389 U.S. 299 (1967)
- *Williams v. Patterson*, 286 F.2d 333 (5th Cir. 1961)
- Rev. Rul. 75-168, 1975-1 C.B. 58 and Rev. Rul. 75-432, 1975-2 C.B. 60

CHAPTER

8

ITEMIZED DEDUCTIONS



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Identify qualified medical expenses and compute the medical expense deduction
2. Identify taxes that are deductible as itemized deductions
3. Identify different types of interest deductions
4. Compute the amount of a charitable contribution deduction and identify limitations
5. Discuss casualty and theft losses
6. Determine the calculation of the qualified business income deduction
7. Describe tax planning considerations for itemized deductions
8. Describe compliance and procedural considerations for itemized deductions

CHAPTER OUTLINE

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Taxes...8-9
Interest...8-12
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As explained in Chapter I:6, most deductible expenses for individuals fit into three general categories:

- Expenses incurred in a trade or business
- Expenses incurred for the production of income (an investment activity)
- Certain specified personal expenses

If an expense is deductible based on the above categories, the expense must be classified as either *for* AGI or *from* AGI. The distinction between *for* and *from* AGI was discussed in Chapter I:6. This chapter focuses on deductions *from* AGI, including **itemized deductions**, which include medical expenses, taxes, interest, and charitable contributions. Chapter I:9 discusses casualty losses on personal-use property. This chapter also discusses the qualified business income deduction, which is also a deduction from AGI but is not a personal expense.

In arriving at taxable income, individuals may subtract from AGI the larger of the standard deduction or the sum of all itemized deductions. In calculating the sum of the itemized deductions, certain deductions are subject to reductions and limitations.

MEDICAL EXPENSES

OBJECTIVE 1

Identify qualified medical expenses and compute the medical expense deduction

Medical expenses, which comprise one category of deductible personal expenditures, are deductible because Congress felt that excessive medical expenses might ultimately affect a taxpayer's ability to pay his or her federal income tax. However, under Sec. 213, taxpayers may deduct medical expenses only to the extent the expenses exceed 10% (7.5% in 2018) of the taxpayer's AGI. To qualify as a medical expense deduction, the expenditure must be incurred for the medical care of a qualified individual. Taxpayers may not take a deduction for medical expenses to the extent the expenses are reimbursed (i.e., compensated for by insurance or otherwise).

QUALIFIED INDIVIDUALS

To deduct medical expenses, taxpayers must pay the expenses on behalf of themselves, their spouses, or their dependents.

Taxpayer's Dependent. Deductible medical expenses include those paid on behalf of a taxpayer's dependent as well as on behalf of a person for whom the taxpayer could take a dependency exemption except for the failure to meet the gross income or joint return tests.[1]

KEY POINT

Medical expenses are deductible for a person who satisfies only the support, relationship, and citizenship dependency tests.

EXAMPLE I:8-1 ▶

In March of 2019, Jean's son, Steve, is involved in an automobile accident. At the time of the accident Jean is 54 years old and Steve is 25 years old. Steve has worked full-time for part of the year, earning a total of $15,000. Because Steve has a very high deductible insurance plan and cannot pay his share of the medical bills or support himself as a result of the accident, Jean pays Steve's share of the medical expenses and supports him for the rest of the year. Because Jean provides over one-half of Steve's support for the year and Steve, except for the gross income test, otherwise qualifies as Jean's dependent, (Steve is a qualifying relative rather than a qualifying child because he is over 19 and is not a full-time student) Jean may deduct the medical expenses she pays on his behalf to the extent that these expenses, along with all of Jean's other medical expenses, exceed 10% of her AGI for the year. ◀

Children of Divorced Parents. As long as one divorced parent qualifies to claim the child as a dependent under Sec. 152(e), the parent who pays medical expenses on behalf of the children may deduct the expenses. The parent taking the medical expense deduction doesn't need to be the parent who may claim dependency.

[1] Sec. 152. See Chapter I:2 for the tests that must be met to claim a qualifying child or qualifying relative as a dependent.

QUALIFIED MEDICAL EXPENSES

The **medical expense deduction** is available only for expenditures paid for medical care. Section 213 defines *medical care* as amounts paid for

- The diagnosis, cure, mitigation, treatment, or prevention of disease
- The purpose of affecting any structure or function of the body
- Transportation primarily for and essential to the first two items listed above
- Qualified long-term care services
- Insurance covering all of the items listed above

ADDITIONAL COMMENT

According to the IRS's Statistics of Income, in 2016 the deduction for medical expenses totaled $90.2 billion, representing 7% of the total dollar amount of the itemized deductions for medical expenses, taxes, interest, and charitable contributions.

Diagnosis, Cure, Mitigation, Treatment, or Prevention of Disease. Although the tax law does not precisely define the term *medical expense,* it is clear that medical expenses are deductible only if paid for procedures or treatments that are legal. For example, taxpayers cannot deduct amounts paid for "controlled substances (such as marijuana, laetrile, etc.) that aren't legal under federal law, even if such substances are legalized by state law."[2] The definition of medical care includes preventive measures such as routine physical and dental examinations. However, other expenses should be "confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness." Thus, unless they are for routine physical or dental examinations, the expenditures must be for the purpose of curing a specific ailment rather than related to the general health of an individual. This determination is especially critical when the expenditures in question are for items such as vacations, weight loss programs, or stop smoking programs. The taxpayer may or may not incur such expenses for a specific ailment.

EXAMPLE I:8-2 ▶ Helmut is nervous and irritable because of pressures at work and begins to suffer angina symptoms. In order to relax and get away from it all, he takes an ocean cruise around the world. Helmut's angina symptoms ease while he is on the cruise. In a case with facts very similar to Helmut's situation, the Tax Court held that a cruise is not a proven medical necessity because the taxpayer's physician did not specifically prescribe it. Although the cruise was beneficial to Helmut's general health, it was not deductible.[3] ◀

EXAMPLE I:8-3 ▶ Dave enrolls in a weight reduction program on the advice of two doctors who prescribe the program as a means of relieving his obesity, hypertension, and certain hearing problems. Based on a revenue ruling issued by the IRS, these expenses qualify as deductible medical expenditures because they are incurred for a specific medical condition.[4] ◀

Although a doctor's recommendation appears to lend a great deal of weight to deductibility, it is not always sufficient. For example, a taxpayer could not deduct the cost of dancing lessons for an emotionally disturbed child, even though the lessons proved to be beneficial and were recommended by a physician. Likewise, a taxpayer suffering from arthritis could not deduct the cost of ballroom dance lessons, even though a doctor recommended the lessons. On the other hand, the IRS has ruled that the cost of a clarinet and clarinet lessons was deductible when recommended by an orthodontist to correct a malocclusion of a child's teeth.[5] In short, determining the deductibility of certain expenditures can be difficult.

ADDITIONAL COMMENT

One cannot deduct the cost of nonprescription medicine (except insulin), toothpaste, toiletries, maternity clothes, diaper service, or funeral expenses.

Range of Deductible Medical Services. According to the Treasury Regulations, typical medical expenses include payments for a wide range of medical, dental, and other diagnostic and healing services. Thus, taxpayers may deduct payments to licensed or certified medical professionals such as general practitioners, obstetricians, surgeons, ophthalmologists,

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[2] Reg. Sec. 1.213-1(e)(1)(ii). See also Rev. Rul. 97-9, 1997-1 C.B. 77 and IRS Publication 502 (2018) which contains the IRS's recommended treatment for a number of medical expenses.

[3] Daniel E. Mizl, 1980 PH T.C. Memo ¶80,227, 40 TCM 552. Even if the taxpayer's physician had prescribed the trip, it still may not have been deductible. See Reg. Sec. 1.213-1(e)(1)(ii).

[4] Rev. Rul. 2002-19, 2002-1 C.B. 778. However, taxpayers still may not deduct the cost of diet foods or weight loss programs directed at general health or appearance. Taxpayers may deduct costs incurred for prescription medications and programs to stop-smoking, but not over-the-counter stop smoking aids. See Rev. Rul. 99-28, 1999-1 C.B. 1269 and IRS Publication 502 (2017).

[5] *John J. Thoene,* 33 T.C. 62 (1959), *Rose C. France v. CIR,* 50 AFTR 2d 82-5504, 1982-1 USTC ¶9225 (6th Cir., 1982), and Rev. Rul. 62-210, 1962-2 C.B. 89.

opticians, dentists, and orthodontists. Furthermore, deductible medical expenditures include payments for medical services rendered by individuals such as chiropractors, osteopaths, and psychotherapists who may or may not be required to be licensed or certified.[6] Taxpayers may deduct payments to Christian Science practitioners as well as for acupuncture treatment if the taxpayer receives the treatment for a specific medical purpose.[7] Qualified medical expenses also include payment for hospital services, nursing services, laboratory fees, X-rays, artificial teeth or limbs, ambulance hire, eyeglasses, and prescribed medicines and insulin. Nondeductible expenses include expenditures for nonprescription medicines, drugs, vitamins, and other types of health foods that improve the individual's general health.

To deduct costs incurred for schools and camps, the taxpayer must show that the facility has the appropriate medical equipment and regularly engages in providing medical services. For example, a court held that a taxpayer could deduct costs he incurred to send his mentally disabled son to a school with a special curriculum specifically for mentally disabled children. Similarly, another court ruled that a taxpayer could deduct the cost of sending a child with psychiatric problems to a school that specialized in learning disorders. However, taxpayers generally may not deduct the cost of sending children with special medical problems to schools or camps that do not have the proper equipment, facilities, or curriculum for such problems.

TYPICAL MISCONCEPTION

Taxpayers tend to define qualifying medical expenses too narrowly. This may be caused, in part, by comparison with expense reimbursement limitation policies of health insurance companies.

Medical Procedures Affecting Any Function or Structure of the Body. Deductible medical expenditures also include payments for services affecting any function or structure of the body, even though no specific illness or disease exists. Thus, qualifying medical expenses include expenditures for such items as physical therapy, obstetrical services, eyeglasses, dental examinations and cleanings, and hearing aids. Under Sec. 213, cosmetic surgery or any other similar procedure does not qualify as a medical expense unless such surgery is necessary to correct a deformity arising from a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease. Cosmetic surgery is defined as any procedure undertaken to improve a person's appearance that does not meaningfully promote the proper function of the body or prevent or treat an illness or disease.

Transportation Essential to Medical Care. Taxpayers may deduct transportation expenses that are essential to and incurred primarily for qualified medical care. Thus, taxpayers may deduct actual out-of-pocket automobile expenditures, taxis, airfare, ambulance fees, and other forms of transportation if the travel is for medical reasons. However, the tax law disallows a deduction if the travel is undertaken for recreational purposes or for the general improvement of the taxpayer's health.

ADDITIONAL COMMENT

For 2019, the standard mileage rate for business mileage is 58 cents per mile. For medical and moving it is 20 cents, and for charitable purposes it is 14 cents.

In lieu of the actual cost of the use of an automobile, for 2019 the IRS allows a deduction of 20 cents for each mile that the automobile is driven for medical reasons. In addition to this standard mileage rate, taxpayers may also deduct the cost of tolls and parking.

Certain courts have held that the cost of meals and lodging while en route to a medical facility is part of deductible travel costs incurred for medical purposes. However, taxpayers may not deduct the cost of meals eaten on trips that are too short to warrant a stop for meals. Additionally, taxpayers may deduct only 50% of the cost of meals. (See Chapter I:7 for a discussion of the 50% disallowance rule for meals and entertainment.) Sec. 213(d)(2) limits the potential deduction for the cost of lodging to $50 per night. Furthermore, lodging expenses qualify as medical expenditures only if the travel is primarily for and essential to medical care, the medical care is provided in a licensed hospital (or a facility related or equivalent to a licensed hospital), and there is no significant element of personal pleasure or recreation in the travel. The tax law imposes the $50 limitation on lodging on a per-individual basis. Thus, if the patient is unable to travel alone, the taxpayer may deduct an additional $50 per night for the lodging costs of a nurse, parent, or spouse.

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[6] Reg. Sec. 1.213-1(e)(1) and Rev. Rul. 63-91, 1963-1 C.B. 54 and IRS Publication 502 (2018). See also Ltr. Rul. 8919009 (February 6, 1989) where a pregnant woman was entitled to a deduction for the cost of childbirth classes to the extent that they prepared her for the childbirth. However, the cost of the classes where she received instructions on the care of the unborn child represented a flat fee that allowed a coach to attend the class with the taxpayer. Thus, one-half of the fee was deemed attributable to the coach and was not allowed as a qualified medical expense.

[7] Rev. Rul. 72-593, 1972-2 C.B. 180 and IRS Special Ruling, February 2, 1943.

Qualified Long-Term Care. Taxpayers may also deduct expenditures for qualified long-term care as medical expenses subject to the 10% of AGI limitation. Long-term care is defined as medical services required by a chronically ill individual which are provided under a prescribed plan of care. Under Sec. 7702B, such items include expenditures for diagnostic, preventive, therapeutic, curing, treating, mitigating, rehabilitative, and personal care services. A chronically ill individual generally is someone who, for a period of at least 90 days, cannot perform at least two daily living tasks such as eating, toileting (including continence), bathing, or dressing. According to Sec. 213(d)(11), if the long-term care service is provided by the individual's spouse or relative, any payment for the long-term care service is not deductible unless the spouse or relative is a licensed professional to be able to provide this care. Furthermore, services provided by a corporation or partnership in which the person owns over 50% are also not deductible.

Expenditures for long-term care insurance premiums also qualify as medical deductions, subject to an annual limit based upon the age of an individual.[8]

Capital Expenditures for Medical Care. Generally, taxpayers may not currently deduct capital expenditures for federal income tax purposes. For assets used in a trade or business or held for the production of income, taxpayers must recover such costs through depreciation, cost recovery, or amortization. Capital expenditures incurred for personal medical purposes are not depreciable or amortizable. However, a current deduction is available when the capital expenditure is made to acquire an asset primarily for the medical care of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents. To qualify as a deduction, the taxpayer must incur the expenditure as a medical necessity for primary use by the individual in need of medical treatment, and the expenditure must be reasonable in amount. The following are the three categories of deductible capital expenditures for medical care:[9]

- Expenditures that relate only to the sick or handicapped person, not to the permanent improvement or betterment of the taxpayer's property (e.g., eyeglasses, dogs or other animals that assist the blind or the deaf, artificial teeth and limbs, wheelchairs, crutches, and portable air conditioners purchased for the sole use of a sick or disabled person)
- Expenditures that permanently improve or better the taxpayer's residence for the purpose of providing medical care (e.g., a swimming pool installed in the home of an individual suffering from arthritis)
- Expenditures to remove structural barriers in the home of a physically disabled individual (e.g., costs of constructing entrance ramps, widening doorways and halls, lowering kitchen cabinets, and adding railings)

REAL-WORLD EXAMPLE

The cost of installing an elevator in the home upon the recommendation of a physician to help a patient with a heart condition was deductible to the extent that it did not increase the value of the home. *James E. Berry v. Wiseman,* 2 AFTR 2d 6015, 58-2 USTC ¶9870 (D.C. Okla., 1958).

Capital expenditures that relate only to the sick person (the first category) are fully deductible in the year paid. Expenditures that improve the residence (the second category) are deductible only to the extent that the amount of the expenditure exceeds the increase in the fair market value (FMV) of the residence. Expenditures to remove physical barriers in the home of a physically disabled individual (the third category) are deductible in full (i.e., the increase in the home's value is deemed to be zero). In addition, any costs of operating or maintaining the assets in all three categories are deductible as long as the medical reason for the capital expenditure continues to exist.[10] All of the above expenditures are subject to the 10% of AGI floor.

EXAMPLE I:8-4 ▶ During the current year, Rita is injured in an industrial accident. As a result, she sustains a chronic disabling leg injury, which requires her to spend much time in a wheelchair. Rita's physician recommends that a swimming pool be installed in her backyard and that she devote several hours each day to physical exercise. During the year, Rita makes the following expenditures:

Wheelchair	$ 2,500
Swimming pool	27,000
Operation and maintenance of the pool	1,800
Entrance ramp and door modification	5,000

[8] For 2019, if the individual is 40 years of age or less, the annual deductible limit for the premiums is $420. For individuals over 40 but not more than 50, the limit is $790. For those who are over 50 but not more than 60, the limit is $1,580. For those who are over 60 but not more than 70, the limit is $4,220. For those who are more than 70, the limit is $5,270.

[9] Reg. Sec. 1.213-1(e)(1)(iii) and H. Rept. No. 99-841, 99th Cong., 2d Sess., p. II-22 (1986).

[10] Rev. Rul. 87-106, 1987-2 C.B. 67.

REAL-WORLD EXAMPLE

Taxpayers made nonrefundable advance payments required as a condition for an institution's future acceptance of their disabled child for lifetime care in the event that taxpayers could not care for the child. The amounts paid were deductible as expenses for medical care in the year paid. Rev. Rul. 75-303, 1975-2 C.B. 87. This current deduction for prepaid amounts is only available for certain lifetime care expenditures incurred in situations described in this ruling. Rev. Rul. 93-72, I.R.B. 1993-34,7.

A qualified appraiser estimates that the swimming pool increases the value of Rita's home by only $20,000. Rita's medical expenses for the year include $2,500 for the wheelchair, $7,000 for the swimming pool (the excess of the cost of the pool over the increase in the FMV of the home), $1,800 for the operation and maintenance of the pool, and $5,000 for the ramp and door modification. ◀

Costs of Living in Institutions. The entire cost of in-patient hospital care, including meals and lodging, qualifies as a medical expense. However, if an individual is in an institution other than a hospital (e.g., a nursing home or a special school for the disabled), the deductibility of the costs involved depends on the facts of the particular case. If the principal reason for the taxpayer's presence in an institution is the need for and availability of the medical care furnished by that institution, the qualified medical expenditures include the entire costs of meals, lodging, and other services necessary for furnishing the medical care. If medical care is not the principal reason for the taxpayer's presence in the institution, the institutional expenses are not deductible. Only specific medical expenses, such as doctor bills, prescription drugs, etc., are eligible for deduction.

ADDITIONAL COMMENT

A taxpayer cannot deduct the Medicare (hospital insurance benefits) tax that is withheld from wages as part of the Social Security tax.

Medical Insurance Premiums. Qualified medical expenses also include premiums paid for medical insurance, including premiums paid for supplementary medical insurance for the aged under the Social Security Act and premiums paid for qualified long-term care insurance contracts. In many cases, taxpayers pay premiums for insurance coverage that extends beyond mere medical care. For example, in addition to the standard medical care coverage, an insurance policy may provide coverage for loss of income or loss of life, limb, or sight. In such cases, the tax law allows a deduction for the medical care portion of the premium only if the cost of each type of insurance is either separately stated in the contract or furnished to the policyholder by the insurance company in a separate statement.[11]

EXAMPLE I:8-5 ▶ Each month Malazia pays $300 for an insurance policy under which she is reimbursed for any doctor or hospital charges she incurs. In addition, the policy will pay two-thirds of her regular salary each month if she becomes disabled. Finally, the policy will pay her $10,000 for the loss of any limb. At the end of the year, her insurance company issues a statement that allocates two-thirds of the premiums to the medical insurance coverage. Malazia's medical care expenditure is $2,400 ($300 × 12 × 0.667). ◀

If a taxpayer pays the premiums attributable to an individual or group medical insurance plan, the payments are deductible as medical expenses, which are itemized deductions in most cases. Self-employed individuals may deduct 100% of these amounts as deductions *for* AGI. Any amounts paid by the taxpayer's employer are excluded from the employee's gross income and are not includible in the taxpayer's medical expenses.[12]

Chapter I:7 discusses the deduction for certain medical savings accounts established for employees.

AMOUNT AND TIMING OF DEDUCTION

The amount and timing of the allowable medical expense deduction depend on when the taxpayer actually pays the medical expenses, the taxpayer's AGI, and whether the taxpayer receives any reimbursement for the medical expenses.

Timing of the Payment. In general, taxpayers may deduct medical expenses only in the year they actually pay the expenses. This rule applies regardless of the taxpayer's method of accounting or when the event that caused the expenditure occurs.[13] Thus, if taxpayers receive medical care during the year but have not paid for it as of the end of the year, taxpayers must defer the deduction for that care until the year they pay for the medical care. If the obligation is charged on a credit card, payment is deemed to have been

[11] Sec. 213(d)(6). See also Rev. Ruls. 66-216, 1966-2 C.B. 100, and 79-175, 1979-1 C.B. 117.

[12] Sections 162 and 106.

[13] Reg. Sec. 1.213-1(a)(1). However, medical expenses paid within one year from the day following the taxpayer's death are treated as paid at the time they are incurred (see Sec. 213(c)).

made on the date of the charge, not on the later date when the taxpayer pays the credit card balance. Conversely, if medical care is prepaid, the deduction is deferred until the year the taxpayer receives the care unless there is a legal obligation to prepay or unless the prepayment is a requirement for the receipt of the medical care.[14]

Limitation on Amount Deductible. As previously noted, other than medical insurance premiums paid by self-employed individuals, the tax law allows a medical expense deduction only for the years in which the taxpayer itemizes his or her deductions and the taxpayer's expenditures for medical care exceed 10% of AGI.

EXAMPLE I:8-6 ▶ During 2019, Kelly incurs qualified medical expenditures of $6,000. Kelly is 45 and her AGI for the year is $50,000. After subtracting the floor, she has $1,000 ($6,000 − [0.10 × $50,000]) of deductible medical expenses. These medical expenses are added to Kelly's other itemized deductions to determine whether they exceed the standard deduction. ◀

SELF-STUDY QUESTION

Why does the IRS not require that the taxpayer file an amended return when a reimbursement is received in a later year?

ANSWER

The administrative burden on the IRS of processing additional returns would be too great.

Medical Insurance Reimbursements. Taxpayers may only deduct unreimbursed medical expenditures. It does not matter whether the reimbursement is from an insurance plan purchased from an insurance company, a medical reimbursement plan of an employer, or a payment resulting from litigation.

If the taxpayer receives reimbursement in the same year he or she pays for the medical expenses, the amount of the reimbursement reduces the allowed deduction. If a taxpayer receives a reimbursement in a year subsequent to the year of payment, the taxpayer must include the reimbursement in gross income in the year of receipt to the extent that the taxpayer derived a tax benefit from the deduction in the previous year. If the taxpayer did not take a deduction in the prior year, the taxpayer doesn't need to report the reimbursement as income. This may occur because the taxpayer's total itemized deductions do not exceed the standard deduction or because the taxpayer's total medical expenses do not exceed 10% of AGI. If the taxpayer took a deduction in the prior year, however, the taxpayer must report as income the lesser of the amount of the reimbursement or the amount the medical expenses reduced the taxable income in the prior year.

EXAMPLE I:8-7 ▶ During 2019, Dan, a single taxpayer, reports the following items of income and expense:

AGI	$80,000
Total qualified medical expenses	14,000
Itemized deductions other than medical	8,000

Dan's taxable income for 2019 is calculated as follows:

AGI			$80,000
Reduction: Larger of itemized deductions or standard deduction			
Medical expenses	$14,000		
Minus: 10% of AGI	(8,000)	6,000	
Other itemized deductions		8,000	
Total itemized deductions		$14,000	
Greater of itemized deductions or standard deduction ($12,200)			(14,000)
Taxable income			$66,000

If during 2020 Dan receives a reimbursement of $2,000 for medical expenses he incurred the prior year, he must include $1,800 ($14,000 − $12,200) in gross income for 2020, which is the amount of the tax benefit from the medical expense deduction for the prior year. This amount can be calculated by comparing Dan's actual taxable income for 2019 with what would have been his 2019 taxable income if the reimbursement had been received that year. This calculation is as follows:

[14] Rev. Rul. 78-39, 1978-1 C.B. 73 and *Robert M. Rose v. CIR*, 26 AFTR 2d 70-5653, 70-2 USTC ¶9646 (5th Cir., 1970). See also Rev. Rul. 93-72, Rev. Rul. 1993-2 C.B. 77, Rev. Rul. 75-302, 1975-2 C.B. 86, and Rev. Rul. 75-303, 1975-2 C.B. 87.

AGI			$80,000
Reduction: Larger of itemized deductions or standard deduction			
Medical expenses	$14,000		
Minus: Reimbursement	(2,000)		
Minus: 10% of AGI	(8,000)	4,000	
Other itemized deductions		8,000	
Total itemized deductions		$12,000	
Greater of itemized deductions or standard deduction ($12,200)			(12,200)
Taxable income (assuming reimbursement was received in 2019)			$ 67,800
Minus: Actual 2019 taxable income			($ 66,000)
Tax benefit			$ 1,800 ◀

Topic Review I:8-1 highlights the principal requirements for the medical expense deduction previously discussed.

STOP & THINK

Question: Vince and Diane are married and file a joint tax return. For the current year they estimate their AGI at $90,000. They also estimate their itemized deductions for taxes, interest, and charitable contributions total $25,000. Up to the current date they have incurred $6,500 in deductible medical expenses. For several months they have been considering laser surgery on Diane's eyes. The total expenditure for the operations will be $6,000 and is not covered by their medical insurance. Since they already have spent so much this year on medical expenses and they do not anticipate such large expenses next year, they are considering delaying the eye operation until next year. They estimate their AGI next year will be approximately $110,000. Does this decision make sense from a tax point of view?

Solution: From a tax point of view, Vince and Diane should consider having and paying for the operation this year. If so, $6,000 is added to the prior $6,500 medical expenditures for a total of $12,500 for the year. After applying the 10% of AGI limitation, $3,500 [$12,500 − ($90,000 × 0.10)] of their total medical expenses are deductible and their total itemized deduction sums to $28,500 ($25,000 + $3,500). Without the additional eye surgery expenses, the $6,500 of their prior medical expenses this year is less than the 10% of AGI limit, and they can't deduct any of their medical expenses. Thus, their total itemized deduction would be $25,000, which only exceeds the standard deduction by $600 ($25,000 − $24,400). If they wait until next year to do the eye surgery, none of the $6,000 for the eye surgery is deductible in either year because of the AGI limitation (assuming their estimates are correct and assuming they don't anticipate any other medical expenses next year).

TOPIC REVIEW I:8-1

Medical Expense Deductions

Items	Deduction Rules and Limitations
Qualifying expenditures	(a) Expenditures for the diagnosis, cure, mitigation, treatment, or prevention of disease and qualified long-term care. (b) Transportation at 20¢ per mile for 2019; lodging limited to $50 per night, per person; and 50% of meals. (c) Medical and qualified long-term care insurance premiums. (d) Capital expenditures (subject to specific limitations).
Qualifying individuals	Taxpayer, spouse, dependents, children of divorced parents even if not dependent, and persons who would qualify as dependent except for the failure to meet gross income or joint return tests.
Amount and timing of the deduction	Deduct in the year paid unless prepaid, then deductible when medical treatment is received. If prepayment is required or there is a legal obligation to prepay, then deduct in year of prepayment.
Treatment of insurance reimbursements	Medical expenses are subject to a 10% of AGI nondeductible limitation. The deduction is reduced if the reimbursement is received in the year of payment. Reimbursements received in a subsequent year are included in gross income of the year received to the extent that a tax benefit was received in the earlier year.

Taxes

OBJECTIVE 2

Identify taxes that are deductible as itemized deductions

Section 164 provides taxpayers with a deduction for specifically listed taxes paid or accrued during the taxable year. Generally, cash-method taxpayers deduct the taxes when they pay for them, whereas taxpayers using the accrual method deduct taxes in the year the taxes accrue. The tax law specifically lists other taxes as nondeductible. To be deductible as a tax, the assessment in question must be a tax rather than a fee or charge imposed by a government for providing specific goods or services. For tax years 2018 through 2025, TCJA 2017 limits the itemized deductions for state and local taxes to $10,000 ($5,000 for married filing separately).

ADDITIONAL COMMENT

According to the IRS's Statistics of Income, in 2016 the deduction for taxes totaled $556.1 billion, representing 43% of the total dollar amount of the itemized deductions for medical expenses, taxes, interest, and charitable contributions.

DEFINITION OF A TAX

A **tax** is a mandatory assessment levied under the authority of a political entity for the purpose of raising revenue to use for public or governmental purposes. Thus, fees, assessments, or fines imposed for specific privileges or services are not deductible as taxes under Sec. 164. These nontax items include:

- Vehicle registration and inspection fees
- Registration tags for pets
- Toll charges for highways and bridges
- Parking meter charges
- Charges for sewer, water, and other services
- Special assessments against real estate for items such as sidewalks, lighting, and streets

However, if taxpayers incur these nontax fees and charges in a business or income-producing activity, the taxpayers may either capitalize or deduct these items as ordinary and necessary business expenses or ordinary and necessary expenses incurred for the production of income.

DEDUCTIBLE TAXES

The following taxes are specifically deductible under Sec. 164:

- State, local, and foreign real property taxes
- State and local personal property taxes if based on value
- State, local, and foreign income, war profits, and excess profits taxes
- The GST (Generation Skipping Transfer Tax) imposed on income distributions.[15]
- Other state, local, and foreign taxes that are paid or incurred in either a trade or business or an income-producing activity
- Generally taxpayers cannot deduct state and local sales taxes unless they make an election to deduct their state and local sales taxes instead of deducting their state and local income taxes. They make this election annually.

In general, taxes imposed by the federal government are not deductible in calculating a taxpayer's income tax. However, federal customs and excise taxes incurred in the taxpayer's business or income-producing activity are deductible as ordinary and necessary expenses under Secs. 162 or 212. Furthermore, an employer may deduct the *employer's* portion of Federal Social Security taxes and federal and state unemployment taxes as ordinary and necessary business expenses if the employee works in the employer's business or income-producing activity. A self-employed individual may deduct one-half of the self-employment tax imposed on the individual's self-employment income as a *for* AGI deduction.

LIMITS ON ITEMIZED DEDUCTIONS FOR STATE AND LOCAL TAXES

Beginning in 2018, itemized deductions for state and local real property taxes, state and local personal property taxes, and state and local income taxes (or state and local sales taxes, if elected instead of income taxes) are limited to $10,000 ($5,000 for married filing separately).

[15] The generation-skipping transfer tax is imposed by the United States on certain distributions from a trust (see Sec. 2601) and is deductible for federal income tax purposes. Furthermore, under Sec. 691(c) a taxpayer who includes income in respect of a decedent in taxable income may deduct the estate tax attributable to that amount.

BOOK-TAX DIFFERENCE

For financial accounting purposes, all taxes are expensed in arriving at net income after taxes. However, for tax purposes, only certain taxes are deductible. This gives rise to an M-1 or M-3 adjustment.

STATE AND LOCAL INCOME TAXES

For individuals, state and local income taxes are normally an itemized (*from* AGI) deduction. Thus, an individual does not receive any federal income tax benefit if these taxes, in addition to the taxpayer's other itemized deductions, do not exceed the standard deduction. Cash method taxpayers generally deduct all state and local income taxes paid or withheld during the year even if the taxes are attributable to another tax year. However, TCJA 2017 included provisions designed to stop cash method taxpayers from prepaying taxes in 2017 to avoid the limits that the new law placed on the itemized deduction for state and local taxes. For example, the new law stipulated that any payment by December 31, 2017 of state and local income taxes for a later tax year was not deductible as an itemized deduction when paid, but instead, would be treated as if it were paid on the last day of the taxable year for which it was imposed.[16]

EXAMPLE I:8-8 ▶

During 2019, Rita had $1,500 in state income taxes withheld from her salary. On April 15, 2020, Rita pays an additional $400 when she files her 2019 state income tax return. If the sum of her itemized deductions for 2019 exceeds the 2019 standard deduction, for 2019 Rita may deduct as an itemized deduction the $1,500 in state income taxes withheld from her salary during 2019. The $400 that Rita pays on April 15, 2020, is added to her itemized deductions for 2020 even though the liability relates to her 2019 state income tax return. ◀

ADDITIONAL COMMENT

Every state except Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming impose a personal income tax. Although New Hampshire and Tennessee do not impose a personal income tax, they do tax interest and dividends at the individual level.

If a taxpayer receives a refund of state income taxes deducted in a prior year, the taxpayer must include the refund as income in the year of the refund to the extent the taxpayer received a tax benefit from the prior deduction. This calculation is similar to the calculation of the tax benefit from a medical expense reimbursement in Example I:8-7.

STATE AND LOCAL SALES TAXES

As mentioned previously, taxpayers are allowed to deduct state and local sales taxes in lieu of state and local income taxes. Taxpayers electing to deduct state and local sales taxes instead of state and local income taxes have two options for determining the deductible amount. Taxpayers can deduct the actual amount of sales taxes paid by accumulating receipts showing the actual amount of sales taxes paid, or they can deduct the appropriate amount from tables provided by the Treasury Department. If a taxpayer uses the amount from the tables, sales taxes the taxpayer paid on major purchases can be added to the table amount.

PERSONAL PROPERTY TAXES

Many state and local governments impose personal property taxes. For individuals, the key issue is whether the levy is a deductible tax under Sec. 164 or a nondeductible fee. To qualify as a deductible personal property tax, the levy must meet two basic tests:

- The tax must be an ad valorem tax on personal property. In other words, the property's value determines the amount of the tax rather than some other measure such as a vehicle's weight or model year.
- The tax must be imposed on an annual basis, even if not collected annually.[17]

If a personal property tax is based partly on value and partly on some other basis, only the ad valorem portion is deductible.

EXAMPLE I:8-9 ▶

Banner County imposes on all passenger automobiles a property tax of 1% of value plus 20 cents per pound. Clay's automobile has a value of $20,000 and weighs 1,500 pounds. Clay may deduct $200 ($20,000 × 0.01) under Sec. 164. Clay may not deduct the remaining $300 (1,500 × 0.20) under Sec. 164; however, he may deduct it as an ordinary business expense if the automobile is used in his business. ◀

ADDITIONAL COMMENT

Several states impose a tax on the value of a taxpayer's investment portfolio. This is an example of a deductible intangible personal property tax.

[16] Sec. 164(b)(6).

[17] Reg. Sec. 1.164-3(c).

For individuals, personal property taxes are *from* AGI (itemized) deductions unless the individual incurs the taxes in the individual's trade or business or for the production of rental income.

REAL ESTATE TAXES

Apportionment of Taxes. When real estate is sold during the year, the federal income tax deduction for property taxes imposed on that real estate is allocated between the seller and the purchaser based on the amount of time each taxpayer owns the property during the real property tax year. The real property tax year may or may not coincide with the taxpayer's tax year. The apportionment, based on the number of days each party holds the property during the real property tax year of sale, assumes that the purchaser owns the property on the date of the sale. This apportionment is mandatory for all taxpayers even though one of the parties (i.e., the purchaser or seller) may have actually paid the entire property tax bill. The party who actually pays the taxes (either the buyer or the seller) deducts his or her share of the taxes in the year he or she pays the taxes unless the taxpayer makes an election under Sec. 461(c) to accrue the taxes. The tax consequences do not depend on whether the agreement requires proration of the real estate taxes. Both the purchaser and the seller may deduct their apportioned share of the taxes, regardless of who actually pays the taxes. Generally the sales agreement provides for the proper apportionment of property taxes between the buyer and the seller and will state the amount of the taxes apportioned to each party separately from the selling price of the property. If the seller pays all of the taxes prior to the sale, at closing the buyer will reimburse the seller for the payment of these taxes in addition to paying the down payment. On the other hand, if the taxes are to be paid by the buyer after the purchase of the property, the amount collected from the buyer at closing is reduced by the amount of taxes allocated to the seller. This process does not impact the selling price of the property if properly allocated and accounted for at closing.[18]

ADDITIONAL COMMENT

Delinquent taxes of the seller that are paid by the buyer as part of the contract price are not deductible.

EXAMPLE I:8-10 ▶ The real property tax year for Bannock County is the calendar year. Property taxes for a particular real property tax year become a lien against the property as of June 30 of that year, and the owner of the property on that date becomes liable for the tax. However, the taxes are not payable until February 28 of the subsequent year. On May 30 of the current (non-leap) year, Sandy, a cash-method taxpayer, sells a building to Roger, who is also a cash-method taxpayer. The real estate taxes on the property for the current year are $1,095. Although Roger is liable for the payment of the tax, Sandy is treated as having paid $447 ($1,095 × 149/365 [the numerator of 149 is the number of days from January 1 through May 29 and the denominator is the entire real property tax year]) on the date of the sale. Thus, Sandy may deduct $447 in the year of sale. Roger may deduct his share of the taxes, equaling $648 ($1,095 × 216/365), in the subsequent year (i.e., the year during which Roger actually pays the full amount of property tax due of $1,095). On the other hand, if the taxes become a lien against the property on April 1, Sandy is the owner of the building on that date and, since she is liable for the tax, she will be the one who actually pays the tax. Under these circumstances, the result is the same (i.e., Sandy deducts $447 and Roger deducts $648) except that Roger may take the $648 deduction in the year of sale rather than in the year of payment and Sandy takes the $447 deduction in the year of payment rather than the year of sale. ◀

TYPICAL MISCONCEPTION

Taxpayers often fail to differentiate between assessments for new construction and for repairs. For example, an assessment for street repairs is deductible, but an assessment for the construction of a new street is not deductible.

Real Property Assessments for Local Benefits. Local governments often make assessments against real estate for the purpose of funding local improvements. These assessments may be for such items as street improvements, sidewalks, lighting, drainage, and sewer improvements. If the tax assessment is only against the property that benefits from the improvement, it is not deductible, even though the general public may also

[18] However, if the agreement does not specifically provide and account for an apportionment of taxes, the apportionment of the taxes is still made and the seller's gain or loss on the sale (and the purchaser's basis in the property) must be adjusted either upward or downward, depending on which party actually pays the taxes.

incidentally benefit.[19] The tax law requires capitalization of such assessments as part of the property's adjusted basis.

Real property taxes incurred on personal-use assets, such as a personal residence, are deductible *from* AGI. Real property taxes incurred on business property or property held for the production of rental income are deductions *for* AGI.

SELF-EMPLOYMENT TAX

Wages paid to an employee are subject to a payroll tax which consists of two components (Social Security, technically called OASDI, and Medicare). Both the employer and the employee pay a share of the taxes imposed. Thus, on wages paid to an employee, the employer and the employee generally each pay a tax of 6.2% for Social Security (a total of 12.4%) and 1.45% (a total of 2.9%) for Medicare. The Social Security tax is imposed on a limited amount of wages. For 2019, this wage limit is $132,900. However, the Medicare tax is imposed on both the employer and the employee without limit on the amount of the wages paid. Self-employed individuals must pay both of these taxes on their self-employment income. Because these taxes are imposed only on the self-employed individual, these taxes are imposed on the individual's self-employment income at the total 2.9% for Medicare and the total 12.4% (up to self-employment income of $132,900 in 2019) for Social Security. Self-employed individuals may deduct one-half of these self-employment taxes paid as a *for* AGI deduction.[20]

Starting in 2013, an additional surtax is imposed under the Patient Protection and Affordable Care Act passed by Congress in 2012. This new tax is imposed on individuals with over $200,000 in income ($250,000 for married filing jointly) and is imposed at 3.8% on investment income and 0.9% on wages and self-employment income. The reason for this 0.9% (3.8% – 2.9%) difference in these rates is that self-employment income and wages are already subject to the 2.9% Medicare tax whereas investment income is not. This new tax is imposed only on individuals, not on employers. Furthermore, unlike the Social Security tax and the Medicare tax, this new tax is not deductible by individuals.

SELF-STUDY QUESTION

Would a taxpayer normally prefer to deduct foreign taxes or take a foreign tax credit?

ANSWER

Normally the foreign tax credit is better because a credit provides a direct dollar-for-dollar reduction of the tax liability rather than a reduction of taxable income.

NONDEDUCTIBLE TAXES

The following taxes are not deductible under Sec. 164:

- Federal income taxes
- Federal estate, inheritance, legacy, succession, and gift taxes
- Federal import or tariff duties and excise taxes unless incurred in the taxpayer's business or for the production of income
- Employee's portion of Social Security and other payroll taxes
- State and local sales taxes and state inheritance, legacy, succession, and gift taxes (unless the individual taxpayer elects to deduct the state and local sales taxes instead of the state income taxes)
- Foreign income taxes if the taxpayer elects to take the taxes as a credit against his or her federal income tax liability
- Property taxes on real estate to the extent treated as imposed on another taxpayer
- Tax imposed on wages, self-employment income, and investment income under the Patient Protection and Affordable Care Act

INTEREST

OBJECTIVE 3

Identify different types of interest deductions

In years past, taxpayers could deduct virtually all interest paid or accrued in the taxable year. Gradually, however, Congress has enacted numerous exceptions into the tax law rendering several types of interest nondeductible. For example, individuals may not

[19] Reg. Sec. 1.164-4. However, if the assessment that is applied to the local property is also applied to other property and not just to that specific property, the assessment is deductible as a tax. The taxpayer bears the burden of proof to show how much of the assessment is deductible (see Sec. 164(c)(1)).

[20] Sec. 164(f). In calculating its taxable income subject to the income tax, an employer is able to deduct as a business expense its portion of these Social Security taxes and Medicare taxes. Thus, in order to equate the amount and deductibility of these taxes imposed on self-employed individuals, an adjustment is made to the amount of the self-employed income that is subject to these taxes. (See Chapter I:14 for a discussion of the self-employment tax.)

ADDITIONAL COMMENT

According to the IRS's Statistics of Income, in 2016 the deduction for interest paid totaled $305 billion, representing 23.6% of the total dollar amount of the itemized deductions for medical expenses, taxes, interest, and charitable contributions.

deduct personal interest expense, such as interest paid on personal credit cards, automobile loans, etc. Interest incurred in connection with a trade or business is deductible. Thus, to determine the amount of interest expense deduction, individuals must properly classify their interest expense for the year. The interest expense categories include the following: active trade or business, passive activity, investment, personal, qualified residence, and student loan.

DEFINITION OF INTEREST

Interest is defined as "compensation for the use or forbearance of money."[21] Thus, finance charges, carrying charges, loan discounts, premiums, loan origination fees, and points are all considered interest if they represent a cost for the use of money.

Charge for Services. In addition to interest, borrowers may incur other charges in connection with borrowing money. These service charges include fees for appraisals, title searches, bank service charges, and the annual service charge on credit cards. Unless incurred in a trade or business, these expenses are not deductible because they all represent nondeductible personal expenses. As explained in the section in this chapter entitled Personal Interest, although finance charges on credit cards represent interest rather than service costs (on page I:8-16), they likewise are not deductible unless incurred in a trade or business.

Bank Service Charges and Finance Charges. Bank service charges on checking accounts are nondeductible expenses for services rendered rather than interest. The annual service charge on credit cards is also a charge for services rather than interest. However, finance charges on credit cards are interest. Late payments charged by public utilities are interest expense because they do not relate to any specific service.[22] Of course, if taxpayers incur these expenses in a trade or business, they are deductible.

KEY POINT

In general, the classification of interest expense depends on the use to which the borrowed money is put, not on the nature of the property used to secure the loan.

CLASSIFICATION OF INTEREST EXPENSE

The deductibility of interest generally depends on the purpose for which the taxpayer incurs the indebtedness because interest incurred in certain activities is subject to limitation and disallowance. For example, interest expense incurred in the taxpayer's active business is deductible in full against the business income (a deduction *for* AGI, taken on Schedule C), whereas interest expense allocated to the purchase of the taxpayer's residence is subject to the limitations applicable to that type of interest and is an itemized deduction (a deduction *from* AGI). Except for certain student loan interest and certain interest on a personal residence, taxpayers may not deduct interest allocated to personal-use expenditures.

Pursuant to the Treasury Regulations, taxpayers must allocate interest expense to the different interest expense categories by identifying the use of the borrowed money. Property used as collateral in securing the debt normally has no bearing on the allocation of the interest expense.[23]

EXAMPLE I:8-11 ▶ Cathy pledges some stock and securities as collateral for a $30,000 loan. She then purchases an automobile with the proceeds of the loan. The automobile is used 100% of the time for personal use. Even though the collateral for the loan is investment property, the interest expense is allocated to a personal-use asset and is not deductible. ◀

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[21] *Deputy v. Pierre S. DuPont*, 23 AFTR 808, 40-1 USTC ¶9161 (USSC, 1940).

[22] Rev. Rul. 73-136, 1973-1 C.B. 68 and Rev. Rul. 74-187, 1974-1 C.B. 48. See also Rev. Rul. 77-417, 1977-2 C.B. 60, which rules that one-time charges of 2% of each new cash advance and 1% of each new check and overdraft advance on a credit card account is an interest charge if the charges are not for services performed in the maintenance of the account. Of course, interest on a credit card or interest charged by a public utility is not deductible if it is personal interest.

[23] Temp. Reg. Sec. 1.163-8T. The major exception to this rule deals with home equity loans where the funds borrowed may be used for any purpose. Home equity loans are discussed later in this chapter.

If the taxpayer deposits borrowed funds in a bank rather than spending them immediately, the deposit is treated as an investment, and the interest on the loan is investment interest until the taxpayer withdraws or expends the funds. Then the taxpayer allocates the interest expense to a category based on the reason for making the expenditure, regardless of when the taxpayer actually pays the interest expense for the debt. This reallocation occurs as of the date the taxpayer writes the check on the account, as long as the delivery or mailing of the check occurs within a reasonable period of time.[24]

EXAMPLE I:8-12 ▶ On March 1 of the current year, José borrows $100,000 and immediately deposits the funds into an account that contains no other funds. José makes no additional deposits or payments. On May 1 of the current year, he withdraws $40,000 from the account and purchases a sailboat to be used for personal purposes. On July 1, José withdraws an additional $50,000 and purchases a passive activity. For the current year, the interest expense on the loan is categorized as follows: from March 1 through April 30, all of the expense is investment interest expense. 40% ($40,000/$100,000) of the interest expense attributable to the period May 1 through June 30 is classified as personal interest and the remainder is investment interest. The interest expense attributable to the period from July 1 to the end of the year is classified as 40% personal interest, 50% passive activity interest, and 10% investment interest. ◀

If both borrowed and personal funds are mingled in the same account, expenditures from that account are treated as coming first from the borrowed funds.[25]

EXAMPLE I:8-13 ▶ On April 1 of the current year, Diane borrows $30,000 and deposits it into a checking account that contains $10,000 of personal funds. On May 1 of the current year, Diane purchases a passive activity for $15,000, and on June 1 she purchases a personal automobile for $20,000. The $15,000 expended for the passive activity on May 1 is treated as coming from the borrowed funds. Thus, as of that date, one-half of the interest expense on the debt is reallocated from investment interest to passive activity interest. $15,000 of the funds expended for the personal automobile on June 1 is treated as coming from the borrowed funds, and the remaining $5,000 is treated as coming from the personal funds. Thus, as of June 1, the remaining interest expense on the debt is reallocated to personal interest. ◀

When the taxpayer repays the debt, the allocation of the repayment to the expenditures made with the borrowed funds occurs in the following order: (1) personal expenditures, (2) investment expenditures and passive activity expenditures other than rental real estate, (3) passive activity expenditures in rental real estate, and (4) trade or business expenditures.

Active Trade or Business. Generally, a taxpayer may deduct any interest expense incurred in the taxpayer's active trade or business. For 2019, large businesses (defined as those with gross receipts of $26 million or more) must limit their deduction for interest to 30% of taxable income, with any excess being carried forward to following years.[26] As explained in Chapter I:6, the determination of whether a particular activity constitutes a trade or business or an investment depends on an examination of all the relevant facts and circumstances. For individuals, estates, trusts, and certain corporations, however, it is not sufficient that the taxpayer incur the interest in a trade or business. In addition, the taxpayer must *materially participate* in the business. If not, the activity is considered a passive activity, and losses from the activity (including the interest expense) are subject to

[24] Temp. Reg. Sec. 1.163-8T(c). If during any one month several expenditures are made from an account, the taxpayer may elect to treat all the expenditures as if made on the first day of the month. This election is made on each account separately and is available only for accounts where the borrowed funds are already in the account as of the first day of the month. If the funds are not in the account as of the first day of the month, the expenditures may be treated as made on the date that the borrowed funds are deposited in the account. See Temp. Reg. Sec. 1.163-8T(c)(4)(iv).

[25] Temp. Reg. Sec. 1.163-8T(c)(4)(iii)(B). However, if an expenditure is made out of the mingled funds within 15 days of the deposit of the borrowed funds into the account, the taxpayer may designate the expenditure to which the borrowed funds are allocated.

[26] Sec. 163(j).

the passive loss limitation rules (see Chapter I:9 for a discussion of these rules). Interest incurred in an active trade or business is a deduction *for* AGI.

Passive Activity. Individuals, estates, trusts, and certain corporations that incur losses from passive activities are subject to the passive loss limitation rules explained in Chapter I:9. These rules prevent taxpayers from offsetting passive activity losses against other types of income such as salary, interest, dividends, and income from an active business. Taxpayers must include interest expense attributable to the passive activity in computing the net income or loss generated from the passive activity, and thus may not be able to deduct the interest under these limitation rules (see Chapter I:9 for a discussion of these rules).

Investment Interest. Individuals and other noncorporate taxpayers are limited on the deductibility of interest expense attributable to investments. Without any limitation, high-income taxpayers could realize significant tax savings by borrowing money to invest in assets that are appreciating in value but produce little or no current income. This would enable the taxpayer to offset current highly taxed income with a current interest deduction, while deferring the taxable income from the investment until it is sold at a later date. This technique also would enable taxpayers to increase their future capital gain income and reduce their current ordinary income. This procedure is favorable to individual and noncorporate taxpayers because the tax on capital gains is less than the tax on ordinary income.

Because of these concerns, Sec. 163(d) limits the current deduction for investment interest expense to the noncorporate taxpayer's net investment income for the taxable year. Any investment interest expense disallowed as a current deduction is carried over and treated as investment interest expense incurred in the following year.

EXAMPLE I:8-14 ▶ In the current year, Rita earns $27,000 in net investment income and incurs $40,000 of investment interest expense. Rita's interest expense deduction for the year is limited to $27,000, the amount of her net investment income.

The remaining investment interest expense of $13,000 ($40,000 – $27,000) may be carried over and deducted in a subsequent year. This carryover amount is treated as paid or accrued in the subsequent year and is subject to the disallowance rules that pertain to the subsequent year. ◀

Investment Interest. **Investment interest** is interest expense on indebtedness properly allocable to property held for investment. This includes property that generates portfolio types of income such as interest, dividends, annuities, and royalties. It does not include business interest, personal interest, qualified residence interest, or interest incurred in connection with any passive activity. Under Sec. 469, all rental activities are passive (see Chapter I:9 for a discussion of the passive loss limitation rules). Thus, interest incurred in owning and renting property is subject to the passive loss limitation rather than the investment interest limitation.

Investment interest also does not include interest expense incurred to purchase or hold tax-exempt securities. This interest is not deductible at all. Without this disallowance, a taxpayer could, in certain circumstances, actually borrow funds at a higher rate of interest than the rate at which they were reinvested, while still generating a positive net cash flow because the government would be subsidizing the transaction through the interest deduction on the borrowings.

Net Investment Income. For purposes of the investment interest limitation, the term **net investment income** means the excess of the taxpayer's investment income over investment expenses. Investment income is gross income from property held for investment, including items such as dividends, interest, annuities, net short-term capital gains, and royalties (if not earned in a trade or business), but excluding qualified dividends and net long-term capital gains taxed at the preferential capital gains tax rates.

Including either of these two items in the definition of investment income would increase the amount of deductible investment interest expense, which might offset other income that is taxed at higher rates. Thus, the definition of investment income generally excludes net capital gain attributable to the disposition of property held for

investment and qualified dividends. However, at the election of the taxpayer, net capital gain from the disposition of investment property and qualified dividends can be included in investment income. To the extent the taxpayer elects to include gains from the disposition of investment property and qualified dividends in investment income, these items are taxed at the regular tax rates rather than at the preferential long-term capital gain rates.[27] The calculation of investment income does not include gains on business and personal-use property.

EXAMPLE I:8-15 ▶ During the current year, Michael incurs $15,000 investment interest expense, earns $7,000 of qualified dividends and $3,000 interest income. He also reports the following gains and losses from the sale of stocks and bonds during the year:

Short-term capital gains	$4,000
Short-term capital losses	(3,000)
Long-term capital gains	5,000
Long-term capital losses	(2,000)

Considering all of Michael's other income and deductions for the year, assume that he is subject to a 35% marginal tax rate and a 15% tax rate on long-term capital gains. Michael's net capital gain is $3,000 (net long-term capital gain of $3,000 in excess of net short-term capital losses of $0). He also has a $1,000 ($4,000 – $3,000) net short-term capital gain. Thus, of his total capital gain of $4,000 ($9,000 of total gains – $5,000 of total losses), only $1,000 ($4,000 net gain – $3,000 net capital gain) is included in investment income. In addition, the $7,000 of qualified dividends also are not included in investment income. If Michael does not make an election, his investment income is $4,000 ($3,000 of interest plus $1,000 net short-term capital gain). He may deduct $4,000 of the investment interest expense in the current year. The excess investment interest for the current year of $11,000 ($15,000 – $4,000) is carried over to the next year. The $3,000 net capital gain and the qualified dividends are subject to the 15% tax rate on net capital gain. If Michael makes the election, his investment income is $14,000 (the $3,000 net capital gain and $7,000 of qualified dividends are included), and he may deduct $14,000 of the investment interest expense. Thus, only $1,000 ($15,000 – $14,000) of investment interest expense is not currently deductible and is carried over to the next year. However, his $3,000 net capital gain and $7,000 of qualified dividends are subject to the 35% ordinary income tax rate. ◀

Investment expenses include all deductions (except interest) that are directly connected with the production of investment income. Beginning in 2018, the Tax Cuts and Jobs Act eliminated the deduction of investment expenses. After 2018, net investment income equals investment income when calculating the amount of investment interest expenses that can be deducted.

EXAMPLE I:8-16 ▶ Kevin's AGI for the current year is $200,000. Included in his AGI is $175,000 salary and $25,000 of investment income. In earning the investment income, Kevin paid investment interest expense of $33,000.

The investment interest expense deduction is limited to $25,000. The remaining investment interest of $8,000 ($33,000 – $25,000) is carried over and deducted in a subsequent year (subject to the disallowance rules that pertain to the subsequent year). ◀

Personal Interest. In general, the tax law does not allow a deduction for interest expense on debt incurred for personal purposes. Thus, taxpayers may not deduct interest on credit cards, car loans, and consumer debt. However, taxpayers generally may deduct interest on debt to acquire a personal residence. Qualified students may also deduct as a *for* AGI deduction interest incurred on certain student loans.

[27] Secs. 1(h)(3) and 163(d)(4)(B).

ADDITIONAL COMMENT

Banks and other financial institutions that receive mortgage interest from homeowners are required to report interest of $600 or more to the IRS and to the homeowners on Form 1098.

Qualified Residence Interest. Subject to certain limitations discussed below, individuals may deduct **qualified residence interest.** To be qualified residence interest, the interest payment must be acquisition indebtedness with respect to a qualified residence of the taxpayer. In all cases the residence must secure the debt.[28] A qualified residence (discussed below) may consist of the taxpayer's principal residence and a second residence.

Acquisition Indebtedness. Acquisition indebtedness is any debt secured by the residence and incurred in acquiring, constructing, or substantially improving the qualified residence. Debt may be treated as qualified acquisition indebtedness if the taxpayer acquires the residence within 90 days before or after the date that the debt is incurred. In the case of the construction or substantial improvement of a residence, debt incurred before the completion of the construction or improvement can qualify as acquisition debt to the extent of construction expenditures that are made no more than 24 months before the date the debt is incurred. Furthermore, debt incurred after construction is complete and within 90 days of the completion date may qualify as acquisition indebtedness to the extent of any construction expenditures made within the 24-month period ending on the date the debt is incurred.[29] Making payments of principal on the loan reduces the amount of acquisition debt. The only way to increase the amount of acquisition debt is to make substantial improvements to the property. The taxpayer may refinance acquisition indebtedness (and therefore treat it as acquisition indebtedness) to the extent that the principal amount of the refinancing does not exceed the principal amount of the acquisition debt immediately before the refinancing. Acquisition indebtedness includes debt obtained for home improvement. This includes debt labeled "home equity" if the proceeds are used for home improvements.

EXAMPLE I:8-17 ▶ Kay acquired a personal residence in 2006 for $220,000 and borrowed $140,000 on a mortgage that was secured by the property. In the current year the principal balance of the mortgage has been reduced to $100,000. Kay's acquisition indebtedness in the current year is only $100,000 and cannot be increased above $100,000 (except by indebtedness incurred to substantially improve the residence). If she refinances the existing mortgage in the current year and the refinanced debt is $110,000, only $100,000 (the principal balance of the existing acquisition indebtedness) qualifies as acquisition indebtedness. ◀

The limitation for qualified acquisition indebtedness is $1,000,000 ($500,000 for a married individual filing a separate return) for debt contracts entered into before December 15, 2017. Taxpayers who enter into binding contracts after December 14, 2017 are limited to qualified acquisition indebtedness of $750,000 ($375,000 for married filing separately).

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[28] Sec. 163(h). If the loan is not secured by the residence, it does not qualify. In one instance the taxpayer agreed to purchase her ex-husband's ownership interest in their residence. The terms of the sale were $10,000 down plus an unsecured $25,000 note. In a private ruling, the IRS ruled that because the note was not secured by the residence, the interest on the note was not qualified residence interest. (See Ltr. Rul. 8752010 September 18, 1987.) However, if under any state or local homestead law the security interest is ineffective or unenforceable, the interest expense still qualifies as qualified residence interest. See Sec. 163(h)(4)(C). In another letter ruling the taxpayer borrowed money to purchase a residence securing the debt by pledging stock and bonds. Here also, the IRS denied the deduction because the loan was not secured by the residence. (See Ltr. Rul. 8906031 November 10, 1988.)

[29] Notice 88-74, 1988-2 C.B. 385.

Points Paid as Qualified Residence Interest. Often taxpayers must pay **points** on real estate debt. A point is equal to 1% of the loan amount. Thus, two points paid on a $120,000 mortgage equal $2,400 (120,000 × .02). Points often represent prepaid interest because the stated rate of interest for the loan is lower than the current rate of interest. Generally, prepaid interest paid in the form of points must be capitalized and amortized over the life of the loan. However, points paid on a loan incurred to purchase the taxpayer's principal residence (acquisition indebtedness) are automatically deductible when paid if certain requirements are met. The IRS has also indicated that points paid on Veteran Administration (VA) and Federal Home Administration (FHA) loans are also currently deductible as interest if clearly designated as points incurred in connection with the indebtedness.[30]

EXAMPLE I:8-18 ▶ During the current year, Kevin and Donna purchase a new home for $300,000, putting $100,000 down and borrowing $200,000. At the closing, they are required to pay one and one-half points as a loan discount in connection with the loan, which is secured by a mortgage against the home. The practice of charging points is an established business practice where they live.

These points represent prepaid interest on the purchase of a principal residence. Thus, in addition to the interest portion of every payment they make during the year, Kevin and Donna may also deduct $3,000 ($200,000 × 0.015) as interest paid during the year of purchase. ◀

Taxpayers must capitalize points paid on a loan to purchase property other than a principal residence or for refinancing a mortgage on a principal residence. If the property is used in a business, held as an investment, or a qualified residence (the taxpayer's principal residence and one other that the taxpayer chooses) the taxpayer may amortize the points over the life of the loan.[31]

In order for the points to be currently deductible, the purchaser of the principal residence (borrower) must have paid for them with unborrowed funds. However, amounts provided by the borrower as down payments, escrow deposits, earnest money, or other funds are treated as paid for the points. Furthermore, as long as the borrower provides sufficient funds in these other categories, he or she is treated as having paid the points even if the seller has paid for them on behalf of the borrower.[32]

ADDITIONAL COMMENT

Before 2018, taxpayers could also deduct mortgage insurance premiums paid or accrued on a qualified residence. The deduction phased out for taxpayers with AGI in excess of $100,000. The amount of the phase-out was 10% of the amount of the qualified mortgage insurance for each $1,000 (or fraction thereof) that the taxpayer's AGI exceeded $100,000. Congress allowed this provision to expire for years after 2017.

Qualified Residence. For any tax year, a taxpayer may have two qualified residences:

- Taxpayer's principal residence
- One other residence selected by the taxpayer, with regard to which the taxpayer meets the residence test of Sec. 280A(d)(1).

In order to meet this residence test, the taxpayer must have personally used the property more than the greater of 14 days or 10% of any rental days during the year.[33]

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[30] These requirements, are as follows: The points are paid upon the purchase of a principal residence; they are designated as paid in connection with the acquisition debt and are a percentage of the loan; they follow business practices and are secured by the residence. Rev. Proc. 94-27, 1994-1 C.B. 613.

[31] Rev. Rul. 87-22, 1987-1 C.B. 146, and Rev. Proc. 87-15, 1987-1 C.B. 624. The 8th Circuit Court of Appeals has held in one case that points paid on refinancing a "bridge" or temporary loan are currently deductible. *James R. Huntsman v. CIR*, 66 AFTR 2d 90-5020, 90-2 USTC ¶50,340 (8th Cir., 1990), rev'g 91 TC 57 (1988). The IRS will not follow *Huntsman* in other circuits (IRS Action on Decision CC-1991-02, Feb. 11, 1991).

[32] Reg. Sec. 1.6050H-1(f)(3). See also Rev. Proc. 94-27, 1994-1 C.B. 613.

[33] Sec. 280A(d)(1). Use by the taxpayer's family as defined in Sec. 267(c)(4), other individuals under a reciprocal-use arrangement, and anyone when a fair rental is not charged counts as a day of personal use by the taxpayer.

EXAMPLE I:8-19 ▶ Fred owns a lakeside cabin that he uses for vacations. He also rents the cabin out to others when he is not using it. During the year Fred rents the cabin out at a fair rental for 90 days. Fred personally uses the cabin for a total of 22 days. Because Fred's personal use for the year (22 days) exceeds 14 days [the greater of 14 days or 9 days (10% of the rental days)], the cabin qualifies as his residence for purposes of deducting qualified residence interest for the year. ◀

ADDITIONAL COMMENT

Whether property is a residence for tax purposes is based on all the facts and circumstances, including the good faith of the taxpayer. A residence generally includes a house, condominium, mobile home, boat, or house trailer, that contains sleeping space and toilet and cooking facilities. Treas. Reg. § 1.163-10T(p)(3)(ii).

Despite the residence test, the taxpayer may select a property that has not been rented by the taxpayer at any time during the year as the second residence on which the taxpayer may deduct qualified residence interest.

Student Loan Interest. Pursuant to Sec. 221, individuals may take a *for* AGI deduction for interest paid on qualified education loans. The maximum annual interest deduction for qualified student loans is $2,500. Furthermore, the deduction is phased out if the student reports modified AGI in excess of certain amounts. For 2018 the deduction begins phasing out for a single individual with modified AGI of $70,000 (with a $15,000 phase-out range). For a student who is married filing jointly, the phase-out begins at $140,000 (with a $30,000 phase-out range).[34]

EXAMPLE I:8-20 ▶ During 2019, Ryan pays a total of $2,800 in interest on a loan incurred for qualified education expenses. Ryan is single and reports modified AGI of $79,000 for the year. Because his modified AGI of $79,000 is $9,000 more than $70,000, the maximum deduction of $2,500 is reduced by 60% ($9,000/$15,000). Ryan may take a *for* AGI deduction of $1,000 [2,500 − (60% × 2,500)]. If Ryan pays only $1,800 of interest (rather than $2,800), the potential deduction of $1,800 would be reduced by 60% to $720 [$1,800 − (60% × $1,800)]. ◀

To qualify for this deduction, the interest must be payable on a loan incurred solely to pay for qualified higher education expenses. If a taxpayer takes out a loan to pay for higher education expenses and for other purposes, none of the interest on the loan qualifies. Higher education expenses include tuition, fees, books and equipment, and room and board incurred during a time the taxpayer, the taxpayer's spouse, or the taxpayer's dependent is a student at a qualified higher education institution on at least a half-time basis. However, these qualified expenditures do not include amounts excluded from income under an employer educational assistance program or from United States savings bonds, as well as any scholarship or allowance that is excluded from income. Furthermore, to prevent a double deduction, the tax law allows no deduction to an individual who qualifies as a dependent on another person's tax return or for any amount that is deductible under any other provision of the Code.

TIMING OF THE INTEREST DEDUCTION

Under Sec. 163, deductible interest becomes deductible in the year the interest is paid or accrued. This generally means that cash method taxpayers deduct interest in the year paid, whereas accrual method taxpayers deduct interest as it accrues. However, the IRC makes exceptions to this general rule.

[34] Modified AGI includes certain excluded income from Guam, American Samoa, or Puerto Rico, as well as any income excluded under the foreign earned income provisions. Furthermore, the deduction for qualified tuition and related expenses is not allowed.

ADDITIONAL COMMENT

Points paid on the refinancing of an existing mortgage must be written off over the life of the new mortgage.

Prepaid Interest. If a cash method taxpayer prepays interest and the prepayment relates to a loan that extends beyond the end of the tax year, generally the taxpayer must capitalize the prepayment and amortize it over the periods to which the interest relates (i.e., the accrual method applies to cash method taxpayers in regards to prepaid interest). As previously discussed, the law makes one exception to this rule involving interest paid in the form of points charged in connection with the purchase or improvement of the taxpayer's principal residence. If these points represent prepaid interest, the taxpayer may deduct them in the year paid.[35]

Interest Paid with Loan Proceeds. Assuming the interest is otherwise deductible, if an individual borrows money from a third party rather than from the original lending institution and uses the funds to make a payment on a previously outstanding loan, the individual generally may deduct the interest portion of the payment. However, if the taxpayer borrows the funds used to pay the interest on the first loan from the same lender to whom the interest is due, and either (1) the purpose of the second loan is to pay the interest on the first or (2) the borrower does not have unrestricted control of the funds, then the borrower may not deduct the interest.[36]

Discounted Notes. Lending institutions often discount notes. In effect, the borrower pays the interest by repaying more money than is received when the note is signed. A cash method taxpayer can deduct this interest at the time of repayment, whereas an accrual method taxpayer must deduct the interest as it accrues over the term of the loan.

EXAMPLE I:8-21 ▶ On December 1, 2019, Stan borrows $1,000 from his credit union to use in his business. Under the terms of the contract, Stan actually receives $970 but is required to repay $1,000 on February 28, 2020 (three months later). Because Stan is a cash-method taxpayer, he may deduct the full $30 interest in 2020 when the note is repaid. If he were an accrual-method taxpayer, he could deduct $10 ($30 × 1/3) in 2019, and $20 ($30 × 2/3) in 2020. ◀

TYPICAL MISCONCEPTION

Taxpayers sometimes mistakenly assume that any business interest paid on loans between related taxpayers is not deductible. However, if the taxpayers are not governed by the Sec. 267 limitation and the interest is paid on a bona fide business loan, it is deductible.

Interest Owed to a Related Party by an Accrual Method Taxpayer. One of the purposes of Sec. 267 is to require related cash method lenders and accrual method borrowers to report the results of their joint transaction in the same year. Thus, an accrual method taxpayer who is related to a cash method creditor must defer the deduction for any accrued expense (including interest) until the year in which the taxpayer actually pays the expense and the creditor reports the income. Section 267 also disallows losses on the sale of property between related parties. Disallowance of losses between related parties is discussed in Chapter I:6.

The relationships covered by this rule are quite extensive. Some of the more common relationships include the following:

- Members of a family (defined as an individual's brothers, sisters, spouse, ancestors, and lineal descendants)
- An individual and a C corporation in which the individual owns directly or indirectly more than 50% of the outstanding stock
- A corporation and a partnership which are both over 50% owned directly or indirectly by the same people
- A partnership and any partner of the partnership
- An S corporation and any shareholder of the S corporation[37]

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[35] Sec. 461(g). In order for the exception to apply, the home must be used to secure the loan, and the charging of points must be an established business practice in the area where the loan is granted. (See the discussion of the deductibility of points in this chapter under the heading Definition of **Interest** as well as the discussion in Chapter I:6.)

[36] *H. C. Franklin v. CIR*, 50 AFTR 2d 82-5551, 82-2 USTC ¶9532 (5th Cir., 1982) and *Newton A. Burgess*, 8 T.C. 47 (1947). See also *Norman W. Menz*, 80 T.C. 1174 (1983). The IRS has also announced that it will disallow a deduction for interest paid with funds obtained through a second loan from the same lender (see IRS News Release 83-93, July 6, 1983).

[37] Secs. 267(b) and (e). The list of relationships is much more extensive than those mentioned. An S corporation is one that meets certain requirements and has made an election to have its income taxed directly to its shareholders. A C corporation is one that has not made an S election. (See Chapter C:11 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* text or Chapter C:11 of *Pearson's Federal Taxation: Comprehensive* text.)

EXAMPLE I:8-22 ▶ During the current year, Lisa, a cash method taxpayer, loans some money to her 100%-owned calendar year C corporation, which uses the accrual method of accounting. As of December 31 of the current year, the corporation owes Lisa $3,000 in interest. However, because of a shortage of funds, the corporation does not actually pay the interest until February 15 of the following year. Despite the fact that the corporation uses the accrual method of accounting, the corporation cannot deduct the $3,000 until the corporation actually pays the interest to Lisa in the subsequent year. The result would be the same if the corporation were an S corporation even if Lisa owned 50% or less of the outstanding stock. ◀

Imputed Interest. Under certain circumstances, if a taxpayer charges less than an adequate rate of interest, the IRS is authorized to impute an interest charge. This may cause the lender to have additional interest income and the borrower to have additional interest expense. The deductibility of this imputed interest expense depends on the classification of the expense (i.e. personal, investment, etc.). (See Chapter I:11 for a discussion of imputed interest.)

Topic Review I:8-2 summarizes the rules for deducting various types of interest.

TOPIC REVIEW I:8-2

Deductibility of Interest Expense

Type of Interest	Rules
Business	Deductible in full as a *for* AGI deduction.
Passive	Subject to the passive loss limits (see Chapter I:9).
Investment	Deductible as an itemized deduction to the extent of the taxpayer's net investment income for the year. Any amount not deductible is carried over to subsequent years.
Personal	Not deductible.
Qualified residence	(a) Must be attributable to debt secured by the taxpayer's principal residence and one other qualified residence selected by the taxpayer. (b) Interest on up to $750,000 of home acquisition indebtedness is deductible as an itemized deduction.
Student loan interest	(a) Payable on loan incurred to pay qualified higher education expenses. (b) Taken as a *for* AGI deduction. (c) Maximum deductible amount is $2,500. The deduction is phased out ratably for modified AGI between $70,000 and $85,000 ($140,000 and $170,000 for married filing jointly).

CHARITABLE CONTRIBUTIONS

OBJECTIVE 4

Compute the amount of a charitable contribution deduction and identify limitations

Under Sec. 170, individuals who itemize their deductions and corporations can deduct **charitable contributions** to qualified organizations. With the exception of certain contributions made by corporations (explained later in this chapter), a taxpayer takes the deduction in the year the contribution is made, regardless of the taxpayer's method of accounting. The amount of the deduction depends on the type of charity receiving the contribution, the type of property contributed, and the applicable limitations.

QUALIFYING ORGANIZATION

To deduct a contribution for federal income tax purposes, a taxpayer must make the contribution to or for the use of a qualified organization.[38] Contributions made directly to

[38] The Supreme Court has ruled that in order for a contribution to be for the use of a qualifying organization, the gift must be held either in a legally enforceable trust or in a similar legal arrangement. (See *U.S. v. Harold Davis*, 65 AFTR 2d 90-1051, 90-1 USTC ¶50,270 (USSC, 1990).)

ADDITIONAL COMMENT

According to the IRS's Statistics of Income, in 2016 the deduction for charitable contributions totaled $233.9 billion, representing 18% of the total dollar amount of the itemized deductions for medical expenses, taxes, interest, and charitable contributions.

individuals, even though the individuals may be needy, are generally not deductible.[39] Under Sec. 170, qualified organizations include the following:

- The United States, the District of Columbia, a state or possession of the United States, or a political subdivision of a state or possession
- A corporation, trust, community chest, fund or foundation created or organized under the laws of the United States, a state, possession, or the District of Columbia[40]
- A post or organization of war veterans
- A domestic fraternal society, order, or association[41]
- Certain cemetery companies

Because of the restrictions and limitations examined later in this chapter, the qualifying non-governmental entities are further classified into public charities and private nonoperating foundations. Different restrictions and limitations apply to each type of organization.

REAL-WORLD EXAMPLE

The American Red Cross, Boy Scouts of America, United Way, Goodwill, and Indiana University are examples of public charities.

Public charities include:

- Churches or a convention or association of churches
- Educational institutions that normally maintain a regular faculty, curriculum, and regularly enrolled students
- Organizations such as hospitals and medical schools whose principal function is medical care or medical education and research
- Government-supported organizations that exist to receive, hold, invest, and administer property for the benefit of a college or university
- Any qualified governmental unit
- Organizations that normally receive a substantial part of their support from either a governmental unit or the general public
- Certain private operating foundations[42]

TYPE OF PROPERTY CONTRIBUTED

If a taxpayer makes a contribution in cash, the amount of the contribution is easily determinable. However, in order to assure that the contribution has been properly made to a qualified charity, the taxpayer is required to maintain a record of the contribution such as a bank record or a written communication from the donee.[43] If noncash property is donated, the amount of the contribution is not as easy to identify. In the case of noncash property, the amount of the donation depends on two factors: (1) the type of property donated and (2) the type of qualifying organization (public charity or private nonoperating foundation) to whom the property is given. Furthermore, a gift of property that consists of less than the donor's entire interest in the property is not usually considered a contribution of property. Thus, for example, no charitable contribution is allowed when an individual donates the use of a vacation home for a charitable fund-raising auction.[44]

SELF-STUDY QUESTION

Doug purchases an item having a FMV of $75 for $100 in a charity auction. How much can he deduct?

ANSWER

Doug can deduct only $25 because the cash paid must be reduced by the value of the property received.

Contribution of Long-Term Capital Gain Property. In general, the amount of a donation of long-term capital gain property is its FMV. Regulation Sec. 1.170A-1(c)(2) defines a property's FMV as the price at which the property would change hands between a willing buyer

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[39] Under certain circumstances, a taxpayer may take a deduction (limited to $50 per month) for maintaining a student as a member of his or her household. The student may not be a dependent or relative of the taxpayer and must be placed in the taxpayer's home under an arrangement with a qualifying organization (see Sec. 170(g)).

[40] These organizations must be organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes; to foster national or international amateur sports competition; or for the prevention of cruelty to children or animals.

[41] Furthermore, gifts to these organizations must be made by individuals and must be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

[42] Sec. 170(b)(1)(F). The distinction between a private operating foundation and a private nonoperating foundation generally depends on the way the foundation spends or distributes its income and contributions. The details of this distinction are beyond the scope of this text.

[43] Sec. 170(f)(17) and Notice 2008-16. This record must show (1)the name of the donee organization, (2) the date of the contribution, and (3) the amount of the contribution.

[44] Sec. 170(f)(3), Reg. Sec. 1.170A-7(a)(1) and Rev. Rul. 89-51, 1989-1 C.B. 89. Note, however, that certain transfers of partial interests in property do qualify (e.g., the contribution of certain remainder interests to a trust, the transfer of a remainder interest in a personal residence or a farm, or a contribution of an undivided interest in property). These exceptions are beyond the scope of this text.

ADDITIONAL COMMENT

In 2004, rules were added relating to the contribution of used vehicles and intellectual property. For a used vehicle donated to a charity, in most cases the deduction will be limited to the charity's gross proceeds on the subsequent sale of the vehicle. A taxpayer's deduction for the contribution of a patent or similar intellectual property is the taxpayer's basis in the property.

and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. For purposes of charitable contributions, **capital gain property** is property held over one year, on which the taxpayer would recognize a long-term capital gain if the taxpayer sold it at its FMV on the date of the contribution. If a capital loss or a short-term capital gain would be recognized on the sale of the capital asset, the property is considered to be ordinary income property for purposes of calculating the amount of the charitable contribution deduction.

Contribution to a Private Nonoperating Foundation. The tax law provides an exception to this general rule for contributions of capital gain property to private nonoperating foundations. In general, a private nonoperating foundation is an organization that does not receive funding from the general public (e.g., the Carnegie Foundation). Private nonoperating foundations distribute funds to various charitable organizations that actually perform the charitable services. The amount of the contribution of long-term capital gain property to a private nonoperating foundation is the property's FMV, reduced by the capital gain that would be recognized if the property were sold at its FMV on the date of the contribution. This means that generally the deductible amount of the contribution is the lesser of the property's adjusted basis or its FMV.[45]

EXAMPLE I:8-23 ▶ Betty purchased some land in 2002 for $10,000. In the current year, she contributes the land to the United Way. At the time of the contribution, the FMV of the property is $25,000. Because the land is long-term capital gain property donated to a public charity, the amount of the contribution is $25,000 (its FMV).

On the other hand, if Betty donates the land to Cherry Foundation, a private nonoperating foundation, the amount of the contribution is $10,000 ($25,000 − $15,000 capital gain that would be recognized if the land were sold). ◀

TYPICAL MISCONCEPTION

Many people do not understand that the unrelated use restriction applies only to tangible personal property. A gift of shares of stock (intangible property) would not be a gift of unrelated use property where the stock is sold by the donee.

Unrelated Use Property. A second exception applies to capital gain property (that is also tangible personal property) contributed to a public charity and used by the organization for purposes unrelated to the charity's function. In such cases, the amount of the contribution deduction is equal to the property's FMV minus the capital gain that would be recognized if the property were sold at its FMV. This amount generally is the property's adjusted basis. Tangible property is all property that is not intangible property (e.g., property other than stock, securities, copyrights, patents, etc.). Personal property is all property other than real estate. The taxpayer is responsible for proving that the property was not put to unrelated use. However, a taxpayer meets this burden of proof if, at the time of the contribution, the taxpayer reasonably anticipates that the property will not be put to unrelated use. The immediate sale of the property by the charitable organization is a use unrelated to its tax-exempt purpose.

EXAMPLE I:8-24 ▶ Laura purchases a painting for $3,000. Several years later she contributes the painting to a local college. The FMV of the painting is $5,000 at the time the property is contributed. The painting is both tangible personal property and capital gain property. The college places the painting in the library for display and study by art students. Because the college uses the painting for purposes related to its function as an educational institution, the amount of Laura's contribution is equal to the painting's FMV ($5,000). On the other hand, if the college had sold the painting immediately after receiving it, the presumption is that the property's use was unrelated to the college's tax-exempt purpose. In this case, Laura's contribution is only $3,000. ◀

Certain Intangibles. Under Sec. 170(e)(1)(B)(iii), a third exception applies to the contribution of certain intangibles to a charitable organization. In this case, the amount of the charitable contribution is the FMV of the property, reduced by the amount of long-term capital gain that would have been recognized if the taxpayer had sold the property. These intangibles include patents, trademarks, a trade name or secret, know-how, a purchased copyright, and certain software.

[45] The amount of a contribution of appreciated stock held over one year made to a private nonoperating foundation remains at its FMV.

Contribution of Ordinary Income Property

General Rule. If a taxpayer contributes ordinary income property to a charitable organization, the deduction is equal to the property's FMV minus the amount of gain that would be recognized if the taxpayer had sold the property at its FMV on the date of the contribution. In most cases, this deduction is equal to the property's adjusted basis. This rule applies regardless of the type of charitable organization to which the property is donated.

REAL-WORLD EXAMPLE

A retired congressman was not entitled to a charitable contribution of his memos and papers because the papers were ordinary income property and had no basis. *James H. Morrison,* 71 T.C. 683 (1979).

For this purpose, **ordinary income property** includes any property that would result in the recognition of income taxed at ordinary income rates if the taxpayer sold the property. Thus, ordinary income property includes inventory, works of art or manuscripts created by the taxpayer, capital assets that have been held for one year or less, and Sec. 1231 property to the extent a sale would result in the recognition of ordinary income due to depreciation recapture.[46]

EXAMPLE I:8-25 ▶ During the current year, Beta, Inc. purchases land as an investment for $10,000. Five months later, it contributes the land to the United Way. At the time of the contribution the property's FMV is $15,000. The amount of Beta's contribution is $10,000 ($15,000 – [$15,000 – $10,000]) because it held the land for less than one year. ◀

EXAMPLE I:8-26 ▶ Pork, Inc. purchased a machine a few years ago for $20,000 and used the machine in its business. During the current year, Pork, Inc. donates the machine to a local community college. At the time of the contribution, the machine's adjusted basis is $5,000 and its FMV is $8,000. Because Pork, Inc. would have recognized a $3,000 gain (all ordinary income under Sec. 1245) if the machine were sold at its FMV, the amount of the contribution is $5,000 ($8,000 – $3,000), which is equal to the machine's adjusted basis. ◀

Donation of Inventory by a Corporation. Under certain circumstances, the donation of inventory by a C corporation (not an S corporation) to certain public charities provides a larger charitable contribution deduction than the adjusted basis of the property. One of these enhanced charitable contributions involves the donation of inventory to the charity if the charity uses the inventory solely for the care of the ill, needy, or infants.[47] C corporations may also take an enhanced charitable contribution deduction for donating scientific equipment constructed by the taxpayer and donated to a college, university, or qualified research organization for use in research, experimentation, or research training in the physical or biological sciences.[48] The amount of the enhanced charitable contribution is the property's FMV, reduced by 50% (not 100%) of the ordinary income that the corporation would have recognized if it had sold the property at its FMV. However, the amount of the contribution cannot exceed twice the basis of the property.

EXAMPLE I:8-27 ▶ During 2019, Able Corporation, a manufacturer of medical supplies, donated some of its inventory to the American Red Cross. The Red Cross used the inventory for the care of the needy and ill. At the time of the contribution, the FMV of the inventory was $10,000. Able's basis in the inventory was $3,000. Because this transaction qualifies under the exception, the amount of Able's contribution (before any limitations are applied) is $6,500 [$10,000 – (0.50 × $7,000)] but the actual amount of the contribution is limited to $6,000 (2 × the $3,000 basis in the property). ◀

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[46] Reg. Secs. 1.170A-4(b)(1) and 1.170A-4(d). Sec. 1231 property includes property used in a trade or business that is subject to depreciation. If it is sold at a gain, part or all of the gain is treated as ordinary income. Any remaining gain is subject to the Sec. 1231 rules. (See Chapter I:13 for an explanation of the depreciation recapture and Sec. 1231 rules.)

[47] Sec. 170(e)(3). These charitable organizations are known as Sec. 501(c)(3) charities. All taxpayers, not just C corporations, can take this enhanced charitable contribution if the donated property is wholesome food that will be used for the care of the ill, needy, or infants. The total amount of this enhanced donation is generally limited to 15% of the taxpayer's aggregate net income. Special rules must be met to meet the fair market value and the wholesome food tests. (See Sec. 170(e)(3)(C).)

[48] Sec. 170(e)(4). For tax years before 2012, additional enhanced charitable contribution deductions also included the donation of computer technology and equipment to public libraries and elementary and secondary schools, and the donation of books to a public library.

Contribution of Services. When a taxpayer renders services to a qualified charitable organization, the taxpayer may only deduct the unreimbursed expenses incurred incident to rendering the services. These items include out-of-pocket expenses, transportation expenses, the cost of lodging and 50% of the cost of meals while away from home, and the cost of a uniform that is required to be worn in performing the donated services but is not suitable for general wear. The out-of-pocket expenses are deductible only if the taxpayer who actually renders the services to the charity is the person who incurs these out-of-pocket expenses. Taxpayers cannot take a deduction for expenses while away from home unless they experience no significant element of personal pleasure, recreation, or vacation in such travel. Instead of the actual costs of operating an automobile while performing the donated services, the law permits a deduction of 14 cents per mile.[49]

EXAMPLE I:8-28 ▶

During the current year, Tony spends a total of 100 hours developing an accounting system for the local council of the Boy Scouts of America. As an accountant, Tony earns $200 per hour. During the year, Tony also drives his car a total of 500 miles in performing the services for the Boy Scouts of America. If he uses the automatic mileage method to compute the amount of the charitable contribution, he can deduct $70 (0.14 × 500). No deduction is available for the value of 100 hours of Tony's contributed services. ◀

REAL-WORLD EXAMPLE

The cost of newspaper advertising, paper, pencils, and other supplies purchased by volunteers in connection with their involvement in the Volunteer Income Tax Assistance Program (VITA) is deductible. Rev. Rul. 80-45, 1980-1 C.B. 54.

DEDUCTION LIMITATIONS

Overall 50% Limitation. The charitable contribution deduction available for any tax year is subject to certain limitations. For individuals, the general overall limitation applicable to public charities is 50% of the taxpayer's AGI for the year. Any contributions in excess of the overall limitation may be carried forward and deducted in the subsequent five tax years. In addition, the tax law imposes further limitations on contributions of capital gain property to either a public charity or a private nonoperating foundation and all types of property contributions to private nonoperating foundations. Beginning on January 1, 2018, the limitation for cash contributions to a public charity increased to 60% of the taxpayer's AGI.

KEY POINT

The generosity of Congress in permitting individuals to use FMV is tempered by the 30% of AGI limitation.

30% Limitation. Under certain circumstances, a special 30% of AGI limitation applies. Contributions of capital gain property (capital assets held over one year on which a gain would be realized if sold) to public charities are generally valued at the property's FMV, but the deduction may not exceed an overall limit of 30% of AGI instead of a 50% limit. This special 30% limit does not apply, however, in the following situations:

- Capital gain property (which is tangible personal property) donated to a public charity that does not put the property to its related use. In such cases, the amount of the contribution is reduced by the capital gain that would be recognized if the property were sold.
- The taxpayer elects to reduce the amount of the charitable contribution deduction by the capital gain that the taxpayer would recognize if he or she sold the property.

EXAMPLE I:8-29 ▶

Joy donates a painting to the local university during a year in which she has AGI of $50,000. The painting, which cost $10,000 several years before, is valued at $30,000 at the time of the contribution. The university exhibits the painting in its art gallery. Because the painting is put to a use related to the university's purpose, the amount of Joy's contribution is $30,000. If Joy does not make the election, her current year charitable contribution deduction is limited to $15,000 (0.30 × $50,000 AGI). The remaining $15,000 is carried over to the subsequent five years. If she elects to reduce the amount of the contribution by the long-term capital gain, Joy's current year charitable contribution deduction is her basis of $10,000 in the property. She has no charitable contribution carryover. In this case, making the election doesn't make sense. ◀

The overall deduction limitation of 30% of AGI also applies to the contribution of all types of property other than capital gain property (e.g., cash and ordinary income property) to a private nonoperating foundation. However, further restrictions may apply to the deductibility of certain contributions to this type of charity.

[49] Sec. 170(i).

20% Limitation on Capital Gain Property Contributed to Private Nonoperating Foundations. Contributions of capital gain property to private nonoperating foundations may not exceed the lesser of (1) 20% of the taxpayer's AGI or (2) 30% of the taxpayer's AGI, reduced by any contributions of capital gain property donated to a public charity.

Applying the Deduction Limitations. Contributions subject only to the 50% of AGI limitation are accounted for before the contributions subject to the 30% of AGI limitation.

EXAMPLE I:8-30 ▶ During a year when Ted's AGI is $70,000, he donates $22,000 in ordinary income property to his church and $18,000 to a private nonoperating charity. The church contribution is initially subject to the 50% limitation and is fully deductible because the $22,000 contribution is less than the limitation amount of $35,000 (0.50 × $70,000). Ted's deduction for the contribution to the private nonoperating charity (a 30% charity) is limited to $13,000 (the lesser of the following three amounts):

The actual contribution	$18,000
The remaining 50% limitation after the contribution to Ted's church [(0.50 × $70,000) − $22,000]	$13,000
30% of AGI (0.30 × $70,000)	$21,000

◀

The deduction limit is applied differently when there are aggregate cash contributions subject to the 60% rule. When applying the 30 and 50% limits for a tax year, the limit is reduced by the aggregate cash contributions allowed under the 60% limit for the year.[50]

EXAMPLE I:8-31 ▶ During a year when Sandy's AGI is $160,000, she contributes $40,000 to a 50% charity and an automobile worth $12,000 for the use of the 50% charity. Sandy's limit for the cash contribution is $96,000 ($160,000 × 60%). Sandy's limit on contributions for the use of a charity is $48,000 ($160,000 × 30%), but this amount must be reduced by Sandy's cash contribution of $40,000, resulting in a remaining contribution limit of $8,000 ($48,000 − $40,000). Sandy may deduct the $40,000 cash contribution plus $8,000 of the automobile's value in the current year, but must carry the remaining $4,000 of automobile's value in subsequent years. ◀

APPLICATION OF CARRYOVERS

As noted earlier, any contributions that exceed the 60% limitation may be carried over and deducted in the subsequent five years. These carryovers are subject to the limitations that apply in subsequent years. Thus, taxpayers may deduct carryovers only to the extent that the limitation of the subsequent year exceeds the contributions made during that year.

TAX PLANNING

If a taxpayer has contribution carryovers that are about to expire, the taxpayer should consider reducing the current year's contribution so that the carryovers can be deducted.

These general rules also apply with regard to the special limitations. For example, if the taxpayer donates property subject to the 50% limitation during the current year and the amount of the contribution exceeds the limitation, the excess may carry over to the five subsequent years subject to the 50% limitation in the carryover years. In the carryover year, a deduction may be taken for the excess contribution to the extent that the 50% limitation of the subsequent year exceeds the amount of the property donated during the subsequent year subject to the 50% limitation. Excess contributions of property subject to the 30% or 20% limitations may also carry over to the subsequent five years. This carryover is also subject to the special restrictions noted above for the 50% limitation. The carryovers are used in chronological order.

EXAMPLE I:8-32 ▶ Assume that for the years 2019 through 2021, Joan reports AGI and makes charitable contributions in the following amounts:

	2019	*2020*	*2021*
AGI	$40,000	$40,000	$60,000
Cash contributions subject to the 60% of AGI limitation	29,000	27,000	30,000
60% of AGI limitation	24,000	24,000	36,000

[50] Sec. 170(b)(1)(G)(iii)(II).

The amount of the charitable contribution deduction for each year and the order in which the deduction and carryovers are used are as follows:

	2019	2020	2021
Amount of deduction	$24,000	$24,000	$36,000
Amount of carryover			
From 2019	5,000	5,000	0
From 2020		3,000	2,000

◀

SPECIAL RULES FOR CHARITABLE CONTRIBUTIONS MADE BY CORPORATIONS

The rules governing charitable contributions made by corporations are generally the same as those pertaining to contributions made by individuals. However, certain differences do exist.



ETHICAL POINT

A tax practitioner should not be a party to the backdating of a Board of Director's authorization of a charitable contribution pledge so that the corporation may improperly deduct the contribution in the earlier year.

Pledges Made by an Accrual Method Corporation. Generally, taxpayers may only deduct actual contributions (not pledges) made during the tax year. This rule applies to both cash and accrual method taxpayers. A major exception to this general rule exists for accrual method corporations. These accrual method corporations may elect to claim a charitable deduction for the year in which the corporation makes a pledge to make a contribution as long as the actual contribution is made by the fifteenth day of the third month following the close of the year in which the pledge is made. The corporation's board of directors must authorize the pledge.

Limitation Applicable to Corporations. Corporate charitable deductions may not exceed 10% of the corporation's taxable income for the year. This amount is computed without regard to the dividends-received deduction, net operating loss or capital loss carrybacks, or any deduction for the charitable contribution itself. Excess contributions may be carried forward for five years and are deductible only if the current-year contributions are less than the current year's 10% limitation. The corporation also uses the carryovers in chronological order.

SUMMARY OF CHARITABLE CONTRIBUTIONS DEDUCTION LIMITATIONS

Topic Review I:8-3 summarizes the rules governing the deduction for charitable contributions.



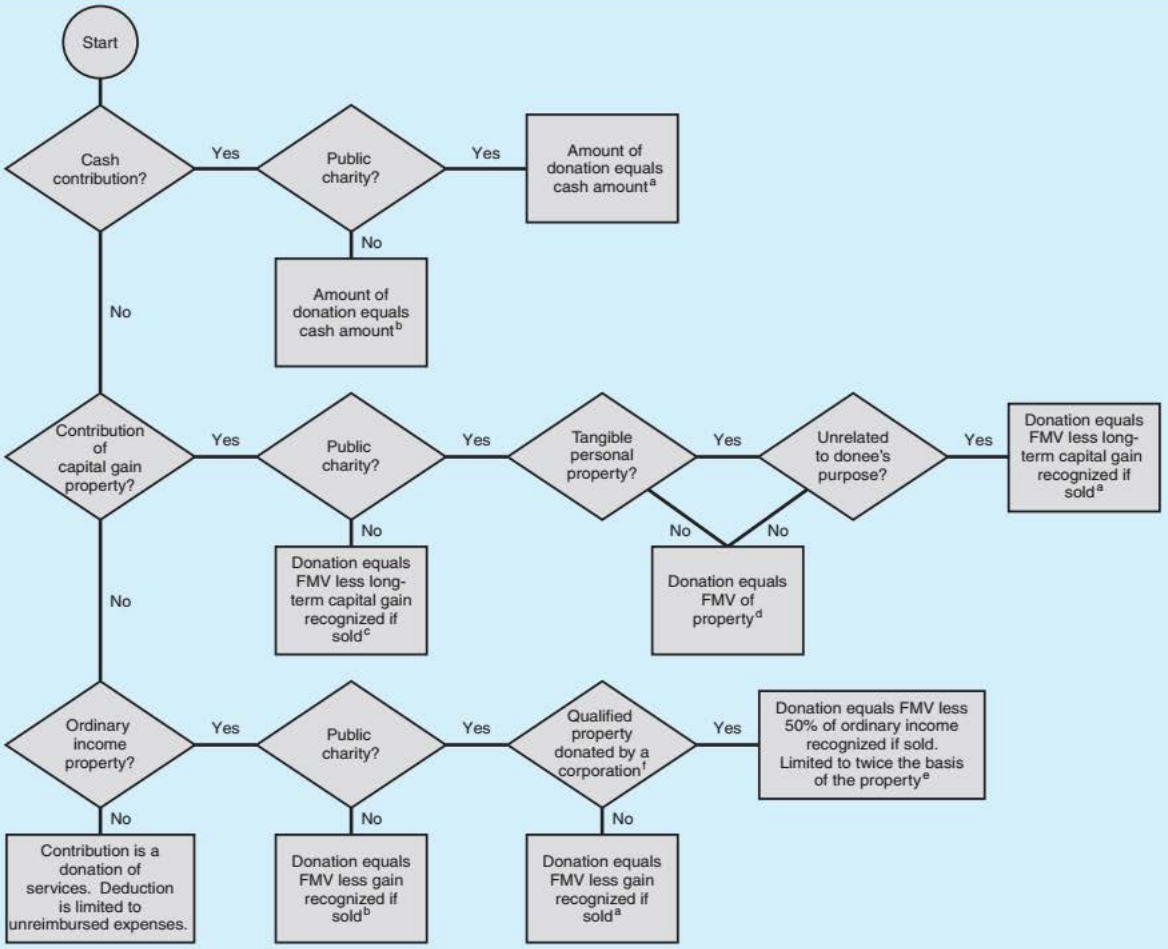
STOP & THINK

Question: During the current year, Kim pledges to contribute $10,000 to both the Boy Scouts of America (BSA) and to a private nonoperating foundation. She wants to satisfy those pledges before the end of the year in order to take a deduction this year. She has enough cash to satisfy one of the pledges, but must either sell or donate some land in order to satisfy the other. The land she has in mind has a fair market value of $10,000 and a cost basis of $2,000. She purchased the land four years ago. Kim estimates that she will have AGI of $170,000 and will be in the 24% marginal tax bracket. Assuming that both charities would gladly accept either contribution, how should Kim satisfy these pledges?

Solution: The amount of contribution of capital gain property to a public charity is the property's fair market value. The 30% of AGI limitation applies to such contributions. However, a contribution of capital gain property to a private non-operating foundation is the property's fair market value, reduced by the gain that the taxpayer would have recognized if he or she had sold the property (generally the property's basis). Since Kim's AGI for the year is so high, the limitations do not apply. Thus, Kim should contribute the land to the BSA and the cash to the private non-operating foundation, for a total charitable contribution of $20,000.

TOPIC REVIEW I:8-3

Deduction Rules for Charitable Contributions



[a] Limited to 60% of AGI (50% of AGI for property).
[b] Limited to lesser of (1) 30% of AGI reduced by any cash contributions to public charities or (2) remaining 50% of AGI after accounting for donations to public charities.
[c] Limited to lesser of (1) 20% of AGI reduced by any cash contributions to public charities or (2) 30% of AGI less capital gain contributions to public charities reduced by any cash contributions to public charities.
[d] Taxpayer may elect to scale down the amount of donation by long-term capital gain. If the election is made, limited to 50% of AGI reduced by any cash contributions to public charities. If no election is made, limited to 30% of AGI reduced by any cash contributions to public charities.
[e] Limited to 10% of the corporation's taxable income without regard to any deduction for charitable contributions, dividends received, a net operating loss carryback or a capital loss carryback.
[f] Qualified property consists of either (1) inventory or property used in a trade or business which will be used by a Sec. 501(c)(3) charity for the care of the ill, needy, or infants and (2) inventory constructed by the corporation which will be used by a qualified research institution in the physical or biological sciences.

CASUALTY AND THEFT LOSSES

OBJECTIVE 5

Discuss casualty and theft losses

Generally, taxpayers may not deduct losses on personal-use property. However, under Sec. 165 individuals may deduct a casualty or theft loss on personal-use property as an itemized deduction on Schedule A of Form 1040 if it is attributable to a federally declared

▼ **TABLE I:8-1**

Summary of Changes Made to Itemized Deductions by the Tax Cuts and Jobs Act of 2017

In December 2017, Congress passed the Tax Cuts and Jobs Act, which changed or eliminated numerous itemized deductions. The table below provides a summary of these changes.

	Law through December 31, 2017	Law as of January 1, 2018
MEDICAL EXPENSES	Medical expenses may be deducted to the extent they exceed 10% of AGI as an itemized deduction (7.5% in 2017)	Medical expenses may be deducted to the extent they exceed 7.5% of AGI (increasing to 10% of AGI in 2019), as an itemized deduction
STATE AND LOCAL TAXES	State and local personal property taxes, state and local real property taxes, state and local income taxes (or if elected in lieu of income taxes, state and local sales taxes) are an itemized deduction without limitation	State and local personal property taxes, state and local real property taxes, state and local income taxes (or if elected in lieu of income taxes, state and local sales taxes) are limited to $10,000 and are an itemized deduction
MORTGAGE INTEREST	Interest on home acquisition indebtedness is limited to interest on $1 million of acquisition debt and interest on up to $100,000 of home equity indebtedness are itemized deductions	Interest on home acquisition indebtedness is limited to interest on $750,000 of acquisition debt as an itemized deduction
CHARITABLE CONTRIBUTIONS	Cash contributions to public charities are limited to 50% of AGI and are an itemized deduction	Cash contributions to public charities are limited to 60% of AGI and are an itemized deduction
CASUALTY AND THEFT LOSSES	Are deductible to the extent they exceed a $100 floor and 10% of AGI as an itemized deduction.	Are deductible to the extent they exceed a $100 floor and 10% of AGI only on losses attributable to a federally declared disaster. They are deductible as an itemized deduction.
MISCELLANEOUS ITEMIZED DEDUCTIONS	These deductions include employee expenses, investment expenses, tax return preparations fees are deductible as an itemized deduction to the extent that they exceed 2% of AGI.	These expenses are no longer deductible
REDUCTION OF CERTAIN ITEMIZED DEDUCTIONS	High wealth taxpayers were required to reduce the total amount of certain itemized deductions by the lesser of 3% of AGI over income thresholds of $313,800 (MFJ), $261,500 (S), $287,650 (Head of household) and $156,900 (MFS) or 80% of certain itemized deductions	There is no longer a reduction of itemized deductions for high-wealth individuals.

disaster. For individuals, casualty losses on business and investment properties held for the production of rents or royalties are deductions in computing AGI. Other casualty losses are itemized deductions. Chapter I:9 discusses casualty losses in greater depth.

QUALIFIED BUSINESS INCOME DEDUCTION

OBJECTIVE 6

Determine the calculation of the qualified business income deduction

For tax years beginning after 2017, the tax law allows a deduction for qualified business income (QBI) under Sec. 199A. The deduction reduces taxable income (instead of adjusted gross income), but taxpayers can take the deduction regardless of whether the taxpayers itemize their deductions or utilize the standard deduction. For pass-through entities, the deduction is taken at the partner or shareholder level. In general, the deduction is the lesser of 20% of net business income from a partnership, S corporation, or sole proprietorship, as well as to a percentage of the taxpayer's qualified REIT and publicly-traded partnership income or 20% of the excess of taxable income (before the QBI deduction) over any net capital gain. The purpose of this deduction was to effectively reduce the tax rate of business income earned by these types of businesses to be closer to that imposed on C corporations. However, there are a number of exceptions and rules that can make the calculation of this deduction fairly complex.

QBI includes income from a U.S. trade or business that is not in the service-related businesses of law, accounting, healthcare, and consulting. Combined QBI is further defined as the lesser of:

1. 20% of qualified business income, or
2. The greater of
   a. 50% of W-2 wages allocable to the taxpayer by the business, or
   b. 25% of allocable W-2 wages plus 2.5% of the allocable share of unadjusted basis qualified property immediately after it has been acquired.

The restrictions for service industries and the W-2 limitations do not apply to taxpayers with taxable income less than a threshold amount of $160,700 for single taxpayers, $160,725 for married filing separately and $321,400 for married filing jointly.

EXAMPLE I:8-33 ▶ Carrie is a 50% partner in CD partnership. In the current year, the partnership had qualified business income of $2.8 million. CD partnership paid W-2 wages of $900,000 and owns depreciable tangible property with an unadjusted basis of $1,600,000. What is Carrie's qualified business income deduction (ignoring the ½ deduction for self-employment taxes)? ◀

Deduction for the general limit ($2,800,000 × 50% ownership × 20%)		$280,000
Deduction limitation limited to greater of:		
$900,000 × 50% interest × 50%	$225,000	
$1,600,000 × 50% × 2.5% + $900,000 × 50% × 25%	132,500	
Allowable Section 199A deduction		$225,000

TAX PLANNING CONSIDERATIONS

OBJECTIVE 7

Describe tax planning considerations for itemized deductions

As noted throughout this chapter, TCJA 2017 made significant changes to many of the itemized deductions. These changes can have implications for tax planning. Table I:8-1 summarizes these changes.

MEDICAL EXPENSE DEDUCTION

Working with the 10% of AGI Floor. As explained previously, a deduction for medical expenses is available to individuals only to the extent that the taxpayer's medical expenditures exceed 10% of the taxpayer's AGI for the year. Thus, many individuals find that no deduction is available, even though their medical expenses are relatively high. In these cases, taxpayers may obtain some benefit if they can bunch the medical expenses into one year. Orthodontic work, certain orthopedic treatment, noncosmetic elective surgery, and new eyeglasses are all examples of medical expenditures that may be either accelerated or delayed into a year in which other medical expenses are high or AGI is lower.

Generally, a taxpayer may take a deduction for medical expenses only in the year in which the expense is actually paid. The mere prepayment of future expenses usually does not accelerate the deduction. However, taxpayers may take a deduction in the earlier year of payment if there is a legal obligation to pay or if the prepayment is a requirement for the receipt of the medical care.[51] If the taxpayer has already received the medical treatment, but the taxpayer does not have sufficient cash to pay the bill, the taxpayer may preserve a deduction for the current year by either borrowing the cash to satisfy the bill or by using a credit card.

EXAMPLE I:8-34 ▶ During the current year, Marty is 40 and he estimates his AGI to be $70,000. Marty has already incurred $5,000 in medical expenses for himself and his family during the year. Because of the 10% of AGI limitation, Marty will not be able to deduct any of the medical expenses. Marty estimates that he will incur $4,000 in medical expenses for orthodontic work for his son next year. He doesn't think he will incur any other major medical expenses next year. Marty also estimates

[51] *Robert M. Rose v. CIR*, 26 AFTR 2d 70-5653, 70-2 USTC ¶9646 (5th Cir., 1970). See also Rev. Ruls. 75-302, 1975-2 C.B. 86, and 75-303, 1975-2 C.B. 87, both clarified by Rev. Rul. 93-72, 1993-2 C.B. 77.

KEY POINT

Even if the medical expenses exceed 10% of AGI the taxpayer may not benefit from the deduction if the medical expenses in addition to the other itemized deductions do not exceed the standard deduction.

his AGI next year to remain the same as this year. If these estimates are correct, Marty won't be able to deduct any medical expenses in either year because the expenses for each year are less than the AGI limitation in each of the years. However, if the orthodontic work is started in the current year and Marty pays for the work in the current year, he will incur a total of $9,000 in medical expenses in the current year. Thus, in the current year Marty may deduct $2,000 ($9,000 – $7,000) of the total medical expenses. This, of course, assumes that the total of Marty's itemized deductions exceeds the standard deduction for the year.

Mere prepayment in this case is not sufficient. Marty must have a portion of the orthodontic services performed in the earlier year. If he does not have sufficient cash to pay the bill in the current year, he could borrow the money or use a bank credit card. ◀

Multiple Support Agreements. An individual may deduct medical expenses incurred for himself or herself, his or her spouse, dependents, children of divorced parents even if not a dependent, and persons who would qualify as a dependent except for the failure to meet the gross income or joint return test. In cases where a multiple support agreement has been filed, the tax law treats the individual who is the subject of the agreement as the dependent of the taxpayer entitled to a deduction for any medical expenses paid on behalf of the dependent.

EXAMPLE I:8-35 ▶ Amy, Bart, Clay, and Donna each provide 25% of the support of their father, Eric. Under the terms of a multiple support agreement, Bart, Clay, and Donna all agree to allow Amy to claim Eric as her dependent. During the year, $3,000 in medical expenses are incurred on Eric's behalf. If Amy pays these expenses, she may deduct them (subject to limitations). However, if Bart, Clay, or Donna pays these expenses, no one may claim the medical expenses as a deduction. ◀

INTEREST EXPENSE DEDUCTION

A taxpayer may deduct qualified residence interest incurred on a principal residence and one other qualified residence that the taxpayer selects. The taxpayer makes this choice annually. The taxpayer may choose any residence that is not a rental property. In order for the second residence to qualify, the taxpayer must either (1) not rent out the second residence at all during the year or (2) use it personally for more than the greater of 14 days or 10% of the rental days during the year. If this personal use test is met, however, the Sec. 280A limitations on the rental of vacation homes also apply. As explained in Chapter I:6, under these rules, taxpayers must allocate expenses between the rental use and the personal use of the property. Taxpayers may deduct the expenses allocated to the rental use only to the extent of the rental income. Of the expenses allocated to the personal use, only the taxes and interest (if the residence is selected and if the loan is secured by the residence) are deductible as itemized deductions.

If the personal use by the taxpayer does not meet the test mentioned above, the interest allocated to the personal use cannot qualify as residence interest and it becomes non deductible personal interest. Furthermore, the passive loss rules apply to the rental income and expenses allocated to the rental use of the property (see Chapter I:9). Under these rules, individuals generally can deduct losses generated from a passive activity only to the extent of the individual's passive income. Certain individuals, however, may deduct up to $25,000 of losses from the rental of real estate. Thus, the two alternatives and their consequences are as follows:

- Meet the personal use test. No loss from the rental portion of the property is deductible. However, the interest allocated to the personal use portion may be fully deductible as qualified residence interest.
- Do not meet the personal use test. The interest allocated to the personal use portion is nondeductible personal interest. However, all of the passive loss from the rental portion is deductible against passive income. Furthermore, certain individuals may deduct up to $25,000 additional passive loss.

The alternative a taxpayer chooses depends on several factors, including the amount of the taxpayer's passive income, the total amount of itemized deductions, and whether the loan is secured by the vacation home.

DEDUCTION FOR CHARITABLE CONTRIBUTIONS

SELF-STUDY QUESTION

What type of property lends itself to the "election to reduce"?

ANSWER

Property on which there is very little appreciation.

Election to Reduce the Amount of a Charitable Contribution. The election to reduce the contribution of capital gain property to public charities by the long-term capital gain that the taxpayer would recognize if he or she sold the property is an annual election that applies to all capital gain property donated to public charities during the year. Because the election increases the ceiling limitation from 30% to 50%, under certain circumstances a taxpayer may actually receive a larger deduction for the year than would normally be available if the taxpayer did not make the election.

EXAMPLE I:8-36 ▶ During the current year, Jane has AGI of $50,000. She donates a painting to the local university during the same year. The painting, valued at $30,000 at the time of contribution, cost her $25,000 several years before. The university displays the painting in its art museum. If Jane does not make the election, the amount of the contribution is equal to its FMV ($30,000). However, Jane's charitable contribution deduction for the year is limited to $15,000 ($50,000 × 0.30). If Jane makes the election to reduce the contribution amount, the deduction is reduced to $25,000 ($30,000 − $5,000 LTCG). The deduction limitation, however, increases to $25,000 for the year because the limitation is now based on 50% of AGI instead of 30%. In this case, Jane will receive a larger deduction for the year by making the election. However, the cost associated with this election is the loss of $5,000 of deduction because the total deduction is reduced from $30,000 to $25,000 if she makes the election. ◀

Many tax practitioners make this election only when preparing the taxpayer's final tax return. The taxpayer makes the election at this time because charitable contribution carryovers to the decedent's estate are not permitted.

ADDITIONAL COMMENT

To help determine the FMV of contributed property, taxpayers can refer to IRS Pub. No. 561, Determining the Value of Donated Property. (2007)

Donation of Appreciated Capital Gain Property. Instead of selling substantially appreciated capital gain property and donating the cash proceeds, the taxpayer should consider donating the property directly to a charity. If property is donated in this way, the donor receives a deduction equal to the FMV of the property and does not recognize any taxable gain on the disposition.

EXAMPLE I:8-37 ▶ Colleen wishes to satisfy a pledge of $100,000 made to a local university. She owns $100,000 worth of marketable securities purchased ten years ago for $30,000. Because the securities are marketable, the university is indifferent as to whether Colleen donates cash or the securities. Although her marginal tax rate is 35%, Colleen would be subject to a tax rate of 15% on the sale of the securities. She has enough AGI to be able to deduct the full contribution in the current year. The following chart summarizes the cash flows to Colleen under two different alternatives:

	Donate Securities	*Sell Securities and Donate Cash*
Proceeds of sale	0	$100,000
Tax on gain	0	(10,500)[a]
Cash payment to charity		(100,000)
Tax savings from the contribution deduction	$35,000[b]	35,000[b]
Net cash flow	$35,000	$ 24,500

[a]($100,000 − $30,000) × 0.15 = $10,500.

[b]$100,000 × 0.35 = $35,000 (assuming the overall reduction of itemized deductions does not apply). ◀

In order to take a tax loss on business or investment property, a taxpayer should not donate property that has decreased in value. Rather, the taxpayer should sell the property, recognize the loss, and donate the cash proceeds.

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 8

Describe compliance and procedural considerations for itemized deductions

MEDICAL EXPENSES

In certain cases, expenditures qualify as both a medical care expense and a dependent care expense (i.e., expenses for household and dependent care services that the taxpayer must pay to be gainfully employed). A taxpayer who incurs an expense that qualifies under both provisions may choose to take either a medical expense deduction or a tax credit under Sec. 21.[52] However, if a taxpayer takes a credit for these expenses, they are not deductible as medical expenses.

EXAMPLE I:8-38 ▶ Joel's daughter, Debbie, has a physical disability. As a result, Joel hires a nurse who provides daily care while he is at work. During the year, Joel pays the nurse a total of $3,000. This amount qualifies for both the dependent care credit and the medical expense deduction. If Joel takes the dependent care credit, he may not deduct the $3,000 as a medical expense. Because of the limitations imposed on each, the determination of which treatment is more advantageous depends on items such as the taxpayer's AGI, other medical expenses, and total itemized deductions. ◀

CHARITABLE CONTRIBUTIONS

ADDITIONAL COMMENT

On Form 8283, the charitable organization is required to acknowledge receipt of the gift and to file an information return if the property is sold or disposed of within two years.

Over the past several years, the IRS has significantly tightened the requirements needed to properly substantiate a charitable contribution in an attempt to prevent abuses in claiming inflated charitable contributions. In order for a taxpayer to take a deduction for a cash contribution of any amount, the taxpayer must be able to substantiate the contribution with either a bank record or a written receipt from the charity. Self-created documents are not sufficient. Previously, this requirement was imposed only on cash contributions of $250 or more. In addition, when a taxpayer donates property other than cash to a qualifying charity, proper determination of the property's FMV is a critical issue. Because of actual and perceived abuses in this area, the IRS often scrutinizes and, if necessary, challenges the valuation of contributed property. This is especially true for contributions of property for which no published market quotes exist. Thus, the taxpayer must (1) properly substantiate the fact that the contribution has actually been made, and (2) in the case of the contribution of property, the taxpayer may be required to acquire and retain or provide to the IRS information documenting the property's FMV. As noted below, special detailed substantiation and documentation requirements apply to the contribution of used motor vehicles, boats, and airplanes.

REAL-LIFE EXAMPLE

In one case the taxpayer, a CPA, failed to support a contribution with a qualified appraisal. As a result, his charitable deduction for art and printing supplies donated to a high school was denied. To substantiate the claimed $40,000 charitable deduction, the taxpayer submitted with Form 8283 an appraisal of the donated items made by the high school's principal. The principal, however, wasn't a "qualified appraiser." *D'Arcangelo,* TC Memo 1994-572 (1994).

Proper Substantiation. As mentioned above, if the contribution is made in cash, the taxpayer must retain evidence of the donation by keeping a cancelled check or other bank record or a receipt from the charitable organization. If the contribution is in the form of noncash property, the taxpayer must maintain records containing the following:

- Name and address of the charity to which the contribution was made
- Date and location of the contribution
- Description of the property
- FMV of the property
- Method of determining the property's FMV
- Signed copy of the appraisal report if an appraiser was used[53]

ADDITIONAL COMMENT

If the taxpayer's total deduction for art is $20,000 or more, he or she must include an 8 × 10 inch color photograph or a color transparency no smaller than 4 × 5 inches.

[52] A credit of up to 35% of expenses for child and dependent care services is allowed if the dependent is under age 13 or a spouse or dependent who is mentally or physically incapable of caring for himself or herself. The credit is reduced 1% for every $2,000 (or portion thereof) of AGI over $15,000. However, the credit may not be reduced below 20%. (See the discussion on Personal Tax Credits in Chapter I:14 for a more detailed explanation of the child and dependent care credit.)

[53] Reg. Sec. 1.170A-13.

For charitable contributions of $250 or more, no deduction is allowed unless the contribution is substantiated by a contemporaneous, written acknowledgment (receipt) by the donee organization.This acknowledgment must contain the following information:

- The amount of cash and a description of any property contributed
- Whether or not the organization provided any goods or services in consideration for the cash or property received, including a description and good faith estimate of the value of any goods or services provided by the organization

The acknowledgment is contemporaneous if obtained by the earlier of the date the taxpayer files a return for the year in question or the extended due date for filing such a return. This substantiation requirement is waived if the donee organization files a return that contains the required information.[54] Additionally, no deduction is allowed for a contribution of clothing or household items unless the items are in "good" condition. Unfortunately, the law does not provide guidance as to what constitutes "good" condition.

Documentation of Property's FMV. In addition to the substantiation requirement, in certain cases the taxpayer must also properly document the property's FMV. The specific documentation requirements depend upon the amount of the claimed deduction for the contributed property. If a claimed deduction for a contribution of property exceeds $500, noncorporate taxpayers (and closely held C corporations and personal service corporations) must include with their tax return a description of the property and any other information the IRS requires, including the type, location, holding period, basis, and FMV of the property. This information is reported on Form 8283 (see Appendix B). If the claimed deduction exceeds $5,000, in addition to the above requirements, all taxpayers must obtain a qualified appraisal of the property and must include with their tax return any additional information that the IRS requires. Finally, if the claimed deduction exceeds $500,000, all taxpayers are additionally required to obtain a qualified appraisal and actually attach the appraisal to their tax return. Because these documentation requirements are based on the amount of a claimed contribution, the donation of similar items of property donated to all charities will be treated as the donation of one property. This requirement prevents taxpayers from avoiding these documentation requirements by spreading out their contributions. If a partnership or an S corporation donates property, these documentation requirements are applied at the entity level. However, if the documentation requirements are not met, the deduction is denied at the partner or shareholder level. In general, these documentation rules do not apply to contributions of cash, certain intangibles, inventory, or publicly traded securities.

Contribution of Used Motor Vehicles, Boats, and Airplanes. Special documentation rules apply to contributions of motor vehicles, boats, and airplanes if the claimed value of the property exceeds $500. However, these rules do not apply if the contributed vehicle, boat, or airplane is inventory in the hands of the donor. If these special rules apply, the substantiation rules for a donation of property exceeding $250 are no longer applicable. Instead, the charity must give the taxpayer and the IRS a contemporaneous written acknowledgment of the contribution. This acknowledgment must be included with the taxpayer's tax return. The information included in the acknowledgment and the date by which the charity must give the acknowledgment to the taxpayer depend upon whether or not the charity sells the vehicle without any significant use or any material improvement of the vehicle. In either case, the acknowledgment must include the name and taxpayer identification number of the taxpayer who donated the vehicle, as well as the vehicle identification number. If the vehicle is sold by the charity before any significant use or material improvement, the acknowledgment must also include (1) a certification that the vehicle was sold in an arm's length transaction to an unrelated party, (2) the gross proceeds from the sale, and (3) a statement that the deductible amount may not exceed the amount of the gross proceeds. This acknowledgment must be given to the taxpayer within 30 days of the contribution of the vehicle to the charity, and, as mentioned earlier, the amount of

[54] Sec. 170(f)(8) and Reg. Sec. 1.170A-13(f).

For charitable contributions of $250 or more, no deduction is allowed unless the contribution is substantiated by a contemporaneous, written acknowledgment (receipt) by the donee organization.This acknowledgment must contain the following information:

- The amount of cash and a description of any property contributed
- Whether or not the organization provided any goods or services in consideration for the cash or property received, including a description and good faith estimate of the value of any goods or services provided by the organization

The acknowledgment is contemporaneous if obtained by the earlier of the date the taxpayer files a return for the year in question or the extended due date for filing such a return. This substantiation requirement is waived if the donee organization files a return that contains the required information.[54] Additionally, no deduction is allowed for a contribution of clothing or household items unless the items are in "good" condition. Unfortunately, the law does not provide guidance as to what constitutes "good" condition.

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[54] Sec. 170(f)(8) and Reg. Sec. 1.170A-13(f).

the deduction for the vehicle is limited to the gross proceeds received from the sale. On the other hand, if the charity uses or improves the vehicle, the acknowledgment must also state: (1) the intended use or improvement and the intended duration of the use and (2) a certification that the vehicle will not be transferred or sold before completion of the intended use or improvement. This acknowledgment must be given to the taxpayer within 30 days of the donation of the vehicle.[55]

EXAMPLE I:8-39 ▶ During the current year, Peter Smith (SSN. 123-45-6789) reports AGI of $250,000. Smith also makes the following charitable contributions during the year:

- Smith performs voluntary dental work three days each month in rural areas of the state. Smith drives a total of 4,000 miles on these trips during the year.
- Smith makes the following contributions by cash or check: $750 to the city library, $2,000 to the United Way, $500 to a local community college, and $4,000 to his church.
- Smith contributes a tract of land to a small rural town. The town plans to erect a public library on the site. Smith purchased the land in 1997 for $5,000. Its appraised value at the time of the contribution is $8,000.

Smith's contributions are reported on the partially completed Schedule A shown in Figure I:8-1. The out-of-pocket expenses of $560 (4,000 miles× $0.14) and the contributions by cash or check of $7,250 (library, United Way, church, and community college) are totaled and reported on line 11. The property contribution of $8,000 is separately stated on line 12. Because Smith contributes property with a value exceeding $500, Form 8283, an appraisal summary, and signed statements by the qualified appraiser and an authorized official of the organization that received the property must be attached to the return. In addition, for the donations that separately exceed $250, Peter must obtain and retain written acknowledgments from the donee organizations in order for the contributions to be deductible. ◀

TAXES

Individuals generally report their deduction for property taxes on Schedule A of Form 1040. However, if the taxpayer incurs the taxes in his or her business, they are reported on Schedule C. Taxes incurred for the production of rents and royalties are reported on Schedule E. Taxes incurred in the taxpayer's farming business are reported on Schedule F. State and local income taxes imposed on individuals are always reported on Schedule A, even if the individual is self-employed.

Real estate brokers must report any real estate tax allocable to the purchaser of a residence. (See the discussion in this chapter regarding the allocation of real estate taxes between the seller and buyer of a residence.)[56] The broker reports this information on Form 1099-S (Proceeds from Real Estate Transactions).

WHAT WOULD YOU DO IN THIS SITUATION?

GIVING TO BOTH: GOODWILL AND THE IRS

Much has been written about abusive practices concerning the valuation of noncash property donated to qualified charities. Under Sec. 170, both corporations and individuals may deduct the FMV of property contributed to charitable organizations. Of course, a number of valuation and percentage limitations and carryover rules are applicable to both individual and corporate taxpayers.

Assume your clients, Mr. and Mrs. Nicholas Nice, come into your office on December 27 for some year-end tax planning. Your review of their tax situation indicates that they have made substantial donations of clothing and household goods to Goodwill Industries. They have obtained proper documentation for donations made during the year but do not know how to qualify for taking a charitable deduction vis-à-vis valuation, forms, and the like. They do know that their original cost basis in the donated goods was $15,000 and that the goods were in good condition at the time of the donation. What tax and ethical issues should be considered?

[55] Sec. 170(f)(11) and (f)(12).

[56] Sec. 6045(e)(4) and Notice 93-4, 1993-1 C.B. 295.

SCHEDULE A (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Go to *www.irs.gov/ScheduleA* for instructions and the latest information.
▶ Attach to Form 1040.
Caution: If you are claiming a net qualified disaster loss on Form 4684, see the instructions for line 16.

OMB No. 1545-0074

2018

Attachment Sequence No. **07**

Name(s) shown on Form 1040: Peter Smith

Your social security number: 123-45-6789

Medical and Dental Expenses		**Caution:** Do not include expenses reimbursed or paid by others.			
	1	Medical and dental expenses (see instructions)	1		
	2	Enter amount from Form 1040, line 7	2		
	3	Multiply line 2 by 7.5% (0.075)	3		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4
Taxes You Paid	5	State and local taxes.			
	a	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 ▶ ☐	5a		
	b	State and local real estate taxes (see instructions)	5b		
	c	State and local personal property taxes	5c		
	d	Add lines 5a through 5c	5d		
	e	Enter the smaller of line 5d or $10,000 ($5,000 if married filing separately)	5e		
	6	Other taxes. List type and amount ▶	6		
	7	Add lines 5e and 6			7
Interest You Paid	8	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 ▶ ☐			
Caution: Your mortgage interest deduction may be limited (see instructions).	a	Home mortgage interest and points reported to you on Form 1098	8a		
	b	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 ▶	8b		
	c	Points not reported to you on Form 1098. See instructions for special rules	8c		
	d	Reserved	8d		
	e	Add lines 8a through 8c	8e		
	9	Investment interest. Attach Form 4952 if required. See instructions	9		
	10	Add lines 8e and 9			10
Gifts to Charity	11	Gifts by cash or check. If you made any gift of $250 or more, see instructions	11	7,810	
If you made a gift and got a benefit for it, see instructions.	12	Other than by cash or check. If any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500	12	8,000	
	13	Carryover from prior year	13		
	14	Add lines 11 through 13			14 15,810
Casualty and Theft Losses	15	Casualty 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			15
Other Itemized Deductions	16	Other—from list in instructions. List type and amount ▶			16
Total Itemized Deductions	17	Add the amounts in the far right column for lines 4 through 16. Also, enter this amount on Form 1040, line 8			17 15,810
	18	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ ☐			

For Paperwork Reduction Act Notice, see the Instructions for Form 1040. Cat. No. 17145C **Schedule A (Form 1040) 2018**

FIGURE I:8-1 ▶ PARTIALLY COMPLETED SCHEDULE A

EXAMPLE I:8-40 ▶ During the year, Andrea incurs $1,500 in property taxes on a two-family duplex. Andrea lives in one unit and rents out the other. She also pays $100 in registration fees and $600 in personal property taxes on her automobile, based on its value. Andrea uses the automobile 80% of the time in an unincorporated business. During the current year, she also pays $2,000 in state income taxes, all of which is attributable to her income of the prior year from the unincorporated business.

Because one-half of the real estate taxes are attributable to property used to produce rental income, $750 (0.50 × $1,500) is reported on Schedule E, and the remaining personal-use portion ($750) is reported on Schedule A. Because 80% of the use of the automobile is in Andrea's business, $80 (0.80 × $100) of the registration fee is deductible as a business expense on Schedule C. The remaining $20 is not deductible because the registration fee is not a tax. However, $480 (0.80 × $600) of the personal property tax on the automobile is deductible as a business expense on Schedule C. The remaining $120 is deductible as a tax on Schedule A. Finally, even though the state income tax is related to Andrea's business income, all $2,000 of the state income tax is reported on Schedule A. Because Andrea pays the state income tax in the current year, it is deductible in the current year. ◀

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:8-1 a. For which persons may a taxpayer deduct medical expenses?
b. In the case of children of divorced parents, must the parent who is entitled to the dependency exemption pay the medical expenses of the child to ensure that the expenses are deductible? Explain.
c. Who should pay the medical expenses of an individual who is the subject of a multiple support agreement?

I:8-2 What is the definition of medical care for purposes of the medical care deduction?

I:8-3 a. What is the definition of cosmetic surgery under the Internal Revenue Code?
b. Is the cost of cosmetic surgery deductible as a medical expense? Explain.

I:8-4 a. If a taxpayer must travel away from his or her home in order to obtain medical care, which en route costs, if any, are deductible as medical expenses?
b. Are there any limits imposed on the deductibility of these expenses?

I:8-5 What are the rules dealing with the deductibility of the cost of meals and lodging incurred while away from home in order to receive medical treatment as an outpatient?

I:8-6 a. Which types of capital expenditures incurred specifically for medical purposes are deductible?
b. What limitations, if any, are imposed on the deductibility of these expenditures?

I:8-7 Bill, a plant manager, is suffering from a serious ulcer. Bill's doctor recommends that he spend three weeks fishing and hunting in the Colorado Rockies. Can Bill deduct the costs of the trip as a medical expense?

I:8-8 In what cases are medical insurance premiums paid by an individual not deductible as qualified medical expenses?

I:8-9 What is the limit placed on medical expense deductions? When can a deduction be taken for medical care? What if the medical care is prepaid?

I:8-10 a. Which taxes are specifically deductible for federal income tax purposes under Sec. 164?
b. If a tax is not specifically listed in Sec. 164, under what circumstances may it still be deductible?

I:8-11 If Susan overpays her state income tax because of excess withholdings, can she deduct the entire amount in the year withheld? When Susan receives a refund from the state how must she treat that refund for tax purposes?

I:8-12 What is an ad valorem tax? If a tax that is levied on personal property is not an ad valorem tax, under what circumstances may it still be deductible?

I:8-13 When real estate is sold during a year, why is it necessary that the real estate taxes on the property be apportioned between the buyer and seller?

I:8-14 a. Identify the different categories of interest expense an individual may incur. How is the classification of the interest determined?
b. Are these different categories of interest deductible? If so, how?

I:8-15 At times, the term *points* is used to refer to different types of charges. Define the term and describe when points are deductible.

I:8-16 In which year or years are points (representing prepaid interest on a loan) deductible?

I:8-17 Why does Sec. 267 impose a restriction on the deductibility of expenses accrued and payable

by an accrual method taxpayer to a related cash method taxpayer?

I:8-18 a. What is the amount of the annual limitation placed on the deductibility of investment interest expense?
b. Explain how net investment income is calculated.
c. Is any disallowed interest expense for the year allowable as a deduction in another year? If so, when?

I:8-19 Explain what acquisition indebtedness and home equity indebtedness are with respect to a qualified residence of a taxpayer. Identify any limitations on the deductibility of interest expense on this indebtedness.

I:8-20 Explain what a qualified residence is for purposes of qualified residence interest.

I:8-21 Why is interest expense disallowed if it is incurred to purchase or hold tax-exempt obligations?

I:8-22 When is interest generally deductible for cash-method taxpayers? Explain if the general rule applies to prepaid interest, interest paid with loan proceeds, discounted notes, and personal interest. If the general rule does not apply, explain when these interest expenses are deductible.

I:8-23 a. For purposes of the charitable contribution deduction, what is capital gain property? Ordinary income property?
b. What is the significance of classifying property as either capital gain property or ordinary income property?

I:8-24 How is the *amount* of a charitable contribution of capital gain property determined if it is donated to a private nonoperating foundation? How does this determination differ if capital gain property is donated to a public charity?

I:8-25 May an individual who is married and files a joint return deduct any charitable contributions if the itemized deductions total $7,000 (of which $3,000 are qualified charitable contributions)?

I:8-26 For individuals, what is the overall deduction limitation on charitable contributions? What is the limitation for corporations?

I:8-27 If a taxpayer's charitable contributions for any tax year exceed the deduction limitations, may the excess contributions be deducted in another year? If so, in which years may they be deducted?

I:8-28 How are charitable contribution deductions reported on the tax return for individuals? What reporting requirements must be met for the contribution of property?

I:8-29 What is the purpose of the qualified business income deduction? Does it achieve its goal?

ISSUE IDENTIFICATION QUESTIONS

I:8-30 Wayne and Maria file a joint tax return on which they itemize their deductions and report AGI of $50,000. During the year they incurred $1,500 of medical expenses when Maria broke her leg. Furthermore, their dentist informed them that their daughter, Alicia, needs $3,000 of orthodontic work to correct her overbite. Wayne also needs a new pair of eyeglasses that will cost $300. What tax issues should Wayne and Maria consider?

I:8-31 This year, Chuck took out a loan to purchase some raw land for investment. He paid $40,000 for the land, and he expects that within 5 years the land will be worth at least $75,000. Chuck is married, and his AGI for the year is $230,000. Chuck paid $4,300 in interest on the loan this year. Chuck has $2,600 in interest income and $1,300 in dividend income for the year. He plans to itemize his deductions so he can use the interest expense to offset his investment income. What tax issues should Chuck consider?

I:8-32 During the current year, George made contributions totaling $40,000 to an organization called the National Endowment for the Preservation of Liberty (NEPL). Later during the year, the NEPL started giving money to a political candidate to help with his campaign expenses. What tax issues should George consider?

I:8-33 During the current year, Bob has AGI of $100,000. He also donated some stock to his church. He purchased the stock two years ago for $55,000. The FMV of the stock at the time of the contribution is $60,000. Bob has $5,000 of unused excess contributions from a prior year. What tax issues should Bob consider?

PROBLEMS

I:8-34 ***Medical Expense Deduction.*** During 2019, Angela sustains serious injuries from a snow-skiing accident. She incurs the following expenses:

Item	*Amount*
Doctor bills	$11,700
Hospital bills	9,400
Legal fees in suit against ski resort	3,000

Angela is single and has no dependents. For the year, her salary is $58,000. She pays $600 in medical and dental insurance premiums, which is withheld from her paycheck on an after-tax basis, $6,750 in mortgage interest on her home, and $1,200 in interest on her car loan. Her health insurance provider reimburses her for $10,000 of the medical expenses. What is her 2019 taxable income?

I:8-35 ***Reimbursement of Previously Deducted Medical Expenses.*** Assume the same facts as in Problem I:8-34. In addition, assume that in 2020, Angela receives an additional $7,000 in a settlement of a lawsuit arising because of the snow-skiing accident. $4,000 of the settlement is to pay Angela's medical bills, and $3,000 is to reimburse her legal expenses. What is the proper tax treatment of this $7,000 settlement?

I:8-36 ***Medical Expense Deduction.*** Dan lives in Duncan, a small town in Arizona. Because of a rare blood disease, Dan is required to take special medical treatments once a month. The closest place these treatments are available to Dan is in Phoenix, 200 miles away. The treatments are provided on an outpatient basis but require him to stay overnight in Phoenix. During the year, Dan makes 12 trips to Phoenix by automobile to receive the treatments. The motel he always stays in charges $85 per night. For the year, Dan also spends a total of $250 for meals on these trips. $100 of this $250 is spent while en route to Phoenix. What is the amount of Dan's qualified medical expenses for 2018?

I:8-37 ***Medical Expense Deduction.*** Chad is divorced and has custody of Brett, his 14-year-old son. Chad's ex-wife has custody of their daughter, Sara. During the year, Chad incurs $3,000 for orthodontic work for Sara to correct a severe overbite and $2,000 in unreimbursed medical expenses associated with Brett's broken leg. Chad also pays $900 in health insurance premiums, which is withheld from his paycheck on a pre-tax basis. Both Brett and Sara are covered under Chad's medical insurance plan. In addition, Chad incurs $400 for prescription drugs and $1,000 in doctor bills for himself. Chad's AGI is $40,000. What is Chad's medical expense deduction for the year assuming that his other itemized deductions exceed the standard deduction?

I:8-38 ***Medical Expense Deduction.*** In 2019, Charla, a single taxpayer with no dependents, was severely hurt in a farm accident. Charla is 38 years old. The accident left Charla's legs 85% paralyzed. After incurring $14,000 of medical expenses at the hospital, the doctor recommended that Charla install a pool at her home for therapy. The pool cost $25,000 to install and increased the value of her home by $22,000. She spent $930 maintaining the pool in 2019 and $1,060 in 2020. Charla also purchased a wheelchair on December 28, 2019, for $2,300, which she charged to her credit card. She paid her credit card bill on January 6, 2020. She also purchased a hospital bed for $3,800 but did not pay for the bed until 2020. Charla paid her physical therapist $4,000 for services performed in 2020. Charla paid $1,200 in medical insurance premiums on an after-tax basis in both 2019 and 2020. In 2020, the insurance company reimbursed Charla $9,000 for her hospital stay in 2019. Her AGI for 2019 and 2020 is $38,000 and $43,000, respectively, not considering any of the above items. Charla has no other itemized deductions in either year.

a. What is Charla's taxable income for 2019?

b. What is Charla's medical expense deduction for 2020? How does she treat the reimbursement?

I:8-39 ***Deduction of Taxes.*** Joyce is a single, cash-method taxpayer. On April 11, 2018, Joyce paid $120 in state income taxes with her 2017 state income tax return. During 2018, Joyce had $1,600 in state income taxes withheld. On April 13, 2019, Joyce paid $200 with her 2018 state tax return. During 2019, she had $2,100 in state income taxes withheld from her paycheck. Upon filing her 2019 tax return on April 15, 2020, she received a refund of $450 for excess state income taxes withheld. Joyce had total AGI in 2019 and 2020 of $51,000 and $53,500, respectively. In 2019, Joyce also paid $10,500 in qualified residence interest.

a. What is the amount of state income taxes Joyce may include as an itemized deduction for 2018?

b. What is Joyce's allowed itemized deduction for state income taxes for 2019?

c. What is Joyce's taxable income for 2019?

I:8-40 ***Deduction of Taxes.*** Dawn, a single, cash-method taxpayer, paid the following taxes in the current year: Dawn's employer withheld $5,400 for federal income taxes, $2,000 for state income taxes, and $3,800 for FICA from her paychecks. Dawn purchased a new car and paid $600 in sales tax and $70 for the license. The car's FMV was $20,000 and it weighed 3,000 pounds. The county also assessed a property tax on the car. The tax was 2% of the

car's value and $10 per hundredweight. Dawn uses the car 100% of the time for personal purposes. Dawn sold her house on April 15 of the current year. The county's property tax on the home for the year is $1,850, payable on February 1 of the current year. The county's real property tax year is the calendar year. Dawn's AGI for the year is $50,000 and her other itemized deductions exclusive of taxes are $8,000 (disregard any leap year).

a. What is Dawn's deduction for taxes in the current year?

b. Where should Dawn report her deduction for the taxes on her tax return?

I:8-41 ***Apportionment of Real Estate Taxes.*** On May 1 of the current year, Tara sells a building to Janet for $500,000. Tara's basis in the building is $300,000. The county in which the building is located has a real property tax year that ends on June 30. The taxes are payable by September 1 of that year. On September 1, Janet pays the annual property taxes of $6,000. Both Tara and Janet are calendar-year, cash method taxpayers. The closing agreement does not separately account for the property taxes. Disregard any leap year.

a. What amount of real property taxes may Janet deduct in the current year?

b. What amount of real property taxes may Tara deduct in the current year?

c. If no apportionment on the real property taxes is made in the sales agreement, what is Tara's total selling price of the building? Janet's basis for the building?

I:8-42 ***Classification of Interest Expense.*** On January 1 of the current year, Scott borrows $80,000, pledging the assets of his business as collateral. He immediately deposits the money in an interest-bearing checking account. Scott already had $20,000 in this account. On April 1, Scott invests $75,000 in a limited real estate partnership. On July 1, he buys a new ski boat for $12,000. On August 1, he makes a $10,000 capital contribution to his unincorporated business. Scott repays $50,000 of the loan on November 30 of the current year. Classify Scott's interest expense for the year.

I:8-43 ***Investment Income and Deductions.*** During the current year, Travis takes out a $40,000 loan, using stock he owns as collateral. He uses $10,000 to purchase a car, which he uses 100% for personal use. He uses the remaining funds to purchase stocks and bonds. He pays $3,200 interest on the loan. Travis also reports the following for the year:

AGI without any investment income	$130,000
State income taxes paid	8,400
Dividend income	10,000
Interest income	2,100
Qualified residence interest	7,800
Investment expenses (exclusive of interest)	8,000
Net short-term capital gains	7,300
Net long-term capital gain	8,600

Travis is single. What is his net taxable income?

I:8-44 ***Qualified Residence Interest.*** During the current year, Tina purchases a beachfront condominium for $600,000, paying $150,000 down and taking out a $450,000 mortgage, secured by the property. At the time of the purchase, the outstanding mortgage on her principal residence is $700,000. This debt is secured by the residence. The FMV of the principal residence is $1,400,000. She purchased the principal residence in 1997. What is the amount of qualified indebtedness on which Tina may deduct the interest payments?

I:8-45 ***Interest Between Related Parties.*** Crown Corporation is an accrual method taxpayer owned 55% by Brett and 45% by Susie. Brett and Susie are good friends and have been business associates for several years. BJ Partnership is a cash method taxpayer, owned 40% by Brett and 60% by Jeremy, Brett's uncle. Both Crown Corporation and BJ Partnership are calendar year entities. On January 5 of the current year, Crown borrows $50,000 from BJ Partnership and pays 8% interest on the loan. Crown must pay the interest on January first of next year.

a. What amount of interest expense can Crown Corporation deduct in the current year?

b. How would your answer change if Jeremy were Brett's brother, instead of his uncle?

I:8-46 ***Timing of Interest Deduction.*** On April 1 of the current year, Henry borrows $12,000 from the bank for a year. Because the note is discounted for the interest charge and Henry receives proceeds of $10,200, he is required to repay the face amount of the loan ($12,000) in four equal quarterly payments beginning on July 1 of the current year. Henry is a cash method individual.

a. What is the amount of Henry's interest expense deduction in the current year with respect to this loan?

b. Assume the same facts except that the initial starting date when the repayments begin is April 1 of the following year. What is the amount of Henry's interest expense deduction in the current year?

c. Assume the same facts as in Part b, except that Henry is an accrual method taxpayer and the loan will be outstanding for one year. What is the amount of his interest expense deduction in the current year?

I:8-47 ***Itemized Deductions.*** During 2019, Doug incurs the following deductible expenses: $2,300 in state income taxes, $3,000 in local property taxes, $800 in medical expenses, and $2,000 in charitable contributions. Doug is 33, single, has no dependents, and has $35,000 AGI for the year. What is the amount of Doug's taxable income?

I:8-48 ***Computation of Taxable Income.*** During 2019, James, a single, cash method taxpayer incurred the following expenditures:

Qualified medical expenses	$ 8,000
Investment interest expense	16,000
Other investment activity expenses	15,000
Qualified residence interest	12,000
Interest on loan on personal auto	2,000
Charitable contributions	3,000
State income tax paid	7,000
State sales tax paid	4,500
Property taxes	4,000
Tax return preparation and consulting fees	5,000

James' income consisted of the following items:

Salary	$70,000
Interest income	7,000
Long-term capital gains	23,000
Long-term capital losses	(15,000)

a. Compute James' taxable income for the year (assuming that he makes an election to have the net capital gain taxed at the regular tax rates).

b. What is James' investment interest carryover (if any)?

I:8-49 ***Computation of Taxable Income.*** Assume all the same facts as in Problem I:8-48 except that James' salary income is $130,000 instead of $70,000 and that he does not make the election. Compute James' taxable income for the year.

I:8-50 ***Charitable Contributions: Services.*** Donna is an attorney who renders volunteer legal services to a Legal Aid Society, which provides legal advice to low-income individuals. The Legal Aid Society is a qualified charitable organization. During the current year she spends a total of 200 hours in this volunteer work. Her regular billing rate is $350 per hour. In addition, she spends a total of $800 in out-of-pocket costs in providing these services. She receives no compensation and is not reimbursed for her out-of-pocket costs. What is Donna's charitable contribution for the year because of these activities?

I:8-51 ***Charitable Contribution Limitations.*** In each of the following independent cases, determine the amount of the charitable contribution and the limitation that would apply. In each case, assume that the donee is a qualified public charity.

a. Sharon donates a tract of land to a charitable organization. She has held the land for seven years. Her basis in the land is $10,000 and its FMV is $40,000.

b. Assume the same facts in Part a, except that Sharon has held the land for only 11 months and that its FMV is $23,000.

c. Jack purchases a historical document for $50,000. He donates the historical document to a charitable organization two years later. The organization plans to use it for research and study. Its FMV at the time of the donation is $100,000.

d. Assume the same facts in Part c, except that the organization plans to sell the document and put the money into an endowment fund.

e. Valerie donates some inventory to a charitable organization. The inventory is not food or clothing. The inventory is purchased for $500 and its FMV is $1,200 at the time of the donation. She held the inventory for seven months.

I:8-52 ***Charitable Contributions to Private Nonoperating Foundations.*** Assume the same facts as Problem I:8-51, except that the qualified organization is a private nonoperating foundation. Determine the amount of the charitable contribution for Parts a through e.

I:8-53 ***Charitable Contribution Limitations.*** During the current year, Helen donates stock worth $50,000 to her local community college. Two years ago the stock cost Helen $40,000. Her AGI for the current year is $100,000. Beginning next year, the bulk of her income will be from tax-exempt municipal securities. Thus, she is not interested in any carryover of excess charitable contribution. What is the maximum charitable contribution deduction Helen may take this year?

I:8-54 ***Charitable Contribution Limitations.*** During the current year, Melissa reports AGI of $200,000. As part of some estate planning, she donates $30,000 to her alma mater, Middle State University, and $65,000 to a private nonoperating foundation.

a. What is the amount of Melissa's charitable deduction for the current year?

b. Assume the same facts in Part a except that she donates $45,000 to Middle State University.

I:8-55 ***Corporate Charitable Contributions.*** Circle Corporation, an accrual method taxpayer, manufactures and sells mainframe computers. In January of the current year, Circle Corporation donates a mainframe that was part of its inventory to City College. City College will use the computer for physical science research. Circle's basis in the mainframe is $300,000. The computer's FMV is $650,000. On December 15 of the current year, Circle also pledged stock to the Red Cross and promised delivery of the stock by March 1 of the following year. The stock's FMV is $100,000 and Circle's adjusted basis in the stock is $50,000. Circle has held the stock for over one year. Circle's taxable income (before deducting any charitable contributions) for the current year is $4,000,000.

a. What is the amount of Circle's charitable contribution for the current year?

b. How much of the contribution can Circle deduct in the current year and how much may be carried over, if any?

I:8-56 ***Charitable Contribution Carryovers.*** Bonnie's charitable contributions and AGI for the four-year period are as follows:

	2019	*2020*	*2021*	*2022*
AGI	$50,000	$60,000	$58,000	$60,000
Contributions subject to the 60% limitation	40,000	39,000	25,000	10,000

What is the amount of the charitable deduction for each year and the order in which the deduction and carryovers are used?

I:8-57 ***Qualified Business Income Deduction.*** The LM Partnership has two equal partners, Liam and Martin. In the current year, the partnership earns $400,000 of ordinary income (all business) and recognizes a $15,000 long-term capital gain. Liam is married, files a joint return, and claims a standard deduction. Other than partnership items, Liam has only a $6,000 short-term capital loss at the individual level. What is Liam's taxable income?

I:8-58 ***Qualified Business Income Deduction.*** Cathy is a 50% partner in the CD partnership, which owns a small manufacturing business. In the current year, the business had qualified business income of $2.8 million. CD partnership paid W-2 wages of $900,000 and owns depreciable tangible property with an unadjusted basis of $1,600,000. What is Carrie's qualified business deduction (ignoring the ½ deduction for self-employment taxes)?

I:8-59 ***Qualified Business Income Deduction.*** During the current year, Marilyn earned $115,000 as an accounting consultant.

a. If she has no other income besides a $20,000 capital gain, how much can she claim as a QBI deduction (please ignore the 50% self-employment tax deduction)?

b. If she is married and files jointly with her husband, who makes $600,000 a year as an attorney, how much can she claim as a QBI deduction?

COMPREHENSIVE PROBLEM

I:8-60 Tim and Monica Nelson are married, file a joint return, and are your newest tax clients. They provide you with the following information relating to their 2019 tax return:

1. Tim works as a pediatrician for the county hospital. The W-2 form he received from the hospital shows wages of $150,000 and state income tax withheld of $8,500.

2. Monica spends much of her time volunteering, but also works as a substitute teacher for the local schools. During the year, she spent 900 hours volunteering. When she doesn't volunteer, she earns $8.00 per hour working as a substitute. The W-2 form she received from the school district shows total wages of $3,888 and state income tax withheld of $85.
3. On April 13, the couple paid $250 in state taxes with their 2018 state income tax return. The Nelson's state and local sales taxes in 2019 were $5,500.
4. On December 18, the Nelsons donated a small building to the Boy Scouts of America. They purchased the building three years ago for $80,000. A professional appraiser determined the fair market value of the home was $96,000 on December 12.
5. Tim and Monica both received corrective eye surgery, at a total cost of $3,000. They also paid $1,900 in health insurance premiums.
6. On June 1, the couple bought a car for $30,000, paying $18,000 down and borrowing $12,000. They paid $750 total interest on the loan in 2019.
7. On June 10, the Nelsons took out a home equity loan of $20,000 to expand their home. They paid a total of $850 interest with their monthly payments on the loan.
8. The Nelsons paid a total of $2,300 interest on their original home loan.
9. They sold stock in Cabinets, Inc. for $5,200, which they purchased for $7,900 in March of the current year. They also sold stock in The Outdoor Corporation for $12,500, which they purchased several years ago for $8,600.
10. Tim incurred the following expenses related to his profession, none of which were reimbursed by his employer:

Item	*Amount*
Subscriptions to medical journals	$400
American Medical Association (AMA) annual membership fee	250

11. During the year, the couple paid their former tax advisor $700 to prepare their prior year tax return.
12. The Nelsons do not have children, and they do not provide significant financial support to any family members.

Required: Compute the Nelson's taxable income for 2019.

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:8-61 Dean makes a pledge of $30,000 to a local college. The college is willing to accept either cash or marketable securities in fulfillment of the pledge. Dean owns stock in Ajax Corporation worth $30,000. The stock was purchased five years ago for $10,000. Dean's marginal tax rate is 35% and he is subject to the long-term capital gains rate of 15%. Should Dean sell the stock and then donate the cash, or should he donate the stock directly? Compute the net tax benefit from each alternative and explain the difference. (Ignore the 3.8% tax on the net investment income of high-income taxpayers for this comparison.)

I:8-62 On December 1, 2019, Rebecca Ward, a single taxpayer, comes to you for tax advice. At the end of every year, she donates $5,000 to charity. She has no other itemized deductions. This year, she plans to make her charitable donation with stock. She presents you with the following information relating to her stock investments:

Corporation	*FMV on Dec. 1*	*Adjusted Basis*	*Date Purchased*
Sycamore	9,600	7,800	5/22/14
Oak	2,900	3,800	9/10/15
Redwood	5,400	4,900	6/15/19

Which stock should Rebecca donate to charity? What other tax advice would you give her?

TAX FORM/RETURN PREPARATION PROBLEMS

I:8-63 Following is a list of information for Peter and Amy Jones for the current tax year. Peter and Amy are married and have three children, Aubrynne, Bryson, and Caden. They live at 100 Main Street, Anytown, USA 00000. Peter is a lawyer working for a Native American

law firm. Amy works part-time in a genetic research lab. The Jones' Social Security numbers and ages are as follows:

Name	*S.S. No.*	*Age*
Peter	111-11-1111	32
Amy	222-22-2222	28
Aubrynne	333-33-3333	5
Bryson	444-44-4444	3
Caden	555-55-5555	1

Receipts

Peter's salary	$70,000
Amy's salary	32,000
Interest income on municipal bonds	2,400
Interest income on certificate of deposit (Universal Savings)	3,100
Dividends on GM stock	1,600

Disbursements

Eyeglasses and exam for Aubrynne	$ 600
Orthodontic work for Bryson to correct a congenital defect	2,500
Medical insurance premiums, after-tax basis	1,800
Withholding for state income taxes	7,200
Withholding for federal income taxes	16,000
State income taxes paid with last year's tax return (paid when the return was filed in the current year)	500
Property taxes on home	1,100
Property taxes on automobile	300
Interest on home	9,700
Interest on credit cards	200
Cash contribution to church	5,900

In addition to the above, on September 17, Peter and Amy donate some Beta Trader, Inc. stock to Lakeville Community College. Beta Trader, Inc. is publicly traded. The FMV of the stock on the date of the contribution is $700. Peter and Amy had purchased the stock on November 7, 2004 for $300.

Compute Peter and Amy's income tax liability for 2018 using Form 1040, Schedules A and B, and Form 8283, if necessary.

I:8-64 Kelly and Chanelle Chambers, ages 47 and 45, are married and live at 584 Thoreau Drive, Boston, MA 59483. Kelly's Social Security number is 111-11-1111 and Chanelle's is 222-22-2222. The Chambers have two children: Emma, age 23, and Chet, age 19. Their Social Security numbers are 333-33-3333 and 444-44-4444, respectively. Emma is a single college student and earned $8,000 during the summer. Kelly and Chanelle help Emma through school by paying for her room, board, and tuition. Emma lives at home during the summer. Chet has a physical handicap and lives at home. He attends a local university and earned $4,000 working for a marketing firm. In sum, Kelly and Chanelle provide more than 50% of both Emma's and Chet's total support for the year.

Kelly is a commercial pilot for a small airline. His salary is $95,000, from which $19,000 of federal income tax and $8,000 of state income tax were withheld. Kelly also pays premiums for health, disability, and life insurance. $2,000 of the premium was for health insurance, $250 for disability, and $400 for life insurance.

Chanelle owns Alliance Networks, a proprietorship that does network consulting. During the year, Chanelle's gross revenues were $23,000. She incurred the following expenses in her business:

Liability insurance	$ 700
Software rental	5,400
Journals and magazines	150
Training seminars	1,200
Supplies	1,300
Donations to a political campaign fund	800

Kelly enjoys playing guitar and plays in a band. Kelly's band has developed a local following. This year, his gross revenues were $1,200 for playing shows and $700 on CD sales. He incurred the following expenses:

Studio rent expense	$1,300
Sound system repairs	200
CD production	500
New guitar and amplifier	800

Kelly's father passed away during the year. Kelly and Chanelle received $100,000 from the life insurance policy. Neither Kelly nor Chanelle paid any of the premiums.

Chanelle purchased 100 shares of Thurston Co. stock on May 1, 1992, for $1,000. Thurston Co. was declared bankrupt during the current year.

Chet's physician recommended that he see a physical therapist to help with his disability. Kelly paid the therapist $7,000 during the year because his insurance would not cover the bills.

Kelly and Chanelle went to Las Vegas and won $5,000 at the blackjack table. The next night, they lost $6,000.

Kelly and Chanelle gave $900 to their church and, during the year, they had the following other income and expenses:

Real estate taxes	$1,400
Property taxes on car (determined by value)	500
Home mortgage interest	9,000
Credit card finance charges	2,600
Tax return preparation fees ($600 is allocable to Chanelle's business)	1,000
Sales tax on purchases during the year	6,200
Interest from a savings account	800
Interest from City of Boston Bonds	700
Dividend from 3M stock	400

Prepare Kelly and Chanelle's tax return Form 1040 and Schedules A, B, C, D, and SE for 2018.

CASE STUDY PROBLEMS

I:8-65 Brian Brown, an executive at a manufacturing enterprise, comes to you on December 1 of the current year for tax advice. He has agreed to donate a small tract of land to the Rosepark Community College. The value of the land has been appraised at $58,000. Mr. Brown purchased the land 14 months ago for $50,000. Mr. Brown's estimated AGI for the current year is $100,000. He plans to retire next year and anticipates that his AGI will fall to $35,000 for all subsequent years. He does not anticipate making any additional large charitable contributions. He understands that there are special rules dealing with charitable contributions and wants your advice in order to get the maximum overall tax benefit from his contribution. Because the college plans to use the property, selling the land is not an alternative. You are to prepare a letter to Mr. Brown explaining the tax consequences of the different alternatives. His address is 100 East Rosebrook, Mesa, Arizona 85203. For purposes of your analysis, assume that Mr. Brown is married and files a joint return. Also assume that Mr. Brown feels that an appropriate discount rate is 10%. In your analysis, use the tax rate schedules for the current year.

I:8-66 For several years, you have prepared the tax return for Alpha Corporation, a closely held corporation engaged in manufacturing garden tools. On February 20 of the current year, Bill Johnson, the president of Alpha Corporation, delivered to your office the files and information necessary for you to prepare Alpha's tax return for the immediately preceding tax year. Included in this information were the minutes of all meetings held by Alpha's Board of Directors during the year in question.

Then on February 27, Bill stops by your office and hands you an "addendum" to the minutes of the director's meeting held December 15 of the tax year for which you are preparing the tax return. The addendum is dated the same day as the director's meeting, and authorizes a charitable contribution pledge of $20,000 to the local community college. With a wink and a big smile, Bill explains that the addendum had been misplaced. In reviewing the original minutes, you find no mention of a charitable contribution pledge.

What should you do? [See Appendix E and the *Statements on Standards for Tax Services* section in Chapter I:15 (or C:1 of the *Comprehensive* volume) for a discussion of these issues.]

TAX RESEARCH PROBLEMS

I:8-67 Mark Hancock is a self-employed attorney who operates his law practice as an unincorporated sole proprietorship. In 2018, the IRS disallowed several business deductions he took in 2016 and 2017. In addition to paying the deficiency and assessed penalties, he also pays $18,000 in interest on the tax owed. Can he deduct that interest in the current year?

- Sec. 162, Sec. 163
- Reg. Sec. 1.163-9T
- *Kikalos v. Comm.*, 84 AFTR 2d 99-5933

I:8-68 Last year, Mr. Smith was involved in an automobile accident, severely injuring his legs. As part of a long-term rehabilitation process, his physician prescribes a daily routine of swimming. Because there is no readily available public facility nearby, Smith investigates the possibility of either building a pool in his own back yard or purchasing another home with a pool. In the current year he finds a new home with a pool and purchases it for $175,000. He then obtains some estimates and finds that it would cost approximately $20,000 to replace the pool in the home he has just purchased. He also obtains some real estate appraisals, which indicate that the existing pool increases the value of the home by only $8,000. During the current year, Smith also expends $500 in maintaining the pool and $1,800 in other medical expenses. What is the total amount of medical expenses he may claim in the current year? Smith's AGI for the year is $60,000.

- Sec. 213
- Reg. Sec. 1.213-1(e)(1)(iii)
- *Richard A. Polacsek,* 1981 PH T.C. Memo ¶81,569, 42 TCM 1289
- *Paul A. Lerew,* 1982 PH T.C. Memo ¶82,483, 44 TCM 918
- *Jacob H. Robbins,* 1982 PH T.C. Memo ¶82,565, 44 TCM 1254

CHAPTER

9

LOSSES AND BAD DEBTS



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Identify transactions that may result in losses
2. Determine the proper classification for losses
3. Examine the tax treatment of passive losses
4. Identify and calculate the deduction for a casualty or theft loss
5. Compute the deduction for a bad debt
6. Compute a net operating loss deduction
7. Compute the excess business loss limitation
8. Identify tax planning considerations for losses and bad debts
9. Identify compliance and procedural considerations for losses and bad debts

CHAPTER OUTLINE

Transactions That May Result in Losses...9-2
Classifying the Loss on the Taxpayer's Tax Return...9-4
Passive Losses...9-7
Casualty and Theft Losses...9-17
Bad Debts...9-24
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Tax Planning Considerations...9-33
Compliance and Procedural Considerations...9-34

Taxpayers often sustain losses on property they sell, exchange, or dispose of. If the taxpayer uses the property in a trade or business or holds the property for investment, the tax law generally provides a deduction for these losses. Noncorporate taxpayers may also take a limited deduction for losses on personal-use property that is either stolen or damaged in a casualty. However, in general, taxpayers may not deduct other types of losses on personal-use property (e.g., a loss they realize on the sale of a personal residence or an automobile that they use exclusively for personal purposes). Special rules allow taxpayers to take a deduction for losses they incur because of uncollectible business or nonbusiness debts. This chapter discusses the rules concerning the deductibility of these types of losses.

TRANSACTIONS THAT MAY RESULT IN LOSSES

OBJECTIVE 1

Identify transactions that may result in losses

For taxpayers to deduct a loss on property, the loss must be both *realized* and *recognized* for tax purposes. Generally, *realization* occurs in a completed (closed) transaction evidenced by an identifiable event such as a sale or exchange. This is referred to as the closed transaction doctrine. As a general rule, taxpayers who have realized losses on business or investment property may recognize such losses for tax purposes unless a specific provision holds otherwise (see pages I:9-6 and I:9-7).

EXAMPLE I:9-1 ▶ Capital Corporation purchased 500 shares of Data Corporation stock for $10,000 on February 22 of the current year. By October 31 of the same year, the price of the stock declines to $8,000. Even though Capital has suffered an economic loss on the stock, no realization event has occurred, and the corporation may not deduct the $2,000 loss. However, if Capital sells the stock for $8,000 on October 31, it realizes the loss for tax purposes in the current year. ◀

ADDITIONAL COMMENT

If property is used partly for business and partly for personal use, the loss attributable to the business portion is deductible but the loss on the personal-use portion is not unless the loss was sustained in a casualty from a federally declared disaster.

KEY POINT

Anticipated losses, including those for which reserves have been established, are not deductible.

Losses on property may arise in a variety of transactions, including:

- Sale or exchange of the property
- Expropriation, seizure, confiscation, or condemnation of the property by a government
- Abandonment of the property
- Worthlessness of stock or securities
- Planned demolition of the property in order to construct other property in its place
- Destruction of the property by fire, storm, or other casualty
- Theft
- Deductible business expenses exceeding business income, giving rise to a net operating loss (NOL)

SALE OR EXCHANGE OF PROPERTY

The amount of the loss a taxpayer incurs in a sale or exchange of property equals the excess of the property's adjusted basis over the amount realized for the property.[1] The amount realized for the property equals the sum of the money received plus the fair market value (FMV) of any other property the taxpayer receives in the transaction. If the property sold or exchanged is subject to a mortgage or other liability, the amount realized by the taxpayer also includes the amount of the liability transferred to the buyer.[2] The treatment of any selling costs depends on the type of property sold or exchanged. If the property is inventory (i.e., property normally held for sale in the taxpayer's business), the selling costs are generally deductible expenses in the year in which the taxpayer incurs the expenses. However, if the sale involves property not normally held for sale by the taxpayer, the selling costs reduce the amount realized from the sale or exchange.

[1] Sec. 1001.

[2] *Beulah B. Crane v. CIR*, 35 AFTR 776, 47-1 USTC ¶9217 (USSC, 1947); and Reg. Sec. 1.1001-2.

EXAMPLE I:9-2 ▶ Four years ago, Boyer Corporation purchased a plot of land as an investment for $50,000. Unfortunately, local economic conditions worsened after Boyer, Inc. purchased the land and the land's value declined to $35,000. Boyer sells the property in the current year. At the time of the sale, the land is subject to a $10,000 mortgage. The terms of the sale are $25,000 paid in cash with the purchaser assuming the mortgage. Boyer also incurs $2,000 in sales commissions. The amount realized is $33,000 ($25,000 cash + $10,000 mortgage assumed by the buyer − $2,000 commissions). The loss on the sale is $17,000 ($50,000 basis − $33,000 amount realized). ◀

In general, taxpayers can only deduct losses they incur in the sale or exchange of property used in a trade or business or held for investment. Taxpayers cannot deduct losses they incur in the sale or exchange of personal-use property. Furthermore, the type of deduction a taxpayer may take for a loss realized on the sale or exchange of business or investment property depends on the type of property sold. For example, if inventory is sold, the loss is an ordinary loss. If the asset is a capital asset, the loss is a capital loss (see Chapter I:5). If the sale is of property used in a trade or business (a Sec. 1231 asset), the type of loss depends on the total net gain or loss realized on all the taxpayer's Sec. 1231 transactions during the year (see Chapter I:13).

EXPROPRIATED, SEIZED, CONFISCATED, OR CONDEMNED PROPERTY

A taxpayer may own property that the government expropriates, seizes, confiscates, or condemns. In these cases, the taxpayer incurs a deductible loss if the taxpayer used the property in a trade or business or held it for investment. The Tax Court has held that the confiscation, seizure, condemnation, or expropriation of property does not constitute a theft or a casualty. Rather, it is treated as a sale or exchange. Thus, no deductible loss arises if the seized property is personal-use property.[3] If the seized or condemned property is business or investment property, the classification of the loss depends on the type of property. (See the section in this chapter titled Classifying the Loss on the Taxpayer's Return.) A taxpayer may take the deduction only in the year in which the property is actually seized. Whether formal expropriation or nationalization occurs in a later year is irrelevant.[4] A taxpayer realizes gain if he or she receives compensation for the property in excess of its basis. Under certain circumstances, the taxpayer may defer this gain. (See Chapter I:12 for a discussion of the nonrecognition of gain in an involuntary conversion.)

ABANDONED PROPERTY

If a taxpayer's property becomes worthless or is not worth repairing in order to return the property to a serviceable condition, the taxpayer may simply abandon the property. If the property still has basis, the taxpayer realizes a loss. The taxpayer may not deduct such losses if the property is personal-use property. However, the taxpayer may deduct losses on business or investment property. Furthermore, because the abandonment of property is not a sale or exchange, the loss is an ordinary loss. The amount of the loss is the property's adjusted basis on the date of abandonment. The taxpayer bears the burden of proof to verify that the property was actually abandoned. If the property is depreciable (e.g., machinery and buildings), the taxpayer must actually physically abandon it to take the full amount of the loss.[5]

WORTHLESS SECURITIES

A taxpayer may take a deduction for securities that become completely worthless during the tax year.[6] Because the deduction is only available in the year the security actually becomes worthless, both the taxpayer and the IRS may have problems determining the year in which the security becomes worthless. A mere decline in value is not sufficient to create a deductible loss if the stock has any recognizable value. Furthermore, the sale of the stock for a nominal amount such as $1 does not necessarily establish that the stock became

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[3] *William J. Powers*, 36 T.C. 1191 (1961). (See also *Gouhari v. U.S.*, 83 AFTR 2d 99-2726 (4th Cir., 1999).)

[4] Rev. Rul. 62-197, 1962-2 C.B. 66 as modified by Rev. Rul. 69-498, 1969-2 C.B. 31. (See also *Estate of Frank Fuchs v. CIR*, 24 AFTR 2d 69-5077, 69-2 USTC ¶9505 (2nd Cir., 1969).)

[5] Reg. Sec. 1.167(a)-8(a)(4).

[6] For this purpose, a *security* is defined in Sec. 165(g)(2) as stock in a corporation, the right to subscribe for or receive a share of stock in a corporation, or a bond, debenture, note, or certificate of indebtedness issued by a corporation or a government either in registered form or with interest coupons. Promissory notes issued by a corporation are generally not securities.

worthless in the year of the sale. The taxpayer must show that the security is completely worthless and that the security became worthless during the year.

Under Sec. 165, once the taxpayer determines the year of worthlessness, the taxpayer treats the loss as a loss from the sale of a capital asset on the last day of the tax year. Although this provision does not help in determining the year of worthlessness, it does establish a definite date for purposes of measuring whether the loss is short- or long-term. In some cases, this provision causes the loss to be long-term because it extends the date of worthlessness to the end of the year.

EXAMPLE I:9-3 ▶ On February 20 of the current year, Control Corporation enters into bankruptcy with no possibility for the shareholders to receive anything of value. Because the amount of Control Corporation's outstanding liabilities exceeds the FMV of its assets on that date, the stock of the corporation becomes worthless. Janet, a calendar-year taxpayer, owns 500 shares of Control's common stock, which she had purchased for $10,000 through her broker on June 17 of the prior year. Under Sec. 165(g), she treats the loss as having arisen from the sale of a capital asset on the last day of the current year. Thus, Janet incurs a $10,000 long-term capital loss because the holding period for the stock is more than one year. On the other hand, if Janet had received the stock directly from Control Corporation in exchange for either money or other property, and if certain other requirements are met, the stock may qualify as Sec. 1244 stock. Individuals who sustain losses on Sec. 1244 stock receive a limited amount of ordinary loss treatment rather than capital loss treatment. (See the discussion in this chapter under the heading "Losses on Sec. 1244 Stock.") ◀

Under certain circumstances, if a domestic corporation owns worthless securities of an affiliated corporation, the domestic corporation treats the loss as having arisen from the sale of a noncapital asset. This allows the corporation to treat the loss as an ordinary loss rather than as a capital loss.[7] For this exception to apply, the corporation must meet the following requirements:

- The domestic corporation that is deducting the loss must own at least 80% of the voting power of all classes of the affiliated corporation's stock and 80% of the total value of the affiliated corporation stock.
- More than 90% of the affiliated corporation's gross receipts for all its taxable years must be from nonpassive income.[8]

DEMOLITION OF PROPERTY

At times, taxpayers, intent on building their own facilities, purchase land with an existing structure that must first be removed. Taxpayers may also demolish a structure they currently use to construct new facilities. In both cases, taxpayers may not deduct any demolition costs or any loss sustained on account of the demolition. Instead, under Sec. 280B, taxpayers must add these amounts to the basis of the land on which the demolished structure previously stood.

CLASSIFYING THE LOSS ON THE TAXPAYER'S TAX RETURN

OBJECTIVE 2

Determine the proper classification for losses

If a loss is deductible, the taxpayer must determine whether the loss is an ordinary loss or a capital loss. In addition, individual taxpayers must also identify the deductible amount as either a deduction *for* or *from* AGI.

[7] As explained in Chapter I:5, the deductibility of capital losses is limited. For corporate taxpayers, capital losses must initially be offset against capital gains of the current year, and any excess loss is not deductible but may be carried back three years and forward for five years. Individuals may offset capital losses against capital gains and any excess loss is deductible up to $3,000 per year as an offset to ordinary income. Capital losses in excess of this amount for an individual are carried forward for an indefinite period. Thus, taxpayers generally prefer ordinary losses rather than capital losses.

[8] Sec. 165(g)(3). *Nonpassive income* includes all income other than royalties, rents, dividends, interest, annuities, and gains from the sale or exchange of stocks and securities.

ORDINARY VERSUS CAPITAL LOSS

Whether a deductible loss is ordinary or capital depends on the type of property involved and the transaction in which the taxpayer sustains the loss. To incur a capital loss, a sale or exchange of a capital asset must occur. If both elements (i.e., a sale or exchange and a capital asset) are not present, the deduction generally is an ordinary loss. In general, all assets *except* inventory, notes and accounts receivable, and depreciable property and land used in a trade or business (i.e., property, plant, and machinery) are classified as **capital assets.**[9]

Because a casualty is not a sale or exchange, the destruction of a capital asset in a casualty creates an ordinary rather than a capital loss. Likewise, a deductible loss realized on the abandonment of property is an ordinary loss because an abandonment is not a sale or exchange.

EXAMPLE I:9-4 ▶ On July 24 of the current year, Jermaine & Associates, LLP sells some investment property for $75,000. The property's adjusted basis is $85,000. The investment property is a capital asset. Jermaine realizes a $10,000 ($75,000 − $85,000) capital loss. If, instead, the property had been destroyed by fire and the partnership had received $75,000 in insurance proceeds, the $10,000 loss would have been an ordinary loss because a casualty is not a sale or exchange. ◀

BOOK-TAX DIFFERENCE

For book purposes, it makes no difference if a gain or loss is ordinary or capital. The full amount of the loss is deductible. However, because corporations may not deduct a capital loss in excess of its capital gains for the year, a book-tax timing (temporary) difference may arise, making an M-1 or M-3 adjustment necessary.

Certain transactions, though not actually constituting a sale or exchange, receive sale or exchange treatment. For example, as mentioned previously, if a security owned by an individual investor becomes worthless during the year, the individual treats the loss as a loss from the sale of a capital asset on the last day of the tax year, even though no sale actually occurs. Thus, the loss is a capital loss. Likewise, the taxpayer will treat a seizure or condemnation of property as a sale or exchange.

Section 1231 Property. Whether a loss on a particular transaction is treated as a capital loss may also depend on the gains and losses the taxpayer reports from other property transactions for the tax year. For instance, under Sec. 1231, taxpayers must net certain gains and losses together. If the Sec. 1231 gains exceed the Sec. 1231 losses for the year, the taxpayer treats the net gain as a long-term capital gain. However, if the losses equal or exceed the gains, both the gains and the losses are treated as ordinary. **Section 1231 property** includes real or depreciable property used in a trade or business and held for more than one year. (See Chapter I:13 for a discussion of the netting procedure under Sec. 1231.)

Losses on Sec. 1244 Stock. Taxpayers generally recognize capital gain or loss on the sale of stock or securities. For individuals, the tax law provides an exception for losses from the sale or worthlessness of small business corporation (Sec. 1244) stock. Individuals may deduct these losses as ordinary losses up to a maximum of $50,000 per tax year ($100,000 for married taxpayers filing a joint return). Any remaining loss for the year is a capital loss.

To qualify the loss as ordinary under Sec. 1244, the following requirements must be met:

- The stock must be owned by an individual or a partnership.
- The stock must have been originally issued by the corporation to the individual or to a partnership in which an individual is a partner.[10]
- The stock must be stock in a domestic (U.S.) corporation.
- The taxpayer must have received the stock in exchange for cash or property (other than stock or securities) that the taxpayer contributed to the corporation. Stock issued to the taxpayer for services rendered is not eligible for Sec. 1244 treatment.

[9] Sec. 1221. Certain other exceptions also exist. The definition of a capital asset is more fully examined in Chapter I:5.

[10] Stock received in certain reorganizations of corporations in exchange for Sec. 1244 stock is also considered Sec. 1244 stock. Section 1244 does not apply to stock that the individual has received through other means such as purchase in a secondary market, exchange, gift, or inheritance.

- The corporation must not have derived over 50% of its gross receipts from passive income sources during the five tax years immediately preceding the year of sale or worthlessness.[11]
- The amount of money and property contributed to both capital and paid-in surplus may not exceed $1 million at the time the corporation issues the stock.

Note that the last test listed above occurs when the corporation *actually issues the stock*. As long as the corporation's capital and paid-in surplus does not exceed $1 million at the time the stock was issued, the individual taxpayer may still report an ordinary loss on the stock even if the corporation has capital and paid-in surplus in excess of the $1 million limit at the time the loss is realized.



STOP & THINK

Question: Tony, a single taxpayer, incorporated Waffle, Inc. three years ago by contributing $70,000 in exchange for the stock. Waffle owns and operates a small restaurant. Unfortunately, Waffle's business never really became profitable. Tony has been trying to sell the Waffle stock since July of last year, but because the corporation had become insolvent, he couldn't find any buyers. In February of the current year, Waffle was judged to be bankrupt. Tony didn't receive anything for his stock. What issues should Tony's tax advisor address with regard to the Waffle, Inc. stock?

Solution: Tony's tax advisor must determine (1) the amount of any realized loss, (2) the year in which the loss is recognized, and (3) the character of the realized loss. The Waffle, Inc. stock is considered a security under Sec. 165. Whenever a security becomes completely worthless and it is determined that the owner will receive nothing for it, the owner realizes a loss to the extent of the security's basis ($70,000). The loss is deemed to be realized in the year in which the security becomes worthless. While the bankruptcy court ruled the stock to be worthless in February of the current year, the fact that Tony could not find any buyers last year because the corporation was insolvent may indicate that the stock really became worthless last year. This determination is important because Tony must recognize the loss in the year in which the stock becomes worthless. Furthermore, the stock is deemed to become worthless on the last day of that year. Since Tony received the stock directly from the corporation in exchange for contributed cash, Waffle, Inc.'s gross receipts are from business operations, and the capitalization at the time the stock was issued is less than $1 million, the stock qualifies as Sec. 1244 stock. Thus, $50,000 of the loss is characterized as ordinary loss. The remaining $20,000 is a long-term capital loss.

DISALLOWANCE POSSIBILITIES

The tax law may disallow or defer losses incurred in certain transactions and activities. Some of these transactions include:

- Transfers of property to a controlled corporation in exchange for stock of the corporation (see the discussion in Chapter C:2 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* text and Chapter C:2 of the *Comprehensive* volume)
- Exchanges of property for other property considered to be like-kind to the property given up (see the discussion in Chapter I:12)
- Property sold to certain related parties (see the discussion in Chapter I:6)
- Wash sale transactions (see the discussion in Chapter I:6)
- Losses limited because the losses exceed the amount for which the taxpayer is at risk (see the discussion in Chapter C:9 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* text and Chapter C:9 of the *Comprehensive* volume)

In addition, the passive loss rules discussed below may limit the amount of losses that individuals and certain corporations may deduct.

Topic Review I:9-1 contains a summary of loss transactions.

[11] For this purpose, passive income sources include royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks and securities. If the corporation has not been in existence for a full five years, the gross receipts test is applied to the shorter period. If the corporation has not been in existence for an entire taxable year, the test is applied to the time period up to the date of the loss (see Sec. 1244(c)(2)).

TOPIC REVIEW I:9-1

Transactions That May Result in Losses

Type of Transaction	Result
Sale or exchange	Taxpayers may not deduct a loss on personal-use property. The tax treatment of a loss on business or investment property depends on the type of property. Losses on capital assets result in capital losses. Losses on Sec. 1231 assets are subject to the Sec. 1231 netting rules discussed in Chapter I:13.
Seizure, expropriation, confiscation, or condemnation	Treated as a sale or exchange.
Abandonment	Not treated as a sale or exchange. No deduction is allowed for a loss on personal-use property. Business or investment property is given ordinary loss treatment.
Worthless securities	Treated as a loss from the sale of the securities on the last day of the year in which the securities become worthless. This generally results in a capital loss. However, if the requirements of Sec. 1244 are met, an individual taxpayer may treat at least part of the loss as an ordinary loss. (See Sec. 1244 stock below.) A loss realized by a corporation on worthless securities of an affiliated corporation results in an ordinary loss.
Demolition	No deductible loss is allowed. Instead, losses and costs of demolition are added to the basis of the land where the demolished structure was located.
Sec. 1244 stock	Individual taxpayers may take an ordinary loss of up to $50,000 per year ($100,000 for married filing jointly) for losses realized on qualified Sec. 1244 stock. The remaining loss is capital. The stock must have been originally issued to the individual for property or cash, and the corporation must meet the requirements to be a small business corporation.

Passive Losses

OBJECTIVE 3

Examine the tax treatment of passive losses

Before 1987, taxpayers were able to reduce their income tax liability on their salary or on income from business or investment activities with deductions, losses, and credits arising in other activities. Thus, taxpayers often invested in activities, called **tax shelters**, that would spin off tax deductions and credits. Many of these tax shelters were simply *passive investments* because they did not require the taxpayer's involvement or participation. In some situations, tax shelters had real economic substance, i.e., a taxpayer's economic return in this type of shelter was not based solely on the tax benefits that the activity generated. In many cases, however, tax shelters had no real economic substance other than the creation of deductions and credits that enabled taxpayers to reduce, and sometimes eliminate, the income tax liability from their other business activities. To prevent these perceived and real abuses, Congress enacted Sec. 469, which restricts taxpayers from currently using losses and credits that arise in rental activities and in other activities in which the taxpayer does not materially participate. These activities constitute passive activities. (See the "Definition of a Passive Activity" section in this chapter for an extended discussion of what constitutes a passive activity.)

HISTORICAL NOTE

Before the passive activity loss limits became effective in 1987, most tax shelters were concentrated in the areas of real estate, oil and gas, equipment leasing, farming, motion pictures, timber, and research and development. Many tax shelters took advantage of liberal depreciation rules during the early 1980s such as the rapid depreciation of real estate over a 15-year period.

COMPUTATION OF PASSIVE LOSSES AND CREDITS

In enacting the passive loss rules of Sec. 469, Congress did not want to prevent taxpayers from currently deducting or using losses and credits that the taxpayer incurs in an active business. At the same time, Congress realized that certain investments (such as investments that generate interest or dividend income) normally give rise to taxable income, which could itself be sheltered by losses and credits that arise in other passive activities. Thus, Sec. 469 requires certain taxpayers to classify their income into three categories: **active income** (such as wages, salaries, and active business income), *portfolio (or investment) income*, and *passive income*. **Portfolio income** includes dividends, interest, annuities, and royalties (and allocable expenses and interest expense) not derived in the ordinary

ADDITIONAL COMMENT

Even though portfolio income and passive income from passive activities are calculated separately for purposes of the regular income tax, in general they are added together in calculating net investment income, which is subject to the 3.8% Net Investment Income Tax imposed as part of the Affordable Care Act.

course of a trade or business. Portfolio income also includes gains and losses on property that produces these types of income if the disposition of the property does not occur in the ordinary course of business.[12] Portfolio income becomes part of net investment income, which is used in computing the deduction limit for investment interest expense. (See Chapter I:8 for a discussion of the investment interest expense limitation.)

Passive Income and Losses. Taxpayers compute income and loss in the passive category separately for each passive activity in which they have invested. In general, for any tax year, a taxpayer may use losses generated in one passive activity to offset income from other passive activities, but may not use them to offset either active or portfolio income.

EXAMPLE I:9-5 ▶ During the year, Kasi, a CPA, reports $100,000 of active business income from his CPA practice. He also owns two passive activities. From activity A, he earns $10,000 of income, and from activity B, he incurs a $15,000 loss. Kasi may use $10,000 of the loss from activity B to offset the $10,000 of income from activity A. However, Kasi may not deduct the $5,000 excess loss from activity B in the current year, even though he has $100,000 of active business income. ◀

CARRYOVERS

KEY POINT

Excess passive activity losses are not "lost" because they can be carried over to future years.

A taxpayer carries over disallowed passive activity losses indefinitely and treats them as losses allocable to that specific passive activity in the following tax years. The taxpayer may use these losses, known as **suspended losses**, to offset passive activity income of the subsequent year, but generally may not offset other types of income. If a taxpayer has invested in several passive activities, and for the year some of the activities generate income while others generate losses, the loss carried over for each loss activity is a pro rata portion of the total passive loss for the year.

EXAMPLE I:9-6 ▶ Tammy reports the following income and loss for the year:

Salary	$200,000
Loss from activity X	(40,000)
Loss from activity Y	(10,000)
Income from activity Z	30,000

X, Y, and Z are all passive activities. The losses generated in activities X and Y offset the income from activity Z, but none of the salary income is offset. Thus, Tammy has a net passive loss for the year of $20,000 ($40,000 + $10,000 – $30,000), which must be carried over to subsequent years. The amount of the carryover attributable to each activity is as follows:

Activity X: $\$20{,}000 \times \frac{\$40{,}000}{\$50{,}000} = \$16{,}000$

Activity Y: $\$20{,}000 \times \frac{\$10{,}000}{\$50{,}000} = \$\ 4{,}000$ ◀

Taxable Disposition of Interest in a Passive Activity. When a taxpayer disposes of a passive activity in a taxable transaction, the taxpayer can compute the economic gain or loss generated by the activity and can deduct the suspended losses of the activity against other income after applying the limitation based on excess business losses for noncorporate taxpayers of $250,000 ($500,000 for married filing joint).[13] However, the amount of the total net economic loss from the asset disposed of must first offset any passive income for the year from other passive activities.[14]

EXAMPLE I:9-7 ▶ During the current year, Pam realizes $6,000 of taxable income from activity A, $1,000 of loss from activity B, and $8,000 of taxable income from activity C. All three activities are passive activities with regard to Pam. In addition, $30,000 of passive losses from activity C are carried over from prior years. During the current year, Pam sells activity C for a $15,000 taxable gain. Pam reports salary income of $90,000 for the year. Because Pam sells activity C in a fully taxable transaction, Pam may deduct $2,000 of loss against the salary income:

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[12] Sec. 469(e)(1). Gain or loss on property dispositions occurring in the ordinary course of business is either passive or active business income, depending on the taxpayer's level of involvement (i.e., material participation) in the activity.

[13] Sec. 461(l). The loss limitation applies to taxable year ends beginning after December 31, 2017. This limitation is discussed in more detail later in this chapter.

[14] Sec. 469(g). Income from the activity for prior years may also be taken into account in arriving at the net income from all passive activities for the year if it is necessary to prevent avoidance of the passive loss rules.

Income for the year from C	$ 8,000	
Gain from the sale of C	15,000	
Suspended losses from C	(30,000)	
Total loss from C		($7,000)
Income for the year from A	$ 6,000	
Loss for the year from B	(1,000)	5,000
Pam's deduction against salary income		($2,000)

◀

BOOK-TAX DIFFERENCE

Since passive losses are not limited under financial accounting rules, the limitation and carryover of passive losses for tax purposes will create a timing (temporary) difference between book and tax. However, many taxpayers subject to the passive loss rules are individuals who do not use financial accounting rules.

If the taxpayer sells the passive activity to a related party, he or she may not deduct the suspended loss until the related party sells the activity to a nonrelated person. The definition of *related persons* includes spouse, brothers and sisters, ancestors, lineal descendants, and corporations or partnerships in which the individual has a greater than 50% ownership.[15]

Although the death of a taxpayer is not a taxable disposition of the asset, some of the suspended losses may be deductible when a taxpayer dies. The amount of the deduction allowed is the amount by which the suspended losses exceed the increase in basis of the property. The decedent's final income tax return generally includes the deduction for these losses. Any suspended losses up to the amount of the increase in basis will never be deductible.[16]

EXAMPLE I:9-8 ▶ At the time that John died, he owned passive activity property with an adjusted basis of $20,000 and FMV of $35,000. Suspended losses attributable to the property totaled $25,000. Because the increase in the basis of the property is $15,000 ($35,000 – $20,000), $15,000 of the suspended losses are lost. However, $10,000 ($25,000 suspended losses – $15,000 increase in basis) of the suspended losses are deductible on John's final income tax return. ◀

In general, the suspended losses of a passive activity become deductible only when the taxpayer completely disposes of his or her interest in the activity. However, in Treasury Reg. 1.469-4(g) the government has stated that taxpayers may treat the disposition of a substantial part of an activity as the disposition of a separate activity. This treatment is only available, however, if the taxpayer can establish with reasonable certainty the amount of income, deductions, credits, and suspended losses and credits that are allocable to that part of the activity.

Carryovers from a Former Passive Activity. The determination of whether an activity is passive with respect to a taxpayer must be made annually. Thus, an activity that was previously passive may not be passive with respect to the taxpayer for the current year. This is called a **former passive activity**. A taxpayer may deduct any loss carryover from a former passive activity against the current year's income of that activity even though the activity is not a passive activity in the current year. However, any suspended loss in excess of the activity's income for the year is still subject to the carryover limitations. Because the activity is no longer passive for the year, the current year's loss is deductible against active business income.

EXAMPLE I:9-9 ▶ Kris owns activity A, which, for the immediately preceding tax year, was considered a passive activity with regard to Kris. $10,000 in losses from activity A were disallowed and carried over to the current year. Because of Kris' increased involvement in activity A in the current year, it is not considered passive with regard to Kris for the current year. During the current year, activity A generates a $5,000 loss. During the current year, Kris also has an investment in activity B, a passive activity. Her share of activity B's income is $7,000. Kris reports $60,000 in salary. Because for the current year activity A is not a passive activity, the $5,000 current year loss is fully deductible against her salary. However, the $10,000 loss carryover from the prior year is deductible only against the $7,000 of income from passive activity B. The $3,000 ($10,000 – $7,000) excess is carried over to the subsequent year. ◀

[15] Other relationships described in Secs. 267(b) and 707(b) are also considered related parties for this purpose.

[16] Sec. 469(g)(2). For 2011 and later the basis of inherited property is its FMV on the date of death (see Chapter I:5).

Credits. A taxpayer may only use tax credits generated in a passive activity against the portion of the taxpayer's tax liability that is attributable to passive income. The taxpayer determines this amount by comparing the tax liability on all income for the year with the tax liability on all income excluding the passive income.

EXAMPLE I:9-10 ▶ Dale invests in a passive activity. For the year, he must report $10,000 of taxable income from the passive activity. Dale's share of tax credits generated by the passive activity is $5,000. Assume Dale's precredit tax liability on all income (including the $10,000 from the passive activity) is $25,000, and his precredit tax liability on all income excluding the passive activity income is $22,000. He may use only $3,000 ($25,000 – $22,000) of the tax credits generated by the passive activity. Dale must carry forward the remaining $2,000 of tax credits and can use them in a subsequent year against the portion of his tax liability attributable to his passive activity income in that year. However, these credits may never offset any portion of the tax liability attributable to nonpassive activities. (See Chapter I:14 for a discussion of credits and their carryovers.) ◀

DEFINITION OF A PASSIVE ACTIVITY

The term *passive activity* includes any trade or business in which the taxpayer does not materially participate as well as any rental activity. An important exception applies to a rental activity that is considered to be a *real property trade or business*. This exception is discussed below on page I:9–14.[17] The definition of a passive activity is based on two critical elements: an identification of exactly what constitutes an activity and a determination of whether the taxpayer has materially participated in that activity.

Identification of an Activity. Identification of the activity becomes critical for several reasons. (1) The determination of whether a taxpayer materially participates in an activity is determined separately for each activity. (2) A taxpayer may deduct suspended losses of a passive activity when the taxpayer completely terminates his or her ownership of the activity. (3) As explained in a subsequent section of this chapter, taxpayers may deduct currently up to $25,000 of passive losses from rental real estate activities. Thus, taxpayers must not combine losses from passive business and rental real estate activities into one activity.

The way taxpayers combine or separate operations into activities can significantly impact the deductibility of losses generated by the activities. Taxpayers may treat one or more activities as a single activity only if they constitute an "appropriate economic unit."[18] Although the taxpayer makes this determination by examining all the relevant facts and circumstances, the following factors receive the greatest weight:

- Similarities and differences in the types of business,
- The extent of common control,
- The extent of common ownership,
- The geographical location, and
- Any interdependencies between the operations (i.e., the extent to which the operations purchase or sell goods between each other, have the same customers, are accounted for with a single set of books, etc.).

A taxpayer may treat more than one operation as a single activity, even if all of these factors do not apply. Furthermore, a taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping the activities.

EXAMPLE I:9-11 ▶ Carla owns a bakery and a movie theater in each of two different shopping malls, one located in Baltimore and the other in Philadelphia. Depending on other relevant facts and circumstances, a reasonable grouping of the operations may result in any of the following:

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[17] Secs. 469(c)(1) and (c)(2). Sec. 469(c)(6) also includes investment (production of income) activities under Sec. 212 as a passive activity. Section 469(j)(8) defines the term *rental activity* as any activity where payments are principally for the use of tangible property. Pursuant to the Regulations, there are six exceptions to this general rule. These exceptions include (1) providing the use of tangible property where the average period of customer use is seven days or less, (2) the average period of customer use is 30 days or less and significant personal services are provided by the owner in conjunction with the use of the property, (3) extraordinary personal services are provided by the owner in conjunction with the use of the property, (4) the rental of the property is incidental to a nonrental activity of the taxpayer, (5) the property is customarily made available during defined business hours for nonexclusive use by various customers, or (6) the property is provided for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest. The details of these exceptions are beyond the scope of this text. (See Reg. Sec. 1.469-1(e)(3)(iii).)

[18] Reg. Sec. 1.469-4.

- One activity involving all four operations
- Two activities: a bakery activity and a theater activity
- Two activities: a Baltimore activity and a Philadelphia activity
- Four activities ◀

Under the Treasury Regulations, taxpayers apparently have some degree of flexibility in determining the grouping into activities of different business operations. However, once taxpayers establish the activities, they must be consistent in grouping these activities in subsequent years unless material changes in the facts and circumstances clearly make the groupings inappropriate.

In identifying separate activities, taxpayers generally may not group rental operations with trade or business operations. However, a combination is allowed if either the rental operation is insubstantial in relation to the business operation or vice versa. Unfortunately, the Treasury Regulations do not give any guidance with regard to what is insubstantial. Furthermore, because of the special rules dealing with real estate rental activities (explained later in this chapter), the taxpayer may not combine rental activities involving real estate with rental activities involving personal property.

EXAMPLE I:9-12 ▶ Sandy owns a building in which she (1) operates a restaurant and (2) leases out apartments to tenants. Generally the tenants sign apartment leases of one year or longer. Of the total gross income derived from the building, 15% comes from the apartment rentals and 85% comes from the restaurant operation. If the apartment rental operation is insubstantial in relation to the restaurant operation, the taxpayer may combine the two into one activity. If it is not insubstantial, the two operations are considered two separate activities: a business activity and a rental real estate activity. ◀

Partnerships and S corporations (pass-through entities) must identify their business and rental activities by applying these rules at the partnership or S corporation level and then must report the results of their operations by activity to the partners or shareholders. Each partner or shareholder must then take the results from these activities and, using these same rules, combine them where appropriate with operations conducted either directly or through other pass-through entities. In fact, in practice taxpayers often hold real estate passive activities as either partnerships or S corporations.

Material Participation. Once each activity is identified, taxpayers must determine whether the activity is passive or active. If the taxpayer does not **materially participate** in the activity, it is deemed to be a passive activity with respect to that taxpayer. Pursuant to the Treasury Regulations,[19] taxpayers materially participate in an activity if they meet at least one of the following tests:

- The individual participates in the activity for more than 500 hours during the year.
- The individual's participation in the activity for the year constitutes substantially all of the participation in the activity by all individuals, including individuals who do not own any interest in the activity.
- The individual participates in the activity for more than 100 hours during the year, and that participation is more than any other individual's participation for the year (including participation by individuals who do not own any interest in the activity).
- The individual participates in "significant participation activities" for an aggregate of more than 500 hours during the year.[20] Thus, an individual who spends over 100 hours each in several separate significant participation activities may aggregate the time spent in these activities in order to meet the 500-hour test.
- The individual materially participated in the activity in any five years during the immediately preceding ten taxable years. These five years need not be consecutive.

[19] Temp. Reg. Sec. 1.469-5T(a).

[20] A significant participation activity is a trade or business in which the individual participates for more than 100 hours during the year but for which the individual does not meet the material participation test alone (i.e., with respect to that activity, the individual does not meet one of the other material participation tests). (See Temp. Reg. Sec. 1.469-5T(c).)

- The individual materially participated in the activity for any three years preceding the year in question, and the activity is a personal service activity.[21]
- The individual participates in the activity on a regular, continuous, and substantial basis during the year, taking into account all the relevant facts and circumstances.

ADDITIONAL COMMENT

A taxpayer may be a material participant in an activity one year and a passive investor the next year. A taxpayer must satisfy one of the material participation tests each year to be treated as a material participant for that year.

Note that the first four tests are based on the number of hours the taxpayer spent in the activity during the current year. The fifth and sixth tests are based on the material participation of the taxpayer in prior years and are designed to prevent taxpayers from asserting that retirement income is passive and offsetting it with passive losses from tax shelters. To determine whether a taxpayer materially participates in an activity, the participation of the taxpayer's spouse is also taken into account.

Limited Partnerships. A limited partner has limited liability for his or her investment in the partnership and normally is not actively involved in the business of the partnership. As a consequence, a limited partner generally does not meet the material participation test and the limited partner's investment is treated as passive. Thus, most income and deductions passed through to a limited partner from a limited partnership are passive. However, a limited partner can meet the material participation test if the individual meets either the 500 hour test or the fifth or sixth tests above (prior year tests).

Working Interest in an Oil and Gas Property. A working interest is an interest that is responsible for the cost of development or operation of the oil and gas property. This type of interest in an oil and gas property is not a passive activity as long as the taxpayer's liability in the interest is not a limited interest. Thus, even though a taxpayer may not materially participate in the activity, the passive loss rules do not apply. This is so even if the taxpayer holds the interest through an entity such as a partnership.

TAXPAYERS SUBJECT TO PASSIVE LOSS RULES

The passive loss limitation rules apply to:

- Individuals, estates, trusts
- Any closely held C corporation
- Any personal service corporation
- Certain publicly traded partnerships

Because the income and losses of partnerships and S corporations are taxed directly to the partners and shareholders, the passive loss rules do not apply to these entities.[22] Rather, the passive loss limitations apply directly at the partner or shareholder level. Thus, the situation may arise where one partner or shareholder is subject to the passive loss rules with regard to an activity conducted by the partnership or S corporation while other partners or shareholders are not.

Generally, regular corporations (i.e., C corporations) are not subject to the passive loss limitation rules. However, to prevent certain individuals from avoiding the passive loss rules through the use of a regular corporation, the passive loss rules do apply to closely held C corporations and personal service corporations.

ADDITIONAL COMMENT

Because a closely held C corporation's passive losses may offset its income from active business operations, some tax professionals advise their clients to transfer their investments in passive activities that generate passive losses to their profitable corporations.

Closely Held C Corporations. The passive loss rules apply to closely held C corporations but only on a limited basis. A **closely held C corporation** is a C corporation where more than 50% of the stock is owned by five or fewer individuals at any time during the last half of the corporation's taxable year.[23] Without this special rule involving

[21] A personal service activity involves rendering personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. It also includes any other trade or business in which capital is not a material income-producing factor. (See Temp. Reg. Sec. 1.469-5T(d).)

[22] An S corporation is a corporation that has elected for federal income tax purposes to be treated as a flow-through entity. Thus, the income or losses and separately stated items of an S corporation flow through to the shareholders who report these items on their individual tax returns.

[23] Secs. 469(j)(1), 465(a)(1)(B), and 542(a)(2).

closely held C corporations, taxpayers would be motivated to transfer their investments (both portfolio investments and passive activities) to a C corporation where the portfolio income could be offset by the corporation's passive losses. Thus, as applied to a closely held C corporation, the passive loss rules prevent passive activity losses from offsetting portfolio income. However, a closely held C corporation's passive losses may offset its income from active business operations.

EXAMPLE I:9-13 ▶ All of the outstanding stock of Delta Corporation is owned equally by individuals Allen and Beth. During the current year, Delta generates $15,000 taxable income from its active business operations. It also earns $10,000 of interest and dividends from investments and reports a $30,000 loss from a passive activity. Because Delta is a closely held C corporation, the $15,000 of taxable income from the active business is offset by $15,000 of the passive loss. However, the $10,000 of portfolio income may not be offset. Thus, for the current year, Delta reports $10,000 of taxable income from its portfolio income and has a $15,000 passive loss carryover. ◀

Personal Service Corporation. A **personal service corporation (PSC)** is a regular C corporation whose principal activity is the performance of personal services that are substantially performed by owner-employees.[24] However, a corporation is not a PSC unless owner-employees own more than 10% of the value of the stock. In contrast with a closely held C corporation, the passive loss limitation rules apply in their entirety to a PSC. If a corporation is both a PSC and a closely held C corporation, the more restrictive rules for PSCs apply. Thus, a PSC cannot offset its active business income or portfolio income with losses from its passive activities.

Material Participation by PSCs and Closely Held C Corporations. Special rules apply for determining whether closely held C corporations or PSCs materially participate in an activity. These corporations materially participate in an activity only if one or more shareholders who own more than 50% in value of the outstanding stock materially participate in the activity. In addition, a closely held C corporation (other than a PSC) materially participates in an activity if it meets *all* of the following tests with regard to an activity:

1. A substantial portion of the services of at least one full-time employee is in the active management of the activity.
2. A substantial portion of the services of at least three full-time nonowner employees is directly related to the activity.
3. The Sec. 162 business deductions of the activity exceed 15% of the activity's gross income for the period.[25]

Publicly Traded Partnerships. In many cases, the tax law provisions for corporations apply to publicly traded partnerships (PTP). For purposes of the passive loss rules, a PTP is defined as any partnership if interests in the partnership are either traded on an established securities market or readily tradable on a secondary market.[26] If the corporate tax provisions apply to a PTP, the passive loss rules generally do not apply. However, if a PTP meets certain gross income requirements, the partnership tax provisions may still apply, causing its items of income, loss, and credit to flow through to the partners.[27] If this is the case, the passive loss rules apply at the partner level separately to the flow through items from each PTP. Thus, partners treat losses from a PTP as separate from any other type of income (passive, active business, or portfolio) and separate from any income from

[24] Secs. 469(j)(2) and 269A(b)(1). For this purpose any employee who owns any stock of the corporation is an owner-employee. This stock ownership is determined by using the Sec. 318 constructive ownership rules as modified by Sec. 469(j)(2).

[25] Secs. 469(h)(4) and 465(c)(7). Tests 1 and 2 must be met for the 12-month period ending on the last day of the tax year. Test 3 must be met for the tax year. Furthermore, the Sec. 404 deductions are also included in the 15% of gross income test.

[26] Sec. 469(k)(2). (See Chapter C:10 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* and Chapter C:10 of the *Comprehensive* volume for a definition and discussion of publicly traded partnerships.)

[27] Sec. 7704(c). For the taxable year and all preceding years beginning after Dec. 31, 1987, at least 90% of the PTP's gross income consists of dividends, interest, real property rents, income from certain gas, oil, mineral or timber activities, and gains from the sale of real estate or certain capital assets. Furthermore, certain other PTPs may also elect to continue to be treated as a partnership rather than as a corporation.

other PTPs. Partners can only carry these losses forward and offset them against income generated by that particular PTP in a subsequent year. Furthermore, a PTP loss may not offset any portfolio income that the PTP might generate. Any net income from PTPs is portfolio income.

EXAMPLE I:9-14 ▶ Mark owns interests in partnerships A and B, both of which are PTPs that are treated as partnerships. During the current year, Mark's share of the income from A is $2,000. Mark's share of B's loss is $1,200. B also generates some portfolio income. Mark's share of B's portfolio income is $800. The $1,200 loss from B may not offset any of B's $800 portfolio income. Furthermore, it may not offset any of the $2,000 income from A. The $2,000 income from A is treated as portfolio income. Thus, Mark reports $2,800 portfolio income and has a $1,200 suspended loss from B. In a subsequent year, Mark's share of any income from B can be offset by the $1,200 of suspended loss that is carried forward. ◀

A partner may deduct suspended losses from a PTP in the year the partner disposes of his or her interest in the PTP. Partners do not recognize a loss in the year that the PTP itself sells a passive activity.

REAL ESTATE BUSINESSES

In general, rental activities are considered passive activities. However, the passive activity loss rules do not apply to certain taxpayers who are involved in real property trades or businesses. Instead, these activities are treated as active businesses. A *real property trade or business* involves the development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokering of real property.

This exception only applies to a taxpayer if he or she meets both of the following requirements:

- More than one-half of the personal services the taxpayer performs in all trades or businesses during the year are in real property trades or businesses in which the taxpayer materially participates.
- The taxpayer performs more than 750 hours of work during the taxable year in real property trades or businesses in which the taxpayer materially participates.

In meeting these tests, personal services a taxpayer renders in his or her capacity as an employee are not treated as performed in real property trades or businesses unless the employee owns at least 5% of the employer. Furthermore, for married taxpayers filing a joint return, the exception applies only if one of the spouses separately meets both requirements. The time spent in the activity by both spouses counts toward the determination of whether or not the taxpayer meets the material participation test.

EXAMPLE I:9-15 ▶ Anwar and Anya are married and file a joint return. They own four large apartment complexes which they manage themselves. Neither is employed elsewhere. During the current year, Anya spent 500 hours keeping records and corresponding with tenants. Anwar spent 700 hours during the year maintaining and repairing the apartments. Even though all of Anya and Anwar's personal services are connected with a real property trade or business in which they materially participate, this rental activity is considered passive because neither Anwar nor Anya alone spends more than 750 hours doing services related to the rental activity. ◀

For a closely held C corporation to meet this rental real estate business exception, the corporation must derive more than one-half of its gross receipts from real property businesses in which it materially participates.

Any deduction allowed under the previously discussed exception for taxpayers involved in real property trades or businesses is not considered in determining the taxpayer's AGI for purposes of the phase-out of the $25,000 deduction available for taxpayers who actively participate in a rental real estate activity. (See the following section in this chapter for a discussion of the $25,000 active participation exception.)

KEY POINT

Up to $25,000 of passive losses attributable to rental real estate can be deducted each year against income from nonpassive sources such as salary, interest, and dividends.

OTHER RENTAL REAL ESTATE ACTIVITIES

Many rental real estate activities are not considered rental real estate businesses and are, therefore, subject to the passive loss rules. However, if an individual taxpayer meets certain requirements, the taxpayer still may deduct against other income up to $25,000 of annual losses from these passive rental real estate activities. To meet this exception, an individual must do both of the following:

- *Actively* participate in the activity
- Own at least 10% of the value of the activity for the entire tax year

Additionally, in order to take a deduction in the current year for a loss sustained in a prior year, Section 469(i) requires the taxpayer to actively participate in the activity during both years.

Active Participation. A taxpayer can achieve *active participation*, as opposed to material participation, without regular, continuous, and material involvement in the activity and without meeting any of the material participation tests. However, the taxpayer still must participate in making management decisions or arranging for others to provide services in a significant and bona fide sense. This includes approving new tenants, deciding on rental terms, approving expenditures, and other similar decisions. Taxpayers may achieve active participation even if they hire a rental agent and others to provide the services. However, a lessor under a net lease arrangement generally does not achieve active participation. Additionally, a limited partner generally cannot actively participate in any activity of a limited partnership.

KEY POINT

Active participation is different from *material participation*, and is a lesser standard of involvement.

Limitation on Deduction of Rental Real Estate Loss. Taxpayers must first apply rental real estate losses against other net passive income for the year. Taxpayers may then reduce their portfolio or active business income by up to $25,000. However, the tax law requires reduction of the $25,000 amount by 50% of the taxpayer's AGI in excess of $100,000.[28] For this purpose, AGI does not include any passive activity loss or any loss allowable to taxpayers who materially participate in real property trades or businesses (e.g., a real estate developer). Thus, if a taxpayer has AGI of $150,000 or more, the rental real estate losses are not eligible for the $25,000 deduction and are aggregated with the taxpayer's other passive losses.

EXAMPLE I:9-16 ▶ During the current year, Penny, a married individual who files a joint return, reports the following items of income and loss:

Salary income	$120,000
Activity A (passive)	15,000
Activity B (nonbusiness rental real estate)	(50,000)

Penny owns over 10% and actively participates in activity B. Her AGI for the year is as follows:

Salary		$120,000
Passive income from activity A	$15,000	
Minus: Passive loss from activity B ($50,000, but limited to $15,000)	(15,000)	–0–
Minus: Maximum rental real estate loss (from activity B)	$25,000	
Reduced by phase-out: [($120,000 – $100,000) × 0.50]	(10,000)	
Deductible amount (but not to exceed actual loss)		(15,000)
AGI		$105,000

ADDITIONAL COMMENT

In calculating AGI to determine the amount of the $25,000 that is phased out, married taxpayers filing joint returns must include the income of both spouses. This provision results in a marriage penalty where both spouses have income.

Penny may deduct $30,000 of the loss from activity B during the year ($15,000 as an offset to the passive income from activity A + $15,000 deductible against portfolio or active business income). Penny has $20,000 ($50,000 – $30,000) of suspended passive losses from activity B that are carried over to the following year. ◀

[28] This provision which allowed taxpayers to either (1) take a current deduction equal to 50% of certain qualified commercial revitalization expenditures on certain buildings, or (2) amortize the qualified expenditures over a ten-year period only applied to property placed into service before January 1, 2010. Even though this provision has been repealed, if a taxpayer elected to amortize the qualified expenditures over a ten-year period, the amount amortized and deducted in years after 2009 is not subject to the $25,000 passive loss limit. Further analysis of this provision is beyond the scope of this discussion. Additionally, AGI is modified by certain items that are beyond this discussion.

KEY POINT

Up to $25,000 of passive losses attributable to rental real estate can be deducted each year against income from nonpassive sources such as salary, interest, and dividends.

OTHER RENTAL REAL ESTATE ACTIVITIES

Many rental real estate activities are not considered rental real estate businesses and are, therefore, subject to the passive loss rules. However, if an individual taxpayer meets certain requirements, the taxpayer still may deduct against other income up to $25,000 of annual losses from these passive rental real estate activities. To meet this exception, an individual must do both of the following:

- *Actively* participate in the activity
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In calculating AGI to determine the amount of the $25,000 that is phased out, married taxpayers filing joint returns must include the income of both spouses. This provision results in a marriage penalty where both spouses have income.

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The $25,000 limit applies to the sum of both deductions and credits. Thus, in order to properly apply the limit, taxpayers must convert the credits into deduction equivalents. A *deduction equivalent* is an amount that, if taken as a deduction, would reduce the tax liability by an amount equal to the credits. The amount of deduction equivalents can be computed by dividing the amount of the credit by the taxpayer's marginal tax rate. If the sum of the deductions and the deduction equivalents exceeds the $25,000 limit, the taxpayer must first use the deductions.

EXAMPLE I:9-17 ▶ Hal owns over 10% of activity A, in which he actively participates. Activity A is a passive real estate rental activity. Hal's marginal tax rate is 25% and he has AGI of less than $100,000. For the year, activity A generates a $20,000 net loss and $10,000 in tax credits, which amounts to $40,000 in deduction equivalent {$10,000/25%}. After deducting the $20,000 net loss against his active business and portfolio income, Hal has a remaining real estate deduction under the limit of $5,000 ($25,000 – $20,000). Thus, Hal may use $1,250 ($5,000 × 0.25) of the credits. The remaining $8,750 ($10,000 – $1,250) of tax credits must be carried over to subsequent years. ◀

If deductions and credits exceeding the $25,000 limit arise from more than one passive activity, the taxpayer must allocate the deductions and credits between the activities.[29]

EXAMPLE I:9-18 ▶ Mary has AGI of less than $100,000 and a 25% marginal tax rate. During the year she reports a $30,000 loss from activity A and a $10,000 loss from activity B. Additionally, activity A generates $5,000 of tax credits. Both activities A and B are passive real estate rental activities in which Mary actively participates and owns over 10% of each activity. The $25,000 deduction is first allocated to the losses. Because the sum of the losses ($40,000) exceeds the limit, the deductible loss must be allocated ratably between the activities as follows:

Activity A: $25,000 × $30,000 ÷ $40,000 = $18,750
Activity B: $25,000 × $10,000 ÷ $40,000 = $6,250

Activity A has an $11,250 ($30,000 – $18,750) suspended loss, and activity B has a $3,750 ($10,000 – $6,250) suspended loss. In addition, activity A has $5,000 of suspended tax credits. ◀

Topic Review I:9-2 summarizes the passive activity loss rules.

STOP & THINK

Question: Jana is a businesswoman who has successfully invested in various stock and bond funds. Now she is considering diversifying her holdings by investing in real estate. She is considering purchasing an interest in a limited partnership that invests in real estate. A friend is also urging Jana to go into a partnership with him in order to purchase a small office building they would rent out. Assume that the size of Jana's investment in the two alternatives would be exactly the same and that Jana estimates the economic results to be equivalent (e.g., she expects both to spin off equivalent losses for the first few years and then begin turning a profit). What tax issues should Jana consider when making her investment decision?

Solution: In comparing alternatives such as these, of course, the most important considerations should be the non-tax factors such as cash flow from the investment, the capital appreciation of the assets, the marketability of the investment, and the risk. For example, as a limited partner, Jana will not personally be liable for debts of the partnership or lawsuits filed against the partnership. Purchase of the office building as a general partner with her friend will cause her to be personally liable unless it is done through an LLC or LLP. Additionally, in comparing these two alternatives, certain tax issues may come into play. Both alternatives are investments in rental real estate. However, Jana is not eligible to deduct up to $25,000 of the passive losses from the limited partnership because she will

[29] A taxpayer may earn different types of credits, based upon the different types of investments. Furthermore, the phase-out of the $25,000 limit is treated differently for different types of credits. For example, the phase-out for the rehabilitation credit only begins when the taxpayer's AGI exceeds $200,000. Additionally, there is no phase-out applied to the credit for low income housing. (See Sec. 469(e)(3) and Chapter I:14 for a discussion of these credits.) Thus, taxpayers are required to allocate the deductions and credits among the activities and account for them in a specific order. A complete analysis of these rules is beyond the scope of this discussion. Example I:9-18 assumes both activities earn the same type of credit and are subject to the $25,000 limit.

TOPIC REVIEW I:9-2

Passive Losses

Topic	Summary
Taxpayers covered	Individuals, estates, trusts, closely held C corporations, personal service corporations, certain publicly traded partnerships.
Passive activity	Any trade or business activity in which the taxpayer does not materially participate. Includes all rental activities except for certain rental real estate activities and exceptions contained in regulations. Does not include working interests in oil and gas property.
Limitation	Passive losses are deductible against passive income, but not against active or portfolio income. Disallowed losses are carried over to subsequent years (suspended losses). Losses must be accounted for separately by activity. Activities are identified by examining the taxpayer's undertakings.
Suspended losses	Must be allocated and attributed among the passive activities that generated the losses.
Disposition of interest	Taxpayers may deduct suspended losses in the year of a taxable disposition of the passive activity subject to the limitation on excess business losses of $255,000. For inherited property, suspended losses in excess of the increase in basis may be deducted on the final return of a decedent. Losses up to the amount of the basis increase are lost.
Material participation	Must be regular, continuous, and substantial. The regulations contain seven separate tests; four based on current-year participation; two based on participation in prior years; and one based on facts and circumstances.
Real property trades or businesses	Passive activity loss rules do not apply to taxpayers who materially participate in real property trade or business activities for more than 750 hours during the year. Additionally, more than one-half of the taxpayer's personal services must be performed in real property trades or businesses in which the taxpayer materially participates.
Rental of real estate	Individuals may deduct losses up to $25,000 against active and portfolio income if they actively participate in the activity and own at least 10% of the value of the activity. Additionally, they may take certain credits generated in passive rental activities in which they actively participate. Active participation is a lesser standard than material participation, but the taxpayer must still participate in management decisions or arranging for others to provide services. The deduction and credits phase out at a 50% rate for AGI in excess of $100,000.

not actively participate in the partnership. On the other hand, if she is involved in management decisions regarding the office building held by the partnership, she will be actively participating and will be eligible for the $25,000 passive loss deduction exception. Of course, the benefit of this exception begins phasing out if her AGI exceeds $100,000.

Casualty and Theft Losses

OBJECTIVE 4

Identify and calculate the deduction for a casualty or theft loss

Taxpayers may deduct losses incurred in connection with business or investment property, but individuals generally are not allowed a deduction for losses on personal-use property. However, under Sec. 165, individuals may take a limited deduction if the loss on personal-use property arises from a fire, storm, shipwreck, other casualty, or theft. In other words, losses on personal-use property are deductible only if the loss results from a casualty. In order for an event to qualify as a casualty, the event must meet certain requirements.

CASUALTY DEFINED

According to the IRS, a deductible **casualty loss** is one that occurs in an identifiable event that is sudden, unexpected, or unusual.[30] In addition, beginning January 1, 2018, the deduction for personal casualty and theft losses is limited to those losses incurred in a "federally-declared disaster." Casualty and theft losses of business and investment property are deductible.

[30] Rev. Rul. 79-174, 1979-1 C.B. 99. See also IRS *Publication No. 547*, Casualties, Disasters, and Thefts, 2016, p.2.

Identifiable Event. Because the event that causes the loss must be *identifiable*, the act of losing or misplacing property is generally not considered a casualty.

However, an accidental loss of property can qualify as a deductible casualty if the loss is the result of an identifiable event.

KEY POINT

The taxpayer has the burden of proof to establish that a loss was caused by a casualty. The taxpayer should gather as much evidence as possible. Newspaper clippings, police reports, photographs, and insurance reports can be helpful in establishing the cause of the loss.

Sudden, Unexpected, or Unusual Events. According to the IRS, a *sudden event* is one that is swift, not gradual or progressive. An *unexpected event* is one that is ordinarily unanticipated and not intended. An *unusual event* is one that is not a day-to-day occurrence and that is not typical of the activity.

Thus, the IRS has ruled that a deductible casualty loss occurred when a taxpayer went ice fishing and his automobile fell through the ice.[31] A taxpayer whose automobile was damaged as the result of an accident also sustained a deductible casualty loss. However, a taxpayer may not deduct losses incurred in an accident caused by the taxpayer's willful negligence or willful act.[32] Damage sustained as the result of an accident in an automobile race was held to be nondeductible because accidents occur often and are not unusual events in automobile races.[33]

ADDITIONAL COMMENT

Sudden, unexpected, or unusual events must also be accompanied by an external force. For example, a blown engine in an automobile is a sudden event but because no external force caused the event, the loss is not a casualty loss.

The following are a few examples of events that the courts have held to constitute a deductible casualty loss:

- Rust and water damage to furniture and carpets caused by the bursting of a water heater
- Damage to the exterior paint of a building caused by a severe, sudden, and unexpected concentration of chemical fumes in the air
- Loss caused by fire (unless the taxpayer sets the fire, in which case no deduction is available)
- Damage to a building caused by an unusually large blast at a nearby quarry or a jet sonic boom[34]
- Death of trees just a few days after a sudden infestation of pine beetles[35]

The following are examples of events that the courts have held *not* to be a casualty:



ETHICAL POINT

A client loses his business-use cell phone while fishing and wants to deduct the loss as a casualty. The CPA should not sign the tax return unless he or she believes that the client's position has a realistic possibility of being sustained on its merits if challenged, which is doubtful in this situation.

- Water damage to the walls and ceiling of a taxpayer's personal residence as the result of the gradual deterioration of the roof[36]
- Trees dying because of gradual suffocation of the root systems
- The loss of trees and shrubs because of disease[37]
- Damage to carpet and clothing caused by moths and carpet beetles[38]
- Damage to a road due to freezing, thawing, and gradual deterioration[39]
- Damage caused by drought because it occurs through progressive deterioration
- The steady weakening of a building caused by normal wind and weather conditions
- The rusting and deterioration of a water heater[40]

At times it is very difficult to determine under the particular facts whether the necessary requirements of suddenness, unexpectedness, or unusualness exist. For example, as

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[31] Rev. Rul. 69-88, 1969-1 C.B. 58.

[32] *Willie C. Robinson*, 1984 PH T.C. Memo ¶84,188, 47 TCM 1510 and Reg. Sec. 1.165-7(a)(3).

[33] Ltr. Rul. 8227010 (March 30, 1982) contains the above examples.

[34] *Ray Durden*, 3 T.C. 1 (1944), *acq.* 1944 C.B. 8 and Rev. Rul. 60-329, 1960-2 C.B. 67.

[35] Rev. Rul. 79-174, 1979-1 C.B. 99. See also *Charles A. Smithgall v. U.S.*, 47 AFTR 2d 81-695, 81-1 USTC ¶9121 (D.C.-Ga., 1980), Rev. Rul. 87-59, 1987-2 CB 59, and Rev. Rul. 90-61, 1990-2 CB 39. However, the IRS has ruled in Ltr. Rul. 8544001 (July 12, 1985) that no casualty loss results when the time interval between the infestation and the death of the trees was too long.

[36] *Lauren Whiting*, 1975 PH T.C. Memo ¶75,038, 34 TCM 241.

[37] *William R. Miller*, 1970 PH T.C. Memo ¶70,167, 29 TCM 741 and Rev. Rul. 57-599, 1957-2 C.B. 142. Modified by Rev. Rul. 79–174, 1979-1 C.B. 99. (See also *Howard F. Burns v. U.S.*, 6 AFTR 2d 6036, 61-1 USTC ¶9127 (6th Cir., 1960).)

[38] Rev. Rul. 55-327, 1955-1 C.B. 25. (See also *J. P. Meersman v. U.S.*, 18 AFTR 2d 6152, 67-1 USTC ¶9125 (6th Cir., 1966).)

[39] *Howard Stacy*, 1970 PH T.C. Memo ¶70,127, 29 TCM 542. However, the breaking up of a road over a 4-month period because of extreme weather conditions was held to be a casualty. See *Emmett J. O'Connell v. U.S.*, 29 AFTR 2d 72-596, 72-1 USTC ¶9312, (D.C. Cal., 1972). (See also *Stephen L. Shaffer*, 1983 PH T.C. Memo ¶83,677, 47 TCM 285.)

[40] Rev. Rul. 70-91, 1970-1 C.B. 37 and IRS *Publication No. 547* (Casualties, Disasters, and Thefts), 2015 contain the above examples.

mentioned above, damage caused by the sudden infestation of pine beetles in some instances has been held to be a casualty, but in other instances it has not.[41]

THEFT DEFINED

Under Sec. 165, a taxpayer may also deduct a loss sustained as the result of a theft. This includes theft of business, investment, or personal-use property. The Treasury Regulations state that "the term theft shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery."[42] A determination whether other actions also constitute theft often depends on whether the action involves criminal intent and is illegal under the state law where the action has occurred. Thus, the IRS has stated that blackmail, extortion, and kidnapping for ransom may also constitute theft.[43]

DEDUCTIBLE AMOUNT OF CASUALTY LOSS

The amount of a casualty loss deduction depends on the amount of the loss sustained, any insurance or other reimbursement the taxpayer received, and, in the case of personal-use property, the limitations imposed under the tax law.

Measuring the Loss. As explained below, one measurement of the amount of the loss sustained in a casualty is the amount by which the casualty reduces the property's FMV. This is measured by comparing the property's FMV immediately before and immediately after the casualty.[44] The amount of the loss may not include any reduction in the FMV of the taxpayer's surrounding but undamaged property.

EXAMPLE I:9-19 ▶ Gail purchased a rental cabin for $310,000. Shortly after she purchased the property, a mudslide completely destroyed several neighboring cabins. Gail's cabin sustained no damage. After the slide, an appraisal reveals that the FMV of the cabin has declined to $250,000 because of fears that other mudslides might occur. The $60,000 reduction in the FMV of the cabin does not constitute a deductible casualty loss. ◀

ADDITIONAL COMMENT

Taxpayers cannot deduct a loss unless they own the damaged property. Therefore, a taxpayer cannot deduct amounts he or she paid to another individual for damage he or she caused to the other individual's property.

The taxpayer must use actual market value, not sentimental value, to compute the reduction in the FMV. Additionally, the cost of protecting property to prevent damage from a casualty is not a deductible loss.

If the property involved in the casualty is only partially destroyed, the amount of the loss is the lesser of the reduction in the property's FMV or the taxpayer's adjusted basis in the property.

EXAMPLE I:9-20 ▶ Troy purchased a home for $225,000 several years ago. Through the years, the value of the home appreciated until it was appraised at $325,000 in the current year. Shortly after the appraisal, a flood swept through the area and severely damaged Troy's home, and the flood was declared a federal disaster. After the flood, the value of the home declined to $90,000. Troy does not have any flood insurance. His loss is limited to his $225,000 basis in the home even though the economic loss is $235,000 ($325,000 – $90,000). ◀

TYPICAL MISCONCEPTION

Taxpayers sometimes think their loss should be based on the total economic loss rather than just the property's basis. Taxpayers should remember that they have not paid a tax on the appreciation in value and, therefore, should not be entitled to a deduction for a loss on the unrealized gain.

If business or investment property is totally destroyed in a casualty, the amount of the loss is the taxpayer's adjusted basis in the property, even if it is greater than the property's FMV. However, if personal-use property is totally destroyed, the amount of the loss is limited to the lesser of the reduction in the property's FMV or the property's adjusted basis.

EXAMPLE I:9-21 ▶ A machine Beth uses in her business is completely destroyed by fire. At the time of the fire, the adjusted basis of the machine is $5,000 and its FMV is $3,000. Because the machine is business property, Beth's loss is $5,000. If the machine were a personal-use asset, the amount of the loss would be $3,000, the amount of the reduction in the property's FMV rather than Beth's basis of $5,000. ◀

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[41] Rev. Rul. 79-174, 1979-1 C.B. 99 and *George K. Notter*, 1985 PH T.C. Memo ¶85,391, 50 TCM 614.
[42] Reg. Sec. 1.165-8(d).
[43] Rev. Rul. 72-112, 1972-1 C.B. 60 and IRS *Publication* No. 547 (Casualties, Disasters, and Thefts), 2015.
[44] Reg. Sec. 1.165-7(a)(2).

Generally, taxpayers must establish the reduction in the FMV of the property by an appraisal. If an appraisal is difficult or impossible to obtain, the taxpayer may use the cost of the repairs instead. The repairs must meet all of the following requirements before the taxpayer may use this alternative:

KEY POINT

The reason for this difference is that taxpayers may not deduct a loss on the sale of personal-use property. Thus, taxpayers should not be able to deduct the decline in the personal property's value that occurs before the casualty.

- The repairs will bring the property back to its condition immediately before the casualty.
- The cost of the repairs is not excessive.
- The repairs do no more than repair the damage incurred in the casualty.
- The repairs do not increase the value of the property over its value immediately before the casualty.

If the same casualty destroys more than one property, the taxpayer calculates the loss on each property separately.[45] Thus, the taxpayer compares each property's basis with the reduction in the FMV of that property, rather than aggregating the basis and FMV amounts for all the properties destroyed in the casualty.

If the taxpayer receives insurance or any other type of recovery, the taxpayer must reduce the amount of the loss by these amounts. In some cases these payments may actually exceed the taxpayer's basis in the property, causing the realization of a gain. If certain requirements are met, taxpayers may defer or exclude the recognition of these gains. (See the detailed discussion of involuntary conversions in Chapter I:12.)

LIMITATIONS ON PERSONAL-USE PROPERTY

The amount an individual may deduct for a casualty loss on personal-use property is subject to two limitations: (1) losses sustained in each separate casualty must be reduced by $100, and (2) the total amount of all net casualty losses for personal-use property is reduced by 10% of the taxpayer's AGI for the year. For property destroyed in the same casualty, only $100 is deducted from all the properties (i.e., the taxpayer does not reduce the loss from each separate property by $100).

EXAMPLE I:9-22 ▶ During the year a hurricane, which was declared a federal disaster, blows over a large tree in front of Cathy's house, damaging the house and totally destroying her automobile. After the insurance reimbursement, the loss on the house amounts to $3,000, and the loss on the automobile is $2,500. Because the losses occur in the same casualty, the total amount of the loss is reduced to $5,400 ($3,000 + $2,500 − $100). If the damage to the car was sustained in a separate event such as an automobile accident, the total amount of the casualty losses incurred by Cathy during the year would have been $5,300 [($3,000 − $100) + ($2,500 − $100)]. This $5,300 or $5,400 loss is then further reduced by 10% of Cathy's AGI for the year. ◀

EXAMPLE I:9-23 ▶ As the result of a storm declared a federal disaster, Liz incurs a $4,100 casualty loss on personal-use property during the year. She also sustains a $600 loss from a flood, a second federally declared disaster. Liz's AGI for the year is $50,000. She receives no tax deduction for the casualty and theft losses because they do not exceed the following limitations:

KEY POINT

Many taxpayers cannot deduct their casualty losses because of the $100 floor and 10% of AGI limitation.

	Storm	*Flood*	*Total*
Loss before limitations	$4,100	$600	$4,700
Minus: $100 floor	(100)	(100)	(200)
	$4,000	$500	$4,500
Minus: 10% of AGI ($0.10 \times \$50,000$)			(5,000)
Deductible loss			0 ◀

Because of these limitations, many taxpayers who sustain casualty and theft losses on personal-use property do not receive a tax deduction. Furthermore, if the taxpayer's insurance covers the property, the taxpayer cannot take a casualty loss deduction unless he

[45] Reg. Sec. 1.165-7(b)(2). For personal-use property, losses on real property and improvements to the property are computed in the aggregate. Thus, no separate basis need be apportioned to the improvements. (See Reg. Secs. 1.165-7(b)(2)(ii) and 1.165-7(b)(3) Example (3).)

ADDITIONAL COMMENT

Individuals sometimes fail to file insurance claims for damage to their personal automobile for fear that their insurance rates will increase, and hope instead to deduct the loss. In this situation, the taxpayer cannot deduct the loss.

or she timely files an insurance claim for the loss. This disallowance relates only to the portion of the loss covered by the insurance.

Below is a summary of the rules concerning deductibility of casualty losses:

Result of Casualty		*Business*	*Investment*	*Personal Use Federal Disaster*
Total Destruction	Amount of Casualty[a]	Basis	Basis	Lesser of: basis or decline in FMV, reduced by $100 and 10% of AGI
	Type	For AGI	From AGI (For AGI if Rental)	From AGI
Partial Destruction	Amount of Casualty[a]	Lesser of: basis or decline in FMV	Lesser of: basis or decline in FMV	Lesser of: basis or decline in FMV, reduced by $100 and 10% of AGI
	Type	For AGI	From AGI (For AGI if Rental)	From AGI

[a] All amounts are first reduced by any insurance reimbursement.

NETTING CASUALTY GAINS AND LOSSES ON PERSONAL-USE PROPERTY

TYPICAL MISCONCEPTION

The concept of a gain on a casualty can be confusing. Nevertheless, if the insurance proceeds exceed the property's basis, a gain results.

Taxpayers must net casualty gains and losses incurred during the year on personal-use assets. Personal casualty losses that do not result from a federally declared disaster are deductible to the extent the taxpayer has personal casualty gains for the year. An individual would first reduce the amount of personal casualty gains by the amount of non-federally declared disaster losses. Any remaining personal casualty gain is then used to reduce the federally declared disaster loss. These gains and losses are not combined with casualty gains and losses on business and investment property. For purposes of the netting process, the losses should be reduced by any insurance reimbursements and the $100 limitation, but not the 10% of AGI floor. If the gains exceed the losses for the year, all the gains and losses are treated as capital gains and losses.

EXAMPLE I:9-24 ▶ During the year, Pat incurs the following casualty gains and losses on personal-use assets. Assets W and X are destroyed in one casualty, and asset Y is destroyed in another. Pat acquired assets X and Y in the current year, whereas she acquired asset W several years ago.

Asset	*Reduction in FMV*	*Adjusted Basis*	*Insurance*	*Holding Period*
W	$10,000	$3,000	$10,000	More than 12 months
X	3,600	5,000	2,000	Less than one year
Y	1,600	3,000	0	Less than one year

Pat realizes a $7,000 ($10,000 – $3,000) gain on asset W because the insurance proceeds received for the asset exceed its basis. She realizes a $1,600 ($3,600 reduction in FMV – $2,000 insurance) loss on asset X. This loss is reduced to $1,500 because of the $100 reduction for personal casualty losses. She realizes a $1,600 loss on asset Y. Because this loss is realized as a result of the second casualty, the $100 limitation is deducted, resulting in a $1,500 loss from that casualty. Pat realizes a $4,000 [$7,000 – ($1,500 + $1,500)] net casualty gain for the year. Thus, the gain or loss on each asset is treated as a capital gain or loss. Pat must report a $7,000 long-term capital gain on asset W, a $1,500 short-term capital loss on asset X, and a $1,500 short-term capital loss on asset Y. ◀

If the casualty losses on personal-use property exceed the casualty gains for the year, the taxpayer must further reduce the net loss by 10% of AGI. The taxpayer performs all of these calculations (the netting process and reductions) on Form 4684. If any loss remains after the netting and reductions, the taxpayer reports the loss as an itemized deduction on Schedule A of Form 1040.

EXAMPLE I:9-25 ▶ Matt has AGI of $100,000 for the current year. After applying the $100 floor, Matt has $10,000 of nonfederal casualty losses, $18,000 of federal disaster losses, and $15,000 of personal casualty gains for the year. Matt's nonfederal losses are applied against the casualty gain. The remaining casualty gain of $5,000 ($15,000 − $10,000) is applied against the federal disaster loss ($18,000 − $5,000). Next, Matt applies the 10% limit of AGI of $10,000 (10% × $100,000), resulting in a $3,000 ($13,000 − $10,000) deductible loss. ◀

CASUALTY GAINS AND LOSSES ATTRIBUTABLE TO BUSINESS AND INVESTMENT PROPERTY

Taxpayers must net casualty gains and losses on business and investment property held over one year. (See Chapter I:13 for a discussion of the netting procedure under Sec. 1231.) If the losses exceed the gains, the business losses and losses on investment property that generate rents or royalties are *for* AGI deductions. Losses on other investment property (e.g., the theft of a security) are itemized deductions. The $100 or 10% of AGI limitations do not apply to losses on business and investment property. Casualty gains and losses on business and investment property held one year or less are all treated as ordinary.

TIMING OF CASUALTY LOSS DEDUCTION

In general, taxpayers must deduct casualty losses in the tax year in which the taxpayer sustains the loss. In the following instances, however, taxpayers may deduct the loss in another year:

- ▶ Theft losses
- ▶ Insurance or other reimbursements that the taxpayer can reasonably expect to receive in a subsequent year
- ▶ Certain disaster losses

Theft. Taxpayers must deduct a theft loss in the tax year in which the taxpayer discovers the theft. This rule is equitable and practical because a taxpayer may not discover a theft until a subsequent year.

EXAMPLE I:9-26 ▶ Dale owns an investment property in upstate New York. Sometime after his last trip to the lodge in November 2018, someone breaks into the property and steals paintings. Dale discovers the theft when he returns to the property on May 19, 2019. Dale's insurance does not cover the entire cost of the items. The loss is deductible in 2019, even though the theft may have occurred in 2018. ◀

REAL-WORLD EXAMPLE

A taxpayer had property confiscated by the Cuban government in 1960. The taxpayer left the country and could have filed for indemnity but did not because she expected to return. Later, the government took away the right of indemnity in 1961. Since she did not file for indemnity from the Cuban government when she had the chance, she was not allowed a casualty or theft loss. *Vila v. U.S.*, 23 AFTR 2d 69-1311 (1969).

Insurance and Other Reimbursements. Taxpayers must subtract any reimbursement received as compensation for a loss in arriving at the amount of the loss. This is necessary even when the taxpayer has not yet received the reimbursement, as long as there is a reasonable prospect that the taxpayer will receive it in the future. Thus, the taxpayer may not take a deduction in the year of loss if in that year a reasonable expectation of full recovery exists.[46] If no anticipation of full recovery exists, the taxpayer may deduct a loss in the year the casualty occurs for the estimated unrecovered amount. As previously mentioned, the taxpayer may not take a deduction to the extent the taxpayer has insured the personal-use property and the taxpayer does not file a timely insurance claim.

EXAMPLE I:9-27 ▶ In December of the current year, Andrea suffers a $10,000 casualty loss when her business-use automobile is struck by a city bus. Although she does not receive any reimbursement from the insurance company by December 31, she reasonably expects to recover the full amount. Andrea may not deduct a casualty loss in the current year. ◀

EXAMPLE I:9-28 ▶ Assume the same facts as in Example I:9-27, except that Andrea reasonably anticipates her reimbursement from the insurance company will be only $7,000. In this case, her casualty loss in the current year is $3,000. ◀

If the taxpayer does not receive the full amount of the anticipated recovery in the subsequent year, he or she may deduct the unrecovered portion. However, rather than filing an amended return for the year of loss, the taxpayer deducts the loss in the subsequent year. Thus in some cases, the taxpayer may spread the income tax consequences for a single casualty loss over two years.

[46] Reg. Sec. 1.165-1(d)(2)(i).

EXAMPLE I:9-29 ▶ During the current year, Javier's home is damaged by an exceptionally severe blast at a nearby stone quarry owned by Acme Corporation. The blast is declared a federal disaster. Although the amount of the damage is properly appraised at $20,000, Javier can reasonably anticipate a recovery of only $15,000 from Acme Corporation at the end of the current year. He does not receive any recovery from Acme during the current year. Unfortunately, in the subsequent year Acme Corporation is declared bankrupt, and Javier does not receive any reimbursement. Javier's AGI is $40,000 in the current year and $45,000 in the subsequent year. During the current year, Javier may deduct $900 {$5,000 loss reasonably anticipated in the current year − [$100 limitation + (0.10 × $40,000)]}. In the subsequent year, Javier may deduct an additional casualty loss of $10,500 [$15,000 additional loss − (0.10 × $45,000)]. ◀

If a taxpayer receives a subsequent recovery for a previously deducted loss, the taxpayer includes the reimbursement in income in the year of recovery. The taxpayer does not file an amended return. However, the amount that the taxpayer must include in income is limited to the amount of tax benefit the taxpayer received for the previous deduction.

EXAMPLE I:9-30 ▶ During the current year, Becky's automobile sustains $5,000 in damages when it is struck by another automobile during an earthquake declared a federal disaster. The driver of the other automobile is uninsured, and Becky does not reasonably expect to recover any of the loss. Becky's AGI for the current year is $35,000. Becky deducts $1,400 ($5,000 loss − [$100 + $3,500]). During the subsequent year, the other driver reimburses Becky for the full amount of the damage. Because Becky received a tax benefit of only $1,400 for the loss in the year of the accident, she must only include $1,400 in gross income in the subsequent year, even though she receives a $5,000 reimbursement. Becky does not file an amended return for the year of the accident. ◀

Disaster Losses. Under certain circumstances, a taxpayer may elect to deduct a casualty loss in the year preceding the year in which the loss actually occurs. This election is available to taxpayers who suffer losses attributable to a disaster that occurs in an area subsequently declared by the President of the United States as a disaster area.[47] Thus, an individual can elect to deduct a disaster loss occurring in 2019 on his or her 2018 tax return or report it in the regular way on his or her 2019 return. The taxpayer must file an amended return (Form 1040X) unless he or she has not filed the prior year's return when the disaster is declared. This election allows taxpayers the possibility of receiving financial help sooner from potential tax refunds by filing an amendment to the prior year's return.

Topic Review I:9-3 summarizes the casualty loss deduction rules.

STOP & THINK

Question: Due to a series of hurricanes that hit Florida during the current year, many homes, roads, and other property are destroyed. Because of the tremendous destruction, the President of the United States declares the area a disaster area. One of the properties totally destroyed is Jack's vacation home in Miami. Jack uses the home exclusively for vacationing. The value of the home is $390,000. Unfortunately, Jack had not insured the home against a hurricane. What issues must Jack consider in determining the year in which to take the casualty loss?

Solution: Since the property was destroyed in a disaster and is located in an area which the President subsequently declared as a disaster area, Jack may take the casualty deduction either in the year of the casualty or in the previous year. The year which is most beneficial is based on several factors. The destroyed property was personal use property, so the deduction is an itemized deduction that would normally be subject to the 10% of AGI limitation. Thus, Jack should compare his estimated AGI for the current year with his AGI in the last year. He also should consider his other itemized deductions, including any other casualty losses that might be subject to the $100 or 10% of AGI limitation. In addition, he should compare his marginal tax rates in the two years. Jack should also consider the time value of money, since by taking the deduction on his prior year return, he will receive the tax benefit earlier than if he takes the deduction on the current year return.

[47] Sec. 165(i). Additionally, the same treatment may apply under Sec. 165 to taxpayers who live in a disaster area and who are ordered by a state or local government to move from or relocate their residence because the disaster caused the residence to be unsafe. In order to qualify for this treatment, the order to move must come from the state or local government within 120 days of the date that the President determines the area to be a disaster area. If the property destroyed in a presidentially declared disaster area is the taxpayer's principal residence and the casualty results in a gain, the taxpayer may exclude a portion of the gain if certain conditions are met (see Chapter I:12).

TOPIC REVIEW I:9-3

Casualty Losses

Type of Property	Limitation and Treatment
Personal use	The amount of the loss is the lesser of the property's adjusted basis or the reduction of the asset's FMV. This amount is reduced by any insurance reimbursement. If the insurance reimbursement exceeds the property's basis, a gain is realized. To the extent the property is insured, the taxpayer must file a claim or the loss is disallowed.
	The amount of loss incurred in each separate casualty event during the year is reduced by $100.
	All casualty gains and losses for the year are netted. Gains are netted against casualty losses that are not related to a federal disaster first. Any remaining disaster losses unrelated to a federal disaster are not deductible. Any remaining losses that are related to a federal disaster are reduced by 10% of AGI. Any remaining loss is deducted.
Business or investment	If the property is totally destroyed, the amount of the loss is the adjusted basis of the property. If only partially destroyed, the amount of the loss is the lesser of the property's adjusted basis or the reduction of the asset's FMV. This amount is reduced by any insurance reimbursement. A gain is realized if the insurance reimbursement exceeds the property's basis.
	For property held one year or less, the losses and gains are ordinary losses and gains. For property held over one year, the casualty gains and losses for the year are netted. The treatment depends on the total of the taxpayer's other Sec. 1231 transactions (see Chapter I:13). Business casualty losses and losses on investment property that generate rents or royalties are not subject to the $100 or 10% of AGI limitations.

Bad debts

OBJECTIVE 5

Compute the deduction for a bad debt

In addition to losses on property, taxpayers may also sustain losses because of uncollectible debts. In dealing with a deduction for **bad debts**, taxpayers must address the following requirements and issues:

- A bona fide debtor-creditor relationship must exist between the taxpayer and some other person or entity.
- The taxpayer must have basis in the debt.
- The debt must actually have become worthless during the year.
- The type and timing of a bad debt deduction depend on whether the debt is a business or nonbusiness bad debt.

ADDITIONAL COMMENT

The tax provisions that deal with deductions for losses and the tax provisions that deal with the deductions for bad debts are mutually exclusive, and an amount properly deductible as a loss cannot be deducted as a bad debt or vice versa.

Generally, taxpayers may use only the specific write-off method of accounting when deducting the bad debt. A partial or complete recovery of a debt that was previously deducted may occur. In many cases a recovery of this type causes income recognition in the year of the recovery.

BONA FIDE DEBTOR-CREDITOR RELATIONSHIP

Only items constituting bona fide debt are eligible to be deducted as a bad debt. A **bona fide debt** is one that arises from a valid and enforceable obligation to pay a fixed or determinable sum of money and results in a debtor-creditor relationship.[48]

KEY POINT

The fact that the debtor is a related party does not preclude deduction of a bad debt, but the taxpayer must be able to document the debt as being bona fide.

Related-Party Transactions. Determining whether a bona fide loan transaction has actually taken place is especially critical when the transaction is between the taxpayer and a family member or other related party (e.g., a controlled corporation). The tax advisor must carefully examine all the facts and circumstances surrounding the transaction because a gift does not constitute a debt. The taxpayer's intent is critical. For example, if the taxpayer's intent is to provide property, cash, or services to someone else without receiving

[48] Reg. Sec. 1.166-1(c).

any consideration in return, a gift—not a loan—has been made. Some tests used to determine the taxpayer's intent include the following:

- Does a note or other written instrument exist which evidences an obligation to repay?[49]
- Have the parties established a definite schedule of repayment?
- Have the parties documented a stated reasonable rate of interest?
- Would a person unrelated to the debtor make the loan?[50]

EXAMPLE I:9-31 ▶ During the current year Maria loaned $20,000 to her son Sam, who used the money in his business. Although they signed no written note or contract, Sam orally promised to repay Maria as soon as his business became profitable. No rate of interest was stated. Unfortunately, the business failed and Sam went out of business in the subsequent year. He never repaid the loan principal or interest.

In this case, no valid debt exists because the taxpayer did not establish an interest rate or a repayment schedule. An unrelated person would not have made a loan to Sam under these conditions. In addition, Maria does not receive any consideration in return for the "loan." Since the facts indicate that the transaction is actually a gift, Maria may not claim a bad debt deduction because of Sam's failure to repay. ◀

REAL-WORLD EXAMPLE

A taxpayer advanced $8,500 to his son-in-law who operated a livestock auction barn. The taxpayer was entitled to a bad debt deduction upon default because notations on the checks indicated that they were loans and undisputed testimony indicated that repayment was to be made within 90 days. *Giffin A. Andrew*, 54 T.C. 239 (1970).

Tax advisors should also closely examine other related party transactions. For example, a loan from a shareholder to a controlled corporation may actually be an additional contribution to capital disguised as a loan. Thus, a transfer of cash by a shareholder who owns a controlling (i.e., more than 50%) interest in the stock of a corporation may indicate a capital contribution rather than a loan. Likewise, a "loan" from a corporation to a controlling shareholder may actually be a disguised dividend or a salary payment.

Third Party Debt. In some cases a taxpayer will guarantee or endorse someone else's obligation. If under the terms of the guarantee, the guarantor is required to pay the debtor's remaining outstanding principal as well as any accrued interest on the debt, the relationship between the debtor and the guarantor as well as the terms of the guarantee must be carefully analyzed. The guarantor's intent determines whether the guarantee and subsequent payment of the outstanding principal and accrued interest constitutes a gift to the debtor. If the guarantor's intent was a gift, the guarantor may not deduct the payment of the outstanding principal and accrued interest. On the other hand, if the guarantor can prove that the guarantee was not a gift, the guarantor may deduct the principal and accrued interest as a bad debt issued to the debtor at the time of the payment.

EXAMPLE I:9-32 ▶ Ron is the sole shareholder and a full-time employee of Zip Corporation. For Zip Corporation to obtain a bank loan, Ron personally signs a guarantee that the loan will be repaid. Unfortunately, Zip Corporation defaults on the loan and Ron must repay the loan. Assume proof exists that Ron signed the guarantee to preserve his job and enhance his investment in Zip Corporation. Although Ron receives no direct consideration for having signed the note, he does receive indirect consideration in the form of continued job security and protection of his investment. Because a business or investment purpose motivated Ron to sign the loan guarantee, Ron may deduct the bad debt. On the other hand, without proof, this guarantee and subsequent payment of Zip Corporation's debt by Ron may be seen as merely an additional capital contribution by Ron to Zip Corporation. ◀

TAXPAYER'S BASIS IN THE DEBT

For a bad debt to be deductible, the creditor must have basis in the debt. The taxpayer may acquire this basis in different ways. If a taxpayer loans money, the taxpayer's basis in the debt is the amount loaned. If the debt arises because the taxpayer provides property or

[49] A written note or other instrument is an evidence of a bona fide debtor-creditor relationship. However, if the note or other instrument is registered or has interest coupons and is issued by a corporation or a government, the bad debt provisions of Sec. 166 do not apply. Instead, the worthless security provisions of Sec. 165 (previously discussed) apply.

[50] *Jean C. Tyler v. Tomlinson*, 24 AFTR 2d 69-5426, 69-2 USTC ¶9559 (5th Cir., 1969). See also, *C. L. Hunt*, 1989 PH T.C. Memo ¶89,335, 57 TCM 919, where certain loans that the taxpayer made to his children were treated as bona fide loans, whereas others were treated as gifts. In that case, the children had been trading in silver futures and were required to make margin calls. Because they could not make the calls, the children's positions were involuntarily liquidated. Up to the date of the liquidation, the taxpayer had made loans to the children that were payable on demand and were subject to the prime rate of interest. These loans were evidenced by promissory notes. After the liquidation, the taxpayer continued to make loans to the children. However, these loans were not evidenced by notes. The loans up to the time of the liquidation were treated as bona fide loans and the subsequent loans were treated as gifts.

TYPICAL MISCONCEPTION

Taxpayers sometimes mistakenly assume that a cash method taxpayer can take a bad debt deduction on a debt that arose from services rendered by the taxpayer.

services for the other party, basis is established only if the taxpayer has previously included the FMV of the property or services in income. This often depends on the taxpayer's method of accounting. An accrual method taxpayer generally reports income in the year the services are performed or the property is provided. (See the discussion in Chapter I:11.) Thus, an accrual method taxpayer has a basis in either a note receivable or an open account receivable equal to the amount included in gross income (i.e., the FMV of the services). A cash method taxpayer, however, reports income only in the year in which the taxpayer receives payment in the form of cash or property. Because a note constitutes the receipt of property, a cash method taxpayer reports income (and establishes basis) in the year the note is received. However, if the cash method taxpayer does not receive a note and the receivable is an open account item, the taxpayer reports no income until the receivable is collected. Thus, the taxpayer has no basis in the receivable and does not receive a bad debt deduction if the receivable is not collected.

EXAMPLE I:9-33 ▶ In October of the current year, Jim performs some legal services for Joy. Jim bills Joy for $10,000. Joy does not sign a note for the debt. As a cash method taxpayer, Jim does not include the $10,000 in his current year's income. After repeated efforts to collect the fee, Jim discovers in June of the subsequent year that Joy has left the city and cannot be found. Jim may not deduct a bad debt for the uncollected amount in the subsequent year because he has not taken the amount into income and he has no basis in the debt. If Joy had signed a note for the debt, Jim would have reported income in the current year in an amount equal to the note's FMV. Thus, Jim can deduct the loss when the note becomes uncollectible in the subsequent year. ◀

ADDITIONAL COMMENT

Because in many cases it is difficult to pinpoint the exact time of worthlessness, the statute of limitations is extended to seven years for bad debts.

DEBT MUST BE WORTHLESS

To deduct a bad debt, the taxpayer must show that the debt is worthless. This determination is made by reference to all the pertinent evidence, including the general financial condition of the debtor and whether the debt is secured by collateral.

In proving the worthlessness of a debt, a taxpayer does not need to take legal action if the surrounding circumstances indicate that legal action probably would not result in the collection of the debt. By simply showing that legal action is not warranted, the taxpayer provides sufficient proof that the debt is worthless.[51] Indications that an unsecured debt is worthless include bankruptcy of the debtor, disappearance or death of a debtor, and repeated unsuccessful attempts at collection. Furthermore, if the surrounding circumstances warrant it, a taxpayer may deduct a worthless debt even before the debt comes due. As will be explained later in this chapter, a nonbusiness debt must be totally worthless before a deduction is allowed. However, a current deduction is allowed for a partially worthless business bad debt.

KEY POINT

Taxpayers must distinguish between business and nonbusiness bad debts because the tax treatment varies according to the type of debt.

NONBUSINESS BAD DEBTS

The distinction between a business bad debt and a nonbusiness bad debt is important because the classification of the debt determines its tax treatment. A business bad debt gives rise to an ordinary deduction, whereas a taxpayer must treat a nonbusiness bad debt as a short-term capital loss. All loans made by a corporation are assumed to be associated with the corporation's business; therefore, the provisions for nonbusiness bad debts do not apply to corporations.

TYPICAL MISCONCEPTION

Assume that a taxpayer lends money to a friend to be used in the friend's business. If the friend does not repay the loan, the debt is a nonbusiness bad debt unless the taxpayer is in the business of lending money. This type of debt is occasionally improperly classified as a business debt.

Definition of a Nonbusiness Bad Debt. A *nonbusiness debt* is defined as any debt other than (1) a debt created or acquired in connection with a trade or business of the taxpayer or (2) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. This determination depends on an examination of the facts and circumstances surrounding the debt in question.

A debt incurred in a taxpayer's business continues to be a business debt for that taxpayer even if, at the time the debt goes bad, the taxpayer has ceased conducting that particular business (situation (1) above). If another taxpayer acquires a business,

[51] Reg. Sec. 1.166-2.

any outstanding debt at the time the business is acquired continues to be business debt as long as the purchaser continues the business (situation (2) above). The debt is a nonbusiness debt if the person who owns the debt when it becomes worthless is not engaged in the business in which the debt is incurred either at the time the debt arose or when it becomes worthless.

EXAMPLE I:9-34 ▶ Matt, an individual who uses the accrual method of accounting, is engaged in the grocery business. During 2019, he extends credit to Jeff on an open account. In 2020, Matt sells his business to Joan, but retains Jeff's account. Jeff's account becomes worthless in 2020. Even though Matt is no longer engaged in the grocery business at the time the debt becomes worthless, he may deduct the loss as a business bad debt in 2020. If Joan purchases Jeff's account upon acquiring the grocery business, Joan is entitled to a business bad debt deduction in 2020 because the debt was incurred in the trade or business in which Joan is currently engaged. ◀

In addition, classification as a business debt requires a proximate relationship between the loan and the taxpayer's business.[52] According to the Supreme Court, this relationship exists if a business motive is the taxpayer's dominant motivation in making the loan. This determination must be made on a case-by-case basis. For example, when an individual stockholder who is also an employee of the corporation loans money to the corporation, is the loan a business or nonbusiness debt? Because an employee is considered to be engaged in the business of working for a corporation, a loan made to the corporation in an attempt to protect the employment relationship may be held to be a business debt. However, if the individual's dominant motive is to protect his or her stock investment, the loan is a nonbusiness debt.[53]

EXAMPLE I:9-35 ▶ Lisa is an individual engaged in the advertising business. If clients occasionally need additional funds to meet their cash-flow obligations, Lisa sometimes lends them money. Lisa's dominant motive for making the loans is to retain the clients. She has no ownership interests in these clients. Under these facts, if any of these loans becomes worthless, it would likely be considered a business bad debt.[54] ◀

Tax Treatment. Individuals deduct nonbusiness debts that become wholly worthless during the year as short-term capital losses. The length of time the debt is outstanding has no bearing on this treatment.

Individuals generally prefer an ordinary deduction rather than a short-term capital loss because capital losses are first used to offset capital gains. If the capital losses exceed the capital gains, the individual taxpayer is limited to an additional $3,000 tax deduction each year. Any loss in excess of this limit is carried over to subsequent years to be included in the capital gain and loss netting process in those years (see Chapter I:5).

EXAMPLE I:9-36 ▶ During 2019, Kim loaned her friend $10,000. The friend used the funds to invest in commodity futures. The transaction had all the characteristics of a bona fide debt rather than a mere gift to a friend. Unfortunately, the commodities market prices declined, and Kim's friend incurred substantial losses. In 2020, Kim's friend declared personal bankruptcy and Kim was unable to collect any of the loan. Kim did not recognize any other capital gains or losses during 2020. The $10,000 bad debt loss recognized in 2020 is treated as a short-term capital loss. Thus, Kim may deduct only $3,000 in 2020. The remaining $7,000 is carried forward indefinitely to 2021 and subsequent years. ◀

TYPICAL MISCONCEPTION

Partial worthlessness means that a debt is still partially recoverable. The term is sometimes erroneously applied to debt where there has been a partial recovery even though there is no prospect for further recovery.

Partial Worthlessness. As previously noted, taxpayers may not deduct a partially worthless nonbusiness debt. Thus, a taxpayer cannot deduct a loss for a nonbusiness debt that is still partially recoverable during the year.

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[52] Reg. Sec. 1.166-5(b)(2).

[53] *John M. Trent v. CIR*, 7 AFTR 2d 1599, 61-2 USTC ¶9506 (2nd Cir., 1961). See also *Charles L. Hutchinson*, 1982 PH T.C. Memo ¶82,045, 43 TCM 440 and *U.S. v. Edna Generes*, 29 AFTR 2d 72-609, 72-1 USTC ¶9259 (USSC, 1972).

[54] *Stuart Bart*, 21 T.C. 880 (1954), *acq*. 1954-1 C.B. 3.

EXAMPLE I:9-37 ▶ Gordon, an individual, made a $5,000, five-year interest-bearing loan to a small company in 2017. Gordon was not in the trade or business of making commercial loans. In 2019, Gordon received word from the attorney who was appointed trustee of the company that bankruptcy proceedings had been filed. The trustee indicated that, although final disposition of the case will not occur until 2020, Gordon can reasonably expect to receive only 20 cents for every $1 invested. Because this is a nonbusiness bad debt that is still partly recoverable in 2019, Gordon may not deduct the partial loss as a short-term capital loss in 2019 and must wait until 2020 when the case is finally settled to deduct the nonbusiness bad debt. ◀

BUSINESS BAD DEBTS

The tax treatment of losses from business bad debts differs substantially from the treatment of nonbusiness bad debts. As previously discussed, a business bad debt provides an ordinary loss deduction. Furthermore, taxpayers may also deduct a business debt that has become only partially worthless during the year.

EXAMPLE I:9-38 ▶ Assume the same facts as in Example I:9-37 except that Gordon's loan is made for business reasons (e.g., to provide assistance to a customer in financial difficulty). Because 80% of the loan is reasonably expected to be unrecoverable during 2019, Gordon may deduct $4,000 (0.80 × $5,000) as an ordinary loss in 2019. If Gordon receives only $600 in 2020 as a settlement, he may deduct an additional $400 of ordinary loss for the year. ◀

BOOK-TAX DIFFERENCES

In general, for tax purposes, taxpayers can use only the specific write-off method of accounting for bad debts. However, a corporation or other taxpayer would probably be required to use the reserve method for financial reporting purposes. This book-tax difference is one of the most common M-1 or M-3 adjustments in filing a Form 1120 for corporate taxpayers.

Accounting for the Business Bad Debt. In general, two basic methods are available to account for business bad debts: the specific write-off method and the reserve method. Except for certain specialized industries, however, taxpayers can use only the specific write-off method for tax purposes. Under the **specific write-off method**, the taxpayer deducts each bad debt individually as it becomes worthless and the taxpayer writes it off as an expense. Taxpayers use this method for (1) business bad debts that are either totally or partially worthless and (2) nonbusiness bad debts that are totally worthless. However, as previously noted, taxpayers take no deduction for partially worthless nonbusiness bad debts.

In the case of a partially worthless business bad debt, taxpayers may only deduct the worthless part of the debt. The taxpayer must prove to the satisfaction of the IRS the amount of the debt that has become worthless.

Recovery of Bad Debts. A taxpayer may collect a debt that was previously written off for tax purposes. Since the taxpayer previously deducted the uncollectible debt, the taxpayer must report the recovery as income in the year it is collected. The amount of the income that must be reported depends on the tax benefit rule discussed in Chapter I:4.

DEPOSITS IN INSOLVENT FINANCIAL INSTITUTIONS

At their election, qualified individuals may treat a loss on deposits in qualified bankrupt or insolvent financial institutions as a personal casualty loss in the year in which the individual can reasonably estimate the loss. The recognized loss is the difference between the taxpayer's basis in the deposit and a reasonable estimate of the amount that the taxpayer will receive. This treatment allows the individual an ordinary loss deduction, but subjects the loss to the personal casualty loss limitations.

Qualified financial institutions include banks, federal or state chartered savings and loans and thrift institutions, and federal or state insured credit unions.

This election applies to all losses sustained by the individual in the same institution and cannot be revoked unless the taxpayer receives IRS permission.

The treatment of business and nonbusiness bad debts for non-corporate taxpayers is summarized in Topic Review I:9-4.

TOPIC REVIEW I:9-4

Bad Debts

Type of Debt	Results
Nonbusiness	Deductible as a short-term capital loss. Deductible only when the debt is totally worthless. The taxpayer must have basis in the debt.
Business	Deductible as an ordinary loss. Except for certain specialized exceptions, the specific write-off method must be used. The reserve method is not available. May deduct partial worthlessness. Must have basis in the debt.

Net operating losses

OBJECTIVE 6

Compute a net operating loss deduction

A **net operating loss** (**NOL**) under Sec. 172 generally involves only business income and expenses. An NOL occurs when taxable income for any year is negative because business expenses exceed business income. A deduction for the NOL arises when a taxpayer carries the NOL to a year in which the taxpayer has taxable income. Thus, an NOL for one year becomes a deduction against taxable income in a subsequent year.

The NOL deduction is intended to mitigate the inequity caused by the interaction of the progressive rate structure and the requirement to report income on an annual basis. This inequity arises between taxpayers whose business income fluctuates widely from year to year and those whose business income remains relatively constant.

EXAMPLE I:9-39 ▶

KEY POINT

If taxpayers were not entitled to a deduction for net operating losses, taxpayers would actually pay a tax on an amount that exceeded their economic income over a period of time. The NOL deduction permits taxpayers to offset taxable income with losses incurred in other years.

John and Julie Jones and Ken and Karen Smith are both married couples and file joint returns. Over a two-year period they both report a total of $140,000 in taxable income. However, John and Julie report $70,000 of taxable income each year; Ken and Karen report $60,000 of loss in the first year and $200,000 of income in the second year. Without the NOL provisions and using the 2019 tax rates for both years, John and Julie will report a $16,024 ($8,012 + $8,012) total tax liability for the two years, whereas Ken and Karen will report a total tax liability of $22,517 on their taxable income of $140,000 ($200,000 – $60,000) in the second year.[55] Although the total tax liability over the two years for the two couples is still unequal ($16,024 for the Joneses, and $22,517 for the Smiths), the ability to carry over NOLs substantially reduces the difference and helps provide some degree of fairness. ◀

COMPUTING THE NET OPERATING LOSS FOR INDIVIDUALS

ADDITIONAL COMMENT

In computing the NOL for corporations, only minor adjustments are necessary.

The starting point in calculating an individual's NOL is generally taxable income. As mentioned earlier in this chapter, individuals may deduct three basic types of expenses to arrive at the amount of taxable income: business-related expenses, investment-related expenses, and certain personal expenses. The NOL, however, generally attempts to measure only the economic loss that occurs when business expenses exceed business income. Thus, individual taxpayers must make several adjustments to taxable income to arrive at the amount of the NOL for any particular year. These include adjustments for an NOL deduction, a capital loss deduction, the deduction for personal exemptions, and the excess of nonbusiness deductions over nonbusiness income.

ADDITIONAL COMMENT

If taxpayers were permitted to calculate the NOL for the current year by including NOL carryovers from earlier years, they could possibly extend the carryover period beyond the statutorily established 20-year carryforward period allowed for losses before January 1, 2018.

Add Back any NOL Deduction. Under certain circumstances, a taxpayer might have taken a deduction for an NOL arising from another tax year in computing the taxable loss for the current loss year. Allowing this deduction to create or increase the NOL of the current loss year would provide an unwarranted benefit. Thus, taxable income for the current loss year must be increased for this deduction.

[55] Using the 2019 tax rate schedules for both years.

Add Back any Capital Loss Deduction. To compute taxable income, individuals may deduct up to a maximum of $3,000 capital losses in excess of capital gains in any year. Any capital loss in excess of this limit can be carried over and deducted in a subsequent tax year, subject to the same limitation. Because capital losses have their separate carryover provisions, taxpayers must add back any deduction associated with these losses to taxable income to arrive at the NOL for the current loss year. To make this adjustment, the taxpayer must follow several steps:

Step 1. A taxpayer must separate nonbusiness capital gains and losses from business capital gains and losses. The nonbusiness gains and losses are then netted, while the business gains and losses are netted separately.

Step 2. If the nonbusiness capital gains exceed the nonbusiness capital losses, the excess, along with other types of nonbusiness income, is first used to offset any nonbusiness ordinary deductions. Any nonbusiness capital gain remaining is then used to offset any business capital loss in excess of the business capital gain for the year.[56]

Step 3. If both groups of transactions result in net losses, the capital loss deduction provided by these transactions must be added back. For purposes of the NOL, no deduction is allowed for either business or nonbusiness net capital losses.

Step 4. If the taxpayer's nonbusiness capital losses exceed the nonbusiness capital gains, the losses may not be offset against the taxpayer's excess business capital gains. Allowing this offset would provide an indirect deduction for a nonbusiness economic loss.[57]

EXAMPLE I:9-40 ▶ During the current year, Nils recognizes a short-term capital loss of $10,000 on the sale of an investment capital asset. He also recognizes a $5,000 long-term capital gain on the sale of a business capital asset. For taxable income purposes, the loss is netted against the gain, leaving a $5,000 net short-term capital loss. This loss provides a $3,000 deduction from taxable income, with the remaining $2,000 being carried forward to the following year. To compute the NOL, however, none of the $10,000 nonbusiness capital loss is deductible. Thus, the $3,000 deduction as well as the $5,000 loss that offset the business capital gain must be added back because in computing taxable income the taxpayer, in essence, has received a total $8,000 reduction from the nonbusiness capital loss. ◀

PRE-2018 LAW

Individual taxpayers were allowed a deduction for personal and dependency exemptions prior to December 31, 2017. The exemptions had to be added back to arrive at the year's NOL.

ADDITIONAL COMMENT

An excess of nonbusiness deductions over nonbusiness income cannot increase the NOL. However, an excess of nonbusiness income over nonbusiness expenses can reduce the NOL.

Add Back Excess of Nonbusiness Deductions over Nonbusiness Income. Because nonbusiness deductions do not reflect an economic loss from business, they are not deductible in arriving at the NOL. However, these deductions do offset any nonbusiness income reported during the year. Nonbusiness income includes sources of income such as dividends and interest, as well as nonbusiness capital gains in excess of nonbusiness capital losses. Wages and salary, even if they are earned in part-time employment, are considered business income. Nonbusiness deductions include itemized deductions such as charitable contributions, medical expenses, and nonbusiness interest and taxes. Casualty losses on personal-use assets, however, are treated as business losses and are excluded from this adjustment.[58] If a taxpayer does not have itemized deductions in excess of the standard deduction, the standard deduction is used as the amount of the nonbusiness deductions.

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[56] Reg. Sec. 1.172-3. If the nonbusiness deductions exceed the nonbusiness income, the excess is added back. This adjustment is discussed later in the chapter.

[57] Sec. 172(d)(2). Note that all deductible nonbusiness capital losses involve investment property because capital losses on personal-use assets are not deductible in arriving at taxable income. To make the adjustment for any capital loss, the exclusion under Sec. 1202 for gains from small business stock is not allowed (see Chapter I:5).

[58] Sec. 172(d)(4)(C).

Following are several independent examples demonstrating these required adjustments. In each case, assume that Nancy is a single taxpayer.

EXAMPLE I:9-41 ▶ During 2019, Nancy, who is single, reports the following taxable income:

Gross income from business			$123,000	
Minus:	Business expenses		(147,000)	($24,000)
Plus:	Interest income			700
	Dividend income			400
AGI				($22,900)
Minus:	Greater of itemized deductions or standard deduction:			
	Interest expense		$ 6,000	
	Taxes		7,000	
	Casualty loss (reduced by the $100 floor)		1,000	
	Total itemized deductions		$ 14,000	
			or	
	Standard deduction		12,200	(14,000)
Taxable income				($36,900)

Nancy's NOL for the year is computed as follows:				
Taxable income				($36,900)
Nonbusiness deductions:				
Itemized deductions		$14,000		
Minus:	Casualty loss	(1,000)	$ 13,000	
Minus:	Nonbusiness income:			
	Interest	$700		
	Dividends	400	(1,100)	
Plus:	Excess of nonbusiness deductions over nonbusiness income			11,900
Net operating loss				($25,000)[a] ◀

[a]Note that the NOL equals the total of the $24,000 net business loss and the $1,000 casualty loss.

EXAMPLE I:9-42 ▶ During 2019, Betsy, who is single, reports the following taxable income:

Gross income from business			$123,000	
Minus:	Business expenses		(147,000)	($24,000)
Plus:	Interest income			700
	Dividend income			400
AGI				($22,900)
Minus:	Greater of itemized deductions or standard deduction:			
Interest expense			$ 2,000	
			or	
Standard deduction			12,200	(12,200)
Taxable income				($35,100)

Betsy's NOL for the year is computed as follows:				
Taxable income				($35,100)
Nonbusiness deductions:				
Standard deduction			$ 12,200	
Minus:	Nonbusiness income:			
	Interest	$ 700		
	Dividends	400	(1,100)	
Plus:	Excess of nonbusiness deductions over nonbusiness income			11,100
Net operating loss				($24,000)[a] ◀

[a]Note that the NOL equals the net business loss for the year.

EXAMPLE I:9-43 ▶ During 2019, Rachael, who is single, reports the following taxable income:

Gross income from business			$123,000	
Minus:	Business expenses		(147,000)	($24,000)
Plus:	Interest income			700
	Dividend income			400
	Salary			6,000
	Nonbusiness LTCG			14,000
AGI				($2,900)
Minus:	Greater of itemized deductions or standard deduction:			
	Interest expense		$ 6,000	
	Taxes		7,000	
Casualty (reduced by the $100 floor)			1,000	
Total itemized deductions			$ 14,000	
			or	
Standard deduction			12,200	(14,000)
Taxable income				($16,900)
Rachael's NOL for the year is computed as follows:				
Taxable income				($16,900)
Plus:	Nonbusiness deductions:			
	Itemized deductions	$14,000		
Minus:	Casualty loss	(1,000)	$ 13,000	
Minus:	Nonbusiness income:			
	Interest	$700		
	Dividends	400		
	LTCG	14,000	(15,100)	
Excess of nonbusiness deductions over nonbusiness income				0
Net operating loss				($16,900)[a] ◀

[a]Note that the NOL can also be calculated as follows:

Loss from business	($24,000)
Salary	6,000
Casualty loss	(1,000)
Excess of nonbusiness income ($15,100) over nonbusiness deductions ($13,000)	2,100
NOL	($16,900)

CARRYOVER PERIODS

NOLs arising from non-farming businesses after December 31, 2017 are allowed to be carried forward indefinitely.[59] The amount that can be deducted in a following year is limited to the lesser of the aggregate net operating losses carried over or 80% of taxable income computed before any NOL deduction is taken.

EXAMPLE I:9-44 ▶ During 2019, Sue has a NOL of $50,000 that she can carry forward. In the following year, 2020, Sue has taxable income of $60,000. Sue carries the NOL to 2020 and can deduct the lesser of:

1. the NOL carryforward of $50,000, or
2. 80% of taxable income before the NOL. In this case 80% × $60,000 = $48,000.

So Sue will be able to deduct $48,000 of the NOL in 2020, but will need to carry forward the remaining $2,000 of NOL from 2019 to future years. ◀

PRE-2018 LAW

NOLs arising before January 1, 2018 were allowed to be carried back 2 years and carried forward 20 years.

[59] For NOLs arising in a farming business, in a qualified small business attributable to a Presidentially declared disaster, or in a casualty or theft sustained by an individual, the carryback period is extended to three years. These NOLs are taken after the regular NOL. Certain "specified liability losses" are entitled to a ten-year carryback. Sec. 172(b)(1)(C) and (f).

TOPIC REVIEW I:9-5

Net Operating Losses

Item	Rules
Computation of NOL (adjustments to taxable income)	Add back any NOL deduction carried to the current year.
	Add back any capital loss deduction. Add back the excess of nonbusiness deductions over nonbusiness income. For this purpose, casualty losses on personal-use property are treated as business losses.
Carryover period	May be carried forward indefinitely.
Income limitation	NOL deduction is limited to 80% of taxable income.

Excess business losses

OBJECTIVE 7

Compute the excess business loss limitation

For taxable years beginning after December 31, 2017, a noncorporate taxpayer is not allowed to deduct any excess business losses.[60] Any excess losses are carried forward and are treated as a part of the taxpayer's NOL. An excess business loss is the excess of aggregate business deductions for the year over the sum of a taxpayer's aggregate business gross income and gains plus $255,000 if single and $510,000 if married in 2019 ($250,000/$500,000 in 2018). The excess business loss limitations for partnerships and S corporations are applied at the partner or shareholder level. This limitation is applied to passive activities after the application of the passive loss rules.

EXAMPLE I:9-45 ▶ During 2019, Tim, who is single, reports the following income/loss from his business activities:

Gross income from sole proprietorship	$ 2,500,000
Gross expenses from sole proprietorship	($2,200,000)
Net loss from ABC Partnership	($ 785,000)

Tim's excess business loss is $235,000, calculated as follows:

Business deductions ($2,200,000 + $785,000)	$ 2,985,000
Business income plus $255,000 ($2,500,000 + $255,000)	–$ 2,755,000
Excess Business Loss	$ 230,000

$235,000 of business losses are disallowed and will become an NOL carryover. ◀

Tax planning considerations

OBJECTIVE 8

Identify tax planning considerations for losses and bad debts

BAD DEBTS

To deduct a bad debt, a taxpayer must show that the debt is worthless. At times the IRS might assert that the debt being written off is either not yet worthless or that it became worthless in a previous year. If the taxpayer is unable to overcome the IRS's assertion concerning the year of worthlessness, the taxpayer might be barred from filing

[60] Sec. 461(l).

an amended return for the prior year because of the statute of limitations.[61] Thus, taxpayers should carefully document all efforts at collection and other facts that show the debt is worthless.

KEY POINT

If uncertainty exists as to the year in which a debt became worthless, the issue may not be settled within the normal three-year statute of limitations. For this reason, a taxpayer may claim a deduction for a worthless debt at any time within seven years.

As previously mentioned, a third-party guarantor of a loan who is required to repay the debt may, under certain circumstances, be entitled to a bad debt deduction. The guarantor must demonstrate that he or she received reasonable consideration in the form of cash or property in exchange for guaranteeing the debt. If the taxpayer does not receive proper consideration, the guarantee and subsequent payment of the loan by the guarantor is considered to be a gift rather than a loan. Reasonable consideration is also deemed to be received if the taxpayer enters into the agreement for a good faith business purpose or in accordance with normal business practice. However, if the taxpayer guarantees the debt of a spouse or a relative, the taxpayer must receive the consideration in the form of cash or property.

In the case of an outright loan between related taxpayers, the lender should always make sure to retain proper documentation to substantiate the fact that the transaction is a loan. If the taxpayer does not keep such documentation, the IRS may assert that the transaction is a gift.

CASUALTIES

A deduction is allowed for stolen property, but no deduction is allowed for lost property. Thus, taxpayers should always carefully document losses of property through theft (e.g., the filing of police reports or claims with the taxpayer's insurance company). In addition, pictures and written appraisals may be helpful to prove the amount of the loss.

Compliance and Procedural Considerations

OBJECTIVE 9

Identify compliance and procedural considerations for losses and bad debts

CASUALTY LOSSES

If a taxpayer sustains a casualty loss in a location that the President of the United States declares a disaster area, he or she may make an election to deduct the loss in the year preceding the year in which the loss occurred. A taxpayer makes this election by either filing the return for the previous year and including the loss in that year (if the return has not already been filed) or filing an amended return or claim for refund for that year.[62] The return should clearly include all the following information:

ADDITIONAL COMMENT

Instant access for downloading federal income tax forms, instructions, publications, etc. is available on the Internet (http://www.irs.gov).

- That the election is being made
- The date of the disaster giving rise to the loss
- The city, county, and state in which the damaged property is located

The taxpayer must make the election before the due date of the return for the year in which the disaster actually occurs. Although the Regulations state that the election may not be revoked more than 90 days after it is made, the Tax Court has held that this part of the Regulation is invalid.[63]

WORTHLESS SECURITIES

As explained earlier in this chapter, securities that become worthless during the taxable year are deemed to have become worthless on the last day of the year. In many cases,

[61] However, the statute of limitations for claims for a refund or credit because of a bad debt is extended from three years to seven years under Sec. 6511(d)(1), thus giving the taxpayer additional time if this is the case.

[62] Sec. 165(i).

[63] *Chester Matheson*, 74 T.C. 836 (1980), *acq.* 1981-2 C.B. 2.

this treatment causes the loss to be treated as a long-term capital loss. If the loss from the worthless security is long term, the taxpayer reports it in Part II of Schedule D (Form 1040) along with the other long-term gains and losses for the year. The taxpayer reports short-term capital losses in Part I of Schedule D.

WHAT WOULD YOU DO IN THIS SITUATION?



A client comes to you with an idea to treat a loan that he made to one of his children two years ago as a bad debt. The loan is evidenced by a properly executed note with stated interest and payment dates. However, the client has not collected any loan payments or interest during the two-year period. The child is insolvent and has declared bankruptcy. Before leaving your office, the client also mentions in passing that the child is in London on vacation with other members of the family and will stay in Europe for six weeks. What would you do about classifying this loan as a bad debt?

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:9-1 What is the closed transaction doctrine, and why does it exist for purposes of recognizing a loss realized on holding property?

I:9-2 When property is disposed of, what factors influence the amount of the deductible loss?

I:9-3 Describe the usual tax consequences that apply to a worthless security.

I:9-4 Under what circumstances will a loss that is realized on a worthless security not be treated as a capital loss?

I:9-5 What two general requirements must be met for a transaction to result in a capital loss?

I:9-6 What requirements must be met for stock to be considered Sec. 1244 stock?

I:9-7 What tax treatment applies to gains and losses on Sec. 1244 stock?

I:9-8 Describe a situation where a loss on the sale of business or investment property is not currently deductible, and explain why.

I:9-9
a. What is a passive activity?
b. Who is subject to the passive loss limitation rules?

I:9-10
a. For purposes of the passive loss rules, what is a closely held C corporation?
b. In what way do the passive loss rules differ from the regular passive loss rules when applied to closely held C corporations?

I:9-11 Why is it important to identify exactly what constitutes an activity for purposes of the passive activity rules?

I:9-12
a. If a taxpayer is involved in several different business operations during the year, how is the determination made as to how many activities these operations constitute for purposes of the passive activity loss rules?
b. Can a business operation and a rental operation ever be combined into one activity? Explain.

I:9-13 Which of the following activities are considered passive for the year? Explain. Consider each situation independently.
a. Laura owns a rental unit that she rents out to students. The rental unit is Laura's only business and she spends approximately 875 hours per year managing, collecting the rent, advertising, and performing minor repairs. At times she must hire professionals such as plumbers to do the maintenance. Is the rental unit a passive activity with respect to Laura?
b. Kami is a medical doctor who works four days a week in a medical practice that she and five other doctors formed. Last year she and her partners formed another partnership that owns and operates a medical lab. The lab employs ten technicians, one of whom also acts as manager. During the year Kami spent 120 hours in meetings, reviewing records, etc., for the lab. Is the lab a passive activity with respect to Kami?
c. Assume the same facts in part b. In addition, assume that the same group of doctors have formed two other partnerships. One is a medical supply partnership. Kami spent 150

hours working for this partnership. The medical supply partnership has five full-time employees. Kami also spent 250 hours during the year working for the other partnership. This partnership specializes in providing medical services to individuals from out of town who are staying at local hotels and motels. This partnership hires two full-time and six part-time nurses. Are the lab and the two other partnerships passive activities with respect to Kami?

I:9-14 Explain the difference between materially participating and actively participating in an activity. When is the active participation test used?

I:9-15 **a.** What requirements must be met in order for a taxpayer to deduct up to $25,000 of passive losses from rental real estate activities against active and portfolio income?
b. What requirements must be met in order for a real estate rental activity to be considered a real estate business that is not subject to the passive loss rules?

I:9-16 Are the losses suspended under the passive loss rules lost forever? Explain.

I:9-17 What tests must be met to qualify a loss as deductible under the casualty loss provisions? Discuss the application of each of these tests.

I:9-18 Explain how a taxable gain on property can be realized because of a casualty event such as a fire or theft. How are these gains treated?

I:9-19 During the current year, Rulon's toilet overflowed due to a pipe breaking during a nationally declared earthquake disaster. Rulon was at work when the earthquake hit, and by the time he returned, the water had flooded the basement, causing damage to the carpet, walls, and ceiling. The cost of repairing the damage was $9,000. Rulon has homeowners insurance that will cover half of the damage. However, because he has already had claims this year, Rulon does not want to report the incident to his insurance company for fear of a large increase in insurance rates. Instead, Rulon wants to deduct the loss as a casualty loss on his tax return. His AGI for this year is $50,000, and he has other itemized deductions of $6,000. Rulon is single. What amount of the casualty loss may he deduct?

I:9-20 Compare and contrast the computational rules for deducting casualty losses on personal-use property with casualty losses incurred on business or investment property.

I:9-21 Under what circumstances may a loss arising from a casualty or theft be deducted in a year other than the year in which the loss occurs?

I:9-22 For individuals, how are casualty losses on personal-use property reported on the tax return? How are casualty losses on business property reported?

I:9-23 Is the $100 floor on personal-use casualty losses imposed on each individual loss item if more than one item of property is destroyed in a single casualty? Is the floor imposed before or after the casualty gains are netted against the casualty losses?

I:9-24 How are excess business losses calculated? Does the limitation apply to passive activities as well as nonpassive activities?

I:9-25 Sarah loans $50,000 to her best friend, John. John uses the money to open a pizza parlor next to the local high school. Three years later, when John still owed Sarah $15,000, John closed the pizza parlor and declared bankruptcy. Discuss the appropriate tax treatment for Sarah.

I:9-26 Dana is an attorney who specializes in family law. She uses the cash method of accounting and is a calendar-year taxpayer. Last year, she represented a client in a lawsuit and billed the client $5,000 for her services. Although she made repeated attempts, Dana was unable to collect the outstanding receivable. Finally, in November of the current year, she finds out that the individual has moved without leaving any forwarding address. Dana's attempts to locate the individual are futile. What is the amount of deduction that Dana may take with respect to this bad debt?

I:9-27 Under what circumstances may a taxpayer deduct a bad debt even though another party to the transaction is the creditor?

I:9-28 What is the definition of a nonbusiness debt? What is the character of the deduction for a nonbusiness bad debt?

I:9-29 How can individuals deduct a loss on a deposit in a qualified financial institution on their tax returns?

I:9-30 A taxpayer collects a debt that was previously written off as a bad debt. What tax consequences arise if the recovery is received in a subsequent tax year?

I:9-31 What is an NOL deduction, and why is it allowed?

I:9-32 List the adjustments to an individual taxpayer's negative taxable income amount that must be made in computing an NOL for the year. What is the underlying rationale for requiring these adjustments for individuals?

I:9-33 Can a casualty loss on a personal-use asset create or increase an NOL? Explain.

I:9-34 The Tax Cuts and Jobs Act changed the NOL carryover rules. Prior to the tax law change, taxpayers could carry back an NOL for 2 years and carry forward for 20 years. After the tax law change, taxpayers can carry forward the NOL indefinitely. Compare the advantages and disadvantages of the two sets of rules.

ISSUE IDENTIFICATION QUESTIONS

I:9-35 On January 12 of the current year, Barney Corporation, a publicly held corporation, files for bankruptcy. During the bankruptcy proceedings it is determined that creditors will only receive 10% of what they are owed and that the shareholders will receive nothing. Sheryl, a calendar-year taxpayer, purchased 1,000 shares of Barney Corporation common stock for $7,000 on February 22 of the prior year. What tax issues should Sheryl consider?

I:9-36 Five years ago, Cora incorporated Gold, Inc., by contributing $80,000 and receiving 100% of the Gold common stock. Gold, Inc. is engaged in a retail business. Cora is single. Gold experienced financial difficulties. On December 22 of the current year, Cora sold all of her Gold stock for $5,000. What tax issues should Cora consider?

I:9-37 As a result of a federally declared earthquake disaster, Evan crashed his automobile, doing $8,000 worth of damage. Fortunately, no one was injured. Since Evan received two speeding tickets during the past year, he is concerned about losing his insurance if he files an insurance claim. What tax issues should Evan consider?

I:9-38 Dan, a full-time employee of Beta, Inc., also owns 10% of its outstanding stock. The other 90% is owned by his three brothers. During the year, the president of Beta came to Dan, expressing grave concern about whether the company had the financial resources to remain in business. He mentioned specifically that a bank was threatening to force Beta to file bankruptcy if it didn't repay its $100,000 loan in full. After some negotiation, Dan agreed to loan Beta the $100,000 for one year until permanent financing could be obtained. A reasonable interest rate was set and a payment schedule was documented. Unfortunately, business did not improve, and Beta discontinued its business and did not repay the loan. What tax issues should Dan consider?

PROBLEMS

I:9-39 ***Section 1244 Losses.*** During the current year, Karen sells her entire interest in Central Corporation common stock for $22,000. She is the sole shareholder, and originally organized the corporation several years ago by contributing $89,000 in exchange for her stock, which qualifies as Sec. 1244 stock. Since its incorporation, Central has been involved in the manufacture of items that protect personal computers from static electricity. Unfortunately, this market is extremely competitive, and Central Corporation incurs substantial losses throughout its existence.

a. Assuming Karen is single, what are the amount and the character of the loss recognized on the sale of the Central Corporation stock?

b. Assuming Karen is married and files a joint return, what are the amount and the character of the loss recognized on the sale of the Central Corporation stock?

c. How would your answer to Part a change if Karen had originally purchased the stock from another shareholder rather than organizing the corporation?

d. How might Karen have structured the transaction in Part a to receive a greater tax advantage?

I:9-40 ***Amount and Character of Loss Transactions.*** On September 30 of the current year, Fox Corporation files for bankruptcy. At the time, it estimates that the total FMV of its assets is $725,000, whereas the total amount of its outstanding debt amounts to $950,000. Fox Corporation has been engaged in the resale of tax preparation and tax research-related books and software for several years.

a. At the time of the bankruptcy, Fox is owned by Randall, who purchased the stock from an investor for $250,000 several years ago. Randall is single. What are the amount and character of the loss sustained by Randall upon Fox's bankruptcy?

b. How would your answer to part a change if Randall originally organized Fox Corporation, capitalizing it with $250,000 of cash and assuming Fox qualifies as a small business corporation?

c. How would your answer to Part a change if Randall were a corporation instead of an individual?

d. How would your answer to Part b change if Randall were a corporation instead of an individual?

I:9-41 ***Amount and Character of Loss Transactions.*** Five years ago, Brian and his brother Boyd formed Stewart Corp., a golf apparel manufacturing corporation. At that time, Brian contributed $300,000 to the corporation in exchange for 50% of its stock. During the current

year, Brian needed some cash to purchase a golf course so he sold a third of his interest in Stewart Corp. for $85,000. He also sold stock in the following companies for the amounts indicated:

Corporation	*Sales Proceeds*	*Adjusted Basis*	*When Acquired*
IBM	$15,000	$10,000	52 months ago
Microsoft	25,000	45,000	18 months ago
Tidal Radio	32,000	12,000	7 months ago
Wavetable	20,000	26,000	4 months ago

During the year Brian hired a collection agency to collect a $14,000 loan he made to an old friend, which was due in full on January 1 of the current year. The agency found no trace of his friend. Also during the year, BTR Corporation, in which he owns stock, went bankrupt. His investment was worth $94,000 on January 1, he purchased it six years ago for $100,000, and he expects to receive only $8,000 in redemption of his stock. Finally, Brian's salary for the year was $114,000 for his work as an associate professor.

a. What are the net gains and losses from the above items and their character?

b. What is Brian's AGI for the year assuming he has no other items of income or deduction?

I:9-42 ***Passive Losses.*** In the current year Alice reports $150,000 of salary income, $20,000 of income from activity X, and $35,000 and $15,000 losses from activities Y and Z, respectively. All three activities are passive with respect to Alice and are purchased during the current year. What is the amount of loss that may be deducted with respect to each of these activities? Also compute the amount of loss that must be carried over for each activity.

I:9-43 ***Passive Losses.*** In the current year Clay reports income and losses from the following activities:

Activity X	$ 28,000
Activity Y	(10,000)
Activity Z	(20,000)
Salary	100,000

Activities X, Y, and Z are all passive with respect to Clay. Activity Z has $40,000 in passive losses which are carried over from the prior year. In the current year Clay sells activity Z for a taxable gain of $30,000.

a. What is the amount of loss that Clay may deduct and what is the amount that must be carried over in the current year?

b. Based solely on the amounts above, compute Clay's AGI for the current year.

I:9-44 ***Passive Losses: Rental Real Estate.*** During the current year, Irene, a married individual who files a joint return, reports the following items of income and loss:

Salary	$130,000
Activity X (passive)	10,000
Activity Y (rental real estate, nontrade or business)	(30,000)
Activity Z (rental real estate, nontrade or business)	(20,000)

Irene actively participates in activities Y and Z and owns 100% of both Y and Z.

a. What is Irene's AGI for the year?

b. What is the amount of suspended losses (if any) that may be carried over with respect to each activity?

I:9-45 ***Passive Losses.*** In 2018, Mark purchased two separate activities. Information regarding these activities for 2018 and 2019 is as follows:

	2018			*2019*	
Activity	*Status*	*Income (Loss)*	*Activity*	*Status*	*Income (Loss)*
A	Passive	($24,000)	A	Active	$10,000
B	Passive	(8,000)	B	Passive	20,000

The 2018 losses were suspended losses for that year. During 2019, Mark also reports salary income of $120,000 and interest and dividend income of $20,000. Compute the amount (if any) of losses attributable to Activities A and B that are deductible in 2019 and any suspended losses carried to 2020.

I:9-46 ***Passive Losses.*** During the current year, Juan, a single individual, has AGI of $124,000 before taking into account any passive activity losses. He also actively participates and owns 100% of activity A, which is a real estate rental activity. For the year, activity A generates a net loss of $6,000 and $3,000 in tax credits. Juan is in the 24% tax bracket. What is the amount of suspended loss and credit from activity A that must be carried to subsequent years?

I:9-47 ***Passive Losses.*** In 2019, Julie, a single individual, reported the following items of income and deduction:

Salary	$166,000
Interest income	14,000
Long-term capital gain from sales of stock	22,000
Short-term capital losses from sales of stock	(17,000)
Loss from a passive rental real estate activity	(20,000)
Interest expense on loan to purchase stock	(21,000)
Qualified residence interest on residence	(12,000)
Charitable contributions	(8,000)
Property taxes on residence	(5,000)
Tax return preparation fees	(2,500)
Unreimbursed employee business expenses	(2,000)

Julie owns 100% and is an active participant in the rental real estate activity. What is her taxable income for 2019?

I:9-48 ***Casualty Losses.*** Tony is a carpenter who owns his own furniture manufacturing business. During the current year, a tornado (a federally declared disaster) damaged several pieces of equipment and destroyed his delivery truck and his personal automobile, which he often kept in the workshop garage. The asset descriptions and related values are as follows:

Asset	*FMV Before Casualty*	*FMV After Casualty*	*Cost to Repair/Replace*	*Adjusted Basis*	*Insurance Proceeds*
Equipment A	$12,300	$4,000	$ 8,700	$ 9,000	$ 3,700
Equipment B	8,100	0	9,000	3,000	7,800
Equipment C	Not Available	Not Available	13,800	15,300	11,400
Delivery Truck	18,000	0	32,000	17,500	16,000
Automobile	15,000	0	12,000	28,000	12,000

Although he could not obtain its fair market value after the casualties, Troy decided to repair rather than replace Equipment C.

Before considering any deductions because of these casualties, Troy's AGI is $80,000. What deductions may Tony take relating to these losses?

I:9-49 ***Theft Losses.*** On December 17 of the current year, Kelly's business office safe is burglarized. The theft is discovered a few days after the burglary. $3,000 cash from the cash registers is stolen. A diamond necklace and a ring that Kelly frequently wore are also stolen. The necklace cost Kelly $2,300 many years ago and is insured for its $6,000 FMV. Kelly purchased the ring for $3,000 just two weeks before the burglary. Unfortunately, the ring and the cash are not insured. Kelly's AGI for the year, not including the items noted above, is $70,000.

a. What is Kelly's deductible theft loss in the current year?

b. What is Kelly's deductible theft loss in the current year if the theft is not discovered until January of the following year?

I:9-50 ***Casualty Losses: Year of Deduction.*** Jerry sprayed all of the landscaping around his business with a pesticide in June 2019. Shortly thereafter, all of the trees and shrubs unaccountably died. The FMV and the adjusted basis of the plants were $15,000. Later that year, the pesticide manufacturer announced a recall of the particular batch of pesticide that Jerry used. It also announced a program whereby consumers would be repaid for any damage caused by the improper mixture. Jerry is single and reports $38,000 AGI in 2019 and $42,000 in 2020.

a. Assume that in 2019 Jerry files a claim for his losses and receives notification that payment of $15,000 will be received in 2020. Jerry receives full payment for the damage in 2020. How should the loss and the reimbursement be reported?

b. How will your answer to Part a change if in 2020 the manufacturer files for bankruptcy and Jerry receives $1,500 in total and final payment for his claim?

c. How will your answer to Part a change if the announcement and the reimbursement do not occur until late in 2020, after Jerry has already filed his tax return for 2019?

I:9-51 ***Casualty Losses.*** During 2019, Pam incurred the following casualty losses:

Asset	*FMV Before*	*FMV After*	*Basis*	*Insurance*
Business 1	$18,000	$ 0	$15,000	$ 4,000
Business 2	25,000	10,000	8,000	3,000
Business 3	20,000	0	18,000	19,000
Personal 1	12,000	0	20,000	2,000
Personal 2	8,000	5,000	10,000	0
Personal 3	9,000	0	6,000	8,000

All of the items were destroyed in the same casualty, which resulted from a federally declared disaster. Before considering the casualty items, Pam reports business income of $80,000, qualified residential interest of $6,000 property taxes on her personal residence of $2,000, and charitable contributions of $4,000. Compute Pam's taxable income for 2019. Pam is single.

I:9-52 ***Business Bad Debt.*** Elaine is a physician who uses the cash method of accounting for tax purposes. During the current year, Elaine bills Ralph $1,200 for office visits and outpatient surgery. Unfortunately, unknown to Elaine, Ralph moves away leaving no payment and no forwarding address. What is the amount of Elaine's bad debt deduction with respect to Ralph's debt?

I:9-53 ***Nonbusiness Bad Debt.*** During 2018, Becky loans her brother Ken $5,000, which he intends to use to establish a small business. Because Ken has no other assets and needs cash to establish the business, the agreement provides that Ken will repay the debt if (and when) sufficient funds are generated from the business. Becky and Ken do not establish an interest rate. The business is unsuccessful, and Ken is forced to file for bankruptcy in 2019. By the end of 2019, it is estimated that the creditors will receive only 20% of the amount owed. In 2020 the bankruptcy proceedings are closed, and the creditors receive 10% of the amount due on the debt. What is Becky's bad debt deduction for 2019? For 2020?

I:9-54 ***Bad Debt Deduction.*** Assume the same facts as in Problem I:9-53, except that Becky and Ken are not related and that under the terms of the loan Ken agrees to repay Becky the $5,000 plus interest (at a reasonable stated rate) over a five-year period. What is Becky's bad debt deduction for 2019? For 2020?

I:9-55 ***Net Operating Loss Deduction.*** Michelle and Mark are married and file a joint return. Michelle owns an unincorporated dental practice. Mark works part-time as a high school math teacher, and spends the remainder of his time caring for their daughter. During 2019, they report the following items:

Mark's salary	$18,000
Interest earned on savings account	1,200
Interest paid on personal residence	12,700
Itemized deductions for state and local taxes	9,400
Items relating to Michelle's dental practice	
Revenues	65,000
Payroll and salary expense	49,000
Supplies	17,000
Rent	16,400
Advertising	4,600
Depreciation	8,100

a. What is Michelle and Mark's taxable income or loss for the year?
b. What is Michelle and Mark's NOL for the year?

I:9-56 ***Net Operating Loss Deduction.*** Assume the same facts as in Problem I:9-55, except in addition to the other itemized deductions Michelle and Mark suffer a $4,500 deductible personal casualty loss (after limitations).
a. What is Michelle and Mark's taxable income or loss for the year?
b. What is Michelle and Mark's NOL for the year?

I:9-57 ***Net Operating Loss Deduction.*** Assume the same facts as in Problem I:9-55, except that the interest on their personal residence is $15,300 and they also have a $4,500 deductible casualty loss on personal property (after limitations).
a. What is Michelle and Mark's taxable income or loss for the year?
b. What is Michelle and Mark's NOL for the year?

I:9-58 *Net Operating Loss.* During 2019, Karen, a single taxpayer, reports the following income and expense items relating to her interior design business:

Revenues	$52,000
Cost of goods sold	41,000
Advertising	3,300
Office supplies	1,700
Rent	13,800
Contract labor	28,000

Karen also worked part-time during the year, earning $13,500. She reports a long-term capital gain of $4,200, and a short-term capital loss of $3,800. Her itemized deductions total $5,200.

a. What is Karen's taxable income or loss for the year?

b. What is Karen's NOL for the year?

I:9-59 During the current year, Kenneth, who is married, reports the following income/loss from his business activities:

Gross income from sole proprietorship	$ 7,850,000
Gross expenses from sole proprietorship	(7,775,000)
Income from ABC Partnership (Kenneth is a general partner)	120,000
Loss from XYZ Partnership (Kenneth is a general partner)	(1,300,000)

What is the amount of Kenneth's excess business loss? How is the excess business loss treated?

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:9-60 In 2016, Annie Cook and several family members formed Treehouse Rentals, Inc., in Denver, Colorado. Treehouse is a closely held C corporation engaged in the rental real estate business. Treehouse properly classifies its activities as passive. In 2016, 2017, and 2018, the corporation generated net passive losses of ($380,000), ($145,000), and ($194,000), respectively, all of which were properly suspended.

Effective January 2019, Treehouse elected to be taxed as an S corporation. Also during 2019, Treehouse sold two pieces of rental real estate property. The suspended losses related to these properties were ($63,000) and ($112,000).

Write a memo to Treehouse Rentals explaining the tax treatment of the disposition of the rental properties in 2019.

- Sec. 469, Sec. 1371
- TAM 9628002
- *St. Charles Investment Co. v. Comm.*, 86 AFTR 2d 2000-6882 (CA 10, 11/14/2000)

I:9-61 Jace Seaton is a single taxpayer living in Eugene, Oregon. From 2015 to 2018, he worked as the CEO of Wengren & Jeffers, a local architectural firm. In 2019, he left the firm to start his own company as well as spend more time golfing and travelling. On October 25, 2019, he formed Seaton & Associates, a Limited Liability Company (LLC) under Oregon law.

Upon forming the LLC, Jace received an 80% interest in the company. Two other architects, Maria Juarez and Jaman Turhoon, each received a 10% interest in the company. Jace provided all necessary capital, whereas Maria and Jamal provided experience and a commitment to work for the company. Seaton & Associates chose to be taxed as a partnership for federal income tax purposes.

During 2019, Jace worked approximately 300 hours for Seaton & Associates, and received a guaranteed payment of $100,000. Maria and Jamal each worked approximately 600 hours, and each received a guaranteed payment of $150,000. In 2019 the company generated a net loss of $530,000.

Write a memo to Jace explaining how the LLC members, particularly Jace, should treat the loss generated in 2019.

- Reg. 1.469-5T
- *Gregg v. U.S.*, 87 AFTR 2d 2001-337

I:9-62 On November 15, Alex and Deanna Kent come to you for tax advice. The Kents, a married couple that files a joint tax return, own a rental home in Southern California. From January to November 1 of the current year, they rented out the home for 210 days. Since they live in Minnesota, they are considering staying in their rental home from December 10 to 31. If they do not stay in the home during that period, it will sit vacant. They ask you if this decision would have any tax consequences. They also provide you with the following information for the year:

Rental home income and expenses:	
Rental income	$16,000
Mortgage interest	12,400
Property taxes	4,300
Homeowners Assoc. Fees	3,500
Depreciation	18,000
Other income and expenses:	
Deanna's salary	75,000
Alex's salary	65,000
Passive income (from an investment in a limited partnership)	1,000
Mortgage interest on their Minnesota home	7,800
Charitable contributions	14,200
Medical expenses	8,100
Property taxes on their Minnesota home	2,900
State income taxes	9,700

What do you recommend to the Kents?

I:9-63 Jim had $100,000 in deposits in a savings account at a bank in Page, Arizona. The bank collapsed and Jim did not receive anything for his deposits. The bank was chartered by the state of Arizona and was not insured by federal law. Jim is not sure what his options are in deducting this loss on his tax return. What can Jim do to take advantage of this loss on his tax return? He has an AGI of $110,000 and no capital gains for the current year.

I:9-64 On December 21 of the current year, Chelsea Brown, who is in the 32% tax bracket, was reviewing her trades for the past year. She determined that she had a $12,000 net long-term capital gain and an $18,000 short-term capital gain. She has decided to sell one additional stock before the end of the year. She is indifferent between selling her Apple stock or her New York Times stock. She purchased the Apple stock in March of this year for $77,000. The Apple stock is currently worth $64,000. The New York Times stock she purchased 5 years ago for $80,000 is currently worth $67,000.

a. Which shares would you advise her to sell if the investment risk were the same across both stocks?
b. How would your answer change if on December 21 she had a $12,000 long-term capital gain and an $18,000 short-term capital loss?
c. How would your answer change if on December 21 she had an $18,000 long-term capital gain and a $6,000 short-term capital loss?

TAX FORM/RETURN PREPARATION PROBLEMS

I:9-65 Heather and Nikolay Laubert are married and file a joint income tax return. Their address is 3847 Jackdaw Path, Madison, WI 58493. Nikolay's Social Security number is 000-00-1111, and Heather's is 000-00-2222. Nikolay is a mechanical engineer, and Heather is a highly renowned speech therapist. Nikolay's employer provides health care coverage for Heather and Nikolay. Heather is self-employed. They report all their income and expenses on the cash method. For 2018, they report the following items of income and expense:

Gross receipts from Heather's business	$110,000
Rent on Heather's office	12,000
Receivables written off during the year (received in Heather's business)	1,300

Subscriptions to linguistic journals for Heather	250
Salary for Heather's secretary-receptionist	22,000
Nikolay's salary	78,000
Qualified medical expenses	12,000
Property taxes on their personal residence	4,200
State income tax refund received this year (the tax benefit was received in the prior year from the state income tax deduction)	400
State income taxes withheld on Nikolay's salary	4,600
Federal income taxes withheld on Nikolay's salary	12,000
Heather's estimated tax payments	20,000
Interest paid on residence	11,000
Income tax preparation fee for the prior year's return paid this year ($500 is allocated to preparation of Schedule C)	$940

Heather and Nikolay sold the following assets:

Asset	*Acquired*	*Sold*	*Sales Price*	*Cost*
KNA stock	2/12/16	3/13/18	$14,000	$ 8,000
AEN stock	3/2/18	7/7/18	20,000	22,000
KLN stock	6/8/12	4/10/18	13,000	17,000
Motorcycle	5/3/09	9/12/18	2,500	6,000

Heather owned the KLN stock and sold it to her brother, Jacob. Heather and Nikolay used the motorcycle for personal recreation.

In addition to the items above, they donate Miner Corporation stock to their community church. The FMV of the stock on the date it is donated (8/18/18) is $6,200. It cost $2,700 when purchased on 3/12/98. Heather and Nikolay's shed was damaged in a fire that was a federally-declared disaster. The fire damaged a snowblower (FMV $3,500; cost $5,000), the shed (FMV $12,000; cost $10,000), and a lawn mower (FMV $1,500; cost $1,300). The insurance company pays $1,500 for the snowblower, $4,000 for the shed, and $500 for the lawn mower. Complete Heather and Nikolay's Form 1040, Schedules A, C, D, and SE, Form 4684, and Form 8283. For purposes of this problem, disregard the alternative minimum tax, any credits, and the qualified business income deduction.

I:9-66 Kara and Brandon Arnold are married and file a joint return. Their Social Security numbers are 000-00-1111 and 000-00-2222, respectively. Kara and Brandon have one son, Henry, age 3. His Social Security number is 000-00-3333. They live at 356 Welcome Lane, Woodbury, WA 84653. They report their income on the cash method. During 2018, they report the following items:

Salary	$103,000
Interest income from money market accounts	600
Dividend income from Davis Corp. stock	700
Cash contributions to church	6,000
Rental of a condominium in Lutsen:	
Rental income (30 days)	12,000
Interest expense	7,000
Property taxes	3,200
Maintenance	1,700
Depreciation (entire year)	7,500
Insurance	2,000
Days of personal use	16

The address of the Condo is 1127 Skyline Drive, Lutsen, WA 84666. During the year the following events also occur:

a. In 2016, Brandon had loaned a friend $3,000 to help pay medical bills. During 2018, he discovers that his "friend" has skipped town.
b. On June 20, 2018, Brandon sells Kim Corporation stock for $16,000. He purchased the stock on December 12, 2012 for $22,000.
c. On September 19, 2018, Kara discovers that the penny stock of Roberts, Inc. she purchased on January 2 of the prior year is completely worthless. She paid $5,000 for the stock.

d. Instead of accepting $60 the utility store offers for their old dishwasher, they donate it to Goodwill on November 21, 2018. They purchased the dishwasher for $750 on March 30, 2008. The new dishwasher cost $900.
e. Kara and Brandon purchased a new residence for $250,000. As part of the closing costs, they pay two points, or $3,800, on the mortgage, which is interest rather than loan processing fees. This payment enables them to obtain a more favorable interest rate for the term of the loan. They also paid $8,400 in interest on their mortgage on their personal residence.
f. They pay $4,100 in property taxes on their residence and $7,500 in state income taxes.
g. On July 20, 2018, Kara and Brandon donate 1,000 shares of Anton, Inc. stock to the local community college. The value of the stock on that date is $10,200. Anton, Inc. is a listed stock. They had purchased the stock on November 10, 2010 for $1,000.
h. $7,000 in federal income tax was withheld during the year.

Complete Kara and Brandon's Form 1040, Schedules A, B, D, and E, Form 8283 and Form 8949. For purposes of this problem, disregard the alternative minimum tax and any credits.

I:9-67 ***Short Tax Form.*** Fiona Starr (social security number 111-22-3333) is single and earns $105,000 as a manager at Costco. Three years ago, she bought a single-family home on 12 Beach St., Bangor, ME 55555, which she rents out for $3,000 a month. She makes all the decisions regarding the property, including tenant approval, rental terms, and repairs. She incurs $12,000 in property taxes, $28,000 in depreciation, $4,000 for insurance premiums, $15,000 in mortgage interest, and $8,000 in repairs. Complete Schedule E and Form 8582 for Fiona.

CASE STUDY PROBLEMS

I:9-68 Dr. John Brown is a physician who expects to make $150,000 this year from his medical practice. In addition, Dr. Brown expects to receive $10,000 dividends and interest income.

Last year, on the advice of a friend, Dr. Brown invested $100,000 in Limited, a limited partnership. He spends no time working for Limited. Limited's operations did not turn out exactly as planned, and Dr. Brown's share of Limited's losses last year amounted to $15,000. Dr. Brown has already been informed that his share of Limited's losses this year will be $10,000.

In January of the current year, Dr. Brown set up his own laboratory. Originally he intended to have the lab only do the work for his own practice, but other physicians in the area were impressed with the quick turnaround and convenience that the lab provided and began sending their work. This year, Dr. Brown estimates that the lab will generate $30,000 of taxable income. The work in the lab is done by two full-time qualified laboratory technicians. A part-time bookkeeper is hired to keep the books. Dr. Brown has spent 320 hours to date establishing and managing the lab. He plans to hire another technician who will also manage the lab so that it can operate on its own.

In November, Dr. Brown calls you requesting some tax advice. Specifically, he would like to know what actions he should take before the end of the year in order to reduce his tax liability for the current year.

Write a memo to Dr. Brown, detailing your suggestions. His address is: Dr. John Brown, 444 Physicians Drive, Suite 100, Anytown, USA 88888.



I:9-69 In preparing the tax return for one of your clients, Jack Johnson, you notice that he has listed a deduction for a large business bad debt. Jack explains that the loan was made to his corporate employer when the corporation was experiencing extreme cash flow difficulties. In fact, Jack was very concerned at the time he made the loan that the corporation would go bankrupt. This would have been extremely bad, because not only would he have lost his job, but he also would have lost the $80,000 he had invested in the common stock of the corporation.

You know that if the loan is a business loan Jack will receive an ordinary deduction. However, if the loan is a nonbusiness debt, it becomes a short-term capital loss (and Jack can only currently deduct $3,000).

After thoroughly reviewing all of the facts, you do a complete search of the relevant judicial and administrative authority. There you find that the courts are split as to whether under these circumstances the loan should be treated as a business or nonbusiness bad debt.

What position should you take on Jack's federal income tax return? (See the *Statements on Standards for Tax Services* section in Chapter I:15 and Appendix E for a discussion of this issue.)

TAX RESEARCH PROBLEM

I:9-70 Early in the current year, Keith meets Dan through a business associate. Dan tells Keith that he is directing a business venture that purchases poorly managed restaurants in order to turn them around and make them profitable. Dan mentions that he is currently involved in acquiring a real "gold mine" but needs to raise additional cash in order to purchase it. On the strength of Dan's representations, Keith loans Dan $30,000 for the venture. An agreement is written up between Keith and Dan, wherein Dan agrees to repay Keith the entire amount over a five-year period plus 14% interest per annum on the unpaid balance. Later in the year, however, Keith discovers that Dan had never intended to purchase the restaurant and, in fact, had used most of the money for his own benefit. Upon making this discovery, Keith sues Dan for recovery of the money, alleging that Dan falsely, fraudulently, and deceitfully represented that the money would be invested and repaid, in order to cheat and defraud Keith out of his money. Unfortunately for Keith, he is never able to recover any amount of the loan. Discuss the tax treatment that Keith may claim with regard to the loss.

A partial list of research sources is:

- *Robert S. Gerstell*, 46 T.C. 161 (1966)
- *Michele Monteleone*, 34 T.C. 688 (1960)

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CHAPTER

10

DEPRECIATION, COST RECOVERY, AMORTIZATION, AND DEPLETION



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Explain the general concepts of tax depreciation and cost recovery
2. Calculate amortization for intangible assets and distinguish between amortizable and non-amortizable assets
3. Apply cost and percentage depletion methods and summarize the treatment for intangible drilling costs
4. Identify tax planning considerations for depreciation
5. Identify compliance and procedural considerations for depreciation

CHAPTER OUTLINE

Depreciation and Cost Recovery...10-2
Amortization...10-18
Depletion, Intangible Drilling and Development Costs...10-22
Tax Planning Considerations...10-24
Compliance and Procedural Considerations...10-25

The income tax law allows taxpayers to deduct a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or held for the production of income.[1] Such deductions enable taxpayers to recover the cost of an asset under the "return of capital" doctrine. Depreciation, therefore, is the systematic allocation of the cost of an asset over its estimated economic life. The term *depreciation* relates to deductions for most tangible property; *amortization* relates to deductions for intangible property; and *depletion* relates to deductions for natural resources (oil and gas, coal, etc.) While the concepts of depreciation, amortization, and depletion are similar to those in financial accounting, the income tax rules are unique. This chapter discusses the income tax rules relating to depreciation, amortization, and depletion.

DEPRECIATION AND COST RECOVERY

OBJECTIVE 1

Explain the general concepts of tax depreciation and cost recovery

GENERAL CONSIDERATIONS

Taxpayers must use specific depreciation methods depending on *when* an asset is placed in service. Three separate depreciation and cost recovery systems are currently in place. These three distinct systems are the result of tax law changes in 1981 and 1986. The systems that taxpayers must use are as follows:

- Property placed in service after December 31, 1986. Taxpayers must use the Modified Accelerated Cost Recovery System (MACRS) as provided in Sec. 168.
- Property placed in service after December 31, 1980 and before January 1, 1987. Taxpayers must use the Accelerated Cost Recovery System (ACRS) as provided in Sec. 168.
- Property placed in service prior to 1981. Taxpayers must use the rules contained in Sec. 167. These rules basically follow financial accounting principles.

KEY POINT

Depreciation expense under federal income tax rules differs from depreciation expense under financial accounting rules.

In this chapter, we emphasize the MACRS rules because most assets placed in service before 1987 are now fully depreciated.

The terms *depreciation* and *cost recovery* are used interchangeably in this text. The rules in Sec. 167 (or pre-ACRS) and the MACRS rules under Sec. 168 both refer to depreciation. However, the deduction under ACRS is referred to as cost recovery. In 1981, Congress initiated the original ACRS system to achieve a number of objectives, including a stimulus for private investment, improving business productivity, simplifying taxpayer compliance, and facilitating IRS administration of the tax law. Therefore, less importance was placed on the financial accounting concept of matching costs and revenues, which is the primary theory that governed the Sec. 167 depreciation rules. Congress' primary objective in 1981 was to allow businesses and investors to recover the cost of capitalized expenditures over a period of time that is substantially shorter than the property's economic useful life. Thus, the term *cost recovery* rather than *depreciation* was used under the ACRS system. The post-1986 MACRS rules more closely follow the concept of economic useful life and, therefore, the MACRS rules refer to depreciation rather than cost recovery.

HISTORICAL NOTE

Before 1954, except for the limited use of a declining-balance method, taxpayers were required to use the straight-line method.

Common Rules of All Systems. Regardless of the particular system of depreciation required (i.e., MACRS, ACRS, etc.), certain rules are common to all systems of depreciation. These common rules are discussed below.

ADDITIONAL COMMENT

Property is considered to be "placed in service" when it is in a condition or state of readiness and is available for a specifically assigned function. This can be important in attempting to determine the first year that a depreciation deduction is available.

- Depreciation may be claimed only on property used in a trade or business or for the production of income. Thus, personal-use assets, such as a personal-use automobile or the taxpayer's personal residence, are not depreciable.
- No depreciation is permitted for land or other assets that have an indefinite life. Assets such as works of art are generally not depreciable.

[1] Sec. 167(a).

ADDITIONAL COMMENT

A case held that a professional musician could depreciate a nineteenth-century violin bow. The IRS had argued the bow had an indeterminate life, but because the taxpayer played the violin, there was "wear and tear" on the bow and depreciation was allowed. *Simon v. Comm.*, 95-2 USTC ¶50,552 (CA-2, 1995).

- First-year depreciation is permitted only in the year the asset is placed in service. For example, a taxpayer may purchase a depreciable asset in December 2018 but not place it in service until January 2019. In this case, depreciation is not allowed until 2019.
- Regardless of the depreciation system, consistency is required. Taxpayers must consistently use the method selected in the year the asset was placed in service unless the IRS allows a change of accounting method.
- The basis of property being depreciated must be reduced by the amount of depreciation that is allowable for each taxable year. An important aspect of depreciation is determining the amount of depreciation that is *allowed* and *allowable*. The depreciation allowed is the actual depreciation claimed by the taxpayer for a particular taxable year. Allowable depreciation is the amount of depreciation to be claimed under the tax law by using the slowest possible method (i.e., straight-line using the longest permissible recovery period). If a taxpayer does not take any depreciation during a particular year, the basis of property must be reduced by the amount of depreciation that should have been taken during the year (i.e., the allowable depreciation).

EXAMPLE I:10-1 ▶ Maria acquires and places in service a machine (7-year property) for $50,000 to be used in her business. She elects straight-line depreciation under MACRS. Maria properly takes depreciation in the first two years in the amount of $10,714 ($3,571 in Year 1 and $7,143 in Year 2, assuming the half-year convention). However, because of a net operating loss in Year 3, Maria did not take any depreciation on the tax return. The allowable depreciation in Year 3 was $7,143. Even though Maria did not claim the $7,143 in Year 3, the basis of the machine must still be reduced by that amount. Thus, at the end of Year 3, the basis of the machine would be $32,143 ($50,000 minus the allowable accumulated depreciation of $17,857). Obviously, Maria should amend her tax return for Year 3 and deduct the allowable depreciation. This would increase her net operating loss for Year 3, which carries forward indefinitely. ◀

REAL-WORLD EXAMPLE

Harrah's Club in Reno, Nevada, restores antique autos and displays them. The restoration costs cannot be depreciated because the autos have an indefinite life as museum pieces. *Harrah's Club v. U.S.*, 43 AFTR 2d 79-745, 81-2 USTC ¶9677 (Ct. Cls., 1981).

Types of Property. For both property law and income tax purposes, there are two basic types of property, tangible and intangible. **Tangible property** refers to property that has physical substance, such as land, buildings, natural resources, equipment, etc. **Intangible property** refers to property that does not have physical substance, such as goodwill, patents, and stocks and bonds. The cost of tangible property (other than land, of course) is systematically written off through depreciation or depletion. Natural resources, such as oil and gas reserves, are recovered through depletion. Intangible property generally is written off through amortization.

Tangible property is further classified as either real property or personal property. **Real property** (often referred to as real estate or realty) is defined as land or any structure permanently attached to the land, such as buildings. **Personal property** is any tangible property that is not real property, and includes items such as equipment, vehicles, furniture, etc. It is important to distinguish between personal property and personal-use property. **Personal-use property** is any property, tangible or intangible, real or personal, that is used by the taxpayer for his own personal use rather than in a trade or business or for the production of income.

ADDITIONAL COMMENT

The IRS issued a private letter ruling that required an airline to capitalize engine overhauls rather than expensing such amounts in the current year. The IRS position requires capitalization because the overhauls involve replacement or reconditioning of a large portion of the engine's parts. This ruling has been severely criticized by the airlines industry, saying that the decision could negatively impact passenger safety.

Capitalization Versus Expense. A frequent dilemma for taxpayers is whether an expenditure should be capitalized and expensed through depreciation, or expensed entirely in the current year. As discussed in Chapter I:6, if an expenditure either improves the efficiency of an asset or extends the life of an asset beyond the end of the year, the expenditure should generally be capitalized. However, most taxpayers have established materiality limits to justify the expensing of small expenditures that technically should be considered capital expenditures. Since capitalization-expense decisions are frequently subjective in nature, disputes between the IRS and taxpayers are common.

Conversion of Personal-Use Property. If personal-use property is either converted to business-use or held for the production of income (e.g., a principal residence converted to a rental house), the property's basis for depreciation purposes is the lesser of its adjusted basis or its fair market value (FMV) determined as of the conversion date.[2]

[2] Reg. Sec. 1.168(i)-4(b)(1).

This lower of cost or market rule prevents taxpayers from depreciating the portion of the cost that represents a nondeductible loss on a personal-use asset. Chapter I:5 discusses the disposition of personal-use property.

EXAMPLE I:10-2 ▶ Marty purchased a house for $175,000 ten years ago and has been using it as her residence since then. In the current year, she moves to an apartment. Because the house's FMV is only $150,000 due to a depressed local real estate market, she rents out the house rather than selling it. She thus converts the property from personal use to rental use in the current year. The depreciable basis of the rental property is $150,000 (the lesser of its $175,000 adjusted basis or $150,000 FMV when converted). The $25,000 ($175,000 − $150,000) decline in FMV is a nondeductible personal loss and is not depreciable. (The example assumes for simplicity that the $175,000 and $150,000 pertain to the house itself and not the land on which it is located. Any purchase cost or FMV pertaining to the land is not depreciable.) ◀

DEPRECIATION METHODS

As mentioned previously, the depreciation method required for income tax purposes depends on the date the asset was placed in service. Assets placed in service prior to 1987 must use the old depreciation methods that were in effect during those years.[3] Under current law, for assets placed in service after 1986, the MACRS system of depreciation is required for most assets. MACRS is different from depreciation methods used for financial accounting purposes in several ways, including the following:

- MACRS does not consider salvage value in the computation of the depreciation amount.
- MACRS uses specific asset classes. Both tangible personal property and real property must be placed into specific asset classes, based on the type of property. Asset classes refer to the number of years over which the asset must be depreciated, such as 5-year property, 7-year property, etc.
- MACRS uses fewer depreciation methods, and the methods are built into the MACRS tables. Both accelerated and straight-line methods are used in MACRS, but accelerated methods are not permissible for real property. The MACRS tables are summarized in Appendix C.
- MACRS uses assumptions about when assets are either placed in service or disposed of rather than using actual dates. The applicable assumption is called a *convention*. The **half-year convention** is generally required for all tangible personal property. It assumes that all asset acquisitions or dispositions are made at the midpoint of the tax year. A special convention that may apply to tangible personal property is the **mid-quarter convention**, discussed later in this chapter. For real estate, the **mid-month convention** is used. It assumes that all asset acquisitions or dispositions are made at the midpoint of the month in which the transaction occurs.

EXAMPLE I:10-3 ▶ Golden Corporation, a calendar year taxpayer, purchases a business-use machine on March 10, 2019. For depreciation purposes, under the half-year convention, the machine is treated as if it were placed in service on July 1, 2019, so one-half year's depreciation is allowable for 2019. The half-year convention assumes all asset acquisitions and dispositions occur at the midpoint of the tax year. ◀

EXAMPLE I:10-4 ▶ Assume that Golden Corporation, in Example I:10-3 above, uses the machine for several years and sells the machine on October 30, 2021. To compute the depreciation deduction for 2021, Golden is permitted one-half year's depreciation. This one-half year's depreciation is required even though the actual sale occurred on October 30 because the half-year convention applies. ◀

EXAMPLE I:10-5 ▶ Silver, Inc., a calendar year taxpayer, purchases a business-use building on March 5, 2019. For depreciation purposes, under the mid-month convention, the building is treated as if it were placed in service on March 15, 2019, so 9½ months of depreciation is allowable for 2019 (one-half of March plus nine full subsequent months). ◀

[3] For assets placed into service between 1981 and 1986, taxpayers were required to use the ACRS method; for assets placed into service before 1981, a pre-ACRS method was required. Pre-ACRS methods more closely resemble depreciation methods used for financial statement purposes.

CALCULATION OF DEPRECIATION

The annual depreciation deduction involves a number of variables. Below is a discussion of these variables in connection with the two principal types of depreciable property: tangible personal property and real property.

Tangible Personal Property: Classification and Recovery Rates. Tangible personal property, such as equipment, furniture, computers, etc., is depreciable under MACRS if used in a trade or business or held for the production of income. Each piece of tangible personal property acquired must be classified into one of six asset classes.[4] Depreciation is computed using the percentages contained in Table 1 in Appendix C.

The MACRS recovery periods that apply to tangible personal property placed in service after December 31, 1986 are as follows:[5]

ADDITIONAL COMMENT

Most depreciable personal property is classified as 5-year or 7-year property under MACRS.

- 3-Year — Property with a class life of 4 years or less. This category includes property such as tractor units, race horses over 12 years old, and special tools.
- 5-Year — Property with a class life of more than 4 years but less than 10 years. This category includes property such as automobiles, light and heavy-duty general purpose trucks, computers, and research and experimental (R&E) equipment.
- 7-Year — Property with a class life of 10 years or more but less than 16 years. This category includes property such as office furniture and equipment, horses, single-purpose agricultural or horticultural structures, and property with no class life and not classified elsewhere. Many types of machinery are included in this class.
- 10-Year — Property with a class life of more than 16 years, but less than 20 years. This category includes property such as barges, vessels, and petroleum and food processing equipment.
- 15-Year — Property with a class life of more than 20 years, but less than 25 years. This category includes property such as billboards, service station buildings, and land improvements.
- 20-Year — Property with a class life of 25 or more years, including property such as utilities and sewers.

KEY POINT

Notice that an asset's recovery period for tax purposes is not necessarily the same as its estimated useful life.

Depreciation rates for the 3-year, 5-year, and 7-year recovery classes are provided in Table I:10-1. (See Table 1 in Appendix C for depreciation rates for all classes of property.) The rates are based on the 200% DB method switching to straight-line when it yields a larger amount. A half-year convention is used in the year of acquisition and zero salvage value is assumed. To properly apply the half-year convention when property is disposed of in a year before the final table year, the amount calculated from the table must be multiplied by one-half.

KEY POINT

Remember that salvage value is not taken into consideration under the MACRS system.

EXAMPLE I:10-6 ▶ In March 2019, Mary acquires and places in service a business machine which costs $20,000 and has a 7-year recovery period under MACRS rules. Assuming no Sec. 179 expensing or bonus depreciation (discussed later), the depreciation deduction for 2019 is $2,858 ($20,000 × 0.1429). This MACRS depreciation deduction also can be computed by applying the accelerated depreciation rate (using the half-year convention) to the basis of the assets. Thus the depreciation deduction for 2019 is $2,857 ($20,000 ÷ 7 years × 200% DB × 0.50 year). The $1 difference between the two calculations is due to rounding. ◀

Certain types of property are *excluded* from MACRS depreciation, including:[6]

- Property depreciated under a method not expressed in terms of years, such as the units of production method, where the taxpayer elects to not depreciate the property under MACRS;
- Intangible assets, such as goodwill or copyrights;
- Films, videotapes, or sound recordings.

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[4] The class life is similar to the estimated useful life that financial accounting uses when determining depreciation expense, but class life is specified by the IRS rather than the taxpayer (Rev. Proc. 87-56, as modified by Rev. Proc. 88-22).

[5] Sec. 168(e)(1).

[6] Sec. 168(f).

SELF-STUDY QUESTION

In Table I:10-1, how has the 20% first-year cost recovery rate for five-year property been calculated?

ANSWER

The 20% rate is calculated by multiplying the double declining-balance rate of 40% by the half-year convention of depreciation.

▼ **TABLE I:10-1 (a Portion of Table 1 in Appendix C)**
MACRS Percentage Rates for Tangible Personal Property (Using Half-Year Convention)

Recovery Year	Recovery Period		
	3-Year	5-Year	7-Year
1	33.33	20.00	14.29
2	44.45	32.00	24.49
3	14.81	19.20	17.49
4	7.41	11.52	12.49
5	—	11.52	8.93
6	—	5.76	8.92
7	—	—	8.93
8	—	—	4.46

Source: Table 1 of Rev. Proc. 87-57, 1987-2 C.B. 687.

ADDITIONAL COMMENT

Congress has substantially increased the maximum Sec. 179 expensing election several times in recent years. This maximum was $125,000 in 2007 and $510,000 in 2017, but it is $1.02 million in 2019.

Section 179 Expensing Election. In lieu of depreciating the cost of new or used tangible personal business property under the regular MACRS methods discussed above, taxpayers may elect to expense up to $1.02 million (in 2019) of the acquisition cost as an ordinary deduction in the year the property is placed in service. The immediate expensing election is not generally applicable to real estate.[7] The election is made on an annual basis, and the taxpayer must select the assets to which the deduction applies. MACRS rules apply to any amount of an asset's cost not expensed under Sec. 179 or claimed as bonus depreciation (for years bonus depreciation is in effect).

The maximum Sec. 179 expense amount (ceiling) has been increasing over the past several years, as shown in Table I:10-2.

EXAMPLE I:10-7 ▶ In 2019, Arbor Corporation acquires $1.12 million of 7-year MACRS property and places it into service in its business. Arbor elects to expense $1.02 million of the cost under Sec. 179. Assuming Arbor does not claim bonus depreciation (discussed later), its basis for MACRS depreciation is $100,000 ($1,120,000 − $1,020,000). If the half-year convention applies, Arbor claims 14.29% (see Table I:10-1) of the $100,000 as MACRS depreciation. Arbor's total 2019 depreciation is $1,034,290 [$1,020,000 + ($100,000 × 0.1429)]. ◀

▼ **TABLE I:10-2**
Section 179 Expense Amounts

Tax Year Beginning In	Maximum Sec. 179 Expense (Ceiling)
2019	$1,020,000
2018	1,000,000
2017	510,000
2010–2016	500,000
2008–2009	250,000

ADDITIONAL COMMENT

In the case of a partnership, the partnership and each partner are individually subject to the annual Sec. 179 limitation.

The following limitations and special rules apply to the Sec. 179 election:

- The property must be purchased for use in an active trade or business (more than 50% business-use) as distinguished from property that is acquired for the production of income (e.g., personal property used in a rental activity held by an investor does not qualify).

[7] Taxpayers may elect Sec. 179 expensing for qualified real property, which includes qualified improvement property (discussed later). It also includes roofs, HVAC property, fire protection and alarm systems, and security systems that improve nonresidential real property if such improvements are placed in service after the nonresidential real property was first placed in service.

- Qualified property is generally tangible personal property.
- The property cannot be acquired from a related party under Sec. 267 or by gift or inheritance.
- The Sec. 179 tax benefits are recaptured if the property is no longer predominantly used in a trade or business (e.g., the property is converted to personal use) at any time.[8] In the year of recapture, the taxpayer must include in gross income the amount previously expensed reduced by the amount of depreciation that would have been allowed for the period the property was held for business use.[9]
- If the total cost of qualified property placed into service during the year is more than $2,550,000 (in 2019), the $1.02 million ceiling is reduced on a dollar-for-dollar basis by the excess amount. Thus, no deduction is permitted for the 2019 tax year if $3.57 million or more of Sec. 179 property is placed in service. No carryovers of Sec. 179 depreciation under this provision are permitted. However, the portion of cost not expensed remains in the property's basis subject to MACRS depreciation.
- A second limitation on the total Sec. 179 deduction is that it cannot exceed the taxpayer's taxable income (before deducting the Sec. 179 expense) from the trade or business.[10] Any acquisition cost that cannot be deducted because of the limitation based on taxable income is carried forward for an unlimited number of years and is added to the other amounts eligible for the Sec. 179 deduction in the future year. Such carryover amount will be subject to the taxable income limitation in the carryover year.

ADDITIONAL COMMENT

Married taxpayers who file separate tax returns are each entitled to a maximum of half the regular limitation under Sec. 179.

SELF-STUDY QUESTION

Are corporations entitled to the election to expense up to $1 million under Sec. 179?

ANSWER

Yes, but larger corporations will not receive the benefit from it because the Sec. 179 deduction is zero when the cost of qualified property is $3.57 million or more.

EXAMPLE I:10-8 ▶ Davis Corporation operates a manufacturing business. In 2019, it purchases and places into service $2.95 million of tangible personal property for use in its business. Davis' taxable income from its business (before the Sec. 179 deduction) is $900,000. Davis reduces its maximum Sec. 179 deduction by $400,000 ($2,950,000 − $2,550,000), and it cannot carryover any of this $400,000 reduction. Assuming it elects the maximum $620,000 ($1,020,000 − $400,000) it is allowed under Sec. 179, Davis depreciates $2,330,000 ($2,950,000 − $620,000) of the property's cost using MACRS (or bonus depreciation, which is discussed later). Davis' $620,000 Sec. 179 deduction is not limited because it is less than its $900,000 business taxable income.

Assume instead that Davis' business taxable income (before any Sec. 179 deduction) is $340,000. Its maximum Sec. 179 deduction is still $620,000, but it can deduct for 2019 only $340,000. Davis carries over $280,000 ($620,000 − $340,000) to 2020 as Sec. 179 deduction for that year (possibly limited by 2020 business taxable income). Even though only $340,000 is deductible under Sec. 179, Davis carries over $280,000 to 2020 rather than depreciating it using MACRS (or bonus depreciation). However, if Davis elects $340,000 under Sec. 179 instead of its $620,000 maximum, it would not carry over any amount to 2020 and could depreciate $2,610,000 ($2,950,000 − $340,000) using MACRS (or bonus depreciation). ◀

Many states impose income taxes, and they usually follow most federal income tax rules. However, some states use a lower Sec. 179 expensing maximum than the $1.02 million the federal income tax rules allow (and a lower threshold for reducing this maximum).

EXAMPLE I:10-9 ▶ Limestone Corporation operates in State X. In 2019, Limestone purchases and places into service $195,000 of 7-year property for use in its business. For federal income tax purposes, it elects Sec. 179 expensing for all $195,000 of the property's cost and thus does not claim any MACRS depreciation for it.

State X allows a $25,000 maximum Sec. 179 election and uses a $200,000 threshold for reducing this maximum. For State X income tax purposes, Limestone claims $25,000 of Sec. 179 expensing and uses MACRS depreciation for the other $170,000 ($195,000 − $25,000) of the property's cost (if it does not claim bonus depreciation). Its total depreciation expense for 2019 for State X income tax purposes is $49,293 [$25,000 + ($170,000 × 0.1429)]. ◀

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[8] Sec. 179(d)(10).

[9] Reg. Sec. 1.179-1(e).

[10] Sec. 179(b)(3). Under Reg. Sec. 1.179-2(c)(6)(iv), employees are considered to be engaged in the active conduct of the trade or business from their employment. Thus, a small business person who is also an employee may include wages and salary derived from employment in determining taxable income for purposes of this limitation. Such amounts are considered derived from the conduct of a trade or business. For an individual, taxable income is also computed without regard to the deduction for one-half of self-employment taxes paid under Sec. 164(f) (see Chapter I:14).

Bonus Depreciation. In recent years, Congress has temporarily permitted a special depreciation allowance for qualified property, often referred to as bonus depreciation. This allows the taxpayer to deduct a percentage of the property's cost in the year it is placed into service. Unlike Sec. 179 expensing, there is not a maximum dollar amount of bonus depreciation the taxpayer may claim. The bonus depreciation percentage has varied from 30% to 100%, depending on the year. In its most recent legislation affecting this percentage, Congress allowed 100% bonus depreciation for property acquired and placed into service from September 28, 2017 through December 31, 2022, with the percentage decreasing by 20 percentage points each year after 2022. Unless Congress acts yet again to extend bonus depreciation, it will not be available after 2026.

While the bonus depreciation percentage has varied across years, the specific rules discussed below generally are the same for the bonus depreciation property. Bonus depreciation is automatically deductible for both the regular income tax and the alternative minimum tax (AMT), which is discussed in Chapter I:14. Taxpayers must elect *out* of bonus depreciation if they do not wish to claim it.

Qualified property (generally non-real estate) includes: (1) MACRS property with a recovery period of 20 years or less and (2) computer software (other than computer software that must be amortized under Sec. 197). Congress also intended qualified property to include qualified improvement property (discussed later).[11]

Property qualifying for bonus depreciation generally also qualifies for Sec. 179 expensing and MACRS depreciation. The taxpayer claims Sec. 179 expensing first. Second, the taxpayer claims bonus depreciation for any cost remaining after Sec. 179 expensing. Finally, the taxpayer claims MACRS depreciation for any cost remaining after Sec. 179 expensing and bonus depreciation, using the usual MACRS rules for such remaining cost.[12] If the bonus depreciation rate is 100%, the taxpayer can deduct all of the property's cost using Sec. 179 expensing and/or bonus depreciation, leaving no cost for which to claim MACRS depreciation. If the bonus depreciation rate is less than 100%, this ordering is important because it affects the cost for which the taxpayer claims MACRS depreciation.

EXAMPLE I:10-10 ▶ In 2019, Polar Corporation purchases and places into service $1,500,000 of equipment (7-year MACRS property). It claims Sec. 179 expensing for $1,020,000 of the property's cost, 100% bonus depreciation for the remaining $480,000 ($1,500,000 − $1,020,000) of the cost, and no MACRS depreciation for the property. Polar thus can deduct all $1,500,000 ($1,020,000 + $480,000) of the property's cost for 2019, with no depreciation deductions for it in subsequent years. Alternatively, Polar could elect zero Sec. 179 expensing and deduct the entire $1,500,000 cost as bonus depreciation for 2019. ◀

EXAMPLE I:10-11 ▶ Assume the same facts as in Example I:10-10, except the property was placed into service on February 10, 2017, when the maximum Sec. 179 election was $510,000 and the bonus depreciation rate was 50%. Polar claims $510,000 of Sec. 179 expensing and $495,000 [($1,500,000 − $510,000) × 50%] of bonus depreciation for the property. Assuming the half-year convention applies, it claims MACRS depreciation for the remaining $495,000 ($1,500,000 − $510,000 − $495,000) of the property's cost. Polar's total depreciation deduction for 2017 for the property is $1,075,736 [$510,000 + $495,000 + ($495,000 × 0.1429)]. For 2018 and 2019, its depreciation deductions for the property are only the MACRS depreciation of $121,226 ($495,000 × 0.2449) and $86,576 ($495,000 × 0.1749), respectively. ◀

As noted earlier, states usually follow most federal income tax rules. However, many states do not allow bonus depreciation. For income tax returns filed in such states, taxpayers claim Sec. 179 expensing (to the extent allowed) and MACRS depreciation.

EXAMPLE I:10-12 ▶ Assume the same facts as in Example I:10-10, where Polar deducts all $1.5 million of the property's cost for 2019 federal income taxes. Polar operates in State X, which allows $25,000 of Sec. 179 expensing but does not allow bonus depreciation. For its 2019 State X income tax return, Polar claims Sec. 179 expensing of $25,000 and MACRS depreciation of $210,778 [($1,500,000 − $25,000) × 0.1429]. For its 2020 State X income tax return, Polar claims MACRS depreciation of $361,228 [($1,500,000 − $25,000) × 0.2449]. ◀

[11] Qualified property placed into service before September 28, 2017 must have been new property whose original use began with the taxpayer, i.e., used property did not qualify. This requirement does not apply to qualified property acquired and placed into service on or after September 28, 2017, which means that new and used property can qualify for bonus depreciation.

[12] Reg. 1.168(k)-1(d)(3) Example 2.

KEY POINT

Remember, the mid-quarter convention does *not* apply to real property.

Use of the Mid-Quarter Convention. As mentioned previously, the MACRS system generally uses the half-year convention for personal property. However, the MACRS system requires the use of the **mid-quarter convention** if the aggregate basis of all personal property placed in service during the last three months of the year exceeds 40% of the cost of all personal property placed in service during the tax year.[13] The 40% test is applied after reducing the property's basis by Sec. 179 expensing, if elected, but not by bonus depreciation, if claimed. If the test is met, the mid-quarter convention must be used instead of the half-year convention, and special mid-quarter tables must be used to compute depreciation under this convention. (See Table 2 through 5 in Appendix C.) Property placed in service and disposed of during the same tax year is not taken into account for purposes of the mid-quarter test,[14] nor is property expensed under Sec. 179.[15]

The 40% rule prevents taxpayers from using the half-year convention and thereby obtaining one-half year's depreciation in the year of acquisition when a substantial portion of the assets are placed in service during the last quarter of the tax year.

EXAMPLE I:10-13 ▶ In 2019, Fir Corporation purchases and places into service $2.42 million of 5-year MACRS property:

Date Placed in Service	*Acquisition Cost*
March 3	$630,000
April 2	700,000
December 21	1,090,000

Fir does not claim Sec. 179 expensing or bonus depreciation for the property. Because more than 40% of the property acquired during the year is placed in service in the last three months ($1,090,000 ÷ 2,420,000 = 45%), the mid-quarter convention applies for all three properties. Fir computes 2019 depreciation as follows:

Property Placed in Service	*2019 MACRS Depreciation*	*Appendix C Table*
March 3	$630,000 × 35% = $220,500	Table 2
April 2	700,000 × 25% = 175,000	Table 3
December 21	1,090,000 × 5% = 54,500	Table 5
Total	$450,000	

◀

EXAMPLE I:10-14 ▶ Assume the same facts as in Example I:10-13 except Fir elects $1.02 million of Sec. 179 expensing for the December 21 property. The mid-quarter convention does not apply because not more than 40% of the property (after the Sec. 179 election) was placed in service in the fourth quarter [($1,090,000 − $1,020,000) ÷ ($2,420,000 − $1,020,000) = 5%]. Fir uses the half-year convention (Table 1 in Appendix C), and its depreciation for 2019 is computed as follows:

Property Placed in Service	*2019 MACRS Depreciation*	*Sec. 179 Depreciation*	*Total Depreciation*
March 3	$630,000 × 20% = $126,000	–0–	$ 126,000
April 2	700,000 × 20% = 140,000	–0–	140,000
December 21	70,000* × 20% = 14,000	$1,020,000	1,034,000
Total			$1,300,000

* After Sec. 179 election ($1,090,000 − $1,020,000)

In this case, the half-year convention yields a 2019 depreciation deduction that is larger than with the mid-quarter convention. The reverse can be true in some cases, such as when a large percentage of property is placed in service in the first quarter but enough property is placed in service in the fourth quarter to require the mid-quarter convention.

If Fir had claimed 100% bonus depreciation for all $2.42 million of the properties' cost (or claimed $1.02 million of Sec. 179 expensing and $1.4 million of bonus depreciation), the applicability of the mid-year convention instead of the mid-quarter convention would be irrelevant because there would be no cost remaining on which to claim MACRS depreciation. However, for property placed in service in years for which the bonus depreciation rate is less than 100%,

[13] Sec. 168(d)(3).
[14] Sec. 168(d)(3)(B) and Reg. Sec. 1.168(d)-1(b)(3).
[15] PLR 9126014 (March 29, 1991).

it is important that the 40% test for the mid-quarter convention is applied after reducing the property's basis for Sec. 179 expensing but not for bonus depreciation claimed. It also is important for many states' income taxes. ◀

ADDITIONAL POINT

To reflect the applicable convention, the taxpayer must manually adjust the depreciation factor found in the MACRS table for assets disposed of during the year.

Year of Disposition. The MACRS system requires that depreciation be taken in the year of disposition using the same convention that applied on acquisition (e.g., half-year, mid-month, or mid-quarter convention). Therefore, if property is disposed of during any year in which the half-year convention is applicable, the depreciation for the year of disposition will be one-half of the amount computed by using the table percentages.

EXAMPLE I:10-15 ▶ Michelle acquired machinery in March 2015 that qualified as 7-year MACRS property and had a $100,000 basis for depreciation. The half-year convention applied in the year of acquisition, and Michelle claimed no Sec. 179 depreciation or bonus depreciation on the machinery. In December 2019, Michelle sells the machinery. Michelle's depreciation deduction in 2019 is $4,465 ($100,000 × 0.0893 × 0.50). See Table 1 in Appendix C. ◀

If property is subject to the mid-quarter convention, it is treated as being disposed of at the midpoint of the quarter.

EXAMPLE I:10-16 ▶ In addition to other property acquired in the fourth quarter of 2015, Jason acquired $200,000 of 5-year property in May 2015 (second quarter). He depreciated all property acquired in 2015 using the mid-quarter convention. He claimed no Sec. 179 expense or bonus depreciation. If Jason sells the 5-year property on July 14, 2019 (third quarter), the property will be treated as if it were sold on August 15, 2019, which is the midpoint of the third quarter. Thus, using Table 3 in Appendix C, Jason claims $14,213 of depreciation in 2019 [($200,000 × 0.1137) × (2.5 ÷ 4)]. ◀

KEY POINT

Depreciable real property placed in service after 1986 must be depreciated using the straight-line method.

Real property falls into two categories: residential rental property and nonresidential real property. **Residential rental property** is defined as property from which at least 80% of the gross rental income is rental income from dwelling units.[16] Dwelling units include houses, apartments, and manufactured homes that are used for residential purposes but not hotels, motels, or other establishments for transient use. **Nonresidential real property** is any real property other than residential rental property.

ADDITIONAL COMMENT

For purposes of determining whether at least 80% of the gross rental income is rental income from dwelling units, a taxpayer living in any part of the building includes the fair rental value of his unit in the gross rental income.

Real Property: Classification and Recovery Rates. The MACRS recovery periods that apply to real property placed in service in years after 1986 are:

- Residential rental property: 27.5 years (Table 7 in Appendix C)
- Nonresidential real property: 39 years[17] (Table 8 and 9 in Appendix C)

Straight-line depreciation must be used and is reflected in the tables. A mid-month convention is used in the year of acquisition and in the year of disposition.

EXAMPLE I:10-17 ▶ On October 4, 2019, Husker, Inc., acquired an office building to relocate its rapidly-growing staff. The property was purchased for $1,500,000, of which $200,000 was allocated to the underlying land. Because the property is nonresidential real property, it is classified as 39-year property. Depreciation is computed using Table 9 in Appendix C (mid-month convention), totaling $6,955 ($1,300,000 × 0.00535). In 2020, depreciation on the building will be $33,332 ($1,300,000 × 0.02564). ◀

ADDITIONAL COMMENT

In Example I:10-17, Husker cannot claim Sec. 179 expensing or bonus depreciation for the office building.

Taxpayers owning buildings must depreciate subsequent capital improvements. Capital improvements are depreciated over the full MACRS recovery period of the improvement, not over the remaining life or recovery period of the building. Thus, the cost of a new roof on an office building must be depreciated over 39 years, even though the building may have been placed in service several years ago.

Qualified Improvement Property. Qualified improvement property (QIP) is any improvement to an interior portion of nonresidential real property if the improvement is placed into service after the date the real property was placed into service. Certain improvements are not considered to be QIP, such as building enlargements, elevators, escalators, or a building's internal structural framework.

[16] Secs. 168(e)(2)(A).

[17] Sec. 168(c). A 31.5-year recovery period applies to nonresidential real property placed in service on or after January 1, 1987, and before May 13, 1993.

The cost of QIP is eligible for Sec. 179 expensing. In the Tax Cuts and Jobs Act of 2017, Congress intended for QIP to be depreciable over 15 years using the straight-line method, thus making it eligible for bonus depreciation. However, due to a drafting error, the legislation did not actually assign a 15-year recovery period to QIP, which may mean that the 39-year recovery period that normally applies for capital improvements to nonresidential real property also applies to QIP and that QIP is ineligible for bonus depreciation. Congress may need to enact technical correction legislation to address this uncertainty. The drafting error did not affect QIP's eligibility for Sec. 179 expensing.

EXAMPLE I:10-18 ▶ Shaheen Corporation leases office space for some of its business offices. The landlord placed the building into service several years ago. In June 2019, Shaheen spends $120,000 to rearrange the offices' walls and replace the ductwork but does not change the overall size of the offices. The improvements are QIP. Shaheen can deduct all $120,000 in 2019 by claiming Sec. 179 expensing.

Alternatively, Shaheen could forego Sec. 179 expensing. Assuming legislation is enacted that addresses the drafting error and Shaheen elects out of bonus depreciation, it deducts MACRS depreciation of $4,000 [($120,000 ÷ 15 years) × ½] for 2019, assuming the half-year convention applies. For 2020, it deducts $8,000 of MACRS depreciation.

If the drafting error is not corrected and the Treasury Department and IRS do not interpret this part of the IRC consistent with what Congress intended, Shaheen's 2019 MACRS depreciation deduction is $1,669 ($120,000 × 0.01391; see Table 9 in Appendix C) if it foregoes Sec. 179 expensing. For 2020, it deducts $3,077 ($120,000 × 0.02564) of MACRS depreciation. ◀

Straight-Line (Method) Election Under MACRS. Instead of using the accelerated methods previously described under the MACRS rules, taxpayers may elect to use the straight-line method for tangible personal property. If the straight-line election is made, the taxpayer must use either the same depreciation period or an extended period based on the alternative depreciation system, as discussed below.[18]

EXAMPLE I:10-19 ▶ In 2019, Delta Corporation places in service equipment costing $100,000. Delta does not claim Sec. 179 expensing or bonus depreciation for the property, and it elects the straight-line method under MACRS. Using a 7-year recovery period and half-year convention, Delta's depreciation for 2019 is $7,143 [($100,000 ÷ 7 years) × 0.50]. ◀

Alternative Depreciation System. The alternative depreciation system (ADS) is required for certain property and is also allowed for other depreciable assets if the taxpayer so elects.[19] The election is made on a year-by-year basis. Once the election is made for specified property, it is irrevocable. For personal property, the ADS election applies to all property within a class (all 5-year property, for example); for real property, the ADS election may be made on an individual property basis. The principal type of property for which the ADS is *required* is tangible property used predominantly outside the United States. Property that is required to be depreciated under ADS is ineligible for bonus depreciation. ADS recovery periods are generally longer than recovery periods under MACRS, and ADS requires the use of the straight-line method with a half-year, mid-quarter, or mid-month convention, whichever is applicable. Thus, the ADS election is generally made by taxpayers who want to use the straight-line method over a longer recovery period. For example, an individual might anticipate being in a higher tax bracket in the future. Electing the ADS shifts some depreciation deductions from the current year to future years, when the taxpayer expects them to save greater taxes (the taxpayer, however, should not overlook the time value of money).

EXAMPLE I:10-20 ▶ In May 2019, Bob Roaster purchases an office building for $300,000 ($50,000 allocated to the land) as rental property. Roaster elects to depreciate the building using ADS. Depreciation expense for 2019, using the mid-month convention and a 40-year ADS recovery period, is $3,908 [$250,000 × .01563 (Table 12, Appendix C)]. If Roaster had not elected ADS, his depreciation would have been $4,013 [$250,000 × .01605 (Table 9, Appendix C)]. The difference is small because the recovery period is 39 years under regular MACRS and 40 years under ADS. ◀

The alternate depreciation system also is used to compute earnings and profits (E&P) for a corporation (see Chapter C:4), and a variation of the ADS applies to compute

[18] Sec. 168(g)(7).

[19] Sec. 168(g). (See Tables 10–12 in Appendix C.)

TOPIC REVIEW I:10-1

Comparison of MACRS and ADS

	MACRS	ADS
Recovery Periods:		
Automobiles	5 years	5 years
Computers	5 years	5 years
Office machinery	5 years	6 years
Office furniture and equipment	7 years	10 years
Residential rental property	27.5 years	30 years[a]
Nonresidential real property	39 years[b]	40 years
Personal property with no specified class life	7 years	12 years
Conventions:		
Personal property	Half-year or mid-quarter[c]	Half-year or mid-quarter[c]
Real property	Mid-month	Mid-month
Depreciation in year of sale:		
Personal property	Yes	Yes
Real property	Yes	Yes

[a] For property placed in service prior to January 1, 2018, the ADS recovery period is 40 years.
[b] For property placed in service prior to May 13, 1993, the MACRS recovery period is 31.5 years.
[c] If more than 40% of the cost of personal property (after Sec. 179 expensing) is placed in service during the fourth quarter of the year.

depreciation for property placed into service after 1986 but before 1999 for alternative minimum tax purposes for individuals (see Chapter I:14).

Topic Review I:10-1 presents a comparison of the MACRS and ADS rules.



ETHICAL POINT

The personal use of a corporate automobile by a shareholder-employee may be a constructive dividend. Personal use by a nonshareholder-employee results in additional taxable compensation to the employee.

MACRS RESTRICTIONS

Personal-Use Assets. The personal-use portion of an asset's cost is not depreciable. For example, if a taxpayer owns a duplex and uses one unit as a personal residence, only the unit that is rented to tenants qualifies for depreciation.

Listed Property Rules. Because Congress was concerned about taxpayers claiming large depreciation deductions (using accelerated methods) on certain types of assets that are conducive to mixed business/personal use, it placed restrictions on assets that are classified as *listed property*. Listed property includes automobiles and property generally used for purposes of entertainment, recreation, or amusement (for example, a video recorder).[20] If a listed property's business use is greater than 50% of its total use, the taxpayer may elect Sec. 179 expensing for the business portion and may use regular MACRS tables for the remaining business portion of the asset's cost, including bonus depreciation where applicable. However, if the business use is 50% or less, the taxpayer may not elect Sec. 179 expensing, must use ADS (e.g., 5-year straight-line cost recovery for automobiles), and may not use bonus depreciation (because ADS is required).

EXAMPLE I:10-21 ▶ In 2019, Paula acquires an automobile costing $30,000, and 60% of its use is for her business. Paula is not required to use ADS because the automobile is predominantly used in business, i.e., more than 50%. Assuming she does not claim Sec. 179 expensing or bonus depreciation and that the half-year convention applies, the MACRS percentage for 2019 is 20% (see Table 1 in Appendix C.). Paula deducts MACRS depreciation for the business-use portion of the automobile, which is $3,600 ($30,000 × 0.20 × 0.60) for 2019. ◀

EXAMPLE I:10-22 ▶ Assume the same facts as in Example I:10-21 except 40% of the automobile's use is for Paula's business. She must use ADS to depreciate the business portion of the automobile's cost and thus uses the straight-line method over five years. Paula's 2019 depreciation deduction is $1,200 [($30,000 ÷ 5 years) × ½ year]. She is not allowed to claim Sec. 179 expensing or bonus depreciation for the automobile. ◀

[20] Computers and peripheral equipment placed into service before 2018 are also listed property.

ADDITIONAL COMMENT

Congress enacted the restrictions on automobiles in 1984 because of a concern that the tax system was underwriting the acquisition of automobiles whose cost and luxury far exceeded what was required for business needs.

Additional restrictions apply to employees who acquire listed property (e.g., an automobile) for use in employment-related activities. Such use must be for the convenience of the *employer* and be required as a condition of employment.[21] This rule is strictly interpreted by the IRS. Further, deductions connected with listed property are also subject to substantial recordkeeping requirements, similar to the requirements for entertainment expenses.[22]

EXAMPLE I:10-23 ▶ Butch is employed as an architect. He owns an automobile, and 60% of its use during the year is for his job-related activities, such as visiting his employer's clients. Although his employer finds it convenient that Butch uses his own automobile, it does not require that he use it as a condition of employment. Butch thus cannot deduct depreciation for the automobile, even though his use of it is for the convenience of his employer. ◀

Recapture of Excess Cost Recovery Deductions. Taxpayers are subject to depreciation recapture on listed property if MACRS rules were used originally and the property's business-use percentage decreases to 50% or less in a subsequent year. Depreciation deductions for all years are recomputed using ADS. The excess depreciation deducted, including any Sec. 179 expense and bonus depreciation, is recaptured as ordinary income by including it in the taxpayer's gross income in the year the business-use percentage first falls to 50% or below.[23] Once the business use falls to 50% or below, ADS must be used for the current year and for all subsequent years, even if the business-use percentage increases to more than 50% in a subsequent year.

EXAMPLE I:10-24 ▶ Paul, a self-employed attorney, acquired an automobile in June 2017 for $12,000. In both 2017 and 2018, Paul's business-use percentage was 60%. Depreciation under MACRS in 2017 and 2018 were as follows:

2017: Regular MACRS depreciation assuming 100% business use ($12,000 × 0.20)	2,400
Times: Business-use percentage	0.60
Depreciation for 60% business use	$1,440
2018: Regular MACRS depreciation assuming 100% business use ($12,000 × 0.32)	$3,840
Times: Business-use percentage	0.60
Depreciation for 60% business use	$2,304

In 2019, Paul's business-use percentage declines to 40%. Therefore, he must use ADS for 2019 and also recapture the excess depreciation taken in 2017 and 2018. The recapture is computed as follows:

MACRS depreciation taken in 2017 and 2018 ($1,440 + $2,304)		$3,744
2017: Recomputed ADS depreciation ($12,000 × 0.60 × 0.10)	$ 720	
2018: Recomputed ADS depreciation ($12,000 × 0.60 × 0.20)	1,440	(2,160)
Recapture of excess depreciation in 2019 (ordinary income)		$1,584

Paul must use ADS to compute depreciation in 2019 and all subsequent years. His 2019 deduction will be $960 ($12,000 × 0.40 × 0.20).

Limitations on Luxury Automobiles. Because Congress believed that the normal MACRS depreciation deduction for automobiles used for business was too generous, it placed ceilings on deductions related to passenger automobiles. A passenger automobile is defined as a 4-wheeled vehicle which is manufactured primarily for use on public streets, roads, and highways and which is rated at 6,000 pounds or less unloaded gross vehicle weight rating (GVWR).[24] In essence, taxpayers are still allowed to fully depreciate luxury cars, but must depreciate them over longer than the normal five-year recovery period.

[21] Sec. 280F(d)(3). Any other property used for transportation (e.g., a pickup truck) qualifies as listed property if the nature of the property lends itself to personal use. (See Sec. 280F(b)(4).)

[22] Sec. 274(d)(4).

[23] Sec. 280F(b).

[24] Sec. 280F(d)(5)(A).

TAX AUTHORITY UPDATE

At the time this edition went to print, the IRS had not yet released the 2019 ceiling limits. For these examples, we assume the limits will be the same for 2019 as they were in 2018.

To prevent such perceived abuse, Congress limits depreciation deductions for passenger automobiles. For such vehicles placed into service in 2019 that are used 100% for business purposes, these ceiling limits are:

Year 1 (2019)	$10,000 or $18,000*
Year 2 (2020)	16,000
Year 3 (2021)	9,600
After Year 3 (2022 and subsequent years)	5,760

*If the taxpayer does not elect out of bonus depreciation.

EXAMPLE I:10-25 ▶

In 2019, Joe purchases and places into service a passenger automobile costing $85,000 that he uses 100% for business purposes. Under normal MACRS rules and without considering Sec. 179 expensing or bonus depreciation, the depreciation percentages are 20% for the first year and 32% for the second year, resulting in $44,200 [$85,000 × (0.20 + 0.32)] of depreciation deductions in the first two years. If Joe's taxable income is in the 37% tax bracket, he realizes $16,354 ($44,200 × 0.37) of tax savings in those years, which is 19% of the vehicle's cost. ◀

ADDITIONAL COMMENT

The limitations on luxury automobiles mean that the depreciation deductions are limited during the normal 5-year recovery period on business automobiles costing more than $50,000 for 2019 ($10,000 ÷ 0.20).

Different ceiling limits may apply for a passenger automobile the taxpayer placed in service in a prior year (see Table 6 in Appendix C).

If the taxpayer claims 100% bonus depreciation but no Sec. 179 expensing for a passenger automobile whose cost exceeds the first-year ceiling limit ($18,000 if placed in service in 2019), the first-year depreciation deduction is that limit. In each of the next five years of its MACRS recovery period, a safe harbor method can be used, where the depreciation deduction is the lesser of (a) the ceiling limit for that year, or (b) the vehicle's cost exceeding the first-year ceiling limit multiplied by the MACRS depreciation percentage for such year.[25] Any portion of the vehicle's cost exceeding the depreciation deductions for the first six years is deducted in the seventh and subsequent years, limited to the ceiling limit for such years ($5,760 if placed in service in 2019).

EXAMPLE I:10-26 ▶

Assume the same facts as in Example I:10-25. If Joe claims 100% bonus depreciation but no Sec. 179 expensing for the passenger automobile, his 2019 depreciation deduction is $18,000. His 2020–2024 depreciation deductions for the other $67,000 ($85,000 – $18,000) of the vehicle's cost are determined as follows, assuming the half-year convention applies:

		(b)	
Year	(a) *Ceiling limit*	*Cost exceeding first-year ceiling limit × MACRS percentage**	*Lesser of (a) or (b)*
2020	$16,000	$67,000 × 0.32 = $21,440	$16,000
2021	9,600	$67,000 × 0.192 = 12,864	9,600
2022	5,760	$67,000 × 0.1152 = 7,718	5,760
2023	5,760	$67,000 × 0.1152 = 7,718	5,760
2024	5,760	$67,000 × 0.0576 = 3,859	3,859
			$40,979

*Appendix C, Table 1

Through the end of 2024, Joe's depreciation deductions total $58,979 ($18,000 + $40,979). He deducts the remaining $26,021 ($85,000 – $58,979) of the passenger automobile's cost in 2025 and subsequent years, limited to $5,760 for each of these years. Joe thus deducts $5,760 for each year from 2025 through 2028 and $2,981 for 2029. ◀

Depreciating Mixed-Use Automobiles. Taxpayers who use passenger automobiles less than 100% for business must compute the regular MACRS depreciation amount, identify the ceiling amount, and then reduce each one by the percentage of personal use. The actual depreciation deduction for the year will be the lesser of the two reduced amounts.

[25] Rev. Proc. 2019-13 (2019-9 IRB, 2/13/2019). This safe harbor method does not apply if the taxpayer claims Sec. 179 expensing for the passenger automobile.

Complicating the matter, the taxpayer's basis in the automobile will decrease by the lesser of the *unreduced* amounts, even though that was not the amount allowed as a deduction.[26] Example I:10-27 and Table I:10-3 demonstrate this rule.

EXAMPLE I:10-27 ▶ Assume the same facts as in Example I:10-26 except Joe does not claim bonus depreciation and his use of the passenger automobile is 80% for business purposes and 20% for personal purposes in all years. Table I:10-3 details Joe's depreciation deductions. For each year after the end of the regular MACRS recovery period, Joe deducts $4,608 ($5,760 × 0.80) of the unrecovered cost of the automobile's business-use portion. ◀

TYPICAL MISCONCEPTION

It is sometimes mistakenly believed that the Sec. 179 expensing allowance can be used to boost the first-year depreciation of luxury automobiles.

Trucks, Vans, and Suvs. As mentioned previously, depreciation deductions are limited for passenger automobiles whose gross vehicle weight rating (GVWR) is 6,000 pounds or less. Sport utility vehicles (SUVs) often have a GVWR exceeding 6,000 pounds, so the luxury automobile limitations do not apply to them. To prevent taxpayers from deducting the entire cost of a SUV in the year of purchase, the tax law limits Sec. 179 expensing to $25,500 for a SUV with a GVWR exceeding more than 6,000 pounds that is placed into service in 2019.[27] The importance of this limitation is greater for such SUVs placed into service before 2018 and after 2022 because 100% bonus depreciation does not apply for those years.

▼ **TABLE I:10-3**
Depreciation Amounts for Example I:10-27 (80% Business-Use Automobile)

	(A) Depreciation Deduction: 100% Bus. Use (Table 1)	(B) Ceiling Limit: 100% Bus. Use (Table 6)	Deduction Allowed: 80% × Lesser of MACRS or Ceiling	Unrecovered Basis
2019 MACRS depreciation ($85,000 × 0.20)	$17,000	$ 10,000	$ 8,000	$75,000*
2020 MACRS depreciation ($85,000 × 0.32)	$27,200	$16,000	$12,800	$59,000
2021 MACRS depreciation ($85,000 × 0.192)	$16,320	$9,600	$7,680	$49,400
2022 MACRS depreciation ($85,000 × 0.1152)	$9,792	$5,760	$4,608	$43,640
2023 MACRS depreciation ($85,000 × 0.1152)	$9,792	$5,760	$4,608	$37,880
2024 MACRS depreciation ($85,000 × 0.0576)	$ 4,896	$ 5,760	$ 3,917	$32,984
Total through 2024	$85,000	$52,880	$41,613	
2025 and subsequent years until fully depreciated Ceiling limit		$ 5,760	$ 4,608	

* **Unrecovered basis** basis equals original basis minus the lesser of A or B [($85,000 − $10,000) for 2019], even though the annual deduction is limited to business usage.

Note: Based on the unrecovered basis of $32,984 at the end of 2024, it would take Joe six more years to fully depreciate the automobile ($32,984 ÷ $5,760 = 5.7 years). The personal-use portion of the automobile's cost ($85,000 × 0.20 = $17,000) never will be depreciated and will be recovered only upon disposition.

[26] Sec. 280F(d)(8).

[27] Sec. 179(b)(5). Vehicles with a GVWR of more than 14,000 pounds are not considered SUVs and are not subject to the $25,500 limitation.

To qualify for the truck and van depreciation deduction, a vehicle must be a passenger vehicle built on a truck chassis with an unloaded gross weight of over 6,000 pounds. A vehicle built on an automobile chassis is classified as an automobile regardless of weight, even if its manufacturer calls it an SUV.

EXAMPLE I:10-28 ▶ Taxpayers A and B each purchase a vehicle that is used 100% for business in July 2019 for $60,500. Taxpayer A's vehicle is a passenger automobile; A does not elect Sec. 179 expensing and does not elect out of bonus depreciation. Taxpayer B's vehicle is an SUV with a 6,800-pound GVWR; B elects Sec. 179 expensing and does not elect out of bonus depreciation. Each vehicle's 2019 depreciation is computed as follows:

Taxpayer A:	Bonus depreciation ($60,500 × 1.00)	$60,500
	MACRS depreciation	0
	Sum of bonus and MACRS depreciation	60,500
	Ceiling limitation (Table 6)	18,000
	Depreciation deduction (lesser of $60,500 or $18,000)	$18,000
Taxpayer B:	Sec. 179 expensing (limited to $25,500)	$25,500
	Bonus depreciation ($35,000 × 1.00)	35,000
	MACRS depreciation	0
	Ceiling limitation (Table 6)	n/a*
	Depreciation deduction ($25,500 + $35,000)	$60,500

*Does not apply because the vehicle's GVWR is more than 6,000 pounds. ◀

This example shows the significant tax savings from buying a passenger vehicle on a truck chassis that has a GVWR of more than 6,000 pounds. It should be noted that any vehicle that avoids the ceiling limitations must be used more than 50% for business, under the general listed property rules.

Although some taxpayers avoid the ceiling limitations by purchasing heavy vehicles, other taxpayers who use light trucks and vans (6,000 GVWR or less) in their businesses are hurt by the ceiling limitations. In response to small business concerns, two recent exceptions to the ceiling limitations have been issued: (1) exemption from the ceiling limitations for vehicles that clearly are not for personal use and (2) higher ceiling limitation amounts for other light trucks and vans.

- Exemption from ceiling limitations: Certain "nonpersonal use" vehicles are completely exempt from the ceiling limitations.[28] These vehicles must be specifically modified so that they are not likely to be used more than a de minimis amount for personal purposes. This somewhat vague definition is explained further in the regulations as a van that only has a front bench for seating, has permanent shelving that fills most of the cargo area, or has been painted with advertising or the company's logo.

ADDITIONAL COMMENT

As with passenger automobiles, the dollar limitation for the first year for trucks and vans is increased by $8,000 for such vehicles placed into service on or after September 28, 2017.

- Higher ceiling limitations: Even if a light truck or van does not meet the nonpersonal use criteria above, higher ceiling limitations have often applied for trucks and vans on a truck chassis that have a GVWR of 6,000 pounds or less.[29] The ceiling limitations for trucks and vans and those for other vehicles are both based on the same historical dollar amounts in the IRC, but the IRS in recent years has calculated annual inflation adjustments for them separately for the two types of vehicles. Under the 2017 legislation that increases these dollar amounts in the IRC for 2018 and later years, these higher dollar amounts will be adjusted for inflation starting in 2019. For 2018, the ceiling limitations are the same for both types of vehicles. The IRS has not announced whether it will continue its practice of separate inflation adjustments for the two types of vehicles.

ADDITIONAL COMMENT

The amount that can be deducted for leased automobiles is also limited.

Additional Computations for Leased Vehicles. If a taxpayer leases an automobile or light truck or van for business purposes, the deduction for rental payments is reduced to reflect the luxury auto depreciation limits imposed on purchased vehicles. If these restrictions were not applied to leased automobiles, the ceiling limitations could be avoided by leasing instead of

[28] Reg. Sec. 1.274-5(k).

[29] Rev. Proc. 2003-75, 2003-2 C.B. 1018.

purchasing an automobile. The leasing restriction is accomplished by requiring taxpayers to reduce their deduction by an "inclusion amount" obtained from an IRS table.[30] This amount is based on the automobile's FMV and the tax year in which the lease commences, and is prorated for the percentage of business use and number of days used during the year. Partial lease inclusion tables are provided in Tables 13 and 14 in Appendix C.

EXAMPLE I:10-29 ▶

TAX AUTHORITY UPDATE

At the time this edition went to print, the IRS had not yet released the 2019 lease inclusion amounts. For Example I:10-29, we assume the lease inclusion amounts will be the same for 2019 as they were in 2018.

On January 1, 2019, Jim leased and placed in service an automobile with a $65,000 FMV and annual lease payments of $12,000. Jim uses the automobile 80% for business purposes. Jim can deduct $9,600 ($12,000 × 0.80) of the lease payments but must reduce his deduction by 80% of the $41 inclusion amount from Table 13 for the first year to reflect the luxury auto depreciation limitation. Thus, Jim's auto lease deduction for 2019 is $9,567 [$9,600 − ($41 × 0.80)]. For 2020, Jim uses the $90 inclusion amount from Table 13 for the second year, obtaining a lease deduction of $9,528 [$9,600 − ($90 × 0.80)]. ◀

Topic Review I:10-2 summarizes the special depreciation elections and restrictions.

TOPIC REVIEW I:10-2

Special Depreciation Elections and Restrictions

Section 179 Expensing Election

Maximum deduction: $1.02 million (in 2019) of the total cost of qualified property placed in service during the year.

Qualified property: New or used tangible personal business-use property.

Limitations on deduction:

1. Cost limitation: The maximum Sec. 179 expense is reduced dollar-for-dollar by the excess of total qualified property cost over $2,550,000 (in 2019). Taxpayers may not carry forward amounts reduced by this limitation. However, the cost not expensed because of this limitation remains as basis subject to bonus depreciation or MACRS depreciation,
2. Taxable income limitation: The Sec. 179 expense after cost limitation is further limited to taxable income before the deduction. Taxpayers may carry forward amounts lost because of this limitation.

Basis reduction: The basis of qualified property for bonus depreciation or MACRS depreciation is reduced by the Sec. 179 expense (after the cost limitation reduction).

Bonus Depreciation

Maximum allowed: 100% in 2019 of the cost of qualified property placed in service during the year.

Qualified Property: Property that is (1) MACRS property with a recovery period of 20 years or less, (2) computer software, or (3) qualified improvement property (see page I:10-11 for discussion of uncertainty regarding qualified improvement property).

Business Use Restriction

Listed property: If business use of listed property exceeds 50% of total use, taxpayers may elect Sec. 179 expensing for the business portion and may depreciate the remaining business-use portion using bonus depreciation or MACRS rules. If business use is 50% or less of total use, taxpayers may not elect Sec. 179 expensing or bonus depreciation and must depreciate listed property using ADS rules.

Automobiles, Trucks, and Vans

Table 6 in Appendix C provides annual ceiling amounts for depreciation on 100% business-use automobiles and on 100% business-use trucks and vans with a GVWR of 6,000 pounds or less. The taxpayer computes regular depreciation under MACRS, including Sec. 179 expensing and bonus depreciation, and then compares that figure to the Table 6 ceiling figure. The deduction is the lesser of these two. If business-use is less than 100%, both figures must be reduced by the personal-use percentage. Basis nevertheless is adjusted by the unreduced figure. Business-use trucks and vans with a GVWR of more than 6,000 pounds are not subject to these limitations.

Leased Vehicles

Taxpayers who lease vehicles must subtract from their otherwise deductible lease payments as "inclusion amount" (see Tables 13 and 14 in Appendix C) to adjust the lease expense deduction for the luxury auto depreciation limitations imposed on purchased vehicles. This rule prevents individuals from avoiding the luxury auto depreciation limits by leasing vehicles.

[30] The latest lease inclusion table is contained in Rev. Proc. 2018-25, 2018-18 I.R.B.543, 4/17/2018.

AMORTIZATION

OBJECTIVE 2

Calculate amortization for intangible assets and distinguish between amortizable and non-amortizable assets

Amortization deductions are allowed for a variety of intangible assets. Although amortization periods vary greatly depending on the type of asset, all intangible assets are amortized on a *straight-line basis*. The major intangible assets that may be amortized are as follows:

- Goodwill and Other Purchased Intangibles, Sec. 197
- Research and Experimental Expenditures, Sec. 174
- Computer software
- Start-up Expenditures, Sec. 195
- Organizational Expenditures, Sec. 248
- Pollution Control Facilities, Sec. 169

Several of the above intangibles are discussed below.

SEC. 197 INTANGIBLES

Sec. 197 allows taxpayers to deduct the cost of certain Sec. 197 intangibles. The deduction is calculated using straight-line amortization over a 15-year (180-month) period beginning with the month of acquisition; any salvage value is disregarded.[31] However, the cost of an internally-created intangible (the taxpayer creates it rather than acquiring it from someone else) generally is not amortized over 15 years; its treatment depends on its type (discussed below). Sec. 197 intangibles include the following:

BOOK-TO-TAX ACCOUNTING COMPARISON

For financial statement reporting, a firm reduces goodwill by an impairment amount rather than by amortization.

- Goodwill and going concern value. **Goodwill** is the value of a trade or business that is attributable to the expectation of continued customer patronage, whether due to the name or reputation of the trade or business or to any other factor.[32] Going concern value is the added value that attaches to acquired property because it is an integral part of a going concern. A taxpayer generally acquires this type of Sec. 197 intangible when acquiring assets constituting a trade or business, and its cost is amortized over 15 years. Internally-created goodwill and going concern value often arise through advertising, employee training and retention, and other such expenditures that generally are deducted immediately.
- Intangibles relating to the workforce, an information base (e.g., a customer list), know-how, customers, suppliers, or similar items. Know-how related intangibles include patents, copyrights, formulas, and processes. Similar to goodwill and going concern value, the costs of these Sec. 197 intangibles generally are amortized over 15 years if acquired with assets constituting a trade or business but are deducted immediately if internally-created. However, the cost of an internally-created patent or copyright is depreciated under Sec. 167 (not amortized under Sec. 197) using the straight-line method over its useful life (which may be its remaining legal life).[33]
- Licenses, permits, or other rights granted by a governmental unit or agency (e.g., the capitalized cost of acquiring a radio broadcasting license).
- Covenant not to compete. This is an agreement between the buyer and seller of a business that the seller will not compete with the buyer for a specified period of time and/or within a specified geographic area. Its cost is amortized over 15 years even if its term is for a shorter length of time.[34]
- Franchises, trademarks, and trade names. A franchise includes any agreement that gives one the right to distribute, sell, or provide goods, services, or facilities, within a specified area.

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[31] Sec. 197(a) and Reg. Sec. 1.197-2(f)(1). In general, Sec. 197 applies only to intangibles held in connection with the conduct of a trade or business or an activity engaged in for the production of income.

[32] Reg. Sec. 1.197-2(b)(1).

[33] Reg. Sec. 1.167(a)-3.

[34] The cost of a covenant not to compete for five years was required to be amortized over 15 years (*Frontier Chevrolet Co.*, 2003-1 USTC ¶50,490 (9th Cir., 2003) aff'g 116 T.C. 289 (2001)).

EXAMPLE I:10-30 ▶ In January of the current year, Chicago Corporation acquires all the net assets of Coastal Corporation for $1 million. The following intangible assets are included in the purchase agreement:

Assets	*Acquisition Cost*
Goodwill and going concern value	$100,000
Licenses	55,000
Patents	45,000
Covenant not to compete for five years	90,000

All the intangible assets above qualify as Sec. 197 intangible assets and are amortizable on a ratable basis (straight-line) over 15 years beginning with the month of acquisition. This 15-year amortization period applies to the convenant not to compete even though the convenant is only for five years. ◀

EXAMPLE I:10-31 ▶ On June 1 of the current year, McKee Corporation receives a patent for a process it created. McKee incurs $100,000 of legal costs to obtain the patent, which has a useful life of 17 years. The patent is not a Sec. 197 intangible asset because it is internally-created. Instead, McKee depreciates it under Sec. 167 over 17 years using the straight-line method. For the current year, McKee can deduct $3,431 (($100,000/17) x (7/12)). ◀

STOP & THINK

Question: When one company purchases the assets of another company, the purchasing company may acquire goodwill. Because purchased goodwill is a Sec. 197 intangible asset and may be amortized over 15 years, determining the cost of goodwill is important. How is the "cost" of goodwill determined in an acquisition?

Solution: The IRS requires that taxpayers use the "residual method" as prescribed in Sec. 1060. Under this method, all of the assets except for goodwill are valued. The total value of these assets is then subtracted from the total purchase price, and the residual is the amount of the purchase price allocated to goodwill.

ADDITIONAL COMMENT

Sec. 1231 generally allows net gains to be treated as long-term capital gains and net losses to be deducted as ordinary losses. Sec. 1245 requires that gains be classified as ordinary income to the extent depreciation, amortization, or depletion was claimed as an ordinary deduction in prior periods (see Chapter I:13).

Classification and Disposition of Intangible Assets. A Sec. 197 intangible asset is treated as depreciable property. Thus, a disposition is given Sec. 1231 treatment if the intangible asset is held for more than one year.[35] Gain on disposition of a Sec. 197 intangible is subject to depreciation recapture under Sec. 1245 (see Chapter I:13).[36] Loss on disposition of a Sec. 197 intangible asset, however, is not deductible if other intangibles acquired in the same acquisition of a trade or business are retained. In such case, the bases of the retained Sec. 197 intangibles are increased by the disallowed loss.[37]

EXAMPLE I:10-32 ▶ Assume the same facts as in Example I:10-30. After five years, the covenant not to compete expires. Its adjusted basis is $60,000 [$90,000 − ($^5/_{15}$ × $90,000)]. The $60,000 loss is not deductible, and the disallowed loss is allocated to the retained Sec. 197 assets based on their respective FMVs. ◀

EXAMPLE I:10-33 ▶ Assume the same facts as in Example I:10-30. After one year the *patent* is sold for $50,000. In the initial year, $3,000 ($45,000 ÷ 15) of amortization was deducted. The recognized gain on the sale is $8,000 ($50,000 − $42,000). Of the gain, $3,000 is recaptured as ordinary income under Sec. 1245, and $5,000 is classified as Sec. 1231 gain. ◀

TYPICAL MISCONCEPTION

It is sometimes mistakenly believed that if a company constructs a new building to be used entirely as a research facility, the entire cost of the building can be expensed. However, the expensing election applies only to the depreciation allowances on the building.

RESEARCH AND EXPERIMENTAL EXPENDITURES

In general, research and experimental (R&E) expenditures include experimental and laboratory costs incidental to the development of a product.[38] Section 174 was enacted to clarify the income tax treatment of R&E expenditures. Treasury Regulations define items that do and do not qualify as R&E expenditures. These items are summarized in Table I:10-4. For income tax purposes, the following alternatives are available for qualified R&E expenditures:

- Expense in the year paid or incurred.

[35] Sec. 197(f)(7).
[36] Sec. 1245(a)(2)(C).
[37] Sec. 197(f)(1).

[38] Reg. Sec. 1.174-2(a)(2). The Regulations define the term *product* to include any pilot model, formula, invention, technique, patent, or similar product.

▼ **TABLE I:10-4**
Research and Experimental Expenditures

Items That Qualify	Items That Do Not Qualify[a]
▶ Costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention ▶ Costs associated with product improvements ▶ Costs of obtaining a patent, such as attorney fees ▶ Research contracted to others ▶ Depreciation or cost-recovery amounts attributable to capitalized R&E items (e.g., research laboratory and equipment)	▶ Expenditures for ordinary testing or inspection of materials or products for quality control purposes ▶ Efficiency surveys and management studies ▶ Marketing research, advertising, etc. ▶ Cost of acquiring another person's patent, model, production, or process ▶ Research incurred in connection with literary, historical, or similar projects

[a] Certain of these expenses may be deductible as trade or business expenses under Sec. 162, subject to amortization under Sec. 197, or treated as start-up expenditures under Sec. 195.

- ▶ Defer (capitalize as deferred expenses) and amortize the costs as a ratable deduction over a period of 60 months or more beginning with the month in which benefits are first realized.
- ▶ Capitalize and write off the costs only when the research project is abandoned or is worthless.[39]

A taxpayer must make an election to either expense or defer and amortize the costs in the initial year the R&E expenditures are incurred. If no election is made, the costs must be capitalized. The taxpayer must continue to use the same accounting method for the R&E expenditures unless IRS approval to change methods is obtained.

Below are some important points regarding R&E expenditures:

- ▶ Most taxpayers elect to expense the R&E expenditures because they prefer the immediate tax benefit.
- ▶ The deferral and amortization method is desirable if the taxpayer is currently in a low tax rate situation or expects initial NOLs during a start-up period.
- ▶ If the deferral and amortization method is used, the amortization period of 60 or more months commences with the month in which the benefits from the expenditures are first realized.
- ▶ R&E expenses include depreciation allowances related to capitalized expenditures. Thus, if the deferral and amortization method is used, depreciation allowances are deferred as part of the R&E expenditures that are amortized over a period of at least 60 months. Capital expenditures made in connection with R&E activities cannot be expensed when they are incurred merely because an election to expense R&E costs are made.
- ▶ A tax credit may apply to certain research expenditures. (See Chapter I:14 for a discussion of the research activities credit.) Taxpayers must reduce any R&E expense deduction by the amount of the credit claimed.

EXAMPLE I:10-34 ▶ In 2019, Control Corporation leases a research laboratory to develop new products and to improve existing products. Control Corporation, a calendar year taxpayer that uses the accrual method of accounting, incurs the following expenditures during 2019:

Laboratory supplies and materials	$ 40,000
Laboratory equipment	60,000[a]
Utilities and rent	50,000
Salaries	50,000
Total expenditures	$200,000

[a] The MACRS recovery period is 5 years at a 20% rate for the initial year.

[39] Sec. 174.

REAL-WORLD EXAMPLE

An airline company made payments to an aircraft manufacturer to help defray the cost of designing, developing, producing, and testing a supersonic transport prototype aircraft. These payments were considered R&E expenditures. Rev. Rul. 69-484, 1969-2 C.B. 38.

Assume the benefits from the R&E expenditures are first realized in January 2020. If Control Corporation elects to expense the R&E expenditures, the deduction in 2019 is $152,000 ($40,000 laboratory supplies and materials + $12,000 depreciation on the equipment + $50,000 utilities and rent + $50,000 salaries). If the deferral and amortization method is elected, none of the expenditures above are deductible in 2019 because the benefits of the R&E activities are not first realized until January 2020. If the 60-month minimum amortization period is elected, the monthly amortization commencing in January 2020 is $2,533 ($152,000 ÷ 60 months). The $48,000 ($60,000 − $12,000) of laboratory equipment cost is depreciated over the remaining MACRS recovery period beginning in 2020. ◀

The three alternatives discussed earlier will not be available for R&E expenditures (including software development costs) occurring in 2022 and later years. These expenditures instead will be capitalized and amortized over the five-year period beginning with the middle of the year in which they are paid or incurred (the amortization period is 15 years for foreign research).

COMPUTER SOFTWARE

The amortization or depreciation of computer software depends on the nature of the software and how it is acquired. Basically, computer software is either developed by the taxpayer or acquired (purchased or leased) from an outside party.

Developed Computer Software. The cost of developing computer software that is considered R&E may either be expensed in the year the costs are incurred or, if the taxpayer so elects, capitalized and amortized over 60 months beginning with the month in which the taxpayer first realizes benefits from such expenditures, per Sec. 174. If the costs incurred to develop the software are not considered R&E costs (e.g., the software is not in the experimental stage), such costs should be depreciated on a straight line basis over 36 months beginning with the date the software is placed in service.[40] As noted earlier, software development costs occurring in 2022 or later years will be treated as R&E expenditures and will be amortized over five years (15 years for foreign research).

Purchased Computer Software. Purchased computer software generally may be depreciated in two alternative ways: (1) if the software is included in the cost of the computer hardware, the software does not have to be separately stated as long as the taxpayer consistently follows this treatment. Therefore, the computer and software would be depreciated together under MACRS over five years; or (2) if the software is purchased separately, the software must be depreciated on a straight-line basis over 36 months. An exception to these rules occurs if computer software is purchased in connection with the acquisition of a number of assets of an existing trade or business. In this case, the computer software is considered to be a Sec. 197 intangible and must be amortized over a period of 15 years.[41]

EXAMPLE I:10-35 ▶ Morris Corporation purchased all the assets of an existing business on April 1, 2019 for $1,000,000. Included in the assets was some computer software that the corporation intends to use in its business. The software is specialized for use by businesses in Morris' industry. Based on relative fair market values, the computer software is allocated a cost of $63,000. The software is considered a Sec. 197 intangible and would be amortized over 15 years beginning in the month of acquisition. For the nine-month period in calendar year 2019, Morris Corporation's amortization deduction would be $3,150 [($63,000 ÷ 15 years) × 9/12]. ◀

EXAMPLE I:10-36 ▶ Using the same facts as in Example I:10-35, if Morris Corporation had purchased computer software on April 1, 2019 (not in connection with an asset acquisition) for $63,000, the software would not be considered a Sec. 197 intangible and would be depreciable under Sec. 167(f) on a straight-line basis over a period of 36 months. Therefore, in 2019, Morris Corporation's depreciation deduction would be $15,750 ($63,000 × 9/36). ◀

[40] Sec. 167(f)(1) and Rev. Proc. 2007-16, 2007-1 C.B. 358.

[41] Sec. 197(e)(3)(A). If the computer software acquired in an asset acquisition is software that is readily available for purchase by the general public, such software would not be considered a Sec. 197 intangible. (See Sec. 197(e)(3)(A)(i).)

Leased or Licensed Computer Software. Computer software that is leased or licensed for use in the taxpayer's trade or business generally is deductible in full in the year paid.[42]

DEPLETION, INTANGIBLE DRILLING AND DEVELOPMENT COSTS

OBJECTIVE 3

Apply cost and percentage depletion methods and summarize the treatment for intangible drilling costs

The taxation of natural resources, such as oil and gas, coal, iron ore, etc. has many of its own specific rules. This section of the text discusses some of the concepts that apply to the oil and gas industry. Other natural resources have slightly different rules, but the oil and gas industry demonstrates the normal taxation of natural resources.

The exploration, development, and operation of oil and gas properties require an outlay of various types of expenditures. Below are the four major types of oil and gas property expenditures and their income tax treatment.

- Payments for the mineral interest. These costs are capitalized and recovered through depletion.
- Intangible drilling and development costs (e.g., labor and other operating costs to clear land, erect a derrick, and drill the well). Taxpayers elect to either capitalize or immediately expense these expenditures.
- Tangible asset costs (e.g., machinery, pipe). These expenditures must be capitalized and depreciated under the MACRS rules.
- Operating costs after the well is producing. These expenditures are deductible under Sec. 162 as ordinary and necessary business expenses.

DEPLETION METHODS

KEY POINT

A depletion deduction is available in the case of mines, oil and gas wells, other natural resources, and timber. However, the percentage depletion method is not available in the case of timber.

Depletion, similar to depreciation, is the using up of natural resources by the process of mining (coal, for example) or drilling (oil and gas). It is calculated under the **cost depletion method** or the **percentage depletion method** for each period. The method used in any year is the one that results in the largest deduction. Thus, percentage depletion may be used in one year and cost depletion may be used in the following year.

Depletion is allowed to the taxpayer who has an **economic interest** in the property. The person who typically has an economic interest in the property is the owner of the natural resource (i.e., the oil, gas, coal, etc.). Thus, depletion may be claimed by the persons who either own the natural resource property or retain a royalty interest. A mining company that only mines coal from a property and does not own (or lease) the underlying coal is not considered to hold an economic interest and, therefore, is not allowed a depletion deduction. The landowner who owns the coal would be entitled to the depletion deduction.

ADDITIONAL COMMENT

Note that a taxpayer will deduct the greater of cost depletion or percentage depletion. If percentage depletion is used, the adjusted basis of the property is reduced by the percentage depletion amount.

Cost Depletion Method. The cost depletion method is similar to the units-of-production method of depreciation. The adjusted basis of the asset is divided by the estimated recoverable units to arrive at a per-unit depletion cost. This per-unit cost is then multiplied by the number of units sold to determine the cost depletion deduction.[43] If the original estimate of recoverable units is subsequently determined to be incorrect, the per-unit cost depletion rate must be revised and used on a prospective basis to determine cost depletion in future years.[44] It is not proper to file an amended return for the years in which the incorrect estimated unit cost was used.

EXAMPLE I:10-37 ▶ Ralph acquires an oil and gas property interest for $100,000 in 2019. The estimate of recoverable units is 10,000 barrels of oil. The per-unit cost depletion amount is $10 ($100,000 ÷ 10,000). If 3,000 units are produced and 2,000 units are sold in 2019, the cost depletion amount is $20,000 (2,000 units × $10 per unit). If cost depletion is used because it exceeds the percentage depletion amount, the cost basis of the property is reduced to $80,000 ($100,000 − $20,000)

[42] Reg. Sec. 1.162-11 and Rev. Proc. 2000-50, 2000-2 C.B. 601, as modified by Rev. Proc. 2007-16, 2007-1 C.B. 358.

[43] Sec. 612.

[44] Sec. 611(a).

at the beginning of 2020. If the estimate of remaining recoverable units is revised downward in 2020 from 8,000 units (10,000 – 2,000 units sold in 2019) to 5,000 units (including the 1,000 barrels produced but not sold in 2019), the property's $80,000 adjusted basis is divided by 5,000 units to arrive at a new per-unit cost depletion amount of $16 for 2020. This process is continued each year until the cost of the oil and gas property interest is fully depleted. ◀

REAL-WORLD EXAMPLE

Taxpayers are entitled to a depletion deduction if they have an economic interest in the property. This economic interest may be in the form of a royalty interest where a landowner receives a certain amount per unit extracted from her land, such as $10 for each barrel of oil. The landowner would be entitled to a depletion deduction based on the royalty income received.

Percentage Depletion Method. Percentage depletion generally offers substantial tax benefits for taxpayers in the natural resources industry. The purpose of allowing percentage depletion is to encourage persons to invest and/or operate in an industry that is both capital intensive and high risk but is also vital to our national interests. Percentage depletion may be used by taxpayers for a wide variety of natural resources, such as oil and gas, coal, gold, etc. The percentage depletion method has not been available to *large* oil and gas producers since 1974; but it is still available to *small* oil and gas producers and royalty owners under a specific exemption in the law.[45] Percentage depletion is computed by multiplying the percentage depletion rate times the gross income from the property. However, the depletion amount may not exceed 50% of the taxable income from the property before depletion is deducted (100% for oil and gas properties).[46] Percentage depletion may not be calculated on any lease bonus, advance royalty, or other amount payable without regard to production from the property.

Whether the taxpayer uses cost depletion or percentage depletion, the amount of the depletion deduction reduces the basis of the natural resource property. Once the basis of depletable property has been reduced to zero, a taxpayer may no longer claim depletion using the cost depletion method. However, the taxpayer may continue to claim percentage depletion. Subsequent percentage depletion will not reduce the basis of the property below zero. It should be apparent that percentage depletion is a very advantageous method because the total depletion allowed over the life of the property may exceed the property's cost.[47]

Percentage depletion rates vary by the type of mineral. Depletion rates for selected minerals are as follows:

Mineral	*Depletion Rate*
Oil and gas	15%[48]
Coal, asbestos	10%
Gold, silver, copper, iron ore	15%
Sulphur and uranium	22%
Gravel, stone	5%
All other minerals	14%

EXAMPLE I:10-38 ▶ In the current year, Carmen acquires for $400,000 an oil and gas property interest with 200,000 barrels of estimated recoverable oil. During the year, 10,000 barrels of oil are sold for $250,000. Intangible drilling and development costs (IDCs) amount to $100,000 and are expensed in the current year. Other expenses are $50,000. Cost depletion is $20,000 [10,000 barrels sold × ($400,000/200,000 barrels)] in the current year. The computation of percentage depletion is as follows:

(1)	Percentage depletion before taxable income limitation ($250,000 × 0.15)	$ 37,500
(2)	Taxable income ceiling:	
	Gross income	$250,000
	Minus: Intangible drilling costs (IDCs) expensed	(100,000)
	Other expenses	(50,000)
	Taxable income before depletion	$100,000
(3)	Percentage depletion (lesser of (1) or (2))	$ 37,500

HISTORICAL NOTE

An Arab oil embargo to the United States in 1973 created a situation where oil prices increased significantly. Consequently, most domestic U.S. oil producers reported huge profits. This situation contributed to the repeal of the percentage depletion allowance for large oil and gas producers.

KEY POINT

The use of the percentage depletion method permits recovery of more than the cost of the property.

Carmen's depletion deduction is $37,500 because the percentage depletion amount is greater than the $20,000 of cost depletion. The adjusted basis of the property is reduced by $37,500, the amount of depletion actually claimed. ◀

[45] Sec. 613A(c). To be classified as a small oil and gas producer or royalty owner, the maximum depletable quantity is based on average daily production of not more than 1,000 barrels of oil or 6 million cubic feet of natural gas.

[46] Sec. 613(a).

[47] Depletion in excess of the adjusted basis of the property is a tax preference item under Sec. 57(a)(1). See Chapter I:14.

TREATMENT OF INTANGIBLE DRILLING AND DEVELOPMENT COSTS

Intangible drilling and development costs (IDCs) may either be deducted as an expense or capitalized.[49] IDCs apply only to oil, gas, and geothermal wells and basically include all expenditures, other than the acquisition costs of the underlying property, that are incurred for the drilling and preparation of wells. If the IDCs are capitalized, the amounts are added to the property's basis for determining cost depletion, and the costs are expensed through cost depletion. For a well that is nonproductive (i.e., a dry hole), an ordinary loss is allowed for any IDC costs that have been capitalized and not recovered through depletion. The amount of depletion claimed in a tax year equals the greater of the percentage depletion and cost depletion amounts. If IDCs are capitalized and cost depletion is thereby increased, little or no tax benefit may result because the percentage depletion may still produce a greater deduction than cost depletion. Therefore, it is generally preferable to expense the IDCs if the percentage depletion is expected to be more than the cost depletion and is used to compute the depletion allowance.

EXAMPLE I:10-39 ▶ In the current year, Penny acquires certain rights to oil and gas property for $1,000,000, incurring $300,000 of IDCs. If the IDCs are capitalized, the basis for cost depletion purposes is $1,300,000. Assume that the cost depletion amounts are $100,000 in the current year if the IDCs are expensed and $130,000 if IDCs are capitalized. If the percentage depletion amount is $150,000, percentage depletion will be used because it is greater than either of the cost depletion amounts. Thus, expensing the IDCs permits Penny to deduct the entire $300,000 of IDCs in the current year plus $150,000 of percentage depletion. ◀

TAX PLANNING CONSIDERATIONS

OBJECTIVE 4

Identify tax planning considerations for depreciation

ALTERNATIVE DEPRECIATION SYSTEM UNDER MACRS

In some instances, it may be preferable to elect to use the alternative depreciation system (ADS) rather than the regular MACRS rules. For example, a taxpayer who is currently in a low tax bracket but anticipates being in a higher tax bracket in the future may elect to use ADS, which employs the straight-line method of depreciation over a longer recovery period.

EXAMPLE I:10-40 ▶ Gabriel's sole proprietorship normally is very profitable and puts his taxable income in the 37% tax bracket. In the current year, his profits are much lower than normal, putting his taxable income in the 24% tax bracket. Gabriel is confident his business' profitability will return to normal in a few years, so he spends $100,000 to acquire new machinery and equipment for it. The property's MACRS recovery period is seven years, and its ADS recovery period is 12 years. To reduce the portion of the $100,000 he deducts at a 24% tax rate in the current year, Gabriel does not elect Sec. 179 expensing and elects out of bonus depreciation. To further reduce his current-year deduction, Gabriel elects the ADS, under which his deduction is $4,167 [($100,000 ÷ 12 years) × ½ year] if the half-year convention applies (versus $14,290 ($100,000 × 0.1429) under MACRS). Gabriel thus will deduct $95,833 ($100,000 − $4,167) of the property's cost in future years, when he expects them to reduce taxes at a higher rate.[50] ◀

ADDITIONAL COMMENT

A taxpayer who is attempting to report a profit in three out of five years in an attempt to avoid the hobby loss rules might want to use the alternative depreciation system.

USE OF UNITS OF PRODUCTION DEPRECIATION

Many times, the MACRS depreciation system requires taxpayers to use a recovery period that is much longer than the actual useful life of the asset. For example, assume a taxpayer uses a machine in his or her business that is classified as 7-year property under MACRS. However, the machine is operated 24 hours a day, seven days a week and will completely wear out in two years. The use of the 7-year recovery period substantially understates depreciation for the machine in the two years of actual use. Under Sec. 168(f), taxpayers may exclude property from the MACRS system if the property is depreciated under the unit-of-production method or any other method not expressed in terms of years. Therefore, if the

[48] For small producers and royalty owners of oil and gas properties, there is a further limitation: the percentage depletion deduction may not exceed 65% of taxable income from all sources before the depletion deduction. Sec.613A(d)(1).

[49] Sec. 263(c).

[50] In Example I:10-40, Gabriel's increased tax savings are delayed, so he should also consider the time value of money.

WHAT WOULD YOU DO IN THIS SITUATION?

Your CPA firm has a long-standing tax client named Widgets R Us, Incorporated (WRU). WRU has been a worldwide leader in widget technology for years and continues to expand its global market share through a substantial program of basic research and development of widget crystallization processes. You have advised WRU as to which of these expenditures qualify as research and experimental (R&E) expenditures. In addition, you have given timely advice as to when to expense rather than capitalize these expenditures.

You are having your monthly tax conference with Ms. Ima Worthmore, president of WRU, and Mr. Stan Cunning, tax counsel of WMU. Ms. Worthmore relates to you a conversation she had with the local manager of a competitor CPA firm, Ms. Ruth Less. Ms. Less told Ms. Worthmore that she had discovered that WRU was one of the top spenders on research and development in the area and that her firm was "certified" to practice before the IRS and had experienced great success in gaining R&E write-offs for comparable firms. Ms. Less went on to say that, "For you, for this one year only, we offer to prepare your tax returns on a contingent basis. We promise to save you at least $1 million from what you are now paying the IRS through our better use of R&E write-offs, and our fee will only be 30% of the tax savings!"

Ms. Worthmore was excited that WRU might be able to pay considerably lower taxes and is somewhat perturbed because you had not brought this tax opportunity to her attention. She wants your firm to provide her with a counteroffer. How do you ethically respond to your client's request to match or better Ms. Ruth Less' proposal?

taxpayer can express the useful life of the machine in terms of some base other than years (such as machine hours, units produced, etc.), it may be possible to depreciate the machine over a much shorter period than the seven years required under MACRS.

STRUCTURING A BUSINESS COMBINATION

When a company purchases the assets of another business, the agreement must specify the amounts paid for the tangible depreciable, nondepreciable, and intangible assets. Also, the company must comply with the reporting requirements of Sec. 1060, which states that both the transferor and the transferee are bound by their written agreement as to the allocation of the purchase price to individual assets unless the IRS determines that such allocation is not appropriate. Amounts paid for tangible assets should be documented by appraisals and evidence of negotiations between the buyer and seller. Within reason, the purchaser should attempt to allocate as much of the total price to tangible depreciable assets, such as machinery and equipment. The purchaser also should consider allocating part of the purchase price to amortizable Sec. 197 intangible assets such as goodwill, covenants not to compete, patents, copyrights, licenses, and customer lists because such asset costs are recovered over a 15-year period. This is preferable to allocating the purchase price to depreciable real estate because such property must be depreciated over 39 years.

REAL-WORLD EXAMPLE

A taxpayer purchased a business that owned retail franchises. The IRS determined that amounts paid in excess of the value of the net assets represented a nondepreciable "indivisible asset." However, the taxpayer was able to show that retail franchises have limited useful lives, and was able to amortize the excess costs. *Super Food Services, Inc. v. U.S.*, 24 AFTR 2d 69-5309, 69-2 USTC ¶9558 (7th Cir., 1969).

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 5

Identify compliance and procedural considerations for depreciation

REPORTING COST RECOVERY, DEPRECIATION, DEPLETION, AND AMORTIZATION DEDUCTIONS

Form 4562 is the primary reporting device for depreciation (cost recovery), depletion, and amortization. Individual taxpayers engaged in trade or business complete Form 4562 and carry the total to Schedule C of their Form 1040, using a separate 4562 for each enterprise. Corporations, partnerships, and other tax entities also use Form 4562, carrying the total to their specific returns. Individuals with rental property complete a 4562 and carry the total to Schedule E of their Form 1040. If depreciation is computed only on property placed in service before the current year, an exception applies so that Form 4562 is not required. Depreciation totals are entered directly on the applicable primary form, but detailed depreciation records to support the deduction must be maintained.

EXAMPLE I:10-41 ▶ Form 4562 for 2018: Jones Corporation is a building contractor that owns the following 100% business-use properties:[51]

- Specialized utility repair truck (5-year property that is not listed property), $80,000 cost, placed in service on February 15, 2018.
- Machinery and equipment (7-year property), $1,070,000 cost, placed in service on June 10, 2018.
- Patent, $34,000 cost, placed in service on June 1, 2018, when it had a remaining useful life of 17 years. The patent is not a Sec. 197 intangible.
- MACRS deduction for assets placed in service before 2018 is $132,000.

Jones had 2018 taxable income of $1,920,000 (before the Sec. 179 deduction). It elects Sec. 179 expensing ($1,000,000 maximum for 2018) on the machinery and equipment but elects out of claiming bonus depreciation on all qualifying property. Jones' employer identification number is 00-1234567. Depreciation and amortization amounts are reported on Form 4562 and are shown in Figures I:10-1 and I:10-2.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:10-1 Which of the following assets are subject to either amortization, depreciation, or cost recovery? Explain.

a. An automobile held for personal use.
b. Excess amounts paid in a business combination that are attributable to goodwill.
c. Excess amounts paid in a business combination that are attributable to customer lists that have a limited useful life.
d. A patent created internally which has a useful life of 17 years.
e. Land held for investment purposes.
f. A covenant not to compete which is entered into by the buyer and seller of a business.

I:10-2 Rick is a sole proprietor who has a small business currently operating at a loss. He would like to discontinue depreciating the fixed assets of the business for the next few years and to carry the deductions over to a future period. What tax consequences would result if Rick implements the plan to discontinue depreciation and then sells some of the depreciable assets several years later?

I:10-3 Rita acquired a personal residence two years ago for $120,000. In the current year, she purchases another residence and attempts to sell her former residence. Due to depressed housing conditions in the town where she used to live, Rita is unable to sell the house. Her former residence is now being offered for sale at $100,000 (its current FMV according to real estate appraisal experts). Rita has decided to rent the house rather than "give it away." She believes that renting the house on a permanent basis will permit her to write off the original $120,000 investment over its useful life and thus recoup her investment. What restrictions in the tax law may prevent her from accomplishing this objective? Explain.

I:10-4 Daytona Corporation, a manufacturing corporation, acquires the following business assets in the current year:

- Furniture
- Plumbing fixtures
- Land
- Goodwill and a trademark acquired in the acquisition of a business
- Automobile
- Heavy truck
- Machinery
- Building used in manufacturing activities

a. Which of the assets above are eligible for depreciation under the MACRS rules or amortization under Sec. 197?
b. What recovery period should be used for each of the assets listed above that come under the MACRS rules or under Sec. 197?

I:10-5 In 2019, Andes Corporation purchases $1.5 million of machinery (7-year property) and places it into service in its business. What are Andes' depreciation deductions for 2019 and 2020 in each of the following situations? Assume the half-year convention applies and this is the only property Andes places into service in 2019.

a. Andes does not elect Sec. 179 expensing and elects out of bonus depreciation.
b. Andes elects Sec. 179 expensing for the assets and does not elect out of bonus depreciation.
c. Andes does not elect Sec. 179 expensing and does not elect out of bonus depreciation.

[51] Note that Example I:10-41 pertains to 2018, so it reflects the Sec. 179 dollar amounts for that year. The 2019 version of Form 4562 was not available when this edition went to press.

Form **4562**

Department of the Treasury
Internal Revenue Service (99)

Depreciation and Amortization
(Including Information on Listed Property)

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form4562* for instructions and the latest information.

OMB No. 1545-0172

2018

Attachment Sequence No. **179**

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Jones Corporation	Building Contractor	00-1234567

Part I Election To Expense Certain Property Under Section 179

Note: If you have any listed property, complete Part V before you complete Part I.

1	Maximum amount (see instructions)	1	$1,000,000*
2	Total cost of section 179 property placed in service (see instructions)	2	$1,150,000
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	$2,500,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	-0-
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	$1,000,000

6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
	Truck	80,000	-0-
	Machinery and Equipment	1,070,000	1,000,000

7	Listed property. Enter the amount from line 29	7	-0-
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	1,000,000
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	1,000,000
10	Carryover of disallowed deduction from line 13 of your 2017 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5. See instructions	11	1,000,000
12	Section 179 expense deduction. Add lines 9 and 10, but don't enter more than line 11	12	1,000,000
13	Carryover of disallowed deduction to 2019. Add lines 9 and 10, less line 12 ▶	13	

Note: Don't use Part II or Part III below for listed property. Instead, use Part V.

Part II Special Depreciation Allowance and Other Depreciation (Don't include listed property. See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year. See instructions	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III MACRS Depreciation (Don't include listed property. See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2018	17	132,000
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2018 Tax Year Using the General Depreciation System

	(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a	3-year property						
b	5-year property		80,000	5 yrs	HY	MACRS	16,000
c	7-year property		**70,000	7 yrs	HY	MACRS	10,003
d	10-year property						
e	15-year property						
f	20-year property						
g	25-year property						
h	Residential rental property						
i	Nonresidential real property						

Section C—Assets Placed in Service During 2018 Tax Year Using the Alternative Depreciation System

20a	Class life						
b	12-year						
c	30-year						
d	40-year						

Part IV Summary (See instructions.)

21	Listed property. Enter amount from line 28	21	-0-
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	1,158,003
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2018)

*For 2018, the maximum amount a taxpayer can elect under Sec. 179 is $1,000,000.
**Line 19c: $1,070,000 — $1,000,000

FIGURE I:10-1 ▶ FORM 4562

Form 4562 (2018) Page **2**

Part V Listed Property (Include automobiles, certain other vehicles, certain aircraft, and property used for entertainment, recreation, or amusement.)

Note: For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete **only** 24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

Section A—Depreciation and Other Information (Caution: See the instructions for limits for passenger automobiles.)

24a Do you have evidence to support the business/investment use claimed? ☐ **Yes** ☐ **No** **24b** If "Yes," is the evidence written? ☐ **Yes** ☐ **No**

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/ investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/ Convention	(h) Depreciation deduction	(i) Elected section 179 cost
25 Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use. See instructions.						**25**		
26 Property used more than 50% in a qualified business use:								
		%						
		%						
		%						
27 Property used 50% or less in a qualified business use:								
		%				S/L -		
		%				S/L -		
		%				S/L -		
28 Add amounts in column (h), lines 25 through 27. Enter here and on line 21, page 1						**28**		
29 Add amounts in column (i), line 26. Enter here and on line 7, page 1							**29**	

Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
30 Total business/investment miles driven during the year (**don't** include commuting miles)												
31 Total commuting miles driven during the year												
32 Total other personal (noncommuting) miles driven												
33 Total miles driven during the year. Add lines 30 through 32												
	Yes	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**
34 Was the vehicle available for personal use during off-duty hours?												
35 Was the vehicle used primarily by a more than 5% owner or related person?												
36 Is another vehicle available for personal use?												

Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who **aren't** more than 5% owners or related persons. See instructions.

	Yes	**No**
37 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
38 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See the instructions for vehicles used by corporate officers, directors, or 1% or more owners		
39 Do you treat all use of vehicles by employees as personal use?		
40 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
41 Do you meet the requirements concerning qualified automobile demonstration use? See instructions.		

Note: If your answer to 37, 38, 39, 40, or 41 is "Yes," don't complete Section B for the covered vehicles.

Part VI Amortization

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
42 Amortization of costs that begins during your 2018 tax year (see instructions):					
Patent	6-01-18	34,000	167	17 yrs.	*1,167
43 Amortization of costs that began before your 2018 tax year				**43**	
44 Total. Add amounts in column (f). See the instructions for where to report				**44**	1,167

*($34,000 ÷ 17 yrs.) x 7/12 = $1,167

Form **4562** (2018)

FIGURE I:10-2 ▶ FORM 4562 (CONTINUED)

I:10-6 Goodrich Corporation uses the calendar year as its tax year. It acquires and places into service two depreciable assets during 2019:

- Asset #1: 7-year property; $950,000 cost; placed into service on January 20.
- Asset #2: 5-year property; $400,000 cost; placed into service on August 1.

What are Goodrich's depreciation deductions for 2019 and 2020 in each of the following situations if this is the only property it places into service in those years?

a. Goodrich does not elect Sec. 179 expensing and elects out of bonus depreciation for the machine.

b. Goodrich elects Sec. 179 expensing for the assets and does not elect out of bonus depreciation.

c. Goodrich does not elect Sec. 179 expensing and does not elect out of bonus depreciation.

I:10-7 Is a deduction allowed under the MACRS rules for depreciable real estate (used in a business or held for investment) in the year the property is sold? If so, explain how it is calculated.

I:10-8 Jose is considering acquiring a new luxury automobile costing $70,000 that will be used 100% in his business. The salesperson at the automobile dealership states that Jose will be entitled to substantial tax benefits in the initial year (2019) including:

If Sec. 179 is elected:

- A deduction of $70,000 of the acquisition cost under Sec. 179.

If Sec. 179 is not elected:

- A $14,000 ($70,000 × 0.2) depreciation deduction.

a. Assuming Jose elects out of bonus depreciation, are the salesperson's assertions relative to the tax benefits accurate? Explain.

b. Would your answer to Part a differ if the automobile were used only 60% for business purposes?

c. Would your answer to Part a differ if Jose instead were to lease the automobile?

d. Would your answers to Part a differ if the vehicle were a large SUV (gross vehicle weight rating (GVWR) greater than 6,000 pounds) rather than an automobile?

I:10-9 Rhonda acquires and places into service 5-year and 7-year property to use in her sole proprietorship. Rhonda's marginal tax rate currently is 24%, but she expects it to increase to 37% because her business' income is rapidly increasing. Explain why Rhonda may prefer to elect the alternative depreciation system, rather than claiming regular MACRS depreciation.

I:10-10 Rudy is considering whether to make the election under Sec. 179 to expense the maximum amount of the acquisition cost related to certain fixed asset additions. What advantages are associated with the Sec. 179 election?

I:10-11 Luby Corporation has maintained an office in a leased building for several years. The corporation has decided to make some significant improvements to enhance the property. How should Luby Corporation depreciate these improvements?

I:10-12 Your client is a self-employed attorney who is considering the purchase of a $65,000 automobile that will be used 80% for business.

a. What depreciation method and recovery period are used under MACRS for the automobile?

b. How would your answer to Part a change if your client were an employee and the automobile was not required as a condition of employment?

c. What tax consequences occur in Part a if the business use of the automobile decreases to 50% or less in a succeeding year? Explain.

I:10-13 In recent years, Congress has enacted provisions in the tax law that permitted bonus depreciation for certain assets.

a. What types of assets typically qualified for bonus depreciation?

b. How does bonus depreciation interface with Sec. 179 first-year expensing?

I:10-14 On March 1, 2019, Sarah entered into a three-year lease of an automobile used exclusively in her business. The automobile's FMV was $58,500 at the inception of the lease. Sarah made ten monthly lease payments of $600 each during 2019. Is Sarah able to avoid the luxury automobile restrictions on depreciation by leasing instead of purchasing the automobile? Explain. (The lease inclusion amount for Sarah's automobile is found in Table 13 of Appendix C .)

I:10-15 What difference does it make for income tax purposes whether an intangible asset is (1) acquired in connection with a business acquisition, (2) acquired by the purchase of an individual asset (e.g., a patent), or (3) created internally? Explain.

I:10-16 In January of the current year, Park Corporation incurs $34,000 of legal costs associated with a patent that was developed internally and has a useful life of 17 years. Park also acquired for cash the net assets of Central Corporation for $1,000,000. The following assets are specified in the purchase agreement:

Land	$ 200,000
Goodwill and going concern value	100,000
Covenant not to compete	50,000
Licenses	125,000
Customer lists	25,000
Inventory	100,000
Equipment and other tangible depreciable business assets	400,000
Total	$1,000,000

a. What tax treatment should be accorded the intangible assets?
b. Assuming that you were advising Park Corporation during the negotiations before drafting the purchase agreement, what suggestions would you make regarding the allocation of the total purchase price to the individual assets?

I:10-17 Why do most taxpayers prefer to currently expense research and experimental expenditures?

I:10-18 In a business combination, why does the buyer generally prefer to allocate as much of the purchase price to short-lived depreciable assets, ordinary assets such as inventory, and Sec. 197 intangible assets?

I:10-19 Explain the difference between cost depletion and percentage depletion. Which of these two methods generally provides the largest deduction?

I:10-20 Simon acquires an interest in an oil property for $50,000. Intangible drilling costs (IDCs) in the initial year are $10,000. Cost depletion is $5,000 if the IDCs are expensed and $6,000 if the costs are capitalized. Percentage depletion is $15,000 if the IDCs are expensed and $20,000 if the costs are capitalized. The difference in the percentage depletion amounts is due to the 100% taxable income limitation.
a. What method (i.e., expensing or capitalization and amortization) should be elected for the treatment of the IDCs in the initial year if Simon wants to maximize his deductions?
b. Why are intangible drilling costs expensed by most taxpayers?

ISSUE IDENTIFICATION QUESTIONS

I:10-21 Georgia Corporation acquires a business automobile for $60,000 on December 31 of the current year but does not actually place the automobile into service until January 1 of the following year. What tax issues should Georgia Corporation consider?

I:10-22 Paula is planning to either purchase or lease a $75,000 automobile. She anticipates that business use of the auto will be 60% for the first two years but will decline to 40% in years three through five. Currently, Paula's marginal tax rate is 12% but she anticipates that her marginal tax rate will be 37% after a few years. What tax issues should Paula consider relative to the decision to purchase or lease the automobile?

I:10-23 In the current year, Coastal Corporation acquires all of the net assets of Acorn Corporation for $2,000,000. The purchase agreement allocated the following amounts to the individual assets and liabilities:

Land and building	$1,400,000
Accounts receivable	200,000
Inventory	300,000
Goodwill	400,000
Patents (remaining useful life of ten years)	100,000
Covenant not to compete	200,000
Liabilities	(600,000)
Total	$2,000,000

What tax issues should Coastal Corporation consider relative to the asset acquisitions?

I:10-24 Woburn Corporation uses the calendar year as its tax year. Woburn purchases and places into service $1.7 million of depreciable property during 2019:

	Cost	*Recovery Period*
January 20	$800,000	7 years
August 2	$300,000	7 years
November 15	$600,000	5 years

You are working in Woburn's tax department and are trying to decide how to make the Sec. 179 election so as to maximize Woburn's 2019 depreciation deduction. What tax issues should you consider for this decision?

PROBLEMS

I:10-25 ***Allowed Versus Allowable Depreciation.*** Sandy acquired business machinery (which qualified as 7-year MACRS property) on July 15, 2016, for $10,000. In 2016, Sandy claimed a $1,429 regular MACRS depreciation deduction and she elected not to claim Sec. 179 depreciation or bonus depreciation. Because of her low tax rate in 2017–2019, Sandy did

not claim any depreciation deduction on her tax returns in those years. She sells the machine on July 1, 2019, for $6,000.

a. What is the adjusted basis of the machine on the sale date?

b. How much gain or loss is recognized on the sale of the machine?

I:10-26 ***Conversion of Personal Asset to Business Use.*** Sid purchased an automobile for personal use on January 18, 2015 for $20,000. On January 1, 2019, Sid starts a small business and begins to use the automobile exclusively in the business. The automobile's FMV on this date is $12,000. MACRS depreciation deductions are based on a 5-year recovery period.

a. What is the automobile's basis for depreciation when converted to business use in 2019?

b. Assuming Sid does not elect Sec. 179 expensing and elects out of bonus depreciation, what is Sid's depreciation deduction in 2019?

I:10-27 ***MACRS 40% Test and Bonus Depreciation.*** Small Corporation purchased and placed in service the following 100% business-use assets (all of the assets were purchased new). Assume that Small purchased these assets in 2017, when 50% bonus depreciation was available. Small claimed bonus depreciation but no Sec. 179 election on all eligible property in 2017.

- Truck (light-duty, modified non-personal use) costing $20,000: Placed in service on February 15, 2017 with a 5-year MACRS recovery period.
- Machinery costing $50,000: Placed in service on May 1, 2017 with a 7-year MACRS recovery period.
- Land costing $60,000: Placed in service on July 1, 2017.
- Building costing $100,000: Placed in service on December 1, 2017 with a 39-year MACRS recovery period.
- Equipment costing $40,000: Acquired on December 24, 2017 and placed in service on January 5, 2018 with a 5-year MACRS recovery period.

What are Small's total depreciation deductions in 2017, 2018, and 2019?

I:10-28 ***MACRS 40% Test and Partial Year Depreciation.*** Large Corporation acquired and placed in service the following 100% business-use assets. Large did not claim Sec. 179 or bonus depreciation expensing on any of these properties.

- Truck (light-duty, modified non-personal use) costing $36,000: Placed in service on March 3, 2019 with a 5-year MACRS recovery period.
- Machinery costing $85,000: Placed in service on November 15, 2019 with a 7-year MACRS recovery period.
- Land costing $90,000: Placed in service on October 12, 2019.
- Building costing $280,000: Placed in service on December 4, 2019 with a 39-year MACRS recovery period.

a. What is Large's total depreciation deduction in 2019?

b. Large Corporation sells the machinery on February 2, 2021 and sells the building on September 18, 2021. What are the adjusted bases of these two assets on the dates of sale (compute accumulated depreciation to date of sale)?

I:10-29 ***Sec. 179 Expensing and MACRS Depreciation.*** Turner Corporation uses the calendar year as its tax year. It purchases and places into service $1.97 million of property during 2019 to use in its business:

	Placed into service	*Cost*	*Recovery Period*
Apartment building*	May 1	$900,000	27.5 years
Office furniture	June 23	$650,000	7 years
Office machinery	October 15	$420,000	5 years

* $80,000 of the cost pertains to the land on which the apartment building is located.

What is Turner's total depreciation deduction for 2019 in each of the following circumstances? Assume that Turner elects out of bonus depreciation.

a. Turner does not claim Sec. 179 expensing.

b. Turner claims Sec. 179 expensing for $650,000 of the office furniture's cost and $370,000 of the office machinery's cost.

c. Turner claims Sec. 179 expensing for $600,000 of the office furniture's cost and $420,000 of the office machinery's cost.

I:10-30 ***Sec. 179 Limitations and Carryovers.*** In 2019, Tish acquires and places into service in her business 7-year MACRS property costing $40,000 and 5-year MACRS property costing $165,000. Tish elects Sec. 179 expensing for all of the properties' cost. Tish's taxable income (before the Sec. 179 and 50% of self-employment tax deductions) is $160,000.

a. What amount may Tish deduct under Sec. 179 for 2019 for the properties? What amount can she carry over to 2020?
b. What is Tish's total 2019 depreciation deduction?
c. What are the limitations on Tish's ability to use the Sec. 179 carryover in 2020?
d. How would your answers to Parts a, b, and c change if Tish's 2019 business taxable income (before the Sec. 179 expense and the 50% of self-employment tax deductions) was $300,000 instead of $160,000?

I:10-31 ***MACRS Dispositions.*** Tampa Corporation sold the following assets in 2019:

	Date Acquired	*Date Sold*	*Original Cost Basis*	*Depreciation/ Cost-Recovery Method*	*Recovery Period (Years)*	*Sales Price*
Automobile	1/1/16	12/1/19[a]	$ 9,000	MACRS	5	$ 1,200
Equipment	1/6/16	9/1/19[a]	20,000	MACRS	7	9,500
Building (nonresidental)	4/1/09	12/10/19	100,000	MACRS	39	240,000

[a] The half-year convention was used in the year of acquisition. Tampa did not claim Sec. 179 expense or bonus depreciation during the acquisition years.

a. What is the depreciation deduction for each asset in 2019?
b. Compute the gain or loss on each asset sold.

I:10-32 ***Sec. 179 Expensing Election and MACRS Depreciation.*** In 2019, Richmond Corporation purchases and places into service a machine. Richmond elects Sec. 179 expensing for $1.02 million of its $1.22 million cost. The machine has a 7-year MACRS recovery period. Assume the half-year convention applies.

a. What is Richmond's total depreciation deduction for the machine for each year of its recovery period if it elects out of bonus depreciation for 2019?
b. How would your answer to Part a change if Richmond does not elect out of bonus depreciation for 2019?
c. How would your answers to Parts a and b change if Richmond sells the machine for $430,000 on January 31, 2021? What is its gain or loss on the sale?

I:10-33 ***Sec. 179 Expensing and Mid-Quarter Convention.*** In 2019, Wabash Corporation purchases two assets and places them into service (both have a 7-year MACRS recovery period):

- Asset #1: $1,260,000 cost; placed in service in February.
- Asset #2: $1,240,000 cost; placed in service in November.

Wabash elects $1.02 million under Sec. 179 and elects out of bonus depreciation. Compute Wabash's total depreciation deduction for 2019 under each of the following assumptions:

a. Wabash elects the $1.02 million for Asset #1.
b. Wabash elects the $1.02 million for Asset #2.

I:10-34 ***Straight-Line Depreciation.*** Bobby's marginal tax rate has been low for several years because his sole proprietorship has had low profits. Therefore, he has not elected Sec. 179 expensing, elected out of bonus depreciation, and elected to use the alternative depreciation system for property acquisitions. Bobby acquires, holds, or sells the following assets in 2019:

	Date Acquired	*Date Sold*	*Original Cost Basis*	*Selling Price*	*Depreciation Method*	*Recovery Period (Years)*
Equipment	6/1/19	—	$40,000	—	SL ADS	7
Light duty truck (Nonpersonal-use)	5/1/15	12/1/19	30,000	$ 8,000	SL ADS	5
Furniture	3/1/15	—	10,000	—	SL ADS	7
Automobile	7/1/16	12/1/19	12,000	10,000	SL ADS	5

Assume the half-year convention applies for each year.
a. What is the depreciation deduction for each asset in 2019?
b. What amount of gain or loss does Bobby recognize on the properties sold in 2019?

I:10-35 ***Mixed Personal/Business Use.*** Trish is a self-employed CPA who purchases an automobile for $72,000 and places it into service in 2019. Calculate Trish's current year MACRS depreciation deduction, assuming she does not elect Sec. 179 expensing, she elects out of bonus depreciation, and the half-year convention applies.
a. Trish uses the vehicle 60% for her business and 40% for personal purposes.
b. Trish uses the vehicle 40% for her business and 60% for personal purposes.

I:10-36 ***Employee Listed Property.*** Assume the same facts as in Problem I:10-35, except Trish is an employee who uses the automobile for her employment-related activities. While such use is helpful for her employer, it does not require Trish to use her own vehicle as a condition of employment. What is her depreciation deduction for the automobile?

I:10-37 ***Recapture of Depreciation Deductions Due to Personal Use.*** Tammy acquired an automobile for $20,000 on July 1, 2016. Her business use of the vehicle is 70% in 2016, 70% in 2017, 40% in 2018, and 35% in 2019. The property's MACRS recovery period is 5 years, and Tammy does not claim Sec. 179 expensing or bonus depreciation for it. Assume the half-year convention applies.
a. Compute the MACRS depreciation deductions for each year.
b. What amount of previously claimed depreciation deductions must Tammy recapture in 2018?

I:10-38 ***Luxury Auto Limitations.*** Lutz Corporation acquired a 100% business-use automobile (MACRS 5-year recovery) on July 1, 2019 for $64,000. The company did not elect Sec. 179 expensing and elects out of bonus depreciation. What is depreciation for 2019 and each subsequent year?

I:10-39 ***Luxury Auto Limitations.*** In 2019, Luby Corporation acquires and places into service an automobile that it uses only for business purposes. Luby does not claim Sec. 179 expensing or bonus depreciation for the vehicle. Compute Luby's depreciation deduction for 2019 and each subsequent year. Assume the half-year convention applies.
a. Luby purchases the automobile for $68,000.
b. Luby purchases the automobile for $48,000.

I:10-40 ***Luxury Auto Limitations.*** Tracy acquires an automobile (MACRS 5-year recovery) on March 1, 2019. He uses the automobile 70% in his business and 30% for personal use. The automobile cost $76,000. No amount is expensed under Sec. 179, and Tracy elects out of bonus depreciation.
a. What is depreciation for 2019 and each subsequent year?
b. How would your answer to Part a change if the vehicle were a SUV with a gross vehicle weight rated (GVWR) of over 6,000 pounds and Tracy elected to expense the SUV under Sec. 179?

I:10-41 ***Luxury Auto Limitations—Leasing.*** Troy entered into a three-year lease of a luxury automobile on January 1, 2019, for use 80% in business and 20% for personal use. The FMV of the automobile at the inception of the lease was $61,000, and Troy made 12 monthly lease payments of $900 in 2019 and 2020.
a. Before considering the effects of any lease inclusions amounts, what amount of lease payments are deductible in 2019 and 2020?
b. What portion, if any, of the "inclusion amount" must reduce Troy's lease deduction in 2019 and 2020?
c. How would your answers to Parts a and b change if the FMV of the auto was $15,000 and the monthly lease payments are $200?

I:10-42 ***Amortization of Intangibles.*** On January 1 of the current year, Palm Corporation purchases the net assets of Vicki's unincorporated business for $600,000. The tangible net assets have a $300,000 book value and a $400,000 FMV. The purchase agreement states that Vicki will not compete with Palm Corporation by starting a new business in the same area for a period of five years. The stated consideration received by Vicki for the covenant not to compete is $50,000. Other intangible assets included in the purchase agreement are as follows:

- Goodwill: $70,000
- Patents (12-year remaining useful life): $30,000
- Customer list: $50,000

a. How would Vicki's assets be recorded for tax purposes by Palm Corporation?
b. What is the amortization amount for each intangible asset in the current year?

I:10-43 ***R&E Expenditures.*** Park Corporation incurs the following costs in the initial year of doing business:

Materials and supplies for research laboratory	$ 80,000
Utilities and depreciation on research laboratory and equipment	40,000
Costs of acquiring another entity's patent for a new product	20,000
Market research salaries for surveys relative to proposed new products	60,000
Labor and supplies for quality control tests	50,000
Research costs subcontracted to a local university	35,000
Total	$285,000

Park's controller states that all of these costs are qualifying R&E expenditures and that the company policy is to expense such amounts for tax purposes in the year they are incurred. Which of these expenditures are deductible as R&E costs under Sec. 174?

I:10-44 ***R&E Expenditures.*** In 2019, Phoenix Corporation acquires a new research facility and hires several scientists to develop new products. No new products are developed until 2020, although the following expenditures were incurred:

Laboratory materials	$ 40,000
Research salaries	80,000
Overhead attributable to the research facility	30,000
R&E equipment placed into service (5-year MACRS recovery period)	100,000
Total	$250,000

a. What are Phoenix Corporation's deductions for R&E expenditures in 2019 and 2020 if the expensing method is elected?
b. How would your answer to Part a change if the deferral and amortization method were elected and the amortization period were 60 months?

I:10-45 ***Computer Software.*** Phillips Corporation, a construction company that specializes in home construction, uses special computer software to schedule jobs and keep track of job costs. It uses generic software for bookkeeping and spreadsheet analysis. During 2019, Phillips Corporation had the following transactions relating to computer software:

- The corporation purchased a new computer system on May 12, 2019, for $15,000. The system included computer hardware and built-in computer software valued at $3,000. The corporation has never separated computer software from the hardware in prior years when a computer system was purchased.
- The corporation separately purchased new bookkeeping software on September 1, 2019, for $5,760.
- On June 1, 2019, Phillips Corporation acquired another home building company to strengthen its position in higher-priced homes. The total purchase price was $700,000 allocated to specific assets as follows:

Equipment	$500,000
Goodwill	150,000
Computer software	50,000

What amount can Phillips Corporation deduct in 2019 with respect to computer software?

I:10-46 ***Cost Depletion.*** Tina acquires an oil and gas property interest for $200,000 in the current year. The following information about current year operations is supplied for purposes of computing the amount of Tina's depletion and intangible drilling and development cost (IDC) deductions:

Estimated recoverable units	20,000
Units produced	6,000
Units sold	4,000
IDCs	$20,000
Percentage depletion (after limitations)	$25,000

a. What is the cost depletion amount if the IDCs are expensed?
b. What is the cost depletion amount if the IDCs are capitalized?
c. How much depletion is deducted on the tax return?
d. Should the IDCs be capitalized or expensed? Explain.

I:10-47 ***Percentage Depletion.*** Tony has owned an oil and gas property for a number of years. The following information is provided about the property's operations in the current year:

Gross income	$500,000
Minus: Expenses (including IDCs of $100,000)	(300,000)
Taxable income (before depletion)	$200,000
Cost depletion (if IDCs are expensed)	$ 20,000
Cost depletion (if IDCs are capitalized)	$ 30,000

a. What is the percentage depletion amount if the IDCs are expensed?
b. What is the percentage depletion amount if the IDCs are capitalized?
c. What is the depletion deduction amount assuming that the IDCs are expensed?
d. Based on the information above, which method should be used for the IDCs? Explain.

COMPREHENSIVE PROBLEM

I:10-48 John and Ellen Brite are married and file a joint return. They have no dependents. John owns an unincorporated specialty electrical lighting retail store, Brite-On. Brite-On had the following assets on January 1, 2018:

Assets	*Cost*
Old store building purchased April 1, 2003	$100,000
Equipment (7-year recovery) purchased January 10, 2013	30,000
Inventory valued using FIFO method: 4,000 light bulbs	$5/bulb

Brite-On purchased a competitor's store on March 1, 2018, for $206,000. The purchase price included the following:

New store building	$115,000 (FMV)
Land	28,000 (FMV)
Equipment (5-year recovery)	45,000 (FMV)
Inventory: 3,000 light bulbs	$ 6/bulb (cost)

On June 30, 2018, Brite-On sold the 7-year recovery period equipment for $12,000. Brite-On leased a car for $860/month beginning on June 1, 2018. The car is used 100% for business and was driven 14,000 miles during the year.

Brite-On sold 8,000 light bulbs at a price of $15/bulb during the year. Also, Brite-On made additional purchases of 4,000 light bulbs in August 2018 at a cost of $7/bulb. Brite-On had the following revenues (in addition to the sales of light bulbs) and additional expenses:

Service revenues	$94,000
Interest expense on business loans	6,000
Auto expenses (gas, oil, etc.)	4,800
Taxes and licenses	3,300
Utilities	2,800
Salaries	36,000

John and Ellen also had some personal expenses:

Medical bills	$4,500
Real property taxes	3,800
State income taxes	5,100
Home mortgage interest	5,000
Charitable contributions (cash)	2,600

Ellen receives $42,000 of wages from employment elsewhere, from which $4,000 of federal income taxes were withheld. The Brites received interest income on a bank savings account of $275 and qualified dividends of $1,425. John and Ellen made four $3,900 quarterly estimated tax payments. For self-employment tax purposes, assume John spent 100% of his time at the store while Ellen spends no time at the store.

Additional Facts:

- Equipment acquired in 2013: The Brites elected out of bonus depreciation and did not elect Sec. 179.
- Equipment acquired in 2018: The Brites elected Sec. 179 to expense the cost of the 5-year equipment.
- Assume that the lease inclusion rules require that Brite-On reduce its annual deductible lease expense by $41.

Compute the Brite's taxable income and balance due or refund for 2018.

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:10-49 Stan Bushart works as a customer representative for a large corporation. Stan's job entails traveling to meet with customers, and he uses his personal car 100% for business use. In 2019, Stan must decide whether to buy or lease a new car. After bargaining with several car dealers, Stan has agreed to a price of $58,000. If he buys the car, he will borrow the entire $58,000 at an 8% annual interest rate, and his payments will be $1,176.03 per month over 60 months. Annual principal and interest payments are:

	Total	*Principal*	*Interest*
2019	$14,112	$ 9,828	$ 4,284
2020	14,112	10,643	3,469
2021	14,112	11,527	2,585
2022	14,112	12,483	1,629
2023	14,112	13,519	593
Totals:	$70,560	$58,000	$12,560

If he leases the car, his lease payment will be $870 per month for 60 months. At the end of the lease, he has the option of purchasing the car for $10,000. Stan's marginal tax rate is 24% in each of the five years. Using present value analysis with an 8% discount rate, is Stan better off leasing or buying the car?

If Stan purchases the car, he will not claim Sec. 179 expensing or bonus depreciation and will sell the car for $10,000 at the end of five years. If he leases the car, assume he merely turns the car in at the end of the lease.

I:10-50 Helen has operated a sole proprietorship for many years and has tentatively agreed to sell its assets to Blaze Corporation. They are negotiating how to allocate $1.4 million of the transaction's amount to two of the proprietorship's assets: equipment and goodwill. Helen estimates the equipment is worth $750,000 and the goodwill is worth $650,000, but Blaze wants to allocate $1 million to the equipment and $400,000 to the goodwill to enhance the tax benefits it realizes. Helen's adjusted basis is $150,000 for the equipment and zero for the goodwill. Assume the transaction will occur at the beginning of Year 1.

Required:

a. Determine the effect on the present value of tax savings Blaze realizes if the allocation is (i) $1 million for the equipment and $400,000 for the goodwill, versus (ii) $750,000 for the equipment and $650,000 for the goodwill). Blaze will claim 100% bonus depreciation for the equipment, its marginal tax rate is 21%, and it discounts cash flows at a 10% annual rate.

b. Determine the effect on the tax Helen pays with allocations (i) and (ii) from part a. Assume the gain on the equipment is taxed as ordinary income, while the gain on the goodwill is taxed as a long-term capital gain. Helen's marginal tax rate is 37% for ordinary income and 20% for long-term capital gains. (The treatment of the equipment's gain as ordinary income is due to depreciation recapture, which is discussed in Chapter I:13).

c. Which of the two allocations is better?

TAX FORM/RETURN PREPARATION PROBLEMS

I:10-51 Thom Jones (SSN 000-00-1111) is an unincorporated manufacturer of widgets. He uses the LCM method to value his inventory and reports the following for 2018:

Sales (less returns and allowances)	$1,250,000
Cost of goods sold	500,000
Office expenses	10,000
Depreciation*	?
Legal services	4,000
Salary expenses	36,000
Travel expenses	30,000
Repair expenses	20,000

* Information related to Mr. Jones's depreciation:

Cost of office furniture acquired and placed in service on April 15, 2018 (7-year recovery).	$480,000
Cost of warehouse acquired and placed in service on August 1, 2018	750,000
Depreciation on assets purchased and placed in service prior to 2018	28,000

The business operates under the name Jones Widget Company and is located at 400 W. Main Street in Springfield, Maryland 21368. Its employer identification number is 55-9876543. The business uses the cash method, Thom materially participates in it, and it did not make any payments that would require it to file Form 1099.

Complete Thom's 2018 Form 4562 and Schedule C of Form 1040, assuming he elects to expense the maximum amount possible under Sec. 179 and uses bonus depreciation for any eligible amounts exceeding the Sec. 179 maximum.

I:10-52 Refer to the facts in Problem I:10-48 for John and Ellen Brite. The following information is also available for them:

- John and Ellen live at 111 Maple Street, Johnsonville, Colorado 81733.
- Brite-On is located at 3900 Market Street, Johnsonville, Colorado 81733. Its employer identification number is 44-1357924.
- The business uses the accrual method and did not make any payments that would require Form 1099 to be filed. It has used the cost method to value inventory for many years.
- John started using his automobile in his business on July 1, 2011. During 2018, it was used 7,000 miles for John's business, 1,800 miles for commuting, and 6,500 miles for other reasons. The automobile and Ellen's automobile were available for personal use and during off-duty hours. John has written evidence to support his deduction for automobile expenses.

Complete the Brites' 2018 Form 1040, Schedules 1, 4, 5, A, C, and SE, and Forms 4562 and 4797.

CASE STUDY PROBLEMS

I:10-53 Able Corporation is a manufacturer of electrical lighting fixtures. Able is currently negotiating with Ralph Johnson, the owner of an unincorporated business, to acquire his retail electrical lighting sales business. Johnson's assets include the following:

Assets	*Adjusted Basis*	*FMV*
Inventory of electrical fixtures	$ 30,000	$ 50,000
Store buildings	80,000	100,000
Land	40,000	100,000
Equipment: 7-year recovery period	30,000	50,000
Equipment: 5-year recovery period	60,000	100,000
Total	$240,000	$400,000

Mr. Johnson thinks that a total purchase price of $1 million in cash is warranted for the business because of its high profitability and strategic locations, and Able has agreed. Despite the fact that both parties agree that the $600,000 excess payment is goodwill,

Able would prefer that it be designated as a 5-year covenant not to compete so that he can amortize it over a 5-year period.



You are a tax consultant for Able who has been asked to make recommendations as to the structuring of the purchase agreement and the amounts to be assigned to individual assets. Prepare a client memo to reflect your recommendations.

I:10-54 In 2017, the Margate Corporation acquired an automobile with a cost of $30,000 for use in its business. Shortly thereafter, Margate Corporation experienced a decline in sales. Several employees were laid off, and the automobile was not immediately needed for any of the sales personnel. Instead of letting the new automobile sit in the corporate lot, the president decided to permit a corporate officer to use the automobile for personal use. The officer used the automobile in 2017 and 2018 only. In 2019, Margate Corporation hired you as their new CPA (tax consultant). You learn that the officer's personal use of the corporate automobile took place for the two prior years without proper accounting to the IRS. As Margate Corporation's tax consultant, what actions (if any) should you take regarding the proper treatment of the automobile? What are your responsibilities as a CPA regarding this matter under the rules of the AICPA's *SSTS* No. 6? (See the *Statements on Standards for Tax Services (SSTS)* in Appendix E.)

TAX RESEARCH PROBLEM

I:10-55 The Morriss Corporation is a very successful and profitable manufacturing corporation. The corporation just completed construction of new corporate offices, primarily for its top executives. The president and founder of the corporation, Mr. Timothy Couch, is an avid collector of artwork and has instructed that the lobby and selected offices be decorated with rare collections of art. These expensive works of art were purchased by the corporation in accordance with Couch's directives. Couch justified the purchase of these artworks on the premise that (1) they are excellent investments and should increase in value in the future, (2) they provide an appropriate and impressive office atmosphere when current and prospective customers visit the corporation's offices, and (3) the artwork is depreciable property and the corporation will be able to take sizable writeoffs against income. The Financial Vice-President of the corporation has requested your advice as to whether the works of art are, in fact, depreciable property. Prepare a research memorandum for the Financial Vice-President on this issue.

A partial list of research sources is provided below.

- *Rev. Rul. 68-232,* 1968-1 C.B. 79
- *Shauna C. Clinger,* 60 T.C.M. 598 (1990).
- *Simon v. Comr.,* 103 T.C. 247 (1994), *aff'd,* 95-2 USTC ¶50,552 (2d Cir. 1995) *non-acq.* 1996-2 C.B.I.
- *Liddle v. Comr.,* 103 T.C. 285 (1994), *aff'd,* 95-2 USTC ¶50,488 (3rd Cir. 1995)

CHAPTER

11

ACCOUNTING PERIODS AND METHODS



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Explain the rules for adopting and changing an accounting period
2. Explain the differences between cash, accrual, and hybrid accounting
3. Determine what costs must be included in inventory
4. Identify the amount of income to be reported from special accounting methods
5. Compute the amount of imputed interest in certain transactions
6. Determine the tax treatment that results from changes in accounting methods
7. Describe tax planning considerations for accounting periods and methods
8. Describe compliance and procedural considerations for accounting periods and methods

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An **accounting method** is a system of rules and procedures used to determine the year in which income and expenses are reported for tax purposes. The accounting methods used to compute taxable income generally must be the same as those used in keeping the taxpayer's books and records and determine *when* income and expenses are reported, not whether they are reported. Although the accounting methods used by a taxpayer do not necessarily affect the amount of income reported over the life of a business, they do affect the tax burden in two ways. First, selecting the appropriate accounting method can accelerate deductions or defer income recognition in order to postpone tax payments, and second, because of the progressive tax rate structure, taxpayers can save taxes by spreading income over several accounting periods rather than having income bunched into one period.

EXAMPLE I:11-1 ▶ Jane, a taxpayer using the cash method of accounting, has a 24% marginal tax rate for 2019 and expects to have a 12% marginal tax rate in 2020. Jane plans to make a charitable contribution of $1,000 in January 2020. A contribution in 2020 will reduce Jane's tax by $120 (0.12 × $1,000), whereas a contribution in 2019 will reduce Jane's tax by $240 (0.24 × $1,000). Obviously Jane may wish to accelerate the contribution in order to reduce her tax liability. ◀

ACCOUNTING PERIODS

OBJECTIVE 1

Explain the rules for adopting and changing an accounting period

Taxable income is computed on the basis of the taxpayer's annual **accounting period**, which is ordinarily 12 months (either a calendar year or a fiscal year). A **fiscal year** is a 12-month period that ends on the last day of any month other than December. The tax year must coincide with the year used to keep the taxpayer's books and records. Taxpayers who do not have books (e.g., an individual with wage income) must use the calendar year.[1] A taxpayer with a seasonal business may find a fiscal year to be advantageous. During the slow season, inventories may be lower and employees are available to take inventory and perform other accounting duties associated with the year-end. The tax year is elected on the first tax return that is filed by a taxpayer and cannot be changed without consent from the IRS.[2]

A partnership generally must use the same tax year as the partners who own the majority (greater than 50%) of partnership income and capital. If a majority of partners do not have the same year, the partnership must use the tax year of its principal partners (those with more than a 5% interest in the partnership). If the principal partners do not have the same tax year, the partnership must use the taxable year that results in the least aggregate deferral of income to the partners.[3] An exception is made for partnerships that can establish to the satisfaction of the IRS a business purpose for having a different year.

The purpose of the strict rules for selecting accounting periods is to prevent partners from deferring partnership income by choosing a different tax year for the partnership. For example, calendar-year partners might select a partnership year that ends on January 31. Because partnership income is considered to be earned by the partners on the last day of the partnership's tax year, reporting the profits would thus be deferred 11 months because the partnership year ends after the partner's year. (See the section entitled Required Payments and Fiscal Years in this chapter for further discussion of the calendar-year requirement.)

A similar rule generally requires S corporations and personal service corporations to adopt a calendar year unless the corporation has a business purpose for electing a fiscal year.[4] Taxpayers willing to make required payments or distributions may choose a fiscal year. (See the Required Payments and Fiscal Years section in this chapter.)

STOP & THINK

Question: The tax rules related to accounting periods require most partnerships, S corporations, and personal service corporations to report on the calendar year basis.

[1] Sec. 441(g).
[2] Reg. Sec. 1.441-1(b)(4).
[3] Reg. Sec. 1.706-1(a)(3).
[4] Sec. 1378(a).

Of course, almost all individual taxpayers also report on the calendar year basis. What impact does this have on accountants?

Solution: The principal impact is a compression of tax compliance work into the "accounting busy season." A substantial portion of auditing and other accounting work also takes place at year-end. As a result, these services are also compressed into the accounting busy season. The accounting profession has sought to have these rules changed, but has, at least so far, been unsuccessful.

An improper election to use a fiscal year automatically places the taxpayer on the calendar year.[5] Thus, if the first return is filed late because of oversight, the option to choose a fiscal year is lost.

EXAMPLE I:11-2 ▶ City Corporation receives its charter but does not begin operations for three years. Tax returns are required for all years. Timely returns are not filed because City's officers are unaware that returns must be filed for inactive corporations. Thus, City Corporation must use the calendar year. City Corporation may petition the IRS for approval to use a fiscal year. ◀

ADDITIONAL COMMENT

The use of a 52–53-week year aids in budgetary matters and statistical comparisons because a four-week period, unlike a calendar month, is a uniform, fixed period.

While most tax years end on the last day of a month, the tax law allows taxpayers to use a tax year that always ends on the same day of the week, such as the last Friday in October. This means that the tax years will vary in length between 52 and 53 weeks. Taxpayers who regularly keep their books over a period that varies from 52 to 53 weeks may elect the same period for tax purposes. A 52–53-week taxable year must end either the last time a particular day occurs during a calendar month (e.g., the last Friday in October) or the occurrence of the particular day that is closest to the end of a calendar month (e.g., the Saturday closest to the end of November).[6] Under the first alternative, the year may end as many as six days before the end of the month, but must end within the month. Under the second alternative, the year may end as many as three days before or after the end of the month.

TYPICAL MISCONCEPTION

It is sometimes mistakenly believed that a tax year can end on a day in the middle of the month.

The 52–53-week year is especially useful to businesses with inventories. For example, a manufacturer might choose a 52–53-week year that ends on the last Friday in December to permit inventory to be taken over the weekend without interfering with the company's manufacturing activity. Similarly, wage accruals would be eliminated for a company with a weekly payroll if the payroll period always ends on Friday.

Although the 52–53-week year may actually end on a day other than the last day of the month, it is treated as ending on the last day of the calendar month for "effective date" changes in the tax law that would otherwise coincide with the year-end.

EXAMPLE I:11-3 ▶ Eagle Corporation has adopted a 52–53-week year. Eagle's tax year begins on December 29, 2019. Assume that a new tax rate schedule applies to tax years beginning after December 31, 2019. The new tax rate schedule is applicable to Eagle because, in the absence of the 52–53-week year, its tax period would have started on January 1, 2020. ◀

REQUIRED PAYMENTS AND FISCAL YEARS

Virtually all C corporations (other than personal service corporations) have flexibility in choosing an accounting period. Other taxpayers, such as partnerships and S corporations, may use a fiscal year if they have an acceptable business purpose. However, most of these businesses are unable to meet the rather rigid business purpose requirements outlined by the IRS. As a result, these businesses report using the calendar year concentrating most tax work during the early months of the year. Concern over this problem led Congress to enact Sec. 444 which allows partnerships, S corporations, and personal service corporations (such as incorporated medical practices) to elect a taxable year that results in a tax deferral of three months or less (e.g., a partnership with calendar-year partners may elect a September 30 year-end). This is called the **Sec. 444 election**. Furthermore, partnerships,

[5] *Q.A. Calhoun v. U.S.*, 33 AFTR 2d 74-305, 74-1 USTC ¶9104 (D.C. Va., 1973).

[6] Sec. 441(f).

S corporations, and personal service corporations may continue using the fiscal year they were using when the current law was passed in 1986 even if that fiscal year results in a deferral beyond three months.

ADDITIONAL COMMENT

The American Institute of Certified Public Accountants and accounting firms lobbied extensively for the provision that permits partnerships, S corporations, and personal service corporations to continue to use a fiscal year if annual required payments are made.

Partnerships and S corporations making the Sec. 444 election, however, must make annual required payments by May 15 of the following year. The purpose of the required payment is to offset the tax deferral advantage obtained when fiscal years are used.

The amount of the required payment is determined by multiplying the maximum tax rate for individuals plus 1% (38%) times the previous year's taxable income times a deferral ratio.[7] The deferral ratio is equal to the number of months in the deferral period divided by the number of months in the taxable year. An adjustment is made for deductible amounts distributed to the owners during the year. If the amount due is $500 or less, no payment is required.

EXAMPLE I:11-4 ▶ ABC Partnership begins operations on October 1, 2019, and elects a September 30 year-end under Sec. 444. The partnership's net income for the fiscal year ended September 30, 2020, is $100,000. ABC must make a required payment of $9,500 ($100,000 × 38% × $^3/_{12}$) on or before April 15, 2021. ◀

The owners of businesses making such payments do not claim a credit for the amount paid. Instead, the partnership or S Corporation subtracts the previous year's required payment from the current year's required payment. If the result is negative, then the entity is entitled to a refund.

EXAMPLE I:11-5 ▶ Assume the same facts as in Example I:11-4 except that ABC Partnership's required payment for the year ended September 30, 2021 is $6,000. ABC is entitled to a refund of the difference of $3,500 ($9,500 − $6,000). ◀

Personal service corporations also may elect a fiscal year. However, deductions to shareholder/employees may be limited if distributions to such shareholder/employees during the deferral period do not exceed a minimum amount.[8] Personal service corporations are incorporated medical practices and other businesses owned by individuals who provide their services through the corporation. In general, the rules prevent a distribution pattern that creates a tax deferral. This is achieved by requiring that the deductible payments made to owners during the deferral period be at a rate no lower than during the previous fiscal year.

EXAMPLE I:11-6 ▶ Austin, Inc., is a personal service corporation of attorneys with a fiscal year ending September 30. For the year ended September 30, 2019 the company earned a profit of $480,000 before any salary payments to the owners. The entire profit, however, was paid out as wages to the owners, resulting in a taxable income of zero. To avoid any deduction limitation, Austin must pay salaries to its owners of no less than $120,000 ($480,000 × $^3/_{12}$) during the period October 1, 2019, to December 31, 2019. If less than $120,000 is paid during this deferral period, deductions are limited for the year ended September 30, 2020. ◀

An option allows personal service corporations to compute the amount of the minimum distribution by using a three-year average of income and distributions.

CHANGES IN THE ACCOUNTING PERIOD

KEY POINT

The use of a natural business year helps in the matching of revenue and expense because the business is normally in a maximum state of liquidity and the problems associated with making estimates involving uncompleted transactions are reduced to a minimum.

Once adopted, an accounting period cannot normally be changed without IRS approval.[9] The IRS will usually approve a change only if the taxpayer can establish a substantial business purpose for the change (e.g., changing to a natural business year).[10] A natural business year ends at or soon after the peak income earning period (e.g., the natural business year for a department store that has a seasonal holiday business may be on January 31). A business without a peak income period may not be able to establish a natural business year and may, therefore, be precluded from changing its tax year. In general, at least

[7] Sec. 7519(b). The high rate discourages elections by businesses with middle and lower income owners. Businesses do not have to make similar required payments for self-employment and other taxes. As a result, there can be some advantage for businesses with higher income owners.

[8] Sec. 280H(a).

[9] Sec. 442.

[10] Rev. Proc. 2002-39, 2002-1 C.B. 1046.

25% of revenues must occur during the last two months of the year in order to qualify as a natural business year.

EXAMPLE I:11-7 ▶ USA Department Store's sales peak during the holiday season in December. During January the department store further reduces its inventory through storewide clearance sales. USA elects a "natural" business year-end of January 31 because its inventory levels are lowest at the end of January. Also, USA meets the prescribed test because at least 25% of its revenues for the year occur in December and January. ◀

In a few instances IRS approval is not required to change to another accounting period.

REAL-WORLD EXAMPLE

J.C. Penney, Kmart, and Walmart all use an accounting period ending January 31.

- A newly married person may change tax years to conform to that of his or her spouse so that a joint return may be filed. The election must be made in either the first or second year after the marriage date.[11]
- A change to a 52–53-week year that ends with reference to the same calendar month in which the former tax year ended.[12]
- A taxpayer who erroneously files tax returns using an accounting period other than that on which his or her books are kept is not required to obtain permission to file returns for later years based on the way the books are kept.[13]
- A corporation meeting the following specified conditions may change without IRS approval: (1) There has been no change in its accounting period within the past ten calendar years, (2) the resulting year does not have a net operating loss (NOL), (3) the taxable income for the resulting short tax year when annualized is at least 90% of the taxable income for the preceding full tax year, and (4) there is no change in status of the corporation (such as an S corporation election).[14]
- An existing partnership can change its tax year without prior approval if the partners with a majority interest have the same tax year to which the partnership changes or if all principal partners who do not have such a tax year concurrently change to such a tax year.[15]

There is one instance, however, when a change in tax years is required: A subsidiary corporation filing a consolidated return with its parent corporation must change its accounting period to conform with its parent's tax year.

Application for permission to change accounting periods is made on Form 1128, Application for Change in Accounting Period, on or before the due date of the return including extensions. The application must be sent to the Commissioner of the IRS, Washington, D.C.

The IRS may establish certain conditions for the taxpayer to meet before it approves the change to a new tax year. For example, the IRS has ruled that if the short period that results from a change involves a NOL greater than $50,000, the taxpayer may have to forgo a carryback of the loss.[16]

RETURNS FOR PERIODS OF LESS THAN 12 MONTHS

Most income tax returns cover an accounting period of 12 months. On two occasions, however, a taxpayer's accounting period may be less than 12 months: when the taxpayer's first or final return is filed and when the taxpayer changes accounting periods.

Taxpayers filing an initial tax return and executors filing a taxpayer's final return or corporations filing their last return are not required to annualize the year's income, nor are personal exemptions or tax credits prorated. These returns are prepared and filed, and taxes are paid as though they are returns for a 12-month period ending on the last day of

[11] Reg. Sec. 1.442-1(e). A statement should be attached to the resulting short period return indicating that the change is being made.
[12] Reg. Sec. 1.441-2(c)(2). A statement should be attached to the first return filed under the election indicating that the change is being made.
[13] Rev. Rul. 58-256, 1959-1 C.B. 215.
[14] Reg. Sec. 1.442-1(c). A statement should be attached to the return indicating that each condition is met.
[15] Reg. Sec. 1.442-1(b)(2).
[16] Rev. Proc. 2002-37, 2002-1 C.B. 1030.

the short period. An exception permits the final return of a decedent to be filed as though the decedent lived throughout the entire tax year.[17]

EXAMPLE I:11-8 ▶ ABC Partnership, which has filed its returns on a calendar-year basis, terminates on June 30. ABC's final return is due on October 15. ◀

EXAMPLE I:11-9 ▶ Joy, a single individual who has filed her returns on a calendar-year basis, dies on June 30. Joy's final return is due the following April 15. ◀

Taxpayers who change from one accounting period to another must annualize their income for the resulting short period. This prevents income earned during the resulting short period from being taxed at lower rates. Income is annualized as follows:

1. Determine modified taxable income. Individuals must compute their taxable income for the short period by itemizing their deductions (i.e., the standard deduction is not allowed).
2. Multiply modified taxable income by the following fraction:

$$\frac{12}{\text{Number of months in short period}}$$

3. Compute the tax on the resulting taxable income using the appropriate tax rate schedule.
4. Multiply the resulting tax by the following fraction:

$$\frac{\text{Number of months in short period}}{12}$$

EXAMPLE I:11-10 ▶ Pat, a single taxpayer, obtains permission to change from a calendar year to a fiscal year ending on April 30, 2019. During the four months ending April 30, 2019, Pat earns $25,000 and has $5,000 in itemized deductions.[18]

Gross Income	$25,000
Minus: Itemized deductions	(5,000)
Modified taxable income	$20,000
Annualized income [(12 ÷ 4) × $20,000]	$60,000
Tax on annualized income	$ 9,059
Gross tax [(4 ÷ 12) × $9,059]	$ 3,020 ◀

ADDITIONAL COMMENT

A corporation changing its taxable year does not annualize its income because corporate income is subject to a flat 21% tax rate.

Topic Review I:11-1 summarizes the available accounting periods and the rules for changing accounting periods.

STOP & THINK

Question: Why are taxpayers required to annualize when they change tax years? What provision of the tax law creates this need?

Solution: A change of tax years results in a shortened filing period during the period the change takes place. For example, a taxpayer who changes from a calendar year to a April 30 year-end reports income for only a 4-month period on the first return following the change. Less income is reported, and that income would be taxed at lower rates without annualization. Annualization is necessary because of the progressive tax rate structure.

[17] Reg. Sec. 1.443-1(a)(2).

[18] An alternative method to compute the tax is provided in Sec. 443(b)(2) and Reg. Sec. 1.443-1(b)(2) whereby the taxpayer can elect to compute the tax for a 12-month period beginning on the first day of the short period and then convert the tax to a short-period tax.

TOPIC REVIEW I:11-1

Accounting Periods and Changes

Available Years

- Available tax years include the calendar year, a fiscal year (a year that ends on the last day of any month other than December), and a 52–53-week year (a year that always ends on the same day of the week).
- A partnership must use the tax year of its partners unless the partnership can establish a satisfactory business purpose for having a different year or if the partnership makes required payments.
- Similar rules generally require S corporations and personal service corporations to adopt a calendar year unless the corporation has a business purpose for electing a fiscal year. Taxpayers willing to make required payments or distributions may choose a fiscal year ending on September 30, October 31, or November 30.

Change in Accounting Periods

- Once adopted, an accounting period normally cannot be changed without approval by the IRS. The IRS is more likely to approve a change to a natural business year. In general, at least 25% of revenues must occur during the last two months of the year in order to qualify as a natural business year.
- Taxpayers who change from one accounting period to another must annualize their income for the resulting short period. This prevents income earned during the resulting short period from being taxed at lower rates.

Overall Accounting Methods

OBJECTIVE 2

Explain the differences between cash, accrual, and hybrid accounting

A taxpayer's method of accounting determines the year in which income is reported and expenses are deducted. Taxable income must be computed using the method of accounting regularly used by the taxpayer in keeping his or her books if that method clearly reflects income.[19] Permissible overall accounting methods are:

- Cash receipts and disbursements method (often called the cash method of accounting)
- Accrual method
- A combination of the first two methods, often called the hybrid method

KEY POINT

The Code provides the IRS with broad powers in ascertaining whether the taxpayer's accounting method clearly reflects income. It entitles the IRS to more than the usual presumption of correctness.

New taxpayers may generally choose any of the accounting methods listed above. However, the accrual method must be used for sales and cost of goods sold if inventories are an income-producing factor to the business. An exception gives taxpayers (other than tax shelters) whose average gross receipts for the three prior years do not exceed $26 million ($25 million in 2018) the option of using the cash method.[20] This rule simplifies accounting for millions of small and medium sized businesses. Also, businesses without inventories, such as accounting firms and architects, can use the cash method regardless of size. The fact that an overall accounting method is used in one trade or business does not mean that the same method must be used in a second trade or business or for nonbusiness income and deductions.

EXAMPLE I:11-11 ▶ Troy, a practicing CPA, also owns an appliance store. The fact that Troy uses the accrual method of reporting income from the appliance store, where inventories are an income-producing factor, does not preclude Troy from using the cash method to report income from his service-based accounting practice. Troy could also use the cash method for reporting nonbusiness income (such as dividends) and nonbusiness expenses (such as itemized deductions). ◀

REAL-WORLD EXAMPLE

It has been held that the cash method of accounting can be used where inventories are inconsequential. *Michael Drazen,* 34 T.C. 1070 (1960).

The term *method of accounting* is used to include not only overall methods of accounting listed above but also the accounting treatment of any item.[21]

CASH RECEIPTS AND DISBURSEMENTS METHOD

Most individuals and small and medium sized businesses use the cash receipts and disbursements method of accounting. Under the cash receipts and disbursements method

[19] Sec. 446.
[20] Sec. 448.
[21] Reg. Sec. 1.446-1(a)(1). Examples of accounting methods for specific items include Sec. 174, relating to research and experimentation expenses; Sec. 451, relating to reporting income from long-term contracts; and Sec. 453, relating to reporting income from installment sales.

of accounting, a taxpayer is required to report income for the tax year in which payments are actually or constructively received. While it might seem that receipts under the cash method of accounting should only be recognized if the taxpayer receives cash, this is not the case. The Regulations clearly provide that gross income under the cash method includes cash, property, or services.[22] Thus, if a CPA accepts a set of golf clubs as payment from a client for services rendered, the CPA must include the fair market value of the golf clubs in his gross income. However, an accounts receivable or other unsupported promise to pay is considered to have no value and, as a result, no income is recognized until the receivable is collected. Expenses are deducted in the year paid. Because the recognition of expense is measured by the flow of cash, a taxpayer can control the year in which an expense is deductible by choosing when to make the payment. Individual taxpayers do not have the same opportunity to determine the year in which income is recognized, because the constructive receipt rule requires taxpayers to recognize income if a payment is available, even if actual payment has not been received. (See Chapter I:3 for a discussion of constructive receipt.)

KEY POINT

A taxpayer using the cash method is entitled to certain deductions that do not involve current year cash disbursements, such as depreciation, depletion, and losses.

Capitalization Requirements for Cash-Method Taxpayers. Taxpayers who use the cash receipts and disbursements method are required to capitalize fixed assets and to recover the cost through depreciation or amortization. However, Sec. 179 does permit taxpayers to deduct annually up to $1,020,000 in 2019 ($1 million in 2018) of equipment purchases (see Chapter I:10 for a detailed discussion).

The Regulations state that prepaid expenses must be capitalized and deducted over the life of the asset if the life of the asset extends substantially beyond the end of the tax year.[23] Typically, capitalization is required only if the life of the asset extends beyond the close of the tax year following the year of payment.[24]

EXAMPLE I:11-12 ▶ On July 1, 2019, Acme Corporation, a cash basis, calendar-year taxpayer, pays an insurance premium of $3,000 for a policy that is effective July 1, 2019, to June 30, 2020. The full $3,000 is deductible in 2019. ◀

EXAMPLE I:11-13 ▶ Assume the same facts as in Example I:11-12, except that the premium covers a three-year period beginning July 1, 2019, and ending June 30, 2022. Acme Corporation may deduct $500 in 2019, $1,000 in 2020 and 2021, and $500 in 2022. ◀

One notable exception to the one-year rule denies a deduction for prepaid interest. Cash-method taxpayers must capitalize such amounts and allocate interest over the prepayment period. A special rule allows homeowners to deduct points paid on a mortgage used to buy or improve a personal residence. The payment must be an established business practice in the area and not exceed amounts generally charged for such home loans. (See Chapter I:8 for a discussion of the deductibility of points.)

To be deductible, a payment must be more than just a refundable deposit. A taxpayer who has an option of cancelling delivery and receiving a refund of amounts prepaid is not normally entitled to deduct the amount of the deposit.

[22] Reg. Sec. 1.446-1(c)(1)(i).
[23] Reg. Sec. 1.461-1(a)(1).
[24] *Bonaire Development Co.*, 76 T.C. 789 (1981), and *Martin J. Zaninovich v. CIR*, 45 AFTR 2d 80-1442, 80-1 USTC ¶9342 (9th Cir., 1980).

Payments can be made either by a check that is honored in due course or by the use of a credit card.[25] Payment by credit card is considered to be the equivalent of borrowing funds to pay the expense. However, a taxpayer's note is not the equivalent of cash, so if a cash method taxpayer gives a note in payment, he or she cannot take the deduction until the note is paid, even if the note is secured by collateral.[26]

ACCRUAL METHOD

For an accrual basis taxpayer, there are two tests used to determine when an item of income must be reported or an expense deducted: the **all-events test** and the **economic performance test.**

ADDITIONAL COMMENT

The phrase *reasonable accuracy* means that approximate amounts are ascertainable. Although the word *accuracy* means exactness or precision, when it is used with the word *reasonable* it implies something less than an exact amount.

All-Events Test. An accrual-method taxpayer reports an item of income when "all events" have occurred that fix the taxpayer's right to receive the item of income and the amount can be determined with reasonable accuracy.[27] Similarly, an expense is deductible when all events have occurred that establish the fact of the liability and the amount of the expense can be determined with reasonable accuracy. For deductions, the all-events test is not satisfied until economic performance has taken place.

Economic Performance Test. Economic performance (of services or property to be provided to a taxpayer) occurs when the property or services are actually provided by the other party.

EXAMPLE I:11-14 ▶ The owner of a professional football team provides medical benefits for injured players through insurance coverage. Economic performance occurs over the term of the policy rather than when the team enters into a binding contract with the insurance company or during the season when the player earns the right to medical benefits. Thus, a one-year premium is deductible over the year of the insurance coverage rather than over the term of the player's contract under which the benefit is earned. But see below for a possible waiver. ◀

Similarly, if a taxpayer is obligated to provide property or services, economic performance occurs in the year the taxpayer provides the property or service.

EXAMPLE I:11-15 ▶ Assume the same facts as in Example I:11-14 except that medical benefits are required under the terms of a player's contract. Also, the team decides to pay medical costs directly. Economic performance occurs as the team actually provides the benefits. Thus, the deduction is permitted only as medical care is provided. ◀

REAL-WORLD EXAMPLE

Before the economic performance test was added to the tax law, a company engaged in strip mining coal was able to deduct the future land reclamation costs as the coal was mined because the liability was certain and the cost could be estimated. *Ohio River Collieries,* 77 T.C. 1369 (1981).

The requirement that economic performance take place before a deduction is allowed is waived if all of the following five conditions are met:

- The all-events test, without regard to economic performance, is satisfied.
- Economic performance occurs within a reasonable period (but in no event more than 8½ months) after the close of the tax year.
- The item is recurring in nature, and the taxpayer consistently treats items of the same type as incurred in the tax year in which the all-events test is met.
- The taxpayer is not a tax shelter.
- Either the amount is not material or the earlier accrual of the item results in a better matching of income and expense.[28]

EXAMPLE I:11-16 ▶ Bass Corporation, a calendar year taxpayer, pays its annual insurance premium each year on April 30, the anniversary of the policy. The premium paid this year is $6,000 while last year's premium was $5,400. Accrual accounting indicates that Bass deduct $4,000($^{8}/_{12} \times \$6,000$) of the premium paid this year along with $1,800($^{4}/_{12} \times \$5,400$) of the premium paid last year, or a total of $5,800. As all of the conditions for the exception to the economic performance requirements are met, Bass Corporation can deduct $6,000 this year. This assumes that Bass has been consistently following the practice and deducted $5,400 last year. ◀

[25] Rev. Rul. 78-39, 1978-1 C.B. 73.
[26] *Frank D. Quinn Exec. v. CIR,* 24 AFTR 927, 40-1 USTC ¶9403 (5th Cir., 1940).
[27] Reg. Sec. 1.451-1(a). (See Chapter I:3 for a discussion of the all-events test as it applies to gross income.)
[28] Sec. 461(h).

TYPICAL MISCONCEPTION

It is sometimes mistakenly believed that taxpayers can deduct warranty expenses and bad debts using the allowance method instead of the direct write-off method.

Reserves for items such as product warranty expense and uncollectible accounts are commonly encountered in financial accounting. The all-events and economic performance tests prevent the use of such reserves for tax purposes. This is because the amount of such expense is not usually determinable with sufficient accuracy.

HYBRID METHOD

KEY POINT

A taxpayer who uses the cash method in computing gross income from his or her business must use the cash method in computing expenses of such business.

Taxpayers may use a combination of accounting methods as long as income is clearly reflected. To ensure that income is clearly reflected, certain restrictions have been placed on combining accounting methods. Taxpayers who use the cash method of accounting in determining gross income from a trade or business must use the cash method for determining expenses of the same trade or business. Similarly, taxpayers who use the accrual method of accounting for expenses must use the accrual method in computing gross income from the trade or business.

The basic rules relating to accounting methods, the all-events test, and economic performance are summarized in Topic Review I:11-2.

STOP & THINK

Question: If an accountant does tax work for an automobile dealer, in exchange for free use of an automobile, does the accountant have to report any income? Does it make a difference whether the accountant uses the automobile in her business? When is any taxable income reported?

Solution: The rental value of the automobile must be included in gross income. If the automobile is used in the accountant's business, a portion of the rental value is deductible as a business expense. Although it is not entirely clear, it seems that an accrual basis accountant would report income as tax services are provided to the dealer. A cash basis taxpayer would report income over the time the automobile is used.

TOPIC REVIEW I:11-2

Accounting Methods

Available Methods

- Permissible overall accounting methods are the cash receipts and disbursements method, the accrual method, and the hybrid method.
- The cash method is available to taxpayers without inventories and to taxpayers with inventories whose average gross receipts during the three preceding years was $26 million or less.

All-Events Test and Economic Performance Test

- An accrual-method taxpayer reports an item of income when all events have occurred that fix the taxpayer's right to receive the item of income and when the amount of the item can be determined with reasonable accuracy.
- An expense is deductible when all events have occurred that establish that there is a liability and when the amount of the expense can be determined with reasonable accuracy. The all-events test is not satisfied until economic performance has taken place.
- Economic performance takes place when property or services are actually provided.

INVENTORIES

OBJECTIVE 3

Determine what costs must be included in inventory

KEY POINT

Taxpayers cannot always use inventory methods for tax purposes that conform with generally accepted accounting principles.

The inventory method used by a taxpayer must conform to the best accounting practice in the trade or business, and it must clearly reflect income. However, best accounting practices (synonymous with generally accepted accounting principles) and clear reflection of income (which is determined by the IRS) occasionally conflict. The Supreme Court has held that the standard of clear reflection of income prevails in a case where the two standards conflict. In the *Thor Power Tool Co.* case, the company wrote off the cost of obsolete parts for both tax and financial accounting purposes even though the parts were kept on hand and their selling price was not reduced.[29] Regulation Sec. 1.471-4(b) states that obsolete or other slow-moving inventory cannot be written down unless the selling price is also reduced.

Although the company's practice conformed with generally accepted accounting principles, it did not, according to the Supreme Court, clearly reflect income. Hence, generally accepted accounting principles are used only when the Regulations do not specify the treatment of an item or, alternatively, when the Regulations provide more than one alternative accounting method.

Taxpayers who value inventory at cost may write down goods that are not salable at their normal price (e.g., damaged, obsolete, or shopworn goods) only after the selling price has been reduced. Items may be valued at a bona fide selling price reduced by the direct cost of disposal.[30] The option to write down this type of merchandise is available even if the taxpayers use the LIFO inventory method.

EXAMPLE I:11-17 ▶

KEY POINT

The uniform capitalization rules, included in the Tax Reform Act of 1986, require the capitalization of significant overhead costs that previously were expensed.

Stone Corporation publishes books for small academic audiences in Sanskrit and other ancient languages. There is typically one printing of a few hundred or perhaps a thousand copies of each book. Stone may sell a few copies a year of each book. Only after several years can the Corporation determine whether they will ever sell all copies of a given work. Based upon the *Thor Power Tool Co.* case, Stone Corporation cannot write off unsold copies unless they are destroyed or otherwise disposed of, and they cannot write down unsold copies unless the selling price is reduced below cost. ◀

DETERMINATION OF INVENTORY COST



ETHICAL POINT

The UNICAP rules must be followed by taxpayers. To bring a business into compliance with these rules, the taxpayer may need to make certain estimates. SRTP No. 4 provides that a CPA may use a client's estimates if such use is generally acceptable or if it is impractical to obtain exact data. If a change in the overhead application rate is contemplated, it may be desirable to request IRS approval.

Inventories may be valued at either cost or at the lower of cost or market value. Taxpayers who use the LIFO inventory valuation method (discussed later in this chapter) may not use the lower of cost or market method. In the case of merchandise purchased, cost is the invoice price less trade discounts, plus freight and other handling charges.

Unlike financial accounting, purchasing costs (e.g., salaries of purchasing agents), warehousing costs, packaging, and administrative costs related to these functions must be allocated between cost of goods sold and inventory. The costs that must be included in inventory are found in Sec. 263A and are referred to as the Uniform Capitalization rules (UNICAP). The requirement is applicable only to taxpayers whose average gross receipts for the three preceding years exceed $26 million in 2019 ($25 million in 2018).[31]

In the case of goods manufactured by the taxpayer, cost is determined by using the UNICAP rules, which may be thought of as an expanded version of the full absorption costing method. Thus, direct costing and prime costing are not acceptable inventory methods. Direct labor and materials along with manufacturing overhead must be included in inventory. Under UNICAP, the following overhead items are included in inventory:

- Factory repairs and maintenance, utilities, rent, insurance, small tools, and depreciation (including the excess of tax depreciation over accounting depreciation)
- Factory administration and officers' salaries related to production
- Taxes (other than the income tax)

[29] *Thor Power Tool Co. v. CIR*, 43 AFTR 2d 79-362, 79-1 USTC ¶9139 (USSC, 1979).

[30] Reg. Sec. 1.471-2(c).

[31] Sec. 263A(b)(2)(B).

- ▶ Quality control and inspection
- ▶ Rework, scrap, and spoilage
- ▶ Current and past service costs of pension and profit-sharing plans
- ▶ Service support such as purchasing, payroll, and warehousing costs

Nonmanufacturing costs (e.g., advertising, selling, and research and experimentation costs) are not required to be included in inventory. Interest must be inventoried if the property is real property, long-lived property, or property requiring more than two years (one year in the case of property costing more than $1 million) to produce.

KEY POINT

Identifying the appropriate additional overhead costs to capitalize can be confusing and extremely time consuming.

The main difference between full absorption costing traditionally used for financial reporting purposes and UNICAP costing required for tax purposes is that UNICAP expands the list of overhead costs to include certain indirect costs that have not always been included in overhead for financial reporting purposes. For example, for financial reporting purposes, the costs of operating payroll and personnel departments have sometimes been considered sufficiently indirect or remote to justify omitting them from manufacturing overhead. This is true even though much of the effort of the payroll and personnel departments may be directed toward manufacturing operations. For simplicity and other reasons, overhead costs included in inventory for financial purposes are often limited to those incurred in the factory. UNICAP requires that costs associated with these departments be allocated between manufacturing and nonmanufacturing functions (e.g., sales, advertising, research and experimentation).

EXAMPLE I:11-18 ▶ Best Corporation manufactures traditional style rocking chairs in a small factory with 34 employees. The office staff consists of four employees who handle payroll, receivables, hiring, and other office responsibilities. The sales staff includes three employees who travel the region selling to furniture and craft stores. The remaining 27 employees all work in the factory. Under UNICAP, factory costs including the wages of the 27 factory workers are generally all manufacturing costs. The costs associated with the sales staff are not manufacturing costs. This would include their compensation along with related costs such as travel. Office expenses including the wages paid to the four office workers can be allocated between manufacturing overhead and sales. Reasonable allocation methods are acceptable. One possibility might be to allocate office overhead between sales and manufacturing on a basis as simple as the number of employees in sales (3) and the number in manufacturing (27). Thus, 90% of the cost of the office operation could be treated as manufacturing-related and 10% sales-related. In such case, 90% of the office expenses would be allocated to manufacturing and 10% deducted as a period cost (i.e., selling expenses). The office expenses allocated to manufacturing would in turn be allocated between cost of sales and ending inventory. This allocation could be done on a basis as simple as multiplying the allocated office expenses by the number of chairs in ending inventory and dividing by the number of chairs in the ending inventory plus the total number of chairs made during the year. ◀

A manufacturer may use standard costs to value inventory if any significant variance is reallocated pro rata to ending inventory and cost of goods sold.[32] Taxpayers may determine inventory costs by the following methods: specific identification method; first-in, first-out method (FIFO); last-in, first-out method (LIFO); or average cost method. A few taxpayers, such as an automobile or large appliance dealer, may find it practical to determine the specific cost of items in inventory. Most taxpayers, however, must rely on a flow of goods assumption (e.g., FIFO or LIFO). A discussion of the LIFO method is presented below.

LIFO Method. Many taxpayers use the LIFO cost flow assumption because, during inflationary periods, LIFO normally results in the lowest inventory value and hence the lowest taxable income. Once LIFO has been elected for tax purposes, the taxpayer's financial reports must also be prepared using LIFO.[33] This requirement to conform financial reporting often discourages companies from electing LIFO because lower earnings must be reported to shareholders. However, taxpayers may make footnote disclosure of the amount

[32] Reg. Sec. 1.471-11(d)(3).

[33] Sec. 472(c).

of net income that would have been reported under FIFO or other inventory methods.[34] Taxpayers may adopt LIFO by attaching a completed Form 970 (or by a statement acceptable to the IRS) to the return for the tax year in which the method is first used.



STOP & THINK

Question: As noted, many publicly held companies do not use LIFO inventory valuation. This is, in part, attributed to the fact that LIFO ordinarily results in lower reported income for accounting purposes than FIFO, and management prefers to report higher profits. Many closely-held companies also use FIFO even though their earnings are not reported to the public. Why wouldn't closely-held companies use LIFO?

Solution: There are a variety of reasons. Some businesses are very interested in how their financial statements look to banks and other lenders and to potential investors. In some industries, such as electronics, FIFO may actually provide lower inventory values. Also, LIFO cannot be used with lower of cost or market. As a result, some businesses may elect FIFO to be eligible to use lower of cost or market.

Perhaps, however, the main reason is that LIFO is more complex, and small businesses prefer to simplify their accounting. The advent of computers, accounting software, and bar codes may be having some impact on inventory valuation choices. Nevertheless, many accounting packages only track units on hand and sales revenue. They do not track inventory value (cost). Thus, the company must assign a value to inventory at year-end, and the complexity of LIFO remains a deterrent.

REAL-WORLD EXAMPLE

An automobile dealer, using the dollar-value LIFO method in maintaining its inventory, was required to use one pool for new automobiles and a separate pool for new trucks. *Fox Chevrolet, Inc.*, 76 T.C. 708 (1981).

Recordkeeping under LIFO can be cumbersome. For this reason, taxpayers are permitted to determine inventories using "dollar-value" pools and government price indexes rather than by maintaining a record of actual costs.[35] Retailers use appropriate categories in the Consumer Price Index; other taxpayers use categories in the Producer Price Index. Taxpayers using the index method must divide their inventories into one or more pools (groups of similar items). Thus, a department store might create separate pools for tools, appliances, clothing, furniture, and other products. Dividing inventory into pools can be critical because of the different inflation rates associated with various goods and because, if a particular pool is depleted, the taxpayer loses the right to use the lower prices associated with past layers. An important exception permits taxpayers with average annual gross receipts of $5 million or less for the current and two preceding tax years to use the **simplified LIFO method**.[36] The simplified LIFO method uses a single LIFO pool, thereby avoiding problems with multiple pools.

EXAMPLE I:11-19 ▶ In 2019, King Department Store changes its inventory method from FIFO to LIFO. Because King's gross receipts have never exceeded $5 million, the simplified LIFO method is available. King's year-end inventories under FIFO are as follows:

2018	$100,000
2019	$130,000

Assume the 2018 price index is 120% and the 2019 index is 125%. King must convert its 2019 inventory to 2018 prices.

$$\frac{120\%}{125\%} \times \$130{,}000 = \$124{,}800$$

A base period inventory of $100,000 is established. The increase in inventory (the 2019 layer) is valued at 2019 prices.

Base inventory (2018)	$100,000
Plus: 2019 layer [(125% ÷ 120%) × ($124,800 − $100,000)]	25,833
2019 ending inventory	$125,833

Assume the 2020 inventory valued under FIFO is $136,000 and the 2020 price index is 130%. The 2020 inventory is converted to 2018 prices.

[34] Reg. Sec. 1.472-2(e).
[35] Sec. 472(f).
[36] Sec. 474(c).

$$\frac{120\%}{130\%} \times \$136{,}000 = \$125{,}538$$

The 2020 increase in inventory (the 2020 layer) is valued at 2020 prices.

Base inventory (2018)	$100,000
2019 layer	25,833
2020 layer	800[a]
2020 ending inventory	$126,633

[a] [(130% ÷ 120%) × ($125,538 – $124,800)].

ADDITIONAL COMMENT

For tax purposes the lower of cost or market method must ordinarily be applied to each separate inventory item, but for financial accounting purposes it can be applied using an aggregate approach.

Lower of Cost or Market Method. Inventory may be valued at the **lower of cost or market**. This option is available to all taxpayers other than those who determine cost using the LIFO method.[37] The term *market* refers to replacement cost. On the date an inventory is valued, the replacement cost of each item in the inventory is compared with its cost. The lower figure is used as the inventory value. The lower of cost or market method must ordinarily be applied to each separate item in the inventory.

Recall the *Thor Power Tool* case (discussed earlier in this chapter) in which the Supreme Court distinguished market value from expected selling price. **Market value** is the price at which the taxpayer can replace the goods in question. Replacement cost is used in the lower of cost or market determination. Obsolete or other slow-moving inventory can be written down below replacement cost only if the selling price has been reduced.

Cycle Inventory Valuation. Computer technology, including bar codes and software, enables businesses to maintain real-time perpetual inventory records. Many businesses, especially those with multiple locations, do not attempt to count all inventory items on the last day of the taxable period. Instead they count inventory following a scheduled cycle. At year-end, businesses adjust quantities shown in perpetual records for shrinkage since the most recent physical count utilizing estimates based on past experiences. The IRS challenged this practice unsuccessfully arguing that the adjustments failed the "all events" test which requires that amounts must be determined with reasonable accuracy.[38] In midst of the litigation, Congress specifically permitted the method in instances where "the taxpayer makes proper adjustment to such inventories and its estimation method [for] actual shrinkage."[39]

WHAT WOULD YOU DO IN THIS SITUATION?

INVENTORY VALUATION

Jack is a new tax client. He says he and his previous accountant did not get along very well. Jack owns an automobile dealership with sales of $12 million. He has provided you with most of the information you need to prepare his tax return, but he has not yet given you the year-end inventory value. You have completed much of the work on his return, but cannot complete it without the inventory figure. You have called Jack three times about the inventory. Each time he has interrupted, and asked you what his tax liability will be at alternative inventory levels. What problem do you see?

[37] Reg. Secs. 1.471-2(b) and (c).

[38] *Wal-Mart Stores Inc. v. CIR*, 82 AFTR 2d 5601, 98-2 USTC ¶50,645 (8th Cir., 1998), *Dayton Hudson Corp. v. CIR*, 82 AFTR 2d 5610, 98-2 USTC ¶50,644 (8th Cir., 1998), and *Kroger Co.*, 1997 RIA T.C. Memo ¶97,002, 73 TCM 1637.

[39] Sec. 471(b).

SPECIAL ACCOUNTING METHODS

OBJECTIVE 4

Identify the amount of income to be reported from special accounting methods

The term **method of accounting** is used to include not only overall methods of accounting (i.e., cash, accrual, and hybrid) but also the accounting treatment of specific items. Special rules have been established for two types of transactions that cover long periods of time. One rule applies to installment sales (a sale in which final payment is not received until a subsequent tax year) and a separate set of rules applies to long-term contracts (construction and similar contracts that are not completed in the same year they are started). These special rules permit taxpayers to report income from this type of transaction when they have the wherewithal to pay the tax (i.e., the year in which payment is received).

LONG-TERM CONTRACTS

Long-term contracts include building, installation, construction, or manufacturing contracts that are not completed in the same tax year in which they began.[40] A manufacturing contract is long-term only if the contract involves the manufacture of either a unique item not normally carried in finished goods inventory or items that normally require more than 12 calendar months to complete. Contracts for services (architectural, accounting, legal, and so on) do not qualify for long-term contract treatment.[41]

EXAMPLE I:11-20 ▶ Diamond Corporation manufactures two types of airplanes: small, general aviation planes that require approximately six months to complete and large jet aircrafts sold to airlines that require two years to complete. Diamond maintains an inventory of the small planes but manufactures the large planes to contract specification. Diamond can use long-term contract accounting only for the large planes. Assume Diamond also offers aircraft design assistance to the government and others who seek such services. The long-term contract method of accounting is not available for such services. ◀

HISTORICAL NOTE

The use of the completed contract method was severely restricted in the Tax Reform Act of 1986 because Congress found that several large corporations, particularly those with large defense contracts, had significant deferred taxes attributable to this method. Many of these companies had extremely low or negative tax rates for several years.

ADDITIONAL COMMENT

In general, a construction contract must involve what has historically been thought of as construction which includes erecting buildings, building dams, roads, and power plants.

The accounting method selected by a taxpayer must be used for all long-term contracts in the same trade or business.[42] In general, the income and expenses associated with long-term contracts may be accounted for by using either the **percentage of completion method** or the **modified percentage of completion method**. In limited instances (explained below), taxpayers may use the **completed contract method**. Under the percentage of completion method, income from a project is reported in installments as the work progresses. Under the completed contract method, income from a project is recognized upon completion of the contract. The modified percentage of completion method is a hybrid that combines two methods (discussed below). Alternatively, taxpayers may use any other accounting method (e.g., the accrual method) that clearly reflects income.

Costs Subject to Long-Term Contract Rules. Direct contract costs are subject to the long-term contract rules. Labor, materials, and overhead costs must be allocated to the contract and accounted for accordingly. Thus, under the completed contract method, such costs are capitalized and deducted from revenue in the year the contract is completed. Selling, marketing and advertising expenses, expenses for unsuccessful bids and proposals, and research and development costs not associated with a specific contract may be deducted currently.

In general, administrative overhead must be allocated to long-term contracts. (See the earlier list of overhead items that must be included in inventory.) This is not required of taxpayers (other than homebuilders) using the completed contract method, but as noted below, the use of the completed contract method is limited.

As previously mentioned, interest must be capitalized if the property being produced is real property, long-lived property, or property requiring more than two years (one year in

[40] Reg. Sec. 1.451-3(b).

[41] Rev. Proc. 2011-18, 2011-5 I.R.B. 443 and Rev. Proc. 2004-34, 2004-1 C.B. 991, modifying and superseding Rev. Proc. 71-21, 1971-2 C.B. 549, does establish rules for service contracts that extend into the year following the receipt of payment. These rules are discussed in Chapter I:3.

[42] Reg. Sec. 1.451-3(a)(1).

the case of property costing more than $1 million) to produce. Interest costs directly attributable to a contract and those that could have been avoided if contract costs had not been incurred must be allocated to long-term contracts.

Completed Contract Method. Under the completed contract method of accounting, income from a contract is reported in the taxable year in which the contract is completed. This is true without regard to whether the contract price is collected in advance, upon completion of the contract, or in installments. Costs associated with the contract are accumulated in a work-in-progress account and deducted upon completion. Several courts are in conflict with regard to determining when a contract is completed. Some courts have required total completion and acceptance of the contract.[43] Other courts have held the contract to have been completed when the only work remaining consists of correcting minor defects or furnishing incidental parts.[44]

The use of the completed contract method may only be used in two limited circumstances. The method can be used by smaller companies (those whose average gross receipts for the three preceding tax years is $26 million or less) for construction contracts that are expected to take two years or less to complete and for home construction contracts.[45] It cannot be used by larger companies for manufacturing, or for other long-term contracts other than construction or for construction contracts expected to last longer than two years.

KEY POINT

In general, taxpayers with long-term contracts must compute income under the percentage of completion method for contracts entered into after July 10, 1989.

Percentage of Completion Method. Under the percentage of completion method of reporting income, the taxpayer reports a percentage of the gross income from a long-term contract based on the portion of work that has been completed. The portion of the total contract price reported in a given year is determined by multiplying the total contract price by the percentage of work completed in the year. The percentage is determined by dividing current year costs by the expected total costs.

KEY POINT

After a taxpayer has adopted an accounting method for long-term contracts, he or she must continue to use that method unless permission to change methods is granted.

Modified Percentage of Completion Method. At the beginning of a contract, it is difficult to estimate total costs. For this reason, taxpayers may elect to defer reporting any income from a contract until they have incurred at least 10% of the estimated total cost.[46] This is called the modified percentage of completion method. Under this method, if a contract has just been started as of the end of the year, the taxpayer does not have to estimate the profit on the contract during that year. The next year the taxpayer will report profit on all work that has been completed, including work done during the first year. Of course, this assumes that at least 10% of the work has been completed as of the end of the taxable year. If more than 10% of the costs are incurred during the first year, the modified percentage of completion method is identical to the regular percentage of completion method.

The completed contract method, the percentage of completion method, and the modified percentage of completion method are compared in Example I:11-21.

EXAMPLE I:11-21 ▶ In 2019, a contractor enters into a contract to construct a bridge for $1,400,000. At the outset, the contractor estimates that it will cost $1,200,000 to build the bridge. Actual costs in 2019 are $540,000 (45% of the $1,200,000 total estimated costs). Actual costs in 2020 are less than expected and amount to $600,000. The profits reported in both years of the contract are illustrated below.

	2019	*2020*
Completed contract		
Revenue	0	$1,400,000
Costs incurred	0	(1,140,000)
Gross profit	0	$ 260,000

[43] *E. E. Black Limited v. Alsup*, 45 AFTR 1345, 54-1 USTC ¶9340 (9th Cir., 1954), and *Thompson-King-Tate, Inc. v. U.S.*, 8 AFTR 2d 5920, 62-1 USTC ¶9116 (6th Cir., 1961).

[44] *Ehret-Day Co.*, 2 T.C. 25 (1943), and *Nathan Wohlfeld*, 1958 PH T.C. Memo ¶58,128, 17 TCM 677.

[45] Sec. 460(e).

[46] Sec. 460(a).

Percentage of completion		
Revenue	$630,000[a]	$770,000[b]
Costs incurred	(540,000)	(600,000)
Gross profit	$90,000	$170,000

[a] 540,000/1,200,000 × $1,400,000 = $630,000.

[b] $1,400,000 − $630,000 = $770,000. ◀

In Example I:11-21, the modified percentage of completion method results in the same income being reported each year as the percentage of completion method because more than 10% of the estimated costs were incurred during the first year. Note that the completed contract method defers reporting income until the contract is completed, causing all income from the project to be reported in a single year. Thus, the tax is deferred but the taxpayer may end up being taxed at higher rates. As noted, the completed contract is available only for home construction contracts and to certain smaller contractors for projects of two years or less.

Look-Back Interest. Certain contracts (or portions of a contract) accounted for under either the regular or modified percentage of completion method are subject to a **look-back interest** adjustment. When a contract is completed, a computation is made to determine whether the tax paid each year during the contract is more or less than the tax that would have been paid if the actual total cost of the contract had been used rather than the estimated cost.[47] Interest is paid on any additional tax that would have been paid. The taxpayer receives interest on any additional tax that was paid.

Look-back interest is applicable only to contracts completed more than two years after the commencement date. Furthermore, look-back interest is applicable only if the contract price equals or exceeds either 1% of the taxpayer's average gross receipts for the three taxable years preceding the taxable year the contract was entered into or $1 million.[48]

Taxpayers may elect a "de minimis" exception to the "look-back" interest computation. If elected, the exception is applicable to all contracts completed within a year, and the election to use the exception can be revoked only with IRS approval. Under the exception, if income reported each year on a contract is within 10% of the recomputed "look-back income," no interest computation is made for the contract. Whether reported income is within 10% of recomputed income is determined separately for each completed contract.

EXAMPLE I:11-22 ▶ The contractor in Example I:11-21 is exempt from the look-back rule because the contract is completed within two years after the commencement date. On the other hand, if the contract took more than two years to complete, interest would be owed on the underpaid taxes for the first and subsequent contract years. The underreported income for the first year would be $33,158 [($260,000 profit × $540,000 first year's costs ÷ $1,140,000 total costs) − $90,000 first year reported income]. Assuming a 21% tax bracket, the underpaid tax for the first year is $6,963. Upon completion of the contract, interest would be paid on this amount and underpaid taxes for other years. Even if elected, the "de-minimis" exception would be inapplicable as the reported income in the first year of the contract ($90,000) is not within 10% of the income that would have been reported if actual costs had been used in the computation ($123,158 = $33,158 + $90,000). ◀

INSTALLMENT SALES METHOD

In general, the gain or loss from the sale of property is reported in the year the property is sold. If the sales proceeds are collected in years after the sale, the taxpayer may find it difficult to pay the tax on the entire amount of the gain in the year of sale. To reduce the burden, the tax law permits taxpayers to spread the gain from installment sales over the collection period. The installment method is applicable only to gains and is used to report income from an installment transaction unless the taxpayer elects not to use the

[47] Sec. 460(b)(3).

[48] Sec. 460(b)(3).

KEY POINT

The installment sales method allows either a cash or an accrual method taxpayer to spread the gain from the sale of property over the period during which payments are received.

installment method. An **installment sale** is any disposition of property where at least one payment is received after the close of the taxable year in which the disposition occurs. The installment method is *not* applicable to sales of:

- inventory, or
- marketable securities[49]

Computations Under Sec. 453. Income under the installment sales method is computed as follows:

SELF-STUDY QUESTION

A taxpayer sells 100 shares of Ford Motor Company stock for a gain of $800 on December 30, 2019. The taxpayer received the proceeds from the sale from the stockbroker on January 5, 2020. Can the taxpayer use the installment sales method?

ANSWER

No, the method is not applicable to sales of publicly traded property.

TYPICAL MISCONCEPTION

The selling price is sometimes confused with the contract price.

STEP 1: Compute the gross profit from the sale.

Selling price	$xx,xxx
Minus: Adjusted basis	(x,xxx)
Selling expenses	(x,xxx)
Depreciation recapture[50]	(x,xxx)
Gross profit	$ x,xxx

STEP 2: Determine the contract price.

Contract price (greater of the gross profit from above or the selling price reduced by any existing mortgage assumed or acquired by the purchaser)	$xx,xxx

STEP 3: Compute the gross profit percentage.

$$\text{Gross profit percentage} = \frac{\text{Gross profit}}{\text{Contract price}} = \text{xx}\%$$

STEP 4: Compute the gain to be reported in the year of sale.

Collections of principal received during year (exclusive of interest)	$xx,xxx
Plus: Excess mortgage (if any)[a]	x,xxx
Total	$xx,xxx
Times: Gross profit percentage	× xx%
Net gain recognized in year of sale	$ x,xxx
Plus: Depreciation recapture	x,xxx
Gain reported in year of sale	$ x,xxx

STEP 5: Compute the gain to be reported in subsequent years.

Collections of principal received	$ x,xxx
Times: Gross profit percent	× xx%
Gain reported in each of the subsequent years	$ x,xxx

[a] Mortgage − Basis − Selling expense − Depreciation recapture = Excess mortgage

ADDITIONAL COMMENT

On the sale of a capital asset a taxpayer might elect not to use the installment sales method and report the entire gain in the year of sale if he or she has capital losses that could be used to offset the gain.

Note that depreciation recapture (see Chapter I:13) must be reported in the year of the sale even if no payment is received.

EXAMPLE I:11-23 ▶ Gina, a cash basis taxpayer, sells equipment for $200,000. The equipment originally cost $70,000, and $10,000 of MACRS depreciation has been deducted before the sale. The $10,000 of depreciation must be recaptured as ordinary income under Sec. 1245. The buyer assumes the existing mortgage of $50,000, pays $10,000 down, and agrees to pay $10,000 per year for 14 years plus interest at a rate acceptable to the IRS. Selling expenses are $13,000. The selling price is $200,000 [($50,000 + $10,000) + (14 × $10,000)]. The gain to be reported is $127,000 [$200,000 − $13,000 − ($70,000 − $10,000)]. Using the steps listed above, calculations are made as follows:

[49] Sec. 453(b)(2) and (k).

[50] For a discussion of depreciation recapture, see Chapter I:13.

STEP 1: Compute the gross profit from the sale.

Selling price	$200,000
Minus: Adjusted basis	(60,000)
Selling expenses	(13,000)
Depreciation recapture	(10,000)
Gross profit	$117,000

STEP 2: Determine the contract price.

Greater of gross profit of $117,000 or selling price minus mortgage assumed by purchaser ($150,000 = $200,000 − $50,000)	$150,000

STEP 3: Compute the gross profit percentage.

$$\text{Gross profit percentage} = \frac{\text{Gross profit (\$117,000)}}{\text{Contract price (\$150,000)}} = 78\%$$

STEP 4: Compute the gain to be reported in the year of sale.

Principal received during year	$ 10,000
Plus: Excess mortgage	0
Total amount realized	$ 10,000
Times: Gross profit percentage	× 0.78
Gross profit	$ 7,800
Plus: Depreciation recapture	10,000
Gain reported in year of sale	$ 17,800

STEP 5: Compute the gain to be reported in subsequent years.

Principal received	$ 10,000
Times: Gross profit percentage	× 78%
Gain reported in each subsequent year	$ 7,800

Thus, the total gain reported is $127,000 [$17,800 + ($7,800 × 14)]. This is equal to the gross profit of $117,000 (which is the amount of Sec. 1231 gain reported on the sale) plus the $10,000 of depreciation recapture. As a cash basis taxpayer Gina will report the interest income as it is collected. (Figure I:11-1 at the end of this chapter illustrates this computation on Form 6252, Installment Sale Income.) ◀

Many taxpayers deduct the purchase price of equipment in the year of purchase under Sec. 179. In such situations, the installment method is of little use because any gain on the sale is covered by Sec. 1245. As noted, Sec. 1245 gains must be reported in the year of sale, even when the gain is greater than the amount received during the year. The installment method is often used to report real estate sales because the cost of real estate cannot be deducted in the year of purchase.

REAL-WORLD EXAMPLE

When an installment obligation is assigned as collateral for a loan, the transaction is treated as a disposition of the obligation. Rev. Rul. 65-185, 1965-2 C.B. 153.

Disposition of Installment Obligations. A taxpayer who sells property on the installment basis may decide not to hold the obligation until maturity. For example, the holder may sell the obligation to a financial institution for the purpose of raising cash. Alternatively, the holder may not be able to collect the full amount of the installments because of the inability of the buyer to make payments. In these situations, the holder must determine the adjusted basis of the obligation in order to compute the resulting gain or loss. The adjusted basis of an installment obligation is equal to the face amount of the obligation reduced by the gross profit that would be realized if the holder collects the face amount of the obligation. In general, this means the adjusted basis of an obligation is equal to

$$\text{Face amount} \times (100\% - \text{Gross profit percentage})$$

EXAMPLE I:11-24 ▶ Assume the same facts as in Example I:11-23 except that Gina immediately sells a single $10,000 installment to a bank for $9,700. Gina reports a gain of $7,500 computed as follows:

Selling price	$9,700
Minus: Adjusted basis of installment	(2,200)[a]
Recognized gain	$7,500

[a] $10,000 face amount × (100% − 78% gross profit percentage) = $2,200

Gina would have reported a gain of $7,800 had she decided not to sell the installment but to collect the face amount. Because the obligation is discounted by $300 ($10,000 − $9,700), the reported gain is reduced by $300. If the installment had not been sold immediately, the bank would probably also pay to Gina an amount for the accrued interest. In such a situation Gina would report the gain from the sale and the accrued interest as income. ◀

EXAMPLE I:11-25 ▶ Assume that Gina in Example I:11-24 is unable to collect the final $10,000 installment because the individual who purchases the property declares bankruptcy. Gina would be entitled to a bad debt deduction of $2,200, the basis of the installment. Gina does not receive a bad debt deduction for the accrued interest because the interest has not been included in her gross income. ◀

KEY POINT

A donor of property does not normally recognize gain, but a gift of certain installment obligations causes the recognition of gain.

Certain dispositions of installment obligations, such as gifts, are taxable events.[51] The main objective of this rule is to prevent income from being shifted from one taxpayer to another. Thus, if a corporation distributes an installment obligation as a dividend or if a father gives his daughter an installment obligation, gain or loss is recognized. In general, the gain or loss recognized is equal to the difference between the FMV of the obligation and its adjusted basis. In the case of a gift, the gain recognized is equal to the difference between the face of the obligation and its adjusted basis. However, certain exceptions to this rule exist. Transfers to controlled corporations under Sec. 351, certain corporate reorganizations and liquidations, transfers on the taxpayer's death, transfers incident to divorce, distributions by partnerships, and contributions of capital to a partnership are exceptions to this rule. In these cases, the recipients of the obligations report income when the installments are collected.

Repossessions of Property Sold on the Installment Basis. In general, the repossession of property sold on the installment basis is a taxable event. The gain or loss recognized is generally equal to the difference between the value of the repossessed property (reduced by any costs incurred as a result of the repossession) and the adjusted basis of any remaining installment obligations.

EXAMPLE I:11-26 ▶ Yuji sells stock of a non–publicly traded corporation with a $7,000 adjusted basis for $10,000. Yuji receives a $1,000 down payment, and the balance of $9,000 is due the following year. In the year of the sale Yuji reports a capital gain of $300 (0.30 × $1,000) under the installment method of accounting. Yuji is unable to collect the $9,000 note, and after incurring legal fees of $500, he repossesses the stock. When Yuji repossesses the stock it is worth $8,700. The adjusted basis of the note is $6,300 (0.70 × $9,000). Yuji must report a capital gain of $1,900 ($8,700 − $500 − $6,300). The basis of the stock to Yuji is its FMV at the time it is repossessed ($8,700). ◀

The amount of gain recognized from the repossession of real property is limited to the lesser of (1) the gross profit in the remaining installments reduced by the costs incurred as a result of the repossession or (2) the cash and FMV of other property received from the buyer in excess of the gain previously recognized.[52] In the case of the repossession of either real or personal property, the gain or loss retains the same character as the gain or loss on the original sale.

EXAMPLE I:11-27 ▶ Assume the same facts as in Example I:11-26, except that the property sold is land. Yuji reports a capital gain of $700, which is the lesser of $2,200 [(0.30 × $9,000) − $500] or $700 ($1,000 − $300). The basis of the land is $7,500 [$9,000 − (0.30 × $9,000) unrealized profit + $700 gain previously recognized + $500 legal fees]. ◀

Installment Sales for More Than $150,000. Special rules apply to nondealers who sell property for more than $150,000. The special rules do not apply to sales of personal use property, to sales of property used or produced in the trade or business of farming, or to sales of timeshares or residential lots.

[51] Sec. 453B(a).
[52] Sec. 1038.

First, if the taxpayer borrows funds using the installment obligations as security, the amount borrowed is treated as a payment received on the installment obligation.[53] This prevents the taxpayer from using the installment method to defer tax and yet obtain cash by borrowing against the installment obligation. Second, if the installment method is used, interest must be paid to the government on the deferred tax.[54] This rule, however, applies only to deferred principal payments over $5 million.[55]

KEY POINT

Installment sales between related parties cannot be used to defer the recognition of gain by the original owner when the related purchaser receives cash as result of a resale of the property.

Installment Sales Between Related Persons. Installment sales between related persons are subject to the same rules as other installment sales except when the property is resold by the related purchaser. The primary purpose of the resale rule is to prevent the original owner from deferring gain recognition by selling the property to a related person who, in turn, resells the property.

Sec. 453(e) requires the first seller to treat amounts received by the related person (second seller) as having been personally received. Thus, the first seller would be required to report the gain in the year (or years) in which proceeds are received by the second seller. This acceleration provision is applicable only if the resale takes place within two years of the initial sale. For purposes of Sec. 453(e), the term *related person* includes a spouse, children, grandchildren, and parents. Controlled corporations, partnerships, estates, and trusts are also covered.

DEFERRED PAYMENT SALES

The installment sale rules are not applicable to all sales involving future payments. The installment method cannot be used when the sale of property produces a loss. Also, a taxpayer can elect out of the installment method when a sale results in a gain. The manner in which these transactions are reported depends on the taxpayer's accounting method. For accrual method taxpayers, the total *amount receivable* from the buyer (exclusive of interest) is treated as part of the amount realized. Thus, the entire gain or loss is reported in the year of sale. For cash method taxpayers, the FMV of the installment obligation is treated as part of the amount realized in the year of sale. The amount realized, however, cannot be considered to be less than the FMV of the property sold minus any other consideration received (e.g., cash).[56]

EXAMPLE I:11-28 ▶ USA Corporation, an accrual method taxpayer, sells land for $100,000. USA receives $50,000 down and a $50,000 note payable in 12 months plus 14% interest. Assume the basis of the land is $80,000 and that it is a capital asset. Because of the buyer's poor credit, the value of the note is only $45,000. USA affirmatively elects not to report the installment sale on the installment method. USA reports a capital gain of $20,000 ($100,000 − $80,000). If USA collects the face of the note at maturity, no additional gain or loss is recognized. If USA sells the note for $45,000, a $5,000 capital loss is recognized. ◀

EXAMPLE I:11-29 ▶ Assume the same facts as in Example I:11-28, except that USA is a cash method taxpayer. If the FMV of the land is $100,000 (the stated selling price), the treatment of the transaction is exactly the same as it is using the accrual method. If the FMV of the land is assumed to be $95,000 (cash received plus FMV of the note received), USA recognizes a $15,000 ($95,000 − $80,000) capital gain in the year of the sale. If USA collects the face of the note at maturity, $5,000 of ordinary income is recognized. If USA sells the note for $45,000, no gain or loss is recognized. ◀

ADDITIONAL COMMENT

A contingent payment sale is a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the tax year in which the sale took place.

Indeterminate Market Value. In certain transactions, the value of obligations received cannot be determined (e.g., a mineral interest is sold for an amount equal to 10% of the value of future production). Under the Regulations, the value of obligations with an **indeterminate market value** is assumed to be no lower than the value of the property sold less the value of other property received.[57] Hence, if the value of property sold is determinable, the recognized gain equals the excess of the value of the property sold over its basis. On occasion, however, neither the value of the obligation received nor the value of property sold can be determined.

Temporary regulations specify how these types of transactions are to be treated.[58] The basic rules relating to special accounting methods are summarized in Topic Review I:11-3.

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[53] Sec. 453A(d).
[54] The interest computation is described in Sec. 453A(c).
[55] Sec. 453A(b)(2)(B).
[56] Temp. Reg. Sec. 15A.453-1(d)(2)(ii)(A).
[57] Reg. Sec. 1.453-1(d)(3)(iii).
[58] Temp. Reg. Sec. 15A.453-1(c).

TOPIC REVIEW I:11-3

Special Accounting Methods

Long-Term Contracts

- Long-term contracts include building, installation, construction, and manufacturing contracts that are not completed in the same tax year in which they are entered into. A manufacturing contract is long-term only if the contract involves the manufacture of either a unique item not normally carried in inventory or an item that normally requires more than 12 calendar months to complete.
- Long-term contracts may be reported under the regular or the modified percentage of completion method. Under both methods income is reported as work is completed, except that under the modified percentage of completion method no income is reported until at least 10% of the work is completed.
- The completed contract method is available only for home construction contracts, for construction contracts expected to take two years or less to complete, and for use by smaller companies (those whose average gross receipts for the three preceding tax years are $26 million or less).

Installment Method

- Under the installment method gain is reported as the sales proceeds are collected. The installment method is generally not available for sales of inventory or publicly traded property. Furthermore, the method is available only for gains.
- Gain is reported as sales proceeds are collected. However, both depreciation recapture and any mortgage in excess of basis must be reported in the year of sale. Gain recognition is also accelerated in certain situations if the seller borrows against the installment obligation or if a related buyer resells the property within two years.

Imputed Interest

OBJECTIVE 5

Compute the amount of imputed interest in certain transactions

KEY POINT

Imputed interest is important because it alters the amount of gain on the sale and causes an interest expense deduction for the buyer and interest income for the seller.

TYPICAL MISCONCEPTION

Some people mistakenly assumed that the imputed interest rules do not apply if the property is sold for a loss.

Before the enactment of Sec. 1274 and the amendment of Sec. 483, property could be sold on an installment basis in a contract providing for little or no interest. Instead of charging interest, the seller charged a higher price for the property. If the property sold was a capital asset, the result of the arrangement was to reduce the interest income reported by the seller and to increase the amount of favorably taxed capital gain. Sections 483 and 1274 now *impute* interest in a deferred payment contract where no interest or a low rate of interest is provided. Another impact of the **imputed interest rules** on sellers is to reallocate payments received between interest (which is fully taxable) and principal (only the gain portion of which is taxable). The result is often an increase in the income reported in early years and a decrease in later years. The rules are generally applicable to both buyers and sellers. In certain instances, the buyer may want interest to be imputed in order to increase his interest deduction in early years.

The following transactions are exempt from the imputed interest rules:

- Debt subject to original issue discount provisions (basically bonds issued for less than face where amortization of the discount is required under Sec. 1274; see Chapter I:5)
- Sales of property for $3,000 or less
- Any sales where all of the payments are due within six months
- Sales of patents to the extent the payment is contingent on the use or disposition of the patent
- Certain carrying charges for personal property or educational services covered by Sec. 163(b) when the interest charge cannot be ascertained
- Charges for the purchase of personal-use property (purchaser only)[59]

[59] Sec. 483(d). The rule lowers the basis of a personal-use asset in order to increase any gain on the future sale of the property.

EXAMPLE I:11-30 ▶ Joan is involved in several transactions during the current year. No interest is stated on any of the transactions. The terms of the transactions and the applicability of the imputed interest rules are summarized below:

Transaction	*Imputation of Interest*
Purchases furniture costing $8,000 for her residence. Full price is payable within four months.	Not applicable because property is for personal use. Also, all payments are due within six months.
Sells a boat for $2,000. Payment is due in a year.	Not applicable because sales price is not more than $3,000.
Sells land for $100,000. Payment is due in five years.	Interest must be imputed because no exception is applicable.
Purchases a newly issued bond for $650 (face of $1,000).	Not applicable because transaction is subject to the original issue discount rules in Sec. 1274. Also, the price is not more than $3,000. ◀

IMPUTED INTEREST COMPUTATION

In order to avoid the imputation of interest, the stated interest rate must be at least equal to 100% of the applicable federal rate (110% of the applicable federal rate in the case of sale–lease back arrangements). Lower rates are specified for two types of transactions: (1) If the stated principal amount for qualified debt obligations that are issued in exchange for property under Sec. 1274A does not exceed $2.8 million, the interest rate is limited to 9% compounded semiannually; and (2) the interest rate is limited to 6% compounded semiannually in the case of sales of land between related individuals (unless the sales price exceeds $500,000).

The **applicable federal rate** is determined monthly and is based on the rate paid by the federal government on borrowed funds. The rate varies with the terms of the loan. Loans are divided into short-term (not over three years), mid-term (over three years but not over nine years), and long-term (over nine years).

EXAMPLE I:11-31 ▶ Kasi sells land for $100,000 to Bill, an unrelated person. The sales price is to be paid to Kasi at the end of five years in a single installment with no stated interest. Kasi paid $60,000 for the land. Assume the current federal rate is 10%. Because the amount of the stated principal is less than $2,800,000, interest is imputed at a rate not to exceed 9% compounded semiannually. As a result, the effective rate is 9.2025% (9% compounded semiannually), and the present value factor is .64393 ($1 \div 1.092025^5$). Thus, the present value of the final payment is $64,393 (0.64393 × $100,000). Kasi reports a $4,393 ($64,393 − $60,000) gain on the sale of the land and $35,607 ($100,000 − $64,393) interest income instead of a $40,000 gain and no interest income. The buyer is treated as incurring $35,607 in interest and has a $64,393 basis in the land. Whether the interest is deductible depends on a variety of other factors (see Chapter I:8). ◀

ACCRUAL OF INTEREST

Is imputed interest reported under the cash or the accrual method? In other words, is imputed interest reported when it accrues or when it is paid? In general, imputed interest is reported as it accrues. However, there are some major exceptions, as follows:

ADDITIONAL COMMENT

The $2 million and $2.8 million limitations are subject to inflation adjustments.

- Sales of personal residences
- Most sales of farms for $1 million or less
- Sales involving aggregate payments of $250,000 or less
- Sales of land between related persons unless the sales price exceeds $500,000[60]

In addition, if the borrower and lender jointly elect, and if the stated principal does not exceed $2 million, accrual of interest is not required. This election is not available if the lender is an accrual method taxpayer or a dealer with respect to the property sold or exchanged.[61]

[60] Sec. 1274(c)(4).

[61] Sec. 1274A(c).

EXAMPLE I:11-32 ▶ Assume the same facts as in Example I:11-31. Because the aggregate payments do not exceed $250,000, the transaction is exempt from the requirement that interest be accrued. As a result, Kasi reports interest income and Bill reports interest expense in the fifth year when the final payment is made on the transaction. Under the installment method, $4,393 gain on the sale is recognized in the fifth year. ◀

GIFT, SHAREHOLDER, AND OTHER LOANS

Imputed interest rules are not limited to installment transactions. Sec. 7872 applies to transactions involving related parties whose taxes are lowered as a result of low interest or interest-free loans. These situations include

- *Gift loans.* For example, parents in higher tax brackets loan money to their adult children without charging interest. If the children invest the borrowed money and are taxed on the income at a lower rate, the family has reduced its total tax liability in the absence of imputed interest rules.
- *Corporation shareholder loans.* In the absence of imputed interest rules, taxes may be saved by a corporation that makes an interest-free loan to a shareholder. If the corporation had invested the money and paid out the resulting income as a dividend, it would have first been taxed on the profit. By making the interest-free loan, the corporation could, in the absence of imputed interest rules, reduce its taxes by avoiding the otherwise taxable income.
- *Compensation-related loans.* Employers may loan money to employees without charging interest. Without the requirement to impute interest, this could produce tax savings if the employer was unable to deduct additional compensation because of the reasonable compensation limitation or if the employee was unable to deduct the interest, say, because the borrowed funds were used to purchase personal use property.
- *Other tax avoidance loans.* Any other low-interest or interest-free loan that produces tax savings may be subject to the imputed interest rules. For example, a club may offer its members a choice of either paying dues or making a large refundable deposit. The club can invest the money and earn interest perhaps equal to the dues. In the absence of imputed interest rules, the member avoids taxes by not having to report the income that would have been earned if the member personally invested the funds. The club is indifferent between the alternatives because both the dues and the interest income are taxable.

In general, interest is imputed on the above loans by applying the applicable federal rates discussed earlier. The resulting interest income is taxable to the lender. Whether the interest expense is deductible by the borrower is determined by applying the usual interest deduction rules (see Chapter I:8).

The imputation process involves a second step. The lender is treated as returning the imputed interest to the borrower. This is necessary because the interest was not actually paid. For example, in the case of a gift loan, the lender is treated as giving the imputed interest back to the borrower. This would not normally have income tax implications, but if the imputed interest were large enough, it could result in a gift tax. In the case of the corporation-shareholder loan, the corporation is treated as paying the imputed interest back to the shareholder as a dividend. Typically, this does not increase the corporation's tax, but it results in the recognition of dividend income to the shareholder. For compensation-related loans, the second step is to impute compensation paid by the employer and received by the employee. The compensation is taxable to the employee and, if reasonable in amount, is deductible by the employer.

There are several important exceptions intended to limit the application of imputed interest in situations where tax avoidance may be immaterial:

- Interest is not imputed on gift loans between two individuals totaling $10,000 or less, except when the borrowed funds are used to purchase income-producing property.
- If the gift loans between two individuals total $100,000 or less, the imputed interest is limited to the borrower's "net investment income" as defined by Sec. 163(d)(4). (See Chapter I:8 for a discussion of net investment income.) If the net investment income is $1,000 or less, it is not necessary to impute interest.

- Interest is not imputed on compensation-related and corporate shareholder loans totaling $10,000 or less.

These exceptions do not apply when tax avoidance is one of the principal purposes of the loans.

EXAMPLE I:11-33 ▶ Linda made interest-free gift loans to each of her four children: Andy, Bob, Cathy, and Donna. Andy borrowed $9,000 to purchase an automobile. Bob borrowed $25,000 to buy stock. Bob's net investment income is $800. Cathy also borrowed $25,000 to buy stock, but her net investment income is $1,100. Donna borrowed $120,000 to purchase a residence, and her net investment income is $500. Tax avoidance is not a motive for any of the loans. Imputation of interest is not required for the loans to Andy or Bob. The loan to Andy is exempt because the amount is less than $10,000, and the loan to Bob is exempt because his net investment income is under $1,000. Imputation of interest is required for the loans to Cathy and Donna. In the case of Cathy, the amount of imputed interest is limited to her net investment income of $1,100. The imputed interest for Donna, however, is not limited to her net investment income because the amount of the loan is over $100,000. ◀

The imputed interest rules are summarized in Topic Review I:11-4.

Change in Accounting Methods

OBJECTIVE 6

Determine the tax treatment that results from changes in accounting methods

In general, a new taxpayer elects an accounting method by simply applying the selected method when computing income for the initial tax return.[62] If a particular item does not occur in the first year, the accounting method is elected the first year in which the item occurs.

EXAMPLE I:11-34 ▶ Gordon opened a beauty shop several years ago. Because he had no inventory, no inventory method was selected. In the current year, Gordon expanded his business to offer beauty supplies to his customers. Gordon can delay electing an inventory method until the year in which he first has an inventory. ◀

TOPIC REVIEW I:11-4

Imputed Interest

Purpose

The imputed interest rules are intended to prevent taxpayers from reducing their taxes by charging little or no interest on installment payment transactions and loans.

Applies to

In most cases applies to both parties, the debtor and the creditor. The result is to impute interest income to the lender and interest expense to the borrower. Several exceptions exempt small transactions from imputed interest. For example, sales involving payments of $3,000 or less are generally exempt as are loans of less than $10,000.

Rate

Interest is imputed at the applicable federal rate if the stated interest rate is lower. The applicable federal rate is the rate the federal government pays on borrowed funds and is determined monthly. In general, the current rate at the time of the transaction is used throughout the term of the loan. The rate varies with the term of the loan. Loans are divided into short-term (not over three years), mid-term (over three years but not over nine years), and long-term (over nine years).

[62] Reg. Sec. 1.446-1(e)(1).

In general, once an accounting method is chosen, it cannot be changed without IRS approval. There are a few exceptions. For example, taxpayers may adopt the LIFO inventory method without prior IRS approval.[63] Once such methods are adopted, however, they cannot be changed without IRS approval.

As previously noted, the term **accounting method** indicates not only the overall accounting method used by the taxpayer, but also the treatment of any item of income or deduction.[64] A change of accounting methods should not be confused with the correction of an error. Errors include mathematical mistakes, posting errors, deductions of the wrong amount for an expense, omission of an item of taxable income, or incorrect computation of a credit. An error is normally corrected by filing an amended return for the tax year or years in which the error occurs. In general, there is a three-year statute of limitations on the correction of errors. After three years, the tax year is closed and changes cannot be made.[65]

REAL-WORLD EXAMPLE

The write-down of soil aggregate to its market value by a paving company was a change in accounting method rather than the mere correction of an accounting error. The soil aggregate was included in its election to adopt the LIFO inventory method, and the use of this method required that the soil aggregate be included at cost regardless of market value. *First National Bank of Gainesville, Trustee,* 88 T.C. 1069 (1987).

Taxpayers wishing to change accounting methods must file Form 3115 with the IRS, on or before the due date of the tax return including extensions. A duplicate copy of Form 3115 must be filed with the tax return for the year. A taxpayer who amends the original income tax return within six months of its due date may request a change of accounting methods with the amended return.[66]

In general, taxpayers initiate a change in accounting methods from an incorrect to a correct method are exempt from penalty and from retroactive application of the new reporting method. Although changes in accounting methods require IRS approval, the IRS states that approval will automatically be granted for a wide variety of changes if the taxpayer meets specific requirements that include proper filing of both Form 3115 and the current year's tax return, agreeing to take into account the Sec. 481(a) adjustment (as described below), not being under examination, and not having changed the same method of accounting within the last four years.[67] Although the IRS retains the right to again change any method of accounting adopted under these procedures it states that such changes will not be retroactive except in rare or unusual circumstances. Examples of situations where retroactive application may occur include misstatement or omission of material facts, change in material facts, and changes in applicable authority.

REAL-WORLD EXAMPLE

An extension of time to file the application for change of accounting method was granted because of the death of the accountant in charge of filing the application. Rev. Rul. 79-417, 1979-2 C.B. 202.

AMOUNT OF CHANGE

A change in accounting methods usually results in duplications or omissions of items of income or expense.

EXAMPLE I:11-35 ▶ Bonnie, a practicing CPA, has been reporting income using the cash method. In the current year, Bonnie obtains permission to change to the accrual method. At the beginning of the current year, Bonnie has $80,000 of receivables that have not been reported in prior years. The receivables were not reported in prior years because they were not collected. Although the receivables are collected in the current year, they are not taxable because, under the accrual method, Bonnie now reports income as it is earned and the income is not earned in the current year. In this case, the income was earned in prior years.

Also, assume Bonnie has accounts payable of $15,000 at the beginning of the current year. The accounts payable were not deducted in prior years because the expenses had not been paid. Furthermore, the accounts payable are not deductible in the current year even if they are paid. This is because the expenses were incurred in prior years. Obviously, the IRS expects to collect the tax on the $80,000 of receivables, and Bonnie is entitled to deduct the $15,000 of payables. In the absence of any special provision, both amounts would be omitted from the computation of taxable income. On the other hand, if the change were from the accrual

[63] A taxpayer may adopt LIFO by merely determining year-end inventory by that method and attaching Form 970 to the tax return for the year (Reg. Sec. 1.472-3(a)).

[64] Reg. Sec. 1.446-1(e)(2)(ii)(b).

[65] Exceptions are applicable when the taxpayer omits from the return an amount of income that is over 25% of the gross income stated on the return (6 years) or where fraud occurs (no limitation).

[66] The extension will be granted if the taxpayer follows procedures outlined in Rev. Proc. 2002-9, 2002-1 C.B. 327.

[67] Rev. Proc. 97-37, 1997-2 C.B. 455.

method to the cash method, both amounts would be reported twice (in the year prior to the change because they had accrued and in the year of the change because they are collected or paid). Thus, a special provision is also needed for duplications. ◀

REPORTING THE AMOUNT OF THE CHANGE

The net amount of the change must be taken into account.[68] A positive adjustment is added to income, whereas a negative adjustment is subtracted from income. This adjustment can, of course, be made in the year of the change. If the amount is small, recognizing the full amount of the net adjustment in the year of the change is both simple and equitable. This is the only option available when the amount of the change is $3,000 or less. On the other hand, reporting a large positive adjustment in one year could push the taxpayer into a higher marginal tax bracket and result in a significant tax increase. Because the extra income is due to changing accounting methods, not increasing cash flows, the taxpayer may not have the wherewithal to pay the additional tax.

As a result, there are alternative methods that may be used to report the amount of the change. The methods that are available depend on whether the change is voluntary (a change that is initiated by the taxpayer) or involuntary (a change from an unacceptable to an acceptable method that is required by the IRS).

In the case of an involuntary change, several alternative methods are available to the IRS.[69]

In the case of voluntary changes, taxpayers must agree to report the adjustment over a period not to exceed four years. When the amount of the adjustment is $25,000 or less, taxpayers may elect to include the full amount in the current year.[70] In the case of a change spread over four years, equal portions of the change are reported in each of the four years beginning with the year of the change.

EXAMPLE I:11-36 ▶ Diana obtains permission to change from the accrual to the cash method of reporting income. The change results in a $30,000 negative adjustment to income. The IRS requires Diana to spread the adjustment over four years. As a result, she may deduct $7,500 per year for four years. Note that because the amount of the adjustment is spread over the current and future years, the tax savings associated with the deduction are deferred. ◀

In general, the amount of the adjustment cannot be spread over a period longer than the method being changed has been used.

OBTAINING IRS CONSENT

REAL-WORLD EXAMPLE

A pipeline company was required to capitalize reconditioning costs on its natural gas pipelines instead of expensing these costs. *Mountain Fuel Supply Co. v. U.S.*, 28 AFTR 2d 71-5833, 71-2 USTC ¶9681 (10th Cir., 1971).

Most changes in accounting method require IRS approval. Sec. 446(e) states that a taxpayer changing the method of accounting "on the basis of which he regularly computes his income in keeping his books" must obtain consent before computing taxable income under the new method. This implies that a taxpayer who has been computing taxable income on a method other than that used in computing book income does not need approval to conform the computation of taxable income to the method regularly used on the taxpayer's books. This conclusion is supported by Sec. 441(a), which requires that the same method of accounting be used in computing taxable income as is used in keeping the books. The alternative might be to require the taxpayer to conform his or her book accounting method with the tax accounting method. The answer may well be in how one defines "books." The IRS has ruled that a reconciliation of taxable income with accounting income was a part of the taxpayer's auxiliary records.[71] Hence, the taxpayer was using the same accounting method for book and tax reporting. As a result, a taxpayer who changes the method of accounting used for financial reporting may not be required to change the method of accounting used for tax reporting as long as financial income and book income are reconciled.

[68] Sec. 481.
[69] Secs. 481(a), (b)(1), (b)(2), and (c).
[70] Rev. Procs. 2012-20, 2012-14 IRB 700.
[71] Rev. Rul. 58-601, 1958-2 C.B. 81.

Tax planning considerations

OBJECTIVE 7

Describe tax planning considerations for accounting periods and methods

ACCOUNTING PERIODS

KEY POINT

C corporations and estates have more flexibility than S corporations and partnerships in the selection of a tax year.

In the past, taxpayers were able to defer income by selecting different tax years for partners and partnerships or S corporations and shareholders. Current law limits this opportunity. Nevertheless, partnerships and S corporations may adopt a tax year that differs from that of their owners if that year qualifies as a natural business year (i.e., at least 25% of revenues occur during the last two months of the year). Furthermore, deferral is possible in the case of estates, because they are not subject to similar restrictions on the choice of tax years.

ACCOUNTING METHODS

KEY POINT

The election to use an accounting method is made by filing the first tax return on the basis of that method.

New businesses should consider the tax implications of electing an accounting method. For example, taxpayers may benefit from the LIFO inventory method because LIFO typically reduces gross profit and defers the payment of taxes during inflationary periods. Similarly, service companies usually choose the cash method of reporting income because it permits receivables to be reported when collected rather than when the income is earned. Choosing an accounting method requires an understanding not only of the available accounting methods, but also the nature of the taxpayer's business. Will a specific election be to the tax advantage of the taxpayer? LIFO inventory is often recommended because, during inflationary periods, it tends to reduce inventory values and increase the cost of goods sold. In certain industries, such as the computer industry, however, costs are declining, and LIFO actually may result in a higher inventory value.

In other industries, inventories may fluctuate widely from one year to the next because of changing demand, shortages of materials, strikes, or other causes. LIFO layers may have to be depleted simply to continue business operations. This can cause one of two things to happen: (1) incurring extra recordkeeping costs of LIFO for little or no benefit because the inventories are depleted before they produce significant tax deferrals or (2) depleting low-cost layers from years past, resulting in a substantial increase in taxable income in the year of occurrence.

INSTALLMENT SALES

Taxpayers normally choose the installment method of reporting income from casual sales of property. By spreading the gain from a sale over more than one tax year, the taxpayer normally remains in lower tax brackets and defers the tax. A taxpayer with low current taxable income may elect not to use the installment sale method in order to take advantage of the lower current tax rates.

Compliance and procedural considerations

OBJECTIVE 8

Describe compliance and procedural considerations for accounting periods and methods

REPORTING INSTALLMENT SALES ON FORM 6252

Form 6252 (Installment Sale Income) is used to report income under the installment method from sales of real property and casual sales of personal property other than inventory. Figure I:11-1 illustrates how an installment sale transaction is reported. The illustration is based on Example I:11-23. A separate Form 6252 is normally used for each installment sale. Form 6252 is used in the year of the sale and any year in which the taxpayer receives a payment from the sale. Taxpayers who do not wish to use the installment method may report the transaction on either Schedule D or on Form 4797.

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.
▶ Go to *www.irs.gov/Form6252* for the latest information.

OMB No. 1545-0228

2018

Attachment Sequence No. **79**

Name(s) shown on return: Gina Green

Identifying number: 123-45-6789

1 Description of property ▶ Equipment

2a Date acquired (mm/dd/yyyy) ▶ 07-01-2015 b Date sold (mm/dd/yyyy) ▶ 08-31-2018

3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 . . . ☐ Yes ☒ No

4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . ☐ Yes ☒ No

Part I Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	200,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6	50,000		
7	Subtract line 6 from line 5	7	150,000		
8	Cost or other basis of property sold	8	70,000		
9	Depreciation allowed or allowable	9	10,000		
10	Adjusted basis. Subtract line 9 from line 8	10	60,000		
11	Commissions and other expenses of sale	11	13,000		
12	Income recapture from Form 4797, Part III (see instructions)	12	10,000		
13	Add lines 10, 11, and 12			13	83,000
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form (see instructions)			14	117,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	117,000
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	
18	**Contract price.** Add line 7 and line 17			18	150,000

Part II Installment Sale Income. Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. (For years after the year of sale, see instructions)	19	78%	
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20		
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated	21	10,000	
22	Add lines 20 and 21	22	10,000	
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated (23)			
24	**Installment sale income.** Multiply line 22 by line 19	24	7,800	
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)	25		
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)	26	7,800	

Part III Related Party Installment Sale Income. Don't complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy) . . . ▶

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

d ☐ The second disposition occurred after the death of the original seller or buyer.

e ☐ It can be established to the satisfaction of the IRS that tax avoidance wasn't a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2018 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	

FIGURE I:11-1 ▶ REPORTING INSTALLMENT SALE INCOME ON FORM 6252 (BASED ON EXAMPLE I:11-23)

PROCEDURES FOR CHANGING TO LIFO

The LIFO method may be adopted in the initial year that inventories are maintained by merely using the method in that year. In addition, advance approval (e.g., within 180 days following the start of the year) from the IRS is not required for an adoption of the LIFO method in the initial year that inventories are maintained on the LIFO method. However, Form 970 should be filed along with the taxpayer's tax return for the year of the change.[72] The application must include an analysis of the beginning and ending inventories. Further, if a taxpayer is changing to the LIFO method from another method (e.g., FIFO), advance approval from the IRS is also not required. Form 970 must be filed with the return and the beginning inventory for LIFO purposes is the same as under the former inventory method.[73]

If the former inventory is valued based on the lower of cost or market (LCM) method, an adjustment is required to restate the beginning inventory to cost because the LCM method cannot be used under LIFO. Generally, the beginning LIFO inventory is the same as the closing inventory for the prior year, except for the required restatement of previous writedowns to market. This adjustment to the beginning inventory can be spread ratably over the year of the change and the next two years.[74]

EXAMPLE I:11-37 ▶ Delaware Corporation elects to change to the LIFO inventory method. Delaware's inventories are valued using the LCM method based on the FIFO cost-flow assumption. The FIFO cost for the ending inventory is $50,000, and its LCM amount is $35,000. The initial inventory under LIFO must be restated to its cost, or $50,000. The $15,000 ($50,000 cost − $35,000 LCM value) difference can be included in taxable income over the current year and the next two years. $5,000 is added to taxable income in each year. ◀

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:11-1 Do accounting rules determine the amount of income to be reported by a taxpayer?

I:11-2 How does a taxpayer's tax accounting method affect the amount of tax paid?

I:11-3 Most individuals use the calendar year as their tax year. What requirement, if any, in the tax law causes this?

I:11-4 Why is it desirable for a new taxpayer to select an appropriate tax year?

I:11-5 What restrictions apply to partnerships selecting a tax year?

I:11-6 Does a similar restriction apply to S corporations? Explain.

I:11-7 How could the 52–53-week year prove to be beneficial to taxpayers? Explain.

I:11-8 Under what circumstances can an individual taxpayer change tax years without IRS approval?

I:11-9 Is there any instance in which a change in tax years is required? Explain.

I:11-10 **a.** In what situations will a tax year cover a period of less than 12 months?
b. Under what conditions is a taxpayer required to annualize income?
c. Does annualizing income increase or decrease the taxpayer's tax liability? Explain.

I:11-11 When is a final tax return due for an individual who uses a calendar year and who dies during the year?

I:11-12 **a.** Is it correct to say that businesses with inventories must use the accrual method?
b. What other restrictions apply to taxpayers who are choosing an overall tax accounting method?
c. Why is the cash method usually preferred to the accrual method?

I:11-13 **a.** Does the term **method of accounting** refer only to overall methods of accounting? Explain.

[72] An acceptable election is considered to have been made even if Form 970 is not filed as long as all of the information required by Reg. Sec. 1.472-3(a) is provided by the taxpayer.

[73] Reg. Sec. 1.472-2(c).

[74] Sec. 472(d).

b. Does a taxpayer's accounting method affect the total amount of income reported over an extended time period?
c. How can the use of an accounting method affect the total amount of tax paid over time?

I:11-14 a. When are expenses deductible by a cash method taxpayer?
b. Are the rules that determine when interest is deductible by a cash method taxpayer the same as for other expenses?
c. Is a cash method taxpayer subject to the same rules for depreciable assets as accrual method taxpayers?

I:11-15 Who may use the completed contract method of reporting income from long-term contracts?

I:11-16 When is a cash method taxpayer allowed to deduct deposits?

I:11-17 What constitutes a payment in determining when a cash-basis taxpayer is entitled to deduct an expense?

I:11-18 What is meant by economic performance?

I:11-19 What conditions must be met if the economic performance test is to be waived for an accrual-method taxpayer?

I:11-20 Is an accrual method taxpayer permitted to deduct estimated expenses? What about prepaid expenses? Explain.

I:11-21 What is the significance of the *Thor Power Tool Co.* decision?

I:11-22 a. How are overhead costs treated in determining a manufacturing company's inventory?
b. Do retailers have a similar rule?
c. Are these rules the same as for financial accounting? If not, explain.

I:11-23 What transactions are subject to the long-term contract method of reporting?

I:11-24 a. What conditions must be met in order to use the installment method?
b. Why would a taxpayer elect not to use the installment method?

I:11-25 What is the impact of having the entire gain on an installment sale consist of ordinary income from depreciation recapture?

I:11-26 What impact does the gifting of an installment obligation have on the donor?

I:11-27 What treatment is given to an installment sale involving related people?

I:11-28 What is the primary impact of the imputed interest rules on installment sales?

I:11-29 What changes in accounting method can be made without IRS approval?

I:11-30 Can the IRS require a taxpayer to change accounting methods?

I:11-31 Explain the purpose of the four-year method used in computing the tax resulting from a net adjustment due to a change in accounting methods.

I:11-32 If a taxpayer changes the method of accounting used for financial reporting purposes, must the taxpayer also change his or her method of accounting for tax purposes?

ISSUE IDENTIFICATION QUESTIONS

I:11-33 Judy's Cars, Inc., sells collectible automobiles to consumers. She employs the specific identification inventory valuation method. Prices are negotiated by Judy and individual customers. Judy accepts trade-ins when she sells an automobile. Judy negotiates the allowance for trade with the customer. Occasionally, Judy finds that it can take two or three years to sell a given automobile. Judy now has four automobiles that she has held for over two years. She expects to eventually sell those automobiles, but expects that they will sell for less than their original cost. What tax issues should Judy consider?

I:11-34 Lana operates a real estate appraisal service business in a small town serving local lenders. After noting that lenders must pay to bring in a surveyor from out of town, she completes a course and obtains a surveyor's license that enables her to provide this service also. She now provides both services as a proprietor. What tax issues should Lana consider?

I:11-35 John owns a small farm on a lake. A local developer offers John $400,000 cash for his farm. The developer believes John's farm will be very attractive to home buyers because it is on a lake. After John turns down the initial offer, the developer offers to pay John $250,000 plus an amount equal to 10% of the selling price for the homes that are developed and sold. Identify the tax issues John should consider if he accepts the offer.

I:11-36 Lee is starting a small lawn service. On the advice of his accountant, Lee has formed a corporation and made an S corporation election. The accountant has asked Lee to consider electing a fiscal year ending on the last day in February. The accountant pointed out that Lee's business is likely to slow down in the winter. Also, the accountant indicated that the February year end would permit the accountant to do Lee's accounting work after the busy season in accounting is over. What tax issues should Lee consider?

PROBLEMS

I:11-37 *Allowable Taxable Year.* For each of the following cases, indicate whether the taxpayer has selected an allowable tax year in an initial year. If the year selected is not acceptable, indicate what an acceptable year would be.

a. A corporation selects a January 15 year-end.
b. A corporation selects a March 31 year-end.
c. A corporation selects a year that ends on the last Friday in March.
d. A partnership selects a year that ends on December 31 and has three equal partners whose years end on March 31, April 30, and June 30.
e. An S corporation selects a December 31 year-end.

I:11-38 *Change in Accounting Period.* In which of the following instances is a taxpayer permitted to change accounting periods without IRS approval?

a. A calendar-year taxpayer who wishes to change to a year that ends on the last Friday in December.
b. ABC Partnership has filed its tax return using a fiscal-year ending on March 31 for over 40 years. The partnership wishes to change to a calendar year-end that coincides with its partners' year-end.
c. Iowa Corporation, a newly acquired subsidiary, wishes to change its year-end to coincide with its parent.

I:11-39 *Annualization.* Each of the following cases involves a taxable year of less than 12 months. In which situations is annualization required?

a. A new corporation formed in September elects a calendar year.
b. A calendar-year individual dies on June 15.
c. Jean, who has been using a calendar year, marries Hank, a fiscal-year taxpayer. Soon after the marriage, Jean changes her tax year to coincide with her husband's tax year.
d. A calendar-year corporation liquidates on April 20.

I:11-40 *Short Period Return.* Lavanya, a single taxpayer, is a practicing accountant. She obtains permission to change her tax year from the calendar year to a year ending July 31. Her practice income for the seven months ending July 31 is $38,500. In addition, Lavanya has $3,000 of interest income and $6,500 of itemized deductions. What is her tax for the short period?

I:11-41 *Cash Basis Expenses.* How much of the following expenses are currently deductible by a cash basis taxpayer?

a. Medical prescriptions costing $20 paid by credit card (medical expenses already exceed the AGI floor).
b. Prepaid interest (not related to points) of $200 on a residential loan.
c. Taxpayer borrows $300 from the bank to make a charitable contribution. The $300 is paid to the charitable organization before the end of the tax year.
d. Taxpayer gives a note to his church indicating an intent to contribute $300.
e. A calendar-year individual mails a check for $200 to his church on December 31. The check is postmarked December 31 and clears the bank on January 4.

I:11-42 *Economic Performance.* In light of the economic performance requirement, how much is deductible by the following accrual-basis corporate taxpayers this year?

a. Camp Corporation sells products with a one-year warranty. Camp estimates that the warranty costs on products sold during this year will amount to $80,000. Camp performs $38,000 of warranty work on products sold last year and $36,000 of warranty work on products sold this year.
b. Data Corporation agrees to pay $10,000 this year and $10,000 next year to a software developer. The developer completes all work on the software and delivers the product to Data this year.
c. Palm Corporation pays $5,000 to a supplier to guarantee delivery of raw materials. The $5,000 is refundable if Palm decides not to acquire the materials.
d. This year North Corporation pays a $1,000 security deposit on space it rents for a new office. In addition, North pays current year rent of $18,000. The security deposit is refundable if the property is returned in good condition.

I:11-43 *Manufacturing Inventory.* Which of the following costs must be included in inventory by a manufacturing company subject to the UNICAP rules?

a. Raw materials
b. Advertising
c. Payroll taxes for factory employees
d. Research and experimental costs
e. Factory insurance
f. Repairs to factory equipment
g. Factory utility costs
h. Factory rent

I:11-44 ***Single-Pool LIFO.*** Prime Corporation begins operations in late 2019. Prime decides to use the single-pool LIFO method. Year-end inventories under FIFO are as follows:

2019	$110,000
2020	134,000
2021	125,000

The price index for 2019 is 130%; for 2020, 134%; and 2021, 140%. What are 2020 and 2021 inventories?

I:11-45 ***Installment Sale.*** Ace Construction Company sells a used crane to Go Construction for $80,000. The crane, which originally cost $900,000, is fully depreciated. Under Sec. 1245 depreciation recapture rules, the entire gain is taxable as ordinary income. Ace receives a down payment of $20,000 and is to receive $20,000 per year for three additional years plus interest of 8%, which is greater than the applicable federal rate.
a. Compute the gain from the sale.
b. How much gain is taxable in the year of the sale?
c. What income does Ace report in each of the next three years?

I:11-46 ***Inventory Method.*** Zap Company manufactures computer hard drives. The cost of hard drives has been declining for years. Sales totaled $4,000,000 last year. Zap's ending inventory was valued at $300,000 under FIFO. The company's new president is trying to cut taxes and asks you whether the company should switch to LIFO. What do you recommend?

I:11-47 ***Installment Sales.*** First Company sold the following assets during the year. Indicate whether First Company can use the installment method to report each transaction. If not, how is the transaction reported? Assume First Company is an accrual basis taxpayer.
a. First Company sold stock in a publicly held company costing $35,000. First Company received a $20,000 down payment and is to receive $20,000 per year for two years plus interest.
b. First Company sold land costing $150,000. First Company received a $20,000 down payment and is to receive $20,000 per year for five years plus interest.
c. First Company initiated credit sales of merchandise. The company previously sold merchandise only to cash customers. Cash sales this year totaled $4,000,000. Credit sales totaled $500,000. At year end, First Company has receivables of $100,000. The company expects to collect only $85,000 of the current receivables.

I:11-48 ***Installment Sale.*** In December, Dan sells unlisted stock with a cost of $14,000 for $20,000. Dan collects $5,000 down and is scheduled to receive $5,000 per year for three years plus interest at a rate acceptable to the IRS.
a. How much gain must Dan recognize in the year of the sale? Assume Dan uses the installment method to report the gain.
b. The following January, Dan sells the three remaining installments for a total of $13,800. How much gain or loss must Dan recognize from the sale of the remaining installments?

I:11-49 ***Repossession.*** Lina, an attorney, sold an antique rug for $45,000 that had been in her home. The rug cost Lina $12,000 several years ago. Lina collected $15,000 down and received a one-year interest bearing note for the balance. She is unable to collect the balance, and after incurring court costs of $500, she repossesses the rug. The rug is damaged when she recovers it and is now worth only $30,000.
a. How much gain must Lina report in the year of the sale?
b. How much gain, if any, must Lina report in the year she repossesses the rug?
c. What is the basis of the rug after the repossession?

I:11-50 ***Deferred Payment Sale.*** Joe sells land with a $60,000 adjusted basis for $42,000. He incurs selling expenses of $2,000. The land is subject to a $10,000 mortgage. The buyer, who assumes the mortgage, pays $8,000 down and agrees to pay Joe $8,000 per year for three years plus interest. The installment obligations are worth $24,000.

a. How much gain or loss does Joe report in the year of the sale?
b. When does Joe report the interest income from the sale?
c. Does Joe report gain or loss when he collects the installment payments?

I:11-51 ***Imputed Interest.*** On January 30, 2019, Amy sells land to Bob for a stated price of $200,000. The full $200,000 is payable on January 30, 2021. No interest is stated. Amy, a cash-method taxpayer, purchased the land in 2014 for $130,000.
a. How much interest income must be reported by Amy on the sale? Assume a 9% rate compounded semiannually. The present value factor is 0.83856.
b. In what year is the interest reported?
c. How much gain is reported by Amy on the sale?
d. In what year is the gain reported?
e. What is Bob's basis in the land?

I:11-52 ***Change of Accounting Method.*** Dana manages real estate and is a cash method taxpayer. She changes to the accrual method in 2020. Dana's business income for 2020 is $30,000 computed on the accrual method. Her books show the following:

	December 31, 2019	*December 31, 2020*
Accounts receivable	$16,000	$25,300
Accounts payable	15,200	11,800

a. What adjustment is necessary to Dana's income?
b. How should Dana report the adjustment?

I:11-53 ***Required Payment.*** BCD Partnership has, for many years, had a March 31 year-end. The partnership's net income for the fiscal year ended March 31, 2020 is $400,000. Because of its fiscal year, BCD has $100,000 on deposit with the IRS from 2019.
a. How much must BCD add to the deposit?
b. When must BCD make the addition?
c. Will the partners receive any credit for the deposit? That is, are they permitted to treat the amount as estimated payments?

I:11-54 ***Change to LIFO.*** Lance Corporation's management has asked whether they may change their inventory valuation method to LIFO. They now report their inventory using FIFO. If they can change, how would they go about it? How is the related adjustment handled?

I:11-55 ***Imputed Interest.*** Jane loans $80,000 to John, her son, to permit him to purchase a principal residence. The loan principal is secured by John's residence, but the agreement does not specify any interest. The applicable federal rate for the year is 8%. John's net investment income is $800.
a. How much interest is imputed on the loan each year?
b. Assume that the amount of the loan is $125,000. How much interest is imputed on the loan?
c. Is John allowed to deduct the imputed interest?
d. What other tax implications are there for the loan?

I:11-56 ***Long-Term Contract.*** King Construction Company is engaged in a road construction contract to build a highway over a three-year period. King will receive $11,200,000 for building five miles of highway. King estimates that it will incur $10,000,000 of costs before the contract is completed. As of the end of the first year King incurred $3,000,000 of costs allocated to the contract.
a. How much income from the contract must King report during the first year?
b. Assume King incurs an additional $5,000,000 of costs during the second year. How much income is reported during that year?
c. Assume that King incurs an additional $2,500,000 of costs in the third and final year of the contract. How much does King report during the third year?
d. Will King receive or pay look-back interest? Explain.

COMPREHENSIVE PROBLEM

I:11-57 Dan turned age 65 and retired this year. He owned and operated a tugboat in the local harbor before his retirement. The boat cost $100,000 when he purchased it two years ago. A tugboat is 10-year property. Dan deducted $10,000 of depreciation on the boat the

year he purchased it and he deducted $18,000 of depreciation last year. He did not elect Section 179 expensing or bonus depreciation. He sold the tugboat in November of this year for $90,000 collecting an $18,000 down payment. The buyer agreed to pay 8% interest annually on the unpaid balance and to pay $18,000 annually for four years toward the principal. The four $18,000 principal payments and related interest payments begin next year. Dan received $72,000 of business income and incurred other business expenses of $30,000 this year before he retired. He received Social Security benefits of $2,000 and withdrew $20,000 from a regular IRA account. He contributed $5,000 to his church, paid real property taxes of $2,000, and home mortgage interest of $6,500. Dan paid $200 of state income taxes when he filed last year's return earlier this year and he made estimated state income tax payments of $800 during this year and $220 after year end. In addition, Dan made federal estimated payments of $8,000. Dan is a single, cash basis taxpayer. Ignore self-employment taxes.

a. Compute the depreciation for the current year on the tugboat.
b. Compute the amount of gain to be reported currently on the sale of the tugboat. Assume that Dan wants to use the installment method if it can be used. The accumulated depreciation on the tugboat is subject to Sec. 1245 depreciation recapture and must be reported currently.
c. How much interest, if any, must Dan report this year?
d. What is the income from the business, excluding the gain on the sale of the tugboat?
e. What is Dan's AGI?
f. What is the amount of Dan's itemized deductions?
g. What is Dan's taxable income?

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:11-58 Leon has a substantial portfolio of stocks and bonds as well as cash from some bonds that have recently matured. He has been looking at investing $200,000 in corporate bonds that pay 7% interest. The $14,000 of annual interest would be used to pay his 24-year-old son's tuition at State University. A friend suggested that Leon loan the money "interest free" to his son, a student who has no other income. The son would then invest the $200,000 in the corporate bonds and use the $14,000 interest to pay his tuition. Leon is in the 24% tax bracket. Would such a strategy reduce his family's tax? Assume the applicable federal rate is 6.5%.

I:11-59 Linda is selling land she has owned for many years. The land cost $80,000 and will sell for $200,000. The buyer has offered to pay $100,000 down and pay the balance next year plus interest at 8%. Assume that Linda's after tax rate of return on investments is 10%. Would she be better off receiving the installment payments or receiving cash? Assume her ordinary income is taxed at 24% and that long-term capital gains are taxed at 15%.

TAX FORM/RETURN PREPARATION PROBLEM

I:11-60 ***Short Tax Form.*** Barbara B. Kuhn (SSN 987-65-4321) purchases a fourplex on January 8, 2015, for $175,000. She allocates $25,000 of the cost to the land, and she deducts MACRS depreciation totaling $16,364. Barbara sells the fourplex on January 6, 2018, for $225,000. The buyer assumes the existing mortgage of $180,000, pays $15,000 down, and agrees to pay $15,000 per year for two years plus 12% interest. Barbara incurs selling expenses of $18,000. Complete Form 6252.

CASE STUDY PROBLEMS

I:11-61 Lavonne just completed medical school and residency. She plans to open her medical practice soon. She is not familiar with the intricacies of accounting methods and periods. On advice of her attorney, she plans to form a professional corporation (a form of organization permitted under the laws of most states that does not have the usual limited liability found with business corporations, but is taxed as a corporation). She has asked you whether she should elect a fiscal year and whether she should use the cash or accrual method of reporting income. Discuss whether the options are available to her and the implications of available choices.

I:11-62 Don owns equipment that he purchased several years ago for $400,000. Over the years he properly deducted $110,000 of depreciation. The depreciation will have to be recaptured as ordinary income on the sale. There is a $90,000 mortgage on the property. Don has an offer for the equipment from an individual who says he will pay $100,000 down and $100,000 per year for five years. There is no mention of interest. As the mortgage is nonassumable, Don will pay off the mortgage using most of the down payment. Don is age 61, and proceeds from the sale along with a pension from his employer will provide for his retirement. Don plans to retire next year. He currently has a 24% marginal tax rate. Discuss the tax implications of the sale. Is there anything Don can do to improve his situation?



I:11-63 Troy Tools manufactures over one hundred different hand tools used by mechanics, carpenters, and plumbers. Troy's cost accounting system has always been very simple. The costs allocated to inventory have included only materials, direct labor, and factory overhead. Other overhead costs such as costs of the personnel department, purchasing, payroll, and computer services have never been treated as manufacturing overhead even though many of the activities of the departments relate to the manufacturing operations. You are preparing Troy's tax return for the first time and determine that the company is not following the uniform capitalization rules prescribed in the tax law. You have explained to the company's president that there is a problem, and she is reluctant to change accounting methods. She says allocating these costs to the many products the company makes will be a time-consuming and expensive process. She feels that the cost of determining the additional amounts to include in inventory under the uniform capitalization rules will probably be more than the additional tax that the company will pay. What is the appropriate way to handle this situation? (See the *Statements on Standards for Tax Services* section in Chapter I:15 for a discussion of these issues.)

TAX RESEARCH PROBLEMS

I:11-64 Eagle and Hill Corporations discuss the terms of a land sale, and they agree to a price of $230,000. Eagle wants to use the installment sale method, but is not sure Hill is a reliable borrower. As a result, Eagle requires Hill to place the entire purchase price in escrow to be released in five yearly installments by the escrow agent. Is the installment method available to Eagle?

A partial list of research sources is:

- Rev. Rul. 77-294, 1977-2 C.B. 173
- Rev. Rul. 79-91, 1979-1 C.B. 179
- *H. O. Williams v. U.S.*, 46 AFTR 1725, 55-1 USTC ¶9220 (5th Cir., 1955)

I:11-65 Texas Corporation disassembles old automobiles for the purpose of reselling their components (i.e., different types of metals, plastics, rubber, and other materials). Texas sells some of the items for scrap, but must pay to dispose of environmentally hazardous plastics and rubber. At year-end, Texas Corporation has a difficult time determining the cost of the individual parts that are stacked in piles. In fact, it would be very expensive to even weigh some of the materials on hand. Texas has followed the practice of having two experienced employees estimate the weight of different stacks and then price them based on quotes found in trade journals. If Texas must pay to dispose of an item, it is assigned a value of zero. In other words, Texas does not value its inventory using standard FIFO or LIFO methods. Is such a practice acceptable?

A partial list of research sources is:

- Reg. Secs. 1.471-2(a) and 1.471-3(d)
- *Morrie Chaitlen,* 1978 PH T.C. Memo ¶78,006, 37 TCM 17
- *Justus & Parker Co.,* 13 BTA 127 (1928)

I:11-66 Apple Corporation has never been audited before the current year. An audit is now needed from a CPA because the company is expanding rapidly and plans to issue stock to the public in a secondary offering. A CPA firm has been doing preliminary evaluations of the Apple Corporation's accounts and records. One major problem involves the valuation of inventory under GAAP. Apple Corporation has been valuing its inventory under the cost method and no write-downs have been made for obsolescence. A review of the inventory indicates that obsolescence and excess spare parts in the inventory are two major

problems. The CPA states that for GAAP the company will be required to write down its inventory by 25% of its stated amount, or $100,000, and charge this amount against net income from operations for the current period. Otherwise, a "clean opinion" will not be rendered. The company controller asks your advice regarding the tax consequences from the obsolescence and spare parts inventory write-downs for the current year and the procedures for changing to the LCM method for tax purposes. Apple Corporation is on a calendar year, and the date of your contact with the company is December 1 of the current year.

A partial list of research sources is:

- Secs. 446 and 471
- Reg. Secs. 1.446-1(e)(3), 1.471-2 and 1.471-4
- *American Liberty Pipe Line Co. v. CIR*, 32 AFTR 1099, 44-2 USTC ¶9408 (5th Cir., 1944)
- *Thor Power Tool Co. v. CIR*, 43 AFTR 2d 79-362,79-1 USTC ¶9139 (USSC, 1979)

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CHAPTER

12

PROPERTY TRANSACTIONS: NONTAXABLE EXCHANGES



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Examine the tax consequences arising from a like-kind exchange
2. Determine whether gain from an involuntary conversion may be deferred
3. Determine when a gain resulting from the sale of a principal residence is excluded
4. Describe tax planning considerations for nontaxable exchanges
5. Describe compliance and procedural considerations for nontaxable exchanges

CHAPTER OUTLINE

Like-Kind Exchanges...12-2
Involuntary Conversions...12-9
Sale of Principal Residence...12-15
Tax Planning Considerations...12-20
Compliance and Procedural Considerations...12-22

Taxpayers who sell or exchange property for an amount greater or less than their basis in that property have a realized gain or loss on the sale or exchange. Almost any transfer of property is treated as a sale or other disposition (see Chapter I:5). The realized gain or loss must be recognized unless a specific Code section provides for nonrecognition treatment. If the realized gain or loss is not recognized at the time of the transaction, the nonrecognized gain or loss may be deferred in some cases and excluded in others.

The general rules related to the computation of realized and recognized gains or losses are covered in Chapter I:5. Three of the most common transactions that may result in *nonrecognition* of a realized gain or loss are explained in this chapter:

- Like-kind exchanges under Sec. 1031 (deferred gain or loss)
- Involuntary conversions under Sec. 1033 (deferred gain)
- Sales of a personal residence under Sec. 121 (excluded gain)

KEY POINT

The transactions examined in this chapter override the normal rule that provides for the recognition of realized gains and realized losses on property used in a business or held for investment.

Nonrecognition of gain treatment for like-kind exchanges, involuntary conversions, and the sale of a residence may be partially justified by the fact that taxpayers may lack the wherewithal to pay the tax despite the existence of a realized gain. For example, a taxpayer who realizes a gain due to an involuntary conversion of property (damage from fire, storm, etc.) may have to use the amount received to replace the converted property.

A typical requirement in a nontaxable exchange is that the taxpayer is required to maintain a continuing investment in comparable property (e.g., a building is exchanged for another building). In essence, a change in form rather than a change in substance occurs.

A transaction generally considered to be nontaxable may be taxable in part. In a like-kind exchange, for example, the taxpayer may also receive money or property that is not like-kind property. If non–like-kind property or money is received, the realized gain is taxable to the extent of the sum of the money and the fair market value (FMV) of the non–like-kind property received.[1]

LIKE-KIND EXCHANGES

OBJECTIVE 1

Examine the tax consequences arising from a like-kind exchange

Section 1031(a) provides that "No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like-kind which is to be held either for productive use in a trade or business or for investment."[2]

In a **like-kind exchange**, both the property transferred and the property received must be held either for productive use in the trade or business or for investment. An exchange of real property held primarily for sale is not a like-kind exchange.[3]

EXAMPLE I:12-1 ▶ Tom owns land used in his trade or business. He exchanges the land for other land, which is to be held for investment. No gain or loss is recognized by Tom because he has exchanged property used in a trade or business for like-kind property to be held for investment. ◀

EXAMPLE I:12-2 ▶ Joyce owns land used as a baseball field and held for personal use. She exchanges the land, with a $10,000 basis, for stock of AT&T with a $12,000 FMV. The stock is held for investment. A $2,000 gain is recognized because the land is not used in Joyce's trade or business or held for investment. The exchange is not a like-kind exchange because neither personal-use assets nor stock qualify as like-kind property. ◀

Section 1031 is not an elective provision. If the exchange qualifies as a like-kind exchange, nonrecognition of gain or loss is mandatory. To qualify for like-kind exchange treatment, a direct exchange must occur and the property exchanged must be like-kind. A taxpayer who prefers to recognize a loss on an exchange must structure the transaction to avoid having the exchange qualify as a like-kind exchange.

ADDITIONAL COMMENT

The mandatory nonrecognition of loss under Sec. 1031 can be avoided by selling the old property in one transaction and buying the new property in a separate, unrelated transaction.

LIKE-KIND PROPERTY DEFINED

Character of the Property. To be a nontaxable exchange under Sec. 1031, the property exchanged must be like-kind. The Treasury Regulations specify that "the words

[1] Sec. 1031(b).
[2] Sec. 1031(a).
[3] Sec. 1031(a)(2).

'like-kind' have reference to the nature or character of the property and not to its grade or quality."[4] Thus, exchanges of real property qualify even if the properties are dissimilar.

EXAMPLE I:12-3 ▶ Eric owns an apartment building held for investment. Eric exchanges the building for farmland to be used in his trade or business. The exchange is a like-kind exchange because both the building and the farmland are classified as real property and both properties are used either in business or held for investment. ◀

EXAMPLE I:12-4 ▶ Trail Corporation exchanges improved real estate for unimproved real estate, both of which are held for investment. The exchange is a like-kind exchange.[5] ◀

ADDITIONAL COMMENT
Real property is often referred to as real estate.

Location of the Property. Transfers of real property located in the U.S. and real property located outside the U.S. after July 9, 1989, are not like-kind exchanges.

Property Must Be the Same Class. An exchange is not a like-kind exchange when property of one class is exchanged for property of a different kind or class.[6] For example, if real property is exchanged for personal property (or vice versa), no like-kind exchange occurs.[7]

EXAMPLE I:12-5 ▶ Gail exchanges an office building with a $400,000 adjusted basis for an airplane with a $580,000 FMV to be used in business. This is not a like-kind exchange because the office building is real property and the airplane is personal property. Gail must recognize a $180,000 ($580,000 – $400,000) gain. ◀

Exchange of Personal Property Which Is Not Personal-Use Property Prior to the Tax Cuts and Jobs Act, a like-kind exchange of personal property used in a trade or business or held for investment qualified for nonrecognition of gain or loss under the like-exchange rules. However, after 2017, an exchange of like-kind assets such as equipment, livestock, computers and other personal property no longer qualifies for nonrecognition of gain or loss.

EXAMPLE I:12-6 ▶ Wyatt exchanged a business truck in 2017 for another truck to use in his business. This was an exchange of qualifying like-kind property, and no gain or loss was recognized. Today, this exchange would not qualify as a like-kind exchange. ◀

Exchange of Securities. The like-kind exchange rules do not apply to stocks, bonds, or notes.[8] However, Sec. 1036 provides that no gain or loss is recognized on the exchange of common stock for common stock or preferred stock for preferred stock in the same corporation. Sec. 1036 applies even if voting common stock is exchanged for nonvoting common stock of the same corporation. The nontaxable exchange of stock of the same corporation may be between two stockholders or a stockholder and the corporation.[9]

Section 1036 does not apply to exchanges of common stock for preferred stock; stock for bonds of same corporation; or any kind of stock in different corporations.

EXAMPLE I:12-7 ▶ Kelly owns common stock of Best Corporation. Best issues class B common stock to Kelly in exchange for her common stock. No gain or loss is recognized because this is an exchange of common stock for common stock in the same corporation. If Best issues its preferred stock for Kelly's common stock, Kelly will have a recognized gain or loss unless the exchange is part of a tax-free reorganization. ◀

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[4] Reg. Sec. 1.1031(a)-1(b).
[5] *Ibid.*
[6] *Ibid.*
[7] Real property includes land and property attached to land in a relatively permanent manner. Personal property that is affixed to real property in a relatively permanent manner is a fixture and is considered part of the real property. Personal property is all property that is not real property or a fixture.
[8] Reg. Sec. 1.1031(a)-1(a)(1)(ii).
[9] Reg. Sec. 1.1036-1(a).

EXAMPLE I:12-8 ▶ Shirley owns 100 shares of Top Corporation common stock. The stock has a $40,000 adjusted basis and a $50,000 FMV. Bob owns 100 shares of Star Corporation common stock with a $50,000 FMV. If Shirley and Bob exchange their stock, the exchange is taxable, and Shirley has a $10,000 ($50,000 – $40,000) recognized gain. The exchange is neither a like-kind exchange nor an exchange of stock for stock of the same corporation. ◀

A DIRECT EXCHANGE MUST OCCUR

To qualify as a like-kind exchange, a direct exchange of property must occur.[10] Thus, the sale of property and the subsequent purchase of like-kind property does not qualify as a like-kind exchange unless the two transactions are interdependent.

EXAMPLE I:12-9 ▶ Natalie sells a building used in her business to Rashad for an amount greater than the building's adjusted basis. After the sale, Natalie purchases another building for her business from David. The gain is recognized because these two transactions do not qualify as an exchange of like-kind property. ◀

A sale and a subsequent purchase may be treated as an exchange if the two transactions are interdependent. The IRS indicates that a nontaxable exchange may exist when the taxpayer sells property to a dealer and then purchases like-kind property from the same dealer.[11]

THREE-PARTY EXCHANGES

The typical two-party exchange is not always practical. If both parties do not own like-kind property that meets each other's needs, a three-party exchange might be necessary. A three-party exchange is also useful when the taxpayer is willing to exchange property for like-kind property but is not willing to sell the property to a prospective buyer. The taxpayer's unwillingness to sell the property may be motivated by the desire to avoid an immediate tax on a gain resulting from the sale of the property. Therefore, the taxpayer may arrange to have the prospective buyer purchase property from a third party that fulfills the taxpayer's needs. The three-party exchange can be an effective way of allowing the taxpayer to consummate a like-kind exchange.

EXAMPLE I:12-10 ▶ Kathy owns a farm in Nebraska, which Dick offers to purchase. Kathy is not willing to sell the farm but is willing to exchange the farm for an apartment complex in Arizona. The complex is available for sale. Dick purchases the apartment complex in Arizona from Allyson and transfers it to Kathy in exchange for Kathy's farm. The farm and the apartment complex each have a $900,000 FMV. For Kathy, the transaction qualifies as a like-kind exchange because it is a direct exchange of business real property (the farm) for investment real estate (the apartment complex). For Dick, the exchange is not a like-kind exchange. ◀

KEY POINT

Transfers of property in a three-party exchange must be part of a single, integrated plan. It is important that the taxpayers can show their intent to enter into a like-kind exchange even though contractual interdependence is not necessary to the finding of an exchange.

In the example above, the exchange is convenient for all the parties. However, it is not always this convenient to execute a three-party exchange. For example, Kathy may want to own an apartment complex in Arizona, but the property she prefers may not be currently available. In this case, a nonsimultaneous exchange may occur.

TAX STRATEGY TIP

Deferred like-kind exchanges are typically used for real estate transactions. A taxpayer who has highly appreciated real estate can use a deferred, three-party, like-kind exchange to exchange the highly appreciated real estate for other real estate that is more desirable to him.

Nonsimultaneous Exchange. A nonsimultaneous exchange is treated as a like-kind exchange if the exchange is completed within a specified time period. The property to be received in the exchange must be identified within 45 days after the date of the transfer of the property relinquished in the exchange. The replacement property must be received within the earlier of 180 days after the date the taxpayer transfers the property relinquished in the exchange or the due date for filing a return (including extensions) for the year in which the transfer of the relinquished property occurs.[12]

[10] Sec. 1031(a).
[11] Rev. Rul. 61-119, 1961-1 C.B. 395.
[12] Secs. 1031(a)(3)(A) and (B).

EXAMPLE I:12-11 ▶ On May 5, 2019, Joal transfers property to Lauren, who transfers cash to an escrow agent. The escrow agent is to purchase suitable like-kind property for Joal. Joal does not have actual or constructive receipt of the cash during the delayed period. To be a like-kind exchange for Joal, the suitable like-kind property must be identified by June 19, 2019 (45 days after the transfer), and Joal must receive the property by November 1, 2019 (180 days after the transfer). ◀

EXAMPLE I:12-12 ▶ Assume the same facts as in the above example except that the transfer by Joal occurs on November 10, 2019. To be a like-kind exchange for Joal, the suitable like-kind property must be identified by December 25, 2019, and Joal must receive the property by April 15, 2020, unless Joal files an automatic six-month extension for the filing of his return (i.e., the due date is extended until October 15, 2020, given that 2020 is a leap year). In such a case, the property must be received no later than 180 days following the transfer of the property relinquished in the exchange, or by May 8, 2020 (i.e., 180 days after November 10, 2019). ◀

RECEIPT OF BOOT

TYPICAL MISCONCEPTION

In calculating the amount of gain to be recognized when boot is received, a proportionate approach is used sometimes for financial accounting purposes.

Taxpayers who want to exchange property do not always own property of equal value. To complete the exchange, non–like-kind property or money may be given or received. Cash and non–like-kind property constitute **boot.**

Gain is recognized to the extent of the boot received. However, the amount of recognized gain is limited to the amount of the taxpayer's realized gain.[13] In effect, the realized gain serves as a ceiling for the amount of the recognized gain. The receipt of boot as part of a nontaxable exchange does not cause a realized loss to be recognized.[14]

EXAMPLE I:12-13 ▶ Mario exchanges business real estate with a $50,000 adjusted basis for $10,000 cash and business real estate with a $65,000 FMV. The realized gain is $25,000 ($75,000 − $50,000). The recognized gain is $10,000 because the $10,000 of boot received is less than the $25,000 realized gain. ◀

EXAMPLE I:12-14 ▶ Mary exchanges business real estate with a $70,000 adjusted basis for $20,000 cash and business real estate with a $65,000 FMV. Her realized gain is $15,000 ($85,000 − $70,000). The $20,000 of boot received is more than the $15,000 realized gain, so $15,000 of gain is recognized. ◀

TYPICAL MISCONCEPTION

It is possible to erroneously assume that the receipt of boot causes the recognition of loss.

Taxing part or all of the gain when cash is received in like-kind exchanges is consistent with the wherewithal-to-pay concept. However, boot may not always be in the form of a liquid asset. If non–like-kind property other than cash is received as boot, the amount of the boot is the property's FMV.

EXAMPLE I:12-15 ▶ Jane exchanges land held as an investment with a $70,000 basis for other land to be held for investment with a $100,000 FMV and a motorcycle for personal use with a $2,000 FMV. Personal-use property is non–like-kind property and constitutes boot. Jane's realized gain is $32,000 [($100,000 + $2,000) − $70,000]. The amount of boot received is equal to the FMV of the motorcycle. The recognized gain is $2,000, the lesser of boot received ($2,000) or realized gain ($32,000). ◀

EXAMPLE I:12-16 ▶ Assume the same facts in Example I:12-15 except that Jane uses the motorcycle in a business. The motorcycle is boot, and a $2,000 gain is still recognized because the exchange of real property for personal property is not a like-kind exchange. ◀

SELF-STUDY QUESTION

Why is the relief of a liability treated as if one has received cash?

ANSWER

If it were not treated as such, a taxpayer could receive cash shortly before the exchange by borrowing from a bank, using the property as collateral. Then, if the taxpayer is relieved of the debt in the like-kind exchange, he or she would still have cash without having paid a tax on the gain.

Property Transfers Involving Liabilities. If a liability is assumed (or the property is taken subject to a liability), the amount of the liability is considered money received by the taxpayer on the exchange.[15] One who assumes the debt or takes the property subject to a liability is treated as having paid cash, while the party that is relieved of the debt is treated as having received cash. If each party assumes a liability of the other party, only the net liability given or received is treated as boot.[16]

[13] Sec. 1031(b).
[14] Sec. 1031(c).

[15] Sec. 1031(d). If a liability is assumed, the taxpayer agrees to pay the debt. If property is taken subject to the liability, the taxpayer is responsible for the debt only to the extent that the property could be used to pay the debt.
[16] Reg. Sec. 1.1031(b)-1(c).

EXAMPLE I:12-17 ▶ Mary exchanges land with a $550,000 FMV that is used in her business for Doug's building, which has a $450,000 FMV. Mary's basis in the land is $400,000, and the land is subject to a liability of $100,000, which Doug assumes. Mary's realized gain is $150,000 [($450,000 + $100,000) − $400,000]. Because assumption of the $100,000 liability is treated as boot, Mary recognizes a $100,000 gain. ◀

EXAMPLE I:12-18 ▶ Matt owns an office building with a $700,000 basis, which is subject to a liability of $200,000. Susan owns an apartment complex with a $900,000 FMV, which is subject to a $150,000 liability. Matt and Susan exchange buildings and assume the related liabilities. Matt's realized gain is $250,000 [($900,000 + $200,000) − ($700,000 + $150,000)]. Matt receives boot of $50,000 ($200,000 − $150,000) and recognizes a $50,000 gain. ◀

BASIS OF PROPERTY RECEIVED

Like-Kind Property Received. The basis of property received in a nontaxable exchange is equal to the adjusted basis of the property exchanged increased by gain recognized and reduced by any boot received or loss recognized on the exchange.[17]

Basis of property received in a nontaxable exchange	=	Basis of property exchanged	−	Boot received	+	Gain recognized	−	Loss recognized[18]

EXAMPLE I:12-19 ▶ The Belken Corporation exchanged a motel in Oklahoma with a basis of $700,000 for another motel in Texas with an $850,000 FMV and cash of $40,000. The realized gain is $190,000 [($850,000 + $40,000) − $700,000], and $40,000 of the gain is recognized because the boot received is less than the realized gain. Belken's basis for the motel in Texas is $700,000 ($700,000 basis of property exchanged − $40,000 of boot received + $40,000 of gain recognized). ◀

ADDITIONAL COMMENT

In effect the formula used to calculate the basis of the new property involves nothing more than journalizing the transaction and adjusting the basis of the new property by an amount needed to make the entry balance.

The basis of the like-kind property received can also be computed by subtracting the unrecognized gain from its FMV or by adding the unrecognized loss to its FMV. Belkin's $700,000 basis for the motel in Example I:12-19 may be computed by subtracting the $150,000 of unrecognized gain from the $850,000 FMV.

EXAMPLE I:12-20 ▶ The ABC Partnership exchanged an office building in Kentucky with an adjusted basis of $1,000,000 for another office building in Ohio with a FMV of $900,000 and cash of $80,000. The $20,000 realized loss is not recognized [($900,000 + $80,000) − $1,000,000]. The receipt of boot does not cause a realized loss to be recognized. ABC's basis for the office building in Ohio is $920,000 ($1,000,000 basis of property exchanged − $80,000 of boot received). ◀

KEY POINT

The basis adjustment is the mechanism that ensures that gain or loss is temporarily postponed rather than permanently excluded.

As indicated earlier, realized gains and losses resulting from nontaxable exchanges are deferred. This deferral is reflected in the basis of property received and is illustrated in the two preceding examples. In Example I:12-19, the $150,000 ($190,000 − $40,000) unrecognized gain may be recognized when the motel in Texas is sold or exchanged in a taxable transaction, because the basis of the replacement property is less than its FMV by the amount of the deferred gain. For example, if the motel in Texas is sold in a taxable transaction for its $850,000 FMV, the $150,000 ($850,000 − $700,000 basis) of previously unrecognized gain would be recognized. In Example I:12-20, the $20,000 unrecognized loss is reflected in the basis of the Ohio office building. If ABC Partnership sells the Ohio office building for its $900,000 FMV, a $20,000 loss ($900,000 − $920,000 basis) is recognized.

If more than one item of like-kind property is received, the basis is allocated among the properties in proportion to their relative FMVs on the date of the exchange.

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[17] Sec. 1031(d).

[18] A loss is recognized only when the taxpayer transfers boot with a basis greater than its FMV. Transfers of non–like-kind property (i.e., boot) are discussed in a separate section of this chapter.

EXAMPLE I:12-21 ▶ The Pickens Corporation exchanged land with a basis of $360,000 held as an investment for a farm that contained a barn with a FMV of $100,000 and land with a FMV of $900,000. The $640,000 realized gain is not recognized. Pickens' basis for the barn is $36,000 [($100,000/$1,000,000) × $360,000], and the basis for the land is $324,000 [($900,000/$1,000,000) × $360,000]. ◀

Non–Like-Kind Property Received. The basis of non–like-kind property received is "an amount equivalent to its FMV at the date of the exchange."[19]

EXAMPLE I:12-22 ▶ Rachel exchanges land with a basis of $80,000 and held as an investment for land with a FMV of $150,000 and marketable securities with a FMV of $22,000. Rachel's realized gain is $92,000 [($150,000 + $22,000) − $80,000], and $22,000 of the gain is recognized due to the receipt of boot. Rachel's basis for the marketable securities is $22,000 and the basis of the land received is $80,000 ($80,000 basis of land exchanged − $22,000 boot received + $22,000 gain recognized). ◀

KEY POINT

Rachel had basis of $80,000 before the exchange. Since she recognized gain of $22,000, the total basis of the two assets should be $102,000.

STOP & THINK

Question: Chris Reedy owns 40 houses that he uses as rental property. All houses have a FMV greater than their adjusted basis. Chris wishes to diversify his investments and is considering selling ten of his houses and using the proceeds to purchase other types of investment assets such as stocks, bonds, commercial parking lots and land near town that he expects to increase in value. He asks you for advice.

Solution: If he sells the ten houses, he will have a gain and must pay taxes on the gain. He could defer the gain by exchanging the houses for like-kind property. Stocks and bonds are not like-kind property, but the commercial parking lots and the land should qualify as like-kind property, therefore the tax law encourages him to exchange the houses for the commercial parking lot and/or the land.

EXCHANGES BETWEEN RELATED PARTIES

ADDITIONAL COMMENT

The running of the two-year holding period is suspended during any period in which the property holder's risk of loss is substantially diminished.

Prior to 1990, related taxpayers could often use the like-kind exchange provisions to lower taxes because the tax basis for the property received is determined by the basis of the property exchanged. Related taxpayers could take advantage of the shift in tax basis to transfer a gain on a subsequent sale to a related party.[20] However, exchanges of property between related parties are not like-kind exchanges under current law if either party disposes of the property within two years of the exchange. Any gain resulting from the original exchange is recognized in the year of the subsequent disposition.[21] Dispositions due to death or involuntary conversion, or for non–tax avoidance purposes are disregarded.[22]

EXAMPLE I:12-23 ▶ Melon Corporation, 100% owned by Linda, owned land with a basis of $200,000 that was held for investment. Rick wanted to purchase the land for $900,000. Linda owned an office building with a basis of $750,000 and a FMV of $900,000. Instead of selling the land to Rick, Melon Corporation exchanged the land for Linda's office building in December 2018.

Two months later, Linda sells the land to Rick for $900,000. The exchange of the land for the office building is not a like-kind exchange because one of the related parties disposes of the property within two years of the exchange. In 2019, Melon's recognized gain on the exchange of the land is $700,000 ($900,000 − $200,000) and Linda's recognized gain on the exchange of the office building is $150,000 ($900,000 − $750,000). Because Linda's basis for the land is now $900,000, no gain is recognized on the sale of the land to Rick. ◀

ADDITIONAL COMMENT

If Linda in Example I:12-23 sells the land to Rick for $910,000, she has a $150,000 recognized gain on the exchange and a $10,000 recognized gain on the sale.

If the parties in Example I:12-23 were not related, a like-kind exchange occurred in 2018 and Linda's gain on the sale of the land to Rick is $150,000 ($900,000 − $750,000). Of course, the exchange is not a like-kind exchange if Linda does not hold the land for investment or for use in her trade or business after receiving it from Melon.

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[19] Reg. Sec. 1.1031(d)-1(c).

[20] The definition of *related parties* is the same as those for Sec. 267(a) which is discussed in Chapter I:6, and includes brothers, sisters, parents, children, and corporations where the taxpayer owns at least 50% in value. (See Sec. 1031(f)(3).)

[21] Sec. 1031(f)(1)(C).

[22] Sec. 1031(f)(2).

TRANSFER OF NON–LIKE-KIND PROPERTY

In all of the preceding examples that include a transfer of boot, the transferor (i.e., the taxpayer) received boot. If the taxpayer transfers non–like-kind property, gain or loss equal to the difference between the FMV and the adjusted basis of the non–like-kind property surrendered must be recognized. However, if the non–like-kind property is a personal use asset, the loss is not recognized.

EXAMPLE I:12-24 ▶ Shirley exchanges land with a $30,000 basis ($46,000 FMV) and marketable securities with a $10,000 basis ($14,000 FMV) to David for land with a $60,000 FMV in a transaction that otherwise qualifies as a like-kind exchange. Because the non–like-kind property that Shirley transfers has a FMV greater than its basis, she recognizes $4,000 ($14,000 − $10,000) of gain. Shirley's basis for the land received is $44,000 ($30,000 + $10,000 + $4,000), which is the basis of both assets exchanged plus the gain recognized on the exchange. ◀

EXAMPLE I:12-25 ▶ Paul exchanges timberland held as an investment for undeveloped land with a $200,000 FMV to use in his business. Paul's basis for the timberland is $125,000. His tractor with a $6,000 basis and a $4,000 FMV is also transferred. Because the non–like-kind property (i.e., the tractor) that Paul transfers has a FMV less than its basis, he recognizes a $2,000 ($4,000 – $6,000) loss. Paul's basis for the undeveloped land is $129,000 ($125,000 + $6,000 − $2,000). ◀

In Example I:12-25, Paul recognizes a loss on the non–like-kind property he surrenders, despite receiving property in the aggregate with a FMV greater than the total adjusted basis of the transferred assets. Paul is actually making two exchanges. His exchange of timberland with a basis of $125,000 for undeveloped land with a $196,000 FMV is a like-kind exchange, but his exchange of the tractor with a basis of $6,000 for undeveloped land with a $4,000 FMV is a taxable exchange. In Example I:12-26 below, Ed also makes two exchanges. He has a realized and recognized gain as well as a realized but unrecognized loss.

EXAMPLE I:12-26 ▶ Ed owns land used in business with a $20,000 adjusted basis and a $15,000 FMV and marketable securities with a $10,000 basis and an $18,000 FMV. Ed exchanges the marketable securities and the land for other land with a $33,000 FMV. Although the net realized gain is $3,000 [$33,000 − ($20,000 + $10,000)], Ed recognizes an $8,000 gain because he has transferred non–like-kind property with a $10,000 basis and an $18,000 FMV. The $5,000 realized loss on the transfer of land is not recognized due to the nonrecognition of gain or loss rules of Sec. 1031. Ed's basis for the land received is $38,000 ($20,000 + $10,000 + $8,000). ◀

KEY POINT

A taxpayer who exchanges like-kind property and non–like-kind property is actually making two exchanges.

HOLDING PERIOD FOR PROPERTY RECEIVED

ADDITIONAL COMMENT

The holding period is relevant only when the asset is a capital asset or a Sec. 1231 asset.

Like-Kind Property. The holding period of like-kind property received in a nontaxable exchange includes the holding period of the property exchanged if the like-kind property surrendered is a capital asset or an asset that is Sec. 1231 property. In essence, the holding period of the property exchanged carries over to the holding period of the like-kind property received.[23] The rule regarding the holding period carryover is consistent with the notion of a continuing investment in the underlying property that has been transferred.

Boot. The holding period for the boot property received begins the day after the date of the exchange.[24]

EXAMPLE I:12-27 ▶ Mario owns land acquired on May 1, 2000, as an investment. He exchanges the land on April 10, 2019, for a warehouse and marketable securities to be held as investments. The holding period for the warehouse begins on May 1, 2000, and the holding period for the marketable securities starts on April 11, 2019. ◀

The like-kind exchange provisions are summarized in Topic Review I:12-1.

[23] Sec. 1223(1) and Reg. Sec. 1.1223-1(a).

[24] Sec. 1223 and Reg. Sec. 1.1223-1(a).

TOPIC REVIEW I:12-1

Section 1031—Like-Kind Exchanges

- Gains and losses are not recognized for like-kind exchanges.
- Nonrecognition of gains and losses is mandatory if the exchange is a like-kind exchange.
- Section 1031 applies to exchanges of real property used in a trade or business or held for investment.
- Property exchanged and received must be like-kind.
- Subject to certain time constraints, a nonsimultaneous exchange may qualify as a like-kind exchange.
- Some gain may be recognized if the taxpayer receives or gives non–like-kind property (boot) in an otherwise like-kind exchange.
- A loss may be recognized if the taxpayer transfers non–like-kind property (boot) in an otherwise like-kind exchange.
- The basis of property received in an exchange is the basis of the property exchanged less the boot received plus the gain recognized and less any loss recognized.
- The nonrecognized gain or loss is deferred.
- The holding period of like-kind property received includes the holding period of the like-kind property exchanged.
- Like-kind exchange treatment does not apply between related parties if property is disposed of within two years of exchange.

INVOLUNTARY CONVERSIONS

OBJECTIVE 2

Determine whether gain from an involuntary conversion may be deferred

Taxpayers who realize a gain due to the involuntary conversion of property may elect to defer recognition of the entire gain if qualifying replacement property is acquired within a specified time period at a cost equal to or greater than the amount realized from the involuntary conversion. No gain is recognized if the property is converted "into property similar or related in service or use to the property so converted."[25]

The opportunity provided in Sec. 1033 to defer recognition of the gain reflects the fact that the taxpayer maintains a continuing investment and may lack the wherewithal to pay tax on the gain that would otherwise be recognized. Furthermore, the involuntary conversion is beyond the taxpayer's control.

Note that the gain is deferred, not excluded. The basis of the replacement property is the property's cost reduced by the amount of gain deferred. The tax treatment for an involuntary conversion is similar to the tax treatment of a like-kind exchange.

KEY POINT

Unlike the like-kind exchange provisions which are mandatory, the involuntary conversion provisions are elective. Further, the involuntary conversion rules apply only to gains, not losses.

EXAMPLE I:12-28 ▶

Lenea's warehouse with a $500,000 basis is destroyed by a hurricane. She collects $650,000 from the insurance company and purchases a new warehouse for $720,000. Lenea may elect to defer recognition of the $150,000 gain ($650,000 − $500,000). If the election is made, the basis of the new warehouse is $570,000 ($720,000 − $150,000). The $150,000 gain is merely deferred rather than excluded, because an immediate sale of the replacement property at its $720,000 FMV results in a recognized gain equal to the deferred gain on the involuntarily converted property. For example, if the new warehouse is sold for $720,000, the recognized gain is $150,000 ($720,000 − $570,000). ◀

ADDITIONAL COMMENT

Property involved in an involuntary conversion need not be used in a trade or business or held for investment to qualify for the deferral of gain.

TYPICAL MISCONCEPTION

Occasionally, taxpayers fail to realize that Sec. 1033 applies only to gains, not losses.

Section 1033 does not apply to losses realized from an involuntary conversion. A taxpayer may not elect to defer recognition of a loss resulting from an involuntary conversion.

EXAMPLE I:12-29 ▶

Barry's offshore drilling rig with an $800,000 adjusted basis is destroyed by a tsunami. He collects $700,000 from the insurance company and purchases a new drilling rig for $760,000. The $100,000 loss ($700,000 − $800,000) is recognized as a casualty loss, and the basis of the new drilling rig is its $760,000 purchase price. ◀

[25] Sec. 1033(a)(1).

INVOLUNTARY CONVERSION DEFINED

ADDITIONAL COMMENT

Typically, an involuntary conversion consists of either a casualty or a condemnation.

For Sec. 1033 to apply, property must be compulsorily or involuntarily converted into money or other property. An **involuntary conversion** may be due to theft, seizure, requisition, condemnation, or destruction of the property. Destruction of the property may be complete or partial.[26] For purposes of Sec. 1033, destruction of property does not have to meet the "suddenness" test if the cause of destruction otherwise falls within the general concept of a casualty.[27]

An involuntary conversion occurs when a governmental unit exercises its power of eminent domain to acquire the taxpayer's property without the taxpayer's consent. Furthermore, the threat or imminence of requisition or condemnation of property may permit a taxpayer to defer recognition of gain from the sale or exchange of property under the involuntary conversion rules. Taxpayers who transfer property due to such a threat must be careful to confirm that a decision to acquire their property for public use has been made.[28] Written confirmation of potential condemnation is particularly helpful.[29]

EXAMPLE I:12-30 ▶ Bruce owns an automobile dealership near a state university campus. On a number of occasions, the president of the university expressed an interest in acquiring Bruce's property for additional parking space. The president is not certain about the availability of funds for the purchase, and the university is reluctant to have the property condemned for its use. Based on the university's interest in the property, Bruce sells the property to the Jet Corporation. The threat or imminence of conversion does not exist merely because the property is being considered for acquisition. The sale does not constitute an involuntary conversion.[30] ◀

Threat of Condemnation. If a threat of condemnation exists and the taxpayer has reasonable grounds to believe that the property will be condemned, Sec. 1033 applies even if the taxpayer sells the property to an entity other than the governmental unit that is threatening to condemn the property.[31]

EXAMPLE I:12-31 ▶ At its regular meeting on Tuesday night, the city commission authorized the city attorney to start the process of condemning two lots owned by Beth for use as a public park. On Wednesday afternoon, Beth sells the two lots to Marty at a gain. The sale of property to Marty is an involuntary conversion, and Beth may elect to defer recognition of the gain if she satisfies the Sec. 1033 requirements. ◀

ADDITIONAL COMMENT

If the property in Example I:12-31 is later condemned, Marty may be able to defer part or all of the gain.

Conversion Must Be Involuntary. The conversion must be involuntary. For example, an involuntary conversion does not occur when a taxpayer pays someone to set fire to his or her building.[32] An involuntary conversion also does not occur when a taxpayer who is developing a subdivision reserves certain property for a school site and later sells the property to the school district under condemnation proceedings. In this situation, the taxpayer was required to reserve property for a school site in order to receive zoning approval for development of the subdivision.[33]

REAL-WORLD EXAMPLE

Because of mounting losses and declining property values, a taxpayer decided to burn down his building to collect the fire insurance proceeds. Although the building was converted into money (insurance proceeds) as a result of its destruction, this conversion was not involuntary within the meaning of Sec. 1033. Rev. Rul. 82-74, 1982-1 C.B. 110.

Although the typical involuntary conversion generally results from a casualty or condemnation, Sec. 1033 provides that certain transactions involving livestock are to be treated as involuntary conversions.[34] For example, the destruction or sale of livestock because of disease is an involuntary conversion.

TAX TREATMENT OF GAIN DUE TO INVOLUNTARY CONVERSION INTO BOOT

Gain may be deferred if the property is involuntarily converted into money or property that is not similar or related in service or use to the converted property.[35] The taxpayer must make a proper replacement of the converted property within a specific time period and elect to defer the gain.

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[26] Reg. Sec. 1.1033(a)-1.
[27] Rev. Rul. 59-102, 1959-1 C.B. 200.
[28] Rev. Rul. 63-221, 1963-2 C.B. 332, and *Joseph P. Balistrieri,* 1979 PH T.C. Memo ¶79,115, 38 TCM 526.
[29] Rev. Rul. 63-221, 1963-2 C.B. 332.
[30] *Forest City Chevrolet,* 1977 PH T.C. Memo ¶77,187, 36 TCM 768.
[31] Rev. Rul. 81-180, 1981-2 C.B. 161, and *Creative Solutions, Inc. v. U.S.,* 12 AFTR 2d 5229, 1963-2 USTC ¶9615 (5th Cir., 1963).
[32] Rev. Rul. 82-74, 1982-1 C.B. 110.
[33] Rev. Rul. 69-654, 1969-2 C.B. 162.
[34] Secs. 1033(d) and (e). If a taxpayer sells or exchanges more livestock than normal because of a drought, the sale or exchange of the excess amount is treated as an involuntary conversion. The livestock must be other than poultry and be held by the taxpayer for draft, breeding, or dairy purposes.
[35] Sec. 1033(a)(2).

Realized Gain. The taxpayer's realized gain is the excess of the amount received due to the involuntary conversion over the adjusted basis of the property converted. The total award or proceeds received are reduced by expenses incurred to determine the amount realized (e.g., attorney's fees incurred in connection with determining the settlement to be received from a condemnation). If the payment of the award or proceeds is delayed, any amounts paid as interest are not included in determining the amount realized.[36] Amounts received as interest on an award for property condemned are taxed as ordinary income even if the interest is paid by a state or political subdivision.[37]

EXAMPLE I:12-32 ▶ Richard's property with a $100,000 basis is condemned by the city of Phoenix. Richard receives a $190,000 award and pays $1,000 in legal expenses for representation at the condemnation proceedings and $800 for an appraisal of the property. The amount realized is $188,200 [$190,000 − ($1,000 + $800)], and the realized gain is $88,200 ($188,200 − $100,000). Richard may elect to defer part or all of the realized gain if the requirements of Sec. 1033 are satisfied. ◀

ADDITIONAL COMMENT

Some or all of the realized gain is recognized if the cost of the replacement property is less than the amount realized.

Gain Recognized. To defer the entire gain, one must purchase replacement property with a cost equal to or greater than the amount realized from the involuntary conversion. If the replacement property is purchased for an amount less than the amount realized, that portion of the realized gain equal to the excess of the amount realized from the conversion over the cost of the replacement property must be recognized.[38] Stated differently, the recognized gain is the lesser of the realized gain or the excess of the amount realized over the cost of the replacement property.

EXAMPLE I:12-33 ▶ Bob owns a restaurant with a $200,000 basis. The restaurant is destroyed by fire, and he receives insurance proceeds of $300,000. Bob's realized gain is $100,000 ($300,000 − $200,000). He purchases another restaurant for $275,000. Bob may elect to defer $75,000 of the gain under Sec. 1033, and $25,000 ($300,000 − $275,000) of Bob's gain must be recognized because he failed to reinvest all of the $300,000 insurance proceeds in a suitable replacement property. ◀

EXAMPLE I:12-34 ▶ Stacey owns a racehorse with a $450,000 basis used for breeding purposes. The racehorse is killed by lightning, and she collects $800,000 from the insurance company. Stacey's realized gain is $350,000 ($800,000 − $450,000). She purchases another racehorse for $430,000. The entire $350,000 of gain is recognized, because the amount realized from the involuntary conversion exceeds the cost of the replacement property by $370,000 ($800,000 − $430,000) which is more than the realized gain. ◀

Basis of Replacement Property. If replacement property is purchased, the basis of the replacement property is its cost less any deferred gain. If the taxpayer elects to defer the gain, the holding period of the replacement property includes the holding period of the converted property.[39]

EXAMPLE I:12-35 ▶ Tracy owns a yacht that is held for personal use and has a $20,000 basis. The yacht is destroyed by a storm, and Tracy collects $24,000 from the insurance company. She purchases a new $35,000 yacht for personal use and elects to defer the $4,000 ($24,000 − $20,000) gain. The basis of the new yacht is $31,000 ($35,000 − $4,000). The holding period for the new yacht includes the holding period of the destroyed yacht. ◀

Severance Damages. If a portion of the taxpayer's property is condemned, the taxpayer may receive **severance damages** as compensation for a decline in the value of the retained property. For example, if access to the retained property becomes difficult or if the property is exposed to greater damage from flooding or erosion, its value may decline.

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[36] *Flushingside Realty & Construction Co.*, 1943 PH T.C. Memo ¶43,286, 2 TCM 259.
[37] *Spencer D. Stewart v. CIR*, 52 AFTR 2d 83-5885, 83-2 USTC ¶9573 (9th Cir., 1983).
[38] Sec. 1033(a)(2)(A).
[39] Sec. 1223(1)(A).

The IRS considers severance damages to be "analogous to the proceeds of property insurance; they represent compensation for damages to the property."[40] Amounts received as severance damages reduce the basis of the retained property, and any amount received in excess of the property's basis is treated as gain.[41]

EXAMPLE I:12-36 ▶ Cindy owns a 500-acre farm with a $200 basis per acre ($100,000 basis). The state condemns ten acres across the northwest corner of her farm to build a major highway. Cindy receives a condemnation award of $500 per acre for the ten acres. The highway separates the farm into a 25-acre tract and a 465-acre tract. Because her ability to efficiently use the 25-acre tract for farming is reduced, the state pays additional severance damages of $90 per acre for the 25 acres. Cindy's gain realized from condemnation of the ten acres is $3,000 [$5,000 − ($200 × 10 acres)]. The $2,250 ($90 × 25 acres) of severance damages reduce the basis of the 25-acre tract from $5,000 to $2,750 [($200 × 25 acres) − $2,250]. The reduction in basis is applied solely to the 25 acres because of its decline in value as farmland. ◀

REAL-WORLD EXAMPLE

Seven of the 18 holes of a golf course were condemned. Although 11 holes remained, it was anticipated that the course would have to be reduced to 9 holes. Therefore, $21,000 of the condemnation award was allocated to severance damages to reflect the decline in value of the two lost holes. *Marco S. Marinello Associates, Inc.*, 1975 PH T.C. Memo ¶75,078, 34 TCM 392.

The Sec. 1033 provisions concerning nonrecognition of gain may apply to severance damages. For instance, if severance damages are used to restore the retained property, only that portion of severance damages not spent for restoration reduces the basis of the retained property. A taxpayer who uses severance damages to purchase adjacent farmland to replace the portion of the farm condemned may use Sec. 1033 to defer a gain due to the receipt of the severance damages.[42]

REPLACEMENT PROPERTY

To qualify for nonrecognition of gain due to an involuntary conversion, the taxpayer must acquire qualified replacement property. With some exceptions, the **replacement property** must be "similar or related in service or use to the property so converted."[43] Taxpayers who own and use the property must use the functional-use test although replacement may be made with like-kind property in certain cases. A taxpayer who owns and leases the property that is involuntarily converted may use the taxpayer-use test.

REAL-WORLD EXAMPLE

The replacement of bowling alleys destroyed in a fire with a recreational billiards center did not pass the functional-use test. Rev. Rul. 76-319, 1976-2 C.B. 242.

Functional-Use Test. The **functional-use test** is more restrictive than the like-kind test. To be considered similar or related in service or use, the replacement property must be functionally the same as the converted property. For example, the exchange of a business building for land used in business qualifies as a like-kind exchange. Replacing a building with land does not qualify as replacement property under the involuntary conversion rules. The building must be replaced with a building that is functionally the same as the converted building.

EXAMPLE I:12-37 ▶ Julie's movie theater is destroyed by fire, and she uses the insurance proceeds to purchase a skating rink. The converted property has not been replaced with property that is similar or related in service or use under the functional-use test. The election to defer gain under Sec. 1033 is not available. ◀

Replacement with Like-Kind Property. If real property held for productive use in a trade or business or for investment is **condemned,** a proper replacement may be made by acquiring like-kind property.[44] This exception to the functional-use test applies only to real property used in a trade or business or held for investment.

EXAMPLE I:12-38 ▶ Ken owns a building used in his business that is condemned by the state to widen a highway. He uses the proceeds to purchase land to be held for investment. The land is a qualified replacement property because the condemned building is real property used in a trade or business, and the like-kind exchange rule may be applied to the condemnation. ◀

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[40] Rev. Rul. 53-271, 1953-2 C.B. 36.
[41] Rev. Rul. 68-37, 1968-1 C.B. 359.
[42] Rev. Ruls. 69-240, 1969-1 C.B. 199, 73-35, 1973-1 C.B. 367, and 83-49, 1983-1 C.B. 191.
[43] Secs. 1033(a)(2)(A) and 1033(f). The replacement of property requirement is modified when proceeds from the involuntary conversion of livestock may not be reinvested in property similar or related in use to the converted livestock because of soil contamination or other environmental contamination. Sec. 1033(f) permits the livestock to be replaced with other property, including real property, used for farming purposes.
[44] Sec. 1033(g)(1).

EXAMPLE I:12-39 ▶ Assume the same facts as in Example I:12-38 except that the building is destroyed by a violent windstorm. Ken's purchase of the investment land is not qualified replacement property because the more flexible like-kind exchange rules apply only to condemnations. He must purchase property with the same functional use as the business building. ◀

REAL-WORLD EXAMPLE

A nursery with its trees and shrubs was condemned, and the taxpayer replaced the condemned property with land and greenhouses. The replacement was considered to have been made with like-kind property. *Evert Asjes, Jr.*, 74 T.C. 1005 (1980).

If business or investment property is involuntarily converted as a result of a Presidentially declared disaster after 1994, the taxpayer may replace the property with any tangible property that is held for productive use in a trade or business.

Taxpayer-Use Test. The **taxpayer-use test** applies to the involuntary conversion of rental property owned by an investor. This test permits greater flexibility than the functional-use test. The principal requirement is that the owner-investor must lease out the replacement property that is acquired. However, the lessee is not required to use the leased property for the same functional use.[45]

EXAMPLE I:12-40 ▶ Sally owns an apartment complex that is rented to college students. The apartment complex is destroyed by fire. She uses the insurance proceeds to purchase a medical building that is leased to physicians. Sally has acquired a qualified replacement property under the taxpayer-use test, and the gain, if any, may be deferred if an election is made under Sec. 1033. ◀

STOP & THINK

Question: Greg Stacey's motel is destroyed by fire on March 10 of the current year. The basis of the property is $400,000 and he receives $2,000,000 from the insurance company. Greg is concerned about the possibility of having to pay income tax on the $1,600,000 gain and is aware of the tax rules relating to involuntary conversions. Greg is considering replacing the destroyed motel by building either a new motel or an ice skating rink on the vacant lot. The cost of a new motel or an ice skating rink is expected to be $2,500,000, and he expects to borrow 60% of the cost. What tax advice would you give him?

REAL-WORLD EXAMPLE

Taxpayer owned land and a warehouse held for rental purposes. Upon condemnation of this property, taxpayer invested the proceeds in a gas station on land already owned by the taxpayer which was also held for rental purposes. The taxpayer-use test applied, and taxpayer was able to defer the gain. Rev. Rul. 71-41, 1971-1 C.B. 223.

Solution: Greg may defer the $1,600,000 gain if the involuntary conversion requirements are met and he makes a proper election. The principal issue is whether the replacement property is considered to be "similar in service or use" to the converted property. Because the functional-use test is applicable in this case, an ice skating rink is not similar property and the gain of $1,600,000 must be recognized. Conversely, the new motel is similar property and, since Greg is reinvesting an amount greater than $2,000,000, none of the gain is recognized. His basis in the new motel is $900,000 ($2,500,000 − deferred gain of $1,600,000). The fact that he borrows money and does not spend the $2,000,000 insurance proceeds does not prevent him from electing to defer the gain. The tax requirement is only that he must reinvest an amount equal to or greater than the $2,000,000 insurance proceeds. In this case, the tax law clearly encourages the taxpayer to build a new motel rather than an ice skating rink.

OBTAINING REPLACEMENT PROPERTY

The general rule is that the taxpayer must purchase the replacement property.[46] Taxpayers may purchase replacement property indirectly by purchasing control (i.e., 80% or more of the stock) of a corporation that owns the replacement property.[47] However, this exception is not applicable to the purchase of like-kind property to replace condemned real property used in a trade or business or held for investment.[48]

EXAMPLE I:12-41 ▶ Hank's airplane, used in business, is hijacked and taken to a foreign country. He uses the insurance proceeds to purchase 80% of Fast Corporation stock. Fast Corporation owns an airplane which is qualified replacement property. The involuntary conversion requirements are satisfied if Hank elects to defer any gain realized. ◀

[45] Rev. Rul. 64-237, 1964-2 C.B. 319.

[46] To qualify as a purchase of property or stock under Sec. 1033(a)(2)(A)(ii), the unadjusted basis of the property or stock must be its cost within the meaning of Sec. 1012 without considering the basis adjustment for the deferred gain. Property acquired by inheritance, gift, or a nontaxable exchange does not qualify as replacement property (see Reg. Sec. 1.1033(a)-2(c)(4)).

[47] Sec. 1033(a)(2)(A) and Reg. Sec. 1.1033(a)-2(c).

[48] Sec. 1033(g)(2).

EXAMPLE I:12-42 ▶ Lynn's farm is condemned by the state for public use. She uses the proceeds to purchase 80% of Vermont Corporation stock. Vermont Corporation owns eight parking lots. A qualified replacement property has not been obtained through the stock purchase because the parking lots are not functionally the same as the farm. A qualified replacement does occur if she buys the parking lots from the Vermont Corporation. ◀

TYPICAL MISCONCEPTION

The first taxable year in which any part of the gain on the conversion is realized is the year in which the insurance proceeds are received, not the year in which the involuntary conversion took place.

TIME REQUIREMENTS FOR REPLACEMENT

To qualify for nonrecognition of gain treatment, the converted property must be replaced within a specified time period. The general rule is that the period begins with the date of disposition of the converted property and ends "two years after the close of the first taxable year in which any part of the gain upon the conversion is realized."[49] If the involuntary conversion is due to condemnation or requisition, or the threat of such, the replacement period begins on the date of the threat or imminence of the requisition or condemnation. The replacement period may be extended by obtaining permission from the IRS.[50]

EXAMPLE I:12-43 ▶ On December 8, 2019, Craig's business property was destroyed by fire. Craig receives insurance proceeds in 2020 and elects to defer recognition of the gain. He must replace the property between December 8, 2019, and December 31, 2022. The two-year time period includes 2022 because the gain is realized when the insurance proceeds are received in 2020. ◀

KEY POINT

The replacement period is three years instead of two years on the condemnation of real property used in a business or held for investment.

The replacement period is longer if the involuntary conversion is due to the condemnation of real property (excluding inventory) held for productive use in a trade or business or for investment. The replacement period ends three years after the close of the first tax year in which any part of the gain is realized.[51] This provision for a longer replacement period applies to the same type of real property that may be replaced with like-kind property.

EXAMPLE I:12-44 ▶ Beth owns a building used in her dry cleaning business. In 2019, the state condemns the building and awards Beth an amount greater than the adjusted basis of the building. Beth may replace the property with like-kind property, and the replacement period ends on December 31, 2022. ◀

The involuntary conversion rules are summarized in Topic Review I:12-2.

TOPIC REVIEW I:12-2

Section 1033: Involuntary Conversions

1. Section 1033 applies only to gains, not losses.
2. Nonrecognition of gain under Section 1033 is elective. (Nonrecognition of gain is mandatory in a direct conversion, but direct conversions seldom occur.)
3. Section 1033 applies to involuntary conversions of all types of properties.
4. Some gain may be recognized if the taxpayer replaces the involuntarily converted property with property that costs less than the amount realized in the involuntary conversion.
5. The nonrecognized gain is deferred.
6. The basis of property acquired to replace the involuntarily converted property is the cost of the property less the deferred gain.
7. Property acquired to replace the involuntarily converted property generally must be functionally related property.
8. The required replacement period generally begins with the date of disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain on the conversion is realized. (A three-year period applies to condemnations of real property used in a trade or business or held for the production of income.)

[49] Sec. 1033(a)(2)(B).
[50] Sec. 1033(a)(2)(B)(ii).
[51] Sec. 1033(g)(4).

SALE OF PRINCIPAL RESIDENCE

OBJECTIVE 3

Determine when a gain resulting from the sale of a principal residence is excluded

Congress uses the tax law to encourage home ownership in many ways: (1) Real estate taxes and interest on a mortgage used to acquire a principal or second residence are deductible (see Chapter I:8), (2) part or all of the interest on home equity debt may be deductible, and (3) taxpayers may elect to exclude up to $250,000 ($500,000 on a joint return) of gain from the sale of a principal residence.

Individuals who sell or exchange their personal residence after May 6, 1997, may exclude up to $250,000 of gain if it was owned and occupied as a principal residence for at least two years of the five-year period before the sale or exchange. A married couple may exclude up to $500,000 when filing jointly if both meet the use test, at least one meets the ownership test and neither spouse is ineligible for the exclusion because he or she sold or exchanged a residence within the last two years.[52]

The Sec. 121 exclusion is available regardless of age, and taxpayers do not have to purchase a replacement residence. Any gain not excluded is capital gain because a personal residence is a capital asset. If long term, these gains are eligible for preferential tax rates. However, any recognized gain on the sale of a personal residence is considered to be investment income, so the gain may be subject to the 3.8% tax on net investment income due to the so-called Medicare tax on higher-income taxpayers (see Chapter I:5 for further discussion of the preferential rates and the additional tax on net investment income). A loss on the sale or exchange of a personal residence is not deductible because the residence is personal-use property.[53]

EXAMPLE I:12-45 ▶ Maki, who is single and 35 years old, sells her principal residence that she purchased four years ago and realizes a $230,000 gain. Maki may exclude the entire gain regardless of her age or whether she purchases a new principal residence. ◀

EXAMPLE I:12-46 ▶ Assume the same facts as in the above example except the realized gain is $320,000. Maki may exclude $250,000 and recognize a $70,000 LTCG. ◀

EXAMPLE I:12-47 ▶ Assume the same facts as in Example I:12-46 except Maki is married to Yixin, and they have owned and occupied the residence for the last four years. They may exclude the entire $320,000 gain. ◀

ADDITIONAL COMMENT

The elimination of taxes on up to $500,000 of gain from the sale of a personal residence has been a great benefit for many taxpayers who had large built-in gains.

Prior to the Taxpayer Relief Act of 1997, taxpayers could defer gain resulting from sale of a personal residence if they purchased another principal residence within two years at a cost greater than the adjusted sales price. Taxpayers who were at least 55 years old could exclude up to $125,000 of gain resulting from the sale of a personal residence. The deferral provision of Sec. 1034 has been repealed; the exclusion has been increased to $250,000 or $500,000; and taxpayers may exclude gain regardless of age and use the exclusion more than once.

Today, the rules for excluding gain resulting from the sale of a personal residence are more favorable for most taxpayers than the old rules because Congress wanted to eliminate the need for homeowners to maintain records for long periods of time. However, taxpayers who expect to sell their homes and have a realized gain of more than $250,000 ($500,000 if a joint return is filed) still need to maintain records. Also, taxpayers who convert their personal residence to business property or rental property will need to know the property's correct adjusted basis to compute depreciation.

Determining the Realized Gain. Gain realized is the excess of the amount realized over the property's adjusted basis.[54] The amount realized on the sale of the property is equal to the selling price less selling expenses.[55] Selling expenses include commissions, advertising, deed preparation costs, and legal expenses incurred in connection with the sale.[56]

EXAMPLE I:12-48 ▶ Kirby sells his personal residence, which has a $100,000 basis, to Maxine. To make the sale, Kirby pays a $7,000 sales commission and incurs $800 of legal costs. Maxine pays $30,000 cash and assumes Kirby's $90,000 mortgage. The amount realized is $112,200 [($30,000 + $90,000) − ($7,000 + $800)]. The realized gain is $12,200 ($112,200 − $100,000). ◀

[52] Sec. 121(a) and (b).
[53] Reg. Secs. 1.165-9(a) and 1.262-1b)(4).
[54] Reg. Sec. 1.1034-1(b)(5).
[55] Reg. Sec. 1.1034-1(b)(4).
[56] Reg. Sec. 1.1034-1(b)(4)(i).

Adjusted Basis of Residence. The original basis of a principal residence is a function of how the residence is obtained. It could be purchased, received as a gift, or inherited. The cost of a residence includes all amounts attributable to the acquisition including commissions and other purchasing expenses paid to acquire the residence.[57] Capital improvements, but not repairs, increase the adjusted basis of the residence. The costs of adding a room, installing an air conditioning system, finishing a basement, and landscaping are capital improvements. Expenses incurred to protect the taxpayer's title in the residence are also capitalized. Under Sec. 1034, which was repealed in 1997, a taxpayer who deferred gain on the sale of a principal residence was required to reduce the basis of the replacement residence by the amount of the deferred gain.[58]

EXAMPLE I:12-49 ▶ In 1996, Susan paid $200,000 to purchase a new residence. She paid a realtor $4,000 to help locate the house and paid legal fees of $1,200 to make certain that the seller had legal title to the property. As a result of the purchase, she deferred a gain of $50,000 from the sale of a former residence in 1995. In 1997, she added a new porch to the house at a cost of $6,000 and installed central air conditioning at a cost of $5,200. Since purchasing the house, she has paid $1,500 for repairs. The adjusted basis of her house is $166,400 [$200,000 + $4,000 + $1,200 − $50,000 + $6,000 + $5,200]. ◀

Multiple Use of the Exclusion. Previously under Sec. 121, a taxpayer was limited to the exclusion once in their lifetime, and a married taxpayer whose spouse had taken the exclusion could not use the exclusion even if the taxpayer filed as married filing separately. The exclusion is now determined on an individual basis. An individual may claim the exclusion even if the individual's spouse used the exclusion within the past two years. Also, for a married couple filing a joint return when each spouse maintains a separate principal residence, the $250,000 exclusion is available for the sale or exchange of each spouse's principal residence.

EXAMPLE I:12-50 ▶ Krista, who has owned and used a house as her principal residence for the last seven years, marries Josh in January 2019. Josh sold his residence in October 2018 and excluded a $145,000 gain. Krista sells her residence in December 2019 and realizes a gain of $378,000. She may exclude $250,000 of the gain.

Assuming that Krista and Josh use her residence in the above example for a two-year period starting in January 2019, they could exclude up to $500,000 if she waits to sell the house until January 2021. ◀

PRINCIPAL RESIDENCE DEFINED

For Sec. 121 to apply, taxpayers must sell property that qualifies as their principal residence. Whether property is used as the taxpayer's principal residence depends upon all the facts and circumstances. If a taxpayer uses more than one property as a residence during the year, the property used a majority of the time will normally be the principal residence.[59]

EXAMPLE I:12-51 ▶ Lanny, a 40-year-old college professor, owns and occupies a house in Oklahoma. During the summer, he lives in a cabin in Idaho. After owning the cabin for eight years, Lanny sells it for $50,000 and realizes a gain. Gain on the sale of the cabin in Idaho must be recognized because Lanny's principal residence is in Oklahoma. ◀

KEY POINT

A taxpayer may own two or more residences, but only one of them qualifies as the principal residence.

Factors other than use of the property that are relevant when determining a taxpayer's principal residence include place of employment, mailing address for bills and correspondence, address for tax returns and voter registration, and location of religious organizations and recreational clubs with which the taxpayer is affiliated. The principal place of abode for the taxpayer's family members is also relevant.[60]

The property does not have to be one's principal residence at time of the sale to qualify for the exclusion. The exclusion applies if the property has been used as a principal residence for at least two of the five years before the sale or exchange and the exclusion has not been used within the past two years.

[57] Reg. Sec. 1.1034-1(c)(4).
[58] Sec. 1034(e).
[59] Reg. Sec. 1.121-1(b)(2).
[60] Reg. Sec. 1.121-1(b)(2).

EXAMPLE I:12-52 ▶ Canan owned and used a house in Buffalo as her principal residence from March 10, 2015, until November 21, 2017, when she purchased a new house in Kansas on December 1, 2017. Her brother lives in the house in Buffalo until Canan sells it on July 10, 2019, and realizes a gain of $288,000. She may exclude $250,000 and recognize a $38,000 LTCG. ◀

Condominium apartments, houseboats, and housetrailers may qualify as principal residences.[61] Stock held by a tenant-stockholder in a cooperative housing corporation is a principal residence if the dwelling that the taxpayer is entitled to occupy as a stockholder is used as his or her principal residence.[62]

SALE OF MORE THAN ONE PRINCIPAL RESIDENCE WITHIN A TWO-YEAR PERIOD

ADDITIONAL COMMENT

The taxpayer does not have to be occupying the old residence at the date of sale. The taxpayer may have already moved to a new residence and be renting the old residence temporarily before its sale.

The new exclusion provided by Sec. 121 applies to only one sale or exchange every two years. However, a portion of the gain may be excluded in certain circumstances even if the two-year requirement is not satisfied.

If a principal residence is sold within two years of a previous sale or exchange of a residence, part of the gain may be excluded if the sale or exchange is due to a change in employment, health, or unforseen circumstances. The portion of the gain excluded is based on a ratio with a numerator in days or months and a denominator of 730 days or 24 months.[63] The numerator is the shorter of:

(1) the period during which the ownership and use tests were met during the five-year period ending on the date of sale, or
(2) the period of time after the date of the most recent prior sale or exchange for which the exclusion applied until the date of the current sale or exchange.[64]

The amount excluded is $250,000 or $500,000 times the above ratio.

EXAMPLE I:12-53 ▶ Winnie, who is single, sold her principal residence in Detroit on November 1, 2019, and excluded the $127,000 gain because she owned and used the residence for two of the last five years. Winnie had purchased another residence in Cleveland on October 1, 2019. She occupies the residence in Cleveland until June 12, 2020, when she moves to Dallas to accept a new job. She sells the residence in Cleveland on November 15, 2020, and realizes a gain of $40,000. Winnie may exclude all of the gain because the sale of her Cleveland residence was due to a change in employment and 251/731 of $250,000 is more than the $40,000 realized gain. She owns and uses the residence in Cleveland for 255 days, and the period between the sale of the residence in Detroit and the sale in Cleveland is 379 days (2020 is a leap year). ◀

ADDITIONAL COMMENT

If Winnie's gain in Example I:12-53 is $100,000, she may exclude $87,209 (255/731 × $250,000).

Ownership and Use Tests. If a principal residence is sold before satisfying the ownership and use tests, part of the gain may be excluded if the sale is due to a change in employment, health, or unforseen circumstances. The portion of the gain excluded is determined by multiplying the amount of the exclusion (i.e., $250,000 or $500,000) by a fraction whose numerator is the number of days the use and ownership tests were met and whose denominator is 730 days (or 24 months).

EXAMPLE I:12-54 ▶ Tim, a single taxpayer who purchased his home on January 1, 2019, for $500,000, recently became ill and sells his home in order to move closer to a relative who can care for him. Tim sells his principal residence on June 14, 2019, for $620,000, realizing a gain of $120,000. Because he owned and occupied the residence for 164 days and the sale was due to a change in his health, he may exclude $56,088 ($250,000 × 164/731). ◀

For purposes of the two-year ownership rule, a taxpayer's period of ownership includes the period during which the taxpayer's deceased spouse owned the residence. When a taxpayer receives a residence from a spouse or an ex-spouse incident to a divorce, the taxpayer's period of owning the property includes the time the residence was owned by the spouse or ex-spouse.[65] When attempting to determine if the taxpayer has occupied the residence for two years, short temporary absences such as for vacation or other seasonal absence are counted as use by the taxpayer.[66]

[61] Rev. Rul. 64-31, 1964-1 C.B. 300.
[62] Reg. Sec. 1.1034-1(c)(3).
[63] Reg. Sec. 1.121-3(g).
[64] Sec. 121(c).
[65] Sec. 121(d)(2) and (3).
[66] Reg. Sec. 1.121-1(c)(2)(i).

EXAMPLE I:12-55 ▶ Sachie receives an $800,000 residence owned for six years by Richard, her former spouse, as part of a divorce settlement. Richard's basis for the residence is $430,000. They lived in the house for five years prior to the divorce. Three months after transfer of the residence to Sachie, she sells it for $825,000, and $250,000 of her $395,000 realized gain is excluded. Sachie must recognize a $145,000 LTCG. Sachie's period of ownership includes the six years Richard owned the residence. ◀

ADDITIONAL COMMENT

The five-year period does not include any period up to ten years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services.

Change Due to Employment, Health, or Unforeseen Circumstances. The Treasury has issued Regulations to provide guidance as to how a homeowner may qualify for partial exclusion if the sale was before the two-year use and ownership test is satisfied or if the sale occurs within two years of a previous sale where the exclusion was used. The exceptions may apply even if a person other than the taxpayer has a change in employment or health.

A taxpayer is viewed as being eligible for partial exclusion if she sells her residence because a qualified individual has a change in employment that satisfies the test under Sec. 217 for the moving expense deduction. A qualified individual includes the taxpayer, the taxpayer's spouse, co-owner of the residence, or a person who uses the residence as a principal place of abode. Taxpayers may qualify for the exclusion and the moving expense deduction if moving to take a new job, continue with present employer or accept a job if the 50-mile distance test is satisfied. The change in employment must occur when the taxpayer is satisfying the ownership and use test for the residence except for the two-year requirement.[67]

EXAMPLE I:12-56 ▶ Mark has lived in his first house for one year in Omaha when he marries Karen. Six months later, Karen receives a job offer and they move to Florida. Mark may exclude a realized gain equal to 18/24 of $250,000, because the move is due to a change in employment of a qualified individual. ◀

When determining if the sale or exchange of the residence is due to a change in health, the definition of a "qualified individual" is expanded to include relatives who satisfy the relationship test used to determine if one is a dependent of the taxpayer. The relative must satisfy the relationship test but does not have to be a dependent to be a qualified individual. A sale or exchange is because of health if the primary reason is "to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of a disease, illness, or injury of a qualified individual."[68]

EXAMPLE I:12-57 ▶ Daniel has lived in his first house in Virginia for eight months when he sells the house and moves to Texas to take care of his 60-year-old father who recently suffered a stroke. Daniel may exclude a realized gain equal to 8/24 of $250,000 because the primary reason for the sale is due to the health of a qualified individual. ◀

REAL-WORLD EXAMPLE

In LTR 200601009, taxpayers who sold their home within two years of the purchase because they became aware of various criminal activities occurring in their neighborhood were allowed to utilize Sec. 121. In addition to their son being assaulted and threatened, one of the taxpayers was assaulted by the neighbors.

A sale or exchange is due to unforeseen circumstances if the primary reason for the sale or exchange is an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. For the unforeseen circumstances exception, a qualified individual is the same as a qualified individual for the change in employment test.

The following are specific events considered to qualify as unforeseen circumstances:

1. Involuntary conversion of residence;
2. Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence;
3. Death of a qualified individual;
4. Loss of employment by a qualified individual if the individual is eligible for unemployment compensation;
5. Change of employment that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses;
6. Divorce or legal separation;
7. Multiple births from the same pregnancy.[69]

Note that marriage and adoption are not included in the above safe-harbor list of unforeseen circumstances. One who sells her residence before meeting the two-year test because she has adopted a child will not be assured of qualifying for possible exclusion

[67] Reg. Sec. 1.121-3(c).
[68] Reg. Sec. 1.121-3(d).
[69] Reg. Sec. 1.121-3T(e).

under the unforeseen circumstances exception. She will have to argue that the facts and circumstances justify her use of the partial exclusion.

The IRS has issued a number of letter rulings that suggest that it is willing to consider many different reasons for selling due to unforseen circumstances. In LTR 200601022, a taxpayer purchased a house, but then married someone with a child who attended a school in a different school district. They decided to temporarily use their house as rental property and rent another house for their use located in the child's school district. While living in the rented house, they had a child and decided to sell the first house because it was too small for their expanding family. Despite the fact that the taxpayer did not use the house as a principal residence, they were allowed to utilize Sec. 121.

EXAMPLE I:12-58 ▶ Benjamin purchases a house near the airport and sells it four months later because of noise caused by planes. He may not exclude any of the gain, because the airport noise is not an unforeseen circumstance. ◀

REAL-WORLD EXAMPLE

Unlike Example I:12-58, a taxpayer in LTR 200702032 was able to utilize Sec. 121 when he sold his principal residence located near an airport because he was mislead about the amount of noise, despite his considerable efforts to determine if noise would be a problem. He sold the house at a loss, but he sued the real estate agents and the seller for their failure to disclose the excessive noise during peak periods in the early morning and evening. The defendants settled and the settlement proceeds were treated as additional proceeds from the sale of the residence resulting in a gain which the taxpayer was able to exclude.

STOP & THINK

Question: Rebecca's uncle told her that she could purchase his house for $150,000 in five years provided that she could pay at least $30,000 of the purchase price in cash. Rebecca has $15,000 and is considering two alternative methods to obtain the remaining $15,000 in five years. The first alternative is to purchase $15,000 of non-dividend paying stock that she expects to increase in value to $30,000 within five years. The second alternative is to purchase an $80,000 residence by paying $15,000 and borrowing $65,000. Payments on the mortgage will be interest only for five years and amount to $450 per month. Insurance, property taxes, and other home ownership expenses average $90 per month. She expects the house to be worth $95,000 at the end of five years. She will rent an apartment for $540 per month, including utilities, if she buys the stock. Ignoring transaction costs and assuming that she does not itemize deductions, should Rebecca purchase the stock or the house?

Solution: The $15,000 gain resulting from sale of the stock is LTCG and probably taxed at 15%. If the rate is 15%, she must pay taxes of $2,250 and has only $27,750 available to purchase her uncle's house. She will have a gain of $15,000 if she sells the house but the gain is excluded. She has $30,000 of cash and is able to buy her uncle's house. The tax law encourages Rebecca to buy a principal residence.

NONQUALIFIED USE AFTER 2008

A taxpayer who owns a principal residence and a second home (rental property, vacation home, etc.) that has appreciated in value has an incentive to convert the second home to a principal residence if planning to sell the second home. The Housing Assistance Tax Act of 2008 reduced the advantage of converting residences that have not been the principal residence to one's principal residence.

Gain from the sale of a principal residence that is allocable to periods of nonqualified use after 2008 is not excluded from income. Gain allocated to periods of nonqualified use after 2008 is based on the ratio which the aggregate periods of nonqualified use after 2008 bears to the total time the property was owned. A period of nonqualified use is any period that the property is not used as a principal residence after 2008. As under prior law, any depreciation attributable to periods of business use is subject to taxation.

Any portion of the five-year period ending on the date of sale that is after the property ceases to be used as a principal residence is not considered nonqualified use, thus the taxpayer may vacate the residence before selling it without recognizing that time after moving out as nonqualified use. Absences due to change in employment, health condition, or other unforeseen circumstances are not considered nonqualified use. Also, nonqualified use does not include any period in which the taxpayer or taxpayer's spouse is serving on qualified official extended duty.

EXAMPLE I:12-59 ▶ The Eberts owned a house on Elm Street that had been used as rental property for 18 years until they moved into it on May 1, 2008. They used it as their principal residence until the current year when they sell the Elm Street property and realize a $700,000 gain. Any of the gain due to depreciation must be recognized, but they are eligible to exclude up to $500,000 of the remaining gain. The use of the property as rental property is not nonqualified use because it occurred before 2009. ◀

EXAMPLE I:12-60 ▶ Assume the same facts as in Example I:12-59 except the Eberts did not move into the Elm Street property until May 1, 2016, and sell the property on December 22, 2019. In this case, the period from January 1, 2009 through April 30, 2016 is nonqualified use and a prorata share of the gain after considering the gain due to depreciation is not eligible for the $500,000 exclusion. In this case, the Eberts have 88 months of nonqualified use. ◀

EXAMPLE I:12-61 ▶ Dale owned a house and used it as rental property for ten years until January 1, 2016, when he moved into the house and used it as a principal residence. Depreciation for the ten years that it was used as rental property is $50,000. If he sells the house on January 1, 2019, and realizes a gain of $230,000, the first $50,000 of gain is recognized because of depreciation. He may exclude 6/13* of the remaining gain of $180,000, and must recognize another $96,923 (7/13 of $180,000) due to the nonqualified use. Gain attributed to the six years of the 13-year period is eligible for the Sec. 121 exclusion. He must recognize $146,923 ($50,000 + $96,923) of the $230,000 gain and may exclude $83,077.

* To further clarify the calculations in this example, an explanation of the relevant time periods is below:

13 years = total ownership period, 1/1/06 – 1/1/19.
7 years = nonqualified use period, 1/1/09 – 12/31/15.
6 years = qualified use years, 1/1/06 – 12/31/08 and 1/1/16 – 1/1/19. ◀

INVOLUNTARY CONVERSION OF A PRINCIPAL RESIDENCE

Ordinarily, the involuntary conversion of a principal residence is governed by Sec. 1033, discussed earlier in this chapter. A gain due to an involuntary conversion of a personal residence may be deferred if the requirements of Sec. 1033 are satisfied. The functional-use test must be satisfied regardless of the type of involuntary conversion.

For purposes of Sec. 121, the destruction, theft, seizure, requisition, or condemnation of property is treated as a sale.[70] Thus, taxpayers may exclude a gain of up to $250,000 or $500,000 due to the involuntary conversion of a principal residence if the use and ownership tests are satisfied. Taxpayers normally prefer to exclude gain if the use and ownership tests are satisfied rather than defer gain under the involuntary conversion provisions.

If taxpayers make a proper and timely replacement of the residence subject to the involuntary conversion, gain may be excluded up to $250,000, or $500,000, and the remaining gain may be deferred. For purposes of applying the involuntary conversion provisions, the amount realized due to the involuntary conversion is reduced by any gain excluded under Sec. 121.[71]

EXAMPLE I:12-62 ▶ The Kochs' principal residence, with an adjusted basis of $200,000, has been used and owned by them for nine years. The house is destroyed by a hurricane, and the Kochs receive insurance proceeds of $820,000. Four months later, they purchase another residence for $900,000. The Kochs have a realized gain of $620,000 and may exclude $500,000 under Sec. 121. The remaining $120,000 gain may be deferred and the basis of their replacement residence is $780,000 ($900,000 – $120,000). ◀

Because the amount realized is reduced by the gain excluded, the Kochs could have deferred the $120,000 gain in the above example by investing only $320,000 in a replacement residence.

If gain due to the involuntary conversion of a principal residence is deferred under Sec. 1033, the holding period of the replacement residence includes the holding period of the converted property for purposes of satisfying the use and ownership tests of Sec. 121.[72] The Kochs satisfy the use and ownership requirements for Sec. 121 with respect to their new residence in Example I:12-62 because gain is deferred under Sec. 1033.

A loss due to a condemnation of a personal residence is not recognized. If the loss is due to a casualty, the deductibility of the loss follows the rules for casualty losses of nonbusiness property (see Chapter I:9).

TAX PLANNING CONSIDERATIONS

OBJECTIVE 4

Describe tax planning considerations for nontaxable exchanges

AVOIDING THE LIKE-KIND EXCHANGE PROVISIONS

In some cases, a taxpayer may prefer a taxable exchange to a nontaxable like-kind exchange. For instance, if the gain is taxed as a capital gain and the taxpayer has capital

[70] Sec. 121(d)(5)(A).
[71] Sec. 121(d)(5)(B).
[72] Sec. 121(d)(8).

losses to offset the gain, the taxpayer may prefer to recognize the gain during the current year. If gain on the exchange is recognized instead of deferred, the basis of the property received in the exchange is higher.

EXAMPLE I:12-63 ▶ Connie owns land with a $20,000 basis. The land is held as an investment. Connie exchanges the land for a duplex with a $100,000 FMV. Because the exchange qualifies as a like-kind exchange, no gain is recognized and Connie's basis for the duplex is $20,000. If the exchange does not qualify as a like-kind exchange (e.g., the land is a personal-use asset), Connie recognizes an $80,000 capital gain. Connie's basis for the duplex is $100,000. The basis of the duplex, except for the portion allocable to land, is eligible for depreciation. ◀

If an exchange qualifies as a like-kind exchange, no loss on the exchange is recognized. A taxpayer who prefers to recognize a loss should avoid making a like-kind exchange. It may be advantageous to sell the property to recognize the loss and then purchase the replacement asset in two independent transactions. If the sale and purchase transactions are with the same party, the IRS may maintain that the like-kind exchange rules apply because the two transactions are in substance a like-kind exchange (i.e., the judicial doctrine of substance over form might be applied).

SALE OF A PRINCIPAL RESIDENCE

Election Provision. When the requirements of Sec. 121 are satisfied, gain is excluded unless the taxpayer elects not to have Sec. 121 apply.[73]

EXAMPLE I:12-64 ▶ Paula has owned a house in Wyoming for eight years and occupied it until 18 months ago when she moved to Idaho and purchased a new house. She sells the house in Wyoming on May 23, 2019, and the realized gain is $25,000. Paula anticipates that she will move next year and have to sell the house in Idaho which has appreciated more than $100,000 since purchased. Paula may want to elect not to have Sec. 121 apply and recognize the $25,000 gain and then use the exclusion when she sells the house in Idaho next year. ◀

Property Used as Residence and for Business. If a house is used for both residential use and business use, the tax treatment depends on whether or not the business portion of the house is conducted in a separate structure. If the business portion of the house is conducted in a separate structure, the sale should be treated as a sale of two assets, the residence and the portion of the property used as a business. The Sec. 121 exclusion only applies to the residence portion of the property.

EXAMPLE I:12-65 ▶ Mormor owns a one-acre lot with a house she uses as her residence and a barn that she uses to display and sell antiques. She purchased the property in 1990 for $100,000 and $10,000 of the purchase price was allocated to the barn. Depreciation of $8,000 has been allowed for the barn. She sells the property during the current year for $300,000 and estimates that 10% of the price received is for the barn. She may exclude the $180,000 ($270,000 − $90,000) gain on the sale of the residence. Her $22,000 ($30,000 − $8,000) gain on the sale of the barn is recognized. ◀

ADDITIONAL COMMENT

As explained in Chapter I:13, Mormor's $24,000 gain in Example I:12-65 is a Sec. 1231 gain and $8,000 is taxed at a maximum rate of 25% because it is unrecaptured Sec. 1250 gain.

If the business activity is conducted within the house and not in a separate structure, the sale does not have to be treated as a sale of two different assets. However, gain attributable to depreciation after May 6, 1997, is not eligible for the exclusion. The remaining gain is eligible for the exclusion.

EXAMPLE I:12-66 ▶ Kate, who is self-employed, purchased a house in 2009 for $200,000 and uses 15% of the house as an office. The office is used on a regular and exclusive basis and is her principal place of business. Depreciation of $3,400 has been deducted when she sells the house for $430,000. Her gain is $233,400 ($430,000 − $196,600), and she may exclude $230,000 but must recognize $3,400 of the gain. ◀

The government's decision to allow Kate to treat the property in the above example as one property instead of two is beneficial for her. If the property was viewed as two properties or if the office was in a separate structure, only $195,500 ($365,500 − $170,000) of the gain would qualify for the exclusion.

[73] Sec. 121(f).

EXAMPLE I:12-67 ▶ Bobbi purchased a house on March 1, 2008 and used it as her principal residence until March 1, 2010, when she rented the house to the Allens while she lived with her mother. On November 1, 2017, the Allens' lease expired and Bobbi moved back into the house. She sells the house on July 12, 2019, and realizes a gain of $210,000. She may not exclude any of the gain because she has not used the property as her principal residence for two of the last five years. ◀

If Bobbi in the above example did satisfy the two-out-of-five-year requirement, gain equal to depreciation would first be recognized. A portion of the remaining gain could not be excluded because of the nonqualified use after 2008.

EXAMPLE I:12-68 ▶ Assume the same facts as in the above example except that Bobbi sells the house on December 1, 2019. Because she has used the property as her principal residence for two of the last five years, she may exclude part of the excess of the $210,000 gain over depreciation allowed. Ninety-two months of the use is nonqualified use because of its use as rental property for 92 months after 2008. Because she owned the property for 141 months and nonqualified use amounted to 92 months, 92/141 of the gain remaining after gain recognized due to depreciation is recognized. ◀

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 5

Describe compliance and procedural considerations for nontaxable exchanges

REPORTING OF INVOLUNTARY CONVERSIONS

The election to defer recognition of the gain from an involuntary conversion is made by not reporting the gain as income for the first year in which gain is realized. All details pertaining to the involuntary conversion (including those relating to the replacement of the converted property) should be reported for the taxable year or years in which any of the gain is realized.[74]

ADDITIONAL COMMENT

The failure to include gain from an involuntary conversion in gross income is deemed to be an election even though the details are not reported.

A taxpayer who elects to defer recognition of the gain but does not make a proper replacement of the property within the required period of time must file an amended return for the year or years for which the election was made. An amended return may be needed if the cost of the replacement property is less than expected at the time of the election. All details pertaining to the replacement of converted property must be reported in the year in which replacement occurs.[75]

EXAMPLE I:12-69 ▶ Bob's property, with a $40,000 adjusted basis, was destroyed by a storm in 2018. Bob received $45,000 insurance proceeds in 2018 and planned to purchase property similar to the converted property in 2019 at a cost of $47,000. Bob elected to defer recognition of the gain in 2018. In 2019 the replacement property is purchased for $44,500. Bob must file an amended return for 2018 and recognize a $500 ($45,000 − $44,500) gain. ◀

ADDITIONAL COMMENT

The replacement period may be extended if special permission is obtained from the IRS.

A taxpayer who either is ineligible or does not want to defer the gain must report the gain in the usual manner. If a taxpayer does not elect to defer the gain in the year the gain is realized and the replacement period has not expired, a subsequent election may be made. In such an event, a refund claim should be filed for the tax year in which the gain was realized and previously recognized.[76]

Taxpayers who do not initially elect to defer the gain from an involuntary conversion may later make the election, but the election may not subsequently be revoked. The Tax Court has ruled that the Treasury Regulations allow the filing of an amended return for a year in which the election is made only if proper replacement is not made within the specified time period or the replacement is made at a cost lower than anticipated at the time of the election.[77] The IRS takes the position that taxpayers who designate qualifying property as replacement property may not later designate other qualifying property as the replacement property.[78]

EXAMPLE I:12-70 ▶ In 2017 Troy collected $200,000 from an insurance company as the result of the destruction of rental property with a $140,000 basis. He made the election to defer the gain realized in 2017 and attached a supporting schedule of details regarding the involuntary conversion including

[74] Reg. Sec. 1.1033(a)-2(c)(2).
[75] *Ibid.*
[76] *Ibid.*
[77] *John McShain*, 65 T.C. 686 (1976).
[78] Rev. Rul. 83-39, 1983-1 C.B. 190.

a designation of replacement property to be acquired in 2018. In 2018 Troy purchased the designated replacement rental property for $225,000. In 2019 Troy purchases other rental property for $400,000 and now wants to designate that property as the replacement property for the property destroyed in 2017. Troy may not designate the property acquired in 2019 as the replacement property because the rental property purchased in 2018 was already designated as such. ◀

REPORTING OF SALE OR EXCHANGE OF A PRINCIPAL RESIDENCE

Taxpayers only have to report the sale if any of the gain is not excluded. If the taxpayer does not qualify to exclude all of the gain or elects not to exclude the gain, the entire gain realized is reported on Schedule D either on line 1, if residence is held for one year or less, or on line 8. On the line below where the entire gain is shown, the taxpayer should indicate on the following line the amount of the gain that is being excluded as a loss (i.e., show in parentheses).

Publication 523, Selling Your Home, provides a series of worksheets that may be used to determine if any gain is recognized. If the taxpayer has to utilize the exceptions to the two-year ownership and use tests, the publication provides additional guidance on calculating the impact of the exceptions.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:12-1 Evaluate the following statement: The underlying rationale for the nonrecognition of a gain or loss resulting from a like-kind exchange is that the exchange constitutes a liquidation of the taxpayer's investment.

I:12-2 Why might a taxpayer want to avoid having an exchange qualify as a like-kind exchange?

I:12-3 Debbie owns a building with a basis of $300,000 and a holding period starting on May 10, 2007. Debbie exchanges the building for a building owned by Doug on July 23, 2019. Doug's building has a FMV of $500,000. Both Debbie and Doug use the building in their businesses.

a. What is Debbie's basis for the building received in the exchange and when does the holding period start for that building?

b. If Debbie and Doug are related taxpayers, explain what action could occur that would cause the exchange not to qualify as a like-kind exchange.

I:12-4 Kay owns real property used in her business and exchanges the property for other like-kind real property and marketable securities.

a. Will Kay's recognized gain ever exceed the realized gain?

b. Will Kay's recognized gain ever exceed the FMV of the marketable securities?

c. What is the basis of the marketable securities received?

d. When does the holding period of the marketable securities begin?

I:12-5 When may a sale of real property and a subsequent purchase of real property be treated as a like-kind exchange?

I:12-6 When determining whether property qualifies as like-kind property, is the quality or grade of the property considered?

I:12-7 When does a nonsimultaneous exchange qualify as a like-kind exchange?

I:12-8 Burke is anxious to purchase land owned by Kim for use in his trade or business. Kim's basis for the land is $150,000, and Burke has offered to pay $800,000 if she will sell within the next 10 days. Kim is interested in selling but wants to avoid recognizing gain. What advice would you give?

I:12-9 Lanny wants to purchase a farm owned by Jane, but Jane does not want to recognize a gain on the transfer of the appreciated property. Explain how a three-party exchange might be used to allow Lanny to obtain the farm without Jane having to recognize a gain.

I:12-10 Does the receipt of boot in a transaction that otherwise qualifies as a like-kind exchange always cause the exchange to be at least partially taxable?

I:12-11 When must a taxpayer who gives boot recognize a gain or loss?

I:12-12 What is the justification for Sec. 1033, which allows a taxpayer to elect to defer a gain resulting from an involuntary conversion? May a taxpayer elect under Sec. 1033 to defer recognition of a loss resulting from an involuntary conversion?

I:12-13 Must property be actually condemned for the conversion of property to be classified as an involuntary conversion? Explain.

I:12-14 What are severance damages? What is the tax treatment for severance damages received if the taxpayer does not use the severance damages to restore the retained property?

I:12-15 The functional use test is often used to determine whether the replacement property is similar or related in service or use to the property converted. Explain the functional use test.

I:12-16 In what situations may a gain due to an involuntary conversion of real property be deferred if like-kind property is purchased to replace the converted property?

I:12-17 Prior to the Taxpayer Relief Act of 1997, taxpayers could defer a gain on the sale of a principal residence sold before May 7, 1997, if they purchased and occupied a new principal residence within two years before or after the sale and the cost of the new residence was at least equal to the adjusted sales price of the old residence. Some taxpayers who were at least 55 years old had a once-in-a-lifetime exclusion up to $125,000 if they owned and used the property as a principal residence for at least three years of the five-year-period ending on the date of sale. Discuss why current law with respect to the sale of a personal residence is more favorable than the law prior to the Taxpayer Relief Act of 1997.

I:12-18 One reason Congress expanded the exclusion of gain on the sale of a principal residence and eliminated the deferral provision was to eliminate the need for many taxpayers to keep records of capital improvements that increase the basis of their residence. Why might taxpayers still need to maintain such records to substantiate the adjusted basis of their principal residence?

I:12-19 Steve maintains that the cost of wallpapering his three-bedroom house is a capital expenditure while Martha maintains that the cost of wallpapering her three-bedroom house is an expense. Steve uses his house as his personal residence while Martha's house is rental property. Explain why Steve and Martha view the cost of wallpapering differently.

I:12-20 The Nelsons purchased a new residence in 2002 for $300,000 from David who owned and used the residence as rental property. When the Nelsons wanted to purchase the property, it was being rented to tenants who had four months remaining on their lease. The Nelsons paid the tenants $1,000 to relinquish the lease and vacate the property. In 2006, they added a family room to the house at a cost of $79,200. In 2008, they suffered hail damage to the roof and received $7,000 from the insurance company. They did not repair the damaged roof, and no casualty loss deduction was allowed. What is their adjusted basis for the house today?

I:12-21 What requirements must be satisfied by an unmarried taxpayer under Sec. 121 to be eligible for the election to exclude a gain up to $250,000 on the sale or exchange of a principal residence?

ISSUE IDENTIFICATION QUESTIONS

I:12-22 John owns 25% of the ABC Partnership and Jane owns 25% of the XYZ Partnership. The ABC Partnership owns a farm and produces corn and the XYZ Partnership owns a farm and produces soybeans. John and Jane agree to exchange their partnership interests. What tax issues should John and Jane consider?

I:12-23 Chauvin Housing Corporation operates primarily in the United States and owns a large houseboat that can provide sleeping accommodations for as many as ninety individuals. Chauvin is considering a possible exchange of its houseboat, with an adjusted basis of $3,000,000, for a new houseboat with a FMV of $7,000,000. Chauvin will also need to pay $1,200,000 cash. Chauvin is considering the possible relocation of the houseboat to Finland. What tax issues should Chauvin consider?

I:12-24 Jaharta, Inc., owns land used for truck farming and cattle raising. The California Division of Highways condemned 36 acres of Jaharta's land to build a new highway. Jaharta owned a 50% interest in property being used for apricot, prune, and walnut orchards. Jaharta used the proceeds received as a result of the condemnation to purchase the remaining interest in the property being used for orchards. What tax issues should Jaharta consider?

PROBLEMS

I:12-25 ***Like-Kind Property.*** Which of the following exchanges qualify as like-kind exchanges under Sec. 1031?

a. Acme Corporation stock held for investment purposes for Mesa Corporation stock also held for investment purposes
b. A motel used in a trade or business for an apartment complex held for investment
c. A pecan orchard in Texas used in a trade or business for an orange grove in Florida used in a trade or business
d. A one-third interest in a general partnership for a one-fourth interest in a limited partnership
e. Inventory for equipment used in a trade or business
f. Unimproved land held as an investment for a warehouse used in a trade or business
g. An automobile used as a personal-use asset for marketable securities held for investment

I:12-26 ***Like-Kind Property.*** Which of the following exchanges qualify as like-kind exchanges under Sec. 1031?

a. A motel in Texas for a motel in Italy
b. An office building held for investment for an airplane to be used in the taxpayer's business
c. Land held for investment for marketable securities held for investment
d. Land held for investment for a farm to be used in the taxpayer's business

I:12-27 ***Like-Kind Exchange: Boot.*** Determine the realized gain or loss, the recognized gain or loss, and the basis of the land received for the following like-kind exchanges:

Basis of Land Exchanged	*FMV of Boot Received*	*FMV of Land Received*
$20,000	$ –0–	$85,000
45,000	14,000	70,000
60,000	25,000	65,000
70,000	38,000	60,000
90,000	22,000	55,000

I:12-28 ***Exchange: Personal Property.*** Beach Corporation owns a computer with a $34,000 adjusted basis. The computer is used in the company's trade or business. What is the realized and recognized gain or loss for each of the following independent transactions where the computer is exchanged for?

a. A used computer with a $70,000 FMV plus $16,000 cash.
b. A used computer with a $18,000 FMV plus $7,000 cash.
c. Marketable securities with a $61,000 FMV.

I:12-29 ***Like-Kind Exchange: Liabilities.*** Paul owns a building used in his business with an adjusted basis of $340,000 and a $750,000 FMV. He exchanges the building for a building owned by Kelley. Kelley's building has a $950,000 FMV but is subject to a $200,000 liability. Paul assumes Kelley's liability and uses the building in his business. What is Paul's

a. realized gain?
b. recognized gain?
c. basis for the building received?

I:12-30 ***Like-Kind Exchange: Liabilities.*** Helmut exchanges his apartment complex for Heidi's farm, and the exchange qualifies as a like-kind exchange. Helmut's adjusted basis for the apartment complex is $600,000 and the complex is subject to a $180,000 liability. The FMV of Heidi's farm is $770,000 and the farm is subject to a $100,000 liability. Each asset is transferred subject to the liability. What is Helmut's recognized gain and the basis of the new farm?

I:12-31 ***Like-Kind Exchange: Liabilities.*** Carol owns land used in her business with a basis of $70,000 and a fair market value of $90,000. She is planning to exchange the land for a warehouse owned by Jeff and used in his business. Jeff's warehouse has a basis of $50,000 and a fair market value of $110,000. The warehouse is also subject to a liability of $20,000. Carol has agreed to assume the liability for Jeff. What is Jeff's recognized gain and his basis in the new land?

I:12-32 ***Like-Kind Exchange: Transfer of Boot.*** Wayne exchanges unimproved land with a $50,000 basis and marketable securities with a $10,000 basis for an eight-unit apartment building having a $150,000 FMV. The land and marketable securities are held by Wayne as investments, and the apartment building is held as an investment. The marketable securities have a $25,000 FMV. What is his realized gain, recognized gain, and the basis for the apartment building?

I:12-33 ***Like-Kind Exchange: Related Parties.*** Bob owns a duplex used as rental property. The duplex has a basis of $86,000 and $300,000 FMV. He transfers the duplex to Cindy, his sister, in exchange for a triplex that she owns. The triplex has a basis of $279,000 and a $300,000 FMV. Two months after the exchange, Cindy sells the duplex to a business associate for $312,000. Determine:

a. Bob's realized and recognized gain on the exchange.
b. Cindy's realized and recognized gain on the exchange.

I:12-34 ***Like-Kind Exchange: Related Parties.*** Assume the same facts as in I:12-33 except Cindy sells the duplex to a nonrelated individual more than two years after the exchange with Bob. Ignore any changes in adjusted basis due to depreciation that would have occurred after the exchange. Determine:

a. Bob's realized and recognized gain on the exchange.
b. Cindy's realized and recognized gain on the exchange.
c. Cindy's realized and recognized gain on the sale.

I:12-35 ***Involuntary Conversion.*** Duke Corporation owns an office building with a $400,000 adjusted basis. The building is destroyed by a tornado. The insurance company paid $750,000 as compensation for the loss. Eight months after the loss, Duke uses the insurance proceeds and other funds to acquire a new office building for $682,000 and machinery for one of the company's plants at a $90,000 cost. Assuming that Duke elects to defer as much of the gain as possible, what is the recognized gain, the basis for the new office building, and the basis for the machinery acquired?

I:12-36 ***Involuntary Conversion: Replacement Period.*** The Madison Corporation paid $3,000 for several acres of land in 1995 to use in its business. The land is condemned and taken by the state in March 2019. The company receives $25,000 from the state. Whenever possible, the corporation elects to minimize taxable income. For each of the following independent cases, what is the recognized gain or loss in 2019 on the conversion and the tax basis of the replacement property (replacement land will be purchased in July)?

a. 2020 for $22,500.
b. 2021 for $28,500.
c. 2022 for $23,600.

I:12-37 ***Involuntary Conversion of Real Property.*** On April 27, 2019, an office building owned by the Ava James Corporation, an offshore drilling company that is a calendar-year taxpayer, is destroyed by a hurricane. The basis of the office building is $600,000, and the corporation receives $840,000 from the insurance company.

a. To defer the entire gain due to the involuntary conversion, what amount must the corporation pay for replacement property?
b. To defer the gain due to the involuntary conversion, by what date must the corporation replace the converted property?
c. If Ava James replaces the office building by purchasing a 900,000 gallon storage tank for $810,000, may it defer any of the gain due to the involuntary conversion?
d. Will answers to Parts b and c change if the office building had been condemned by the state? Explain.

I:12-38 ***Involuntary Conversion: Different Methods of Replacement.*** On September 3, 2019, Federal Corporation's warehouse is totally destroyed by fire. $800,000 of insurance proceeds are received, and the realized gain is $300,000. Whenever possible, Federal elects to defer gains. For each of the following independent situations, what is the amount of gain recognized? Explain why the gain is not deferred, if applicable.

a. On October 23, 2019, Federal purchases a warehouse for $770,000.
b. On February 4, 2020, Federal purchases 100% of the Park Corporation, which owns a warehouse. Federal pays $895,000 for the stock.
c. On November 20, 2021, Federal purchases an apartment complex for $900,000.
d. On March 26, 2022, Federal purchases a warehouse for $888,000.

I:12-39 ***Severance Damages.*** Twelve years ago, Marilyn purchased two lots in an undeveloped subdivision as an investment. Each lot has a $10,000 basis and a $40,000 FMV when the city condemns one lot for use as a municipal sewage treatment plant. As a result of the condemnation, Marilyn receives $40,000 from the city. Because the value of the other lot is reduced, the city pays $7,500 severance damages. She does not plan to replace the condemned lot. What is her:

a. recognized gain due to the condemnation?
b. recognized gain from the receipt of the severance damages?
c. basis for the lot she continues to own?

I:12-40 ***Sale of a Principal Residence.*** Marc, age 45, sells his personal residence on May 15, 2019, for $180,000. He pays $8,000 in selling expenses and $900 in repair expenses to help sell the residence. He has lived in the residence since 1993, when he purchased it for $55,000. In 2000, he paid $6,000 to install central air conditioning. If Marc purchases a new principal residence in December of the current year for $162,000, what is the realized gain, recognized gain, and the basis for the new residence?

I:12-41 ***Sale of a Principal Residence.*** Mr. and Mrs. Rusbarsky purchased a residence on June 12, 2016, for $200,000. On March 12, 2019, they sell the residence for $300,000, and selling expenses amount to $11,000. They purchase another house in a new subdivision for $275,000. Determine the gain realized and recognized.

I:12-42 ***Sale of a Principal Residence.*** On January 10, 2019, Kirsten married Joe. Joe sold his personal residence on October 25, 2018, and excluded the entire gain of $175,000. Although they had originally planned to live in the house that Kirsten had received as a gift from her parents in 2010, they decided to purchase a larger house, and Kirsten sold her house 60 days after their wedding and realized a $370,000 gain.

a. If they file a joint return, how much of the $370,000 gain may be excluded?
b. If Kirsten files as married filing separately, how much of the $370,000 gain may be excluded?

I:12-43 ***Involuntary Conversion of Principal Residence.*** Mr. and Mrs. Snell own and live in a house, with an adjusted basis of $300,000, that was purchased in 1995. The house is destroyed by a tornado on March 10 of the current year, and the Snells receive insurance proceeds of $410,000. They purchase another residence for $480,000 four months later.

a. May they exclude the $110,000 gain, and if so, what is the basis of the residence purchased in July?
b. May they defer the $110,000 gain, and if so, what is the basis of the residence purchased in July?

I:12-44 ***Sale of a Principal Residence.*** Mr. and Mrs. Kitchens purchased their first home in Ohio for $135,000 on October 1, 2018. Because Mr. Kitchens' employer transferred him to Utah, they sold the house for $160,000 on January 10, 2019. How much of the gain is recognized?

I:12-45 ***Sale or Other Disposition of a Principal Residence.*** In 1971, Mr. and Mrs. Self purchased their first principal residence for $80,000. In 1996, they sold the house for $300,000 and purchased a new residence for $1.5 million. At that time, the Selfs were allowed to defer the $220,000 gain because they purchased a more expensive residence, but the basis of the residence was reduced by the gain deferred. The Taxpayer Relief Act of 1997 eliminated this deferral provision and made it easier for taxpayers who sell a principal residence to exclude the gain resulting from the sale even if they do not purchase a replacement residence.

In 2002, the Selfs spent $200,000 to add a porch to their house that overlooks the small pond behind their house. In 2005, they hired painters to paint the entire house at a cost of $18,000. They estimate that $20,000 has been spent on routine repairs since 1996, but insurance of $11,000 was collected for the repairs resulting from a small tornado in 2009. No casualty loss deduction was allowed. They hold the residence as joint tenants.

a. What is the current adjusted basis of the house?
b. Mrs. Self is an employee of Bulldog Consulting and has a nice office on the business premises; however, she finds it helpful to use one of the bedrooms as an office to do work in the evenings and on weekends. May the Selfs claim a deduction for depreciation?

c. Determine their recognized gain and character if they sell the house today for $2.8 million.
d. If the property is owned by Mrs. Self instead of owned jointly, determine their recognized gain and character if they sell the house today for $2.8 million.
e. If the property is owned by Mrs. Self instead of owned jointly and Mr. Self dies, will the basis of the house be increased?
f. Determine their recognized gain if they exchange the house today for an apartment complex valued at $2.8 million. The Selfs will purchase another house and hire someone to manage the apartment complex.
g. If the house is destroyed by a fire when its FMV is $2.8 million and the Selfs receive $2.6 million, determine their casualty loss deduction and gain recognized, if any. The Selfs do not plan to purchase another residence.
h. If the Selfs want to purchase another principal residence after collecting the insurance in part g. above, what is the minimum amount they would have to pay for the new residence to avoid recognizing any gain?

I:12-46 ***Unqualified Use.*** Sherron, who is single, purchased a house to use as rental property on April 1, 2008, for $300,000. He moved into the house on June 1, 2018, and used it as a personal residence until August 1, 2019, when he sells the house for $500,000. Depreciation allowed while property was used as rental property amounts to $25,000. Determine his:
a. realized gain on the sale
b. recognized gain on the sale
c. recognized gain on the sale if the house is not sold until August 1, 2020, for $500,000

I:12-47 ***Sale of a Principal Residence: Rental Property.*** For the last five years, Mr. and Mrs. Cockrell rented their furnished basement to local college students. When determining their taxable income each year, they deducted a portion of the utilities, property taxes, interest, and depreciation based on the fact that 15% of the house is used for rental purposes. The original basis of the property is $100,000, and depreciation of $4,000 has been allowed on the rental portion of the property. During the current year, Mr. and Mrs. Cockrell sell the house for $300,000. No selling expenses or fixing-up expenses are incurred. Determine:
a. realized gain on the sale.
b. recognized gain on the sale.

I:12-48 ***Multiple Sales of a Principal Residence.*** Consider the following information for Mr. and Mrs. Di Palma:

- On June 10, 2018, they sold their principal residence for $80,000 and incur $6,000 of selling expenses. The basis of the residence, acquired in 2006, is $50,000.
- On June 25, 2018, they purchased a new principal residence for $90,000 and occupied it immediately.
- On May 10, 2019, they purchase their neighbor's residence for $115,000 and occupy the residence immediately.
- On August 29, 2019, they sell the residence purchased on June 25, 2018, for $148,000. They pay $7,000 of selling expenses. Determine:
  a. realized gain on the sale of the residence in 2018.
  b. recognized gain on the sale of the residence in 2018.
  c. realized gain on the sale of the residence in 2019.
  d. recognized gain on the sale of the residence in 2019.

I:12-49 ***Multiple Sales of a Principal Residence.*** Consider the following information for Mr. and Mrs. Gomez:

- On May 26, 2018, they sold their principal residence, acquired in 2001, for $200,000. They paid $8,000 of selling expenses. Their basis in the residence was $70,000.
- On July 25, 2018, they purchased a new principal residence for $250,000.
- On June 2, 2019, Mr. Gomez, a bank officer, is transferred to another bank in the northern part of the state and they vacate their house.
- On July 1, 2019, they purchase a new principal residence for $420,000.
- On October 6, 2019, they sell the residence that was purchased on July 25, 2018, for $520,000. They pay $30,000 of selling expenses. Determine:

a. realized gain on the sale of the residence in 2018.
b. recognized gain on the sale of the residence in 2018.
c. realized gain on the sale of the residence in 2019.
d. recognized gain on the sale of the residence in 2019.

COMPREHENSIVE PROBLEM

I:12-50 Paden, who is single and has been employed as an accountant for 27 years with Harper, Inc., lost his job due to company downsizing. His last day of employment is July 31, 2019, and Harper provides a $9,000 severance payment. The severance payments are based on an employee's time of employment. During the year, Paden received a salary from Harper of $56,000. Harper also paid $8,500 of Paden's medical insurance premiums.

In May 2019, Paden, who had always wanted to be associated with a football team, applied for the head coaching job at Hawk University in Iowa and, much to his surprise, received the job beginning on August 1. In June and July, Paden paid $4,500 to take courses in sports management at the local university. Hawk University is substantially short of funding and Paden paid $2,000 for entertainment expenses related to his job and $500 for supplies. No reimbursement was received.

His salary from Hawk is $5,000 per month payable at the end of each month. His salary for December was not received until January 6, 2020.

On August 1, he sold his house for $329,000 in Texas and paid a sales commission of $14,000. He inherited the house 20 years ago when his mother died. Her basis for the house was $37,000 and the FMV when she died was $50,000. Property taxes for the 2019 calendar year amount to $3,600, and property taxes were apportioned at the closing. Property taxes are payable on October 1. He paid $2,100 of interest on home equity debt of $30,000, incurred to purchase a new car.

To move to Iowa, he drove 700 miles and spent $62 for meals during the trip in July. Movers charged $4,150 to move his household items. He purchased a new house in Iowa for $150,000 on August 15 and borrowed $110,000. He also agreed to pay all property taxes for 2019. Real property taxes for the home in Iowa will be paid on January 30, 2020, and amount to $1,500.

Interest on the $110,000 debt during the current year is $1,930. To obtain the loan, Paden paid points of $1,000.

He contributed common stock (basis of $1,000 and FMV of $6,000) held as an investment for three years to Hawk University. He also paid state income taxes of $1,765 (which was greater than state sales taxes for the year) as well as personal property taxes of $435 for his car.

Paden sold 200 shares of Dell Corporation stock on April 10 for $100 per share. His basis was $145 per share. On May 1, he purchased 300 shares of Dell at $89 per share.

Determine:

1. gross income without considering the sale of his house or the Dell Corporation stock.
2. recognized gain due to the sale of his house.
3. net capital gain.
4. adjusted gross income.
5. total amount of itemized deductions.
6. taxable income.
7. basis of his house in Iowa.
8. if the sales price for his home was $470,000 instead of $370,000, would his taxable income increase by more than $100,000. If yes, explain.

TAX STRATEGY AND CRITICAL THINKING PROBLEM

I:12-51 ***Sale of a Principal Residence.*** Ray and Ellie have each owned a principal residence used for more than five years. Ray's residence has an adjusted basis of $100,000 and a FMV of $325,000, while Ellie's residence has an adjusted basis of $300,000 and a FMV of $490,000. They plan to marry and will purchase another house.

a. Should they sell their houses before the marriage in order to minimize their taxes?
b. Will your answer to Part a change if the FMV of Ellie's house is $690,000?
c. In Part b, what tax strategy should Ray and Ellie consider?

TAX FORM/RETURN PREPARATION PROBLEMS

I:12-52 ***Short Tax Form.*** On October 29, 2018, Miss Joan Seely (SSN 123-45-6789) sells her principal residence for $150,000 cash. She purchased the residence on May 12, 2009, for $85,000. She spent $12,000 for capital improvements in 2009. To help sell the house, she pays $300 for minor repairs. The realtor's commission amounts to $7,500. Her old residence is never rented out or used for business. Complete the worksheets in Publication 523 to determine the recognized gain for Miss Seely for 2018.

I:12-53 At the beginning of 2018, Donna Harp was employed as a cinematographer by Farah Movie, Inc., a motion picture company in Los Angeles, California. In June, she accepted a new job with Ocala Production in Orlando, Florida. Donna is single and her Social Security number is 000-00-1111. She sold her house in California on August 10 for $500,000. She paid a $14,000 sales commission. The house was acquired on March 23, 1991, for $140,000.

The cost of transporting her household goods and personal effects from California to Orlando amounted to $2,350. To travel from California to Florida, she paid travel and lodging costs of $370 and $100 for meals.

On July 15, she purchased a house for $270,000 on 1225 Minnie Lane in Orlando. To purchase the house, she incurred a 20-year mortgage for $170,000. To obtain the loan, she paid points of $3,400. The $3,600 of property taxes for the house in Orlando were prorated with $1,950 being apportioned to the seller and $1,650 being apportioned to the buyer. In December of the current year she paid $3,600 for property taxes.

Other information related to her return:

Salary from Farah Movie, Inc.	$30,000
Salary from Ocala Production, Inc.	70,000
Federal income taxes withheld by Farah	6,000
Federal income taxes withheld by Ocala	22,000
FICA taxes withheld by Farah	2,295
FICA taxes withheld by Ocala	5,355
Interest income from Sun National Bank	1,800
Dividend income (qualifying dividends)	10,000
Interest paid for mortgage:	
Home in California	6,780
Home in Orlando	3,800
Property taxes paid in California	4,100
Sales taxes paid in California and Florida	3,125
State income taxes paid in California	2,900

a. Determine the amount of recognized gain on the sale of the residence.
b. Prepare Forms 3903, 8960, and 1040, including Schedules A, B, and D.

I:12-54 Jim Sarowski (SSN 000-00-2222) is 70 years old and single. He received Social Security benefits of $16,000. He works part-time as a greeter at a local discount store and received wages of $7,300. Federal income taxes of $250 were withheld from his salary. Jim lives at Rt. 7 in Daingerfield, Texas.

In March of 2018, he purchased a duplex at 2006 Tennessee Street to use as rental property for $100,000, with 20% of the price allocated to land. During the year, he had the following receipts and expenditures with respect to the duplex:

Rent receipts	$8,800
Interest paid	5,900
Property taxes	1,400
Insurance	800
Maintenance	300

Other expenditures during the year:

Contributions to the church	$2,600
Personal property taxes	225
Sales tax	345

On July 24, he exchanged ten acres of land for a car with a $16,500 FMV to be held for personal use. The land was purchased on November 22, 1993, for $18,000 as an investment. Because of pollution problems in the area, the value of the land declined.

On December 1, he sold his residence, which had been his home for 30 years, for $475,000. Sales commissions of $16,000 were paid, and the adjusted basis for his home is $110,000. He plans to rent an apartment and does not plan to purchase another home. His only other sale of a principal residence occurred 32 years ago.

a. Determine the amount of recognized gain on the sale of the residence.

b. Prepare Forms 4562 and 1040, including Schedules D and E.

CASE STUDY PROBLEM

I:12-55 The Electric Corporation, a publicly held corporation, owns land with a $1,600,000 basis that is being held for investment. The company is considering exchanging the land for two assets owned by the Quail Corporation: land with a FMV of $4,000,000 and marketable securities with a $1,000,000 FMV. Both assets will be held by the Electric Corporation for investment, although the corporation is considering the possibility of developing the land and building residential houses. The president of the corporation has hired you to prepare a report explaining how the exchange will affect the corporation's reported net income and its tax liability. The corporation has a tax rate of 21%.

TAX RESEARCH PROBLEMS

I:12-56 For the last nine years, Mr. and Mrs. Orchard live in a residence located on eight acres. In January of the current year they sell the home and two acres of land. The purchaser of the residence does not wish to own the entire eight acres of land. In December they sell the remaining six acres of land to another individual for $60,000. The house and the land have never been used by the Orchards in a trade or business or held for investment. The realized gains resulting from the two sales are computed as follows:

	House and Two Acres January Sales	*Eight Acres December Sale*
Selling price	$140,000	$ 60,000
Minus: Selling expenses	(8,000)	(3,000)
Amount realized	$132,000	$ 57,000
Minus: Basis	(80,000)	(18,000)
Realized gain	$ 52,000	$ 39,000

As a result of the sales described above, what is the amount of realized gain that must be recognized during the current year?

A partial list of research sources is:

- Reg. Sec. 1.121-1(b)

I:12-57 George, age 68, decides to retire from farming and is considering selling his farm. The farm has a $100,000 basis and a $400,000 FMV. George's two sons are not interested in farming. Both sons have large families and would like to own houses suitable for their needs. The Iowa Corporation is willing to purchase George's farm. George's tax advisor suggests that Iowa Corporation should buy the two houses the sons want to own for $400,000 and then exchange the houses for George's farm. After the exchange, George could make a gift of the houses to the sons.

a. If the transactions are executed as suggested by the tax advisor, George's recognized gain will be $300,000. Explain why the transaction does not qualify as a like-kind exchange.

b. George wants the exchange to qualify as a like-kind exchange and still help his sons obtain the houses. What advice do you have for him?

A partial list of research sources is:

- *Dollie H. Click,* 78 T.C. 225 (1982)
- *Fred S. Wagensen,* 74 T.C. 653 (1980)

I:12-58 On March 10, 2016, Elizabeth, a college professor, purchased a house for $300,000. She did not move into the house until August 8, 2016. On August 1, 2017, she accepted a position as a visiting professor at Hogwatts University for one year and moved to Liverpool where she rented an apartment. While away at Hogwatts, two of her former students lived in the house but did not pay rent. She returned to the house on August 1, 2018,

and lived in the house until July 15, 2019, when she sold the house for $500,000. The realtor's commission was $35,000. Determine her recognized gain.

A partial list of research sources is:

- Reg. Sec. 1.121-1(c)

I:12-59 Mr. and Mrs. Hattan have lived in their residence for 20 years and purchased the house for $100,000 as joint tenants with right of survivorship. Mr. Hattan died in May of the current year when the house's FMV was $800,000. Mrs. Hattan wants to sell the house. What is the tax effect of selling the house this year for $825,000 or next year for $830,000?

A partial list of research sources is:

- Sections 121 and 1014

I:12-60 Joseph Allen, who is single, purchased his first house in Orono, ME one year ago for $200,000. Katahdin wants to purchase the house for $360,000. Refer to the regulations to determine if he may exclude part of the gain in the following independent cases:

a. He has been unemployed for 16 months and has a chance to start work for Penobscot Manufacturing whose plant is located 62 miles from Joseph's home in Orono.

b. His dependent son, Ryan, has chronic asthma, and the son's doctor has advised Joseph that Ryan should live in a warm, dry climate to mitigate the chronic asthma. Joseph and Ryan move to Nevada.

c. Joseph has become increasingly annoyed at the amount of traffic in his neighborhood although the amount of traffic has not increased much compared to the traffic when he purchased the house.

A partial list of research sources is:

- Reg. Sec. 1.121-3(c), (d), and (e)

CHAPTER

13

PROPERTY TRANSACTIONS: SECTION 1231 AND RECAPTURE



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Understand the basic tax treatment for Sec. 1231 transactions
2. Identify Sec. 1231 property
3. Understand the tax treatment for Sec. 1231 transactions
4. Apply the recapture provisions of Sec. 1245
5. Apply the recapture provisions of Sec. 1250
6. Understand recapture provisions for corporations
7. Describe other recapture applications
8. Describe tax planning considerations for Sec. 1231 assets
9. Describe compliance and procedural considerations for Sec. 1231 assets

CHAPTER OUTLINE

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Chapter I:5 states that all recognized gains and losses must eventually be designated as either capital or ordinary. However, gains or losses on certain types of property are designated as Sec. 1231 gains or losses, which are given preferential treatment under the tax law. Section 1231 property primarily is business property, either real or depreciable property used in a trade or business.[1] A net Sec. 1231 loss, defined as the excess of Sec. 1231 losses over Sec. 1231 gains, is treated as an ordinary loss.[2] Net Sec. 1231 gain, the excess of Sec. 1231 gains over Sec. 1231 losses, is generally treated as long-term capital gain.[3] However, the preferential treatment of Sec. 1231 gains is diminished, principally by the so-called depreciation recapture rules and the five-year lookback rule. This chapter discusses the important rules dealing with Sec. 1231 gains and losses and depreciation recapture.

HISTORY OF SEC. 1231

During the depressed economy of the early and mid-1930s, business property was classified as a capital asset. Many business properties were worth less than their adjusted basis. Instead of selling business properties, taxpayers found it advantageous to retain assets that had declined in value because they could recover the full cost as depreciation. Capital losses had only limited deductibility during this period. To encourage the mobility of capital (i.e., the replacement of business fixed assets), the Revenue Act of 1938 added business property to the list of properties not considered to be capital assets.

KEY POINT

Taxpayers normally prefer to have gains treated as capital gains, and losses treated as ordinary losses. Because Sec. 1231 property receives the preferable treatment for both net gains and losses, it has been said that this property enjoys the best of both worlds.

From 1938 to 1942, gains and losses on the sale or exchange of business property were treated as ordinary gains and losses. Without favorable capital gain treatment, taxpayers with appreciated business properties were reluctant to sell the assets because of the high tax cost. This restriction on the mobility of capital was more significant than usual because business assets had to be shifted into industries that were heavily involved in the production of military goods. Furthermore, taxpayers were often forced to recognize ordinary gains because the government used the condemnation process to obtain business property for the war effort. In 1942, Congress created the predecessor of Sec. 1231, which allowed taxpayers to treat net gains from the sale of business property as capital gains and net losses as ordinary losses. Before 1987, only 40% of an individual's net capital gain might be subject to tax because of the 60% long-term capital gain deduction.

ADDITIONAL COMMENT

Beginning in 2013, higher-income taxpayers also have to pay an additional 3.8% tax on net investment income, which includes capital gains. Generally, for this provision, higher-income taxpayers are defined as those with modified AGI of greater than $200,000 if single or head of household and $250,000 if married, filing jointly. More information on this additional tax can be found in Chapter I:5.

The Tax Reform Act of 1986 eliminated the 60% long-term capital gain deduction for net capital gains. Favorable long-term capital gain treatment was reinstated into the tax law in 1991 in the form of a 28% maximum tax rate applying to net capital gains for noncorporate taxpayers. The Taxpayer Relief Act of 1997 significantly increased the preferential tax treatment by reducing the maximum rate to 20% for net capital gain that is adjusted net capital gain. The maximum rate was reduced by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (2003 Tax Act) to 15%, for sales after May 5, 2003. The American Tax Relief Act of 2012 increased the maximum rate to 20% starting in 2013. For 2019, this maximum rate of 20% applies for single taxpayers with taxable income above $434,550, head of household taxpayers with taxable income above $461,700, and married taxpayers with taxable income above $488,850.

It may also be advantageous to have gains classified as capital or Sec. 1231 if taxpayers have capital losses or capital loss carryovers because of the limitations imposed on the deductibility of capital losses. Furthermore, there are other situations where it may be important for the property to be Sec. 1231 property (e.g., a contribution of appreciated property to a charitable organization).

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[1] (See page I:13-5 for a more complete definition of Sec. 1231 property.)
[2] Secs. 1231(c)(4) and (a)(2).
[3] Secs. 1231(c)(3) and (a)(1). There are several exceptions to this rule that are covered later in this chapter.

Overview of Basic Tax Treatment for Sec. 1231

OBJECTIVE 1

Understand the basic tax treatment for Sec. 1231 transactions

NET GAINS

At the end of the tax year, Sec. 1231 gains are netted against Sec. 1231 losses. If the overall result is a net Sec. 1231 gain, the gains and losses are treated as long-term capital gains (LTCGs) and long-term capital losses (LTCLs), respectively.[4] For the sake of expediency, it is often stated that a net Sec. 1231 gain is treated as a LTCG. However, a portion or all of the net Sec. 1231 gain may be treated as ordinary income because of a special five-year lookback rule (see discussion below).

EXAMPLE I:13-1 ▶ Dawn owns a business that has $20,000 of Sec. 1231 gains and $12,000 of Sec. 1231 losses during the current year. Because the Sec. 1231 gains exceed the Sec. 1231 losses, the gains and losses are treated as LTCGs and LTCLs. After the gains and losses are offset, there is an $8,000 net long-term capital gain (NLTCG). ◀

EXAMPLE I:13-2 ▶ Assume the same facts as in Example I:13-1 except that Dawn also recognizes a $7,000 LTCG from the sale of a capital asset. After considering the $8,000 net Sec. 1231 gain, which is treated as a LTCG, Dawn has a $15,000 NLTCG ($8,000 + $7,000). ◀

NET LOSSES

If the netting of Sec. 1231 gains and losses at the end of the year results in a net Sec. 1231 loss, the Sec. 1231 gains and losses are treated as ordinary gains and losses.[5] For expediency, it is often stated that the net Sec. 1231 loss is treated as an ordinary loss.

EXAMPLE I:13-3 ▶ David owns an unincorporated business and has $30,000 of Sec. 1231 gains and $40,000 of Sec. 1231 losses in the current year. Because the losses exceed the gains, they are treated as ordinary losses and gains. ◀

EXAMPLE I:13-4 ▶ Assume the same facts as in Example I:13-3 except that David receives a $67,000 salary as a corporate employee. David has no other income, losses, or deductions affecting his adjusted gross income (AGI). The Sec. 1231 gains and losses are treated as ordinary gains and losses, and David's AGI is $57,000 ($67,000 salary − $10,000 of ordinary loss). The $40,000 of ordinary losses offsets the $30,000 of ordinary gains and $10,000 of David's salary. ◀

TYPICAL MISCONCEPTION

It is sometimes erroneously thought that each Sec. 1231 gain should be treated as a LTCG and each Sec. 1231 loss as an ordinary loss. However all Sec. 1231 gains and losses must be combined to determine whether the Sec. 1231 gains and losses are LTCGs and LTCLs or ordinary gains and losses.

One important advantage of Sec. 1231 is illustrated in Example I:13-4. Because the Sec. 1231 gains and losses are treated as ordinary, the $10,000 net Sec. 1231 loss is fully deductible in the current year. If the gains and losses were classified as long-term capital gains and losses, David would have a $10,000 net long-term capital loss (NLTCL). Only $3,000 of the $10,000 NLTCL would have been deductible against David's other income. As explained in Chapter I:5, only $3,000 of net capital losses may be deducted from noncapital gain income per year for individual taxpayers.

ADDITIONAL COMMENT

A taxpayer's share of a Sec. 1231 loss from a partnership or S Corporation may be subject to the passive activity loss rules.

Five-Year Lookback Rule Beginning in 1985, the benefits of Sec. 1231 were reduced. For tax years beginning after 1984, any net Sec. 1231 gain is ordinary gain to the extent of any nonrecaptured net Sec. 1231 losses from the previous five years.[6] This provision is referred to as the *five-year lookback rule*. In essence, net Sec. 1231 losses previously deducted as ordinary losses are recaptured by changing what would otherwise be a LTCG into ordinary income.

EXAMPLE I:13-5 ▶ In 2019, Craig recognizes $25,000 of Sec. 1231 gains and $15,000 of Sec. 1231 losses. In 2015, Craig reported $14,000 of Sec. 1231 losses and no Sec. 1231 gains. No other Sec. 1231 gains or losses were recognized by Craig during the five-year period, 2014–2018. The $10,000

[4] Sec. 1231(a)(1).
[5] Sec. 1231(a)(2).
[6] Sec. 1231(c)(1).

HISTORICAL NOTE

Congress reduced the benefits of Sec. 1231 by requiring the recapture of any nonrecaptured net Sec. 1231 loss. This recapture is required because taxpayers have a certain amount of control over the timing of the recognition of Sec. 1231 gains or losses. Taxpayers attempted to recognize Sec. 1231 losses in one year and Sec. 1231 gains in another year to avoid the netting process.

($25,000 – $15,000) of net Sec. 1231 gain in 2019 is treated as ordinary income due to the $14,000 of nonrecaptured net Sec. 1231 losses. ◀

To determine the amount of nonrecaptured net Sec. 1231 losses, compare the aggregate amount of net Sec. 1231 losses for the most recent preceding five tax years with the amount of such losses recaptured as ordinary income for those preceding tax years. The excess of the aggregate amount of net Sec. 1231 losses over the previously recaptured loss is the nonrecaptured net Sec. 1231 loss. In Example I:13-5, the remaining $4,000 of nonrecaptured net Sec. 1231 losses could be recaptured in 2020. In 2020, the preceding five-year period includes 2015 through 2019.

TAX RATE FOR NET SEC. 1231 GAIN

In general, net Sec. 1231 gains are taxed similarly to net long-term capital gains. Thus, a Sec. 1231 gain may be taxed at a rate of zero, 15% or 20%. Section 1231 property must have a holding period of more than one year. Recall from Chapter I:5 that adjusted net capital gain (ANCG) is net capital gain (NCG) determined *without* regard to:

(1) the 28% rate gain (collectible gain and possibly part of Sec. 1202 gain), and
(2) unrecaptured Sec. 1250 gain, which is taxed at no more than 25% as explained later.

ANCG might be taxed at 20%, 15% or zero. If Sec. 1231 property is sold at a gain, the Sec. 1231 gain is LTCG if there are no Sec. 1231 losses or nonrecaptured net Sec. 1231 losses. However, all or part of this gain is unrecaptured Section 1250 gain if the asset is a building. Thus, net Sec. 1231 gain might be taxed today at 15%, 20%, or 25% depending on the taxpayer's taxable income and whether or not the gain is unrecaptured section 1250 gain. Part or all of Sec. 1231 gain due to the sale of real property subject to depreciation that is unrecaptured Sec. 1250 gain is taxed at a maximum of 25%.

EXAMPLE I:13-6 ▶ Savannah, who is single with a tax rate of 24%, which means her taxable income is equal to or less than $160,725, sells land at a gain of $10,000 and other land at a gain of $15,000. Both tracts of land qualify as Sec. 1231 property. She has no other transactions involving capital assets or 1231 property and no nonrecaptured net Sec. 1231 losses. Savannah has net Sec. 1231 gain of $25,000 that is NLTCG and her NCG is $25,000. Her ANCG is $25,000 taxed at a rate of 15%. ◀

EXAMPLE I:13-7 ▶ Assume the same facts as in Example I:13-6 except Savannah also has a $7,000 loss from the sale of a third tract of land that is Sec. 1231 property. Her net Sec. 1231 gain is $18,000. Her NCG is $18,000 and her ANCG is $18,000 taxed at a rate of 15%. ◀

EXAMPLE I:13-8 ▶ Grace, whose tax rate is 10%, sells land that is Sec. 1231 property at a gain of $2,000. She has no other transactions involving capital assets or Sec. 1231 property and no nonrecaptured net Sec. 1231 losses. The $2,000 gain is not taxed since her tax rate for ANCG is zero. ◀

ADDITIONAL COMMENT

Because Sec. 1231 property in Examples I:13-6, I:13-7, and I:13-8 is land, none of the gain is unrecaptured Section 1250 gain.

Applying the Five-Year Lookback Rule. As explained earlier, net Sec. 1231 gain is ordinary income to the extent of nonrecaptured net Sec. 1231 losses. Net Sec. 1231 gain is recharacterized as ordinary income under the five-year lookback rule in the following order:

(1) Net Sec. 1231 gain in the 25% group (unrecaptured Sec. 1250 gain)
(2) Net Sec. 1231 gain in the 20% or 15% group

EXAMPLE I:13-9 ▶ Chris, whose tax rate for ANCG is 15%, has nonrecaptured net Sec. 1231 losses of $20,000 at the beginning of the current year when he recognizes gains from the sale of two assets used in his trade or business and held more than one year. Asset #1 is a building and the entire $14,000 Sec. 1231 gain is unrecaptured Sec. 1250 gain. Asset #2 is land and the Sec. 1231 gain is $15,000. All gain resulting from the sale of asset #1 is ordinary income and $6,000 of the gain from the sale of asset #2 is ordinary income because of the five-year lookback rule. The remaining $9,000 gain from the sale of asset #2 (land) is taxed at 15%. ◀

SECTION 1231 PROPERTY

OBJECTIVE 2

Identify Sec. 1231 property

SECTION 1231 PROPERTY DEFINED

Section 1231 property includes the following types of property:

- Real property or depreciable property used in a trade or business with a holding period of more than one year
- Timber, coal, or domestic iron ore
- Livestock
- Unharvested crops

Each of these types of Sec. 1231 assets are discussed below.

REAL OR DEPRECIABLE PROPERTY USED IN TRADE OR BUSINESS

KEY POINT

Inventory, free publications of the U.S. government, and copyrights, as well as literary, musical, or artistic compositions are not capital assets.

As noted in Chapter I:5, the IRC does not provide a definition of a capital asset. Instead, Sec. 1221 provides a list of noncapital assets that includes both depreciable property and real property used in a trade or business.[7] These properties are treated as Sec. 1231 properties if held for more than one year. Depreciable property and real property used in a trade or business and held for **one year or less** are neither capital assets nor Sec. 1231 property. Any gain or loss resulting from the disposition of such assets is ordinary.

EXAMPLE I:13-10 ▶ The Prime Corporation owns land held as an investment and land used as an employee parking lot. The land held as an investment is a capital asset. The land used as a parking lot is real property used in a trade or business and is not a capital asset. The land used as a parking lot is a Sec. 1231 asset if held for more than one year. ◀

EXAMPLE I:13-11 ▶ Dale, a self-employed plumber, owns an automobile held for personal use and a truck used in his trade. The automobile is a capital asset, but the truck is a Sec. 1231 asset if held for more than one year. As described later, a portion or all of any gain realized on the sale of the truck may be taxed as ordinary income due to the Sec. 1245 depreciation recapture provisions, which are explained on page I:13-8. ◀

KEY POINT

Only property used in a trade or business is included in the definition of Sec. 1231 property. Gains and losses on property held for investment may be included only if the result of a condemnation or casualty.

Certain types of property do not qualify as Sec. 1231 property, even if used in a trade or business. For example, inventory is not Sec. 1231 property. Thus, a sale of inventory results in ordinary gain or loss. Publications of the U.S. government received other than by purchase at its regular sale price; a copyright; literary, musical, or artistic compositions; letters or memorandums; patent, invention, model or design, secret formula or process; or similar properties held by certain taxpayers, such as their creator, are not classified as Sec. 1231 property.[8]

EXAMPLE I:13-12 ▶ Carl, who owns a recording studio, writes a musical composition and obtains a copyright that is later sold to the Hudson Record Company. Because the musical composition is created by the personal efforts of the taxpayer, the musical composition is not Sec. 1231 property or a capital asset, and the sale results in ordinary gain from the sale of an ordinary asset. ◀

KEY POINT

The Hudson Record Company in Example I:13-12 may amortize the cost of the copyright. The copyright is Sec. 1231 property if held more than one year.

Timber. Section 631 allows taxpayers to elect to treat the cutting of timber as a sale or exchange of such timber. To be eligible to make this election, the taxpayer must own the timber or hold the contract right on the first day of the year and for more than one year. Furthermore, the timber must be cut for sale or for use in the taxpayer's trade or business.[9]

REAL-WORLD EXAMPLE

Christmas trees can be included in the definition of Sec. 1231 property.

The gain or loss is determined by comparing the timber's adjusted basis for depletion with its fair market value (FMV) on the first day of the tax year in which it is cut. If the timber is eventually sold for more or less than its FMV (determined on the first day of the year the timber is cut), the difference is ordinary gain or loss.

[7] Sec. 1221(2).
[8] Sec. 1231(b)(1).
[9] Sec. 631(a) and Reg. Sec. 1.631-1.

EXAMPLE I:13-13 ▶ Vermont Corporation owns timber with a $60,000 basis for depletion. The timber, acquired four years ago, is cut during the current year for use in the corporation's business. The FMV of the timber on the first day of the current year is $200,000. Vermont Corporation may elect to treat the cutting of the timber as a sale or exchange and recognize a $140,000 ($200,000 – $60,000) gain. ◀

SELF-STUDY QUESTION

Is the possible inclusion of timber and coal or domestic iron ore in the definition of Sec. 1231 property favorable to the taxpayers who produce these items?

ANSWER

Yes, it can result in income being taxed at rates applicable for LTCG instead of ordinary income from the sale of inventory.

If the election is made to treat the cutting of timber as a sale or exchange, the timber is considered Sec. 1231 property.[10] Thus, the $140,000 gain in Example I:13-13 is Sec. 1231 gain. If the taxpayer does not make the election, the character of any gain or loss depends on whether the timber is held for sale in the ordinary course of the taxpayer's trade or business, held for investment, or held for use in a trade or business.

Coal or Domestic Iron Ore. An owner who disposes of coal (including lignite) or domestic iron ore while retaining an economic interest in it must treat the disposal as a sale.[11] The coal or iron ore is considered Sec. 1231 property.[12] The owner must own and retain an economic interest in the coal or iron ore in place.[13] An economic interest is owned when one acquires by investment any interest in mineral in place and seeks a return of capital from income derived from the extraction of the mineral.

ADDITIONAL COMMENT

Livestock includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals but excludes poultry, fish, frogs, and reptiles.

Livestock. Livestock held by the taxpayer for draft, breeding, dairy, or sporting purposes is considered Sec. 1231 property if held for 12 months or more from the date of acquisition. However, cattle and horses must be held for 24 months or more from the date of acquisition to qualify as Sec. 1231 property.[14]

ADDITIONAL COMMENT

The treatment of unharvested crops as a Sec. 1231 asset is largely a rule of convenience. If the taxpayer were not permitted to treat the crops in this fashion, it would be necessary to allocate the selling price between the land and crops.

Unharvested Crops and Land. An unharvested crop growing on land used in a trade or business is considered Sec. 1231 property if the crop and the land are both sold at the same time to the same person and the land is held more than one year.[15] Section 1231 does not apply to the sale or exchange of an unharvested crop if the taxpayer retains any right or option to reacquire the land.[16]

If Sec. 1231 applies to the sale or exchange of an unharvested crop sold with the land, no deductions are allowed for expenses attributable to the production of the unharvested crop.[17] Instead, costs of producing the crop must be capitalized.

INVOLUNTARY CONVERSIONS

Gains and losses from involuntary conversions of property used in a trade or business generally are classified as Sec. 1231 gains and losses. Involuntary conversions of capital assets that are held in connection with a trade or business or in a transaction entered into for profit also generally qualify for Sec. 1231 treatment. The property that is involuntarily converted must be held more than one year. Certain involuntary conversions are treated differently for income tax purposes. For example, the tax rules are different for condemnations and casualties, even though both are involuntary conversions of property.

CONDEMNATIONS

Gains and losses resulting from condemnations of Sec. 1231 property and capital assets held more than one year are classified as Sec. 1231 gains and losses. As indicated above, the capital assets must be held in connection with a trade or business or with a transaction entered into for profit.[18]

EXAMPLE I:13-14 ▶ Kathryn owns land with a $20,000 basis and a $30,000 FMV as well as a building with a $40,000 adjusted basis and a $26,000 FMV. Both assets are used in her trade or business and have been held for more than one year. As a result of the state exercising its powers of requisition or

[10] Sec. 1231(b)(2) and Reg. Sec. 1.631-1(d)(4).
[11] Sec. 631(c) and Reg. Sec. 1.631-3(a)(1).
[12] Sec. 1231(b)(2) and Reg. Sec. 1.631-3(a)(2).
[13] Reg. Sec. 1.631-3(b)(4).
[14] Sec. 1231(b)(3).
[15] Sec. 1231(b)(4) and Reg. Secs. 1.1231-1(c)(5) and 1(f).
[16] Reg. Sec. 1.1231-1(f).
[17] Sec. 268 and Reg. Sec. 1.268-1.
[18] Secs. 1231(a)(3)(A) and (4)(B).

condemnation, Kathryn is required to transfer both properties to the state for cash equal to their FMVs. No other transfers of assets occur during the current year. The $10,000 gain due to condemnation of the land is a Sec. 1231 gain and the $14,000 loss due to condemnation of the building is a Sec. 1231 loss. ◀

OTHER INVOLUNTARY CONVERSIONS

TYPICAL MISCONCEPTION

The inclusion of gains and losses from condemnations in the netting of the other involuntary conversions is a common error.

Gains or losses resulting from an involuntary conversion arising from fire, storm, shipwreck, other casualty, or theft are not classified as Sec. 1231 gains or losses if the recognized losses from such conversions exceed the recognized gains.[19] In such a case, the involuntary conversions are treated as ordinary gains and losses. However, if the gains from such involuntary conversions exceed the losses, both are classified as Sec. 1231 gains and losses.

EXAMPLE I:13-15 ▶ Jose owns equipment having a $50,000 adjusted basis and a $42,000 FMV and a building having a $30,000 adjusted basis and a $35,000 FMV which are used in Jose's trade or business. The straight-line method of depreciation is used for the building. Both assets are held for more than a year. As a result of a fire, both assets are destroyed, and Jose collects insurance proceeds equal to the assets' FMV. No other transfers of assets occur during the current year. Because the $8,000 ($42,000 − $50,000) recognized loss exceeds the $5,000 ($35,000 − $30,000) recognized gain, the recognized loss and gain are both treated as ordinary. ◀

PROCEDURE FOR SEC. 1231 TREATMENT

OBJECTIVE 3

Understand the tax treatment for Sec. 1231 transactions

After determining the recognized gains and losses from transfers of property qualifying for Sec. 1231 treatment, it is necessary to determine whether any gain must be recaptured as ordinary income under Secs. 1245 and 1250. The recaptured gain, discussed later in this chapter, is not eligible for Sec. 1231 treatment. After eliminating the gain recaptured as ordinary income due to the recapture of depreciation, the procedure for analyzing Sec. 1231 transactions is as follows:

STEP 1. Determine all gains and losses resulting from casualties or thefts of Sec. 1231 property and non–personal-use capital assets held for more than one year. Gains and losses are netted and the net gain is treated as Sec. 1231 gain if the gains exceed the losses.

If the losses exceed the gains, both are treated as ordinary losses and gains and do not, therefore, enter into the Sec. 1231 netting procedure. Recall from Chapter I:8 that business casualty losses are deductible *for* AGI and other casualty losses are taken *from* AGI, if deductible.

KEY POINT

Gains that are recaptured under Secs. 1245 and 1250 are not eligible for Sec. 1231 treatment.

STEP 2. Combine the following gains and losses to determine whether Sec. 1231 gains exceed Sec. 1231 losses or vice versa:

- Net casualty and theft *gains* resulting from Step 1, if any
- Gains and losses resulting from the sale or exchange of Sec. 1231 property
- Gains and losses resulting from the condemnation of Sec. 1231 property and non–personal-use capital assets held more than one year.

If a net Sec. 1231 loss is the result, the losses and gains are treated as ordinary losses and gains. If a net Sec. 1231 gain is the result, the gains and losses are treated as LTCGs and LTCLs, although a portion or all of the capital gain may be recaptured as ordinary income as outlined in Step 3 (five-year lookback rule) below.

STEP 3. If a net Sec. 1231 gain is the result of Step 2, determine if the taxpayer has any nonrecaptured net Sec. 1231 losses. Nonrecaptured net Sec. 1231 losses are the excess of aggregate net Sec. 1231 losses for the preceding five years over losses previously recaptured as ordinary income due to the recapture provision of Sec. 1231. Net Sec. 1231 gains to the extent of any nonrecaptured net Sec. 1231 losses are treated as ordinary income. Section 1231 gain that is unrecaptured Sec. 1250 gain is first treated as ordinary income to the extent of nonrecaptured net Sec. 1231 losses. Any net Sec. 1231 gain in excess of nonrecaptured net Sec. 1231 loss is treated as a LTCG.

[19] Sec. 1231(a)(4)(C).

EXAMPLE I:13-16 ▶ The following gains and losses pertain to Danielle's business assets that qualify as Sec. 1231 property. Danielle does not have any nonrecaptured net Sec. 1231 losses from previous years, and the portion of gain recaptured as ordinary income due to the depreciation recapture provisions has been considered.

ADDITIONAL COMMENT

If Danielle has AGI of $80,000 without considering the gains and losses in Example I:13-16, her AGI is $93,000.

Gain due to an insurance reimbursement for fire damage	$10,000
Loss due to condemnation	(19,000)
Gain due to the sale of Sec. 1231 property	22,000

The $10,000 casualty gain is classified as a Sec. 1231 gain because gains resulting from casualties or thefts of Sec. 1231 property exceed losses. Danielle has $32,000 ($10,000 + $22,000) of Sec. 1231 gains and a $19,000 Sec. 1231 loss. Danielle's $13,000 net Sec. 1231 gain is treated as a LTCG. No portion of the $13,000 LTCG is recaptured as ordinary income because Danielle does not have any nonrecaptured net Sec. 1231 losses during the preceding five-year period. ◀

EXAMPLE I:13-17 ▶ Assume the same facts as in Example I:13-16 except that Danielle has a $10,000 loss because of the fire instead of a $10,000 gain. The $10,000 casualty loss is an ordinary loss, not a Sec. 1231 loss because losses resulting from casualties or thefts of Sec. 1231 property exceed gains. Because the loss is a business loss, it is deductible *for* AGI. Due to the $19,000 condemnation loss and the $22,000 of Sec. 1231 gain, she has a $3,000 net Sec. 1231 gain that is treated as a LTCG. ◀

EXAMPLE I:13-18 ▶ The following gains and losses recognized in 2019 pertain to Fred's business assets that were held for more than one year. The assets qualify as Sec. 1231 property.

ADDITIONAL COMMENT

If Danielle has AGI of $80,000 without considering the gains and losses in Example I:13-17, her AGI is $73,000.

Gain due to an insurance reimbursement for a casualty	$15,000
Gain due to a condemnation	25,000
Loss due to the sale of Sec. 1231 property	(12,000)

A summary of Fred's net Sec. 1231 gains and losses for the previous five-year period is as follows:

Year	*Sec. 1231 Gain*	*Sec. 1231 Loss*	*Cumulative Nonrecaptured Net Sec. 1231 Losses (from five prior years)*
2014	$ 5,000		–0–
2015		$2,000	$2,000
2016		6,000	8,000
2017	13,000		–0–
2018		9,000	9,000

The $15,000 gain due to the insurance reimbursement for a casualty is treated as a Sec. 1231 gain. The $25,000 gain from the condemnation is also a Sec. 1231 gain. Fred's net Sec. 1231 gain in 2019 is $28,000 [($15,000 + $25,000) – $12,000]. However, $9,000 of the Sec. 1231 gain is recaptured as ordinary income due to the $9,000 of nonrecaptured net Sec. 1231 loss existing at the end of 2018. The remaining $19,000 of net Sec. 1231 gain is a LTCG. ◀

RECAPTURE PROVISIONS OF SEC. 1245

OBJECTIVE 4

Apply the recapture provisions of Sec. 1245

In 1962, Congress enacted Sec. 1245, which substantially reduced the advantages of Sec. 1231. A gain from the disposition of Sec. 1245 property is treated as ordinary income to the extent of the total amount of depreciation (or cost-recovery) deductions allowed since January 1, 1962. The gain recaptured as ordinary income cannot exceed the amount of the realized gain.

EXAMPLE I:13-19 ▶ Adobe Corporation sells equipment used in its trade or business for $95,000. The equipment was acquired several years ago for $110,000 and is Sec. 1245 property.[20] The equipment's adjusted basis is $60,000 because $50,000 of depreciation was deducted. The entire $35,000 ($95,000 – $60,000) gain is treated as ordinary income because the total amount of depreciation taken ($50,000) is greater than the $35,000 realized gain. ◀

[20] Throughout this chapter, property is considered to be placed in service when it is purchased or acquired. The term *Sec. 1245 property* is used here to refer to either recovery property under the ACRS or MACRS rules or nonrecovery property that falls outside of the ACRS or MACRS rules.

TYPICAL MISCONCEPTION

It is sometimes thought that only tangible property is subject to Sec. 1245 recapture. In fact, both tangible and intangible personal property are included.

The recapture provisions of Sec. 1245 apply to the total amount of depreciation (or cost recovery) allowed or allowable for Sec. 1245 property. It makes no difference which method of depreciation is used.[21]

Generally, the entire gain from the disposition of Sec. 1245 property is recaptured as ordinary income because the total amount of depreciation (or cost recovery) is greater than the gain realized. A portion of the gain will receive Sec. 1231 treatment if the realized gain exceeds total depreciation or cost recovery.

EXAMPLE I:13-20 ▶ Assume the same facts as in Example I:13-19 except that the asset is sold for $117,000. Because the $57,000 ($117,000 − $60,000) realized gain is greater than the $50,000 of total depreciation, $50,000 of the gain is ordinary income and the remaining $7,000 is a Sec. 1231 gain. ◀

ADDITIONAL COMMENT

Section 1245 does not apply to losses because in these cases the taxpayers have not taken more depreciation than the asset's decline in value.

PURPOSE OF SEC. 1245

The purpose of Sec. 1245 is to eliminate any advantage taxpayers would have if they were able to reduce ordinary income by deducting depreciation and subsequently receive Sec. 1231 treatment when the asset was sold. For individuals, Sec. 1245 recapture prevents net Sec. 1231 gain from being treated as LTCG. The conversion of Sec. 1231 gain to Sec. 1245 ordinary income also prevents taxpayers from possibly using capital losses.

EXAMPLE I:13-21 ▶ During the current year, Coastal Corporation has capital losses of $50,000 and no capital gains for the current year or the preceding three years. The corporation owns equipment purchased several years ago for $90,000, and depreciation deductions of $48,000 have been allowed. If Coastal sells the equipment for $72,000, the entire $30,000 ($72,000 − $42,000) gain, which is due to the depreciation deductions, is Sec. 1245 ordinary income. Without Sec. 1245, the $30,000 gain is a Sec. 1231 gain that could be offset by $30,000 of the corporation's capital loss if Coastal has net Sec. 1231 gain. ◀

KEY POINT

On the sale of Sec. 1245 property, a portion of the gain is treated as Sec. 1231 gain only if the property is sold for more than the original cost. This is very unlikely for factory equipment, trucks, office equipment, and other Sec. 1245 property.

Note that Sec. 1245 does not apply to losses. If Coastal Corporation sells the equipment in Example I:13-21 for $40,000, a $2,000 ($40,000 − $42,000 basis) Sec. 1231 loss is recognized.

KEY POINT

Property must be depreciable or amortizable to be considered Sec. 1245 property.

Section 1245 Property. **Section 1245 property** is certain property subject to depreciation and, in some cases, amortization. The most common example of Sec. 1245 property is depreciable personal property such as equipment. Automobiles, livestock, railroad grading, and single-purpose agricultural or horticultural structures are Sec. 1245 properties as well as intangible assets subject to amortization under Sec. 197 (see Chapter I:10).[22] Except for certain buildings placed in service after 1980 and before 1987, buildings and structural components generally are not Sec. 1245 property.[23]

EXAMPLE I:13-22 ▶ Buckeye Corporation owns the following assets acquired in 2013: equipment, a patent, an office building (including structural components), and land. The equipment and patent are Sec. 1245 property. The office building and the land are not Sec. 1245 property. ◀

REAL-WORLD EXAMPLE

Pipelines, electric transmission towers, blast furnaces, greenhouses, and oil tanks are examples of real property that are included in the definition of Sec. 1245 property.

In many cases, taxpayers are allowed preferential treatment with respect to amortizing certain costs. For example, taxpayers may elect to expense up to $15,000 of the cost of making any business facility more accessible to handicapped and elderly people,[24] or to amortize pollution control facilities over 60 months[25] and reforestation expenditures over 84 months.[26] If taxpayers have amortized the costs of any real property under the special provisions, Sec. 1245 applies to the gain resulting from the disposition of such property.[27]

If taxpayers elect to expense certain depreciable property under Sec. 179, the amount deducted is treated as a depreciation deduction for purposes of the Sec. 1245 recapture provisions.[28]

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[21] As explained later in this chapter, the method of cost recovery used determines whether certain real property is treated as Sec. 1245 recovery property.
[22] Sec. 1245(a)(3).
[23] Sec. 1245(a)(3)(B)(i). Tangible real property "used as an integral part of the manufacturing, production, extraction, or furnishing of transportation, communication, electrical energy, gas, water, or sewage disposal services" is Sec. 1245 property.
[24] Sec. 190.
[25] Sec. 169(a).
[26] Sec. 194(a).
[27] Sec. 1245(a)(3)(C). The Sec. 1245 rules recapture amortization deductions claimed on real property under Secs. 169, 179, 185, 188, 190, 193, and 194.
[28] Sec. 1245(a)(2)(C). The maximum amount deductible under Sec. 179 is $1,020,000 in 2019.

EXAMPLE I:13-23 ▶ Compact Corporation purchased $90,000 of five-year equipment on March 10, 2018, and elected to expense $20,000 of the cost under Sec. 179. Compact sells the equipment on July 30, 2019, for $95,000. Regular depreciation allowed under MACRS for 2018 and 2019 is $14,000 and $11,200 (1/2 year), respectively. The adjusted basis of the equipment on the date of sale is $44,800 ($90,000 − $20,000 − $25,200 depreciation). The realized gain is $50,200 ($95,000 − $44,800), and $45,200 ($20,000 + $25,200) of the gain is Sec. 1245 ordinary income. The remaining $5,000 is Sec. 1231 gain. ◀

TYPICAL MISCONCEPTION

The categorization of nonresidential real estate acquired between 1981 and 1986 on which an accelerated depreciation method was used as Sec. 1250 property rather than as Sec. 1245 property is a common error.

Application of Sec. 1245 to Nonresidential Real Estate. Most real property is not affected by Sec. 1245. However, Sec. 1245 does apply to nonresidential real estate that qualified as recovery property under the ACRS rules (i.e., placed in service after 1980 and before 1987) unless the taxpayer elected to use the straight-line method of cost recovery.[29] Section 1245 does not apply to depreciable real estate acquired after 1986.

EXAMPLE I:13-24 ▶ Brad sells two warehouses during the current year that are totally depreciated because their recovery period is 19 years.

HISTORICAL NOTE

Taxpayers acquiring nonresidential real property between 1981 and 1986 were confronted with choosing between straight-line ACRS and ACRS using the statutory rates. In making the decision, these taxpayers should have considered the number of years the property would be held, the estimated selling price, the present value of the tax savings due to deducting depreciation sooner, and any preferential treatment for net capital gains.

	Warehouse 1	*Warehouse 2*
Year of purchase	1985	1985
Cost*	$720,000	$900,000
Cost recovery—straight line ACRS	720,000	
Cost recovery—ACRS statutory rates (accelerated)		900,000
Adjusted basis	0	0
Selling price	700,000	800,000

*does not consider the cost of land

Both warehouses were placed in service after 1980 and before 1987 and qualify as recovery property under ACRS. The $700,000 ($700,000 − $0) gain on the sale of Warehouse 1 is a Sec. 1231 gain. Section 1245 does not apply because Brad elected to use the straight-line method of cost recovery. Section 1245 applies to the sale of Warehouse 2 because accelerated cost recovery was used and the property is nonresidential real estate placed in service after 1980 and before 1987. Therefore, the $800,000 ($800,000 − $0) gain is Sec. 1245 ordinary income because the $800,000 gain is less than the $900,000 total ACRS cost-recovery allowance. ◀

As illustrated in the example above, nonresidential buildings placed in service after 1980 and before 1987 are Sec. 1245 property if an accelerated method of cost recovery was used.

If the properties in Example I:13-24 were acquired before 1981 or after 1986, they would not be subject to the Sec. 1245 recapture rules regardless of the method of depreciation used.

The Sec. 1245 recapture rules are summarized in Topic Review I:13-1.

Recapture Provisions of Sec. 1250

OBJECTIVE 5

Apply the recapture provisions of Sec. 1250

In 1964, Sec. 1250 was enacted to extend the recapture concept to include most depreciable real property. Unlike Sec. 1245, where the recapture is based upon the total amount of depreciation (or cost recovery) allowed, Sec. 1250 applies solely to additional depreciation. **Additional depreciation**, also referred to as **excess depreciation**, is the excess of the actual amount of accelerated depreciation (or cost-recovery deductions under ACRS) over

[29] Sec. 1245(a)(5).

TOPIC REVIEW I:13-1

Section 1245 Recapture

- Section 1245 affects the character of the gain, not the amount of gain. Character refers to gain being classified as either ordinary income or Sec. 1231 gain.
- Section 1245 does not apply to assets sold or exchanged at a loss.
- Section 1245 ordinary income is never more than the realized gain.
- Section 1245 recapture applies to the total depreciation or amortization allowed or allowable but not more than the realized gain.
- Section 1245 property includes depreciable personal property and amortizable intangible assets (e.g., a patent).
- Section 1245 property includes nonresidential real estate placed in service after 1980 and before 1987 under the ACRS rules *unless* the taxpayer elected to use the straight-line method of cost recovery.
- Section 1245 does not apply to any buildings placed in service after 1986.

the amount of depreciation that would be deductible under the straight-line method. Any gain due to excess depreciation is Sec. 1250 ordinary income.

EXAMPLE I:13-25 ▶ Wyatt sells a building that was placed in service before 1981 and the gain is $50,000. Accelerated depreciation was used and excess depreciation amounts to $74,000. All $50,000 of the gain is Sec. 1250 ordinary income. If the gain is $90,000, $74,000 is Sec. 1250 ordinary income and $16,000 is Sec. 1231 gain. ◀

ADDITIONAL COMMENT

Since buildings generally must be depreciated on a straight-line basis since 1987, Sec. 1250 depreciation recapture becomes less and less applicable as time passes.

PURPOSE OF SEC. 1250

Section 1250 has the effect of converting a portion of the Sec. 1231 gain into ordinary income when real property is sold or exchanged. The incremental benefits from using accelerated depreciation or ACRS cost recovery may be recaptured when the property is sold. Noncorporate taxpayers can avoid Sec. 1250 recapture by either using the straight-line method of depreciation or cost recovery or holding the Sec. 1250 property for its entire useful life or recovery period.

The Sec. 1250 recapture rules are applied solely to the additional depreciation amount instead of total depreciation allowable as is the case for Sec. 1245 property. Sec. 1250 provides for less depreciation recapture than Sec. 1245.

ADDITIONAL COMMENT

Elevators and escalators are Sec. 1245 property if placed in service before 1987, but Sec. 1250 property if placed in service after 1986.

SECTION 1250 PROPERTY DEFINED

Section 1250 property is any depreciable real property other than Sec. 1245 property.[30] As stated on page 13-10, nonresidential real estate placed in service after 1980 and before 1987 is Sec. 1245 property unless the straight-line method of cost recovery is elected. The property is Sec. 1250 property if straight-line cost recovery is elected.

KEY POINT

An apartment building is the most common type of property classified as residential real estate.

Depreciation recapture is not required on real property placed in service after 1986 because such property must be depreciated under the straight-line MACRS rules.[31]

EXAMPLE I:13-26 ▶ Frances sells an office building during the current year for $800,000. The office building was purchased before 1981 for $700,000* and depreciation of $500,000 has been allowed using an accelerated method of depreciation. If the straight-line method was used, depreciation would be $420,000. The office building is Sec. 1250 property. Her recognized gain is $600,000 and $80,000 is Sec. 1250 ordinary income due to excess depreciation ($500,000–$420,000). The remaining $520,000 gain is Sec. 1231 gain.

If Frances purchased the building after 1986, she was required to use the straight-line method. Thus her recognized gain is $520,000 ($800,000 – $280,000) with straight-line depreciation being $420,000. None of the gain is Sec. 1250 ordinary income. The gain is Sec. 1231 gain. ◀

ADDITIONAL COMMENT

If the building in Example I:13-26 was placed in service after 1980 and before 1987, the building is Sec. 1245 property if Frances uses accelerated cost recovery and not the straight-line method.

*does not consider the cost of land

[30] Sec. 1250(c).

[31] As explained in the Additional Recapture for Corporations section in this chapter, corporations may have depreciation recapture under Sec. 291(a) despite the use of straight-line depreciation.

SELF-STUDY QUESTION

In Example I:13-24, how much of the $700,000 Sec. 1231 gain resulting from the sale of warehouse #1 is unrecaptured Sec. 1250 gain?

ANSWER

All $700,000

HISTORICAL NOTE

Prior to the Taxpayer Relief Act of 1997, all LTCGs were taxed at a maximum rate of 28%. When the maximum rate was reduced to 20% (now 15% unless taxable income exceeds threshold amounts when the rate is 20%). Congress did not extend this favorable treatment to depreciable real estate. The maximum rate on this type of property was reduced from 28% to 25%.

As explained below, $420,000 of the Sec. 1231 gain in Example I:13-26 is taxed at a maximum rate of 25% and $100,000 is taxed at 15% or 20% if there are no Sec. 1231 losses, nonrecaptured net Sec. 1231 losses, and no capital gains and losses from other transactions. Recall from Chapter I:5 that the tax rate on ANCG may be 20%, 15%, or zero.

UNRECAPTURED SECTION 1250 GAIN

For sales of real property, some or all of the Sec. 1231 gain may be LTCG that is unrecaptured Sec. 1250 gain taxed at a maximum rate of 25%. Unrecaptured Sec. 1250 gain is the amount of LTCG which would be taxed as ordinary if Sec. 1250 provided for the recapture of all depreciation instead of additional (excess) depreciation. When a taxpayer sells Sec. 1250 property (e.g., an office building) at a gain, any gain due to excess depreciation is ordinary income. Any remaining gain is Sec. 1231 gain and may be LTCG; however, any of the LTCG due to depreciation other than excess depreciation is unrecaptured Sec. 1250 gain taxed at a maximum rate of 25%.

An individual taxpayer who uses straight-line depreciation for Sec. 1250 property does not have any additional depreciation that would be recaptured as ordinary gain under Sec. 1250. Therefore, for buildings placed in service after 1986, all of the Sec. 1231 gain to the extent of the depreciation is unrecaptured Sec. 1250 gain subject to a maximum tax rate of 25% because only straight-line depreciation may be used.

EXAMPLE I:13-27 ▶ Linnie, whose tax rate for ANCG is 15%, owns a building used in her trade or business that was placed in service in 1995. She has no Sec. 1231 losses, nonrecaptured net Sec. 1231 losses or capital gains and losses. The building cost $400,000* and depreciation-to-date amounts to $172,000. If she sells the building for $350,000, her $122,000 gain ($350,000–$228,000) is Sec. 1231 gain and there is no depreciation recapture under Sec. 1250 because straight-line depreciation was allowed. The $122,000 Sec. 1231 gain is LTCG taxed at a maximum rate of 25% because it is unrecaptured Sec. 1250 gain. ◀

*does not consider the cost of land

STOP & THINK

Question: What is the difference between *Sec. 1250 depreciation recapture* and *unrecaptured Sec. 1250 gain*?

Solution: Section 1250 depreciation recapture is the recharacterization of some or all of the Sec. 1231 gain on a building to ordinary income. Section 1250 depreciation recapture only applies to a noncorporate taxpayer if accelerated depreciation was used. Because accelerated depreciation is not allowed after 1986, this provision does not apply to noncorporate taxpayers for buildings placed in service after 1986. Unrecaptured Sec. 1250 gain is taxed at a maximum rate of 25% and occurs when there is a sale or an exchange of a building that is not Sec. 1245 property. If straight-line depreciation is used for a building, the gain is Sec. 1231 gain and the portion of the gain due to depreciation is unrecaptured Sec. 1250 gain. Part or all of the Sec. 1231 gain is taxed at a maximum rate of 25% with any excess taxed at 15% (or possibly 20%).

EXAMPLE I:13-28 ▶ Assume the same facts as in Example I:13-27 except Linnie sells the building for $500,000. Her Sec. 1231 gain is $272,000 ($500,000–$228,000), and $172,000 of the gain is taxed at 25% because it is unrecaptured Sec. 1250 gain. The remaining $100,000 of gain is taxed at 15%. ◀

ADDITIONAL COMMENT

When a building is sold at a gain, different tax rates might apply to portions of the gain: rate for ordinary income, 25% for unrecaptured Sec. 1250 gain, and 15% or 20% for ANCG.

TAXATION OF GAINS ON SALE OR EXCHANGE OF DEPRECIABLE REAL PROPERTY

Noncorporate taxpayers who placed real property in service after 1963 and before 1981 may have to recognize Sec. 1250 ordinary income if they used a depreciation method greater than straight-line. Only noncorporate taxpayers may have gain treated as unrecaptured Sec. 1250 gain and the amount of unrecaptured Sec. 1250 gain is not greater than the amount of depreciation allowed.

There is a difference between Sec. 1250 ordinary income and unrecaptured Sec. 1250 gain. Section 1250 ordinary income could be taxed at 37% after 2017 for noncorporate taxpayers

while unrecaptured Sec. 1250 gain is taxed at a maximum rate of 25%. To have unrecaptured Sec. 1250 gain, the property must have a holding period greater than one year.

EXAMPLE I:13-29 ▶ Erin, whose tax rate is 35%, owns an office building purchased for $1 million* on April 10 of last year. The building is sold on March 28 of the current year for $990,000 when its adjusted basis is $966,850. The $23,150 gain is not Sec. 1231 gain and none of the gain is unrecaptured Sec. 1250 gain because the holding period is not more than one year. The $23,150 gain is ordinary taxed at 35%. If the holding period was more than one year, the Sec. 1231 gain of $23,150 is LTCG that is unrecaptured Sec. 1250 gain taxed at 25%. ◀

*does not consider the cost of land

The proper tax treatment for depreciable real estate depends on the method of depreciation, when the property was placed in service, and how the property is used. Section 1245 applies to a building placed in service after 1980 and before 1987 if accelerated cost recovery is allowed and the building is not used as residential rental property. Buildings used as residential rental property are never subject to the Sec. 1245 recapture rules.

For a building or structure to qualify as residential rental property, 80% or more of the gross rental income from the building or structure must be rental income from dwelling units. Residential rental property does not include any unit in a hotel, motel, inn, or other establishment if more than one-half of the units are used on a transient basis.[32]

When a building is sold at a gain, different tax rates may apply to portions of the gain:

Rate for ordinary income – Sec. 1250 due to recapture of excess depreciation or Sec. 1245 due to recapture of depreciation
25% – unrecaptured Sec. 1250 gain
20%, 15%, or zero – portion of Sec. 1231 gain that becomes ANCG

Depreciable Real Property Placed in Service Before 1981. Taxpayers who elected to use accelerated depreciation on real property placed in service before 1981 may have some or all of their gain treated as Sec. 1250 ordinary income. Gain due to excess depreciation allowed after 1963 is Sec. 1250 ordinary income unless the building is used as residential rental property where gain due to excess depreciation after 1975 is ordinary income. The Sec. 1250 recapture rules are the same for residential rental property and other real property placed in service after 1975.

EXAMPLE I:13-30 ▶ Buddy sells an apartment complex used as residential rental property and placed in service on January 1, 1977. The cost of the apartment complex is $900,000,* and the complex is sold on January 1, 2019, for $700,000. Depreciation claimed by Buddy on the property is as follows:

Time Period	*Depreciation Allowed*	*Straight-Line Depreciation*	*Excess Depreciation*
Jan. 1, 1977–Jan. 1, 2019	$800,000	$710,000	$90,000

On the date of sale, the adjusted basis of the apartment is $100,000 ($900,000 – $800,000) and the realized gain is $600,000 ($700,000 – $100,000). All $90,000 of excess depreciation allowed is recaptured as Sec. 1250 ordinary income because the excess depreciation is less than the realized gain. The remaining $510,000 ($600,000 – $90,000) of gain is a Sec. 1231 gain. The Sec. 1231 gain is LTCG if 1231 gains exceed 1231 losses and is taxed at 25% because it is unrecaptured Sec. 1250 gain. ◀

*does not consider the cost of land

ADDITIONAL COMMENT

If the selling price in Example I: 13-30 is $172,000, all of the gain is Sec. 1250 ordinary income.

Selling Price	$172,000
Adjusted Basis	100,000
Realized Gain	$ 72,000
Ordinary Gain	$ 72,000

[32] Reg. Sec. 1.167(j)-3(b)(1)(i).

EXAMPLE I:13-31 ▶ Assume the same facts as in Example I:13-30 except the building is nonresidential real estate such as a warehouse, manufacturing plant, or an office building. The tax treatment is the same for both examples. Buddy has $90,000 of ordinary income and Sec. 1231 gain of $510,000. The Sec. 1231 gain is LTCG if 1231 gains exceed 1231 losses and is taxed at 25% because it is unrecaptured Sec. 1250 gain. ◀

There is no excess depreciation, and thus no Sec. 1250 ordinary income if the building is fully depreciated when sold or exchanged. As each year passes, noncorporate shareholders are increasingly less likely to have Sec. 1250 ordinary income.

EXAMPLE I:13-32 ▶ Assume the same facts as in Examples I:13-30 and I:13-31 except the buildings are fully depreciated and the selling price is $720,000. For both buildings, the realized gain of $720,000 is Sec. 1231 gain and is unrecaptured Sec. 1250 gain taxed at a maximum rate of 25%. ◀

ADDITIONAL COMMENT

Real property placed in service before 1981 will most likely be fully depreciated by 2019.

Depreciable Real Property Placed in Service After 1980 and Before 1987. Gain due to excess depreciation for buildings used as residential rental property placed in service after 1980 and before 1987 is Sec. 1250 ordinary income. Because the recovery period for buildings placed in service during this period is 15, 18, or 19 years, all such buildings will be fully depreciated if sold in 2019, thus there is no excess depreciation and no Sec. 1250 ordinary income.

The method of depreciation used for other buildings (not residential rental property) placed in service during this period is a critical factor in determining the tax treatment when sold. If accelerated cost recovery was used, the nonresidential real estate is Sec. 1245 property where all gain due to depreciation is ordinary income. If the straight-line method is used, the property is Sec. 1250 property and none of the gain is ordinary income for noncorporate taxpayers.

EXAMPLE I:13-33 ▶ Ford purchased three buildings (A, B, and C) in 1982 for $500,000 each*. The recovery period for each building is 15 years, so each building is fully depreciated when he sells the buildings during the current year for $400,000 each.

*does not consider the cost of land

Building	*Use of Property*	*Method of Cost Recovery (Depreciation)*
A	residential rental property	accelerated or straight-line
B	office building	accelerated
C	warehouse	straight-line

Building B is Sec. 1245 property, and the $400,000 gain is Sec. 1245 ordinary income. For buildings A and C, the $400,000 gain is Sec. 1231 gain and is unrecaptured Sec. 1250 gain because all of the gain is due to depreciation. ◀

EXAMPLE I:13-34 ▶ Assume the same facts as in Example I:13-33 except the selling price is $570,000. For building B, Ford must recognize $500,000 of Sec. 1245 ordinary income and $70,000 of Sec. 1231 gain taxed at 15% or 20%. For buildings A and C, the $570,000 gain is Sec. 1231 gain with $500,000 taxed at 25% and $70,000 taxed at 15% or 20%. ◀

Depreciable Real Property Placed in Service After 1986. The straight-line method of depreciation is the only method of depreciation allowed for buildings placed in service after 1986, and thus noncorporate taxpayers will not have any Sec. 1250 ordinary income when they sell or exchange buildings placed in service after 1986. Gain due to depreciation is unrecaptured Sec. 1250 gain subject to a maximum tax rate of 25%.

The tax treatment for residential rental property and other real property placed in service after 1986 is the same, but taxpayers may depreciate residential rental property over 27.5 years and other real property placed in service after May 12, 1993, over 39 years.

EXAMPLE I:13-35 ▶ Stella purchased an apartment complex on October 10, 2012, for $275,000 (exclusive of land) while Mack purchased an office building for $275,000 on the same day. Stella and Mack sell the

▼ **TABLE I:13-1**

Character of Gain on Sale or Exchange of Depreciable Real Property for Noncorporate Taxpayers

	Sec. 1245 Ordinary	Sec. 1250 Ordinary	Sec. 1231	Unrecaptured Sec. 1250 (Maximum rate of 25%)
RESIDENTIAL RENTAL				
Placed in Service Before 1981				
Use straight-line depreciation	No	No	Yes	Yes
Use accelerated depreciation	No	Yes*	Yes**	Yes
Placed in Service After 1980 & Before 1987				
Use straight-line depreciation	No	No	Yes	Yes
Use accelerated depreciation	No	Yes*	Yes**	Yes
Placed in Service After 1986				
Use straight-line depreciation	No	No	Yes	Yes
NONRESIDENTIAL				
Placed in Service Before 1981				
Use straight-line depreciation	No	No	Yes	Yes
Use accelerated depreciation	No	Yes*	Yes**	Yes
Placed in Service After 1980 & Before 1987				
Use straight-line depreciation	No	No	Yes	Yes
Use accelerated depreciation	Yes	No	Yes***	No
Placed in Service After 1986				
Use straight-line depreciation	No	No	Yes	Yes

* Portion of gain due to excess depreciation
** To extent gain is greater than excess depreciation
*** To extent gain is greater than total depreciation

buildings on April 22, 2019, for $250,000. At the date of sale, Stella's adjusted basis in the apartment complex is $210,005 based on a 27.5-year recovery period and Mack's adjusted basis in the office building is $229,166 based on a 39-year recovery period. Stella has a Sec. 1231 gain of $39,995 [$250,000 – $210,005 adjusted basis], and all of the gain is unrecaptured Sec. 1250 gain. Mack has a Sec. 1231 gain of $20,834 [$250,000 – $229,166 adjusted basis], and all of the gain is unrecaptured Sec. 1250 gain. ◀

LOW-INCOME HOUSING

Congress has provided incentives for the construction and rehabilitation of low-income housing. For tax years after 1986, a low-income housing credit is available to owners of qualified low-income housing projects.[33]

If the low-income housing unit is held for 16 years and 8 months, none of the additional depreciation is subject to recapture as ordinary income.[34] Thus noncorporate taxpayers will not have any Sec. 1250 ordinary income if the low-income housing is sold after 2002.

The Sec. 1250 recapture rules for noncorporate taxpayers are summarized in Topic Review I:13-2.

[33] Sec. 42.

[34] Secs. 1250(a)(1)(B)(i), (ii), (iii), and (iv).

TOPIC REVIEW I:13-2

Section 1250 Recapture for Noncorporate Taxpayers

- Section 1250 affects the character of the gain, not the amount of gain.
- Section 1250 does not apply to assets sold or exchanged at a loss.
- Section 1250 ordinary income is never more than the realized gain.
- Section 1250 ordinary income is never more than the *additional* (excess) depreciation allowed. (Note, that this statement is not true for corporate taxpayers.)
- Section 1250 property includes depreciable real property unless the real property is nonresidential real estate placed in service in 1980 and before 1987 under the ACRS rules and the straight-line method is not elected.
- Section 1250 ordinary income does not exist if the straight-line method of depreciation is used. (This statement is not true for corporate taxpayers because of the additional recapture requirements under Sec. 291.)

ADDITIONAL RECAPTURE FOR CORPORATIONS

OBJECTIVE 6

Understand recapture provisions for corporations

KEY POINT

Section 291 has no effect on Sec. 1245 property because gain is already recaptured to the extent of all depreciation.

ADDITIONAL COMMENT

Corporations are subject to 20% depreciation recapture rule under Sec. 291 on sales of Sec. 1250 property.

Corporations are subject to additional recapture rules under Sec. 291 if depreciable real estate is sold or otherwise disposed of. The additional ordinary income that is recaptured effectively reduces the amount of the Sec. 1231 gain.

The additional recapture amount under Sec. 291 is equal to 20% of the difference between the amount that would be recaptured if the property was Sec. 1245 property and actual recapture amount under Sec. 1250, which will almost always be zero.[35]

EXAMPLE I:13-36 ▶

In 1990, Orlando Corporation purchased an office building for $500,000* for use in its business. The building is sold during the current year for $480,000. Total depreciation allowed for the building is $372,000. The realized and recognized gain is $352,000 ($480,000 – adjusted basis of $128,000), and all of the gain would be ordinary if the building were Sec. 1245 property.

Section 291 depreciation recapture applies because the taxpayer is a corporation, so $70,400 [20% × ($352,000 – $0)] of the gain is Sec. 1250 ordinary income, and $281,600 is Sec. 1231 gain.

*does not consider the cost of land; any gain or loss on the sale of land is Sec 1231 gain or loss

SELF-STUDY QUESTION

If the taxpayer in Example I:13-36 is a noncorporate taxpayer, how much of the gain is Sec. 1250 ordinary income?

ANSWER

Zero.

Except for Section 291, which applies only to corporate taxpayers, none of the gain in Example 13-36 would be Sec. 1250 ordinary income because there is no excess depreciation. The straight-line method of depreciation is the only method allowed for buildings placed in service after 1986. ◀

EXAMPLE I:13-37 ▶

Pacific Corporation purchased an office building ten years ago for 700,000* for use in its business. The building is sold during the current year for $790,000. Total depreciation allowed for the building is $180,000. The realized and recognized gain is $270,000 ($790,000 – adjusted basis of $520,000), and $180,000 of the gain would be ordinary if the building were Sec. 1245 property.

Section 291 depreciation recapture applies, so $36,000 [20% × ($180,000 – $0)] of the gain is Sec. 1250 ordinary income, and $234,000 is Sec. 1231 gain. ◀

*does not consider the cost of land; any gain or loss on the sale of land is Sec 1231 gain or loss

SELF-STUDY QUESTION

If the taxpayer in Example I:13-37 is a noncorporate taxpayer, how much of the gain is Sec. 1250 ordinary income?

ANSWER

Zero
The $270,000 gain is Sec. 1231 gain and $180,000 is unrecaptured Sec. 1250 gain subject to a maximum tax rate of 25%.

For corporations, none of the Sec. 1231 gain is unrecaptured Sec. 1250 gain.

[35] Sec. 291(a)(1).

SELF-STUDY QUESTION

Refer back to Example I:13-36 and assume that the adjusted basis is zero when the building is sold. Will the Orlando Corporation still have to recognize any Sec. 1250 ordinary income?

ANSWER

Yes, 20% of the smaller of gain recognized or $500,000 depreciation. A noncorporate taxpayer will have no Sec. 1250 ordinary income.

SELF-STUDY QUESTION

If a corporation sells an office building purchased in 2001 at a gain, what is the maximum amount of Sec. 1250 ordinary income that might be recognized?

ANSWER

20% of depreciation.

SUMMARY OF SECS. 1231, 1245, AND 1250 GAINS

Section 1231 property is depreciable property and nondepreciable real property used in one's trade or business and held for more than one year. Net Sec. 1231 gain, the excess of Sec. 1231 gain over Sec. 1231 loss, is LTCG unless the five-year lookback rule applies in which case the gain is ordinary to the extent of the nonrecaptured net Sec. 1231 loss. Net Sec. 1231 loss, the excess of Sec. 1231 loss over Sec. 1231 gain, is ordinary.

Section 1245 applies to depreciable personal property and amortizable intangible assets. It also applies to certain nonresidential real property placed in service during ACRS (after 1980 and before 1987) if accelerated cost recovery is used. Gain to the extent of depreciation is ordinary income. All of the gain resulting from the sale of Sec. 1245 property is ordinary income unless the asset is sold for more than its original basis.

Section 1250 property is depreciable real property, and gain is ordinary income to the extent of excess depreciation, the excess of accelerated depreciation over straight-line. After 1986, the straight-line method must be used for real property and thus noncorporate taxpayers will not have any Sec. 1250 ordinary income on the sale of depreciable real property placed in service after 1986. Unfortunately, Congress made the sale and exchange of buildings more complicated in 1997 when it created the concept of unrecaptured Sec. 1250 gain that is taxed at 25%. When a noncorporate taxpayer sells depreciated buildings at a gain, any gain to the extent of straight-line depreciation is Sec. 1231 gain but is taxed at a rate no higher than 25% because it is unrecaptured Sec. 1250 gain.

To further illustrate Sec. 1231, 1245, and 1250, refer to Topic Review I:13-3 where a noncorporate taxpayer with a 35% tax rate and a 15% rate for ANCG sells various assets during the current year. Each asset was purchased in 1997 and the selling price is $450,000 for each of the first three assets. All assets are used in a trade or business. There are no other gains and losses and no nonrecaptured net Sec. 1231 losses.

TOPIC REVIEW I:13-3

Sections 1231, 1245, and 1250—Comparison of Various Assets

The taxpayer is a noncorporate taxpayer with a 35% tax rate who sells each of the first three assets for $450,000. Each asset was purchased in 1997 and is used in a trade or business. The difference between the original basis and the adjusted basis of the equipment and building is attributable to depreciation. There are no other gains and losses and no nonrecaptured net Sec. 1231 losses, thus the Sec. 1231 gain becomes LTCG.

	Original Basis	Adjusted Basis	Tax Treatment
1. Land	$400,000	$400,000	$50,000 Sec. 1231 gain taxed at 15%.*
2. Equipment	600,000	400,000	$50,000 Sec. 1245 ordinary income taxed at 35%. All gain is due to depreciation.
3. Building	500,000	400,000	$50,000 Sec. 1231 gain which is unrecaptured Sec. 1250 gain taxed at 25%.
For assets 4, 5, & 6, assume the selling price is $700,000.			
4. Land	$400,000	$400,000	$300,000 Sec. 1231 gain taxed at 15%.*
5. Equipment	600,000	400,000	$200,000 Sec. 1245 ordinary income taxed at 35% and $100,000 Sec. 1231 gain taxed at 15%.*
6. Building	500,000	400,000	$300,000 Sec. 1231 gain with $100,000 of unrecaptured Sec. 1250 gain taxed at 25% and $200,000 taxed at 15%.*

* 20% if single with taxable income above $434,550, head of household with taxable income above $461,700 or married with taxable income above $488,850.

RECAPTURE PROVISIONS—OTHER APPLICATIONS

OBJECTIVE 7

Describe other recapture applications

Sections 1245 and 1250 recapture provisions take precedence over other provisions of the tax law.[36] Unless an exception or limitation is specifically stated in Secs. 1245 or 1250, gain is recognized under Secs. 1245 or 1250 despite the existence of provisions elsewhere in the IRC that allow nonrecognition of gain.[37]

GIFTS OF PROPERTY SUBJECT TO RECAPTURE

A gift of appreciated depreciable property does not result in the recapture of depreciation or cost-recovery deductions under Secs. 1245 or 1250.[38] However, the donee must consider the recapture potential when disposing of the property. The recapture amount for the donee is computed by including the recaptured amount attributable to the donor.[39]

EXAMPLE I:13-38 ▶ Ashley makes a gift of equipment with an $8,200 FMV to Helmut. Ashley paid $10,000 for the equipment and deducted $4,000 of depreciation before making the gift. Ashley does not have to recapture any depreciation when making the gift. Helmut's basis for the equipment is $6,000 and the potential depreciation recapture carries over to Helmut. ◀

EXAMPLE I:13-39 ▶ Assume the same facts as in Example I:13-38 except that Helmut uses the equipment in a trade or business, deducts $1,500 of depreciation, and sells the equipment for $7,100. When determining the amount of depreciation subject to recapture, Helmut must also consider the depreciation allowed to Ashley. The entire $2,600 [$7,100 − ($6,000 − $1,500)] gain is recaptured as ordinary income because it is less than the $5,500 ($4,000 + $1,500) of depreciation claimed. ◀

ADDITIONAL COMMENT

If the taxpayer in Topic Review I:13-3 is a corporation, the character of the gain is the same for assets 1, 2, 4, and 5. For asset 3, $10,000 of the gain is Sec. 1250 ordinary income because of Sec. 291 and $40,000 is Sec. 1231 gain. For asset 6, $20,000 is Sec. 1250 ordinary income because of Sec. 291 and $280,000 is Sec. 1231 gain.

TRANSFER OF PROPERTY SUBJECT TO RECAPTURE AT DEATH

The transfer of appreciated property at death does not cause a recapture of depreciation deductions to the decedent's estate under Secs. 1245 and 1250.[40] In addition, recapture potential does not carry over to the person who receives the property from the decedent.

EXAMPLE I:13-40 ▶ Jackie dies while owning a building with a $900,000 FMV. The building is Sec. 1245 property acquired in 1985 for $800,000* on which cost-recovery deductions of $800,000 have been claimed. Pam inherits the building from Jackie. Pam's basis for the building is $900,000, and the $800,000 of cost-recovery deductions are not recaptured. If Pam later sells the building, there is no depreciation recapture attributable to the $800,000 of cost-recovery deductions taken by the decedent. ◀

*does not include cost of land

KEY POINT

Death is one of the few ways to avoid the recapture provisions.

CHARITABLE CONTRIBUTIONS

As discussed in Chapter I:8, the deduction for a charitable contribution of appreciated ordinary income property is generally limited to its adjusted basis (i.e., the amount of the contribution deduction is equal to the FMV of the property less the amount of gain that would not have been LTCG [or Sec. 1231 gain] if the contributed property had been sold by the taxpayer at its FMV).[41] Thus, the contribution deduction for recapture property is reduced to reflect the ordinary income that would be recognized if the property were sold rather than contributed to the charity.

EXAMPLE I:13-41 ▶ Ralph makes a gift of an organ to a church. The organ is used in Ralph's trade or business and has a $6,300 FMV. Ralph paid $10,000 for the organ, and $8,000 depreciation has been claimed. If the organ were sold for its $6,300 FMV, the realized and recognized gain would be $4,300 ($6,300 − $2,000) and all of the gain would be ordinary income due to the recapture of depreciation under Sec. 1245. The charitable contribution deduction is limited to $2,000 ($6,300 − $4,300), because none of the $4,300 gain would be taxed as a LTCG if the organ were sold. ◀

[36] Secs. 1245(d) and 1250(i).
[37] Reg. Secs. 1.1245-6(a) and 1.1250-1(c)(1).
[38] Secs. 1245(b)(1) and 1250(d)(1).
[39] Reg. Secs. 1.1245-2(a)(4) and 1.1250-2(d).
[40] Secs. 1245(b)(2) and 1250(d)(2).
[41] Sec. 170(e)(1)(A).

ADDITIONAL COMMENT

If the FMV of the organ in Example I:13-41 is $11,000, the charitable contribution deduction is limited to $3,000, the $11,000 FMV less $8,000. If the organ is sold for $11,000, $8,000 of the gain is ordinary income.

LIKE-KIND EXCHANGES

A taxpayer who receives boot (i.e., non–like-kind property) in a transaction that otherwise qualifies as a like-kind exchange recognizes gain equal to the lesser of the realized gain or the amount of boot received. If the property is Sec. 1245 or 1250 property, the gain is first considered to be ordinary income up to the maximum amount of the gain that is subject to the recapture provisions.

EXAMPLE I:13-42 ▶ The Krider Corporation owns a building used in its trade or business that cost $300,000 three years ago. During the current year, the building is exchanged when its adjusted basis is $280,000 for another building with a FMV of $287,000 and $36,000 of cash. Gain realized on the exchange is $43,000 [($287,000 + $36,000) − $280,000], and gain recognized is the lesser of $36,000 boot received or the $43,000 gain realized. $4,000 (20% × $20,000 depreciation) is Sec. 1250 ordinary income under Sec. 291, and $32,000 is Sec. 1231 gain. ◀

If gain is not recognized in a like-kind exchange, the recapture potential carries over to the replacement property (i.e., any recapture potential associated with the property exchanged attaches to the property received in the exchange).[42]

EXAMPLE I:13-43 ▶ Scarlet exchanged an apartment complex in Arizona for an apartment complex (FMV of $800,000) in Texas in 2013. The apartment complex in Arizona was purchased in 2006 for $500,000 and had an adjusted basis of $450,000. The $350,000 gain realized was not recognized because the exchange was a like-kind exchange. After deducting $42,000 of depreciation, Scarlet sells the apartment complex for $1,000,000 during the current year. Her Sec. 1231 gain is $592,000 ($1,000,000 − $408,000).

If the taxpayer is a corporation, $18,400 (20% × $92,000) is Sec. 1250 ordinary income and $573,600 is Sec. 1231 gain.[43] ◀

INVOLUNTARY CONVERSIONS

If an involuntary conversion of Sec. 1245 property occurs and all or a portion of the gain is not recognized,[44] the amount of gain considered to be Sec. 1245 ordinary income is limited and cannot be more than the recognized gain.[45] A similar provision exists for the involuntary conversion of Sec. 1250 property.[46]

EXAMPLE I:13-44 ▶ The Ryan Corporation's printing equipment with original cost of $600,000 and adjusted basis of $200,000 is destroyed by fire. Ryan, Inc. receives $550,000 of insurance proceeds and purchases $510,000 of printing equipment. If the corporation elects to defer gain, it must recognize a $40,000 gain which is Sec. 1245 ordinary income. The basis of the printing equipment acquired is $200,000. ◀

REAL-WORLD EXAMPLE

Taxpayer received insurance proceeds in excess of the adjusted basis of a business automobile upon the destruction of the auto in an accident. The taxpayer did not use Sec. 1033 to defer the gain and the court held that the gain was subject to recapture under Sec. 1245. *Anthony Astone*, 1983 PH T.C. Memo ¶83,747, 47 TCM 632.

INSTALLMENT SALES

As discussed in Chapter I:11, gain resulting from an installment sale is generally recognized as payments are received. Thus, the gain may be spread over more than one accounting period. An installment sale of depreciable property may result in all of the recaptured gain being taxed in the year of the sale.[47] Recapture income is "the aggregate amount which would be treated as ordinary income under Sec. 1245 or 1250 for the taxable year of the disposition if all payments to be received were received in the taxable year of disposition."[48] Recapture income must be recognized in the year of sale, even if no payments are received.

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[42] Reg. Sec. 1.1245-2(c)(4).
[43] Sec. 291.
[44] As discussed in Chapter I:12, one may elect to defer recognition of the gain if the Sec. 1033 requirements are satisfied.
[45] Sec. 1245(b)(4) and Reg. Sec. 1.1245-4(d)(1).
[46] Sec. 1250(d)(4) and Reg. Sec. 1.1250-3(d).
[47] Sec. 453(i)(1).
[48] Sec. 453(i)(2).

EXAMPLE I:13-45 ▶

KEY POINT

In the case of an installment sale of Sec. 1245 or 1250 property, it is possible to report a large taxable gain even though the taxpayer has not yet received the cash to pay the tax on such gain.

Pat owns equipment with a $100,000 acquisition cost and a $42,000 adjusted basis. During the current year, Pat sells the property for $30,000 cash and a $60,000 interest-bearing note to be paid over a ten-year period. The realized gain is $48,000 ($90,000 − $42,000), and the recapture income amount is $48,000 (the lesser of total depreciation deductions of $58,000 or the $48,000 realized gain). The $48,000 gain is all recognized as ordinary income in the current year, despite the fact that the transaction qualifies as an installment sale and only $30,000 of cash is received in the year of sale. ◀

If gain realized from the installment sale exceeds the recapture income, the excess gain is reported under the installment method.[49] The amount of recapture income recognized is added to the adjusted basis to determine the gross profit ratio.

EXAMPLE I:13-46 ▶

SELF-STUDY QUESTION

What method of cost recovery did Bob use in Example I:13-46?

ANSWER

Accelerated cost recovery. The office building is subject to Sec. 1245 recapture.

Bob owns an office building acquired for $700,000* in 1986 and subject to the Sec. 1245 recapture rules. After claiming $700,000 of cost recovery deductions, Bob sells the building to Janet in 2019 for $1 million. Bob receives $200,000 in cash and an $800,000 interest-bearing note. The note is to be paid with annual principal payments of $100,000 and interest on the unpaid balance beginning in 2020. The total amount of realized gain is $1 million ($1,000,000 − 0). In 2019, Bob recognizes $700,000 of Sec. 1245 ordinary income. The gross profit ratio is determined by adding $700,000 recapture income to the $0 basis. The gross profit ratio is 30% [($1,000,000 − $700,000) ÷ $1,000,000]. In addition to recognizing $700,000 of ordinary income, Bob recognizes $60,000 (0.30 × $200,000) Sec. 1231 gain in 2019 because a $200,000 cash down payment was received in the year of the sale. In 2020 and in each subsequent year, $30,000 (0.30 × $100,000) of Sec. 1231 gain is recognized as the cash payments on the principal are received. ◀

*does not include cost of land

SECTION 179 EXPENSING ELECTION

In lieu of capitalizing the cost of new or used tangible personal business property, taxpayers may elect to expense up to $1,020,000 of the acquisition cost in 2019.[50] (see Chapter I:10). If the property is subsequently converted to nonbusiness use, previous tax benefits derived from the immediate expensing election must be recaptured and added to the taxpayer's gross income in the year of the conversion.[51] The recaptured amount equals the difference between the amount expensed under Sec. 179 and the total depreciation that would otherwise have been claimed for the period of business use.

EXAMPLE I:13-47 ▶

SELF-STUDY QUESTION

If Behren in Example I:13-47 sells the equipment for $15,000 instead of converting it to a nonbusiness use, what is the character of the gain?

ANSWER

$15,000 of Sec. 1245 ordinary income

Behren purchased business equipment (a five-year recovery period) in 2018 for $18,100 and elected to expense the entire amount under Sec. 179. In 2019, he converts the equipment to nonbusiness use. Depreciation of $3,620 (0.20 × $18,100) under the MACRS rules would have been allowed during the period the equipment was held for business use if Behren had not elected to expense the $18,100 cost. Behren must recognize $14,480 ($18,100 − $3,620) of Sec. 1245 ordinary income in 2019. ◀

CONSERVATION AND LAND CLEARING EXPENDITURES

Taxpayers engaged in the business of farming may deduct expenditures paid or incurred during the taxable year for soil and water conservation or the prevention of erosion. The expenditures must be made with respect to land used in farming and would be capital expenditures except for this provision.[52]

The deductions for conservation expenditures may be partially or fully recaptured as ordinary income if the farmland is disposed of before the land is held for more than nine years.[53] The amount of deductions recaptured as ordinary income under Sec. 1252 is a percentage of the aggregate deductions allowed for conservation expenditures. The amount of ordinary income recognized under Sec. 1252 is limited to the lesser of the taxpayer's realized gain or the applicable recapture percentage times the total conservation expenditures.

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[49] Sec. 453(i)(1)(B).0.

[50] Secs. 179(a) and (b)(1). In 2019, the maximum Sec. 179 deduction is $1,020,000 with a dollar for dollar reduction when the cost of qualifying property placed in service exceeds $2,550,000.

[51] Sec. 179(d)(10) and Reg. Sec. 1.179-1(e).

[52] Sec. 175(a).

[53] Sec. 1252(a)(1).

WHAT WOULD YOU DO IN THIS SITUATION?

You recently graduated with an advanced degree in taxation and have accepted a job with a CPA firm in the tax department. One of the firm's clients, a wealthy individual, was in need of cash and decided to sell some assets to raise the cash. The client asked the firm to advise him, from a tax standpoint, which assets he should sell. The client is in the 35% tax bracket. You suggested in a written memo that the client sell one of the client's jet airplanes. The plane you recommended to be sold had originally cost $16 million and now had an adjusted basis of $5 million. A buyer had offered to buy the plane for $12 million on the installment basis, paying $4 million per year for three years plus interest at 9%. The principal reason for selling that particular plane is that it would raise $12 million over three years, but the tax could be spread over three years by using the installment sale method. The client took your advice and sold the plane in the current year.

Later, when preparing the client's tax return, you realize that gain due to depreciation of the airplane must be recognized in the year of sale, even if the property is sold under the installment sale method. Thus, all of the gain on the sale of the plane must be recognized in the year of sale, not spread over three years. You go to your manager and tell him about your major mistake. Your manager, who reviewed your original memo, indicates that he thinks that the two of you should not tell anyone about the mistake as it will negatively impact both of your careers. The manager thinks that because the client has such a large amount of income, reporting the entire gain on the sale of the plane on the client's return might not be detected by the client. Thus, the manager instructs you to prepare the current year return with the entire $7 million of gain and not tell anyone about the mistake. What should you do in this situation?

KEY POINT

There is no recapture of conservation costs if the farmland is held for at least ten years.

The recapture percentage is 100% if the farmland is disposed of within five years after the date it is acquired. The percentage declines by 20 percentage points for each additional year the property is held. If the land is disposed of after being held for more than nine years, none of the expenses are recaptured.[54]

EXAMPLE I:13-48 ▶ Paula owns farmland with a $400,000 basis. She has deducted $50,000 for soil and water conservation expenditures. After farming the land for six years and five months, Paula sells the land for $520,000. The realized gain is $120,000 ($520,000 − $400,000) and the recapture percentage is 60%, because the farmland is disposed of within the seventh year after it was acquired. The amount of ordinary income due to recapture under Sec. 1252 is $30,000, the lesser of the $120,000 realized gain or the $30,000 (0.60 × $50,000) recapture amount. ◀

ADDITIONAL COMMENT

Intangible drilling and development costs represent the major cost of operations and can provide investors with working interests in oil and gas properties with a first-year write-off of substantially all of their investment.

INTANGIBLE DRILLING COSTS AND DEPLETION

Taxpayers may elect to either expense or capitalize intangible drilling and development costs (IDC).[55] If the election to expense is not made, the costs are capitalized and recovered through additional depletion deductions. Intangible drilling and development costs include "all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas."[56]

Part or all of the gain from the sale of oil and gas properties may be recaptured as ordinary income due to the recapture of the IDC deduction and the deduction for depletion. However, the amount of ordinary income recognized from the recapture of IDC and depletion is limited to the gain realized from disposition of the property.[57]

EXAMPLE I:13-49 ▶ In 2012, Marty purchased undeveloped property to drill for oil and gas. Intangible drilling and development costs of $400,000 were paid in 2012, and Marty elected to expense the IDC. During the current year, Marty sells the property and realizes a $900,000 gain. $300,000 of cost depletion was also allowed. Marty must recognize $700,000 of ordinary income because of the recapture of IDC ($400,000) and the recapture of depletion ($300,000). The remaining $200,000 ($900,000 − $700,000) gain is Sec. 1231 gain. ◀

[54] Sec. 1252(a)(3).
[55] Sec. 263(c).
[56] Reg. Sec. 1.612-4(a).
[57] Sec. 1254(a)(1).

EXAMPLE I:13-50 ▶ In 2011, Tina acquired oil and gas properties for $700,000 and paid $200,000 for intangible drilling costs. During 2011, she elected to expense the $200,000 of IDC. Total depletion allowed was $80,000. During the current year, Tina sells the property for $840,000 and realizes a $220,000 [$840,000 − ($700,000 − $80,000)] gain. The amount of ordinary income due to recapture is $220,000, because both IDC and depletion must be recaptured only to the extent of the gain. ◀

SELF-STUDY QUESTION

If Tina in Example I:13-50 sells the properties for $990,000, what is the character of her gain?

ANSWER

$280,000 of ordinary income and $90,000 of Sec. 1231 gain

GAIN ON SALE OF DEPRECIABLE PROPERTY BETWEEN RELATED PARTIES

All gain recognized on the sale or exchange of property between related parties is ordinary income if the property is subject to depreciation in the hands of the transferee (i.e., the person who purchases the property). The sale or exchange may be direct or indirect.[58]

EXAMPLE I:13-51 ▶ Phil owns a building with a $500,000 adjusted basis and $800,000 FMV. The building, which cost $700,000, is used in his business, and the straight-line method of depreciation is used. $200,000 of depreciation deductions were allowed. If the building is sold to Phil's 100%-owned corporation for $800,000, the $300,000 realized gain ($800,000 − $500,000) is treated as ordinary income under Sec. 1239, because the property is subject to depreciation in the hands of the transferee and the corporation and Phil are related parties. ◀

SELF-STUDY QUESTION

If Phil sells the building in Example I:13-51 to an unrelated party, what is the character of the gain?

ANSWER

$300,000 of Sec. 1231 gain. If the Sec. 1231 gain becomes LTCG, $200,000 of the gain is unrecaptured Sec. 1250 gain taxed at a maximum rate of 25%

A sale or exchange of property could be subject to depreciation recapture under Sec. 1245 or 1250 as well as the Sec. 1239 related party rules. If so, recapture under Sec. 1245 or 1250 is considered before recapture under Sec. 1239.[59]

EXAMPLE I:13-52 ▶ Assume the same facts as in Example I:13-51 except that Phil sells equipment to the corporation instead of a building. All of the $300,000 realized gain is treated as ordinary income. The recapture amount under Sec. 1245 is $200,000, and Sec. 1239 applies to the remaining $100,000 gain. ◀

Purpose of Sec. 1239. Without Sec. 1239, a taxpayer could transfer appreciated depreciable property to a related party and recognize a Sec. 1231 gain on the sale. Net Sec. 1231 gain is treated as LTCG. The related purchaser of the property would receive a step up in the depreciable basis of the property to its FMV and be able to claim a larger amount of depreciation. In Example I:13-51, Phil might prefer to recognize a $300,000 Sec. 1231 gain if the 100%-owned corporation was able to obtain a step-up in the property's basis to $800,000. Because Sec. 1239 applies, Phil must recognize $300,000 of ordinary income rather than Sec. 1231 gain. This rule prevents an individual taxpayer from receiving favorable Sec. 1231 gain treatment and prevents all taxpayers having large capital loss carryovers from using a related party to recognize a Sec. 1231 or capital gain which can be offset against their capital losses.

Related Parties. A person is related (1) to any corporation if the individual owns (directly or indirectly) more than 50% of the value of the outstanding stock and (2) to any partnership in which the person has a capital or profits interest of more than 50%.[60] Constructive ownership rules apply when determining whether the person owns more than 50% of the corporation or has more than a 50% interest in the partnership. Thus, an individual is considered to own stock owned by other family members and related entities (e.g., corporations, partnerships, estates, and trusts).

EXAMPLE I:13-53 ▶ Tony sells a truck used for nonbusiness purposes to the Able Corporation for $15,000 when its original cost basis is $12,000. Tony owns 30% of Able and his spouse owns 40% of Able. Tony and Able are related parties because Tony is deemed to own 70% of Able under the constructive ownership rules and $3,000 of ordinary income must be recognized under Sec. 1239. ◀

A person is related to any trust in which such a person or the person's spouse is a beneficiary.[61] Section 1239 also applies to a sale or exchange of depreciable property between two corporations if the same individual owns more than 50% of each corporation.[62]

[58] Sec. 1239(a).
[59] Reg. Sec. 1.1245-6(f).
[60] Sec. 1239(c).
[61] Sec. 1239(b)(2).
[62] Rev. Rul. 79-157, 1979-1 C.B. 281.

Tax planning considerations

OBJECTIVE 8

Describe tax planning considerations for Sec. 1231 assets

For noncorporate taxpayers, net Sec. 1231 gains are generally preferable to ordinary gains because of the possible lower tax rate applicable to net capital gains. The tax rate could be zero, 15%, 20%, or 25%. For corporate taxpayers, however, after 1986 it usually does not make any difference whether a gain is classified as Sec. 1231 or ordinary unless the corporation has capital losses. Corporations do not have preferential tax rates on net capital gains.

EXAMPLE I:13-54 ▶ Western Corporation has taxable income of $550,000 without considering the sale of equipment for $400,000 during the current year. The equipment originally cost $500,000 and has a $350,000 adjusted basis after deducting depreciation. The corporation has no other gains and losses during the year or any capital loss carryovers from previous years. For Western Corporation, it does not make any difference whether the gain is Sec. 1245 ordinary income or Sec. 1231 gain. The effect on the corporation's taxable income and tax liability is the same regardless of whether the gain is classified as capital or ordinary. ◀

The avoidance of the recapture provisions is important to both corporate and noncorporate taxpayers if capital loss carryovers exist. For example, if Western Corporation has a capital loss carryforward of $40,000 in Example I:13-54, the corporation's taxable income is increased by $10,000 ($50,000 − $40,000) if the $50,000 gain is Sec. 1231 gain. However, because the gain is Sec. 1245 ordinary income, the corporation's taxable income is increased by $50,000. The $40,000 capital loss carryforward is deductible only if Western has capital gain or net Sec. 1231 gain which becomes capital gain.

AVOIDING THE RECAPTURE PROVISIONS

In view of the pervasiveness of the recapture provisions discussed in this chapter, recapture is difficult to avoid. In some cases, recapture can be avoided by holding the property a specific length of time before disposing of it (e.g., the recapture of conservation and land clearing expenses can be avoided by holding the farmland for more than nine years).[63] Contributing appreciated property to a qualified charitable organization cannot be used to circumvent the recapture provisions because in such case the amount of the charitable contribution is reduced by the amount of the gain that would not be a LTCG if the property were sold by the taxpayer.[64]

Although it is often difficult to avoid the recapture provisions, taxpayers may dispose of the property and defer recapture if the disposition is a nontaxable exchange. In a like-kind exchange where no boot is received, the recapture potential is carried over to the property received in the exchange.

Proper timing of the asset's disposition may be advantageous. Disposition may be delayed until the taxpayer's tax rate is low or the property can be sold in the same year that the taxpayer has an NOL that is about to expire.

Taxpayers can shift the recapture potential to other taxpayers by making a gift of property subject to recapture. The recapture potential remains with the property and must be considered when the donee disposes of the property.

Transfer Property at Death. One way to avoid the recapture provisions is to transfer the property at death. No recapture occurs at the time of the transfer, and the basis of property received from a decedent is generally the FMV of the property at the date of the decedent's death.[65] The property's recapture potential does not carry over to the beneficiary as in the case of a gift made to a donee.

[63] Sec. 1252(a)(1).
[64] Sec. 170(e)(1)(A).
[65] Sec. 1014(a). For property inherited in 2010, it is possible that carryover basis rules might be used.

Compliance and Procedural Considerations

OBJECTIVE 9

Describe compliance and procedural considerations for Sec. 1231 assets

Form 4797, Supplemental Schedule of Gains and Losses, is used to report gains and losses from sales or exchanges of assets used in a trade or business (see Figures I:13-1 through I:13-3). The form is also used to report gains or losses resulting from involuntary conversions, other than casualties or thefts, of property used in the trade or business and capital assets held more than a year. If gains or losses due to casualties or thefts of property used in a trade or business or property held to produce income are recognized, they are reported on Form 4684, Casualties and Thefts (see Figure I:13-3). If such casualties or thefts occur, Form 4684 is prepared either before or at the same time as Form 4797.

ADDITIONAL COMMENT

Form 4797 has four major parts. In completing this form one should normally begin with Part III on page 2, where the recapture of depreciation is calculated. Note that the total amount recaptured from line 31 is carried forward to Part II, where it is combined with other ordinary gains and losses. Any unrecaptured gain from line 32 is carried forward to Part I, where it is netted with other Sec. 1231 gains and losses.

Reporting Sec. 1231 Gains and Losses on Form 4797

Part I of Form 4797, which is reproduced in Figure I:13-1, is used to report gains and losses resulting from

- The sale or exchange of Sec. 1231 property
- An involuntary conversion, other than a casualty or theft, of Sec. 1231 property
- An involuntary conversion, other than a casualty or theft, of capital assets held more than one year and used to produce income.

As indicated on lines 3 through 6 in Part I of Form 4797, gains and losses recorded on other forms and in Part III of Form 4797 are reported in Part I. The netting of Sec. 1231 gains and losses occurs in Part I of Form 4797. All gains and losses are recorded in column (g). If line 7(g) has a loss, Sec. 1231 losses exceed Sec. 1231 gains and the net loss is reported on line 11 as ordinary loss. If there is no nonrecaptured net section 1231 losses, all gain reported on line 7(g) is transferred to Schedule D. If the taxpayer does have nonrecaptured net Sec. 1231 losses, that amount is reported on line 8. Gains reported on line 7(g) will be recharacterized as ordinary income to the extent of the nonrecaptured net Sec. 1231 losses and reported as ordinary income on line 12.

Ordinary gains and losses recognized including those recorded on other forms and in Parts I and III of Form 4797 are reported on lines 11 through 17 in Part II of Form 4797.

Reporting Gains Recaptured as Ordinary Income on Form 4797

Part III of Form 4797 for 2018, reproduced in Figure I:13-2, is completed before Parts I and II to determine and report ordinary income due to the recapture provisions of Secs. 1245, 1250, 1252, 1254, and 1255. To illustrate the use of Part III, assume an individual sells equipment (7-year recovery) used in a trade or business for $60,000 on April 30, 2018. The equipment cost $58,000 on March 10, 2016, and depreciation deductions through the date of sale of $27,565 were allowed. The $29,565 ($60,000 − $30,435) total gain is reported on line 24. On line 30, total gains resulting from the sale of all properties ($29,565 in this illustration) reported in Part III are combined. The total amount of ordinary income due to the recapture provisions ($27,565 in this illustration) is reported on line 31 and then reported as ordinary income on line 13 in Part II. The excess of the gain over the amount of ordinary income is reported on line 32. The portion of this gain not due to casualty or theft ($2,000 in this illustration) is a Sec. 1231 gain and is reported on line 6 of Part I of Form 4797. If any of the gain is due to casualty or theft, that portion of the gain is reported on Section B of Form 4684.

Reporting Casualty or Theft Gain or Loss on Form 4684

Section A of Form 4684 is used to report gains and losses resulting from a casualty or theft of personal-use property. These gains and losses are not Sec. 1231 transactions, and Sec. A of Form 4684 is not discussed in this chapter.

Section B of Form 4684, reproduced in Figure I:13-3, is used to report gains and losses resulting from a casualty or theft of property used in a trade or business or held for the

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184

2018

Attachment Sequence No. **27**

Name(s) shown on return | **Identifying number**

1	Enter the gross proceeds from sales or exchanges reported to you for 2018 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft.	6	2,000
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	2,000
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	27,565
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824.	16	
17	Combine lines 10 through 16	17	27,565
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), line 14	18b	27,565

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2018)

FIGURE I:13-1 ▶ PART I AND PART II OF FORM 4797

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Equipment	3-10-16	4-30-18
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	60,000			
21 Cost or other basis plus expense of sale	21	58,000			
22 Depreciation (or depletion) allowed or allowable	22	27,565			
23 Adjusted basis. Subtract line 22 from line 21	23	30,435			
24 Total gain. Subtract line 23 from line 20	24	29,565			
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a	27,565			
b Enter the **smaller** of line 24 or 25a	25b	27,565			
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975. See instructions	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 If section 1252 property: Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage. See instructions	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 If section 1254 property:					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b Enter the **smaller** of line 24 or 29a. See instructions	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	29,565
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	27,565
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	2,000

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation. See instructions	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2018)

FIGURE I:13-2 ▶ PART III OF FORM 4797

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side. | Identifying number

SECTION B—Business and Income-Producing Property

Part I Casualty or Theft Gain or Loss (Use a separate Part I for each casualty or theft.)

19 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft. **See instructions if claiming a loss due to a Ponzi-type investment scheme and Section C is not completed.**

Property **A**

Property **B**

Property **C**

Property **D**

		Properties A	B	C	D
20	Cost or adjusted basis of each property	20			
21	Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3	21			
	Note: If line 20 is **more** than line 21, skip line 22.				
22	Gain from casualty or theft. If line 21 is **more** than line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	22			
23	Fair market value **before** casualty or theft	23			
24	Fair market value **after** casualty or theft	24			
25	Subtract line 24 from line 23	25			
26	Enter the **smaller** of line 20 or line 25	26			
	Note: If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.				
27	Subtract line 21 from line 26. If zero or less, enter -0-	27			

28 Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 **or** line 34 (see instructions) . . . 28

Part II Summary of Gains and Losses (from separate Parts I)

(a) Identify casualty or theft	(b) Losses from casualties or thefts (i) Trade, business, rental, or royalty property	(b) Losses from casualties or thefts (ii) Income-producing and employee property	(c) Gains from casualties or thefts includible in income
Casualty or Theft of Property Held One Year or Less			
29	( )	( )	
	( )	( )	
30 Totals. Add the amounts on line 29 — 30	( )	( )	
31 Combine line 30, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions — 31			
32 Enter the amount from line 30, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 28, or Form 1040NR, Schedule A, line 14, and enter the amount from property used as an employee on Schedule A (Form 1040), line 23, or Form 1040NR, Schedule A, line 9. Estates and trusts, partnerships, and S corporations, see instructions — 32			
Casualty or Theft of Property Held More Than One Year			
33 Casualty or theft gains from Form 4797, line 32 — 33			
34	( )	( )	
	( )	( )	
35 Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii) — 35	( )	( )	
36 Total gains. Add lines 33 and 34, column (c) — 36			
37 Add amounts on line 35, columns (b)(i) and (b)(ii) — 37			
38 If the loss on line 37 is **more** than the gain on line 36:			
a Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships (except electing large partnerships) and S corporations, see the note below. All others, enter this amount on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions — 38a			
b Enter the amount from line 35, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 28, or Form 1040NR, Schedule A, line 14, and enter the amount from property used as an employee on Schedule A (Form 1040), line 23, or Form 1040NR, Schedule A, line 9. Estates and trusts, enter on the "Other deductions" line of your tax return. Partnerships (except electing large partnerships) and S corporations, see the note below. Electing large partnerships, enter on Form 1065-B, Part II, line 11 — 38b			
39 If the loss on line 37 is **less** than or **equal** to the gain on line 36, combine lines 36 and 37 and enter here. Partnerships (except electing large partnerships), see the note below. All others, enter this amount on Form 4797, line 3 — 39			
Note: Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 11. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 10.			

FIGURE I:13-3 ▶ SECTION B OF FORM 4684

production of income. Note that a separate Part I is used for each different casualty or theft. Gains are reported on line 26, and losses are reported on line 32. For properties held a year or less, the gains and losses are reported on lines 33 through 36 of Part II. These gains and losses are either recorded as ordinary gains and losses on line 14 of Part II of Form 4797 or as itemized deductions on Schedule A of Form 1040.

For properties held more than a year, the gains and losses are reported on lines 40 and 41. If gains exceed losses, the net gain is reported on line 43 and then on line 3 of Part I of Form 4797 (i.e., the gains and losses are treated as Sec. 1231 gains and losses). If the losses exceed the gains, all or part of the gains and losses are reported as ordinary in Part II of Form 4797 and/or on Schedule A of Form 1040.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:13-1 Explain how the gain on the sale or exchange of land could be classified as either ordinary income, a Sec. 1231 gain, or a LTCG, depending on the facts and circumstances.

I:13-2 Why were taxpayers reluctant to sell appreciated business property between 1938 and 1942? What effect did this reluctance have on the tax law?

I:13-3 Alice owns timber, purchased six years ago, with an adjusted basis of $50,000. The timber is cut for use in her furniture business on October 1, when the FMV of the timber is $200,000. The FMV of the timber on January 1 is $190,000. May Alice treat any of the gain as Sec. 1231 gain? If so, how much?

I:13-4 Explain how the gain from an involuntary conversion of business property held more than one year is taxed if the involuntary conversion is the result of a condemnation. Explain the tax treatment if the involuntary conversion is due to a casualty.

I:13-5 When is livestock considered Sec. 1231 property?

I:13-6 When is a net Sec. 1231 gain treated as ordinary income?

I:13-7 Carlie who is single has a Sec. 1231 gain of $10,000 and no Sec. 1231 losses during the current year. Explain why the gain might be taxed at (a) 15%, (b) 37%, (c) 25%, (d) 20%, or (e) zero.

I:13-8 Why is it unlikely that gains due to the sale of equipment will be treated as Sec. 1231 gains?

I:13-9 Hank sells equipment used in a trade or business for $25,000. The equipment costs $30,000 and has an adjusted basis of $25,500. Why is it important to know the holding period?

I:13-10 Jackie purchases equipment during the current year for $800,000 that has a seven-year MACRS recovery period. She expects to sell the property after three years. Jackie anticipates that her marginal tax rate in the year of sale will be significantly higher than her current marginal tax rate. Why might it be advantageous for her to use the straight-line method of depreciation?

I:13-11 Karen purchased a computer three years ago for $15,300 to use exclusively in her business. She expensed the entire cost of the computer under Sec. 179. If she sells the computer during the current year for $3,721, what is the amount and character of her recognized gain?

I:13-12 Sheila owns a motel that is used in a trade or business. If she sells the motel, the gain will be Sec. 1245 ordinary income. During what period of time was the motel placed into service?

I:13-13 Will an individual taxpayer ever have to recognize Sec. 1250 ordinary income on the sale of a building used for business and placed in service after 1986? Explain.

I:13-14 Marty sells his fully depreciated building at a gain to an unrelated party. The building is purchased before 1981. Is any of the gain taxed as ordinary income?

I:13-15 Which of the following assets (assume all assets have a holding period of more than one year) do not qualify as Sec. 1231 property: inventory, a pig held for breeding, land used as a parking lot for customers, and marketable securities?

I:13-16 When is an office building subject to the depreciation recapture rules of Sec. 1245?

I:13-17 Does a building that is 60% rented for residential use and 40% for commercial use qualify as residential rental property?

I:13-18 Roger owns an apartment complex with a FMV of $2 million. If he sells the apartment complex, $700,000 of the gain is Sec. 1231 gain with $600,000 taxed at 25% because it is unrecaptured Sec. 1250 gain. If he dies before selling the apartment complex and his estate sells the property for $2 million, how much ordinary income must the estate recognize?

I:13-19 Rashad owns a duplex used 100% as residential rental property. Under what conditions, if any,

will any gain that he recognizes be Sec. 1245 ordinary income?

I:13-20 John and Karen are unrelated individuals. John sold land that is Sec. 1231 property held for three years and recognized a $50,000 gain. Karen sold a building that is Sec. 1231 property held for three years and recognized a $50,000 gain. Straight-line depreciation was used. John and Karen both have a 32% tax rate, no other transactions involving capital assets or 1231 assets, and no nonrecaptured Sec. 1231 losses. Except for the sales of different assets, their tax situation is exactly the same. As a result of selling his Sec. 1231 property, will John pay more, less or the same amount of taxes than Karen as a result of selling her Sec. 1231 property? Explain.

I:13-21 Why may a corporation recognize a greater amount of ordinary income due to the sale of Sec. 1250 property than a noncorporate taxpayer?

I:13-22 Assume a taxpayer sells equipment used in a trade or business for a gain that is less than the depreciation allowed. If the taxpayer is a corporation, will a greater amount of Sec. 1245 income be recognized than if the taxpayer is an individual? Explain.

I:13-23 Dale owns business equipment with a $100,000 FMV and an adjusted basis of $60,000. The property was originally acquired for $150,000. Which one of the following transactions would result in recognition of $40,000 ordinary income by Dale due to the depreciation recapture rules of Sec. 1245?

a. He makes a gift of the property to a daughter.

b. He contributes the property to a qualified charitable organization.

c. He disposes of the equipment in an installment sale and receives $10,000 cash in the year of sale.

I:13-24 Carlos owns equipment with an $800,000 acquisition cost, a $270,000 adjusted basis, and a $500,000 FMV. Carlos makes a gift of the equipment to a charitable organization. The equipment is used by the charity in its exempt function. What is the amount of his charitable contribution deduction?

I:13-25 Ted owns a warehouse that cost $850,000 in 1984 and is subject to depreciation recapture under Sec. 1245. The warehouse, which has an adjusted basis of zero, is destroyed by a tornado and Ted receives $580,000 from the insurance company. Within nine months, he pays $500,000 for a new warehouse and an election is made to defer the gain under Sec. 1033. What is the amount and character of Ted's recognized gain?

I:13-26 When a taxpayer disposes of oil, gas, or geothermal property, part or all of the gain may be recaptured as ordinary income. Explain how the recapture amount is determined for oil and gas and geothermal properties.

I:13-27 William owns two appreciated assets, land and a building, which have been used in his trade or business since purchased in 1990. If he sells the two assets to his 100%-owned corporation, will William have to recognize any ordinary income? Explain.

ISSUE IDENTIFICATION QUESTIONS

I:13-28 Six years ago Joelle started raising chinchillas. She separates her chinchillas into two groups, a breeding group and a market group. During the year, she had the following sales of chinchillas from her market group: 400 to producers of fur products; 100 to pet stores; and 25 to individuals to use as pets. From her breeding stock, she sold six chinchillas to Rebecca, an individual who is starting a chinchilla ranch, and five to Fur Pelts, a producer of fur products. All 11 chinchillas from the breeding group have been held for at least 22 months, and the five sold to Fur Pelts were poor performers.

I:13-29 Green Acres, Inc., owns 1,400 acres adjacent to land owned by the U.S. government. The government, wanting to sell timber from its land, had to assure prospective bidders of access to the timber. The government entered into an agreement with Green Acres for a logging road easement across land owned by Green Acres. The government agreed to pay $2 per thousand board feet of timber removed up to a maximum of $130,000. Bidders for the rights to obtain the government's timber had to agree to pay the fee to Green Acres as part of their bids for the timber. Stanley Lumberyard, Inc. provided the highest bid and paid $80,000 to Green Acres during the first year of cutting and removing the timber and $50,000 during the second year. What tax issues should Green Acres and Stanley Lumberyard consider?

I:13-30 Sarah, who has been in the business of erecting, maintaining, and renting outdoor advertising displays for 18 years, has an offer to purchase her business. Two basic types of advertising displays are used in her business: structure X and structure Y. Structure X consists of a single sign face nailed to a wooden support frame and attached to wooden poles 30 feet long. Its structure is rather easy to dismantle and move from one location to another. In contrast, structure Y is a permanent sign that is designed to withstand winds

of up to 100 miles per hour. None of the Structure Y signs have ever been moved. What tax issues should Sarah consider?

I:13-31 Sylvester owns and operates an unincorporated pizza business that delivers pizza to customers. Three years ago, he acquired an automobile for $30,000 to provide delivery service. Recently, Sylvester hired an employee who prefers to use his personal automobile to make the deliveries. Thus, Sylvester decided to permit his 18-year-old daughter to use the automobile for her personal use. The automobile's adjusted basis is $12,300 and its FMV is $15,200. What tax issues should Sylvester consider?

PROBLEMS

I:13-32 ***Secs. 1231, 1245, and 1250 Transactions.*** All assets listed below have been held for more than one year. Which assets might be classified as Sec. 1231, Sec. 1245, or Sec. 1250 property? An asset may be classified as more than one type of property.

a. Land on which a factory is located
b. Equipment used in the factory
c. Raw materials inventory
d. Patent purchased to allow use of a manufacturing process
e. Land held primarily for sale
f. Factory building acquired in 1986 (the straight-line ACRS recovery method is used)

I:13-33 ***Sec. 1231 Gains and Losses.*** Vivian's AGI is $40,000 without considering the gains and losses below. Determine her revised AGI after the inclusion of any applicable gains or losses for the following independent cases. Assume she has no nonrecaptured net Sec. 1231 losses at the beginning of the year.

	Case A	*Case B*	*Case C*	*Case D*
Sec. 1231 gain	$19,000	$10,000	$30,000	$ 5,000
Sec. 1231 loss	5,000	22,000	39,000	12,000
LTCG	–0–	–0–	6,300	–0–
LTCL	–0–	–0–	–0–	4,200

I:13-34 ***Sec. 1231 Gains and Losses.*** Edith, who has no other sales or exchanges and no nonrecaptured Sec. 1231 losses, sells three tracts of land that are used in her trade or business. Edith is single, and her taxable income is $120,000 without considering the following sales.

Asset #1—$15,000 gain and holding period of 20 months
Asset #2—$17,000 loss and holding period of 25 months
Asset #3—$ 5,000 gain and holding period of 13 months

a. What is the increase in her taxes as a result of the three sales?
b. If the holding period for Asset #2 is nine months, what is the decrease in her taxes as a result of the three sales?
c. Same as part a except her taxable income is $500,000.

I:13-35 ***Sec. 1231 Transactions.*** Which of the following transactions or events is treated as a Sec. 1231 gain or loss? All assets are held for more than one year.

a. Theft of uninsured diamond ring, with an $800 basis and a $1,000 FMV.
b. Gain due to condemnation of land used in business.
c. Loss on the sale of a warehouse.
d. Gain of $4,000 on the sale of equipment. Depreciation deductions allowed amount to $10,000.

I:13-36 ***Capital Loss Versus Sec. 1231 Loss.*** Vicki has an AGI of $70,000 without considering the sale of a nondepreciable asset for $23,000. The asset was acquired six years ago and has an adjusted basis of $35,000. She has no other sales or exchanges. Determine her AGI for the following independent situations when the asset is:

a. A capital asset.
b. Sec. 1231 property.

I:13-37 ***Ordinary Income Versus Sec. 1231 Gain.*** At the beginning of 2019, Silver Corporation has a $95,000 capital loss carryforward from 2018. During 2019, the corporation sells land, held for four years, and realizes an $80,000 gain. Silver has no unrecaptured net Sec. 1231 losses, and it made no other sales during the current year. Determine the amount of capital loss carryforward that Silver can use in 2019 if the land is:

a. Sec. 1231 property.
b. Not a capital asset or Sec. 1231 property.

I:13-38 ***Sec. 1231 Transactions.*** During the current year, Sean's office building is destroyed by fire. After collecting the insurance proceeds, Sean has a $50,000 recognized gain. The building was acquired in 1998, and the straight-line method of depreciation has been used. He does not plan to acquire a replacement building. In addition to the gain on the building, consider the following independent cases and determine his total net capital gain. For each case, include the $50,000 casualty gain described above.

a. Land used in his trade or business and held more than a year is condemned by the state. The recognized gain is $60,000.

b. Assume the same facts as in Part a, except the condemnation results in a $60,000 loss.

c. An apartment building used as residential rental property and held more than one year is destroyed by a sudden, unexpected mudslide. The building is not insured, and the loss amounts to $200,000.

I:13-39 ***Nonrecaptured Net Sec. 1231 Losses.*** Consider the following summary of Sec. 1231 gains and losses recognized by Janet during the period 2014–2019. Janet had no nonrecaptured Sec. 1231 losses at the beginning of 2014. If Janet has no capital gains and losses during the six-year period, determine her net capital gain and ordinary income/loss for each year.

	Sec. 1231 Gains	*Sec. 1231 Losses*
2014	$ 9,000	$ 7,000
2015	20,000	24,000
2016	12,000	19,000
2017	9,000	4,000
2018	25,000	13,200
2019	10,000	17,000

I:13-40 ***Nonrecaptured Net Sec. 1231 Losses.*** Dillion has taxable income of less than $300,000 without considering the $53,000 Sec. 1231 gain mentioned below, and he has a tax rate of 35%. He has $40,000 of net nonrecaptured Sec. 1231 losses at the start of the year. During the year, he recognizes a Sec. 1231 gain of $53,000 from the sale of land. As a result of the sale, how much does Dillion's tax liability increase?

I:13-41 ***Sec. 1245.*** The Pear Corporation owns equipment with a $300,000 adjusted basis. The equipment was purchased six years ago for $650,000. If Pear sells the equipment for the selling prices given in the three independent cases below, what are the amount and character of Pear's recognized gain or loss?

Case	*Selling Price*
A	$407,000
B	752,000
C	245,000

I:13-42 ***Sec. 1245.*** Elizabeth owns equipment that cost $500,000 and has an adjusted basis of $230,000. If the straight-line method of depreciation had been used, the adjusted basis would be $300,000.

a. What is the maximum selling price that she could sell the equipment for without having to recognize Sec. 1245 ordinary income?

b. If she sold the equipment and had to recognize $61,000 of Sec. 1245 ordinary income, what was the selling price?

I:13-43 ***Sale of Business and Personal-Use Property.*** Arnie, a college student, purchased a truck in 2017 for $6,000. He used the truck 70% of the time as a distributor for the local newspaper and 30% of the time for personal use. The truck has a five-year recovery period, and he claimed depreciation deductions of $840 in 2017 and $1,344 in 2018. Arnie sells the truck on June 20, 2019, for $3,000.

a. What is the amount of allowable depreciation in 2019?

b. Determine Arnie's realized and recognized gain or loss and its character.

I:13-44 ***Exchange of Sec. 1245 Property.*** General Corporation owns equipment which cost $70,000 and has a $44,000 adjusted basis. General exchanges the equipment in June of 2019 for other equipment ($52,000 FMV) and marketable securities ($30,000 FMV). Determine the following:

a. Realized gain

b. Recognized gain

c. Gain treated as ordinary income

d. Gain treated as Sec. 1231 gain

e. Basis of marketable securities received

f. Basis of equipment received

I:13-45 ***Exchange of Sec. 1245 Property Before 2018.*** Leroy owned a truck used in his trade or business that cost $50,000 and had an adjusted basis of $34,000 in 2016 when the truck was exchanged for a new truck that was like-kind property with a FMV of $40,000. Prior to selling the new truck in 2019, Leroy was allowed depreciation of $13,000 for the new truck. Determine:

a. Realized gain on the exchange in 2016
b. Recognized gain on the exchange that was a like-kind exchange in 2016
c. Basis of truck received in 2016
d. Recognized gain, and the character of the gain, if the sales price of the truck is $41,000
e. Recognized gain, and the character of the gain, if the sale price of the truck is $52,000
f. If the exchange had occurred during the current year, determine the recognized gain and the basis of the new truck.

I:13-46 ***Purpose of Sec. 1245.*** Martin owns equipment used in his trade or business purchased four years ago for $200,000. Martin sells the equipment in the current year for $110,000 when its adjusted basis is $52,000. No other sales or exchanges are made this year or the preceding five years. His tax rate is 35% and 15% for ANCG for all years since the year of purchase.

a. Determine the increase in Martin's AGI for the current year as a result of the sale if Sec. 1245 did not exist.
b. Determine the increase in Martin's AGI for the current year as a result of the sale if Sec. 1245 does exist.
c. Given that Sec. 1245 does exist, how much higher is his tax in (b) than in (a)?

I:13-47 ***Secs. 1231 and 1250-Real Property Placed in Service Before 1981.*** Charles owns an office building and land that are used in his trade or business. The office building and land were acquired in 1978 for $800,000 and $100,000, respectively. During the current year, the properties are sold for $900,000 with 20% of the selling price being allocated to the land. The assets as shown on the taxpayer's books before their sale are as follows:

Building	$800,000	
Accumulated depreciation	690,000[a]	$110,000
Land		100,000

[a]If the straight-line method of depreciation had been used, the accumulated depreciation would be $560,000.

a. What is the recognized gain due to the sale of the building?
b. What is the character of the recognized gain due to the sale of the building?
c. What is the recognized gain and character of the gain due to the sale of the land?

I:13-48 Assume the same facts as in Problem I:13-47 except the taxpayer is a corporation and answer the same questions.

I:13-49 ***Secs. 1231, 1245, and Unrecaptured Sec. 1250.*** Brigham is single and is in the 32% marginal income tax bracket. He has the sales or exchanges below. At the beginning of the year, he has nonrecaptured net Sec. 1231 losses of $10,000. Determine the increase or decrease in Brigham's tax liability as a result of the following independent sales or exchanges.

a. Sells equipment used in his trade or business for $40,000. The equipment was purchased for $100,000 and depreciation allowed amounts to $72,000.
b. Sells land used in his trade or business for $80,000. The land was purchased four years ago for $61,000.
c. He sells a building used in his trade or business for $163,000. The building was purchased in 1997 for $250,000 and depreciation allowed amounts to $110,000.
d. Same as Part c except he sells the building for $127,000.

I:13-50 ***Secs. 1245 and 1231.*** The LaPoint Corporation placed in service $350,000 of used equipment (seven-year recovery property) on June 3, 2018 and elected to expense $250,000 as Sec. 179 depreciation expense but elected out of bonus depreciation. LaPoint sold the equipment for $150,000 on November 22, 2019. Determine the following:

a. Depreciation allowed in 2018
b. Depreciation allowed during 2019
c. Amount of gain or loss and character

I:13-51 ***Unrecaptured Sec. 1250 Gain and 1231.*** Mr. Briggs purchased an apartment complex on January 10, 2017, for $2 million with 10% of the price allocated to land. He sells the complex on October 22, 2019, for $2.5 million. Assume that 10% of the $2.5 million selling price is allocated to land and 90% is allocated to the building.

a. How much depreciation was allowed for 2017?
b. How much depreciation is allowed for 2019?

c. Will any of the gain be ordinary income?
d. What is the amount of gain and the character of the gain on the sale of the building?
e. What is the amount of gain and the character of the gain on the sale of the land?
f. Will any of the gain be taxed at 25%?

I:13-52 ***Sec. 1250 Residential Rental Property-Placed in Service After 1981 and Before 1987.*** Jesse owns a duplex used as residential rental property. The duplex cost $100,000 in 1986, and 10% of the cost was allocated to the land. Total cost-recovery deductions allowed amount to $90,000. The statutory percentages were used to compute cost-recovery deductions. If the straight-line method of cost recovery were used instead, $90,000 of cost-recovery deductions would have been allowed.

a. What is the amount of recognized gain and the character of the gain if Jesse sells the duplex for $125,000 with 10% of the price allocated to land?
b. Same as (a) except the building is an office building.

I:13-53 ***Sec. 1250-Real Property Placed in Service Before 1981.*** Rosemary owns an office building placed in service in 1980 that cost $625,000 and has an adjusted basis of $227,000. If the straight-line method of depreciation were used, the adjusted basis would be $300,000.

a. What is the maximum selling price that she could sell the building for without having to recognize Sec. 1250 ordinary income?
b. If she sold the building and had to recognize $51,000 of Sec. 1250 ordinary income, what was the selling price?

I:13-54 ***Nonresidential Real Property-Noncorporate Taxpayer.*** Consider three office buildings placed in service as shown below and answer the following true-false questions. Assume all assets are sold by a noncorporate taxpayer at a gain and there are no other sales or exchanges or nonrecaptured Sec. 1231 loss unless told otherwise. None of the buildings are fully depreciated when sold and the taxpayer's tax rate is 32% and 15% for ANCG.

	Placed in Service
Building #1	Before 1981
Building #2	After 1980 and before 1987
Building #3	After 1986

1. Some or all of the gain on sale of #1 is ordinary if accelerated depreciation was used.
2. If the straight-line method of depreciation was used for #1, some or all of the gain may be taxed at 25%.
3. Gain on the sale of #2 could be Sec. 1245 ordinary income.
4. Gain on the sale of #2 could be Sec. 1231 gain.
5. Part of the gain on the sale of #2 could be Sec. 1245 ordinary income and part could be Sec. 1231 gain.
6. If the straight-line method of depreciation was used for #2, some or all of the gain may be taxed at 25%.
7. Some or all of the gain on the sale of #3 could be Sec. 1245 ordinary income.
8. Some or all of the gain on the sale of #3 could be taxed at 25%.
9. Some of the gain on the sale of #3 could be Sec. 1250 ordinary income.
10. If the taxpayer has a nonrecaptured Sec. 1231 loss of $30,000 and the gain on the sale of #3 is $40,000, all $40,000 of the gain is taxed as ordinary income.

I:13-55 ***Nonresidential Real Property-Corporate Taxpayer.*** Assume the same facts as in Problem I:13-54 except the taxpayer is a corporate taxpayer with a 21% tax rate and answer the ten true-false questions.

I:13-56 ***Secs. 1231 and 1250-Placed in Service After 1986.*** Molly, whose tax rate is 37%, sells an apartment complex for $4.5 million with 10% of the price allocated to land. The apartment complex was purchased in 1994. She has no other sales or exchanges during the year and no nonrecaptured net Sec. 1231 losses. Information about the assets at the time of sale is:

	Building	*Land*
Original Cost	$2,700,000	$300,000
Accumulated Depreciation	1,000,000	0

a. What is the recognized gain on the sale of the building and the character of the gain?
b. What is the recognized gain on the sale of the land and the character of the gain?
c. How much of the Sec. 1231 gain is taxed at 25%?
d. If Molly has NSTCL of $50,000, will the capital loss reduce the Sec. 1231 gain taxed at 25% or 20%?

I:13-57 ***Secs. 1231 and 1250 for Corporate Taxpayer.*** Assume the same facts as in Problem I:13-56 except the taxpayer is a corporation instead of an individual.

a. What is the recognized gain on the sale of the building and the character of the gain?
b. What is the recognized gain on the sale of the land and the character of the gain?
c. How much of the Sec. 1231 gain is taxed at 25%?

I:13-58 ***Charitable Contribution of Sec. 1231 Property.*** Raquel owns land used in her trade or business for more than one year. The basis is $10,000 and its FMV is $40,000. Her tax rate is 32% and her AGI is $250,000. She makes no other charitable contributions except for the ones considered below.

a. If she gives the land to a university, determine her tax savings.
b. If she sells the land for $40,000, pays the tax and then contributes the remainder of the cash to the charity, determine her tax savings because of the contribution and the amount that the university receives. Assume that she has no other sales or exchanges during the year.

I:13-59 ***Secs. 1231, 1245, and 1250.*** Glen, whose tax rate is 32%, sells each of the following assets for $200,000. Each case is an independent case.

	Sec. 1231 Gain (Loss)	*Ordinary Income*	*Taxed at 32%*	*Taxed at 25%*	*Taxed at 20%*	*Taxed at 15%*
Building purchased in 2003 for $220,000 with adjusted basis of $165,000	_____	_____	_____	_____	_____	_____
Equipment purchased in 2015 for $300,000 with adjusted basis of $144,000	_____	_____	_____	_____	_____	_____
Land purchased in 1996 for $30,000 to use as a building site	_____	_____	_____	_____	_____	_____
Building purchased in 2002 for $150,000 with adjusted basis of $112,000	_____	_____	_____	_____	_____	_____
Equipment purchased in 2016 for $180,000 with adjusted basis of $140,000	_____	_____	_____	_____	_____	_____

I:13-60 ***Recapture of Soil and Water Conservation Expenditures.*** Bob owns farmland with a $600,000 basis, and he elects to expense $100,000 of expenditures incurred for soil and water conservation purposes. Bob sells the farmland after farming for seven years and four months. What is the amount of the recognized gain and the character of the gain if the selling price is

a. $825,000
b. $615,000

I:13-61 ***Recapture of Intangible Drilling Costs.*** Jeremy purchased undeveloped oil and gas property five years ago. He paid $300,000 for intangible drilling and development costs and elected to expense the $300,000. During the current year, Jeremy sells the property, which has an $800,000 adjusted basis, for $900,000. What is the amount of gain treated as ordinary income under Sec. 1254 because of the election to expense intangible drilling and development costs?

I:13-62 ***Recapture of Intangible Drilling Costs and Depletion.*** In 2013, Jack purchased undeveloped oil and gas property for $900,000 and paid $170,000 for intangible drilling and development costs. He elected to expense the intangible drilling and development costs. During the current year he sells the property for $950,000 when the property's adjusted basis is $700,000. Depletion of $200,000 was allowed on the property.

a. What is the realized gain and how much of the gain is ordinary income?
b. For Jack to have a Sec. 1231 gain, the selling price must exceed what amount?

I:13-63 ***Related Party Transactions.*** Ed operates a storage business as a sole proprietorship and owns the following assets acquired in 2000:

Warehouse	$400,000
Minus: Accumulated depreciation	(230,000)

Adjusted basis	$170,000
Land	65,000

The FMV of the warehouse and the land are $500,000 and $200,000, respectively. Ed owns 75% of the stock of the Crane Corporation. If he sells the two assets to Crane at a price equal to the FMV of the assets, determine the recognized gain and its character due to the sale of the:

a. Building
b. Land

COMPREHENSIVE PROBLEM

I:13-64 Betty, whose tax rate is 32%, is in the business of breeding and racing horses. Except for the transactions below, she has no other sales or exchanges and she has no unrecaptured net Sec. 1231 losses. Consider the following transactions that occur during the year:

- A building with an adjusted basis of $300,000 is destroyed by fire. Insurance proceeds of $500,000 are received, but Betty does not plan to replace the building. The building was built 12 years ago at a cost of $430,000 and used to provide lodging for her employees. Straight-line depreciation has been used.
- Four acres of the farm are condemned by the state to widen the highway and Betty receives $50,000. The land was inherited from her mother 15 years ago when its FMV was $15,000. Her mother purchased the land for $10,300. Betty does not plan to purchase additional land.
- A racehorse purchased four years ago for $200,000 was sold for $550,000. Total depreciation allowed using the straight-line method amounts to $160,000.
- Equipment purchased three years ago for $200,000 is exchanged for $100,000 of IBM common stock. The adjusted basis of the equipment is $120,000. If straight-line depreciation had been used, the adjusted basis would be $152,000.
- An uninsured pony, with an adjusted basis of $20,000 and FMV of $35,000, that her daughter uses only for personal use is injured while attempting a jump. Because of the injury, the uninsured pony has to be destroyed by a veterinarian.

a. What amount of Sec. 1245 ordinary income must be recognized?
b. What amount of Sec. 1250 ordinary income must be recognized?
c. Will the loss resulting from the destruction of her daughter's pony be used to determine net Sec. 1231 gains or losses?
d. What is the amount of the net Sec. 1231 gain or loss?
e. After all of the netting of gains or losses is completed, will the gain resulting from the involuntary conversion of the building be treated as LTCG?
f. What is the amount of her Sec. 1231 gain that is unrecaptured Sec. 1250 gain?

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:13-65 Russ has never recognized any Sec. 1231 gains or losses. In December 2019, Russ is considering the sale of two Sec. 1231 assets. The sale of one asset will result in a $20,000 Sec. 1231 gain while the sale of the other asset will result in a $20,000 Sec. 1231 loss. Russ has no other capital or Sec. 1231 gains and losses in 2019 and does not expect to have any other capital or Sec. 1231 gains and losses in 2019. He is aware that it might be advantageous to recognize the Sec. 1231 gain and the Sec. 1231 loss in different tax years. However, he does not know whether he should recognize the Sec. 1231 gain in 2019 and the Sec. 1231 loss in 2020 or vice versa. His marginal tax rate for each year is expected to be 32%. Advise the taxpayer with respect to these two alternatives:

a. Recognize the $20,000 Sec. 1231 loss in 2019 and the $20,000 Sec. 1231 gain in 2020.
b. Recognize the $20,000 Sec. 1231 gain in 2019 and the $20,000 Sec. 1231 loss in 2020.

I:13-66 Holly has recognized a $9,000 STCL. She has no other recognized capital gains and losses in 2019. She is considering the sale of a Sec. 1231 asset held for four years at a $5,000 gain in 2019. She had not recognized any Sec. 1231 losses during the previous five years and does not expect to have any other Sec. 1231 transactions in 2019. Her marginal tax rate for 2019 is 32%. What is the amount of increase in her 2019 taxes if Holly recognizes the $5,000 Sec. 1231 gain in 2019?

TAX FORM/RETURN PREPARATION PROBLEMS

I:13-67 ***Short Tax Form.*** George Buckner sells an apartment building on October 10 for $1.75 million. The building was purchased on January 1, 1998, for $2 million. Depreciation of $420,000 has been taken. The figures given above do not include the purchase price or the selling price of the land. Mr. Buckner's adjusted basis for the land is $200,000, and the sales price is $350,000. Mr. Buckner, who owns and operates a taxi business, sells one of the automobiles for $1,800 on November 14th. The automobile's adjusted basis is zero, and the original cost is $15,000. The automobile was purchased on April 25, 2009. Mr. Buckner has no other gains and losses during the year, and nonrecaptured net Sec. 1231 losses amount to $32,000. Prepare Form 4797.

I:13-68 Julie Hernandez is single and has no dependents. She operates a dairy farm and her Social Security number is 000-00-1111. She lives at 1325 Vermont Street in Costa, Florida. Consider the following information for the current year:

- Schedule C was prepared by her accountant and the net profit from the dairy operations is $48,000.
- Itemized deductions amount to $4,185.
- Dividend income (qualified dividend) amounts to $280.
- State income tax refund received during the year is $125. She did not itemize last year.
- In June, a burglar broke into her house and stole the following two assets, which were acquired in 1989:

	Basis	*FMV*	*Insurance Proceeds Received*
Painting	$2,000	$10,000	$9,000
Sculpture	1,700	1,500	0

The following assets used in her business were sold during the year:

	Acquisition Date	*Original Cost*	*Depreciation to Date of Sale*	*Date of Sale*	*Selling Price*
Tractor	June 10, 2008	$25,000	$25,000	Oct. 20	$ 8,300
Barn	May 23, 1998	90,000	61,000	May 13	87,000
Land	May 23, 1998	15,000	–0–	May 13	27,000
Cows	Sept. 7, 2016	20,000	13,000	Nov. 8	21,000

In August, three acres of the farm were taken by the state under the right of eminent domain for the purpose of building a highway. The basis of the three acres is $1,500, and the state paid the FMV, $22,000, on February 10. The farm was purchased on August 12, 1987.

Nonrecaptured net Section 1231 losses from the five most recent tax years preceding the current year amount to $7,000. Estimated taxes paid during the year amount to $32,000.

Prepare Forms 1040, 4684 Section A, 4797, and Schedule D. (Do not consider the alternative minimum tax or self-employment taxes discussed in Chapter I:14.)

CASE STUDY PROBLEMS

I:13-69 Your client, Kent Earl, whose tax rate is 35%, owns a bowling alley and has indicated that he wants to sell the business for $1 million and purchase a minor league baseball franchise. His business consists of the following tangible assets:

	Acquisition Date	*Original Cost*	*Adjusted Basis*
Equipment	2007	$600,000	$150,000
Building	2007	900,000	494,000
Land	2002	100,000	100,000
Inventory	Current year	50,000	50,000

Because you have another client, Tom Quick, who is interested in purchasing a business, you informed Tom of Kent's interest in selling. Tom wants to purchase the bowling alley, and the price sounds right to him. The bowling alley business has been very profitable in the last few years because Kent has developed a loyal group of customers by promoting bowling leagues during the week days and a special Saturday afternoon session for children

in the elementary school grades. Kent and Tom have come to you and want to know how the transaction should be handled for the best tax results. You know that the $1 million purchase price will have to be allocated among the assets and it will be necessary to estimate the FMV of all assets. Because FMV is often subjective, Kent and Tom recognize that some flexibility might exist in allocating the purchase price. For example, it might be just as easy to justify a FMV of $300,000 or $325,000 for the equipment.

a. What advice do you have for Kent with respect to the allocation (i.e., should he be interested in allocating more to some assets than others)? Explain the reasoning for your advice.

b. Would your advice to Kent be different if he had a large amount of capital losses and no nonrecaptured net Sec. 1231 losses?

c. What advice do you have for Tom with respect to the allocation (i.e., should he be interested in allocating more of the purchase price to some assets than to others)? Explain the reasoning for your advice.

d. What advantages might result from having Kent sign an agreement not to compete (i.e., operate a bowling alley)?

e. Should you have a concern about the ethical implications of advising both Kent and Tom?



I:13-70 Assume the same facts as in Case Study Problem I:13-69 except you have the following market values as a result of an appraisal:

Equipment	$ 250,000
Building	500,000
Land	140,000
Inventory	110,000
Total	$1,000,000

Tom insists that $150,000 of the purchase price should be allocated to inventory and $100,000 should be allocated to land. He refuses to complete the purchase unless the allocation is made as he requests. What action should you take with respect to Tom's request? (See Chapter I:10 for a discussion of valuation issues in the purchase and sale of a business.)

TAX RESEARCH PROBLEM

I:13-71 Berkeley Corporation has a policy of furnishing new automobiles to the athletic department of the local university. The automobiles are used for short periods of time by the extremely popular head basketball coach. When the automobiles are returned to Berkeley Corporation, they are sold to regular customers. The owner of Berkeley Corporation maintains that any such cars held for more than one year should qualify as Sec. 1231 property. Do you agree?

Research sources include:

- Rev. Rul. 75-538, 1975-2 C.B. 34

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CHAPTER

14

SPECIAL TAX COMPUTATION METHODS, TAX CREDITS, AND PAYMENT OF TAX



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Calculate the alternative minimum tax
2. Describe self-employment income and compute the self-employment tax
3. Describe the various business and personal tax credits
4. Describe and compute the premium tax credit
5. Explain the mechanics of the federal withholding tax system and the requirements for making estimated tax payments
6. Describe tax planning considerations for AMT, tax credits, and payment of taxes
7. Describe compliance and procedural considerations for AMT, tax credits, and payment of taxes

CHAPTER OUTLINE

Alternative Minimum Tax ...14-2
Self-Employment Tax ...14-8
Personal and Business Tax Credits ...14-10
Provisions Related to Health Insurance ...14-24
Payment of Taxes ...14-26
Tax Planning Considerations ...14-30
Compliance and Procedural Considerations ...14-32

Chapter I:2 discussed the basic tax computation for individuals using the tax table and tax rate schedules. This chapter completes the discussion of the tax computation by examining three principal topics:

1. Two additional taxes: the alternative minimum tax and self-employment tax;
2. Various tax credits that reduce tax liability; and
3. Methods for prepayment of an individual's tax liability, including wage withholding and estimated tax payments.

ALTERNATIVE MINIMUM TAX

OBJECTIVE 1

Calculate the alternative minimum tax

Although its central purpose is to raise revenue to fund federal government operations, Congress has expanded the use of the federal income tax system to include provisions designed to promote economic and social goals. As the number of special tax provisions increased, some high-income individual taxpayers were able to plan their financial affairs to substantially reduce or eliminate their income tax liability. As a result, in 1969, Congress passed a new set of rules to ensure that all taxpayers would pay at least a minimum amount of income tax. The original "minimum tax" has evolved into a broad tax known today as the **alternative minimum tax (AMT)**.

The present AMT applies to individuals, estates, and trusts.[1] The AMT system is structured as a separate tax system, but it operates in parallel with the regular income tax system. After taxpayers determine their regular taxable income and regular tax liability, they determine the AMT tax base by modifying regular taxable income for AMT preferences and adjustments and the AMT exemption. AMT tax rates are applied to compute the tax, which is known as the Tentative Minimum Tax (TMT). Taxpayers must pay the *greater* of the regular income tax or the TMT.

ADDITIONAL COMMENT

The Tax Cuts and Jobs Act of 2017 is expected to significantly decrease the number of taxpayers subject to AMT starting in 2018, due to increased exemption amounts and increases in the income level at which exemptions begin to phase out.

In aggregate, few individual taxpayers pay the AMT. Only about 4.6 percent of taxpayers were subject to the AMT in 2016, but the tax revenue from it exceeded $31 billion, or 2 percent of the combined total of regular income tax and AMT.[2]

EXAMPLE I:14-1 ▶ Ricardo and Sue are married and file a joint return for 2019 with regular taxable income of $90,000 and tax preferences and adjustments of $12,000. Their alternative minimum taxable income (AMTI) is $102,000 ($90,000 + $12,000), but the alternative minimum tax base is zero because of the $111,700 exemption. Thus, their tax liability is based on the regular tax computation, and they owe no AMT liability. ◀

EXAMPLE I:14-2 ▶ Assume the same facts for Ricardo and Sue as in Example I:14-1 except they have tax preferences and adjustments of $70,000. Their alternative minimum taxable income (AMTI) is $160,000. Their tentative minimum tax (TMT) is $12,558 [($160,000 − $111,700) = $48,300 × 26% = $12,558]. Regular tax on taxable income of $90,000 is $11,517. Ricardo and Sue must pay the TMT of $12,558 because it exceeds the regular tax of $11,517. ◀

[1] The AMT applicable to corporations is repealed by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97).

[2] IRS, *Statistics of Income*, 2016, Individual Income Tax Returns, Publication 1304, September 2018. IRS, Statistics of Income, Individual Income Tax Returns, Line Item Estimates, 2016. Publication 4801, September 2018.

HISTORICAL NOTE

The original add-on minimum tax, enacted in 1969, was 10% of the taxpayer's tax preferences in excess of a $30,000 statutory exemption.

AMT COMPUTATION

The individual AMT uses the approach outlined below to determine the AMT tax base and the amount of AMT imposed, if any.[3]

ADDITIONAL COMMENT

Some tax advisors recommend accelerating income into a year in which the taxpayer is subject to the AMT because the income will be taxed at a 26% or a 28% rate rather than a possibly higher rate in a later year.

TAXABLE INCOME (determined under the regular income tax system)
Plus: AMT preference items
Plus or minus: AMT adjustments

=ALTERNATIVE MINIMUM TAXABLE INCOME (AMTI)
Minus: AMT exemption amount (see table below)

=ALTERNATIVE MINIMUM TAX BASE
Multiplied by AMT tax rates

=TENTATIVE MINIMUM TAX
Minus: Regular income tax

ALTERNATIVE MINIMUM TAX

In the American Taxpayer Relief Act of 2012, Congress provided for automatic annual inflation adjustments for the AMT exemption amount, the AMT exemption phase-out range, and the AMT tax brackets (Sec. 55(d)(4)). The inflation adjusted amounts for the 2019 AMT exemption and phase-out range appear in the table below.

AMT TAX RATES AND BRACKETS

The AMT for 2019 (2018) is imposed on the AMT base at 26% of the first $194,800 ($191,100) and at 28% on AMTI over $194,800 ($191,100).[4]

AMT EXEMPTION AMOUNT

The AMT exemption operates as a buffer to reduce the impact of AMT. The buffer is ineffective for high-income taxpayers both because of the limited amount of the basic exemption and because the exemption amount is disallowed (phased-out) as income rises over a threshold amount. The exemption is reduced by 25 cents per dollar of AMTI over the threshold: Exemption allowed = Basic exemption amount − 25% (AMTI − Threshold). The phase-out concludes when the amount of AMTI is sufficient to reduce the exemption allowed to $0.

Filling Status	*2019 Basic Exemption*	*2019 Phaseout Threshold*	*2018 Basic Exemption*	*2018 Phaseout Threshold*
Married filing joint	$111,700	$1,020,600	$109,400	$1,000,000
Married filing separate	$55,850	$510,300	$54,700	$500,000
Single, Head of household	$71,700	$510,300	$70,300	$500,000

[3] Sec. 55(b)(1).

[4] The AMT rate on net capital gains and qualified dividends depends on the taxpayers taxable income. 0% rate applies to married filing joint taxpayers with taxable income below $78,750 (single $39,375). 15% rate applies to married filing joint taxpayers with taxable income between $78,750–$488,850 (single $39,375–$434,550). 20% rate applies to married filing joint taxpayers with taxable income above $488,850 (single $434,550). (Sec. 1(h)(1)).

EXAMPLE I:14-3 ▶ Rita, an unmarried taxpayer filing single, has regular taxable income of $550,000 in 2019, a regular tax liability of $168,488, a positive AMT adjustment (due to limitations on itemized deductions) of $50,000, and tax preferences of $60,000. Rita's alternative minimum tax is calculated as follows:

Taxable income	$ 550,000
Plus: Tax preferences	60,000
Plus: AMT Adjustment for itemized deductions	50,000
Alternative minimum taxable income (AMTI)	$ 660,000
Minus: Exemption amount ($71,700 − $37,425)[a]	(34,275)
Alternative minimum tax base	$ 625,725
Tax on first $194,800: ($194,800 × 26%)	$ 50,648
Tax on excess over $194,800: ($430,925 × 28%)	120,659
Tentative minimum tax	$ 171,307
Minus: Regular tax	(168,488)
Alternative minimum tax (AMT)	$ 2,819

[a]Exemption phaseout: [25% × ($660,000 - $510,300)] = $37,425 ◀

AMT TAX PREFERENCE ITEMS

ADDITIONAL COMMENT

Over the years, tax preference items have diminished in importance while adjustments have increased their impact on AMT liabilities.

Certain provisions in the Internal Revenue Code grant favorable treatment to taxpayers. However, because of concern that some taxpayers may overuse these favorable provisions, Congress has classified them as tax preferences (IRC Sec. 57). For example, though the regular tax system allows deductions for depletion in excess of the property's basis, the AMT system limits depletion deductions to the property's basis. So, an AMT preference item (equal to depletion deducted in excess of basis) is a required addition. All AMT tax preference items are additions toward AMTI. However, only certain items receiving preferential regular tax treatment are tax preference items.

ADDITIONAL COMMENT

Under the American Recovery and Reinvestment Act of 2009, interest on private activity bonds issued in 2009 or 2010 is not treated as a tax preference item.

To compute the AMT tax base, the tax preferences designated in Sec. 57 must be added to regular taxable income. Some common tax preference items include:

- The excess of accelerated depreciation expense over a hypothetical straight-line depreciation amount for real property placed in service before 1987 (computed on an item-by-item basis).
- Tax-exempt interest on certain private activity bonds. In general, private activity bonds are state or local bonds that are issued to help finance a private business (for example, professional sports fields).
- The excess of depletion expense over the adjusted basis of the underlying natural resource asset. The preference does not apply to independent oil and gas producers and royalty owners (Sec. 57(a)(1)).

EXAMPLE I:14-4 ▶ Richard, a single taxpayer, has the following tax preference items for the current year:

- $15,000 ACRS cost-recovery deduction on real property placed in service before 1987 and held for investment. The straight-line ACRS deduction would have been $10,000.
- $10,000 of tax-exempt interest on private activity bonds.

Richard's total tax preferences are $15,000, consisting of $5,000 excess cost recovery deductions and $10,000 tax-exempt interest on the private activity bonds. ◀

KEY POINT

For purposes of the alternative minimum tax, no deduction is allowed for the standard deduction.

AMT ADJUSTMENTS

For most individual taxpayers, adjustments fall into three categories: (1) regular tax itemized deductions disallowed in computing AMTI, (2) the AMT system's disallowance of the standard deduction (if taken), and (3) timing differences relating to the deferral of income or the acceleration of deductions under the regular tax rules.

ADDITIONAL COMMENT

Some tax advisors recommend that cash basis taxpayers prepay their local property taxes or state income taxes before the end of the year to reduce the current year's tax liability. However, if the taxpayer is subject to the AMT, this may not be effective in reducing the current tax liability.

Itemized Deductions. Only certain itemized deductions are allowed in computing AMTI. The more significant itemized deductions that *are not deductible* for the AMT include:

- State, local, and foreign income taxes, sales taxes, and real and personal property taxes.
- Home mortgage interest expense that is *not* "qualified housing interest." Qualified housing interest includes only interest on debt incurred to acquire/build/improve taxpayers' principal residence or second home (e.g., interest on a home equity loan used to buy a car).

Standard Deduction. Although allowed for regular tax, a standard deduction is not allowed for AMTI.

EXAMPLE I:14-5 ▶ Robin, age 45, is a single taxpayer with no dependents. She has AGI of $100,000 and the following itemized deductions for the current tax year:

Charitable contributions	$ 4,000
Medical expenses, net of insurance	10,500
Mortgage interest (100% qualified housing interest)	18,400
Real estate taxes	4,000
State income taxes	6,000

From the information above, Robin's regular taxable income would be:

TAX AUTHORITY UPDATE

Prior to the Tax Cuts and Jobs Act of 2017, taxpayers could take miscellaneous itemized deductions subject to the 2% AGI floor for regular tax purposes. In tax years 2018–2025 this deduction is no longer allowed for regular tax purposes and therefore is no longer an AMT adjustment. Similarly, personal and dependency exemptions that were allowed prior to 2018 are no longer an AMT adjustment.

AGI			$100,000
Itemized deductions:			
Charitable contributions		$ 4,000	
Medical expenses	$10,500		
Less 10% of AGI	(10,000)	500	
Mortgage interest (100% qualified housing interest)		18,400	
Real estate taxes		4,000	
State income taxes		6,000	(32,900)
Taxable income			$67,100

Assume that Robin also has $20,000 of tax preferences. Her AMTI would be computed as follows:

Taxable income	$67,100
Tax preferences	20,000
AMT adjustments:	
Real estate and state income taxes (not allowed for AMTI)	10,000
AMTI	$97,100 ◀

Timing Differences. Other adjustments are required when the rules for calculating regular taxable income permit the taxpayer temporarily to defer the recognition of income or to accelerate deductions (timing differences). Common AMT adjustments for timing differences include:

- For personal property placed in service after 1998 and before 2016 in which the taxpayer elects out of taking bonus depreciation, the difference between the MACRS depreciation deduction and the hypothetical amount determined by using the 150% declining balance method over the recovery period used for regular tax purposes. Bonus depreciation, where applicable, is allowed in full for purposes of the AMT, and if bonus depreciation is taken or the property was simply eligible for bonus depreciation and placed in service after 2015, AMT depreciation and regular depreciation are calculated the same, and there will be no timing adjustment.
- For real property placed in service after 1986 and before January 1, 1999, the difference between the MACRS depreciation claimed using the property's actual recovery

period and a hypothetical straight-line depreciation amount calculated using a 40-year life (see Chapter I:10 for a discussion of the alternative depreciation system).[5]

- For incentive stock options, the excess of the option's fair market value over the price paid by the individual for the option. This adjustment is measured on the date the rights to the underlying stock are freely transferable or are not subject to a substantial risk of forfeiture.
- For research and experimental (R&E) expenditures, the difference between the regular tax deduction and the deduction that would have been allowed if the expenditures were capitalized and amortized over a ten-year period.

EXAMPLE I:14-6 ▶ Rob has the following AMT adjustments caused by timing differences in 2019:

- Depreciation of $3,636 on residential rental property costing $100,000 and placed in service in January 1999 (using the straight-line method and a 27.5-year recovery period under MACRS). Depreciation for AMT purposes is $2,500 (using the straight-line method and a 40-year recovery period under the alternative depreciation system). Thus, the positive AMT adjustment is $1,136 ($3,636 – $2,500).
- For 2019, depreciation is $2,498 on office furniture used in business costing $20,000 and placed in service in January 2016 based on MACRS rules. Depreciation for AMT purposes is $2,450 based on the alternative depreciation system (i.e., 150% DB method, half-year convention, and a seven-year recovery period). Thus, the positive AMT adjustment is $48 ($2,498 – $2,450). Had bonus depreciation been taken at the beginning of the asset's life, or the asset been placed in service after 2015 and was eligible for bonus depreciation, there would be no AMT depreciation adjustment.
- R&E expenditures amounting to $50,000 are expensed in the current year. For AMT purposes, the R&E deduction would be $5,000 ($50,000 ÷ 10 years) since the expenditures are capitalized and amortized over a ten-year period. Thus, the positive AMT adjustment is $45,000 ($50,000 – $5,000).[6]

Rob's total positive AMT adjustment to taxable income to arrive at AMTI is $46,184 ($1,136 + $48 + $45,000). ◀

AMT CREDITS

Credits That Reduce AMT. As discussed later in this chapter, a number of credits are allowed to reduce a taxpayer's regular tax liability. However, only the foreign tax credit and nonrefundable personal credits are allowed to reduce AMT. The foreign tax credit that applies to the AMT is a specially computed credit, called the "AMT foreign tax credit" and is beyond the scope of this text. Nonrefundable personal tax credits are allowed against both regular tax and the AMT. They are discussed beginning on page I:14-10 and are summarized in Topic Review I:14-2.

STOP & THINK

Question: What are the most common characteristics of taxpayers who are subject to the AMT?

Solution: While each situation is unique, certain taxpayers are more likely to be subject to the AMT. First, taxpayers who have materially invested in real estate before January 1, 1999 are likely candidates for the AMT because they will have a large positive adjustment caused from differences in depreciation. Second, higher-income taxpayers are more likely to face AMT because the AMT exemption amount phases out as taxpayer income increases.

ADDITIONAL COMMENT

The American Recovery and Reinvestment Act of 2009 allows taxpayers with deferred credits from tax years beginning before 2006 (deferred research credits or deferred AMT credits) to turn these into refundable credits in lieu of taking bonus and accelerated depreciation on qualified eligible property (see Chapter I:10).

Minimum Tax Credit (MTC). Under Sec. 53, individual taxpayers are allowed a credit for AMT paid in past years against future years' *regular tax liability*. The logic is as follows: the AMT may be caused by adjustments that will reverse in the future, and the taxpayer will actually pay a higher regular tax in those future years. Thus, the combination of a prior year AMT and current year regular tax essentially constitutes double taxation. A

[5] For real property being depreciated under the straight-line method and placed in service after 1998, the Taxpayer Relief Act of 1997 eliminates this adjustment.

[6] For years 2–10, the AMT adjustment will be negative, ($5,000), each year.

taxpayer who paid AMT in prior years but is not subject to AMT in the current year may be entitled to an MTC against his regular tax liability in the current year.[7]

SUMMARY ILLUSTRATION OF THE AMT COMPUTATION

EXAMPLE I:14-7 ▶ Roger and Kate are married, file a joint return, and have four dependent children. All the children are under age 17. Assume that the couple has $19,500 of AMT preference items. The following items were used to compute regular taxable income for the current year:

Gross income:		
Salary		$ 227,000
Interest income		20,000
Business income		30,000[a]
AGI		$ 277,000
Itemized deductions:		
State and local taxes	$10,000	
Mortgage interest (100% qualified housing interest)	12,000	
Charitable contributions	3,000	(25,000)
Qualified business income deduction ($30,000 × 20%)		(6,000)
Taxable income		$ 246,000
Regular tax		$ 47,389
Child tax credit		(8,000)
Net regular tax		$ 39,389

[a]MACRS depreciation deductions of $75,000 on personal property placed in service after 1998 were claimed in arriving at business income. Only $50,000 of depreciation would be claimed under the alternative depreciation system using the 150% declining balance method.

Their AMT is computed as follows:

Taxable income		$ 246,000
AMT preferences and adjustments:		
Preferences	$19,500	
Excess depreciation ($75,000 − $50,000)	25,000	
State and local taxes	10,000	54,500
AMTI		$300,500
AMT exemption		(111,700)
Alternative Minimum Tax base		$ 188,800
Tax rate		× 0.26
Tentative minimum tax before credit		$ 49,088
Child tax credit		(8,000)
Tentative minimum tax		$ 41,088
Net regular tax after child tax credit		(39,389)
Alternative minimum tax		$ 1,699[b]

The total tax liability for Roger and Kate is $41,088 ($39,389 + $1,699).

[b]An AMT credit may be available in future years to offset regular tax. However, the AMT credit applies only to the AMT that results from timing differences (e.g., depreciation adjustments) and not from exclusions (e.g., taxes). ◀

[7] The Minimum Tax Credit applies to timing adjustments rather than permanent adjustments. A detailed discussion of the rules for computing this credit for individuals is beyond the scope of this book.

SELF-EMPLOYMENT TAX

OBJECTIVE 2

Describe self-employment income and compute the self-employment tax

An individual may work either as an employee or as an independent contractor. The distinction generally hinges on the degree of influence and control an individual has over his work.[8] The classification is important in determining the responsible party for employment taxes imposed under the Federal Insurance Contribution Act (FICA). FICA includes old-age, survivors, and disability insurance (OASDI, commonly referred to as Social Security) and hospital insurance (Medicare).

ADDITIONAL COMMENT

The distinction between employees and contractors remains problematic. Congress recently repeated encouragement for the IRS to resolve pending taxpayer inquiries about worker classification. Recent high profile cases have involved drivers for UPS, Inc., FedEx Inc., and Uber as well as Microsoft software programmers.

Individuals classified as *employees* pay the employee part of FICA on their earnings as they are earned through withholding, and their employers pay the employer part of employment taxes on the same earnings. Because employers report and remit both the withheld employee portion and the employer portion of FICA taxes to the U.S. Treasury, it is not necessary for employees to report employment taxes within their federal income tax returns.

Individuals classified as *self-employed* are responsible for paying both the employee share and employer share of employment taxes. This tax is called the self-employment (SE) tax, and it is imposed on net earnings from self-employment (defined below). It is reported as part of the self-employed individual's federal income tax return.

A combined FICA rate of 15.3% applies for years after 2012. The rate includes the following:

- Social Security tax imposed at a rate of 12.4% on wages (6.2% by withholding for the employee portion and 6.2% for the employer portion) and on net earnings from self-employment (SE);[9] and
- Medicare tax imposed at a rate of 2.9% on wages (1.45% by withholding for the employee portion and 1.45% for the employer portion) and on net earnings from self-employment. (See next page for separate discussion of the Additional Medicare Tax.)

Social Security tax is imposed on wages and net earnings from SE up to a ceiling amount (adjusted for inflation annually). For 2019 (2018), the ceiling equals $132,900 ($128,400). The regular Medicare tax is imposed on all wages and net earnings from SE—without limit.

Net earnings from SE is defined as 92.35% of self-employment income The SE tax is imposed only if net earnings from SE equals or exceeds $400.

Self employed individuals are entitled to deduct—*for* AGI—50% of the employer portion of their SE tax.[10]

EXAMPLE I:14-8 ▶ Robert, a cabinet maker, works as a sole proprietor. For 2019, his self-employment earnings totaled $75,000. His net earnings from SE equal $69,263 ($75,000 × 0.9235). His SE tax of $10,596 includes Social Security tax and Medicare tax. His deduction for SE tax equals $5,298.

Social Security tax: 0.124 × ($69,263) = $8,589
Medicare tax: 0.029 × ($69,263) = $2,009
SE tax deduction: 0.50 × ($8,589 + $2,009) = $5,299 ◀

EXAMPLE I:14-9 ▶ The facts are identical to I:14-8 except Robert's self-employment earnings totaled $175,000. His net earnings from SE equal $161,613 ($175,000 × 0.9235).

His SE tax of $21,167 includes Social Security tax and Medicare tax. His deduction for SE tax equals $10,584.

Social Security tax: 0.124 ($132,900 ceiling) = $16,480
Medicare tax: 0.029 ($161,613) = $4,687
SE tax deduction: 0.50 ($16,480 + $4,687) = $10,584 ◀

Individuals who work as employees but also operate a business are subject to self-employment tax on net earnings from self-employment (SE). For Social Security tax,

[8] Rev. Rul. 87-41 provides a list of twenty factors to be considered in evaluating whether an employer-employee relationship exists.

[9] Sec. 1402 provides more detail on what constitutes net earnings from self-employment.

[10] As discussed later, no deduction is allowed for the Additional Medicare Tax on SE income.

the tax base equals the lesser of (1) net earnings from self-employment or (2) the Social Security tax ceiling reduced by the individual's earnings as an employee. The Medicare tax is imposed on net earnings from SE (without limit).

EXAMPLE I:14-10 ▶ In the current year, Sandy earns $75,000 in employee wages. In addition, from her small consulting practice, she earns $10,000 of income from self-employment. The tax base for her Social Security tax equals the smaller of $9,235 (0.9235 × $10,000) or $57,900 ($132,900 − $75,000). Sandy's SE tax equals $1,413, including Social Security tax of $1,145 ($9,235 × 0.124), and Medicare tax of $268 ($9,235 × 0.029). Her deduction for SE tax equals $707 (0.50 × $1,413). ◀

EXAMPLE I:14-11 ▶ Assume the facts in Example 14-10 apply except that Sandy earns $145,000 in employee wages. The tax base for her Social Security tax equals $0 because her employee earnings exceed the Social Security tax ceiling (more precisely, the tax base equals the smaller of $9,235 [0.9235 × $10,000] or $0 [$132,900 − $145,000]). The Medicare tax (and the SE tax) totals $268 ($9,235 × 0.029). Her deduction for SE tax equals $134 (0.50 × $268). ◀

For tax years after 2012, a hospital insurance tax (Additional Medicare Tax) of 0.9% applies to self-employment income and to wages (Sec. 1401(b)(2) and Sec. 3101(b)(2)) of individuals whose earned income exceeds threshold amounts (table below). Unlike the regular Medicare Tax of 2.9%, the Additional Medicare Tax is *not* included in the "for AGI" deduction allowed to self-employed taxpayers for the employer portion of SE tax (Sec. 164(f)(1)).

ADDITIONAL COMMENT

If an individual works for more than one employer during the year and earns (in total) more than the Social Security tax ceiling, the employers will have withheld more than the employee's required Social Security tax. The taxpayer is entitled to a credit (or refund) for the overpaid tax against his regular income tax liability.

Filing Status	*Threshold Amount*
Married Jointly	$250,000
Single	$200,000
Married Separately	$125,000

Because the new tax applies to all earned income, in determining the amount of earned income subject to the new tax, the threshold amount is used first against employee compensation, and any remainder used against self-employment income.

EXAMPLE I:14-12 ▶ Henry, an unmarried taxpayer filing single for 2019, earns a salary of $135,000 plus self-employment income of $145,000 in consulting fees. His net earnings from SE is $133,908 ($145,000 × 0.9235).

ADDITIONAL COMMENT

For some self-employed taxpayers, the amount of SE tax exceeds the amount of income tax for the year. For example, a married couple with two children and $17,000 of self-employment income would not owe any income tax, but would have a $2,402 (17,000 × .9235 × 15.3%) SE tax liability.

For regular SE tax, Henry will not pay Social Security tax on his SE income from consulting (his salary subject to this tax exceeds the $132,900 ceiling). He will pay Medicare tax of $3,883 ($133,908 × 0.029). One-half of the Medicare tax, $1,942, is allowed as a deduction for AGI.

Henry will pay the Additional Medicare Tax because his earned income exceeds $200,000. The $200,000 threshold first will exempt his salary from the additional tax ($200,000 threshold − $135,000 = $65,000 remaining), and the remainder will exempt all but $68,908 of his self- employment income ($133,908 − $65,000 remaining threshold = $68,908).

The Additional Medicare tax imposed will equal $620 ($68,908 × 0.009). A deduction for AGI is not allowed for the Additional Medicare Tax. ◀

WHAT CONSTITUTES SELF-EMPLOYMENT INCOME

Individuals who carry on a trade or business as a proprietor or partnership are subject to the SE tax. If an individual has two separate self-employment activities, the *net* earnings from each activity are aggregated. However, where a husband and wife file a joint return and both have self-employment income, the SE tax must be computed for each individual separately.

EXAMPLE I:14-13 ▶ Bob and Ruth are married and file a joint return. Bob has $93,000 net earnings from a consulting business and a $4,000 net loss from a retail store that he operates as a sole proprietorship. Ruth has wages of $50,000 from her employer that are subject to FICA taxes. Bob's net earnings from self-employment are $82,192 ($89,000 × 0.9235). No reduction in Bob's SE tax base is allowed for Ruth's wages. The SE tax is computed separately for Bob and Ruth. ◀

KEY POINT

In the case of married taxpayers filing joint returns, it is important on Schedule SE of Form 1040 to fill in the name and Social Security number of the spouse with the self-employment income. This information is used to establish specific benefit eligibility.

Among the items that constitute earnings subject to the SE tax are:

- Net earnings from a sole proprietorship

- Director's fees[11]
- Taxable research grants
- Distributive share of partnership income plus guaranteed payments from the partnership[12, 13]

The self-employment tax is computed on Schedule SE of Form 1040 (see Appendix B). The rules for computing the SE tax are summarized in Topic Review I:14-1.

TOPIC REVIEW I:14-1

Self-Employment Tax Summary

- The tax base is generally net earnings from SE which equals 92.35% of self-employment income.
- The Social Security tax is imposed at 12.4% of net earnings from SE; the Medicare tax is imposed at 2.9% of net earnings from SE.
- For years after 2012, an Additional Medicare Tax is imposed on earnings from employment (employee wages and net earnings from SE). The tax is imposed at a rate of 0.9% on earnings in excess of a threshold amount.
- In 2019, a ceiling of $132,900 applies to the amount of SE earnings subject to Social Security tax. No ceiling applies to the Medicare portion of the tax.
- SE tax is computed separately for each spouse for married individuals filing joint returns.

PERSONAL AND BUSINESS TAX CREDITS

OBJECTIVE 3

Describe the various business and personal tax credits

USE AND IMPORTANCE OF TAX CREDITS

Tax credits are an important part of the income tax law. They may serve as incentives for activities supporting broader policy objectives. For example, tax credits may help to increase employment, encourage energy conservation and research and experimental activities, and provide tax relief for low-income taxpayers. Tax credits are also used to mitigate the effects of double taxation on income from foreign countries.

Credits are classified into two broad categories, **nonrefundable** and **refundable**. Nonrefundable credits only offset tax liability. Refundable credits, on the other hand, not only offset tax liability but if the credits exceed the tax liability, the excess will be paid (refunded) directly to the taxpayer. Two credits, the child tax credit and the American Opportunity tax credit, are partially refundable. At the end of the section, Topic Review I:14-2 provides a summary of selected tax credits and the rationale for their inclusion in the tax law. Taxes withheld from employee wages are prepayments of tax, but are also referred to as refundable credits.

VALUE OF A CREDIT VERSUS A DEDUCTION

As discussed in Chapter I:2, tax credits reduce tax liability on a dollar-for-dollar basis. This is in contrast to tax deductions, which reduce taxable income. The value of a tax deduction increases with the taxpayer's marginal tax rate, so tax deductions are more valuable to high-income taxpayers than to lower-income taxpayers. Tax credits, however, benefit all taxpayers in the same amount regardless of their marginal tax rate.

EXAMPLE I:14-14 ▶ Tasha and Sean are both single taxpayers. Each has an $800 expenditure that qualifies as either a tax deduction or a 20% credit. Tasha is in the 12% marginal tax bracket while Sean is in the 32% marginal tax bracket. If the $800 is claimed as a deduction, Tasha would receive a tax benefit of $96 ($800 x 12%) whereas Sean would receive a tax benefit of $256 ($800 x 32%). Conversely, if the credit is claimed, Tasha and Sean would benefit equally from a $160 credit ($800 × 20%). In this case, Tasha would prefer the credit while Sean would prefer the tax deduction. ◀

[11] Rev. Rul. 57-246, 1957-1 C.B. 338. It is a factual question whether an officer who also serves as a director is performing services as an employee or as an independent contractor. The courts have recognized that an individual can perform services as a director and also perform employment-related services, but the director fees may be recharacterized by the courts if the fees are in reality compensation for services rendered as an employee. (See *Peter H. Jacobs*, 1993 RIA T.C. Memo ¶93, 570, 66 TCM 1470.)

[12] A limited partner's share of partnership income is not considered SE income (Sec. 1402(a)(13)) given the inability of limited partners to participate in managing the partnership.

[13] LLCs developed as business entities after 1977, when Sec. 1402(a)(13) became law. Individuals are considered members of LLCs, and they participate in management (like general partners). But, their liability is limited. Determination of whether LLC earnings are SE income is unsettled. Prop. Reg. Sec. 1.1402(a)-2 was issued in 1997 but not yet finalized. In 2014 and in 2016, administrative guidance from the IRS was published on the issue of SE taxes and LLC member earnings (Chief Counsel Advice 201436049, May 20, 2014 and Chief Counsel Advice 201640014, June 15, 2016). Although not official authority, both reflect the IRS position of consistently treating members' shares of LLC earnings as SE income, because an LLC member who provides significant services to the LLC or manages the LLC cannot be treated as a limited partner in Sec. 1402(a)(13).

NONREFUNDABLE PERSONAL TAX CREDITS

As a result of tax legislation in the last few years, the number of personal tax credits for individual taxpayers has increased significantly. Nonrefundable personal credits may not exceed an individual's regular tax liability (minus foreign tax credit) and AMT (Sec. 26(a)). The more important nonrefundable personal tax credits are discussed below.

ADDITIONAL COMMENT

The dollar amount of the child and dependent care credit amounted to $3.6 billion in 2016.

Child and Dependent Care Credit. The child and dependent care credit provides tax savings for taxpayers who incur child and dependent care expenses because of employment activities. To be eligible for the credit, the taxpayer must incur qualifying expenses for the care of a qualifying individual to enable the taxpayer to be gainfully employed. A qualifying individual is either a qualifying child under age 13 or an incapacitated dependent or spouse who lived with the taxpayer for more than one-half of the year. The credit equals 35% of qualified expenditures.

EXAMPLE I:14-15 ▶ Tim and Tina are married and have two children under age 13. They incur child care expenses (e.g., a housekeeper and nurse) to enable both Tim and Tina to work on a full-time basis. These expenditures are eligible for the child and dependent care credit because Tim and Tina incurred them for qualifying individuals and to be gainfully employed. Alternatively, if Tina were not employed, but incurred the child care expenses to volunteer at the city library, the expenditures would not be eligible for the credit. ◀

ADDITIONAL COMMENT

Qualifying child care expenses include amounts spent to send a child to nursery school or kindergarten, but not first grade.

Qualifying Employment-Related Expenses. Qualifying expenses include amounts paid for care inside the home or outside the home for a qualifying individual. Payments to a relative are qualifying expenses unless the relative is a dependent or a child (under age 19) of the taxpayer.[14] If care is provided in the home, amounts paid for care and household maintenance (e.g., housekeeper who cares for the child, and serves as maid and cook) are qualifying expenses. If the care is provided outside the home by a dependent care facility (e.g., a day care facility), the amounts will be eligible expenses only if the dependent care facility operates in compliance with federal, state and local law.[15] Amounts paid for services outside of the taxpayer's household (e.g., adult day care) that are spent for the care of an incapacitated dependent or spouse qualify only if the individual lives in the taxpayer's home for at least eight hours a day.

EXAMPLE I:14-16 ▶ Tony is divorced and has two children under age 13. He is employed and incurs child care expenses at a preschool nursery for one of the children. He also relies on a live-in nanny who cares for both children and provides housekeeping services and a gardener to care for his yard. All of the expenditures for the preschool nursery and the nanny qualify because these services constitute eligible household services, and care of qualifying individuals. However, the payments to the gardener are not eligible because they do not constitute qualifying household services. ◀

ADDITIONAL COMMENT

A need for inflation adjustments? Although data from the U.S. Census Bureau suggests that the cost of child care increases annually, the Sec. 21(c) maximum amount of qualifying expenses was changed most recently in 2001.

The following additional limitations apply:

- Ceiling on qualifying expenses: The maximum amount of child and dependent care expenses that qualify for the credit equals $3,000 for one qualifying individual and $6,000 for two or more qualifying individuals. No carryover is permitted for expenses in excess of the maximum amounts.
- Earned income limit: Maximum qualifying expenses cannot exceed the taxpayer's earned income. For married individuals, the limitation is applied to the earned income of the spouse with the smaller earned income. Gratuitous services performed by the taxpayer for charitable organizations are not considered gainful employment.[16] A spouse who is a full-time student or incapacitated is deemed to have an earned income of $250 per month ($500 per month if there are two or more qualifying individuals in the household).[17]

The credit will not be allowed unless the qualifying individual's Social Security number and the dependent care provider's Social Security number (or employer ID number) are reported on the return on which the credit is claimed.

EXAMPLE I:14-17 ▶ Troy and Tracy are married and incur qualifying child care expenses of $4,000 to take care of their two children, ages 1 and 3. Tracy's earned income is $20,000, and Troy's earned income

[14] Sec. 21(e)(6).
[15] Employment-related expenses do not include amounts paid for services outside of the taxpayer's household at an overnight-stay camp.
[16] Rev. Rul. 73-597, 1973-2 CB 69.
[17] Sec. 21(d)(2). To qualify as a full-time student, the individual must enroll in an educational institution on a full-time basis for at least five calendar months of the year (Reg. Sec. 1.44A-2(b)(3)(B)(ii)).

KEY POINT

The percentage used to calculate the credit varies from 20% to 35% depending on the taxpayer's AGI.

from a part-time job is $3,500. Although their expenses do not exceed the overall qualifying expense limitation of $6,000, the earned income limitation applies because Troy's earned income ($3,500) is less than the child care expenses ($4,000). Therefore, the amount of child care expenses eligible for the credit is limited to $3,500. ◀

Credit Rate and Amount. Generally, the credit equals 35% of qualifying expenses. However, the credit rate is reduced by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income in excess of $15,000. The rate goes no lower than 20%.

Credit rates for the child care credit across AGI levels

Adjusted Gross Income	Applicable Percentage	Adjusted Gross Income	Applicable Percentage
$ 0 to $15,000	35%	29,001 to 31,000	27%
15,001 to 17,000	34	31,001 to 33,000	26
17,001 to 19,000	33	33,001 to 35,000	25
19,001 to 21,000	32	35,001 to 37,000	24
21,001 to 23,000	31	37,001 to 39,000	23
23,001 to 25,000	30	39,001 to 41,000	22
25,001 to 27,000	29	41,001 to 43,000	21
27,001 to 29,000	28	43,001 and above	20

EXAMPLE I:14-18 ▶ Mark and Vicki are married, file a joint return, and have three children under age 13. Mark and Vicki's employment-related earnings are $25,000 and $10,000, respectively. Including all sources of income, their AGI is $36,000. They incur $8,000 of child care expenses during the year. First, their eligible child care expenses are limited to $6,000 because Mark and Vicki have more than one qualifying child. Second, the credit rate equals 24%, computed as follows:

Adjusted gross income (AGI)	$36,000
Base amount	(15,000)
Excess	$21,000
Divided by $2,000	10.5
Rounded up to	11
Applicable credit (35% − 11%)	24%

Mark and Vicki's child and dependent care credit for the year is $1,440 ($6,000 × 24%). ◀

Other Sources of Tax Benefits for Dependent Care. Employees may be eligible for two types of employer supported dependent care assistance that exclude from employees' gross income payments made by their employer for the provision for dependent care. The assistance is through dependent care assistance programs (IRC Section 129)[18] and employee funding of flexible spending arrangement (IRC Section 125). Qualifying employment-related expenses for purposes of the child and dependent care credit are reduced to the extent dependent care costs are funded through either of these types of plans.

EXAMPLE I:14-19 ▶ Assume the same facts as in Example I:14-18 except assume that Mark was reimbursed $4,100 by his employer under a qualified dependent care assistance program and assume that this amount was excluded from his gross income. Thus, expenses eligible for the child and dependent care credit are reduced to $1,900 ($6,000 − $4,100) and the child care credit is $456 ($1,900 × 24%). ◀

ADDITIONAL COMMENT

The tax credit for the elderly or disabled amounted to $6.5 million in 2016.

Tax Credit for the Elderly and Disabled. A limited credit is provided for certain low-income individuals who have attained age 65 before the end of the tax year or who retired because of a permanent and total disability.

The maximum credit is 15% of an initial amount of $5,000 ($7,500 for married individuals filing jointly if both spouses qualify).[19] This initial amount is reduced by:

[18] Sec. 129. (See Chapter I:4 for a discussion of the requirements for exclusion.)
[19] Sec. 22(c)(2).

- Nontaxable benefits from Social Security, railroad retirement, or Veterans Administration pension or annuity, and
- One-half of AGI in excess of $7,500 for a single individual ($10,000 (MFJ)).[20]

Few elderly or disabled taxpayers benefit from the credit because they either receive Social Security benefits in excess of ceiling limitations or they have AGI amounts in excess of the limitations, which effectively reduces or eliminates the allowable credit.

EXAMPLE I:14-20 ▶ Wayne and Tammy are both 67 years old and file a joint return. They have AGI of $11,000 and receive nontaxable Social Security benefits of $3,000 during the current year. Their tax credit for the elderly is computed as follows:

Initial ceiling amount		$7,500
Minus: Nontaxable social security benefits	$3,000	
One-half of excess AGI (0.50 × [$11,000 − $10,000])	500	(3,500)
Total credit base		$4,000
		× 0.15
Tax credit		$ 600

◀

Adoption Credit. A nonrefundable credit of up to $14,080 is allowed for qualified adoption expenses in 2019 ($13,810 in 2018).[21] The credit generally is allowable in the year the adoption is finalized. If adoption expenses are paid prior to the year in which the adoption is finalized, such expenses are not eligible for the credit until the year the adoption is finalized. If expenses are paid during or after the year the adoption is finalized, the credit is allowable in the year the expenses are paid or incurred.

The credit is phased out (ratably over a $40,000 range) for high income taxpayers. The 2019 phaseout begins at AGI of $211,160 ($207,140 in 2018).[22]

Qualified adoption expenses include reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that are directly related to the legal adoption of an eligible child. Qualified adoption expenses are reduced by any reimbursements from an employer plan. An eligible child is defined as a child who has not reached 18 years old when the adoption takes place, or one who is physically or mentally incapable of self-care.

Taxpayers adopting a special needs child are treated as having incurred qualified adoption expenses of the maximum credit amount even if actual expenses are less.

EXAMPLE I:14-21 ▶ Oscar and Betty began proceedings in June 2018 to adopt a child. In 2018, they incurred $7,000 of attorney fees and adoption agency fees. In 2019, they incurred an additional $8,000 of qualified adoption expenses, and the adoption became final. Oscar and Betty's AGI in 2019 equals $221,000. The adoption credit is allowable in 2019, computed as follows:

Total qualified adoption expenses	$15,000
Maximum credit (lesser of $15,000 or $14,080)	14,080
Phase-out percentage [($221,000 − $211,160)/$40,000] = 24.60%	
Amount of credit disallowed ($14,080 × 24.60%)	(3,464)
Amount of credit allowed	$ 10,616

Oscar and Betty can take a credit for $10,616 of expenses and must claim the credit in 2019, the year the adoption becomes final. ◀

[20] The Social Security Administration reports that the average retiree received around $17,000 in Social Security benefits in 2018. Even a single taxpayer with no other income who receives this level of benefits would see the credit of $750 reduced to $0.

[21] Sec. 23.

[22] For purposes of the phase-out, AGI is modified and determined without regard to the exclusions from gross income for foreign earned income, after the application of the rules relating to the taxation of Social Security, and other items. (See Sec. 36B(2).)

Child Tax Credit. Taxpayers are allowed a credit of $2,000 for each qualifying child. The definition of qualifying child for the child tax credit requires that the child is the taxpayer's dependent based on the category "qualifying child" under section 152 (the dependent qualification rules),[23] and that the child is under age 17. The Tax Cuts and Jobs Act of 2017 also added an additional $500 nonrefundable credit for "qualifying relatives" under section 152.

The credit begins to phase out when modified AGI[24] reaches a threshold amount ($400,000 (MFJ) or $200,000 (all other taxpayers)). The credit lost to phaseout is determined by the following.

$$[(\text{Modified AGI} - \text{Threshold})/\$1{,}000]^* \times \$50$$

*rounded up to the next whole number

Thus, a married couple filing jointly with one qualifying child and modified AGI of $405,500 will have a tentative child tax credit of $2,000. The credit will be subject to a phaseout of $300 [($405,500 − $400,000) ÷ $1,000 = 5.5 and 6 × $50 = $300]. Their allowable credit will be $1,700.

The child tax credit is generally *nonrefundable*. However, for tax years after 2015, if a taxpayer's tentative child tax credit is greater than the total tax liability, part of the credit (the "additional" child tax credit) is *refundable*. The refundable portion is the lesser of (1) the unclaimed portion of the credit, (2) 15% of taxpayer's earned income in excess of $2,500, or (3) $1,400 per qualifying child (2019). Form 8812 is used to compute the refundable portion of the child tax credit.

Higher Education Costs Tax Credits. Two credits are available to taxpayers who incur higher education expenses. The two credits are the "American Opportunity Tax Credit (AOTC)" and the "Lifetime Learning Credit (LLC)."[25]

ADDITIONAL COMMENT

For taxpayers with three or more qualifying children, the refundable child tax credit equals the lesser of (1) the unclaimed portion of the credit, (2) the greater of a) 15% of the taxpayers earned income in excess of $2,500 or b) the taxpayer's social security taxes in excess of the taxpayer's earned income credit, or (3) $1,400 per qualifying child (2019).

American Opportunity Tax Credit.[26] Under the AOTC, taxpayers are allowed a credit for up to $2,500 for qualified tuition and related expenses paid during the taxable year for each eligible student. The credit allowed equals 100% of the first $2,000 of qualified expenses plus 25% of up to $2,000 of qualified expenses in excess of the first $2,000 ($2,000 + 25%($2,000) = $2,500, maximum credit amount). The AOTC can be taken for each eligible student. Thus, parents who have two children in their first four years of college may claim up to $2,500 for each child.

To qualify, expenses must meet several criteria. First, eligible expenses include payments to enroll in and attend courses. Included are tuition and fees required for enrollment and course materials (including textbooks) but not payments for room & board, activity fees, or other expenses unrelated to academic coursework. Second, qualifying expenses are limited to those paid for the first four years of postsecondary education. This limit applies in years measured by time (the AOTC may be used only four times for a student), and by academic progress (the student is an undergraduate). The student's standing is evaluated at the beginning of the tax year based on the student's standing as assigned by the educational institution. Third, the expenses must be paid for an eligible student. An eligible student is one who is enrolled in an eligible institution, carrying at least a one-half time course load for at least one academic term. Eligible students include the taxpayer, taxpayer's spouse, and taxpayer's dependent(s), but exclude any student with a felony drug conviction. Eligible institutions are generally accredited post-secondary schools eligible to participate in U.S. federal financial aid programs.

ADDITIONAL COMMENT

In addition to the AOTC and Lifetime Learning credits, other tax laws that encourage education include:
(1) Sec. 529 plans;
(2) Improved student loan interest deduction rules;
(3) Increased limits for Coverdell Education IRAs.

Other requirements include the following items.

- If a taxpayer pays qualified expenses in one year but the expenses relate to an academic period that begins during January, February, or March of the next taxable year, the academic period is treated as beginning during the taxable year in which the payment is made. Thus, a payment of tuition in December 2018 for the Spring Semester, 2019 (which begins in January 2019) would be eligible for the AOTC in 2018.

[23] Under IRC Section 152(c) for the dependency rules, a qualifying child must 1) be a relative of the taxpayer (descendent, sibling, or descendent of a sibling), 2) reside in the taxpayer's household for more than one-half of the year, 3) be supported by the taxpayer, 4) not file a joint return with a spouse, and 5) be younger than the taxpayer and under age 19 (or a student under age 24). For the child tax credit, the age requirement in the dependency rules is modified to under age 17.

[24] Modified AGI means AGI increased by any amount excluded from gross income under Secs. 911, 931, or 933. Secs. 911, 931, and 933 are special exclusions in the international tax area.

[25] Sec. 25A.

[26] The provisions discussed for the AOTC represent those of the "expanded" Hope Scholarship credit.

▶ Qualified tuition and related expenses eligible for the AOTC must be reduced by amounts received as scholarships (Sec. 117), employer-sponsored educational reimbursement plans (Sec. 127), education IRAs (Sec. 530), or other provisions of the tax law.

The allowable credit is phased out for high income taxpayers. The phase-out occurs over a $20,000 range (for married filing joint taxpayers) and begins when modified AGI exceeds $160,000 as follows:

$$\text{Tentative AOTC} \times \frac{\text{Modified AGI} - \$160{,}000}{\$20{,}000} = \text{Phaseout for MFJ taxpayers}$$

For taxpayers other than joint filers, phase-out occurs over a $10,000 range, beginning at $80,000 of modified AGI. Modified AGI is AGI before exclusions for foreign earned income and foreign housing costs.

Although it is a nonrefundable credit, up to 40% of the allowable AOTC is refundable.

Lifetime Learning Credit. The LLC allowed equals 20% of qualified education expenses of up to $10,000 per year. The credit is allowed for an unlimited number of tax years. The $10,000 annual limit applies at the "family level" or to the collected qualified expenses incurred for the taxpayer, taxpayer's spouse, and taxpayer's dependents. The LLC is nonrefundable.

Expenses must meet three criteria to be qualified education expenses. First, they must be paid during the year for tuition and academic fees (not course materials). Second, the expenses must be paid for postsecondary academic coursework or courses to obtain or improve job skills. Finally, the expenses must be paid for the taxpayer, taxpayer's spouse, or taxpayer's dependent(s). Unlike the AOTC, the LLC definition of eligible students does not exclude students with felony drug convictions. Consistent with the AOTC conditions, any tax-preferred amounts received (scholarships, etc.) reduce the amount of qualified education expenses.

Eligible expenses for LLC are reduced to effectively phase out the credit for high income taxpayers. For 2019 (2018), the LLC is phased-out proportionately over a $20,000 range beginning at modified AGI of $116,000 ($114,000) for married filing joint taxpayers. For non-married taxpayers, the phase-out occurs over a $10,000 range, beginning at $58,000 in 2019 ($57,000 in 2018).[27] Unlike the AOTC phase-out provisions, the LLC phase-out amounts are revised annually for inflation.

Qualified education expenses of a student eligible for both the AOTC and the LLC may be used either for the AOTC or the LLC—but not both. If any of a student's expenses are used for AOTC, none of the expenses for that student are eligible for LLC in that year.

EXAMPLE I:14-22 ▶ Mark and Jane Green are married, file a joint return, and have three dependent children in college, Ron, Susan, and Bill. Ron and Susan attend State University and Bill attends Private University. The Greens' modified AGI in 2019 is $164,000. Details are as follows:

	Spring Semester 2019 (Paid in January 2019)	*Fall Semester 2019 (Paid in August 2019)*	*AOTC Eligible* ***Expenses***
Ron:	Senior	5th year Senior	
Tuition and fees	$1,500	$1,550	$3,050
Course materials (books)	300	300	600
Room and board	3,500	3,700	—
Susan:	Junior	Senior	
Tuition and fees	$1,500	$1,550	$3,050
Course materials (books)	300	300	600
Room and board	3,500	3,700	—
Bill:		Freshman	
Tuition and fees	—	$3,700	$3,700
Course materials (books)	—	400	400
Room and board	—	3,700	—

[27] Note that inflation adjustments apply only to the phase-outs under LLC, not AOTC.

The Greens can claim education tax credits as follows:

Ron has not completed four years of postsecondary education at the beginning of 2019, so for the AOTC, he qualifies as an eligible student for both semesters. Assuming the AOTC has not been used for Ron in four prior tax years, his 2019 qualifying education expenses include his tuition and fees and course materials, totaling $3,650 ($1,500 + $1,550 + $300 + $300).

Ron's tentative AOTC equals $2,413 ((100% × $2,000) + (25% × $1,650)).

As a junior at the beginning of the year, Susan qualified as an eligible student for the AOTC in both semesters.

Susan's tentative AOTC equals $2,413 ((100% × $2,000) + (25% × $1,650)).

Bill qualified as an eligible student for AOTC in Fall 2019, when he began post-secondary coursework. Bill's qualifying educational expenses total $4,100 ($3,700 + $400), but only the first $4,000 may be used to generate this credit.

Bill's tentative AOTC equals $2,500 ((100% × $2,000) + (25% × $2,000)).

The AOTC allowed for the Greens for 2019 equals $5,861, determined as below.

Tentative AOTC = $2,413 Ron + $2,413 Susan + $2,500 Bill = $7,326
Phase-out = $7,326 × [($164,000 − $160,000)/$20,000] = $1,465
Allowed AOTC = $7,326 − $1,465 = $5,861

Note: If the facts were changed to indicate the AOTC had been used already for Ron in four previous tax years, the Greens could not claim the AOTC for Ron, but they may claim the LLC. In this case, their combined education credit (AOTC + LLC) equals $3,930, determined as below.

Tentative AOTC = $0 Ron + $2,413 Susan + $2,500 Bill = $4,913
Phase-out = $4,913 × [($164,000 − $160,000)/$20,000] = $983
Allowed AOTC = $4,913 − $983 = $3,930

Tentative LLC = 20% × $3,050 = $610 (LLC qualifying expenses exclude course materials)
Phase-out = $610 × [($164,000 − $116,000)/$20,000] = $1,464 (but the phase-out is limited to $610)
Allowed LLC = $610 − $610 = 0 ◄

Residential Energy Credits. Congress has enacted a range of incentives for both individuals and businesses to promote domestic energy production and conservation. Most of these incentives are in the form of tax credits. For individual taxpayers, the residential energy efficient property credit is the primary credit.

Residential Energy Efficient Property (REEP) Credit. For tax years through 2021, the REEP credit is allowed for several types of energy efficient property installed on a taxpayer's principal residence.[28] Eligible residential energy efficiency property includes non-solar property (fuel cell, wind energy, and geothermal heat pump) and solar property (solar water heating and solar electric generating). For property placed in service before 2017, the credit allowed equals 30% of the cost of eligible residential property. After 2016, the REEP credit is allowed only for solar property.[29] The credit rate remains at 30% for solar property placed in service in 2017–2019. But, the credit is phased out after 2021, with the credit rate falling to 26% for property placed in service in 2020, and to 22% for property placed in service in 2021.
Other features of the REEP credit are:

[28] Sec. 25D, as amended by the 2015 PATH Act.

[29] Sec. 25D(h).

- Labor costs to install the property are included in the qualified cost of the property.
- Second homes or vacation homes do not qualify for some parts of the credit.
- If less than 80% of the use of the dwelling is for nonbusiness use, then only the percentage of nonbusiness use can be taken into account.
- The taxpayer's basis in the property is reduced by the amount of the credit.
- The credit is not available for use with swimming pools or hot tubs.
- Credits are nonrefundable, but credits earned but not used in the current year can be carried forward to the next year.

Qualified Retirement Savings Contributions Credit ("Saver's Credit"). The Saver's Credit is designed to encourage low and middle income taxpayers to save for retirement. The credit is based on contributions or deferrals to qualified retirement plans.[30] The saver's credit is allowed *in addition* to otherwise allowable exclusions or deductions from gross income for retirement plan contributions or deferrals.

ADDITIONAL COMMENT

Although its availability and amount are constrained by its structure to favor modest income taxpayers, in 2004, almost 5.2 million taxpayers reported saver's credits of just over $1 billion. By 2016, 7.9 million taxpayers reported this credit in amounts totaling almost $1.43 billion.

To be eligible for the credit, a taxpayer must be at least 18 years of age as of the close of the tax year, must not be claimed as a dependent on another taxpayer's tax return, and must not be a full-time student[31] for purposes of the dependency exemption.

The saver's credit is computed by multiplying the amount contributed (maximum $2,000 per eligible individual per year) by an applicable percentage. The percentage for 2019 depends on the taxpayer's adjusted gross income, as shown in the following table:

Filing Status	*50% Credit Rate AGI Range*	*20% Credit Rate AGI Range*	*10% Credit Rate AGI Range*
Married Filing Joint	$0–$38,500	$38,501–$41,500	$41,501–$64,000
Head of Household	$0–$28,875	$28,876–$31,125	$31,126–$48,000
Other	$0–$19,250	$19,251–$20,750	$20,751–$32,000

Qualified retirement savings contributions equal the sum of contributions or deferrals by the taxpayer to specified retirement plans, including IRAs (Roth and Traditional), 401(k) plans, 403(b) plans, and certain other plans, reduced by any distributions from such plans.

EXAMPLE I:14-23 ▶ Steve is 20 years old, has no dependents, is filing as a single taxpayer and has AGI of $17,000 in 2019. During the year, he contributes $2,000 to his Roth IRA. Steve is eligible for a Qualified Retirement Savings Contributions Credit in the amount of $1,000 ($2,000 × 50%). The credit amount would be the same if he contributed $2,000 to a traditional IRA, but in addition to the $1,000 credit, Steve would be permitted to deduct the $2,000 contribution to the traditional IRA on his individual return. ◀

KEY POINT

The foreign tax credit is available only on income, war profits, and excess profits taxes or taxes paid in lieu of such taxes. It is sometimes difficult to determine whether a particular foreign tax falls into the qualifying category.

FOREIGN TAX CREDIT

U.S. citizens, resident aliens, and U.S. corporations are subject to U.S. taxation on their worldwide income.[32] The foreign-source portion of worldwide income is also subject to taxation by the foreign country. To reduce possible double taxation, U.S. tax law provides a foreign tax credit (FTC) for income taxes paid or accrued to a foreign country or a U.S. possession.

[30] Sec. 25B. The Pension Protection Act of 2006 made the credit permanent.

[31] Sec. 152(f)(2).

[32] Certain exceptions are provided by treaty agreements between the United States and foreign countries whereby certain types of foreign-source income may be exempt from taxation or taxed at a reduced tax rate in the foreign country.

ADDITIONAL COMMENT

In 2016, 7 million individual tax returns showed claims for $13.4 billion in foreign tax credits.

In lieu of the FTC, taxpayers may elect to take a deduction for foreign taxes paid or accrued.[33] In general, the FTC results in a greater tax benefit because (as previously discussed) a credit is fully offset against the tax liability, while a deduction merely reduces the tax base (taxable income). Finally, in lieu of the FTC, taxpayers may elect to exclude foreign earned income from U.S. gross income (Sec. 911). (See Chapter I:4 for more information.)

Allowable FTC. The **FTC** equals the lesser of (1) foreign tax paid or accrued, or (2) the portion of U.S. income tax liability attributable to income earned in all foreign countries (FTC limitation).[34] This limitation restricts claiming the benefit from foreign tax credit if the effective foreign tax rate on foreign earnings exceeds the effective U.S. tax rate on these earnings. The FTC limitation is computed using the following formula:

$$\frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income}} \times \text{U.S. income tax before credits} = \text{FTC limitation}$$

EXAMPLE I:14-24 ▶ Robert Albertson has $200,000 of U.S. source taxable income and $100,000 of foreign source taxable income from country A. Robert's worldwide taxable income is $300,000 ($200,000 + $100,000). Country A levies $40,000 in foreign income taxes on the foreign source taxable income (i.e., a 40% effective tax rate). His U.S. tax before credits is $80,194 on the $300,000 of worldwide taxable income. Using the formula given above, the overall FTC limitation is computed as follows:[35] ◀

$$\frac{\$100{,}000}{\$300{,}000} \times \$80{,}194 = \$26{,}731$$

Because the foreign tax payments ($40,000) exceed the U.S. tax attributable to the foreign source income ($26,731), the limitation applies. Thus, Robert's net U.S. tax equals $53,463 ($80,194 − $26,731), and $13,269 ($40,000 − $26,731) of FTC cannot be used in the current year. ◀

STOP & THINK

Question: Since a credit is generally more valuable than a deduction, under what circumstances would it be beneficial for a taxpayer to take a deduction for foreign taxes in lieu of the foreign tax credit?

Solution: If a taxpayer has foreign source taxable income from one country and an equal loss from another foreign country, the foreign tax credit limitation is zero because the net foreign-source taxable income is zero. Because none of the taxes paid in the foreign country in which taxable income was produced can be claimed as a credit, the taxpayer may choose to deduct them (unless the unused credits can be carried back or forward).

Treatment of Unused Credits. Unused foreign tax credits may be carried back one year and then forward for ten years to tax years where the limitation is not exceeded (i.e., the foreign tax payment is lower than the U.S. taxes attributable to the foreign-source income in the carryback or carryover years). Unused credits are lost if they are not used by the end of the ten-year carryover period.

[33] Sec. 164(a)(3).
[34] Sec. 904.

[35] Two types of income have a separate foreign tax credit limitation: passive income and all other income. (See Chapter C:16 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* for a more detailed discussion of these separate limitations.)

BUSINESS RELATED TAX CREDITS

General Business Credits. The tax credits commonly available to businesses are grouped into a special category called **general business credits.** These credits are combined for the purpose of computing an overall dollar limitation based on the taxpayer's tax liability (discussed in more detail on page I:14-23). If the general business credits earned in the current year exceed the limitation, the excess may be carried back one year and carried forward 20 years. The credits are used in order of time generated with carryforward credits used first, current year credits next, and then carryback credits.[36]

EXAMPLE I:14-25 ▶ Eastern Corporation had unused general business tax credits of $10,000 at the end of last year that are carried forward. In the current year, Eastern earns $5,000 of additional credits and computes an overall credit limitation of $12,000 for the year. The allowable $12,000 credit consists of the $10,000 carryforward and $2,000 from the current year. The $3,000 of unused credit ($5,000 − $2,000) is carried forward. ◀

The more important general business credits are discussed below. All are nonrefundable.

Tax Credit for Rehabilitation Expenditures. Congress provides a credit for investments in the rehabilitation of older industrial and commercial buildings and certified historic structures.[37]

REAL-WORLD EXAMPLE

Taxpayers incurred substantial rehabilitation expenditures on an old factory building, but the tax credit was not allowed because the taxpayers did not use the straight-line depreciation method. *Frank DeMarco,* 87 T.C. 518 (1986).

The credit equals 20% of qualified rehabilitation expenditures (QRE) for certified historic structures, with the credit allowed ratably over a five-year period. The credit applies only to depreciable trade or business property and depreciable property held for investment. Residential rental property does not qualify unless the building is a certified historic structure. Rehabilitation includes renovation, restoration, or construction of a building, but not an enlargement or new construction. For buildings other than certified historic structures, a rehabilitation project must meet certain structural tests and must be substantial (QRE exceed the greater of $5,000 or the building's adjusted basis).[38]

The following additional provisions apply.

- For certified historic structures, the total rehabilitation must be certified by the Department of the Interior as being consistent with the historic character of the building.
- Straight-line depreciation generally must be used with the applicable Sec. 168 recovery periods with respect to rehabilitation expenditures. The regular MACRS depreciation rules apply to the portion of the property's basis that is not eligible for the credit.
- The basis of the property for depreciation is reduced by the full amount of the credit taken.
- The rehabilitation credit is recaptured at a rate of 20% per year if the property is disposed of within five years of the date placed in service.

EXAMPLE I:14-26 ▶ During the current year, Ted incurs $40,000 of qualified rehabilitation expenditures (QRE) in connection with a certified historic structure used in his business. The adjusted basis of the certified historic structure was $38,000 at the time the rehabilitation began. The property qualifies for the rehabilitation credit because:

- It is used in Ted's trade or business and is depreciable.
- The property is a certified historic structure.
- The amount of the QRE exceeds the greater of the property's $38,000 adjusted basis or the $5,000 statutory minimum.

Thus, the total credit is $8,000 (20% × $40,000), but Ted will take $1,600 ($8,000/5) for each of the next five years. The building's depreciable basis attributable to the $40,000 of QRE rehabilitation expenditures is reduced by the full amount of the credit to $32,000 ($40,000 − $8,000). If the property is disposed of after one year, $6,400 of the credit ($8,000 − $1,600) is recaptured. ◀

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[36] Sec. 38(d).

[37] Secs. 47(a)(1) and (2). A certified historic structure must be certified by the Department of the Interior and must be located in a registered historic district or listed in the *National Register.*

[38] Sec. 47(c)(1)(A).

Business Energy Tax Credits. To encourage energy conservation measures, credits are available to businesses that invest in energy-conserving properties.[39] Construction, reconstruction, or erection of the property must be completed by the taxpayer, or if purchased, its original use must begin with the taxpayer. The credit rate is 30% of property basis for energy properties that produce solar energy or hybrid solar light, qualified fuel cell property, and qualified small wind energy property. The credit rate is 10% of property basis for energy properties that are stationary microturbines, combined heat and power systems, geothermal heat pump systems, and others.

Only for solar energy properties, the credit is available if the property is acquired or construction is begun by 2019. If acquired or construction begun in 2020 (2021), the credit rate is reduced to 26% (22%). For all other energy sources, the credit is available for property acquired and placed in service before 2017.

Recent tax law changes have set up a complex interaction among the energy credit, renewable energy grants, and an electricity production credit. Details are beyond the scope of this text, but essentially, taxpayers may choose to receive grants or take credits, but not both.

Work Opportunity Credit. For the years 2015–2019, employers who hire individuals belonging to targeted groups (defined below) may elect the work opportunity credit (WOTC). This credit is designed to provide incentives to hire veterans and individuals who may face economic disadvantages.

The credit equals 40% of qualified first year wages up to $6,000 for individuals in targeted group A, up to $12,000 for individuals in targeted group C, up to $14,000 for individuals in targeted group D, and up to $24,000 for individuals in targeted group E. For individuals in group B, the credit rate is 40% of up to $10,000 of first year wages, and the credit rate is 50% of up to $10,000 of second year wages.

- Group A: qualified veterans, ex-felons, designated community residents, vocational rehabilitation referrals, and summer youth employees; recipients of benefits from programs including temporary assistance for needy families, supplemental nutrition assistance, Social Security supplemental security income, unemployment compensation (if employment extended 27 weeks or more), and veterans whose families received supplemental nutrition assistance for at least three months and who were unemployed from four weeks to six months in the year before hire.
- Group B: recipients of benefits under long-term family assistance.
- Group C: veterans with a service-related disability, hired within 1 year of discharge from active duty.
- Group D: veterans with 6 months or more of unemployment in the year before hire.
- Group E: veterans with a service-related disability, hired within 1 year of discharge from active duty or with more than 6 months of unemployment in the year before hire.

Employer-Provided Child Care Credit. The employer-provided child care credit is an incentive for businesses to provide child care for their employees. The credit is the *sum* of the following two amounts (but may not exceed $150,000 for a tax year):

- 25% of qualified child care expenses. These expenses are amounts paid to acquire, construct, rehabilitate, expand, and operate a qualified child care facility or paid under contract to a qualified child care facility for services to employees; plus
- 10% of qualified child care resources and referral expenditures. These are expenses paid or incurred by a taxpayer under a contract to provide child care resource and referral services to employees.

These are several special rules with regard to the credit, including:[40]

- Employers claiming this credit cannot claim a deduction for child care expenses and also claim the credit. Expenses that would be otherwise deductible must be reduced by the amount of the credit claimed.

[39] Sec. 48(a)(2).
[40] Sec. 45F(d).

- If, within ten years of the year in which a child care facility is placed in service, an employer terminates its use as a qualified child care facility, the credit must be recaptured. The recapture rate begins at 100% (terminate within the first three years), and declines steadily as the years of facility use increase.

This credit is part of, and is subject to the limitations of the general business credit.

EXAMPLE I:14-27 ▶ Gamechicken Partnership began a child care facility for its employees during the current year. The business incurred the following expenses:

Rent on facility	$ 25,000
Leasehold improvements	60,000
Equipment, toys, etc.	18,000
Salaries of child care employees	30,000
Other operating expenses of facility	12,000
Qualified child care referral fees*	8,000
Total expenses	$153,000

*Fees paid to a firm to place children in other facilities.

Gamechicken's credit for the year would be $37,050 [($145,000 × 25%) + ($8,000 × 10%)]. All of the above amounts are also deductible after reduction by the amount of the credit. So, the rent, salaries, and operating expenses of $67,000 ($25,000 + $30,000 + $12,000) must be reduced by a total of $16,750 ($67,000 × 25%), the referral fees must be reduced by $800 ($8,000 × 10%), and the depreciable basis of the leasehold improvements and equipment must be reduced by $19,500 ($78,000 × 25%). ◀

Disabled Access Credit. A nonrefundable tax credit is available to eligible small businesses for expenditures incurred to make existing business facilities accessible to disabled individuals. The disabled access credit is allowed at a 50% rate of eligible expenditures that exceed $250 but do not exceed $10,250.[41] Thus, the annual credit limitation is $5,000 [50% × ($10,250 − $250)]. The allowed credit reduces the deduction for eligible expenses.

Eligible expenditures include payments for removing architectural, communication, physical, or transportation barriers that prevent a business from being accessible. Expenditures made in connection with *new facility* construction are not eligible for the credit. An eligible small business is any business that either (1) had gross receipts of $1 million or less in the preceding year, or (2) in the case of a business failing the first test, had no more than 30 full-time employees in the preceding year. To elect the credit, the taxpayer reports eligible expenditures on IRS Form 8826.

EXAMPLE I:14-28 ▶ In the previous year, Crane Corporation (an S Corp) had 14 employees and $2 million of gross receipts. During the current year, Crane installed concrete access ramps at a total cost of $14,000. Crane is an eligible small business because the company had 30 or fewer full-time employees during the preceding year. Only $10,000 of eligible expenditures qualify for the credit, thereby limiting the credit to $5,000 ($10,000 × 0.50). The depreciable basis of the property must be reduced by the credit amount to $9,000 ($14,000 − $5,000). ◀

Credit for Increased Research Activities. To encourage businesses to conduct research and experimentation, a credit is allowed. The research credit equals the sum of the regular research credit, the university basic research credit, and the energy research consortium credit. The last two are beyond the scope of this book.

This credit is allowed for increased research expenses and at a rate of 20% of the excess of qualified research expenses over the base amount.[42] Qualified research expenses (QRE) are defined as internal and external research expenses that are incident to the development or improvement of a product or component. Only incremental expenditures (the excess over a base amount) are eligible for the credit. Research conducted after the start of commercial production does not qualify for the credit, nor do marketing, advertising, or production expenses.

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[41] Sec. 44.

[42] For many years, Sec. 41 limited eligible expenses to those incurred by a given date, requiring annual (and often retroactive) extension of the credit. The PATH Act of 2015 removed the annual expiration for expenses incurred after 2014.

The base amount equals the greater of (1) the product of the taxpayer's fixed-base percentage and average annual gross receipts over the four years prior to the credit year, and (2) 50% of credit year qualified research expenditures. The fixed-base percentage is the historical ratio of qualified research expenditures to gross receipts and is limited to 16%. The table below specifies the historical period used based on the years in which the taxpayer incurred qualified research expenses, assuming the taxpayer is considered a start-up company.

History of Incurred QREs	*Fixed base percentage*
First year through fifth year	3%
Sixth year	1/6*(QRE/gross receipts for years 4 & 5)
Seventh year	1/3*(QRE/gross receipts for years 5 & 6)
Eighth year	1/2*(QRE/gross receipts for years 5, 6, & 7)
Ninth year	2/3*(QRE/gross receipts for years 5, 6, 7, & 8)
Tenth year	5/6*(QRE/gross receipts for years 5, 6, 7, 8, & 9)

After the tenth year in which the taxpayer incurs QREs, the fixed base percentage equals the ratio of QRE accumulated across any five years in the year five to year ten range divided by the gross receipts for the same five year range.

EXAMPLE I:14-29 ▶ Northern Inc. (an S Corp) began operations in 2015 and had the following gross receipts for the previous four-year period.

2015	$4,500,000
2016	7,000,000
2017	8,000,000
2018	8,500,000

Northern's average annual gross receipts for the four-year prior period is $7,000,000. In 2019, Northern incurred $400,000 of qualified research expenditures. Assuming Northern Inc. uses a fixed-base percentage of 3%, the corporation's base amount equals $210,000, the greater of (1) $210,000 ($7,000,000 × 3%) or (2) $200,000 ($400,000 × 50%). The regular research credit equals $38,000 [20% rate × ($400,000 − $210,000)]. ◀

Taxpayers may elect a simplified credit in lieu of the regular credit. This simplified credit is not based on historical gross receipts, thus opening the research credit to businesses with less than five years of history. The base and credit percentage is computed as follows:

- 14% of the excess of qualified research expenses of the current year over 50 percent of the average qualified research expenses for the three preceding taxable years; or
- 6% of qualified research expenses of the current year if the taxpayer does not have qualified research expenses in each of the three preceding taxable years.

EXAMPLE I:14-30 ▶ Howell Company is a calendar year taxpayer. In the current year, it incurs $175,000 of qualified research expenses. Howell incurred qualified research expenses in each of the three prior years (year 1 $25,000, year 2 $38,000, and year 3 $57,000; average of $40,000 over the period). Howell can elect the simplified credit using a base equal to 50% of qualified research expenses averaged over the three prior years. The base amount equals $20,000 (50% × $40,000), and the current year credit equals $21,700 [14% × ($175,000 − $20,000)]. The deductible expenses equal $153,300 ($175,000 − $21,700).

Instead, if the facts were changed to indicate Howell did not incur research expenses in each one of the prior three years, the current year credit equals $10,500, based on 6% of current year qualified research expenses (6% × $175,000). The deductible expenses equal $164,500 ($175,000 − $10,500). ◀

The business deduction allowed for research and experimentation expenditures under Sec. 174 must be reduced by the amount of the research credit.[43]

General Business Credit Overall Limitation. As noted at the beginning of this section, business credits are summed to an amount called the general business credit. The general business

[43] Sec. 280(c)(2).

ADDITIONAL COMMENT

The general business credit overall limitation is less complicated for C corporations. C corporations have no nonrefundable personal credits (but may have a foreign tax credit), and the AMT does not apply for C corporations for 2018 and later years.

credit claimed is limited based on tax liability. The general business credit may not exceed the smaller of:[44]

1. Net income tax − tentative minimum tax, and
2. Net income tax − 0.25 (Net regular tax − $25,000)

Net income tax means the sum of the net regular tax liability and the AMT, reduced by the nonrefundable personal credits and the foreign tax credit. *Net regular tax liability* means the regular tax reduced by nonrefundable personal credits and the foreign tax credit. The limitation also prevents a taxpayer from claiming a general business credit in the same tax year that the taxpayer has alternative minimum tax. The overall credit limitation is demonstrated in the example below.

EXAMPLE I:14-31 ▶ Steve's general business tax credit before limitation is $50,000 (a $50,000 research credit). Steve's regular tax liability (before credits) is $45,000, and his tentative minimum tax is $10,000. His nonrefundable tax credits also include a $1,200 child and dependent care credit and an $1,800 foreign tax credit. Steve's general business tax credit is initially limited to the smaller of (A) and (B) below. Thus, the limitation on the $50,000 of general business tax credit is $32,000, and Steve's general business credit is limited to $32,000. This credit reduces his tax liability to $10,000 ($45,000 − $1,200 − $1,800 − $32,000)

A) Net income tax − Tentative AMT
[($45,000 − $1,200 − $1,800) − ($10,000)] = $32,000

B) Net income tax − $25% (Net regular tax − $25,000)
{($45,000 − $1,200 − $1,800) − 25% [($45,000 − $1,200 − $1,800) − $25,000] = $37,750}

Note that the limit on the general business credit must be evaluated separately for certain credits listed in Sec. 38(c). ◀

REFUNDABLE PERSONAL CREDITS

As mentioned earlier, refundable credits not only offset a taxpayer's income tax liability but can create a refund. If the refundable credits exceed the tax liability, the excess will be refunded to the taxpayer.

HISTORICAL NOTE

The earned income credit was claimed on 25 million tax returns in 2016 and amounted to $62.5 billion. This compares with 19.4 million returns and $32.5 billion in 2000.

Earned Income Credit. The earned income credit (EIC) is a special type of "negative income tax" designed to encourage individuals to become employed or to continue work despite low earnings.[45] The credit is based on earned income, which includes wages, salaries, tips, and other employee compensation plus net earnings from self-employment. Earned income does not include any form of employee compensation that is not includible in the taxpayer's income for the year.

The EIC is not available to taxpayers whose "disqualified income" exceeds $3,600 in 2019 ($3,500 in 2018). Disqualified income includes taxable interest income and dividends, tax-exempt interest income, net income from nonbusiness rents or royalties, net capital gains, and net passive activity income.

The credit is available to individuals with qualifying children[46] (see Chapter I:2 for the uniform definition of a qualifying child) and to individuals without children.[47] Individuals without children are eligible only if the following requirements are met:

- The individual's principal place of abode is in the United States for more than one-half of the tax year.
- The individual (or spouse if married) is at least age 25 and not more than age 64 at the end of the tax year.
- The individual is not a dependent or qualifying child of another taxpayer for the tax year.[48]

Married taxpayers must file a joint return to be eligible for the credit. Earned income credit percentages and the maximum amount of earned income allowed for the credit in

[44] The PATH Act of 2015 also added an election (Sec. 41(h)) to permit eligible small businesses to choose to use the research credit to reduce employer payroll taxes in up to six tax years.

[45] (See Chapter I:2 for a discussion of the relationship between the child tax credit and the earned income credit.)

[46] Any qualifying child's name, age, and taxpayer identification number must be reported on the tax return.

[47] Sec. 32(c).

[48] Sec. 32(c)(1)(A), as amended by the 2008 Adoption Act.

2019 are summarized in Table I:14-1. The allowable credit is reduced when the taxpayer's AGI or earned income (whichever is greater) exceeds a threshold (Table I:14-1).[49]

EXAMPLE I:14-32 ▶ Vivian is not married, has one qualifying child, and is eligible for the earned income credit in 2019. Vivian's AGI is $19,500 ($15,900 of wages and $3,600 of unearned income, but not "disqualified income"). The wages are considered earned income.

Tentative EIC = 34% × $10,370 = $3,526
Phase-out amount = 15.98% × ($19,500 − $19,030) = $75
Allowed EIC = $3,526 − $75 = $3,451 ◀

▼ **TABLE I:14-1**
2019 Earned Income Credit Amounts

Number of Qualifying Children	Credit Rate	Credit Base (Maximum Earned Income)	Maximum Credit Amount	Phase-out Rate[a]	Phase-out Threshold for Married Filing Joint (Not Married Filing Joint)
0	7.65%	$ 6,920	$ 529	7.65%	$14,450 ($8,650)
1	34%	$10,370	$3,526	15.98%	$24,820 ($19,030)
2	40%	$14,570	$5,828	21.06%	$24,820 ($19,030)
3 or more	45%	$14,570	$6,557	21.06%	$24,820 ($19,030)

[a]Applied to the excess of Earned Income (or AGI if larger) over the threshold amount.

PROVISIONS RELATED TO HEALTH INSURANCE

OBJECTIVE 4

Describe and compute the premium tax credit

HEALTH INSURANCE PREMIUM ASSISTANCE CREDIT (ALSO KNOWN AS PREMIUM TAX CREDIT)

For years after 2013, a credit is allowed for a portion of taxpayers' qualifying health insurance premiums (Sec. 36B). The credit allowed equals the excess of qualifying premiums over the premium amount deemed affordable based on the taxpayer's household income. Qualifying premiums are based on the purchase of health insurance through a state American Health Benefit exchange or a federal exchange. Plans are categorized by the portion of cost of benefits covered by the plan, and they range from Bronze to Silver to Gold to Platinum. Premium amounts are reported by state and family characteristics on the federal website HealthCare.gov (https://www.healthcare.gov/health-plan-information/).

A credit-eligible taxpayer must meet the following four conditions:

1. Does not have access to minimum affordable essential coverage through an employer or government sponsored plan,
2. Files as married filing joint status if married,
3. Is not eligible to be a dependent of another taxpayer, and
4. Has household income in the range between 100% and 400% of the Federal Poverty Guidelines (FPG).[50]

Affordable coverage (condition 1 above) is defined as premiums costing no more than 9.69% of household income, and essential coverage is provided in a plan covering 60% or more of the cost of allowed plan benefits. Household income (condition 4 above) is defined as modified AGI of the taxpayer and the taxpayer's dependent family members required to file a federal income tax return. Modified AGI is AGI plus nontaxable Social Security benefits, tax-exempt interest income, and excluded foreign earned income.[51] The FPG minimums for the 48 contiguous U.S. states are outlined in the following pages.

[49] The percentages are adjusted annually for inflation.

[50] The Federal Poverty Guidelines are defined in Sec. 36B(d)(3) based on its definition in the Social Security Act (42 USC 1397jj(c)(5)). The U.S. Department of Health and Human Services publishes these guidelines annually.

[51] Section 36B(d)(2).

▼ TABLE I:14-2

2019 Federal Poverty Guidelines (FPG)[52]

People in Family/Household	Poverty Guideline (100%)	People in Family/Household	Poverty Guideline (100%)
1	$12,490	5	$30,170
2	$16,910	6	$34,590
3	$21,330	7	$39,010
4	$25,750	8	$43,430

Add $4,420 per person beyond 8.

▼ TABLE I:14-3

2019 Affordable Premium Levels as a Percent of Household Income

Categories of Household Income Relative to the FPG	Affordable Premium as a Percent of Household Income	
	Initial %	Final %
100% up to 133% FPL	2.08%	2.08%
Over 133% up to150% FPL	3.11%	4.15%
Over 150% up to 200% FPL	4.15%	6.54%
Over 200% up to 250% FPL	6.54%	8.36%
Over 250% up to 300% FPL	8.36%	9.86%
Over 300% up to 400% FPL	9.86%	9.86%

Table I:14-3 outlines the rate of affordable premiums relative to household income across the six categories of income relevant for the credit. Application of this rate to a taxpayer's household income provides a measure of the premiums considered affordable (also known as personal share). The premium tax credit is determined by comparing this affordable premium amount to a benchmark—the actual premium amount for a Silver level insurance plan (second lowest in cost)—that matches the location of the taxpayer's home and family size. The premium tax credit allowed is the excess of the benchmark Silver plan premiums over the affordable premium amount.

EXAMPLE I:14-33 ▶ In 2019, Bryan and Heather Delane (27 and 26 years old, respectively) are eligible taxpayers and have household income of $30,400. Their income and household size put them at 180% ($30,400/$16,910) of the FPG.

Neither has available coverage from an employer. For 2019, the Delanes enroll in the second-lowest-cost Silver plan available through their state's health care exchange, for which total premiums will cost $5,500. The amount of the Delanes' health insurance premium tax credit will be determined as follows.

1st: Affordable premiums = Affordable % based on FPG × annual premiums for 2nd-lowest-cost Silver plan

The Delanes' household income relative to the FPG equals 180%, placing them in the 150%–250% category of affordable premium levels. Their share of the affordable premiums must be based on the initial rate in the category plus a prorated portion of the range between the final and initial rates in the category.

Delanes' affordable premiums:

FPG range = 200% − 150% = 50%; Distance from initial rate = 180% − 150% = 30%
Range of rates within Delanes' FPG category: 6.54% − 4.15% = 2.39%
Delanes' rate = initial rate + prorated portion of rate range
= 4.15% + 30/50 (2.39%) = 5.58%

Delanes' affordable premiums = 5.58% × $30,400 household income = $1,696

2nd Premium tax credit = cost of coverage − personal share (affordable premiums)

Delanes' premium tax credit = $5,500 − $1,696 = $3,804

[52] The 2018 Federal Poverty Guidelines included in Table I:14-2 can be found at https://aspe.hhs.gov/poverty-guidelines. The 2019 Affordable Premium Levels in Table I:14-3 can be found in Rev. Proc. 2018-34.

TAX AUTHORITY UPDATE

The Tax Cuts and Jobs Act of 2017 reduced the Shared Responsibility payment to $0 for 2019 and thereafter. The payment was an excise tax imposed on individuals without the required minimum essential health insurance coverage in years 2014–2018.

This credit may be available as an advance payment directly from the U.S. Treasury to the issuer of the health insurance plan. This approach reduces the taxpayer's periodic payment required for the personal share of the total premiums. The tax credit reported on the taxpayer's individual income tax return reflects the computed credit reduced by advance payments of the credit (Sec. 36B(f)). Any excess of the credit over advance payments represents an additional credit. Any shortfall is an additional tax liability.

TOPIC REVIEW I:14-2

Summary of Selected Tax Credits Discussed in Chapter 14

Tax Credit Item	Rationale for Inclusion in Tax Law
NONREFUNDABLE PERSONAL CREDITS:	
Adoption credit (Sec. 23)	Provides relief for taxpayers who incur expenses in the adoption of children
Child tax credit (Sec. 24) Child and dependent care credit (Sec. 21)	Reduces the tax burden on families with dependent children Provides relief for employed parents and other individuals who incur expenses for dependent care
Elderly and disabled credit (Sec. 22)	Provides relief for elderly taxpayers who are not substantially covered by Social Security
American opportunity tax credit and lifetime learning credit (Sec. 25A)	Assists students and families with the cost of post-secondary education
Qualified retirement savings contributions credit (Sec. 25B)	Encourages low- and middle-income taxpayers to save for retirement
Residential energy efficient property credit (Sec. 25 D)	Encourages energy conservation measures on principal residences
MISCELLANEOUS CREDITS:	
Foreign tax credit (Sec. 27)	Mitigates the effects of double taxation on foreign-source income
GENERAL BUSINESS CREDITS:	
Business energy credits (Sec. 48)	Encourages energy conservation measures
Disabled access credit (Sec. 44)	Encourages small businesses to provide access for disabled persons
Work Opportunity Credit (Sec. 51)	Provides incentive for employers to hire veterans and the economically disadvantaged
Employer-provided child care credit (Sec. 45F)	Provides incentive for businesses to provide child care for employees
Rehabilitation expenditures credit (Sec. 21)	Encourages the rehabilitation of older buildings
Research credit (Sec. 41)	Encourages research and experimental activities
REFUNDABLE PERSONAL CREDITS:	
Earned income credit (Sec. 32)	Provides incentive for low-income individuals to work
Overpayment of social security taxes (Sec. 31)	Provides a credit or refund for social security taxes overpaid when a taxpayer has multiple employers
Taxes withheld from wages and other income (Sec. 31)	Recognizes taxpayer's prepayment of tax
Premium tax credit (Sec. 36B)	Reduces the cost of health insurance for households with low and modest incomes.

Payment of Taxes

OBJECTIVE 5

Explain the mechanics of the federal withholding tax system and the requirements for making estimated tax payments

The IRS collects federal income taxes during the year ("pay as you go") through withholding on wages and quarterly estimated tax payments. If the total of withholdings and estimated taxes is less than the amount of tax liability, the taxpayer must pay the balance of the tax due when the tax return is filed. If there has been an overpayment of tax, the taxpayer may either request a refund or apply the overpayment to the following year's estimated tax.

Substantial penalties are imposed if an employer fails to withhold federal income tax and pay such amounts to the IRS.[53] In addition, taxpayers may be subject to penalties for underpayment of estimated tax.[54]

WITHHOLDING OF TAXES

REAL-WORLD EXAMPLE

A teacher claimed a credit for Social Security taxes that had been withheld from his salary. He believed that the Social Security tax was illegally withheld because he did not authorize the collection of the tax. The Tax Court held that the Social Security tax is mandatory for designated employees and does not allow a person to elect not to contribute. *Richard L. Feldman,* 1967 PH T.C. Memo ¶67,091, 26 TCM 444.

HISTORICAL NOTE

The withholding of federal income taxes by employers began in the early 1940s in response to revenue needs for World War II.

Employers must withhold federal income taxes and FICA taxes from an employee's wages. No withholdings are required if an employer-employee relationship does not exist (e.g., an individual who performs services as an independent contractor). Generally, unless a specific exemption is provided, withholding is required on all forms of employee compensation (salaries, fees, bonuses, dismissal payments, commissions, vacation pay, and taxable fringe benefits).[55] Below are some special rules relating to withholding of federal taxes:

- *More than one employer during the same year.* Each employer must withhold FICA and federal income taxes without regard to the fact that the employee has more than one employer. As mentioned on page I:14-9, this may cause an overwithholding of FICA taxes if the employee's wages exceed the ceiling amount on the OASDI portion of the tax. In the event of overwithholding of FICA taxes, the employee may credit the excess amount as an additional payment of tax. However, the matching employer excess FICA contributions are not refundable or creditable against the tax liabilities of either employer or employee.
- *Overall exemption.* Taxpayers are exempt from income tax withholding in the current year if they (1) had no tax liability in the prior year; (2) expect no tax liability in the current year; and (3) can be claimed as dependent by another taxpayer and report no more than $1,100 (2019) total income, no more than $350 of which is unearned. The earnings of such individuals are still fully taxable, and an employer may be liable for FICA tax payments on these earnings.
- *Exemption for certain employment activities.* Certain employees, such as agricultural laborers, ministers, household employees, newspaper carriers under age 18, and those earning tips of less than $20 per month from an employer, are exempt from withholding. The earnings of such individuals are still fully taxable, and an employer may be liable for matching FICA tax payments on these earnings.[56]
- *Backup withholding.* Backup withholding rules were enacted to prevent abusive noncompliance situations, such as not providing the payor of a dividend with the payee's Social Security number. A 28% withholding rate is required on most types of payments that are reported on Form 1099 (e.g., interest, dividends, royalties, etc.) where a proper taxpayer identification number is not provided.
- *Other special rules.* There are many other special rules on withholding in certain circumstances, such as for fringe benefits, pension, and annuity payments, etc. that are beyond the scope of this text.

REAL-WORLD EXAMPLE

It has been held that the employer's withholding of federal income taxes is not an improper taking of property without due process in violation of the Fifth Amendment. *Michael O. Campbell v. Amax Coal Co.,* 610 F.2d 701, 45 AFTR 2d 80-564, 80-1 USTC ¶9185 (10th Cir., 1980).

Withholding Allowances and Methods. On beginning a new job, each employee must file with his/her employer an employee's withholding allowance certificate (Form W-4), which lists the employee's marital status and number of withholding allowances. The W-4 provides the employer with the information needed to determine the amount of federal income tax to be withheld from the employee's earnings. If an employee's circumstances change (e.g., a married taxpayer is divorced during the year), an amended Form W-4 must be provided to the employer within 10 days.

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[53] Sec. 3403. Employers are liable for payment of the full amount that must be withheld and paid to the IRS. In addition, responsible individuals (e.g., corporate officers, directors, and consultants) may be held personally liable for payment of the tax. (See *Renate Schiff v. U.S.,* 69 AFTR 2d 92-804 (D.C. NV, 1992), *Ted E. Touprake v. U.S.,* 69 AFTR 2d 92-821 (D.C. FL, 1992), and *Ralph M. Guito, Jr. v. U.S.,* 67 AFTR 2d 91-1066 (D.C. FL, 1991).)

[54] Sec. 6654.

[55] Reg. Sec. 31.3401(a)-1(a)(2).

[56] Sec. 3510. An employer is liable for FICA tax payments for domestic servants if $2,100 (2019) or more is paid to an individual in any calendar year. See IRS Publication 926 (2019).

The number of withholding allowances claimed on Form W-4 is typically calculated based on the taxpayer's filing status and the number of qualifying children eligible for the child tax credit. An additional withholding allowance (reflecting the standard deduction) may be claimed by a taxpayer who has one job or, if married, has a spouse who is unemployed.[57] Further additional withholding allowances may be claimed 1) if an individual has deductions, losses, or credits from a wide variety of sources, including itemized deductions and losses from a trade or business, rental property, or a farm, or 2) if an individual anticipates tax savings from credits in Sec. 21-41. Form W-4 contains tables and a worksheet to help employees compute the number of additional withholding allowances.[58]

EXAMPLE I:14-34 ▶ Sam and Sally are married and have three dependent children (Adam, age 9, and twins Jack and Joe, age 18). They file a joint tax return. Sally is not employed. Owen is single with no children and is not eligible for any credits. While Sam and Owen begin their employment making similar salaries, Sam will indicate more withholding allowances than Owen. This will result in lower withholdings from Sam's paycheck, which reflects Sam and Sally having a lower gross tax for the year because their gross tax is reduced by an increased standard deduction and child tax credits. ◀

STOP & THINK

Question: Many taxpayers believe that they must claim the same number of withholding allowances for withholding purposes as the number of taxpayers and qualifying dependents on their income tax return. Why is this not correct?

Solution: While the starting point for determining withholding allowances is the taxpayer's marital status and the child tax credit, taxpayers are allowed to adjust the number of withholding allowances based on their individual situation. Taxpayers may claim additional withholding allowances for two principal reasons: (1) a taxpayer has high deductions, losses, or credits; or (2) an unmarried taxpayer qualifies for head of household filing status. The withholding tables are constructed assuming that the taxpayer will use the standard deduction. Therefore, if a taxpayer has much higher itemized deductions than the standard deduction, the withholding tables may prescribe too much withholding, and the taxpayer would have a large refund at the end of the year. To alleviate this situation, taxpayers are allowed to claim additional withholding allowances. Similarly, the withholding tables only have two categories for marital status, single or married. Thus, if an unmarried taxpayer qualifies for head of household status, the "single" withholding tables may cause over-withholding of tax.

Computation of Federal Income Tax Withheld. Employers use either wage bracket tables or an optional percentage method to compute the actual amount of withholding. The two methods produce approximately the same results. Wage bracket tables are available for daily, weekly, biweekly, and monthly payroll periods. Separate tables are used for single (including heads-of-household) and married individuals. Partial wage bracket tables for married and single persons using a monthly payroll period for wages are located in the Tax Tables and Rate Schedules in the Tables beginning on page T-16.

EXAMPLE I:14-35 ▶ Henry is married and claims four withholding allowances. His monthly salary is $3,000. The federal income tax, Social Security tax and Medicare tax withheld per month for 2019 using the wage bracket table on page T-18 is $293.49. Of this amount, $229.50 (7.65% × $3,000) will be withheld per month for Social Security tax and Medicare tax. The remainder is for federal income taxes. ◀

ESTIMATED TAX PAYMENTS

ADDITIONAL COMMENT

The IRS does not mail reminder statements for the required quarterly estimated payments.

Certain types of income are not subject to withholding (e.g., investment income, rents, income from self-employment, and capital gains). Taxpayers who earn this type of income must prepay their income tax by making quarterly estimated tax payments.

[57] Sec. 3402(f)(1)(E).

[58] Married taxpayers who are both employed may allocate withholding allowances between them as they see fit as long as the same allowance is not claimed more than once.

The purpose of the estimated tax payment system is to ensure that all taxpayers have pre-paid enough tax by the end of the tax year to cover most of their tax liability. Thus, estimated tax payments may also be required if insufficient tax is being withheld from an individual's salary, pension, or other income (although many taxpayers prefer to file an amended Form W-4 to reduce the number of withholding allowances). The amount of estimated tax is the taxpayer's estimated tax liability (including self-employment tax and alternative minimum tax) reduced by withholdings and tax credits.

Required Estimated Tax Payments. For calendar-year individuals, required quarterly payments are due by April 15, June 15, September 15 of the current year, and January 15 of the following year. To avoid an underpayment penalty,[59] total estimated tax payments must equal or exceed any of the following three "safe harbor" amounts:

1) 90% of current year tax liability;
2) 100% of the prior year tax liability if the taxpayer's AGI in the prior year was $150,000 or less.
   110% of the prior year tax liability if the taxpayer's AGI in the prior year was more than $150,000.
3) 90% of current year tax liability computed on an annualized basis (helpful for taxpayers who do not earn taxable income evenly through the year).

In addition, no penalty is imposed if (1) the estimated tax for the current year is less than $1,000, or (2) the individual had no tax liability for the prior year.

WHAT WOULD YOU DO IN THIS SITUATION?

THE NANNY TAX: DON'T PAY NOW, WORRY LATER

You are a CPA engaged in tax practice, and one of your clients is Mr. Throckmorton D. Princeton, J.D. He is a senior partner in the prestigious employment litigation firm of Huey, Dewey and Fooey. Mr. Princeton is known for his ruthless litigation style.

Things were rosy for Mr. Princeton until last week, when there was some speculation in the press about his being appointed to a cabinet-level position by the President. A TV news magazine show looked into Mr. Princeton's domestic worker situation. It appears that Mr. Princeton has long engaged in the practice of hiring part-time workers in his household to clean his house, tend to his gardens, walk his dogs, cook his meals, service his car, and nurse him when he is ill. All told, he used over twenty-five people at one time or another in the past year. These workers were paid as little as possible, and all were asked to sign a contract with Mr. Princeton stating that they were to be classified as independent contractors. The total amount paid to these workers was $50,000. Mr. Princeton paid no payroll taxes, although he did file Forms 1099 with the IRS. What tax and ethical issues should be considered?

EXAMPLE I:14-36 ▶ Sarah does not make quarterly estimated tax payments for 2019, even though she has a substantial amount of income not subject to withholding. Her taxable income is $140,000. Her actual tax liability (including self-employment taxes and the alternative minimum tax) for 2019 is $40,000. Federal income tax withheld from her salary equals $30,000. She pays the $10,000 balance due to the IRS when she files her return in April of 2020. Sarah's tax liability for the prior year was $28,000.

No underpayment penalty is imposed because she meets the second exception: the federal income tax withheld of $30,000 in 2019 is more than 100% of her $28,000 prior year tax liability. ◀

[59] Sec. 6654.

EXAMPLE I:14-37 ▶ Assume the same facts in Example I:14-36 except Sarah's AGI in the prior year was $180,000. Since her AGI exceeded $150,000, the second safe harbor amount is 110% (instead of 100%) of the prior year's tax or $30,800 ($28,000 × 1.10). Because the $30,000 of federal income tax withheld in 2019 is less than 110% of her previous year tax liability, Sarah would not meet either exception and would be subject to the underpayment penalty. ◀

Form 2210 (see Appendix B) should be completed and submitted with the tax return if a possible underpayment of tax is indicated. This form is used to determine whether one of the exceptions applies and, if not, to compute the amount of the underpayment penalty. Topic Review I:14-3 summarizes the withholding tax and estimated payment requirements.

TAX PLANNING CONSIDERATIONS

OBJECTIVE 6

Describe tax planning considerations for AMT, tax credits, and payment of taxes

AVOIDING THE ALTERNATIVE MINIMUM TAX

Taxpayers with substantial amounts of tax preference items and/or positive AMT adjustments and a correspondingly low regular tax liability may be subject to the AMT. These taxpayers need to engage in tax planning to minimize or avoid the AMT.

A generous AMT exemption is provided for most individuals, so taxpayers can plan for full use of the exemption by timing certain income and deduction items each year. For example, the AMT may be avoided by delaying payment of certain itemized deductions (e.g., state and local taxes) that reduce the regular income tax but do not reduce the AMT. A cash method taxpayer who defers payment of state income taxes into the following year, triggers an increase in the regular tax for the current year. This increase can eliminate the AMT liability. However, it is necessary to consider tax effects for both the current and following years, because state income taxes are deductible for purposes of the regular tax calculation when payment is made in the following year. This reduction may affect the AMT calculation in the following year and increase the amount of tax owed then.

KEY POINT

The alternative minimum tax can be avoided or its impact lessened by various tax strategies.

TOPIC REVIEW I:14-3

Withholding Taxes and Estimated Payments

EMPLOYER WITHHOLDING OF TAXES:

	FICA	*Income Tax*
Subject to withholding:	For Social Security tax, all employee earnings up to $132,900 in 2019 per employer. No ceiling applies to Medicare portion.	All employee compensation including wages, salaries, fees, bonuses, commissions, taxable fringe benefits.[a]
Withholding amounts:	7.65% of FICA wages including 6.2% on Social Security earnings and 1.45% on Medicare earnings.	Determined using withholding tables or the percentage method based on an individual's filing status and number of withholding allowances.

[a]Exceptions are provided for certain nontaxable fringe benefits.

ESTIMATED TAX PAYMENTS:

- To avoid an underpayment penalty, estimated tax payments and withholdings for the year must equal or exceed: 90% of the current year tax liability; or 100% of the prior year tax liability (110% if prior year AGI exceeds $150,000); or 90% of the current year tax liability computed on an annualized basis.
- The underpayment penalty is not deductible for income tax purposes.
- Form 2210 is used to determine the underpayment penalty amount.

Certain tax-exempt investments, such as interest on private activity bonds, generate additional tax preferences for the investor. Before acquiring such investments, an investor should determine the potential AMT impact.

AVOIDING THE UNDERPAYMENT PENALTY FOR ESTIMATED TAX

Many taxpayers find it difficult to estimate their taxes for the purposes of making quarterly estimated payments and are uncertain whether their withholdings and estimated tax will equal or exceed 90% or more of their actual tax liability for the year. A common planning technique to avoid a possible underpayment tax penalty is to make estimated tax payments and withholdings in an amount that is at least 100% (or 110% if AGI was in excess of $150,000 for the prior year) of the actual tax liability for the prior year, thereby meeting one of the exceptions that prevents the underpayment penalty from being imposed.

EXAMPLE I:14-38 ▶ For 2019, Yong expects his federal income tax withholdings to total $14,000 and estimates that his income tax liability will be $24,000. Yong's actual federal income taxes in the prior year totaled $20,000. If estimated taxes of at least $6,000 are paid during 2019, Yong's estimated taxes plus withholding will be at least 100% of his prior year's tax liability ($14,000 + $6,000 = $20,000), and no underpayment penalty will be imposed, despite the $4,000 ($24,000 − $20,000) balance due on the 2019 return.

If Yong's prior year AGI exceeded $150,000, his estimated taxes plus withholding must be at least 110% of his prior year tax liability or $22,000 (1.10 × $20,000) to avoid the underpayment penalty. Thus, his estimated tax payments must total at least $8,000. ◀

KEY POINT

A taxpayer should avoid making estimated payments that exceed the actual tax liability because the taxpayer is making an interest-free loan to the IRS. Nevertheless, many taxpayers deliberately have excess amounts withheld from their wages or make excessive estimated payments to receive a refund. These taxpayers view this strategy as a forced saving plan.

CASH-FLOW CONSIDERATIONS

Assuming that the underpayment penalty can be avoided, it is generally preferable to have a balance due to the government at the time for filing the return rather than to receive a refund of an overpayment of tax. No interest is paid on a refund if the IRS pays the refund within 45 days from the later of the due date of the return or its filing date.[60] In addition, the IRS has, in effect, received an interest-free loan from the taxpayer during the period such overpayment exists. To avoid an overpayment, a taxpayer may file an amended W-4 form and claim additional withholding allowances if the requirements are met (e.g., the taxpayer has unusually large itemized deductions, tax credits, alimony payments, etc.).

If an individual anticipates that her combined estimated tax payments and withholdings will be insufficient to avoid the underpayment penalty, it may be preferable to increase amounts withheld near the end of the tax year rather than increase the estimated tax payments.[61] This technique may be advantageous because the penalty's quarterly calculation treats withholdings as made evenly over the year, even when withholding amounts are increased near the end of the year. Another way to avoid the underpayment penalty is to accelerate certain deductions (e.g., real estate taxes on a personal residence) by paying such amounts before the end of the current tax year. Additionally, otherwise deductible contributions to an IRA made after the end of the tax year but by the due date for the tax return may be treated as a deduction for the prior year, thereby avoiding the underpayment penalty (see Chapter I:7).

USE OF GENERAL BUSINESS TAX CREDITS

Taxpayers must consider the priority and interrelated aspects of credits to ensure that a particular credit is fully used. For example, an individual's nonrefundable personal tax credits reduce tax liability before the foreign tax credit limitation is applied. Then, the nonrefundable personal tax credits and foreign tax credit are deducted from the individual's tax liability before limitations are applied to the general business tax credit.

[60] Sec. 6611(e).

[61] To completely avoid the underpayment penalty, the tax law generally requires the estimated payments to be made equally on the four installment dates.

FOREIGN TAX CREDITS AND THE FOREIGN EARNED INCOME EXCLUSION

Individuals who accept foreign job assignments should consider federal income tax implications, because U.S. citizens are subject to U.S. tax on their worldwide income. Assuming that certain requirements and limitations are met, an individual may elect to take either a foreign tax credit or a foreign-earned income exclusion of $105,900 in 2019 ($103,900 in 2018) with respect to salaries, allowances, and other forms of earned income that are earned while on extended non-U.S. assignments.[62] Any taxes paid or accrued with respect to the excluded income are not available as a foreign tax credit. In general, when the effective foreign tax rate is less than the effective U.S. tax rate, the exclusion is preferable because the foreign tax credit that can be claimed does not equal the gross U.S. tax owed on the income. When the effective foreign tax rate exceeds the effective U.S. tax rate, U.S. taxpayers ordinarily elect not to use the exclusion. Instead, the excess tax credits on earned income are used to offset the U.S. taxes owed on other types of foreign income. Detailed coverage of the interaction between foreign tax credits and the exclusion is contained in Chapter C:16 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* text.

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 7

Describe compliance and procedural considerations for AMT, tax credits, and payment of taxes

ALTERNATIVE MINIMUM TAX (AMT) FILING PROCEDURES

Individual taxpayers use Form 6251 to compute the AMT (see Appendix B for this form). Form 6251 must be completed and attached to an individual's income tax return in any of the following situations:

- An AMT tax liability actually exists.
- The taxpayer has tax credits that are limited by the tentative minimum tax.
- The AMT base exceeds the AMT exemption amounts, and the individual has AMT adjustment or tax preference items.

WITHHOLDINGS AND ESTIMATED TAX PAYMENTS

Taxpayers who have income taxes withheld from wages, pensions, and other income should receive a Form W-2 (or Form 1099-R for pensions) from the employer by January 31. These forms should be attached to the individual's tax return to substantiate the amount of withholdings.

Married individuals may make either joint or separate estimated tax payments. If joint estimated tax payments are made and the married individuals subsequently file separate returns (e.g., in the case of a divorce that is pending or a divorce completed before the end of the year), the joint estimated tax payments are divided in proportion to each spouse's individual tax if no agreement is reached concerning an appropriate division.

EXAMPLE I:14-39 ▶ George and Alice are married and make joint estimated tax payments of $10,000 during 2019. George and Alice are separated in February 2020 and Alice refuses to file a joint return with George. George's 2019 tax liability on his separate return is $20,000 and Alice's tax liability on her separate return is $5,000. If no agreement is reached concerning the allocation of the joint estimated payments of $10,000, Alice is entitled to claim $2,000 of the estimated tax payments on her return [$5,000/($20,000 + $5,000) × $10,000]. The remaining $8,000 is apportioned to George. ◀

[62] Sec. 911(a). The foreign income exclusion requirements are discussed in Chapter I:4.

GENERAL BUSINESS TAX CREDITS

The computation of the business energy credit is made on Form 3468. Form 3800 must be filed if any other general business credits are claimed.

NONREFUNDABLE PERSONAL TAX CREDITS

Nonrefundable personal tax credits are deducted from the taxpayer's tax liability before other credits. The child tax credit and the credit for other dependents are reported on page 2 of the Form 1040 while the other nonrefundable personal tax credits are reported on Schedule 3 of the Form 1040. The credits section on page 2 of Form 1040 then limits the deduction for nonrefundable personal tax credits to the amount of tax due. Form 2441 (see Appendix B) must be filed to claim the child and dependent care credit. Taxpayers who claim the child and dependent care credit must also include the care provider's name, address, and taxpayer identification number on their tax return. If the caregiver will not provide the required information, the taxpayer has the option to supply the name and address of the caregiver on Form 2441 and attach a statement explaining that the caregiver has refused to provide his or her taxpayer identification number (TIN). Schedule R of Form 1040 is filed to claim the credit for the elderly and disabled.[63]

The earned income tax credit is refundable to an individual even if no income tax is owed. The IRS will automatically compute the credit amount.[64] However, helpful tax tables are included in the IRS instructions to Form 1040. Schedule EIC is filed if the taxpayer has a qualifying child for the earned income credit.

The foreign tax credit for individuals is computed on Form 1116.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:14-1 Why are most taxpayers not subject to the alternative minimum tax (AMT)?

I:14-2 Does the AMT apply if an individual's tax liability as computed under the AMT rules is less than his or her regular tax amount?

I:14-3 Which of the following are tax preference items for purposes of computing the individual AMT?
- **a.** Net long-term capital gain
- **b.** Excess depreciation for real property placed in service before 1987
- **c.** Straight-line depreciation on residential real estate acquired in 1992
- **d.** Appreciated portion of the value of capital gain real property contributed to charity

I:14-4 Which of the following are individual AMT adjustments?
- **a.** Itemized deductions that are allowed for regular tax purposes but not allowed in computing AMTI.
- **b.** Excess of MACRS depreciation over depreciation computed under the alternative depreciation system for real property placed in service after 1986 and before 1999.
- **c.** Excess of MACRS depreciation over depreciation computed under the alternative depreciation system for personal property placed in service after 1986.
- **d.** Tax-exempt interest earned on State of Michigan bonds.

I:14-5 Which of the following itemized deductions are deductible when computing the alternative minimum tax for individuals?
- **a.** Charitable contributions
- **b.** Mortgage interest on a loan used to acquire a personal residence
- **c.** State and local income taxes
- **d.** Interest related to an investment in undeveloped land where the individual has no investment income
- **e.** Medical expenses in excess of 10% of AGI

I:14-6 Why are most individuals not subject to the self-employment tax?

I:14-7 Tony, who is single and 58 years old, is considering early retirement from his salaried job. He currently has $90,000 salary and also earns $50,000 profit from a consulting business. What advice would

[63] Sec. 6014. (See Form 1040 instructions for more reporting details.)

[64] Sec. 6695(g) requires preparers to meet due diligence requirements with respect to the earned income tax credit (EIC). If the EIC is incorrectly computed or overlooked, the *preparer* could be subject to a $100 penalty.

you give Tony relative to the need to make Social Security tax payments if he retires and continues to be actively engaged as a consultant during his retirement?

I:14-8 Theresa is a college professor who wants to work for a consulting firm during the summer. She will be working on special projects relating to professional development programs. What advantages might accrue to the consulting firm if the engagement is set up as a consulting arrangement rather than an employment contract?

I:14-9 Brian and Jennifer are a married couple who believe they may be subject to the AMT this year. Currently, they calculate their alternative minimum taxable income (AMTI) to be $900,000.
- **a.** What is their AMT exemption amount?
- **b.** They are considering an opportunity that would allow them to earn additional income this year. As a result of this additional income, they believe that their AMTI will increase by $200,000. What will their AMT exemption be if they recognize the additional income?

I:14-10 Discuss the underlying rationale for the following tax credit items:
- **a.** Foreign tax credit
- **b.** Research credit
- **c.** Business energy credit
- **d.** Premium tax credit
- **e.** Dependent care credit
- **f.** Earned income credit
- **g.** American Opportunity credit
- **h.** Adoption credit

I:14-11 If Congress is considering a tax credit or deduction as an incentive to encourage certain activities, is a $40 tax credit more valuable than a $200 tax deduction for a taxpayer with a 12% marginal rate? A 22% marginal rate?

I:14-12 What are the more significant tax credit items included in the computation of the general business tax credit?

I:14-13 Discuss the limitations that have been imposed on the general business tax credit, including the following:
- **a.** Overall ceiling limitation based on the tax liability
- **b.** Priority of general business and personal credits
- **c.** Carryback and carryover of unused credits (including the application of the FIFO method)

I:14-14 Sarah, a married taxpayer who files a joint return, is considering a foreign assignment for two years. In 2019, she will earn $120,000 in the foreign country. Sarah has no other income. She will be eligible for either the foreign tax credit or the foreign-earned income exclusion. The average tax rate on Sarah's earnings if fully taxable under U.S. law would be 24%. The average tax rate for the foreign salary is 20% under the foreign country's laws.
- **a.** Discuss in general terms the computation of the foreign tax credit and its limitation.
- **b.** Would Sarah be better off electing the foreign tax credit or the foreign earned income exclusion? Explain.

I:14-15 Queen Corporation has been in business since 1989. During the preceding year, the company had 25 full-time employees and gross receipts of $8,000,000. During the current year, Queen spent $15,000 to install access ramps for disabled individuals. Is Queen Corporation eligible for the disabled access credit? If so, what is the credit amount and the basis reduction (if any) for the depreciable property?

I:14-16 Discuss the special tax rules that apply to the tax credit for rehabilitation expenditures including the following:
- **a.** Types of eligible expenditures
- **b.** Applicable tax credit rates
- **c.** Calculation of basis for expenditures
- **d.** Restrictions on depreciation methods
- **e.** Potential recapture of the credit

I:14-17 What types of business property qualify for the business energy credit?

I:14-18 What are the underlying reason for enactment of many of the personal tax credits?

I:14-19 Discuss the difference between a refundable tax credit and a nonrefundable tax credit. Give at least one example of each type of credit.

I:14-20 If an individual is not employed and has no earned income, is it possible to take a child and dependent care credit for otherwise qualifying child and dependent care expenses? Explain.

I:14-21 Discuss the major differences between the American Opportunity credit and the Lifetime Learning credit. Include in your discussion the type of taxpayers who would likely qualify for each of the credits.

I:14-22 What is the maximum child and dependent care credit available to an employed individual who has $8,000 of qualifying child care expenses and two or more qualifying dependents?

I:14-23 Vivian is a single taxpayer with two children who qualify for the child and dependent care credit. She incurred $7,000 of qualifying child care expenses during the current year. She also received $4,000 in reimbursements from her employer from a qualified employee dependent care assistance program. What is the maximum child and dependent care credit available to Vivian if her AGI is $24,500?

I:14-24 The adoption credit is intended to assist taxpayers with the financial burden of adopting children.
- **a.** Discuss how the credit is computed.
- **b.** Why did Congress impose a phase-out of the credit for taxpayers based on AGI?

I:14-25 Alice is a single mother, 37 years old, and has two qualifying children, ages 3 and 6. In 2019, she

earns $20,000 in wages resulting in $20,000 of AGI. Is Alice eligible for the earned income credit?

I:14-26 Why are most elderly people unable to qualify for the tax credit for the elderly?

I:14-27 If an employer fails to withhold federal income taxes and FICA taxes on wages or fails to make payment to the IRS, what adverse tax consequences may result? May corporate officers or other corporate officials be held responsible for the underpayment?

I:14-28 Taxpayers are permitted to contribute money to qualified retirement plans and receive very favorable tax benefits. Congress has provided further incentives to contribute money to such plans by enacting the Qualified Retirement Savings Contributions Credit.

a. Why did Congress enact this credit when such contributions already receive favorable tax treatment?
b. Briefly describe how the credit is computed.

I:14-29 The credit for employer-provided child care has two major components, a credit for qualified child care expenses and a credit for qualified child care resources and referral expenditures.

a. Discuss each of the two components. What type of expenses are included in each com-ponent?
b. The two components are combined to compute the credit for employer-provided child care. Discuss the rates for each component, the limitation for the credit, and the tax result if the employer ceases to offer child care operations within the first three years after claiming the credit.

I:14-30 A credit is allowed to encourage businesses to conduct research and experimentation. One feature of the research credit is that only incremental expenditures are eligible. Explain the concept that the credit is allowed for *increasing* research activities.

I:14-31 Virginia is entitled to five allowances, but she claims only one withholding allowance on Form W-4.

a. Is it permissible to claim fewer allowances than an individual is entitled to?
b. Why would an individual claim fewer allowances?
c. Is it possible for Virginia to claim more than five withholding allowances?

I:14-32 Mario is a college student who had no income tax liability in the prior year and expects to have no tax liability for the current year.

a. What steps should Mario take to avoid having amounts withheld from his summer employment wages?
b. What are the cash-flow implications to Mario if the employer withholds federal income taxes?

I:14-33 What is backup withholding? What is its purpose?

I:14-34 Vincent anticipates that his actual tax liability for the tax year will be $12,000 and that federal income taxes withheld from his salary will be $9,000. Thus, when he files his current year income tax return, he will have a $3,000 balance due. In the previous year, his actual federal income tax liability was $8,000 and his AGI was less than $150,000.

a. Is Vincent required to make estimated tax payments in the current year? Explain.
b. Will Vincent be subject to an underpayment penalty if his prior year AGI was $175,000? Why?

I:14-35 An individual has increasing levels of income each year and is uncertain regarding the amount of his estimated taxable income for any given year. What tax planning strategy can be used to avoid the penalty for underpayment of estimated tax?

I:14-36 From a cash-flow perspective, why is it generally preferable to have an underpayment of tax (assuming no underpayment penalty is imposed) rather than an overpayment of tax?

I:14-37 Why do many taxpayers intentionally overpay their tax through withholdings to obtain a tax refund?

ISSUE IDENTIFICATION QUESTIONS

I:14-38 Daryl is an executive who has an annual salary of $120,000. He is considering early retirement so he can pursue a career as a management consultant. Daryl estimates that he could earn approximately $80,000 annually from his consulting business. What tax issues should Daryl consider?

I:14-39 Jennifer recently gave a check for $30,000 and securities with a fair market value of $200,000 to her former husband pursuant to a divorce. The $30,000 represents alimony and the securities were transferred pursuant to the property settlement. The property settlement is nontaxable to her former husband. What tax issues should Jennifer consider?

PROBLEMS

I:14-40 *AMT Computation.* William and Maria Smith are a married couple filing jointly. They have no children and report the following items in 2019:

Taxable income	$100,000
Tax preferences	20,000
AMT adjustments related to itemized deductions	30,000
Regular tax liability	13,717

a. What is the Smith's AMT liability?
b. What would be William's AMT liability if he were an unmarried taxpayer filing single with a regular tax liability of $18,175?

I:14-41 *AMT Computation.* Jose, an unmarried taxpayer filing single with no dependents, has AGI of $600,000 and reports the following items in 2019:

Taxable income	$550,000
Tax preferences	70,000
AMT adjustments related to itemized deductions	40,000
Regular tax liability	168,488

What is Jose's AMT liability for 2019?

I:14-42 *AMT Computation.* Dylan is a single taxpayer with $600,000 of taxable income, which results in a regular tax liability of $186,988 in 2019. Dylan is extremely cautious about being subject to AMT and wants to know how much AMT preferences or adjustments she can afford without being subject to AMT.

a. Compute the amount of preference and adjustments it would take for Dylan to have an AMT.
b. Comment on why it takes so many adjustments for Dylan to enter AMT.

I:14-43 *AMT Adjustments and Computation of Tax.* Allen, an unmarried taxpayer filing single, has no dependents and reports the following items on his 2019 federal income tax return:

Adjusted gross income	$82,450
Taxable income	47,950
Regular tax liability	6,408
Tax preferences	20,000
Itemized deductions including:	
Charitable contributions	7,500
Medical expenses (before AGI floor)	10,000
Mortgage interest on personal residence	10,000
State income taxes	5,000
Real estate taxes (before limitations)	8,000

a. What is the amount of Allen's AMT adjustments related to itemized deductions?
b. What is Allen's AMT liability for 2019?

I:14-44 *Self-Employment Tax.* Amelia has wages of $45,000 and net income from a small unincorporated business of $70,000 for 2019.

a. What is the amount of Amelia's self-employment (SE) tax and deduction *for* AGI for her SE tax?
b. How would your answer to Part a change if Amelia's wages were $140,000 rather than $45,000?

I:14-45 *Self-Employment Tax.* Arnie and Angela are married and file a joint return in 2019. Arnie is a partner in a public accounting firm. His share of the partnership's income in the current year is $40,000, and he receives guaranteed payments of $35,000. Angela receives wages of $50,000 from a large corporation. What is each taxpayer's self-employment tax amount? (Hint: Guaranteed payments received from a partnership are considered self-employment income.)

I:14-46 ***Self-Employment Tax.*** Anita, a single taxpayer, reports the following items for 2019:

Salary	$20,000
Income for serving on the Board of Directors for XYZ Corporation	11,000
Consulting gross income	9,000
Expenses related to consulting practice	(15,000)

a. What is the amount of Anita's self-employment tax?
b. How would your answer to Part a change if Anita's salary were $140,000?

I:14-47 ***Computation of Tax Credits.*** During the current year, Becky has personal credits (P) as well as business credits (B) related to her sole proprietorship. Her tentative tax credits for the current year include the following:

Child tax credit	$ 2,000 P
Disabled access credit	$ 900 B
Child and dependent care credit	1,200 P
Business energy credit	600 B

Becky's regular tax liability before credits is $4,000. Her tentative alternative minimum tax is $0.
a. What is the amount of allowable personal tax credits?
b. What is the amount of allowable business tax credits?
c. What treatment is accorded to the unused tax credits for the current year?

I:14-48 ***Child and Dependent Care Credit.*** In each of the following independent situations, determine the amount of the child and dependent care tax credit. (Assume that both taxpayers are employed and the year is 2019.)
a. Brad and Bonnie are married and file a joint return, with earned income of $40,000 and $14,000, respectively. Their combined AGI is $52,000. They have two children, ages 10 and 12, and employ a live-in nanny at an annual cost of $9,000.
b. Assume the same facts as in Part a, except that Brad and Bonnie employ Bonnie's mother, who is not their dependent, as the live-in nanny.
c. Bruce is divorced and has two children, ages 10 and 16. He has AGI and earned income of $35,000. Bruce incurs qualifying child care expenses of $8,000 during the year, incurred equally for both children. Bruce's employer maintains an employee dependent care assistance program. $1,000 was paid to Bruce from this program and excluded from Bruce's gross income.
d. Buddy and Candice are married and file a joint return. Their combined AGI is $50,000. Buddy earns $46,000, and Candice's salary from a part-time job is $4,000. They incur $5,000 of qualifying child care expenses for a day-care facility for their two children, ages 2 and 4.
e. Ben and Bunny are married and file a joint return. Their AGI is $75,000, all earned by Bunny. Ben was a full-time student for two semesters (10 months) at State University during the year. They incur $7,000 of qualifying child care expenses for their two children, ages 6 and 4.

I:14-49 ***Adoption Credit.*** Brad and Valerie decided to adopt a child and contacted an adoption agency in August 2018. After extensive interviews and other requirements (such as financial status, etc.), Brad and Valerie were approved as eligible parents to adopt a child. The agency indicated that it might take up to two years to find a proper match. In March 2019, the adoption became final, and Brad and Valerie adopted an infant daughter (not a special needs child). Below is a list of expenses that they incurred:

2018:	Agency fees (first installment)	$5,000
	Travel expenses for interviews, etc.	1,500
	Publications for prospective adoptive parents	300
	Legal fees connected with the adoption	1,000
	Kennel fees for dog while on adoption trips	250
2019:	Agency fees (final installment)	$4,000
	Travel expenses	400
	Court costs for adoption	1,500
	Kennel fees	100
	Legal fees connected with the adoption	1,000
	Nursery furniture (baby's room) and supplies	2,000

Brad and Valerie's AGI in 2018 was $70,000, and in 2019 was $90,000.
a. Compute Brad and Valerie's qualified adoption expenses for each year.
b. Compute Brad and Valerie's adoption credit. In which year(s) may the credit be taken?
c. Would your answer to Part b change if the adopted child was a special needs child and if a grant covered all adoption cost except for legal fees?

I:14-50 ***American Opportunity Tax Credit and Lifetime Learning Credit.*** Lou and Stella North are married, file a joint return, and have two dependent children in college, Phil and Jaci. Phil attends a State University in a neighboring state, and Jaci attends a State University in their home state. Neither receives any type of financial assistance. The Norths' modified AGI in 2019 is $122,000. The children's classifications and expenses are as follows:

	Spring Semester 2019 (paid in January 2019)	*Fall Semester 2019 (paid in July 2019)*
Phil:	Senior	Master's candidate
Tuition	$7,500	$8,000
Laboratory fees	500	500
Student activity fees	100	100
Course materials (books)	400	450
Room and board	3,200	3,200
Jaci:	Sophomore	Junior
Tuition	$1,600	$1,750
Student activity fees	100	100
Course materials (books)	250	300
Room and board	3,500	3,700

a. Compute any education credits that the Norths may claim in 2019.
b. How would your answer in Part a change if Phil received an academic scholarship of $3,000 (excluded from gross income) for each semester?
c. How would your answer in Part a change if Lou and Stella's modified AGI was $175,000?
d. How would your answer in Part a change if Phil had been a junior during Spring semester and a senior during Fall semester?

I:14-51 ***Tax Credit for the Elderly.*** Caroline, age 66 and filing single as a dependent of another, received the following income items for the current year:

Social Security benefits (nontaxable)	$ 3,000
Pension benefits (taxable)	6,450
Interest income (taxable)	2,050
Total	$11,500

Caroline's tax liability (before credits) is $540.
a. What is Caroline's tentative tax credit for the elderly (before the tax liability limitation is applied)?
b. What is Caroline's allowable tax credit?

I:14-52 ***General Business Tax Credit Limitation.*** During the current year, Joule Company, a sole proprietorship, earned general business tax credits of $30,000 for energy conservation and rehabilitation expenditures. The owner, Mark Joule, knows that the overall credit will be limited. He provides you with the following information for the current year: regular tax (before credits) = $37,500; tentative minimum tax = $20,200; alternative minimum tax = $0; foreign tax credit = $4,500; other nonrefundable credits = $6,100. Mark also has a $3,000 carryforward of general business credit from the prior year.
a. What is the current year limitation on Mark's general business credit?
b. What is Mark's allowable general business credit in the current year and where does it come from?
c. What is Mark's general business credit carryover?

I:14-53 ***Foreign Tax Credit.*** Laser Corporation, a U.S. corporation, has a foreign office that conducts business in France. Laser pays foreign taxes of $74,000 on foreign-source taxable income of $185,000. Its U.S.-source taxable income is $320,000, total U.S. taxable income (worldwide) of $505,000, and U.S. tax liability (before reductions for the foreign tax credit) is $106,050. What is Laser's foreign tax credit? What is Laser's foreign tax credit carryback or carryover?

I:14-54 ***Premium Tax Credit.*** Randall and Dianne Wall live in St. Louis, Missouri. Randall and Dianne are each 30 years old, neither smokes, and they have no children or other dependents.

Randall is attending law school full time and working part time (2019 earnings = $9,000). Dianne works full time (2019 earnings = $38,200). Their 2019 household income is more than 250% of the FPG (but not more than 300% of the FPG).

Dianne's employer does not offer employee health insurance coverage. The Walls choose to purchase insurance through the federal exchange operating in Missouri. They are credit eligible for all 12 months in 2019.

Their premiums for coverage vary by the type of plan.

a. Under a Gold plan, monthly premiums are $585 (covers 2) per month, so the annual cost of coverage is $7,020.

b. The second-least-expensive Silver plan (the benchmark plan) involves premiums of $468 per month (covers 2), or $5,616 per year.

c. Under a Bronze plan, monthly premiums are $390 (covers 2) per month, so the annual cost of coverage is $4,680.

What is the after-tax-credit cost of health insurance for the Walls under each of the plans described above?

I:14-55 ***Rehabilitation Tax Credit.*** Bob acquired a certified historic structure and placed it in service August of the current year, as an office for his business. He paid $20,000 for the building (exclusive of the land) and spent $40,000 for renovation costs.

a. What is the rehabilitation tax credit (before limitations)?

b. What is the basis of the building for MACRS depreciation purposes?

c. Compute the depreciation that Bob can take on the building for the current year.

I:14-56 ***Research Credit.*** Pharm Inc. is a small pharmaceutical company (organized four years ago) that is heavily involved in drug research. During the current year, Pharm Inc. incurred the following expenditures related to the company's research efforts:

Salaries of research scientists and technicians	$180,000
Supplies and materials	162,000
Depreciation on research equipment	30,000

For the previous four years, Pharm Inc. had average gross receipts of $5,000,000. The company's fixed-base percentage is 3%. Compute Pharm Inc.'s current year credit for research activities. Is Pharm Inc. entitled to claim any deduction for research and experimentation expenses for the current year?

I:14-57 ***Earned Income Credit.*** Carolyn is unmarried and has one dependent child, age 6, who lived with her for the entire year. In 2019, she has income of $16,000 in wages and $6,000 of unearned income (none of which was "disqualified income"). Her AGI is $22,000.

a. What is Carolyn's tentative earned income credit (before phaseout)?

b. What is Carolyn's allowable earned income credit?

c. If Carolyn has no income tax liability (before the earned income credit is subtracted), is she entitled to a refund in the current year?

d. How will your answers to Parts a and b change if Carolyn is married filing a joint return?

I:14-58 ***Earned Income Credit.*** Jose is unmarried with no qualifying children. He has $8,800 of 2019 wages and is otherwise eligible for the earned income credit. Jose has $200 of interest income and no *for* AGI deductions.

a. What is Jose's tentative earned income credit before phaseout?

b. What is Jose's allowable earned income credit?

c. If Jose has no income tax liability (before the earned income credit is subtracted), is he entitled to a refund for the current year?

d. Would your answer to Part b change if Jose had dividend and interest income of $3,700 during the taxable year?

I:14-59 ***Refundable Credits.*** Latisha is an unmarried taxpayer, filing head of household. She has two dependent children (7-year-old twins) who lived with her all year. Her 2019 earned income was $18,600, her AGI was $22,700, and she uses the standard deduction. Determine her:

1. Taxable income and regular tax before credits.

2. Earned income credit (EIC).

3. Balance due or refund.

I:14-60 ***Penalties for Nonpayment of Withholding and FICA Taxes.*** Lake Corporation has severe cash-flow problems. You are the company's financial and tax consultant. The treasurer of

the company informed you that the company has failed to make FICA and federal income tax withholding payments to the IRS (both the employer and employee contributions) for a period of approximately six months.

a. What advice can you give to the company treasurer regarding the nonpayment of taxes?
b. Can the liability for payment of the taxes extend to parties other than the corporation? Explain.

I:14-61 ***Exemptions from Withholding.*** Which of the following categories of individuals or income are exempt from the federal income tax withholding requirements?

a. Household employees
b. Independent contractors
c. Newspaper carriers over age 18
d. Bonuses
e. Commissions
f. Vacation pay
g. Tips under $20 per month from a single employer

I:14-62 ***Withholding Exemptions.*** Barry is a college student who is employed as a waiter during the summer. He earns approximately $1,500 during the summer and estimates that he will not be required to file a tax return and will have no federal income tax liability. Last year, however, he made $6,000 and was required to file a return and pay $400 in taxes. Barry is unmarried and is supported by his parents. He has no dependents and does not have any other sources of income or deductions.

a. Can Barry claim exempt status on Form W-4 for withholding purposes?
b. Can Barry claim more than one exemption on Form W-4 (e.g., additional withholding allowances or the standard deduction allowance) to minimize the amount withheld? Explain.

I:14-63 ***Withholding Allowances.*** Bart and Jane Lee are married, file a joint return and have two dependent children (twins, age 9). Bart begins a new job and is asked to fill out a Form W-4. His monthly gross earnings will be $3,200. Jane does not work outside their home. Bart can claim two additional withholding allowances because he will have large deductions.

a. What is the correct number of withholding allowances on Form W-4?
b. What is the amount of federal income tax, FICA and Medicare tax to be withheld using the wage bracket tables (see withholding tables starting on page T-16)?
c. What disclosure procedures must Bart's employer follow if Bart claims more than ten allowances?

I:14-64 ***Estimated Tax Requirements.*** Anna does not make quarterly estimated tax payments even though she has substantial amounts of income that are not subject to withholding. In the previous year, Anna's tax liability was $18,000 and her AGI was $ 135,000. In the current year, Anna's actual tax liability is $30,000, and $18,200 was withheld from her salary.

a. Is Anna subject to the underpayment penalty? Why?
b. If Anna's withholdings were only $15,000, would she be subject to the underpayment penalty? Why?
c. If Anna is subject to an underpayment penalty, can she deduct this amount as interest? Explain.

I:14-65 ***Estimated Tax Underpayment Penalty.*** Jane's estimated tax payments for the current year total $14,000, and federal income taxes withheld from her salary amount to $12,000. Jane's actual tax liability for the current year is $30,000. Her income was earned evenly throughout the current year. Jane's AGI for the prior year was $160,000 and her tax liability was $25,000. Is Jane subject to the underpayment penalty? Explain.

COMPREHENSIVE PROBLEM

I:14-66 Mike Webb, married to Nancy Webb, is employed by a large pharmaceutical company and earns a salary. In addition, Mike is an entrepreneur and has two small businesses on the side, both of which operate as sole proprietorships. One is a profitable consulting

business where Mike provides financial and retirement advice to pharmacists. The other involves the manufacture of Christmas novelties in China, selling the products in gift shops in the U.S. This business is struggling. However, Mike feels the Christmas novelty business has great potential. Mike reports the following for 2019:

Salary		$157,000
Consulting practice: Revenues	$65,000	
Ordinary expenses	12,000	53,000
Sole proprietorship: Revenues	$22,000	
Ordinary Expenses	40,000	(18,000)
Interest (none tax-exempt)		3,000
Dividends, qualified		9,000
LTCG	$24,000	
STCL	(4,000)	20,000
Itemized deductions:		
State and local taxes (before limitations)	$14,000	
Real estate taxes (before limitations)	8,000	
Mortgage interest on personal residence	7,000	
Charitable contributions	8,000	37,000
Child care expenses:		
The Webbs have two dependent children, ages 13 and 11, and pay child care expenses of $4,000 per year for each child. Nancy is not employed, but is a full-time student (all of 2019) at State University, majoring in Accounting.		
Federal income tax withheld from salary		$21,000
Estimated taxes paid for 2019		14,000

For 2018, Mike and Nancy's AGI was $175,000 and their actual federal income tax liability was $29,000.

a. Compute the Webbs regular federal income tax liability for 2019, including self-employment taxes.
b. Are the Webbs subject to AMT in 2019, assuming they have additional AMT preferences of $70,000?
c. Are the Webbs due a refund for 2019?
d. Are the Webbs subject to any underpayment penalties for 2019?

TAX STRATEGY AND CRITICAL THINKING PROBLEM

I:14-67 Jeff and Linda Foley are married and file a joint income tax return. Jeff is a lawyer and a partner in the firm of Foley & Looby, Attorneys at Law. Jeff is a 50% partner in the firm along with his partner, John Looby who is the other 50% partner. Foley & Looby (F&L) currently rent office space in a prestigious building and pay rent of $6,000 per month or $72,000 per year for their 4,000 square foot office. Thus, the firm pays $18 per square foot per year. As no equity is being generated by paying rent, Jeff and John are considering buying an office building. They have two buildings under consideration, as follows:

Building #1

Building #1 is a relatively new building and has 10,000 square feet of space. The new building can be purchased for a total price of $1,000,000. F&L would only use 4,000 square feet of the space and have other businesses that would rent the other 6,000 square feet from F&L for $15 per square foot per year, a total of $90,000 per year. Maintenance costs would amount to approximately $10 per square foot per year. The building is in excellent condition and is ready to be moved into immediately and would require very few other outlays by F&L.

Building #2

Building #2 is located in the downtown area in a certified historic district and would qualify as a certified historic structure. This building, nearly 80 years old, also has 10,000 square feet and, like Building #1, the other 6,000 square feet can be rented to other tenants at $15 per square foot per year, a total of $90,000 per year. However, Building #2 is not in as good condition as Building #1. The purchase price of the building would be

$400,000, and Jeff and John estimate that approximately $600,000 would have to be invested in capital expenditures to make the building suitable for their business. After the significant capital expenditures, F&L estimates the maintenance costs to be similar to Building #1, or $10 per square foot per year.

Both buildings can be 100% financed at 8% annual interest rate for 15 years. The annual cash payment on the $1,000,000 mortgage would be $117,000. Assume both buildings will appreciate at a rate of 8% per year.

Jeff and John have come to you as their financial and tax advisor to help them make the decision as to which building to purchase. If the buildings are equally desirable from a non-financial and non-tax standpoint, what is the best decision for them? That is, should they stay where they are and rent, or purchase one of the two buildings? Assume both Jeff and John are in the 35% marginal tax bracket.

TAX FORM/RETURN PREPARATION PROBLEMS

I:14-68 Len and Christy Vole, ages 42 and 39 respectively, are married and file jointly in 2018. Len is a contractor operating as a sole proprietorship (EIN 11-1111111). Christy is employed, earning $24,000 as a part-time paralegal. They have two dependent children, Jill, age 8 and Lee, age 5. They received $4,550 from Good Bank in taxable interest income.

Their allowable itemized deductions include state income tax $3,700; home mortage interest $6,000; and charity $5,000. Federal income tax withholding was $7,500 and estimated tax payments were $13,000. The Voles also incurred $7,000 of qualifying child care expenses to enable them to work ($3,500 for each child). It was paid to HiTop Daycare, 327 Fowler St., Indianapolis, IN 46802 (EIN 22-2222222).

Len earns $95,000 in profit in a sole proprietorship. He incurred the following expenses that qualify for the general business credit: $6,000 for disabled access. No adjustments are required to this credit and there are no carrybacks or carryforwards.

Social security numbers are: Len, 111-11-1111; Christy, 222-22-2222; Jill, 333-33-3333; Lee, 444-44-4444.

Complete the Voles' Form 1040 for 2018, along with supporting Schedules A, B, C, and SE, Form 2441 (child and dependent care credit), Form 3800 (general business credit), and Form 8826 (disabled access credit). Show detail of the child tax credit computation (with any phaseout) at the bottom of Form 1040, page 2.

I:14-69 Harold J. Milton (SSN 000-22-1111) is 66 years old and unmarried, filing single with no dependents. He had the following income and deductions for 2018:

Salary	$177,000	State income taxes	$18,000
Interest income from State Bank	12,000	Mortgage interest expense on residence (100% acquisition debt)	19,000
Dividend income (qualified)	18,000		
Deductible IRA contribution	5,000	Interest expense on car loan	3,000
Tax-exempt interest income from municipal bonds	24,000	Real estate taxes on residence	2,000
Charitable contributions	27,000	Miscellaneous deductions—other (before the floor)	12,000
Medical expenses (before the floor)	18,000	Income taxes withheld	20,000
		Estimated tax payments ($2,500 per quarter)	10,000

Complete Milton's 2018 Form 1040, Schedule A, B, D, and Form 6251. In 2017, Milton had AGI of $200,000 and his income tax liability was $46,000.

I:14-70 ***Child Tax Credit Short Tax Form.*** Reagan and Grady Wade are married with three qualifying children under the age of 17. In 2018, Reagan and Grady had earned income of $50,000 and no adjustments. Line 7 of their 1040 reports AGI of $50,000. Reagan and Grady take the standard deduction for 2018 ($24,000) and as a result have taxable income of $26,000. The Wades' tax liability before considering the child tax credit is $2,739. Assuming the Wades have no other tax credits, complete the 2018 Child Tax Credit and Credit for Other Dependents Worksheet, then complete the 2018 Schedule 8812 Additional Child Tax Credit.

I:14-71 ***Self Employment Tax Calculation Short Tax Form.*** Doug is a single taxpayer. In 2018, he had wage income of $115,000 from his employer. In addition to his wage income, Doug was a consultant in which he made an additional $75,000 of net income from self-employment (Schedule C, line 31). Complete the 2018 Schedule SE to determine the amount of tax Doug will incur from his consulting business. Note: You will need to complete Section B – Long Schedule SE.

CASE STUDY PROBLEMS

I:14-72 Barbara was divorced two years ago. However, the final property settlement and determination of alimony payments was not made until February 2019 because of extended litigation. Barbara received a $20,000 payment of back alimony in March 2019 and will receive monthly alimony payments of $2,000 for the period April through December 2019. Last year, Barbara's income consisted of $15,000 salary and $2,000 of taxable interest income, and her tax liability was $1,900. She expects to continue working at an annual salary of $15,000 and will have $2,000 of interest income. Federal income taxes withheld from her salary will be $1,500. Her monthly alimony payments of $2,000 are also expected to continue for an indefinite period.

In early April 2019 Barbara requests your advice regarding the payment of 2019 quarterly estimated taxes. Prepare a memo to your client that discusses these requirements, including any possible penalties for not making quarterly payments and nontax issues such as cash-flow and investment income decisions.

I:14-73 Chips-R-Us is a computer technology corporation that designs hardware and software for use in large businesses. The corporation regularly pays individuals to install programs and give advice to companies that buy their software. In the current year, Simone, a computer expert, was sent to a customer of Chips-R-Us to perform computer services. Simone is not a regular employee of the corporation and the corporation did not train Simone for the task. Simone keeps track of the time spent on the job at the customer and reports to the corporation, which pays Simone for her services. The corporation specifies the work to be done for their client. The corporation can also replace Simone with another individual if her work is not satisfactory. Chips-R-Us treats Simone as an independent contractor for employment tax purposes.

In the current year the IRS challenges the corporation that it has failed to remit FICA taxes and income taxes that should have been withheld with respect to Simone's employment. Chips-R-Us refuses to pay the amount, stating that it is not required to do so because Simone is not an employee of the corporation. What will be the likely outcome of the IRS's challenge concerning Simone's status as an employee or independent contractor? Who may be liable for payment of the employment taxes, interest, and penalties to the government? What ethical responsibilities should be followed in the remittance of withheld employee taxes?

TAX RESEARCH PROBLEM

I:14-74 Lean Corporation was incorporated in 2013 by Bruce Smith, who has served as an officer and member of the Board of Directors. Carl Jones has served as the secretary-treasurer of the company as a convenience to his friend Bruce. Carl acted as a part-time bookkeeper but did not run the everyday business affairs and paid only the bills he was instructed to pay. Carl was an authorized signatory for the corporate bank accounts but had no final control over expenditures.

Beginning in the last quarter of 2017, the company failed to pay all of the taxes withheld from employees and the employer's share of FICA taxes to the IRS. Despite this delinquency, the corporation continued to pay other creditors, including its employees, in preference to the IRS.

In January, 2019 Lean Corporation entered into an installment agreement with the IRS to stay current on its withholding tax deposits and to make payments on the past due balance until paid in full. The company subsequently defaulted on the agreement in April 2019. During this period, Bruce Smith was serving as chief financial officer and was a member of the board of directors. He had the authority to make policy decisions. He was responsible for negotiating the installment agreement with the IRS and the decision to default on the agreement.

Who is liable for the penalty for the nonpayment of the payroll tax withholdings?

A partial list of research sources is:

- Sec. 6672
- *Ernest W. Carlson v. U.S.*, 67 AFTR 2d 91-1104, 91-1 USTC ¶50,262 (D.C. UT, 1991)

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CHAPTER

15

TAX RESEARCH



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Distinguish between closed fact and open fact tax situations
2. Describe the steps in the tax research process
3. Explain how the facts influence tax consequences
4. Identify the sources of tax law and assess the authoritative value of each
5. Consult tax services to research an issue
6. Apply the basics of Internet-based tax research
7. Use a citator to assess tax authorities
8. Describe the professional guidelines that CPAs in tax practice should follow
9. Prepare work papers and communicate to clients

CHAPTER OUTLINE

Overview of Tax Research...15-2
Steps in the Tax Research Process...15-3
Importance of the Facts to the Tax Consequences...15-5
The Sources of Tax Law...15-7
Tax Services...15-25
The Internet as a Research Tool...15-26
Citators...15-28
Professional Guidelines for Tax Services...15-30
Sample Work Papers and Client Letter...15-34

This chapter introduces the reader to the tax research process. Its major focus is the sources of the tax law (i.e., the Internal Revenue Code and other tax authorities) and the relative weight given to each source. The chapter describes the steps in the tax research process and places particular emphasis on the importance of the facts to the tax consequences. It also describes the features of frequently used tax services and computer-based tax research resources. Finally, it explains how to use a citator.

The end product of the tax research process—the communication of results to the client—also is discussed. This text uses a hypothetical set of facts to provide a comprehensive illustration of the process. Sample work papers demonstrating how to document the results of research are included in Appendix A. The text also discusses two types of professional guidelines for CPAs in tax practice: the American Institute of Certified Public Accountants' (AICPA's) *Statements on Standards for Tax Services* (reproduced in Appendix E) and Treasury Department *Circular 230*.

OVERVIEW OF TAX RESEARCH

OBJECTIVE 1

Distinguish between closed fact and open fact tax situations

Tax research is the process of solving tax-related problems by applying tax law to specific sets of facts. Sometimes it involves researching several issues and often is conducted to formulate tax policy. For example, policy-oriented research would determine how far the level of charitable contributions might decline if such contributions were no longer deductible. Economists usually conduct this type of tax research to assess the effects of government policy.

Tax research also is conducted to determine the tax consequences of transactions to specific taxpayers. For example, client-oriented research would determine whether Smith Corporation could deduct a particular expenditure as a trade or business expense. Accounting and law firms generally engage in this type of research on behalf of their clients.

This chapter deals only with client-oriented tax research, which occurs in two contexts:

ADDITIONAL COMMENT

Closed-fact situations afford the tax advisor the least amount of flexibility. Because the facts are already established, the tax advisor must develop the best solution possible within certain predetermined constraints.

1. **Closed fact or tax compliance situations:** The client contacts the tax advisor after completing a transaction or while preparing a tax return. In such situations, the tax consequences are fairly straightforward because the facts cannot be modified to obtain different results. Consequently, tax saving opportunities may be lost.

EXAMPLE I:15-1 ▶ Tom informs Carol, his tax advisor, that on November 4 of the current year, he sold land held as an investment for $500,000 cash. His basis in the land was $50,000. On November 9, Tom reinvested the sales proceeds in another plot of investment property costing $500,000. This is a closed fact situation. Tom wants to know the amount and the character of the gain (if any) he must recognize. Because Tom solicits the tax advisor's advice after the sale and reinvestment, the opportunity for tax planning is limited. For example, the possibility of deferring taxes by using a like-kind exchange or an installment sale is lost. ◀

ADDITIONAL COMMENT

Open-fact or tax-planning situations give a tax advisor flexibility to structure transactions to accomplish the client's objectives. In this type of situation, a creative tax advisor can save taxpayers dollars through effective tax planning.

2. **Open fact or tax planning situations:** Before structuring or concluding a transaction, the client contacts the tax advisor to discuss tax planning opportunities. Tax-planning situations generally are more difficult and challenging because the tax advisor must consider the client's tax and nontax objectives. Most clients will not engage in a transaction if it is inconsistent with their nontax objectives, even though it produces tax savings.

EXAMPLE I:15-2 ▶ Diane is a widow with three children and five grandchildren and at present owns property valued at $30 million. She seeks advice from Carol, her tax advisor, about how to minimize her estate taxes and convey the greatest value of property to her descendants. This is an open-fact situation. Carol could advise Diane to leave all but $11.4 million of her property to a charitable organization so that her estate would owe no estate taxes. Although this recommendation would eliminate Diane's estate taxes, Diane is likely to reject it because she wants her children or grandchildren to be her primary beneficiaries. Thus, reducing estate

taxes to zero is inconsistent with her objective of allowing her descendants to receive as much after-tax wealth as possible. ◀

TAX STRATEGY TIP

Taxpayers should make investment decisions based on after-tax rates of return or after-tax cash flows.

When conducting research in a tax planning context, the tax professional should keep a number of points in mind. First, the objective is not to minimize taxes per se but rather to maximize a taxpayer's after-tax return. For example, if the federal income tax rate is a constant 30%, an investor should not buy a tax-exempt bond yielding 5% when he or she could buy a corporate bond of equal risk that yields 9% before tax and 6.3% after tax. This is the case even though his or her explicit taxes (actual tax liability) would be minimized by investing in the tax-exempt bond.[1] Second, taxpayers typically do not engage in unilateral or self-dealing transactions; thus, the tax ramifications for all parties to the transaction should be considered. For example, in the executive compensation context, employees may prefer to receive incentive stock options (because they will not recognize income until they sell the stock), but the employer may prefer to grant a different type of option (because the employer cannot deduct the value of incentive stock options upon issuance). Thus, the employer might grant a different number of options if it uses one type of stock option versus another type as compensation. Third, taxes are but one cost of doing business. In deciding where to locate a manufacturing plant, for example, factors more important to some businesses than the amount of state and local taxes paid might be the proximity to raw materials, good transportation systems, the cost of labor, the quantity of available skilled labor, and the quality of life in the area. Fourth, the time for tax planning is not restricted to the beginning date of an investment, contract, or other arrangement. Instead, the time extends throughout the duration of the activity. As tax rules change or as business and economic environments change, the tax advisor must reevaluate whether the taxpayer should hold onto an investment and must consider the transaction costs of any alternatives.

ADDITIONAL COMMENT

It is important to consider nontax as well as tax objectives. In many situations, the nontax considerations outweigh the tax considerations. Thus, the plan eventually adopted by a taxpayer may not always be the best when viewed strictly from a tax perspective.

One final note: the tax advisor should always bear in mind the financial accounting implications of proposed transactions. An answer that may be desirable from a tax perspective may not always be desirable from a financial accounting perspective. Though interrelated, the two fields of accounting have different orientations and different objectives. Tax accounting is oriented primarily to the Internal Revenue Service (IRS). Its objectives include calculating, reporting, and predicting one's tax liability according to legal principles. Financial accounting is oriented primarily to shareholders, creditors, managers, and employees. Its objectives include determining, reporting, and predicting a business's financial position and operating results according to Generally Accepted Accounting Principles. Because tax and financial accounting objectives may differ, planning conflicts could arise. For example, management might be reluctant to engage in tax reduction strategies that also reduce book income and reported earnings per share. Success in any tax practice, especially at the managerial level, requires consideration of both sets of objectives and orientations.

STEPS IN THE TAX RESEARCH PROCESS

OBJECTIVE 2

Describe the steps in the tax research process

In both open- and closed-fact situations, the tax research process involves six basic steps:

1. Determine the facts.
2. Identify the issues (questions).
3. Locate the applicable authorities.
4. Evaluate the authorities and choose those to follow where the authorities conflict.
5. Analyze the facts in terms of the applicable authorities.
6. Communicate conclusions and recommendations to the client.

[1] For an excellent discussion of explicit and implicit taxes and tax planning see M. S. Scholes, M. A. Wolfson, M. Erickson, M. Hanlon, L. Maydew, and T. Shevlin, *Taxes and Business Strategy: A Planning Approach,* fifth edition (Upper Saddle River, NJ: Pearson Prentice Hall, 2015). Also see Chapter I:18 of the *Individuals* volume. An example of an implicit tax is the excess of the before-tax earnings on a taxable bond over the risk-adjusted before-tax earnings on a tax-favored investment (e.g., a municipal bond).

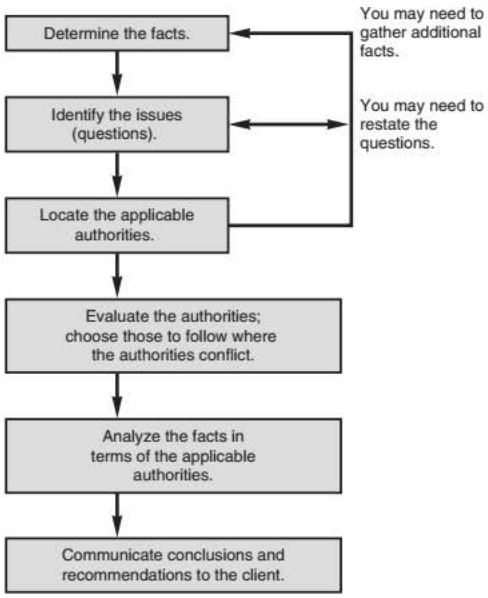


FIGURE I:15-1 ▶ STEPS IN THE TAX RESEARCH PROCESS

ADDITIONAL COMMENT

The steps of tax research provide an excellent format for a written tax communication. For example, a good format for a client memo includes (1) statement of facts, (2) list of issues, (3) discussion of relevant authority, (4) analysis, and (5) recommendations to the client of appropriate actions based on the research results.

Although the above outline suggests a linear approach, the tax research process often is circular. That is, it does not always proceed step-by-step. Figure I:15-1 illustrates a more accurate process, and Appendix A provides a comprehensive example of this process.

In a closed-fact situation, the facts have already occurred, and the tax advisor's task is to analyze them to determine the appropriate tax treatment. In an open-fact situation, by contrast, the facts have not yet occurred, and the tax advisor's task is to plan for them or shape them so as to produce a favorable tax result. The tax advisor performs the latter task by reviewing the relevant legal authorities, particularly court cases and IRS rulings, all the while bearing in mind the facts of those cases or rulings that produced favorable results compared with those that produced unfavorable results. For example, if a client wants to realize an ordinary loss (as opposed to a capital loss) on the sale of several plots of land, the tax advisor might consult cases involving similar land sales. The advisor might attempt to distinguish the facts of those cases in which the taxpayer realized an ordinary loss from the facts of those cases in which the taxpayer realized a capital loss. The advisor then might recommend that the client structure the transaction based on the fact pattern in the ordinary loss cases.

TYPICAL MISCONCEPTION

Many taxpayers think the tax law is all black and white. However, most tax research deals with gray areas. Ultimately, when confronted with tough issues, the ability to develop strategies that favor the taxpayer and then to find relevant authority to support those strategies will make a successful tax advisor. Thus, recognizing planning opportunities and avoiding potential traps is often the real value added by a tax advisor.

Often, tax research involves a question to which no clearcut, unequivocally correct answer exists. In such situations, probing a related issue might lead to a solution pertinent to the central question. For example, in researching whether the taxpayer may deduct a loss as ordinary instead of capital, the tax advisor might research the related issue of whether the presence of an investment motive precludes classifying a loss as ordinary. The solution to that issue might be relevant to the central question of whether the taxpayer may deduct the loss as ordinary.

Identifying the issue(s) to be researched often is the most difficult step in the tax research process. In some instances, the client defines the issue(s) for the tax advisor, such as where the client asks, "May I deduct the costs of a winter trip to Florida recommended by my physician?" In other instances, the tax advisor, after reviewing the documents submitted to him or her by the client, identifies and defines the issue(s) himself or herself. Doing so presupposes a firm grounding in tax law.[2]

[2] Often, in an employment context, supervisors define the questions to be researched and the authorities that might be relevant to the tax consequences.

Once the tax advisor locates the applicable legal authorities, he or she might have to obtain additional information from the client. Example I:15-3 illustrates the point. The example assumes that all relevant tax authorities are in agreement.

EXAMPLE I:15-3 ▶ Mark calls his tax advisor, Al, and states that he (1) incurred a loss on renting his beach cottage during the current year and (2) wonders whether he may deduct the loss. He also states that he, his wife, and their minor child occupied the cottage only eight days during the current year.

This is the first time Al has dealt with the Sec. 280A vacation home rules. On reading Sec. 280A(d), Al learns that a loss is *not* deductible if the taxpayer used the residence for personal purposes for longer than the greater of (1) 14 days or (2) 10% of the number of days the unit was rented at a fair rental value. He also learns that the property is *deemed* to be used by the taxpayer for personal purposes on any days on which it is used by any member of his or her family (as defined in Sec. 267(c)(4)). The Sec. 267(c)(4) definition of family members includes brothers, sisters, spouse, ancestors (e.g., parents and grandparents), or lineal descendants (e.g., children and grandchildren).

Mark's eight-day use is not long enough to make the rental loss nondeductible. However, Al must inquire about the number of days, if any, Mark's brothers, sisters, or parents used the property. (He already knows about use by Mark, his spouse, and his lineal descendants.) In addition, Al must find out how many days the cottage was rented to other persons at a fair rental value. Upon obtaining the additional information, Al proceeds to determine how to calculate the deductible expenses. Al then derives his conclusion concerning the deductible loss, if any, and communicates it to Mark. (This example assumes the passive activity and at-risk rules restricting a taxpayer's ability to deduct losses from real estate activities will not pose a problem for Mark. See Chapter I:9 for a comprehensive discussion of these topics.) ◀

Many firms require that a researcher's conclusions be communicated to the client in writing. Members or employees of such firms may answer questions orally, but their oral conclusions should be followed by a written communication. According to the AICPA's *Statements on Standards for Tax Services* (reproduced in Appendix E),

> Although oral advice may serve a taxpayer's needs appropriately in routine matters or in well-defined areas, written communications are recommended in important, unusual, substantial dollar value, or complicated transactions. The member may use professional judgment about whether, subsequently, to document oral advice.[3]

In addition, Treasury Department *Circular 230* covers all written advice communicated to clients. These requirements are more fully discussed at the end of this chapter and in Chapter C:15.

IMPORTANCE OF THE FACTS TO THE TAX CONSEQUENCES

OBJECTIVE 3

Explain how the facts influence tax consequences

Many terms and phrases used in the Internal Revenue Code (IRC) and other tax authorities are vague or ambiguous. Some provisions conflict with others or are difficult to reconcile, creating for the researcher the dilemma of deciding which rules are applicable and which tax results are proper. For example, as a condition to claiming another person as a dependent, the taxpayer must provide a certain level of support for such person.[4] Neither the IRC nor the Treasury Regulations define "support." This lack of definition could be problematic. For example, if the taxpayer purchased a used automobile costing $8,000 for an elderly parent whose only source of income is $7,800 in Social Security benefits, the question of whether the expenditure constitutes support would arise. The tax advisor would have to consult court opinions, revenue rulings, and other IRS pronouncements to ascertain the legal meaning of the term "support." Only after thorough research would the meaning of the term become clear.

[3] AICPA, *Statement on Standards for Tax Services*, No. 7, "Form and Content of Advice to Taxpayers," 2010 (2018 to include required citations), Para. 6.

[4] Sec. 152(e)(1)(A) and Sec. 152(d)(1)(C).

In other instances, the legal language is quite clear, but a question arises as to whether the taxpayer's transaction conforms to a specific pattern of facts that gives rise to a particular tax result. Ultimately, the peculiar facts of a transaction or event determine its tax consequences. A change in the facts can significantly change the consequences. Consider the following illustrations:

Illustration One
Facts: A holds stock, a capital asset, that he purchased two years ago at a cost of $1,000. He sells the stock to B for $920. What are the tax consequences to A?
Result: Under Sec. 1001, A realizes an $80 capital loss. He recognizes this loss in the current year. A must offset the loss against any capital gains recognized during the year. Any excess loss is deductible from ordinary income up to a $3,000 annual limit.
Change of Facts: A is B's son.
New Result: Under Sec. 267, A and B are related parties. Therefore, A may not recognize the realized loss. However, B may use the loss if she subsequently sells the stock at a gain.

Illustration Two
Facts: C donates to State University ten acres of land that she purchased two years ago for $10,000. The fair market value (FMV) of the land on the date of the donation is $25,000. C's adjusted gross income is $100,000. What is C's charitable contribution deduction?
Result: Under Sec. 170, C is entitled to a $25,000 charitable contribution deduction (i.e., the FMV of the property unreduced by the unrealized long-term gain).
Change of Facts: C purchased the land 11 months ago.
New Result: Under the same IRC section, C is entitled to only a $10,000 charitable contribution deduction (i.e., the FMV of the property reduced by the unrealized short-term gain).

Illustration Three
Facts: Acquiring Corporation pays Target Corporation's shareholders one million shares of Acquiring voting stock. In return, Target's shareholders tender 98% of their Target voting stock. The acquisition is for a bona fide business purpose. Acquiring continues Target's business. What are the tax consequences of the exchange to Target's shareholders?
Result: Because the transaction qualifies as a reorganization under Sec. 368(a)(1)(B), Target's shareholders are not taxed on the exchange, which is solely for Acquiring voting stock.
Change of Facts: In the transaction, Acquiring purchases the remaining 2% of Target's shares with cash.
New Result: Under the same IRC provision, Target's shareholders are now taxed on the exchange, which is not solely for Acquiring voting stock.

CREATING A FACTUAL SITUATION FAVORABLE TO THE TAXPAYER

TYPICAL MISCONCEPTION

Many taxpayers believe tax practitioners spend most of their time preparing tax returns. In reality, providing tax advice that accomplishes the taxpayer's objectives is one of the most important responsibilities of a tax advisor. This latter activity is tax consulting as compared to tax compliance.

Based on his or her research, a tax advisor might recommend to a taxpayer how to structure a transaction or plan an event so as to increase the likelihood that related expenses will be deductible. For example, suppose a taxpayer is assigned a temporary task in a location (City Y) different from the location (City X) of his or her permanent employment. Suppose also that the taxpayer wants to deduct the meal and lodging expenses incurred in City Y as well as the cost of transportation thereto. To do so, the taxpayer must establish that City X is his or her tax home and that he or she temporarily works in City Y. (Section 162 provides that a taxpayer may deduct travel expenses while "away from home" on business. A taxpayer is deemed to be "away from home" if his or her employment at the new location does not exceed one year, i.e., it is "temporary.") Suppose the taxpayer wants to know the tax consequences of his or her working in City Y for ten months and then, within that ten-month period, finding permanent employment in City Y. What is tax research likely to reveal?

Tax research will lead to an IRS ruling stating that, in such circumstances, the employment will be deemed to be temporary until the date on which the realistic expectation about the temporary nature of the assignment changes.[5] After this date, the employment

[5] Rev. Rul. 93-86, 1993-2 C.B. 71.

will be deemed to be permanent, and travel expenses relating to it will be nondeductible. Based on this finding, the tax advisor might advise the taxpayer to postpone his or her permanent job search in City Y until the end of the ten-month period and simply treat his or her assignment as temporary. So doing would lengthen the time he or she is deemed to be "away from home" on business and thus increase the amount of meal, lodging, and transportation costs deductible as travel expenses. The taxpayer should compare the tax savings to any additional personal costs of maintaining two residences.

THE SOURCES OF TAX LAW

OBJECTIVE 4

Identify the sources of tax law and assess the authoritative value of each

The language of the IRC is general; that is, it prescribes the tax treatment of broad categories of transactions and events. The reason for the generality is that Congress can neither foresee nor provide for every conceivable transaction or event. Even if it could, doing so would render the statute narrow in scope and inflexible in application. Accordingly, interpretations of the IRC—both administrative and judicial—are necessary. Administrative interpretations are provided in Treasury Regulations, revenue rulings, revenue procedures, and several other pronouncements discussed later in this chapter. Judicial interpretations are presented in court opinions. The term *tax law* as used by most tax advisors encompasses administrative and judicial interpretations in addition to the IRC. It also includes the meaning conveyed in reports issued by Congressional committees involved in the legislative process.

THE LEGISLATIVE PROCESS

Tax legislation begins in the House of Representatives. Initially, a tax proposal is incorporated in a bill. The bill is referred to the House Ways and Means Committee, which is charged with reviewing all tax legislation. The Ways and Means Committee holds hearings in which interested parties, such as the Treasury Secretary and IRS Commissioner, testify. At the conclusion of the hearings, the Ways and Means Committee votes to approve or reject the measure. If approved, the bill goes to the House floor where it is debated by the full membership. If the House approves the measure, the bill moves to the Senate where it is taken up by the Senate Finance Committee. Like Ways and Means, the Finance Committee holds hearings in which Treasury officials, tax experts, and other interested parties testify. If the committee approves the measure, the bill goes to the Senate floor where it is debated by the full membership. Upon approval by the Senate, it is submitted to the President for his or her signature. If the President signs the measure, the bill becomes public law. If the President vetoes it, Congress can override the veto by at least a two-thirds majority vote in each chamber.

Generally, at each stage of the legislative process, the bill is subject to amendment. If amended, and if the House version differs from the Senate version, the bill is referred to a House-Senate conference committee.[6] This committee attempts to resolve the differences between the House and Senate versions. Ultimately, it submits a compromise version of the measure to each chamber for its approval. Such referrals are common. For example, in 1998 the House and Senate disagreed over what the taxpayer must do to shift the burden of proof to the IRS. The House proposed that the taxpayer assert a "reasonable dispute" regarding a taxable item. The Senate proposed that the taxpayer introduce "credible evidence" regarding the item. A conference committee was appointed to resolve the differences. This committee ultimately adopted the Senate proposal, which was later approved by both chambers.

ADDITIONAL COMMENT

Committee reports can be helpful in interpreting new legislation because they indicate the intent of Congress. With the proliferation of tax legislation, committee reports have become especially important because the Treasury Department often is unable to draft the needed regulations in a timely manner.

After approving major legislation, the Ways and Means Committee and Senate Finance Committee usually issue official reports. These reports, published by the U.S. Government Printing Office (GPO) as part of the *Cumulative Bulletin* and as separate documents, explain the committees' reasoning for approving (and/or amending) the legislation.[7] In addition, the GPO publishes records of both the committee hearings and transcripts of the floor debates. The records are published as separate House or Senate documents. The transcripts are incorporated in the *Congressional Record* for the day of the

[6] The size of a conference committee can vary. It is made up of an equal number of members from the House and the Senate.

[7] The *Cumulative Bulletin* is described in the discussion of revenue rulings on page I:15-12.

debate. In tax research, these records, reports, and transcripts are useful in deciphering the meaning of the statutory language. Where this language is ambiguous or vague, and the courts have not interpreted it, the documents can shed light on **Congressional intent**, i.e., what Congress *intended* by a particular term, phrase, or provision.

EXAMPLE I:15-4 ▶ In 1998, Congress passed legislation concerning shifting the burden of proof to the IRS. This legislation was codified in Sec. 7491. The question arises as to what constitutes "credible evidence" because the taxpayer must introduce such evidence to shift the burden of proof to the IRS. Section 7491 does not define the term. Because the provision was relatively new, few courts had an opportunity to interpret what "credible evidence" means. In the absence of relevant statutory or judicial authority, the researcher might have looked to the committee reports to ascertain what Congress intended by the term. Senate Report No. 105-174 states that "credible evidence" means evidence of a quality, which, "after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted."[8] This language suggests that Congress intended the term to mean evidence of a kind sufficient to withstand judicial scrutiny. Such a meaning should be regarded as conclusive in the absence of other authority. ◀

THE INTERNAL REVENUE CODE

The IRC, which comprises Title 26 of the United States Code, is the foundation of all tax law. First codified (i.e., organized into a single compilation of revenue statutes) in 1939, the tax law was recodified in 1954. The IRC was known as the Internal Revenue Code of 1954 until 1986, when its name was changed to the Internal Revenue Code of 1986. Whenever changes to the IRC are approved, the old language is deleted and new language added. Thus, the IRC is organized as an integrated document, and a researcher need not read through the relevant parts of all previous tax bills to find the current version of the law. Nevertheless, a researcher must be sure that he or she is working with the law in effect when a particular transaction occurred.

ADDITIONAL COMMENT

The various tax services, discussed later in this chapter, provide IRC histories for researchers who need to work with prior years' tax law.

The IRC contains provisions dealing with income taxes, estate and gift taxes, employment taxes, alcohol and tobacco taxes, and other excise taxes. Organizationally, the IRC is divided into subtitles, chapters, subchapters, parts, subparts, sections, subsections, paragraphs, subparagraphs, and clauses. Subtitle A contains rules relating to income taxes, and Subtitle B deals with estate and gift taxes. A set of provisions concerned with one general area constitutes a subchapter. For example, the topics of corporate distributions and adjustments appear in Subchapter C, and topics relating to partners and partnerships appear in Subchapter K. Figure I:15-2 presents the organizational scheme of the IRC.

An IRC section contains the operative provisions to which tax advisors most often refer. For example, they speak of "Sec. 351 transactions," "Sec. 306 stock," and "Sec. 1231 gains and losses." Although a tax advisor need not know all the IRC sections, paragraphs, and parts, he or she must be familiar with the IRC's organizational scheme to read and interpret it correctly. The language of the IRC is replete with cross-references to titles, paragraphs, subparagraphs, and so on.

EXAMPLE I:15-5 ▶ Section 7701, a definitional section, begins, "When used in this title. . ." and then provides a series of definitions. Because of this broad reference, a Sec. 7701 definition applies for all of Title 26; that is, it applies for purposes of the income tax, estate and gift tax, excise tax, and other taxes governed by Title 26. ◀

EXAMPLE I:15-6 ▶ Section 302(b)(3) allows taxpayers whose stock holdings are completely terminated in a redemption (a corporation's purchase of its stock from one or more of its shareholders) to receive capital gain treatment on the excess of the redemption proceeds over the stock's basis instead of ordinary income treatment on the entire proceeds. Section 302(c)(2)(A) states, "In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if. . . ." Further, Sec. 302(c)(2)(C)(i) indicates "Subparagraph (A) shall not apply to a distribution to any entity unless. . . ." Thus, in determining whether a taxpayer will receive capital gain treatment in a stock redemption, a tax advisor must be able to locate and interpret various cross-referenced IRC sections, subsections, paragraphs, subparagraphs, and clauses. ◀

[8] S. Rept. No. 105-174, 105th Cong., 1st Sess. (unpaginated) (1998).

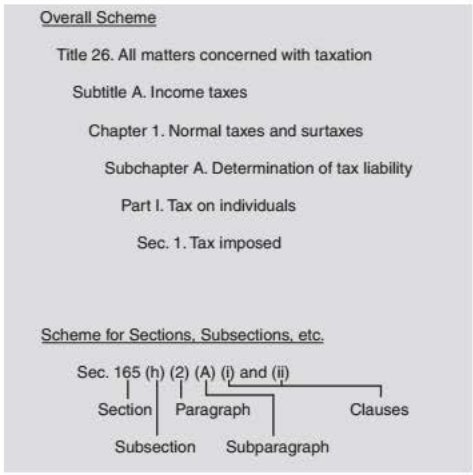


FIGURE I:15-2 ▶ ORGANIZATIONAL SCHEME OF THE INTERNAL REVENUE CODE

TREASURY REGULATIONS

The Treasury Department issues regulations that expound upon the IRC. Treasury Regulations often provide examples with computations that assist the reader in understanding how IRC provisions apply. Treasury Regulations are formulated on the basis of Treasury Decisions (T.D.s). The numbers of the Treasury Decisions that form the basis of a Treasury Regulation usually are found in the notes at the end of the regulation.

Because of frequent IRC changes, the Treasury Department does not always update the regulations in a timely manner. Consequently, when consulting a regulation, a tax advisor should check its introductory or end note to determine when the regulation was adopted. If the regulation was adopted before the most recent revision of the applicable IRC section, the regulation should be treated as authoritative to the extent consistent with the revision. Thus, for example, if a regulation issued before the passage of an IRC amendment specifies a dollar amount, and the amendment changed the dollar amount, the regulation should be regarded as authoritative in all respects except for the dollar amount.

Proposed, Temporary, and Final Regulations. A Treasury Regulation is first issued in proposed form to the public, which is given an opportunity to comment on it. Parties most likely to comment are individual tax practitioners and representatives of organizations such as the American Bar Association, the Tax Division of the AICPA, and the American Taxation Association. The comments may suggest that the proposed rules could affect taxpayers more adversely than Congress had anticipated. In drafting a final regulation, the Treasury Department generally considers the comments and may modify the rules accordingly. If the comments are favorable, the Treasury Department usually finalizes the regulation with minor revisions. If the comments are unfavorable, it usually finalizes the regulation with major revisions or allows the proposed regulation to expire.

Proposed regulations are just that—proposed. Consequently, they carry no more authoritative weight than do the arguments of the IRS in a court brief. Nevertheless, they represent the Treasury Department's official interpretation of the IRC. By contrast, **temporary regulations** are binding on the taxpayer. Effective as of the date of their publication, they often are issued immediately after passage of a major tax act to guide taxpayers and their advisors on procedural or computational matters. Regulations issued as temporary are concurrently issued as proposed. Because their issuance is not preceded by a public comment period, they are regarded as somewhat less authoritative than final regulations.

Once finalized, regulations can be effective the earliest of (1) the date they were filed with the *Federal Register,* a daily publication that contains federal government pronouncements; (2) the date temporary regulations preceding them were first published in the *Federal Register*; or (3) the date on which a notice describing the expected contents of the regulation was issued to the public.[9] For changes to the IRC enacted after July 29, 1996, the Treasury Department generally cannot issue regulations with retroactive effect.

Interpretative and Legislative Regulations. In addition to being officially classified as proposed, temporary, or final, Treasury Regulations are unofficially classified as interpretative or legislative. **Interpretative regulations** are issued under the general authority of Sec. 7805 and, as the name implies, merely make the IRC's statutory language easier to understand and apply. In addition, they often illustrate various computations. **Legislative regulations,** by contrast, arise where Congress delegates its rule-making authority to the Treasury Department. When Congress believes it lacks the expertise necessary to deal with a highly technical matter, it instructs the Treasury Department to set forth substantive tax rules relating to the matter.

Whenever the IRC contains language such as "The Secretary shall prescribe such regulations as he may deem necessary" or "under regulations prescribed by the Secretary," the regulations interpreting the IRC provision are legislative. The consolidated tax return regulations are an example of legislative regulations. In Sec. 1502, Congress delegated to the Treasury Department authority to issue regulations that determine the tax liability of a group of affiliated corporations filing a consolidated tax return. As a precondition to filing such a return, the corporations must consent to follow the consolidated return regulations.[10] Such consent generally precludes the corporations from later arguing in court that the regulatory provisions are invalid.

Authoritative Weight. Final Treasury Regulations are presumed to be valid and have almost the same authoritative weight as the IRC. Despite this presumption, taxpayers occasionally argue that a regulation is invalid and, consequently, should not be followed.

Prior to 2011, courts held interpretive and legislative regulations to different standards, giving more authority to legislative regulations that Congress specifically delegated to the Treasury Department to draft. The difference in authoritative weight largely disappeared, however, in 2011 with the Supreme Court decision in *Mayo Foundation.* [11] Going forward, both types of regulations will have the same authoritative weight and will be overturned only in very limited cases such as when, in the Court's opinion, the regulations exceed the scope of power delegated to the Treasury Department,[12] are contrary to the IRC,[13] or are unreasonable.[14]

KEY POINT

The older a Treasury Regulation becomes, the less likely a court is to invalidate the regulation. The legislative reenactment doctrine holds that if a regulation did not reflect the intent of Congress, lawmakers would have changed the statute in subsequent legislation to obtain their desired objectives.

In assessing the validity of long-standing Treasury Regulations, some courts apply the **legislative reenactment doctrine.** Under this doctrine, a regulation is deemed to receive congressional approval whenever the IRC provision under which the regulation was issued is reenacted without amendment.[15] Underlying this doctrine is the rationale that, if Congress believed that the regulation offered an erroneous interpretation of the IRC, it would have amended the IRC to conform to its belief. Congress's failure to amend the IRC signifies approval of the regulation.[16] This doctrine is predicated on Congress's constitutional authority to levy taxes. This authority implies that, if Congress is dissatisfied with the manner in which either the executive or the judiciary has interpreted the IRC, it can invalidate these interpretations through new legislation.



STOP & THINK

Question: You are researching the manner in which a deduction is calculated. You consult Treasury Regulations for guidance because the IRC states that the calculation is to be done "in a manner prescribed by the Secretary." After reviewing these authorities, you

[9] Sec. 7805(b).
[10] Sec. 1501.
[11] *Mayo Foundation for Medical Education & Research, et al. v. U.S.,* 107 AFTR 2d 2011-341, 131 S.Ct. 704 (2011).
[12] *McDonald v. CIR,* 56 AFTR 2d 85-5318, 85-2 USTC ¶9494 (5th Cir., 1985).
[13] *Jeanese, Inc. v. U.S.,* 15 AFTR 2d 429, 65-1 USTC ¶9259 (9th Cir., 1965).
[14] *United States v. Vogel Fertilizer Co.,* 49 AFTR 2d 82-491, 82-1 USTC ¶9134 (USSC, 1982).
[15] *United States v. Homer O. Correll,* 20 AFTR 2d 5845, 68-1 USTC ¶9101 (USSC, 1967).
[16] One can rebut the presumption that Congress approved of the regulation by showing that Congress was unaware of the regulation when it reenacted the statute.

conclude that another way of doing the calculation arguably is correct under an intuitive approach. This approach would result in a lower tax liability for the client. Should you follow the Treasury Regulations, or should you use the intuitive approach and argue that the regulations are invalid?

Solution: Because of the language "in a manner prescribed by the Secretary," the Treasury Regulations dealing with the calculation are legislative. Whenever Congress calls for legislative regulations, it explicitly authorizes (directs) the Treasury Department to write the "rules." Thus, a challenge based on the existence of a reasonable alternative method is unlikely to succeed in court. Under the *Mayo Foundation* decision, you should reach the same conclusion even if dealing with an interpretive Treasury Regulation.

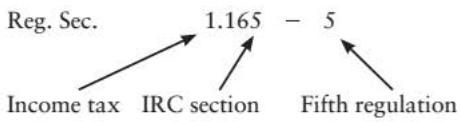
ADDITIONAL COMMENT

Citations serve two purposes in tax research: first, they substantiate propositions; second, they enable the reader to locate underlying authority.

Citations. Citations to Treasury Regulations are relatively easy to understand. One or more numbers appear before a decimal place, and several numbers follow the decimal place. The numbers immediately following the decimal place indicate the IRC section being interpreted. The numbers preceding the decimal place indicate the general subject of the regulation. Numbers that often appear before the decimal place and their general subjects are as follows:

Number	*General Subject Matter*
1	Income tax
20	Estate tax
25	Gift tax
301	Administrative and procedural matters
601	Procedural rules

The number following the IRC section number indicates the numerical sequence of the regulation, such as the fifth regulation. No relationship exists between this number and the subsection of the IRC being interpreted. An example of a citation to a final regulation is as follows:



Citations to proposed or temporary regulations follow the same format. They are referenced as Prop. Reg. Sec. or Temp. Reg. Sec. For temporary regulations the numbering system following the IRC section number always begins with the number of the regulation and an upper case T (e.g., -1T).

Section 165 addresses the broad topic of losses and is interpreted by several regulations. According to its caption, the topic of Reg. Sec. 1.165-5 is worthless securities, which also is addressed in subsection (g) of IRC Sec. 165. Parenthetical information following the text of the Treasury Regulation indicates that the regulation was last revised on March 11, 2008, by Treasury Decision (T.D.) 9386. Section 165(g) was last amended in 2000. A researcher must always check when the regulations were last amended and be aware that an IRC change may have occurred after the most recent regulation amendment, potentially making the regulation inapplicable.

When referencing a regulation, the researcher should fine-tune the citation to indicate the precise passage that supports his or her conclusion. An example of such a detailed citation is Reg. Sec. 1.165-5(j), Ex. 2(i), which refers to paragraph (i) of Example 2, found in paragraph (j) of the fifth regulation interpreting Sec. 165.

ADMINISTRATIVE PRONOUNCEMENTS

The IRS interprets the IRC through **administrative pronouncements**, the most important of which are discussed below. After consulting the IRC and Treasury Regulations, tax advisors are likely next to consult these pronouncements.

TYPICAL MISCONCEPTION

Even though revenue rulings do not have the same weight as Treasury Regulations or court cases, one should not underestimate their importance. Because a revenue ruling is the official published position of the IRS, in audits the examining agent will place considerable weight on any applicable revenue rulings.

Revenue Rulings. In **revenue rulings**, the IRS indicates the tax consequences of specific transactions encountered in practice. For example, in a revenue ruling, the IRS might indicate whether the exchange of stock for stock derivatives in a corporate acquisition is tax-free.

The IRS issues more than 50 revenue rulings a year. These rulings do not rank as high in the hierarchy of authorities as do Treasury Regulations or federal court cases. They simply represent the IRS's view of the tax law. Taxpayers who do not follow a revenue ruling will not incur a substantial understatement penalty if they have substantial authority for different treatment.[17] Nonetheless, the IRS presumes that the tax treatment specified in a revenue ruling is correct. Consequently, if an examining agent discovers in an audit that a taxpayer did not adopt the position prescribed in a revenue ruling, the agent will contend that the taxpayer's tax liability should be adjusted to reflect that position.

A revenue ruling appears in the weekly *Internal Revenue Bulletin* (cited as I.R.B.), published by the U.S. Government Printing Office (GPO). Prior to 2009, revenue rulings appeared in the *Cumulative Bulletin* (cited as C.B.), a bound volume issued semiannually by the GPO. An example of a citation to a revenue ruling appearing in the *Cumulative Bulletin* is as follows:

Rev. Rul. 97-4, 1997-1 C.B. 5.

This is the fourth ruling issued in 1997, and it appears on page 5 of Volume 1 of the 1997 *Cumulative Bulletin*. For rulings after 2008, researchers should use citations to the *Internal Revenue Bulletin*. An example of such a citation follows:

Rev. Rul. 2013-8, 2013-15 I.R.B. 763.

For revenue rulings (and other IRS pronouncements) issued after 1999, the full four digits of the year of issuance are set forth in the title. For revenue rulings (and other IRS pronouncements) issued before 2000, only the last two digits of the year of issuance are set forth in the title. The above citation represents the eighth ruling for 2013. This ruling is located on page 763 of the *Internal Revenue Bulletin* for the fifteenth week of 2013. Once a revenue ruling is published in the *Cumulative Bulletin*, only the citation to the *Cumulative Bulletin* should be used. Thus, a citation to the I.R.B. is temporary.

Revenue Procedures. As the name suggests, **revenue procedures** are IRS pronouncements that usually deal with the procedural aspects of tax practice. For example, one revenue procedure deals with the manner in which tip income should be reported. Another revenue procedure describes the requirements for reproducing paper substitutes for informational returns such as Form 1099.

As with revenue rulings, revenue procedures are published in the *Internal Revenue Bulletin* and, prior to 2009, in the *Cumulative Bulletin*. For revenue procedures issued after 2008, the I.R.B. is the final reference. An example of a citation to a revenue procedure appearing in the *Internal Revenue Bulletin* is as follows:

SELF-STUDY QUESTION

Are letter rulings of precedential value for third parties?

Rev. Proc. 2017-4, 2017-1 I.R.B. 146.

This pronouncement is found in the first issue of the *Internal Revenue Bulletin* on page 146. It is the fourth revenue procedure issued in 2017.

ANSWER

No. A letter ruling is binding only on the taxpayer to whom the ruling was issued. Nevertheless, letter rulings can be very useful to third parties because they provide insight as to the IRS's opinion about the tax consequences of various transactions.

In addition to revenue rulings and revenue procedures, the *Cumulative Bulletin* contains IRS notices, as well as the texts of proposed regulations, tax treaties, committee reports, and U.S. Supreme Court decisions.

Letter Rulings. **Letter rulings** are initiated by taxpayers who ask the IRS to explain the tax consequences of a particular transaction.[18] The IRS provides its explanation in the form of a letter ruling, a response personal to the taxpayer requesting an answer. Only the

[17] Chapter C:15 discusses the authoritative support taxpayers and tax advisors should have for positions they adopt on a tax return.

[18] Chapter C:15 further discusses letter rulings.

taxpayer to whom the ruling is addressed may rely on it as authority. Nevertheless, letter rulings are relevant for other taxpayers and tax advisors because they offer insight into the IRS's position on the tax treatment of particular transactions.

Originally the public did not have access to letter rulings issued to other taxpayers. As a result of Sec. 6110, enacted in 1976, letter rulings (with confidential information deleted) are accessible to the general public and have been reproduced by major tax services. An example of a citation to a letter ruling appears below:

Ltr. Rul. 200130006 (July 30, 2001).

The first four digits (two if issued before 2000) indicate the year in which the ruling was made public, in this case, 2001.[19] The next two digits denote the week in which the ruling was made public, here the thirtieth. The last three numbers indicate the numerical sequence of the ruling for the week, here the sixth. The date in parentheses denotes the date of the ruling.

ADDITIONAL COMMENT

A technical advice memorandum is published as a letter ruling. Whereas a taxpayer-requested letter ruling deals with prospective transactions, a technical advice memorandum deals with past or consummated transactions.

Other Interpretations

Technical Advice Memoranda. When the IRS audits a taxpayer's return, the IRS agent might ask the IRS national office for advice on a complicated, technical matter. The national office will provide its advice in a **technical advice memorandum**, released to the public in the form of a letter ruling.[20] Researchers can identify which letter rulings are technical advice memoranda by introductory language such as, "In response to a request for technical advice. . . ." An example of a citation to a technical advice memorandum is as follows:

T.A.M. 9801001 (January 2, 1998).

This citation refers to the first technical advice memorandum issued in the first week of 1998. The memorandum is dated January 2, 1998.

News Releases. If the IRS wants to disseminate information to the general public, it will issue a **news release.** News releases are written in lay terms and are dispatched to thousands of newspapers throughout the country. The IRS, for example, may issue a news release to announce the standard mileage rate for business travel. An example of a citation to a news release is as follows:

I.R. News Release 2012-25 (February 17, 2012).

This citation is to the twenty-fifth news release issued in 2012. The release is dated February 17, 2012.

ADDITIONAL COMMENT

Announcements are used to summarize new tax legislation or publicize procedural matters. Announcements generally are aimed at tax practitioners and are considered to be "substantial authority" [Rev. Rul. 90-91, 1990-2 C.B. 262].

Announcements and Notices. The IRS also disseminates information to tax practitioners in the form of **announcements** and **notices**. These pronouncements generally are more technical than information releases and frequently address current tax developments. After passage of a major tax act, and before the Treasury Department has had an opportunity to issue proposed or temporary regulations, the IRS may issue an announcement or notice to clarify the legislation. The IRS is bound to follow the announcement or notice just as it is bound to follow a revenue procedure or revenue ruling. Examples of citations to announcements and notices are as follows:

Announcement 2007-3, 2007-1 C.B. 376.
Notice 2007-9, 2007-1 C.B. 401.

The first citation is to the third announcement issued in 2007. It can be found on page 376 of the first *Cumulative Bulletin* for 2007. The second citation is to the ninth

[19] Sometimes a letter ruling is cited as PLR (private letter ruling) instead of Ltr. Rul.

[20] Technical advice memoranda are discussed further in Chapter C:15.

notice issued in 2007. It can be found on page 401 of the first *Cumulative Bulletin* for 2007. Notices and announcements issued prior to 2009 appear in both the *Internal Revenue Bulletin* and the *Cumulative Bulletin*, but after 2008 they appear only in the *Internal Revenue Bulletin*.

JUDICIAL DECISIONS

Judicial decisions are an important source of tax law. Judges are reputed to be unbiased individuals who decide questions of fact (the existence of a fact or the occurrence of an event) or questions of law (the applicability of a legal principle or the proper interpretation of a legal term or provision). Judges do not always agree on the tax consequences of a particular transaction or event. Therefore, tax advisors often must derive conclusions against a background of conflicting judicial authorities. For example, a U.S. district court might disagree with the Tax Court on the deductibility of an expense. Likewise, one circuit court might disagree with another circuit court on the same issue.

Overview of the Court System. A taxpayer may begin tax litigation in any of three courts: the U.S. Tax Court, the U.S. Court of Federal Claims (formerly the U.S. Claims Court), or U.S. district courts. Court precedents are important in deciding where to begin such litigation (see page I:15-21 for a discussion of precedent). Also important is when the taxpayer must pay the deficiency the IRS contends is due. A taxpayer who wants to litigate either in a U.S. district court or in the U.S. Court of Federal Claims must first pay the deficiency. The taxpayer then files a claim for refund, which the IRS is likely to deny. Following this denial, the taxpayer must petition the court for a refund. If the court grants the taxpayer's petition, he or she receives a refund of the taxes in question plus accrued interest. If the taxpayer begins litigation in the Tax Court, on the other hand, he or she need not pay the deficiency unless and until the court decides the case against him or her. In that event, the taxpayer also must pay interest and penalties.[21] A taxpayer who believes that a jury would be sympathetic to his or her case should litigate in a U.S. district court, the only forum where a jury trial is possible.

SELF-STUDY QUESTION

What are some of the factors that a taxpayer should consider when deciding in which court to file a tax-related claim?

ANSWER

(1) Each court's published precedent pertaining to the issue, (2) desirability of a jury trial, (3) tax expertise of each court, and (4) when the deficiency must be paid.

If a party loses at the trial court level, it can appeal the decision to a higher court. Appeals of Tax Court and U.S. district court decisions are made to the court of appeals for the taxpayer's circuit. The appeals court system is comprised of 11 geographical circuits designated by numbers, the District of Columbia Circuit, and the Federal Circuit.[22] Table I:15-1 shows the states that lie in the various circuits. California, for example, lies in the Ninth Circuit. When referring to these appellate courts, instead of saying, for example, "the Court of Appeals for the Ninth Circuit," one generally says "the Ninth Circuit." All decisions of the U.S. Court of Federal Claims are appealable to one court—the Court of Appeals for the Federal Circuit—irrespective of where the taxpayer resides or does business.[23] The only cases the Federal Circuit hears are those that originate in the U.S. Court of Federal Claims.

ADDITIONAL COMMENT

Because the Tax Court deals only with tax cases, it presumably has a higher level of tax expertise than do other courts. Tax Court judges are appointed by the President, in part, due to their considerable tax experience. The Tax Court typically maintains a large backlog of tax cases, sometimes numbering in the tens of thousands.

The party losing at the appellate level can petition the U.S. Supreme Court to review the case under a **writ of certiorari**. If the Supreme Court agrees to hear the case, it grants certiorari.[24] If it refuses to hear the case, it denies certiorari. In recent years, the Court has granted certiorari in only about six to ten tax cases per year. Figure I:15-3 and Table I:15-2 provide an overview and summary of the court system with respect to tax matters.

The U.S. Tax Court. The U.S. Tax Court was created in 1942 as a successor to the Board of Tax Appeals. It is a court of national jurisdiction that hears only tax-related cases. All taxpayers, regardless of their state of residence or place of business, may litigate in the Tax Court. It has 19 judges, including one chief judge.[25] The President, with the consent of the Senate, appoints the judges for a 15-year term and may reappoint them for an additional

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[21] Revenue Procedure 2005-18, 2005-1 C.B. 798, provides procedures for taxpayers to make remittances or apply overpayments to stop the accrual of interest on deficiencies.

[22] The Federal Circuit has nationwide jurisdiction to hear appeals in specialized cases, such as those involving patent laws.

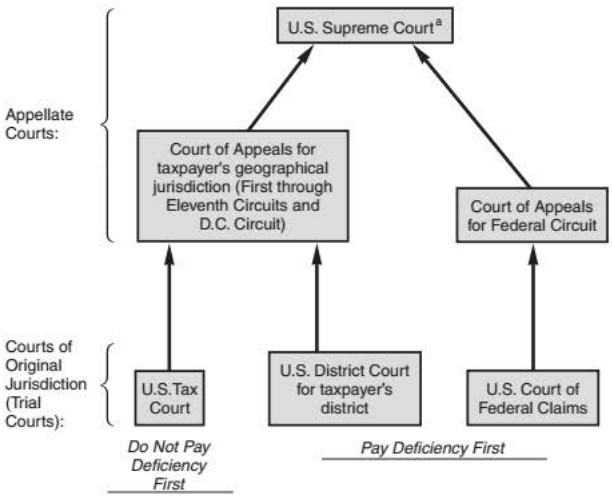
[23] The Court of Claims was reconstituted as the United States Court of Claims in 1982. In 1992, this court was renamed the U.S. Court of Federal Claims.

[24] The granting of certiorari signifies that the Supreme Court is granting an appellate review. The denial of certiorari does not necessarily mean that the Supreme Court endorses the lower court's decision. It simply means the court has decided not to hear the case.

[25] The Tax Court also periodically appoints, depending on budgetary constraints, a number of trial judges and senior judges who hear cases and render decisions with the same authority as the regular Tax Court judges.

▼ **TABLE I:15-1**
Federal Judicial Circuits

Circuit	States Included in Circuit
First	Maine, Massachusetts, New Hampshire, Rhode Island, Puerto Rico
Second	Connecticut, New York, Vermont
Third	Delaware, New Jersey, Pennsylvania, Virgin Islands
Fourth	Maryland, North Carolina, South Carolina, Virginia, West Virginia
Fifth	Louisiana, Mississippi, Texas
Sixth	Kentucky, Michigan, Ohio, Tennessee
Seventh	Illinois, Indiana, Wisconsin
Eighth	Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
Ninth	Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington, Guam, Northern Marina Islands
Tenth	Colorado, Kansas, New Mexico, Oklahoma, Utah, Wyoming
Eleventh	Alabama, Florida, Georgia
D.C.	District of Columbia
Federal	All jurisdictions (for taxpayers appealing from the U.S. Court of Federal Claims)



[a] Cases are heard only if the Supreme Court grants certiorari.

FIGURE I:15-3 ▶ OVERVIEW OF COURT SYSTEM—TAX MATTERS

term. The judges, specialists in tax-related matters, periodically travel to roughly 100 cities throughout the country to hear cases. In most instances, only one judge hears a case.

The Tax Court issues both regular and memorandum (memo) decisions. Generally, the first time the Tax Court decides a legal issue, its decision appears as a **regular decision**. **Memo decisions**, on the other hand, usually deal with factual variations of previously decided cases. Nevertheless, regular and memo decisions carry the same authoritative weight.

At times, the chief judge determines that a particular case concerns an important issue that the entire Tax Court should consider. In such a situation, the words *reviewed by the court* appear at the end of the majority opinion. Any concurring or dissenting opinions follow the majority opinion. A judge who issues a concurring opinion agrees with the basic outcome of the majority's decision but not with its rationale. A judge who issues a dissenting opinion believes the majority reached an erroneous conclusion.

▼ **TABLE I:15-2**
Summary of Court System—Tax Matters

Court(s) (Number of)	Number of Judges on Each	Personal Jurisdiction	Subject Matter Jurisdiction	Determines Questions of Fact	Trial by Jury	Precedents Followed	Where Opinions Published
U.S. district courts (over 95)	1–28*	Local	General	Yes	Yes	Same court Court for circuit where situated U.S. Supreme Court	*Federal Supplement* *American Federal Tax Reports* *United States Tax Cases*
U.S. Tax Court (1)	19	National	Tax	Yes	No	Same court Court for taxpayer's circuit U.S. Supreme Court	*Tax Court of the U.S. Reports* *CCH Tax Court Memorandum Decisions* *RIA Tax Court Memorandum Decisions*
U.S. Court of Federal Claims (1)	16	National	Claims against U.S. Government	Yes	No	Same court Federal Circuit Court U.S. Supreme Court	*Federal Reporter (pre-1982)* *U.S. Court of Federal Claims* *American Federal Tax Reports* *United States Tax Cases*
U.S. Courts of Appeals (13)	About 20	Regional	General	No	No	Same court U.S. Supreme Court	*Federal Reporter* *American Federal Tax Reports* *United States Tax Cases*
U.S. Supreme Court (1)	9	National	General	No	No	Same court	*U.S. Supreme Court Reports* *Supreme Court Reporter* *United States Reports, Lawyers' Edition* *American Federal Tax Reports* *United States Tax Cases*

*Although the number of judges assigned to each court varies, only one judge hears a case.

Another phrase sometimes appearing at the end of a Tax Court opinion is *Entered under Rule 155*. This phrase signifies that the court has reached a decision concerning the tax treatment of an item but has left computation of the deficiency to the two litigating parties.

SELF-STUDY QUESTION

What are some of the considerations for litigating under the small cases procedure of the Tax Court?

ANSWER

The small cases procedure gives the taxpayer the advantage of having his or her "day in court" without the expense of an attorney. But if the taxpayer loses, the decision cannot be appealed. On the other hand, the IRS also cannot appeal if *it* loses.

Small Cases Procedure. Taxpayers have the option of having their cases heard under the **small cases procedure** of the Tax Court if the amount in controversy on an annual basis does not exceed $50,000.[26] This procedure is less formal than the regular Tax Court procedure, and taxpayers can represent themselves without an attorney.[27] The cases are heard by special commissioners instead of by one of the 19 Tax Court judges. A disadvantage of the small cases procedure for the losing party is that the decision cannot be appealed. The opinions of the commissioners generally are not published and have no precedential value.

Acquiescence Policy. The IRS has adopted a policy of announcing whether, in future cases involving similar facts and similar issues, it will follow federal court decisions that are adverse to it. This policy is known as the IRS **acquiescence policy**. If the IRS wants taxpayers to know that it will follow an adverse decision in future cases involving similar facts and issues, it will announce its "acquiescence" in the decision. Conversely, if it wants taxpayers to know that it will not follow the decision in such future cases, it will announce its "nonacquiescence." The IRS does not announce its acquiescence or nonacquiescence in every decision it loses.

ADDITIONAL COMMENT

The only cases with respect to which the IRS will acquiesce or nonacquiesce are decisions that the government loses. Because the majority of cases, particularly Tax Court cases, are won by the government, the IRS will potentially acquiesce in only a small number of cases.

The IRS publishes its acquiescences and nonacquiescences as "Actions on Decision" first in the *Internal Revenue Bulletin,* then in the *Cumulative Bulletin.* Before 1991, the IRS acquiesced or nonacquiesced in regular Tax Court decisions only. In 1991, it broadened the scope of its policy to include adverse U.S. Claims Court, U.S. district court, and U.S. circuit court decisions.

In cases involving multiple issues, the IRS may acquiesce in some issues but not others. In decisions supported by extensive reasoning, it may acquiesce in the result but not the rationale (*acq. in result*). Furthermore, it may retroactively revoke an acquiescence or nonacquiescence. The footnotes to the relevant announcement in the *Internal Revenue Bulletin* and *Cumulative Bulletin* indicate the nature and extent of IRS acquiescences and nonacquiescences.

These acquiescences and nonacquiescences have important implications for taxpayers. If a taxpayer bases his or her position on a decision in which the IRS has nonacquiesced, he or she can expect an IRS challenge in the event of an audit. In such circumstances, the taxpayer's only recourse may be litigation. On the other hand, if the taxpayer bases his or her position on a decision in which the IRS has acquiesced, he or she can expect little or no challenge. In either case, the examining agent will be bound by the IRS position.

Published Opinions and Citations. Regular Tax Court decisions are published by the U.S. Government Printing Office in a bound volume known as the *Tax Court of the United States Reports.* Soon after a decision is made public, Research Institute of America (RIA) and Commerce Clearing House (CCH) each publish the decision in its respective reporter of Tax Court decisions. An official citation to a Tax Court decision is as follows:[28]

MedChem Products, Inc., 116 T.C. 308 (2001).

ADDITIONAL COMMENT

If a particular case is important, the chief judge will instruct the other judges to review the case. If a case is reviewed by the entire court, the phrase *reviewed by the court* is inserted immediately after the text of the majority opinion. A reviewed decision provides an opportunity for Tax Court judges to express their dissenting opinions.

The citation indicates that this case appears on page 308 in Volume 116 of *Tax Court of the United States Reports* and that the case was decided in 2001.

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[26] Sec. 7463. The $50,000 amount includes penalties and additional taxes but excludes interest.

[27] Taxpayers also can represent themselves in regular Tax Court proceedings even though they are not attorneys. Where taxpayers represent themselves, the words *pro se* appear in the opinion after the taxpayer's name. The Tax Court is the only federal court before which non-attorneys, including CPAs, may practice.

[28] In a citation to a case decided by the Tax Court, only the name of the plaintiff (taxpayer) is listed. The defendant is understood to be the Commissioner of Internal Revenue whose name usually is not shown in the citation. In cases decided by other courts, the name of the plaintiff is listed first and the name of the defendant second. For non-Tax Court cases, the Commissioner of Internal Revenue is referred to as *CIR* in our footnotes and text.

From 1924 to 1942, regular decisions of the Board of Tax Appeals (predecessor of the Tax Court) were published by the U.S. Government Printing Office in the *United States Board of Tax Appeals Reports*. An example of a citation to a Board of Tax Appeals case is as follows:

J.W. Wells Lumber Co. Trust A., 44 B.T.A. 551 (1941).

This case is found in Volume 44 of the *United States Board of Tax Appeals Reports* on page 551. It is a 1941 decision.

ADDITIONAL COMMENT

Once the IRS has acquiesced in a federal court decision, other taxpayers generally will not need to litigate the same issue. However, the IRS can change its mind and revoke a previous acquiescence or nonacquiescence. References to acquiescences or nonacquiescences in federal court decisions can be found in the citators.

If the IRS has acquiesced or nonacquiesced in a federal court decision, the IRS's action should be denoted in the citation. At times, the IRS will not announce its acquiescence or nonacquiescence until several years after the date of the decision. An example of a citation to a decision in which the IRS has acquiesced is as follows:

Security State Bank, 85 AFTR 2d 2000-1980, *acq.* 2001-001.

The case appears on page 2000-1980 of Volume 85 of the AFTR, Second Series. In 2001, the IRS acquiesced in this decision. A citation to a decision in which the IRS has nonacquiesced is as follows:

Estate of Algerine Allen Smith, 108 T.C. 412 (1997), *nonacq.* A.O.D. 2000-1.

KEY POINT

To access all Tax Court cases, a tax advisor must refer to two different publications. The regular opinions appear in the *Tax Court of the United States Reports*, published by the U.S. Government Printing Office, and the memo decisions are published by both RIA (formerly PH) and CCH in their own court reporters.

The case appears on page 412 of Volume 108 of the *Tax Court of the United States Reports*. In 2000, the IRS nonacquiesced in this 1997 decision.

Tax Court memo decisions are not published by the U.S. Government Printing Office. They are, however, published by RIA in *RIA T.C. Memorandum Decisions* and by CCH in *CCH Tax Court Memorandum Decisions*. In addition, shortly after its issuance, an opinion is made available electronically and in loose-leaf form by RIA and CCH in their respective tax services. The following citation is to a Tax Court memo decision:

Edith G. McKinney, 1981 PH T.C. Memo ¶81,181 (T.C. Memo 1981-181), 41 TCM 1272.

ADDITIONAL COMMENT

In its Internet-based tax service (see page I:15-26), RIA uses a different format for its Tax Court Memorandum Decisions, which in this textbook appear in parentheses after the "official" RIA citation.

McKinney is found at Paragraph 81,181 of Prentice Hall's (now RIA's)[29] 1981 *PH T.C. Memorandum Decisions* reporter, and in Volume 41, page 1272, of CCH's *Tax Court Memorandum Decisions*. The 181 in the PH citation indicates that the case is the Tax Court's 181st memo decision of the year. A more recent citation is formatted in the same way but refers to RIA memo decisions.

Paul F. Belloff, 1992 RIA T.C. Memo ¶92,346 (T.C. Memo 1992-346), 63 TCM 3150.

U.S. District Courts. Each state has at least one U.S. district court, and more populous states have more than one. Each district court is independent of the others and is thus free to issue its own decisions, subject to the precedential constraints discussed later in this chapter. Different types of cases—not just tax-related—are adjudicated in this forum. A district court is the only forum in which the taxpayer may have a jury decide questions of fact. Depending on the circumstances, a jury trial might be advantageous for the taxpayer.[30]

District court decisions are officially reported in the *Federal Supplement* (cited as F. Supp.) published by West®. Some decisions are not officially reported and are referred

[29] Several ownership changes have occurred for publishers of tax service materials. Thomson Reuters added the former Prentice Hall tax materials to the product line of its RIA tax publishing division. RIA and West® are members of Thomson Reuters, Tax and Accounting Division, and CCH is a member of the Wolters Kluwer Tax, Accounting and Legal Division.

[30] Taxpayers might prefer to have a jury trial if they believe a jury will be sympathetic to their case.

to as **unreported decisions**. Decisions by U.S. district courts on the topic of taxation also are published by RIA and CCH in secondary reporters that contain only tax-related opinions. RIA's reporter is *American Federal Tax Reports* (cited as AFTR).[31] CCH's reporter is *U.S. Tax Cases* (cited as USTC). A case not officially reported nevertheless might be published in the AFTR and USTC. An example of a complete citation to a U.S. district court decision is as follows:

> *Alfred Abdo, Jr. v. IRS,* 234 F. Supp. 2d 533, 90 AFTR 2d 2002-7484, 2003-1 USTC ¶50,107 (DC North Carolina, 2002).

ADDITIONAL COMMENT

A citation, at a minimum, should contain the following information: (1) the name of the case, (2) the reporter that publishes the case along with both a volume and page (or paragraph) number, (3) the year the case was decided, and (4) the court that decided the case.

In the example above, the **primary citation** is to the *Federal Supplement*. The case appears on page 533 of Volume 234 of the second series of this reporter. **Secondary citations** are to *American Federal Tax Reports* and *U.S. Tax Cases*. The same case is found in Volume 90 of the second series of the AFTR, page 2002-7484 (meaning page 7484 in the volume containing 2002 cases) and in Volume 1 of the 2003 USTC at Paragraph 50,107. The parenthetical information indicates that the case was decided in 2002 by the U.S. District Court for North Carolina. Because some judicial decisions have greater precedential weight than others (e.g., a Supreme Court decision versus a district court decision), information relating to the identity of the adjudicating court is useful in evaluating the authoritative value of the decision.

ADDITIONAL COMMENT

The U.S. Court of Federal Claims adjudicates claims (including suits to recover federal income taxes) against the U.S. Government. This court usually hears cases in Washington, D.C., but will hold sessions in other locations as the court deems necessary.

U.S. Court of Federal Claims. The U.S. Court of Federal Claims, another court of first instance that addresses tax matters, has nationwide jurisdiction. Originally, this court was called the U.S. Court of Claims (cited as Ct. Cl.), and its decisions were appealable to the U.S. Supreme Court only. In a reorganization, effective October 1, 1982, the reconstituted court was named the U.S. Claims Court (cited as Cl. Ct.), and its decisions became appealable to the Circuit Court of Appeals for the Federal Circuit. In October 1992, the court's name was again changed to the U.S. Court of Federal Claims (cited as Fed. Cl.).

Beginning in 1982, U.S. Claims Court decisions were reported officially in the *Claims Court Reporter,* published by West® from 1982 to 1992.[32] An example of a citation to a U.S. Claims Court decision appears below:

> *Benjamin Raphan v. U.S.,* 3 Cl. Ct. 457, 52 AFTR 2d 83-5987, 83-2 USTC ¶9613 (1983).

The *Raphan* case appears on page 457 of Volume 3 of the *Claims Court Reporter*. Secondary citations are to Volume 52, page 83-5987 of the AFTR, Second Series, and to Volume 2 of the 1983 USTC at Paragraph 9613.

Effective with the 1992 reorganization, decisions of the U.S. Court of Federal Claims are now reported in the *Federal Claims Reporter.* An example of a citation to an opinion published in this reporter is presented below:

> *Jeffrey G. Sharp v. U.S.,* 27 Fed. Cl. 52, 70 AFTR 2d 92-6040, 92-2 USTC ¶50,561 (1992).

The *Sharp* case appears on page 52 of Volume 27 of the *Federal Claims Reporter,* on page 6040 of the 70th volume of the AFTR, Second Series, and at Paragraph 50,561 of Volume 2 of the 1992 USTC reporter. Note that, even though the name of the reporter published by West® has changed, the volume numbers continue in sequence as if no name change had occurred.

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[31] The *American Federal Tax Reports* (AFTR) is published in two series. The first series, which includes opinions issued up to 1957, is cited as AFTR. The second series, which includes opinions issued after 1957, is cited as AFTR 2d. The *Alfred Abdo, Jr.* decision cited as an illustration of a U.S. district court decision appears in the second *American Federal Tax Reports* series.

[32] Before the creation in 1982 of the U.S. Claims Court (and the *Claims Court Reporter*), the opinions of the U.S. Court of Claims were reported in either the *Federal Supplement* (F. Supp.) or the *Federal Reporter, Second Series* (F.2d). The *Federal Supplement* is the primary source of U.S. Court of Claims opinions from 1932 through January 19, 1960. Opinions issued from January 20, 1960, to October 1982 are reported in the *Federal Reporter, Second Series.*

Circuit Courts of Appeals. Lower court decisions are appealable by the losing party to the court of appeals for the circuit in which the litigation originated. Generally, if the case began in the Tax Court or a U.S. district court, the case is appealable to the circuit for the individual's residence as of the appeal date. For a corporation, the case is appealable to the circuit for the corporation's principal place of business. The Federal Circuit hears all appeals of cases originating in the U.S. Court of Federal Claims.

As mentioned earlier, there are 11 geographical circuits designated by numbers, the District of Columbia Circuit, and the Federal Circuit. In October 1981, the Eleventh Circuit was created by moving Alabama, Georgia, and Florida from the Fifth to a new geographical circuit. The Eleventh Circuit has adopted the policy of following as precedent all decisions of the Fifth Circuit during the time the states currently constituting the Eleventh Circuit were part of the Fifth Circuit.[33]

EXAMPLE I:15-7 ▶ In the current year, the Eleventh Circuit first considered an issue in a case involving a Florida taxpayer. In 1980, the Fifth Circuit had ruled on the same issue in a case involving a Louisiana taxpayer. Because Florida was part of the Fifth Circuit in 1980, under the policy adopted by the Eleventh Circuit, it will follow the Fifth Circuit's earlier decision. Had the Fifth Circuit's decision been rendered in 1982—after the creation of the Eleventh Circuit—the Eleventh Circuit would not have been bound by the Fifth Circuit's decision. ◀

As the later discussion of precedent points out, different circuits may reach different conclusions concerning similar facts and issues.

Circuit court decisions—regardless of topic (e.g., civil rights, securities law, and taxation)—are now reported officially in the *Federal Reporter, Third Series* (cited as F.3d), published by West®. The third series was created in October 1993 after the volume number for the second series reached 999. The primary citation to a circuit court opinion should be to the *Federal Reporter*. Tax decisions of the circuit courts also appear in the *American Federal Tax Reports* and *U.S. Tax Cases*. Below is an example of a citation to a 1994 circuit court decision:

> *Greene v. U.S.*, 185 F. 3d 67, 84 AFTR 2d 99-5415, 99-2 USTC ¶50,701 (3rd Cir., 1999).

The *Greene* case appears on page 67 of Volume 185 of the *Federal Reporter, Third Series*. It also is published in Volume 84, page 99-5415 of the AFTR, Second Series, and in Volume 2, Paragraph 50,701, of the 1999 USTC. The parenthetical information indicates that the Third Circuit decided the case in 1999. (A *Federal Reporter, Second Series* reference is found in footnote 33 of this chapter.)

ADDITIONAL COMMENT

A judge is not required to follow judicial precedent beyond his or her jurisdiction. Thus, the Tax Court, the U.S. district courts, and the U.S. Court of Federal Claims are not required to follow the others' decisions, nor is a circuit court required to follow the decision of a different circuit court.

U.S. Supreme Court. Whichever party loses at the appellate level can request that the U.S. Supreme Court hear the case. The Supreme Court, however, hears very few tax cases. Unless the circuits are divided on the tax treatment of an item, or the issue is deemed to be of great significance, the Supreme Court probably will not hear the case.[34] Supreme Court decisions are the law of the land and take precedence over all other court decisions, including the Supreme Court's earlier decisions. As a practical matter, a Supreme Court interpretation of the IRC is almost as authoritative as an act of Congress. If Congress does not agree with the Court's interpretation, it can amend the IRC to achieve a different result and has in fact done so on a number of occasions. If the Supreme Court declares a tax statute to be unconstitutional, the statute is invalid.

All Supreme Court decisions, regardless of subject, are published in the *United States Supreme Court Reports* (cited as U.S.) by the U.S. Government Printing Office, the *Supreme Court Reporter* (cited as S. Ct.) by West®, and the *United States Reports, Lawyers' Edition* (cited as L. Ed.) by LexisNexis®. In addition, the AFTR and USTC

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[33] *Bonner v. City of Prichard*, 661 F.2d 1206 (11th Cir., 1981).

[34] *Vogel Fertilizer Co. v. U.S.*, 49 AFTR 2d 82-491, 82-1 USTC ¶9134 (USSC, 1982), is an example of a case the Supreme Court heard to settle a split in judicial authority. The Fifth Circuit, the Tax Court, and the Court of Claims had reached one conclusion on an issue, while the Second, Fourth, and Eighth Circuits had reached another.

reporters published by RIA and CCH, respectively, contain Supreme Court decisions concerned with taxation. An example of a citation to a Supreme Court opinion appears below:

> *Boeing Company v. U.S.*, 537 U.S. 437, 91 AFTR 2d 2003-1088, 2003-1 USTC ¶50,273 (USSC, 2003).

According to the primary citation, this case appears in Volume 537, page 437, of the *United States Supreme Court Reports*. According to the secondary citation, it also appears in Volume 91, page 2003-1088, of the AFTR, Second Series, and in Volume 1, Paragraph 50,273, of the 2003 USTC.

SELF-STUDY QUESTION

Is it possible for the Tax Court to intentionally issue conflicting decisions?

ANSWER

Yes. If the Tax Court issues two decisions that are appealable to different circuit courts and these courts have previously reached different conclusions on the issue, the Tax Court follows the respective precedent in each circuit and issues conflicting decisions. This is a result of the *Golsen* Rule.

Table I:15-3 provides a summary of how the IRC, court decisions, revenue rulings, revenue procedures, and other administrative pronouncements should be cited. Primary citations are to the reporters published by West® or the U.S. Government Printing Office, and secondary citations are to the AFTR and USTC.

Precedential Value of Various Decisions.

Tax Court. The Tax Court is a court of national jurisdiction. Consequently, it generally rules uniformly for all taxpayers, regardless of their residence or place of business. It follows U.S. Supreme Court decisions and its own earlier decisions. It is not bound by cases decided by the U.S. Court of Federal Claims or a U.S. district court, even if the district court has jurisdiction over the taxpayer.

In 1970, the Tax Court adopted what is known as the *Golsen* Rule.[35] Under this rule, the Tax Court departs from its general policy of adjudicating uniformly for all taxpayers and instead follows the decisions of the court of appeals to which the case in question is appealable. Stated differently, the *Golsen* Rule mandates that the Tax Court rule consistently with decisions of the court for the circuit where the taxpayer resides or does business.

EXAMPLE I:15-8 ▶ In the year in which an issue was first litigated, the Tax Court decided that an expenditure was deductible. The government appealed the decision to the Tenth Circuit Court of Appeals and won a reversal. This is the only appellate decision regarding the issue. If and when the Tax Court addresses this issue again, it will hold, with one exception, that the expenditure is deductible. The exception applies to taxpayers in the Tenth Circuit. Under the *Golsen* Rule, these taxpayers will be denied the deduction. ◀

U.S. District Court. Because each U.S. district court is independent of the other district courts, the decisions of each have precedential value only within its own jurisdiction (i.e., only with respect to subsequent cases brought before that court). District courts must follow decisions of the U.S. Supreme Court, the circuit court to which the case is appealable, and the district court's own earlier decisions regarding similar facts and issues.

EXAMPLE I:15-9 ▶ The U.S. District Court for Rhode Island, the Tax Court, and the Eleventh Circuit have decided cases involving similar facts and issues. Any U.S. district court within the Eleventh Circuit must follow that circuit's decision in future cases involving similar facts and issues. Likewise, the U.S. District Court for Rhode Island must decide such cases consistently with its previous decision. Tax Court decisions are not binding on the district courts. Thus, all district courts other than the one for Rhode Island and those within the Eleventh Circuit are free to decide such cases independently. ◀

U.S. Court of Federal Claims. In adjudicating a case, the U.S. Court of Federal Claims must rule consistently with U.S. Supreme Court decisions, decisions of the Circuit Court of Appeals for the Federal Circuit, and its own earlier decisions, including those rendered when the court had a different name. It need not follow decisions of other circuit courts, the Tax Court, or U.S. district courts.

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[35] The *Golsen* Rule is based on the decision in *Jack E. Golsen*, 54 T.C. 742 (1970).

▼ **TABLE I:15-3**

Summary of Tax-Related Primary Sources—Statutory and Administrative

Source Name	Publisher	Materials Provided	Citation Example
U.S. Code, Title 26	Government Printing Office	Internal Revenue Code	Sec. 441(b)
Code of Federal Regulations, Title 26	Government Printing Office	Treasury Regulations (final)	Reg. Sec. 1.461-1(c)
		Treasury Regulations (temporary)	Temp. Reg. Sec. 1.62-1T(e)
Internal Revenue Bulletin	Government Printing Office	Treasury Regulations (proposed)	Prop. Reg. Sec. 1.671-1(h)
		Treasury decisions	T.D. 8756 (January 13, 1998)
		Revenue rulings	Rev. Rul. 2009-33, 2009-40 I.R.B. 447
		Revenue procedures	Rev. Proc. 2009-52, 2009-49 I.R.B. 744
		Committee reports	S.Rept. No. 105-33, 105th Cong., 1st Sess., p. 308 (1997)
		Public laws	P.L. 105-34, Sec. 224(a), enacted August 6, 1997
		Announcements	Announcement 2007-3, 2007-4 I.R.B. 376
		Notices	Notice 2009-21, 2009-13 I.R.B. 724
Cumulative Bulletin	Government Printing Office	Treasury Regulations (proposed)	Prop. Reg. Sec. 1.671-1(h)
		Treasury decisions	T.D. 8756 (January 12, 1998)
		Revenue rulings	Rev. Rul. 84-111, 1984-2 C.B. 88
		Revenue procedures	Rev. Proc. 77-28, 1977-2 C.B. 537
		Committee reports	S.Rept. No. 105-33, 105th Cong., 1st Sess., p. 308 (1997)
		Public laws	P.L. 105-34, Sec. 224(a), enacted August 6, 1997
		Announcements	Announcement 2006-8, 2006-1 C.B. 344
		Notices	Notice 88-74, 1988-2 C.B. 385

Summary of Tax-Related Primary and Secondary Sources—Judicial

Reporter Name	Publisher	Decisions Published	Citation Example
U.S. Supreme Court Reports	Government Printing Office	U.S. Supreme Court	*Boeing Company v. U.S.*, 537 U.S. 437 (2003)
Supreme Court Reports	Thomson Reuters/West	U.S. Supreme Court	*Boeing Company v. U.S.*, 123 S. Ct. 1099 (2003)
Federal Reporter (1st–3rd Series)	Thomson Reuters/West	U.S. Court of Appeal Pre-1982 Court of Claims	*Leonard Greene v. U.S.*, 13 F.3d 577 (2nd Cir., 1994)
Federal Supplement Series	Thomson Reuters/West	U.S. District Court	*Alfred Abdo, Jr. v. IRS*, 234 F. Supp. 2d 553 (DC North Carolina, 2002)
U.S. Court of Federal Claims	Thomson Reuters/West	Court of Federal Claims	*Jeffery G. Sharp v. U.S.*, 27 Fed. Cl. 52 (1992)
Tax Court of the U.S. Reports	Government Printing Office	U.S. Tax Court regular	*Security State Bank*, 111 T.C. 210 (1998), acq. 2001-1 C.B. xix
Tax Court Memorandum Decisions	Wolters Kluwer/CCH	U.S. Tax Court memo	*Paul F. Belloff*, 63 TCM 3150 (1992)
RIA Tax Court Memorandum Decisions	Thomson Reuters/RIA	U.S. Tax Court memo	*Paul F. Belloff*, 1992 RIA T.C. Memo ¶92,346 (T.C. Memo 1992-346)
American Federal Tax Reports	Thomson Reuters/RIA	Tax: all federal courts except Tax Court	*Boeing Company v. U.S.*, 91 AFTR 2d 2003-1088 (USSC, 2003)
U.S. Tax Cases	Wolters Kluwer/CCH	Tax: all federal courts except Tax Court	*Ruddick Corp. v. U.S.*, 81-1 USTC ¶9221 (Ct. Cls., 1981)

EXAMPLE I:15-10 ▶ Assume the same facts as in Example I:15-9. In a later year, a case involving similar facts and issues is heard by the U.S. Court of Federal Claims. This court is not bound by precedents set by any of the other courts. Thus, it may reach a conclusion independently of the other courts. ◀

Circuit Courts of Appeals. A circuit court is bound by U.S. Supreme Court decisions and its own earlier decisions. If neither the Supreme Court nor the circuit in question has already decided an issue, the circuit court has no precedent that it must follow, regardless of whether other circuits have ruled on the issue. In such circumstances, the circuit court is said to be writing on a clean slate. In rendering a decision, the judges of that court may adopt another circuit's view, which they are likely to regard as relevant.

EXAMPLE I:15-11 ▶ Assume the same facts as in Example I:15-9. Any circuit other than the Eleventh would be writing on a clean slate if it adjudicated a case involving similar facts and issues. After reviewing the Eleventh Circuit's decision, another circuit might find it relevant and rule in the same way. ◀

In such a case of "first impression," when the court has had no precedent on which to base a decision, a tax practitioner might look at past opinions of the court to see which other judicial authority the court has found to be "persuasive."

Forum Shopping. Not surprisingly, courts often disagree on the tax treatment of the same item. This disagreement gives rise to differing precedents within the various jurisdictions (what is called a "split in judicial authority"). Because taxpayers have the flexibility of choosing where to file a lawsuit, these circumstances afford them the opportunity to **forum shop**. Forum shopping involves choosing where among the courts to file a lawsuit based on differing precedents.

An example of a split in judicial authority concerned the issue of when it became too late for the IRS to question the tax treatment of items that "flowed through" an S corporation's return to a shareholder's return. The key question was this: if the time for assessing a deficiency (limitations period) with respect to the corporation's, but not the shareholder's, return had expired, was the IRS precluded from collecting additional taxes from the shareholder? In *Kelley*,[36] the Ninth Circuit Court of Appeals ruled that the IRS would be barred from collecting additional taxes from the shareholder if the limitations period for the *S corporation's* return had expired. In *Bufferd*,[37] *Fehlhaber*,[38] and *Green*,[39] three other circuit courts ruled that the IRS would be barred from collecting additional taxes from the shareholder if the limitations period for the *shareholder's* return had expired. The Supreme Court affirmed the *Bufferd* decision,[40] establishing that the statute of limitations for the shareholder's return governed. This action brought about certainty and uniformity within the judicial system.

Dictum. At times, a court may comment on an issue or a set of facts not central to the case under review. A court's remark not essential to the determination of a disputed issue, and therefore not binding authority, is called *dictum*. An example of dictum is found in *Central Illinois Public Service Co.*[41] In this case, the U.S. Supreme Court addressed whether lunch reimbursements received by employees constitute wages subject to withholding. Justice Blackman remarked in passing that earnings in the form of interest, rents, and dividends are not wages. This remark is dictum because it is not essential to the determination of whether lunch reimbursements are wages subject to withholding. Although not authoritative, dictum may be cited by taxpayers to bolster an argument in favor of a particular tax result.

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[36] *Daniel M. Kelley v. CIR*, 64 AFTR 2d 89-5025, 89-1 USTC ¶9360 (9th Cir., 1989).

[37] *Sheldon B. Bufferd v. CIR*, 69 AFTR 2d 92-465, 92-1 USTC ¶50,031 (2nd Cir., 1992).

[38] *Robert Fehlhaber v. CIR*, 69 AFTR 2d 92-850, 92-1 USTC ¶50,131 (11th Cir., 1992).

[39] *Charles T. Green v. CIR*, 70 AFTR 2d 92-5077, 92-2 USTC ¶50,340 (5th Cir., 1992).

[40] *Sheldon B. Bufferd v. CIR*, 71 AFTR 2d 93-573, 93-1 USTC ¶50,038 (USSC, 1993).

[41] *Central Illinois Public Service Co. v. CIR*, 41 AFTR 2d 78-718, 78-1 USTC ¶9254 (USSC, 1978).

STOP & THINK

Question: You have been researching whether an amount received by your new client can be excluded from her gross income. The IRS is auditing the client's prior year tax return, which another firm prepared. In a similar case decided a few years ago, the Tax Court allowed an exclusion, but the IRS nonacquiesced in the decision. The case involved a taxpayer in the Fourth Circuit. Your client is a resident of Maine, which is in the First Circuit. Twelve years ago, in a case involving another taxpayer, the federal court for the client's district ruled that this type of receipt is not excludable. No other precedent exists. To sustain an exclusion, must your client litigate? Explain. If your client litigates, in which court of first instance should she begin her litigation?

Solution: Because of its nonacquiescence, the IRS is likely to challenge your client's tax treatment. Thus, she may be compelled to litigate. She would not want to litigate in her U.S. district court because it would be bound by its earlier decision, which is unfavorable to taxpayers generally. A good place to begin would be the Tax Court because it is bound by appellate court, but not district court, decisions and because of its earlier pro-taxpayer position. No one can predict how the U.S. Court of Federal Claims would rule because no precedent that it must follow exists.

ADDITIONAL COMMENT

A tax treaty carries the same authoritative weight as a federal statute (IRC). A tax advisor should be aware of provisions in tax treaties that will affect a taxpayer's worldwide tax liability.

TAX TREATIES

The United States has concluded **tax treaties** with numerous foreign countries. These treaties address the alleviation of double taxation and other matters. A tax advisor exploring the U.S. tax consequences of a U.S. corporation's operations in another country should determine whether a treaty between that country and the United States exists. If one does, the tax advisor should ascertain the applicable provisions of the treaty. (See Chapter C:16 for a more extensive discussion of treaties.)

KEY POINT

Tax articles can be used to help *find* answers to tax questions. Where possible, the underlying statutory, administrative, or judicial sources referenced in the tax article should be cited as authority and not the author of the article. The courts and the IRS will place little, if any, reliance on mere editorial opinion.

TAX PERIODICALS

Tax periodicals assist the researcher in tracing the development of, and analyzing tax law. These periodicals are especially useful when they discuss the legislative history of a recently enacted IRC statute that has little or no administrative or judicial authority on point.

Tax experts write articles on landmark court decisions, proposed regulations, new tax legislation, and other matters. Frequently, those who write articles of a highly technical nature are attorneys, accountants, or professors. Among the periodicals that provide in-depth coverage of tax-related matters are the following:

The Journal of Taxation
The Tax Adviser
Practical Tax Strategies
Taxes—The Tax Magazine
Tax Law Review
Tax Notes
The Journal of Corporate Taxation
PPC's Guide to Choice of Business Entity
PPC's Guide to Real Estate Taxation
Estate Planning

The first six journals are generalized; that is, they deal with a variety of topics. As their titles suggest, the next four are specialized; they deal with specific subjects. All these publications (other than *Tax Notes,* which is published weekly) are published monthly, bi-monthly, or quarterly. Daily newsletters, such as the *Daily Tax Report,* published by Bloomberg BNA in print and electronic formats, are used by tax professionals when they need updates more timely than can be provided by monthly or quarterly publications.

Tax periodicals and tax services are secondary authorities. The IRC, Treasury Regulations, IRS pronouncements, and court opinions are primary authorities. In presenting research results, the tax advisor should always cite primary authorities.

Tax services

OBJECTIVE 5

Consult tax services to research an issue

Various publishers provide multivolume commentaries on the tax law in what are familiarly referred to as **tax services**. Researchers often consult tax services at the beginning of the research process because a tax service helps identify the tax authorities pertaining to a particular tax issue. The actual tax authorities (e.g., IRC, Treasury Regulations, IRS pronouncements, and court cases), and not the tax services, are generally cited as support for a particular tax position. The services are available in print form via the publishers and electronic form via the Internet. (See further discussion at "The Internet as a Research Tool" later in this chapter). Although each major tax service is an outstanding resource, significant differences exist in the content and organizational scheme from one publisher to the next. For example, each service has its own special features and editorial approach to tax issues along with a great deal of proprietary content. The best way to acquaint oneself with the various tax services and the advantages and disadvantages of each is to use them in researching hypothetical or actual problems.

Organizationally, tax services fall into two types: annotated and topical (although this distinction has become somewhat blurred in the Internet version of these services). An **annotated tax service** is organized by IRC section. The IRC-arranged subdivisions of this service are likely to encompass several topics. The annotations accompany editorial commentaries and include digests or summaries of IRS pronouncements and court opinions that interpret a particular IRC section. They are classified by subtopic and cite pertinent primary authorities. A **topical tax service**, on the other hand, is organized by broad topic, including income taxes, estate and gift taxes, and excise taxes. The topically arranged subdivisions of this service are likely to encompass several IRC sections.

Annotated tax services include the *United States Tax Reporter* and the *Standard Federal Income Tax Reporter* services, both of which are organized by IRC section. Many tax advisors find these reporters easy to use because of their extensive indexing system. Topical tax services include RIA's *Federal Tax Coordinator 2d* and Bloomberg BNA's *Tax Management Portfolios*. *Tax Management Portfolios* are popular with many tax advisors because they are very readable yet still provide a comprehensive discussion of a broad range of tax issues. Each portfolio (e.g., Passive Loss Rules, Portfolio 549) covers a particular topic in great detail. However, because the published portfolios do not cover all areas of the tax law, another service may be necessary to supplement the gaps in a portfolio's coverage. Table I:15-4 summarizes the organization and key features of the major tax services.

▼ **TABLE I:15-4**
Summary of Key Features of Tax Services

Name	Publisher	Organization	Key Features
United States Tax Reporter	Thomson Reuters/RIA	IRC section number	• Editorial commentary • Index and findings list • Annotations
Standard Federal Income Tax Reporter	Wolters Kluwer/CCH	IRC section number	• Editorial commentary • Index and findings list • Annotations
Federal Tax Coordinator 2d	Thomson Reuters/RIA	Tax topic (income tax by topic, estate and gift taxes, excise taxes)	• Commentary organized by topic with references to primary authority and tabbed access to IRC and Treasury Regulations.
Tax Management Portfolios	Bloomberg BNA	U.S. income, foreign income, state tax, estate and gift tax	• Over 400 specialized booklets with extensive commentary by topic, heavily footnoted and referenced to primary authority.

THE INTERNET AS A RESEARCH TOOL

OBJECTIVE 6

Apply the basics of Internet-based tax research

Internet databases are rapidly replacing print-based services as the principal source of tax related information. These databases encompass not only the IRC, Treasury Regulations, court cases, state laws, and other primary authorities, but also citators and secondary sources such as tax service reporters, treatises, journals, and newsletters. The principal advantages of using Internet-based tax services are ease and speed of access. These services eliminate the need for searching through several volumes of text, the need for consulting numerous cumulative supplements, and the time required to regularly update a print-based library. In addition, Internet based research tools put a vast amount of information in the hands of a tax practitioner without the cost and space requirements of a well equipped print-based tax library.

ADDITIONAL COMMENT

To apply the online research tools discussed in this chapter, textbook users must have access to the described Internet-based tax services at their institution.

Because of these advantages, the Internet has become the principal medium for conveying tax related information to professionals. The most widely used Internet-based research services are RIA's Checkpoint™ (hereafter CHECKPOINT) and CCH IntelliConnect™. Westlaw®[42] and LexisNexus are online legal research services that are predominately used by legal professionals.[43] This chapter discusses the use of internet-based tax services in general and uses CHECKPOINT for illustrative purposes. Similar features will exist for other major tax services.

The tax services include a variety of libraries that will vary by vendor (e.g., CCH or RIA) and by subscription type (limited or comprehensive). The core of any tax service covers federal taxes but also can cover state and local taxes, estate planning, payroll taxes, pensions, international tax, and financial planning. The federal libraries will include text of the IRC, Treasury Regulations, IRS pronouncements, court opinions, and other primary sources. In addition, the Internet services will include a section containing daily updates for important tax developments in the subscribed practice areas as well as the annotated and/or topical tax services discussed previously, such as the *United States Tax Reporter* (CCH) and the *Federal Tax Coordinator 2d* (RIA). State and local libraries will include tax reporters for all 50 states as well as various multi-state tax guides that provide useful state-by-state comparisons for selected state tax topics (e.g., combined reporting and apportionment methods). Other libraries, such as those covering estate and gift taxes, pensions, and payroll taxes, provide detailed information for professionals heavily engaged in these specialized areas of tax practice.

Libraries and databases in Internet services can be searched in three basic ways:

- By keyword
- By citation
- By index

EXAMPLE I:15-12 ▶ Rhonda Researcher's client is a real estate developer and wants to exchange an office building for a residential condominium in the same town. The client wants to know if he can structure the transaction in a tax advantaged way. Rhonda immediately recognizes the situation as a potential like-kind exchange of real property. Therefore, she undertakes a keyword search using the term *like-kind exchange* to quickly uncover potentially applicable documents. She also knows that Sec. 1031 is the relevant IRC section and can search the IRC or Treasury Regulations by citation. On the other hand, if she were unfamiliar with the topic, she could employ several other options. For example, she may browse the index, which is arranged alphabetically by topic. The index entries under "like-kind exchange" direct Rhonda to a number of entries potentially applicable to the transaction. ◀

Most tax professionals conduct tax research using the keyword and citation methods. We discuss these two methods in more detail below.

[42] Westlaw® is owned by Thomson Reuters.

[43] The research products discussed in this section (e.g., RIA Checkpoint, CCH IntelliConnect™, Westlaw®, and LexisNexus) generally are available only to paid subscribers.

KEYWORD SEARCHES

Searching tax services by keyword is relatively simple, particularly if the researcher is familiar with the Internet. The first step is to select which source (e.g., IRC or editorial materials) to search, perform an initial keyword search, and refine the results after the initial query. The researcher can choose to search across any combination of the available databases. The CHECKPOINT Federal databases include primary sources such as the Internal Revenue Code, Treasury Regulations, and Federal Tax Cases along with editorial databases such as RIA's *Federal Tax Coordinator 2d*. Deciding which database to include in the search depends partly on the expected complexity of the research question and on the researcher's familiarity with the topic.

The search engines within the services look for the terms selected and many variations of the terms. For example, the search for *auto* will return documents with auto, car, automobile, motor vehicle, passenger vehicle, sedan, and others.[44] Searches will include both singular and plural variations. Any document with the term or terms is returned and ranked by best match according to the search. If two terms are used, the best matches generally are documents where the terms are close together. Choosing effective search terms is critical to success. The search must be broad enough to include relevant documents but not so broad to include hundreds or thousands of documents unlikely to be on point.

For example, if the researcher selects the database containing court cases, the term *property exchange* returns thousands of results that have both the words *property* and *exchange* somewhere in the document. Clearly, this outcome is too broad for a researcher just beginning his or her research. Fortunately, several methods of narrowing the search exist. For example, the keyword search "property exchange" that uses quotation marks around the search phrase will return documents only with that exact phrase. Thus, quotation marks should be used sparingly and only when the researcher knows the precise phrase. Using Boolean connectors is helpful as well. These connectors force the search engine to narrow the search based on the parameters set. Table I:15-5 provides a partial list of connectors available in CHECKPOINT.

Another way to narrow a search is to focus on terms unique to the research question at hand. The goal is to identify tax related terms likely to appear only in relevant tax

▼ **TABLE I:15-5**
Connectors Used in CHECKPOINT

Connector	Description	Examples
&, and	Retrieves documents with both terms.	property & exchange
|, or	Retrieves documents with either term.	property | exchange
^, not	Retrieves documents with one term but not the other.	property ^ exchange
/n	Retrieves documents in which the first term is separated from the second term by no more than n number of words.	property /5 exchange Locates property within 5 words of exchange
/s	Retrieves documents that contain the first term within 20 words of the second term (or within the same sentence for RIA).	property /s exchange
/p	Retrieves documents that contain the first term within 80 words of the second term (or within the same paragraph for RIA).	property /p exchange
" "	Exact phrase.	"property exchange"
*	Keyword variation.	Deprecia* returns depreciation, depreciate, depreciated, depreciating
?	Keyword variation.	Advis?r returns advisor and adviser

[44] Tax services provide a thesaurus tool, which can identify synonyms and suggest alternative terms related to search terms used by the researcher. The search engine automatically searches for synonyms unless the researcher restricts the search to specific terms using Boolean connectors or quotation marks. For example, a search for the specific phrase "automobile depreciation" will not return documents that refer to *auto*, *car*, or *vehicle*.

authorities. For example, stamps are a type of collectible, but the term also will appear in documents discussing taxation of distilled spirits, food stamps, and store stamps and coupons. The researcher should begin the search with limiting terms such as *collectible* rather than the broader term *stamps*. Also, researchers with a good working knowledge of the IRC quickly learn that using IRC sections in search terms is a great way to obtain relevant documents. Browsing the index containing editorial content can identify helpful keywords.

Searching using key words is a skill that improves with practice. Researchers becoming familiar with using the databases will learn to craft search terms that include the most relevant elements of the question at hand. Once the researcher finds a document on point, the information within that document often can be used to narrow future searches. The search can be repeated by adding terms, or the documents returned originally can be searched using a new set of terms. Also, the "search within results" feature offered by major tax services is helpful when the search returns too many documents. However, if searches by keyword search do not return the desired results, other options exist.

SEARCH BY CITATION

Often the desired document is a specific IRC section, Treasury Regulation, court case, IRS pronouncement, or other document. If so, tax services offer searches by specific citation. Researchers must be careful to use exact citations using this tool because close matches will not return the desired document.

Within tax services, the citation search tools provide dedicated boxes in which to type the specific type of document requested. For example, to search for IRC Sec. 267, the researcher simply types 267 in the box labeled Current Code in CHECKPOINT under the "Find by Citation" link. Specific boxes also exist for various Treasury Regulations, court decisions, revenue rulings, revenue procedures, and other IRS pronouncements.

NONCOMMERCIAL INTERNET SERVICES

Many noncommercial institutions, such as governments and universities, allow access to their tax-related databases via the Internet. In "tax-surfing" the Internet, the researcher might first visit the IRS site located at *www.irs.gov*. Although oriented to the layman, this site contains a wealth of information useful to the tax professional. Such information includes guidelines for electronic filing, IRS forms and instructions, the full text of Treasury Regulations, and recent issues of the *Internal Revenue Bulletin*. Other useful sites include those maintained by the Library of Congress at *www.loc.gov* and the U.S. Government Publishing Office Federal Digital System at *www.govinfo.gov*. From these sites, the researcher can retrieve the text of recent court opinions, tax legislation, committee reports, state and federal tax laws, and much more.

An excellent gateway for starting tax related research is the Tax, Accounting, and Payroll Sites Directory at *www.taxsites.com*, maintained by AccountantsWorld, LLC. This site provides hundreds of hyperlinks to federal, state, and international tax law and tax form databases. Instrumental in financial accounting searches is the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) site at *www.sec.gov/edgar.shtml*. EDGAR is a document filing and retrieval service sponsored by the U.S. Securities and Exchange Commission (SEC). It provides access to the full text of documents filed with the SEC by publicly traded companies. These documents include annual financial statements on Form 10-K, quarterly financial statements on Form 10-Q, proxy statements, and prospectuses. The EDGAR database extends from January 1994 to the present and is accessible by company name, central index key, document file number, and keyword.

CITATORS

OBJECTIVE 7

Use a citator to assess tax authorities

Citators serve two functions. First, they trace the judicial history of a particular case (e.g., if the case under analysis is an appeals court decision, the citator indicates the lower court that heard the case and whether the Supreme Court reviewed the case). Second, they list

other authorities (e.g., cases and IRS pronouncements) that cite the case or authority in question. These listed authorities are called *citing cases* or *citing rulings*. The judicial history also indicates whether the case is affirmed, reversed or remanded.[45]

Because tax law relies heavily on precedent, the citator provides an index of citing cases and rulings that help the researcher determine the strength of the case or ruling he or she is evaluating. The citator gives full citations for the citing case and lists where the citing cases can be found. It is important to note that the same case may have as many as three decisions (i.e., lower court, court of appeals, and Supreme Court) with each listing having its own list of citing cases. Therefore, if a citing case cites only the Supreme Court decision, the citator will list it only under the Supreme Court cite. The citator allows the researcher to enter case names or case citations. The discussion in this section focuses on the electronic version of the citators, although print versions also exist.

The basic function of a citator is to provide the history of each authority and list cases and pronouncements that have cited the authority. Also, the citator often provides additional information about the citing case, showing whether the citing authorities comment favorably or unfavorably on the cited case or whether they can be distinguished from the cited case.[46]

In addition to tax cases, the citator evaluates revenue rulings and other IRS pronouncements and lists any status changes. Before relying on a revenue ruling or pronouncement, a researcher must confirm that the pronouncement reflects the current position of the IRS. For example, a revoked ruling is one in which the ruling is no longer correct and the correct position is being stated in the new ruling. The IRS does not remove the old ruling from the *Internal Revenue Bulletin* or *Cumulative Bulletin*, but the old ruling does not have authority regarding a transaction occurring after the revocation. Thus, failure to confirm its status could result in an incorrect conclusion. Table I:15-6 provides a list of terms the IRS uses to describe changes in the status of a ruling.

▼ **TABLE I:15-6**

Terms to Describe Status Changes to IRS Rulings

Term	Description of Term
Amplified	No change in the prior published position has occurred, but the prior position is extended to cover a variation of the fact situation previously addressed.
Clarified	Language used in a prior published position is being made clear because the previous language has caused or could cause confusion.
Distinguished	The ruling mentions a prior ruling but points out an essential difference between the two rulings.
Modified	The substance of a previously published ruling is being changed, but the prior ruling remains in effect.
Obsoleted	A previously published ruling is no longer determinative with respect to future transactions, e.g., because laws or regulations have changed, or the substance of the ruling has been adopted into regulations.
Revoked	A previously published ruling has been determined to be incorrect, and the correct position is being stated in the new ruling.
Superseded	The new ruling merely restates the substance of a previously published ruling or series of rulings.
Supplemented	The ruling expands a previous ruling, e.g., by adding items to a list.
Suspended	The previously published ruling will not be applied pending some future action, such as the issuance of new or amended regulations.

Source: Appendices in IRS Internal Revenue Bulletins.

[45] If a case is *affirmed*, the decision of the lower court is upheld. *Reversed* means the higher court invalidated the decision of the lower court because it reached a conclusion different from that derived by the lower court. *Remanded* signifies that the higher court sent the case back to the lower court with instructions to address matters consistent with the higher court's ruling.

[46] When a court distinguishes the facts of one case from those of an earlier case, it suggests that its departure from the earlier decision is justified because the facts of the two cases are different.

USING THE CITATOR

Internet-based versions of the citators are easier to use than print-based citators. For example, assume the researcher is currently reading *Leonarda C. Diaz v. Commissioner of Internal Revenue*, 70 TC 1067 (1978). The researcher can click on the citator, and the service opens up a new tab with a summary of activity of the case. The information provided indicates that the *Diaz* case was first decided by the Tax Court (i.e., TC), and then by the Second Circuit Court of Appeals (i.e., CA-2). It shows that the Second Circuit affirmed (upheld) the Tax Court's decision. Cases underneath the Second Circuit decision cite the *Diaz* decision and might be useful for the researcher to better understand the impact of the case. Cases listed beneath the Tax Court decision cite the Tax Court's opinion.

PROFESSIONAL GUIDELINES FOR TAX SERVICES

OBJECTIVE 8

Describe the professional guidelines that CPAs in tax practice should follow

Professional guidelines for tax services are contained in both government-imposed and professional-imposed tax standards. The following sections briefly describe two types of guidelines—Treasury Department ***Circular 230*** (Rev. 6-2014) and the American Institute of Certified Public Accountants (AICPA) ***Statements on Standards for Tax Services (SSTSs)***. A fuller discussion of these standards appears in Chapter C:15.

TREASURY DEPARTMENT *CIRCULAR 230*

Circular 230 sets forth rules to practice before the Internal Revenue Service and pertains to certified public accountants, attorneys, enrolled agents, and other persons representing taxpayers before the IRS. It presents the duties and restrictions relating to such practice and prescribes sanctions and disciplinary proceedings for violating these regulations.

Circular 230 rules, however, are not ethical standards. Instead, the document focuses on the right to represent clients before the IRS. These standards differ from the AICPA's SSTSs in the following ways:

- They apply only to federal tax issues and not state authorities.
- They generally apply only to federal income tax practice.
- They do not provide the depth of guidance found in the SSTSs.
- They give the government the authority to impose monetary penalties for violations of the rules.

Circular 230 provides guidelines for written advice to taxpayers. In June 2014, the IRS substantially revised and simplified the rules and eliminated the distinction between covered opinions and other written advice. Under the new rules, all written advice is held to a "reasonable practitioner standard" that will vary based on the nature and extent of the advice. An email to a client answering a routine tax question will be held to a different standard than will an opinion on the tax effects of a complex transaction. The written advice rules do not apply to training or educational presentations but do apply to marketing and sales presentations.

For all written advice, the practitioner is expected to base the advice on reasonable assumptions, consider relevant facts and circumstances, identify the facts relevant to the advice, be properly skeptical of representations by the taxpayer and others, relate applicable law and authority to the facts, and not base an opinion on the chances that a transaction will or will not be identified by IRS and subject to audit. The revised Section 10.37 of *Circular 230* does note that the IRS representative will consider the "additional risk" associated with opinions related to tax shelters.

AICPA'S STATEMENTS ON TAX STANDARDS

Tax advisors confronted with ethical issues frequently turn to a professional organization for guidance. Although the guidelines set forth by such organizations are not *legally* enforceable, they carry significant moral weight, and may be cited in a negligence lawsuit as the proper "standard of care" for tax practitioners. They also may provide grounds for the termination or suspension of one's professional license. One such set of guidelines is the *Statements on Standards for Tax Services* (SSTSs),[47] issued by the American Institute of Certified Public Accountants (AICPA) and reproduced in Appendix E.

The SSTSs provide an ethical framework to govern the normative relationship between a tax advisor and his or her client, where, unlike an auditor, a tax advisor acts as the client's advocate. Thus, his or her primary duty is to the client, not the IRS. In fulfilling this duty, the advisor is bound by the highest standards of care. The most recent version of the SSTSs includes seven standards that provide guidance for AICPA members in their professional tax practice.

ADDITIONAL COMMENT

SSTS No. 1 states that tax advisors have both the "right and responsibility" to be an advocate for the taxpayer with respect to any position that otherwise meets the standard.

SSTS No. 1—Tax Return Positions. Tax professionals often provide tax advice in situations where the authority is unclear or evolving. Frequently this advice involves recommending positions that could be reversed upon audit. This statement describes the minimum level of confidence a CPA must achieve to recommend a tax return position to a taxpayer. Members first must determine and comply with all standards imposed by the various taxing authorities. Regardless of those standards, a member should not recommend a position unless he or she has a good faith belief that the position has a "realistic possibility" of being sustained administratively or judicially on its merits if challenged. Members are not permitted to take the probability of audit into account.

If the position does not meet the realistic probability standard, a member still may recommend a tax return position if he or she concludes that the position has a "reasonable basis" and the position is properly disclosed. When recommending a tax return position and when preparing or signing a return on which a tax return position is taken, a member should, when relevant, advise the taxpayer regarding potential penalty consequences of such tax return position and the opportunity, if any, to avoid such penalties through disclosure. The member also may consider any GAAP requirements to disclose aggressive tax positions under the portion of Accounting Standards Codification 740 formerly known as FIN 48.

The standard highlights the dual responsibility of the member. The U.S. tax system can function only when taxpayers file "true, correct, and complete" returns, but taxpayers also have no obligation to pay more in tax than they legally owe. The tax professional's duty is to meet his or her responsibilities to both the tax system and the taxpayer client.

SSTS No. 2—Answers to Questions on Returns. Return preparers often must sign a declaration that the return is "true, correct, and complete." A member should make a reasonable effort to obtain from the taxpayer the information necessary to provide appropriate answers to all questions on a tax return before signing as preparer. However, in certain circumstances, questions or information applicable to the taxpayer may be omitted. Reasonable grounds include the following situations:

- The omitted information is not readily available or is immaterial and has little effect on taxable income or loss or the tax liability.
- The meaning of the question as it relates to the taxpayer is uncertain.
- The requested information is voluminous, in which case the taxpayer can attach a statement indicating that the requested information will be supplied upon request.

[47] AICPA, *Statements on Standards for Tax Services*, 2009, effective January 1, 2010.

SSTS No. 3—Certain Procedural Aspects of Preparing Returns. Tax returns are based on information provided by the client. This statement sets forth the applicable standards for members concerning this information. Specifically, in preparing or signing a return, members are not required to examine or verify a client's supporting data. A member may rely on information supplied by the taxpayer unless the information appears to be incorrect, incomplete, inconsistent, or unreasonable under the circumstances. However, if the applicable law or regulations impose a specific record keeping requirement to claim a deduction, the member should inquire and satisfy himself or herself that the required records do exist.

Members are specifically encouraged to make use of a taxpayer's returns for one or more prior years in preparing the current return, whenever feasible. The practice should help avoid the omission or duplication of items and provide a basis for the treatment of similar or related transactions.

SSTS No. 4—Use of Estimates. For various reasons, precise information about an amount required on a tax return might not be available at the time the tax return is prepared. For example, the taxpayer might not have a record of small transactions or might be missing certain records. In such cases, a member may advise on estimates used in the preparation of the tax return, but the taxpayer has the responsibility to provide the estimated data. Appraisals and valuations are not considered estimates.

If estimates are used, they generally need not be labeled as estimates, but they should not be presented in a manner that provides a misleading impression about the degree of factual accuracy. However, disclosure that estimates were used should be made in some unusual situations, including:

- A taxpayer has died or is ill at the time the return is prepared.
- A taxpayer has not received a schedule K-1 at the time the tax return is to be filed.
- Litigation is pending that affects the return.
- Fire, computer failure, or a natural disaster has destroyed the relevant records.

Notwithstanding this statement, the tax practitioner may not use estimates when such use is implicitly prohibited by the IRC. For example, Sec. 274(d) disallows deductions for certain expenses (e.g., meals and entertainment) unless the taxpayer can substantiate the expenses with adequate records or sufficient corroborating information. The documentation requirement effectively precludes the taxpayer from estimating such expenses and the practitioner from using such estimates.

SSTS No. 5—Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decisions. Members can take positions that differ from a position determined in an administrative proceeding with respect to the taxpayer's prior return (such as an IRS audit, IRS appeals conference, or a court decision.) Departure might be warranted because of a change in the law or regulations, or favorable court decisions. In any event, if the member can otherwise meet the standards of SSTS No. 1, departure from previous positions is permissible.

SSTS No. 6—Knowledge of Error: Return Preparation and Administrative Proceedings. For purposes of this standard, the definition of an error has the common meaning, including a mathematical error, but the definition also encompasses any position that does not meet the standards of SSTS No. 1. A position also qualifies as an error if it met the standard when a return was originally filed but no longer does because of a retroactive legislative or legal proceeding. An error for this purpose does not include immaterial items.

A member should inform the taxpayer promptly upon becoming aware of (1) an error in a previously filed return, (2) an error in a return that is the subject of an administrative proceeding (e.g., an IRS audit or appeals conference), or (3) a taxpayer's failure to file a required return. A member should advise the taxpayer of the potential consequences of the error and recommend corrective measures to be taken. This advice can be given orally.

The member is not obligated to inform the taxing authority of an error and, in fact, may not do so without the taxpayer's permission except when required by law.

However, if the taxpayer requests that a member prepare the current year's return and the taxpayer has not taken appropriate action to correct an error in a prior year's return, the member should consider whether to withdraw from preparing the return and whether to continue a professional or employment relationship with the taxpayer.

The standard recognizes that conflicts can arise between the member's interests and those of the client. For example, withdrawal from an engagement could have an adverse impact on the taxpayer. In some situations, the member should consult his or her own legal counsel before deciding on recommendations to the taxpayer and whether to continue the engagement. In situations involving potential fraud or criminal charges, the member should advise the client to consult with an attorney before taking any action.

SSTS No. 7—Form and Content of Advice to Taxpayers. A member should use professional judgment to ensure that tax advice provided to a taxpayer reflects competence and appropriately serves the taxpayer's needs. The advice can be communicated in writing or orally. When communicating tax advice to a taxpayer in writing, a member should comply with relevant taxing authorities' standards applicable to written tax advice. A member should use professional judgment about any need to document oral advice.

In deciding on the form of advice provided to a taxpayer, a member should consider factors such as:

- The importance of the transaction and the amounts involved
- The technical complexity involved
- The existence of authorities and precedents
- The tax sophistication of the taxpayer
- The need to seek other professional advice
- The potential penalty consequences of a tax return position and whether any penalties can be avoided through disclosure

This statement implies that practitioner-taxpayer dealings should not be casual, nonconsensual, or open ended. Rather, they should be professional, contractual, and definite. Oral advice may be appropriate in routine matters, but written communications are recommended in important, complicated, or significant dollar value transactions.

In addition to these obligations, the tax advisor has a strict duty of confidentiality to the client. Although not encompassed under the SSTSs, this duty is implied in the accountant client privilege. (For a discussion of this privilege, see Chapter C:15.)



Question: As described in the Stop & Think box on pages I:15-10 and I:15-11, you are researching the manner in which a deduction is calculated. The IRC states that the calculation is to be made "in a manner prescribed by the Secretary." After studying the IRC, Treasury Regulations, and committee reports, you conclude that another way of doing the calculation is arguably correct under an intuitive approach. This approach would result in a lower tax liability for the client. According to the *Statements on Standards for Tax Services,* may you take a position contrary to final Treasury Regulations based on the argument that the regulations are not valid?

Solution: You should not take a position contrary to the Treasury Regulations unless you have a "good-faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits." However, you can take a position that does not meet the above standard, provided you adequately disclose the position, and the position has a reasonable basis. Whether or not you have met the standard depends on all the facts and circumstances. Chapter C:15 discusses tax return preparer positions contrary to Treasury Regulations.

WHAT WOULD YOU DO IN THIS SITUATION?

Regal Enterprises and Macon Industries, unaffiliated corporations, have hired you to prepare their respective income tax returns. In preparing Regal's return, you notice that Regal has claimed a depreciation deduction for equipment purchased from Macon on February 22 at a cost of $2 million. In preparing Macon's return, you notice that Macon has reported sales proceeds of $1.5 million from the sale of equipment to Regal on February 22. One of the two figures must be incorrect. How do you proceed to correct it? Hint: See SSTS No. 3 in Appendix E.

SAMPLE WORK PAPERS AND CLIENT LETTER

OBJECTIVE 9

Prepare work papers and communicate to clients

Appendix A presents a set of sample work papers, including a draft of a client letter and a memo to the file. The work papers indicate the issues to be researched, the authorities addressing the issues, and the researcher's conclusions concerning the appropriate tax treatment, with rationale therefor.

The format and other details of work papers differ from firm to firm. The sample in this text offers general guidance concerning the content of work papers. In practice, work papers may include less detail.

PROBLEM MATERIALS

Note: To complete the online research problems for this chapter, textbook users must have access to an Internet-based service.

DISCUSSION QUESTIONS

I:15-1 Explain the difference between closed-fact and open-fact situations.

I:15-2 According to the AICPA's *Statements on Standards for Tax Services,* what duties does the tax practitioner owe the client?

I:15-3 Explain what is encompassed by the term **tax law** as used by tax advisors.

I:15-4 The U.S. Government Printing Office publishes both hearings on proposed legislation and committee reports. Distinguish between the two.

I:15-5 Explain how committee reports can be used in tax research. What do they indicate?

I:15-6 A friend notices that you are reading the Internal Revenue Code of 1986. Your friend inquires why you are consulting a 1986 publication, especially when tax laws change so frequently. What is your response?

I:15-7 Does Title 26 contain statutory provisions dealing only with income taxation? Explain.

I:15-8 Refer to IRC Sec. 301.
- **a.** Which subsection discusses the general rule for the tax treatment of a property distribution?
- **b.** Where should one look for exceptions to the general rule?
- **c.** What type of Treasury Regulations would relate to subsection (e)?

I:15-9 Why should tax researchers note the date on which a Treasury Regulation was adopted?

I:15-10
- **a.** Distinguish between proposed, temporary, and final Treasury Regulations.
- **b.** Distinguish between interpretative and legislative Treasury Regulations.

I:15-11 In 2011, there was a change in the authoritative weight of interpretive versus legislative regulations. Briefly explain what changed and why.

I:15-12 Explain the legislative reenactment doctrine.

I:15-13
- **a.** Discuss the authoritative weight of revenue rulings.

b. As a practical matter, what consequences are likely to ensue if a taxpayer does not follow a revenue ruling and the IRS audits his or her return?

I:15-14 a. In which courts may litigation dealing with tax matters begin?
b. Discuss the factors that might be considered in deciding where to litigate.
c. Describe the appeals process in tax litigation.

I:15-15 May a taxpayer appeal a case litigated under the Small Cases Procedure of the Tax Court?

I:15-16 Explain whether the following decisions are of the same precedential value: (1) Tax Court regular decisions, (2) Tax Court memo decisions, and (3) decisions under the Small Cases Procedures of the Tax Court.

I:15-17 Does the IRS acquiesce in decisions of U.S. district courts?

I:15-18 The decisions of which courts are reported in the AFTR? In the USTC?

I:15-19 Why do some revenue ruling citations refer to the *Internal Revenue Bulletin* (I.R.B.) and others to a *Cumulative Bulletin* (C.B.)?

I:15-20 Explain the *Golsen* Rule. Give an example of its application.

I:15-21 Assume that the only precedents relating to a particular issue are as follows:

Tax Court—decided for the taxpayer
Eighth Circuit Court of Appeals—decided for the taxpayer (affirming the Tax Court)
U.S. District Court for Eastern Louisiana—decided for the taxpayer
Fifth Circuit Court of Appeals—decided for the government (reversing the U.S. District Court of Eastern Louisiana)

a. Discuss the precedential value of the foregoing decisions for your client, who is a California resident.
b. If your client, a Texas resident, litigates in the Tax Court, how will the court rule? Explain.

I:15-22 Which official publication(s) contain(s) the following:
a. Transcripts of Senate floor debates
b. IRS announcements
c. Tax Court regular opinions
d. Treasury decisions
e. U.S. district court opinions
f. Technical advice memoranda

I:15-23 Under what circumstances might a tax advisor find the provisions of a tax treaty useful?

I:15-24 What two functions does a citator serve?

I:15-25 Name three primary sources of authority that tax professionals should check against the citator before relying on those sources for important matters.

I:15-26 List three methods of searching the major tax service databases.

I:15-27 Use any major tax service to answer the following questions:
a. What are the principal primary sources?
b. What are the principal secondary sources?

I:15-28 Compare the features of the computerized tax services with those of Internet sites maintained by noncommercial institutions. What are the relative advantages and disadvantages of each? Could the latter sites serve as a substitute for a commercial tax service?

I:15-29 According to the *Statements on Standards for Tax Services*, what belief should a CPA have before taking a pro-taxpayer position on a tax return?

I:15-30 List an advisor's duties that are excluded under the AICPA's *Statements on Standards for Tax Services*.

I:15-31 List three requirements that apply to written advice under Treasury Department *Circular 230*.

I:15-32 Explain how Treasury Department *Circular 230* differs from the AICPA's *Statements on Standards for Tax Services*.

PROBLEMS

I:15-33 ***Interpreting the IRC.*** Under a divorce agreement executed in the current year, an ex-wife receives from her former husband cash of $25,000 per year for eight years. The agreement does not explicitly state that the payments are excludable from gross income.
a. Does the ex-wife have gross income? If so, how much?
b. Is the former husband entitled to a deduction? If so, is it for or from AGI? Refer only to the IRC in answering this question. Start with Sec. 71.
c. How did the Tax Cuts and Jobs Act of 2017 change the alimony rules?

I:15-34 ***Interpreting the IRC.*** Refer to Sec. 385 and answer the questions below.
a. Whenever Treasury Regulations are issued under this section, what type are they likely to be: legislative or interpretative? Explain.
b. Assume Treasury Regulations under Sec. 385 have been finalized. Will they be relevant to estate tax matters? Explain.

I:15-35 ***Using IRS Rulings.*** Locate PLR 8733007 and Rev. Rul. 81-219.
a. Briefly summarize the tax issue and conclusion of each ruling.
b. Under what circumstances can a researcher rely on the private letter ruling?
c. Under what circumstances can a researcher rely on the revenue ruling?

I:15-36 ***Using Treasury pronouncements.*** Which IRC section(s) does Rev. Rul. 2001-29 interpret? Hint: consult the official pronouncement of the IRS.

I:15-37 ***Using a Major Tax Service for a Keyword Search.*** The objective is to locate a general overview of available home office deductions. On the main research tab, select the *United States Tax Reporter—Explanations database*. How many results does the search return for each search term if the terms and connectors option is selected?
a. Search term: home office deduction.
b. Search term: "home office" deduction.
c. Search term: "home office" /5 deduction.

I:15-38 ***Using a Major Tax Service for a Citation Search.*** The objective is to locate a general overview of available home office deductions. You have previously researched the issue and know that Sec. 280A is the primary authority for this issue. In the Keyword Search box, enter 280A and check the IRS Rulings and Releases database and answer the following questions.
a. How many results for Revenue Rulings does the search return for the search term: 280A?
b. Using the search within results function, use the new term: home office. How many results does the search return?
c. Does using the search within results function improve your results? Explain why.

I:15-39 ***Determining Acquiescence.***
a. What official action (acquiescence or nonacquiescence) did the IRS Commissioner take regarding the 1985 Tax Court decision in *John McIntosh,* 85 T.C. 31 (1985)? Hint: Consult Actions on Decisions (AOD).
b. Did this action concern *all* issues in the case? If not, explain. (Before answering this question, consult the headnote to the court opinion.)

I:15-40 ***Determining Acquiescence.***
a. What 2015 action (acquiescence or nonacquiescence) did the IRS Commissioner take regarding the 9th Circuit decision in *Voss v. Commissioner,* 116 AFTR 2d 2015-5529? Hint: Consult Actions on Decisions (AOD).
b. What issue did the AOD address?

I:15-41 ***Determining Acquiescence.***
a. What original action (acquiescence or nonacquiescence) did the IRS Commissioner take regarding the 1982 Tax Court decision in *Doyle, Dane, Bernbach, Inc.*, 79 T.C. 101 (1982)? Hint: Consult Actions on Decisions (AOD).
b. Did the IRS Commissioner subsequently change his mind? If so, when?

I:15-42 ***Evaluating a Case.*** Look up *James E. Threlkeld,* 87 T.C. 1294 (1988) and answer the questions below.
a. Was the case reviewed by the court? If so, was the decision unanimous? Explain.
b. Was the decision entered under Rule 155?
c. Consult a citator. Was the case reviewed by an appellate court? If so, which one?

I:15-43 ***Evaluating a Case.*** Look up *Bush Brothers & Co.*, 73 T.C. 424 (1979) and answer the questions below.
a. Was the case reviewed by the court? If so, was the decision unanimous? Explain.
b. Was the decision entered under Rule 155?
c. Consult a citator. Was the case reviewed by an appellate court? If so, which one?

I:15-44 ***Writing Citations.*** Provide the proper citations (including both primary and secondary citations where applicable) for the authorities listed below. (For secondary citations, reference both the AFTR and USTC.)
a. *National Cash Register Co.*, a 6th Circuit Court decision
b. *Thomas M. Dragoun v. CIR,* a Tax Court memo decision
c. *John M. Grabinski v. U.S.*, a U.S. district court decision
d. *John M. Grabinski v. U.S.*, an Eighth Circuit Court decision
e. *Rebekah Harkness,* a 1972 Court of Claims decision
f. *Hillsboro National Bank v. CIR,* a Supreme Court decision
g. Rev. Rul. 78-129

I:15-45 ***Writing Citations.*** Provide the proper citations (including both primary and secondary citations where applicable) for the authorities listed below. (For secondary citations, reference both the AFTR and USTC.)

a. Rev. Rul. 99-7
b. *Frank H. Sullivan,* a Board of Tax Appeals decision
c. *Tate & Lyle, Inc.*, a 1994 Tax Court decision
d. *Ralph L. Rogers v. U.S.*, a U.S. district court decision
e. *Norman Rodman v. CIR,* a Second Circuit Court decision

I:15-46 ***Interpreting Citations.*** Indicate which courts decided the cases cited below. Also indicate on which pages and in which publications the authority is reported.

a. *Lloyd M. Shumaker v. CIR,* 648 F.2d 1198, 48 AFTR 2d 81-5353 (9th Cir., 1981)
b. *Xerox Corp. v. U.S.*, 14 Cl. Ct. 455, 88-1 USTC ¶9231 (1988)
c. *Real Estate Land Title & Trust Co. v. U.S.*, 309 U.S. 13, 23 AFTR 816 (USSC, 1940)
d. *J. B. Morris v. U.S.*, 441 F. Supp. 76, 41 AFTR 2d 78-335 (DC TX, 1977)
e. Rev. Rul. 83-3, 1983-1 C.B. 72
f. *Malone & Hyde, Inc. v. U.S.*, 568 F.2d 474, 78-1 USTC ¶9199 (6th Cir., 1978)

I:15-47 ***Using a Tax Service.*** Use the index of any tax service to locate authorities dealing with the deductibility of the cost of a facelift.

a. Cite the authority you find.
b. List the primary IRC section cited as authority.
c. May a taxpayer deduct the cost of a facelift paid in the current year? Explain.

I:15-48 ***Using a Tax Service.*** Using any tax service, locate Reg. Sec. 1.302-1. Does this Treasury Regulation reflect recent amendments to the IRC? Explain.

I:15-49 ***Using a Tax Service.*** Using the index of any tax service, search the editorial materials to locate authorities addressing whether termite damage constitutes a casualty loss.

a. Cite the authority you found.
b. Cite at least two primary authorities.

I:15-50 ***Using a Tax Service.***

a. Using any tax service, locate Sec. 303. This section states that Sec. 303(a) applies only if the stock in question meets a certain percentage test. What is the applicable percentage?
b. Locate Reg. Sec. 1.303-2(a) in the same service. Does this Treasury Regulation reflect recent amendments to the IRC with respect to the percentage test addressed in Part a? Explain.

I:15-51 ***Using a Tax Service.*** Using the BNA tax service, identify the number of the BNA portfolio for the following subjects.

a. Innocent spouse relief.
b. Accounting methods.
c. Involuntary conversions.
d. IRAs.
e. Deductibility of legal and accounting fees, bribes, and illegal payments.

I:15-52 ***Using a Keyword Search.*** Using a keyword search of editorial materials in any tax service, locate authorities dealing with the deductibility of the cost of work clothing by a firefighter. List a revenue ruling addressing this question.

I:15-53 ***Using a Citator.*** Trace *Biltmore Homes, Inc.*, a 1960 Tax Court memo decision, in the citator.

a. According to the citator, how many times has the Tax Court decision been cited by other courts?
b. How many issues did the lower court address in its opinion? Hint: Refer to the case headnote numbers.
c. Did an appellate court review the case? If so, which one?

I:15-54 ***Using a Citator.*** Trace *Stephen Bolaris,* 776 F.2d 1428, in the citator.

a. According to the citator, how many times has the Ninth Circuit's decision been cited?
b. Did the decision address more than one issue? Explain.
c. Was the decision ever cited unfavorably? Explain.

I:15-55 ***Interpreting a Case.*** Using any tax service, refer to the *Holden Fuel Oil Company,* RIA T.C. Memo ¶72,045 (T.C. Memo 1972-45), 31 TCM 184.
a. In which year was the case decided?
b. What controversy was litigated?
c. Who won the case?
d. Was the decision reviewed at the lower court level?
e. Was the decision appealed?
f. Has the decision been cited in other cases?

I:15-56 ***Internet Research.*** Access the IRS Internet site at *www.irs.gov* and answer the following questions:
a. How does one file a tax return electronically?
b. How can the taxpayer transmit funds electronically?
c. What are the advantages of electronic filing?

I:15-57 ***Internet Research.*** Access the IRS Internet site at *www.irs.gov* and indicate the titles of the following IRS forms:
a. Form 4506
b. Form 973
c. Form 8725

I:15-58 ***Internet Research.*** Access the Federation of Tax Administrators Internet site at *www.taxadmin.org/state-tax-forms* and indicate the titles of the following state tax forms and publications:
a. Minnesota Form M-100
b. Oklahoma Form 512 2-D
c. North Carolina Form D-403

I:15-59 ***Internet Research.*** Access the Urban Institute and Brookings Institution Tax Policy Center at *taxpolicycenter.org*. On the home page, search for *state individual income tax rates* and locate the Tax Policy Center's latest summary of each state's rates. Researchers also can locate the file by looking under the TAX FACTS tab and then the *State* tab, *Main Features of State Tax Systems*.
a. How many states do not have a state individual income tax?
b. How many states tax only interest and dividends for individuals?
c. What is the top marginal individual income tax rate in Oregon?
d. Of those that do impose an income tax, which state's top marginal rate is lowest?

COMPREHENSIVE PROBLEM

I:15-60 Your client, a physician, recently purchased a yacht on which he flies a pennant with a medical emblem on it. He recently informed you that he purchased the yacht and flies the pennant to advertise his occupation and thus attract new patients. He has asked you if he may deduct as ordinary and necessary business expenses the costs of insuring and maintaining the yacht. In search of an answer, consult the editorial materials in any tax service. Explain the steps taken to find your answer.

TAX STRATEGY AND CRITICAL THINKING PROBLEM

I:15-61 Your client, Home Products Universal (HPU), distributes home improvement products to independent retailers throughout the country. Its management wants to explore the possibility of opening its own home improvement centers. Accordingly, it commissions a consulting firm to conduct a feasibility study, which ultimately persuades HPU to expand into retail sales. The consulting firm bills HPU $150,000, which HPU deducts on its current year tax return. The IRS disputes the deduction, contending that, because the cost relates to entering a new business, it should be capitalized. HPU's management, on the other hand, firmly believes that, because the cost relates to expanding HPU's existing business, it should be deducted. In contemplating legal action against the IRS, HPU's management considers the state of judicial precedent: The federal court for HPU's district has ruled that the cost of expanding from distribution into retail sales should be capitalized. The appellate court for HPU's circuit has stated in *dictum* that, although in some circumstances switching from product distribution to product sales entails entering a new trade or business, improving customer access to one's existing products generally does not. The

Federal Circuit Court has ruled that wholesale distribution and retail sales, even of the same product, constitute distinct businesses. In a case involving a taxpayer from another circuit, the Tax Court has ruled that such costs invariably should be capitalized. HPU's Chief Financial Officer approaches you with the question, "In which judicial forum should HPU file a lawsuit against the IRS: (1) U.S. district court, (2) the Tax Court, or (3) the U.S. Court of Federal Claims?" What do you tell her?



CASE STUDY PROBLEM

I:15-62 A client, Mal Manley, fills out his client questionnaire for the previous year and on it provides information for the preparation of his individual income tax return. The IRS has never audited Mal's returns. Mal reports that he made over 100 relatively small cash contributions totaling $24,785 to charitable organizations. In the last few years, Mal's charitable contributions have averaged about $15,000 per year. For the previous year, Mal's adjusted gross income was roughly $350,000, about a 10% increase from the year before.

Required: Applying *Statements on Standards for Tax Services* No. 3, determine whether you can accept at face value Mal's information concerning his charitable contributions. Now assume that the IRS recently audited Mal's tax return for two years ago and denied 75% of that year's charitable contribution deduction because the deduction was not substantiated. Assume also that Mal indicates that, in the previous year, he contributed $25,000 (instead of $24,785). How do these changes of fact affect your earlier decision?

TAX RESEARCH PROBLEMS

I:15-63 The purpose of this problem is to enhance your skills in interpreting the authorities that you locate in your research. In answering the questions that follow, refer only to *Thomas A. Curtis, M.D., Inc.,* 1994 RIA TC Memo ¶94,015 (T.C. Memo 1994-15), 67 TCM 1958.

a. What was the principal controversy litigated in this case?
b. Which party—the taxpayer or the IRS—won?
c. Why is the corporation instead of Dr. and/or Ms. Curtis listed as the plaintiff?
d. What is the relationship between Ellen Barnert Curtis and Dr. Thomas A. Curtis?
e. Approximately how many hours a week did Ms. Curtis work, and what were her credentials?
f. For the fiscal year ending in 1989, what salary did the corporation pay Ms. Curtis? What amount did the court decide was reasonable?
g. What dividends did the corporation pay for its fiscal years ending in 1988 and 1989?
h. To which circuit would this decision be appealable?
i. According to *Curtis*, what five factors did the Ninth Circuit mention in *Elliotts, Inc.* as relevant in determining reasonable compensation?

I:15-64 Josh contributes $5,000 toward the support of his widowed mother, aged 69, a U.S. citizen and resident. She earns gross income of $2,000 and spends it all for her own support. In addition, Medicare pays $3,200 of her medical expenses. She does not receive financial support from sources other than those described above. Must the Medicare payments be included in the support that Josh's mother is deemed to provide for herself?

Prepare work papers and a client letter (to Josh) dealing with the issue.

I:15-65 Amy owns a vacation cottage in Maine. She predicts that the time during which the cottage will be used in the current year is as follows:

By Amy, solely for vacation	12 days
By Amy, making repairs ten hours per day and vacationing the rest of the day	2 days
By her sister, who paid fair rental value	8 days
By her cousin, who paid fair rental value	4 days
By her friend, who paid a token amount of rent	2 days
By three families from the Northeast, who paid fair rental value for 40 days each	120 days
Not used	217 days

Calculate the ratio for allocating the following expenses to the rental income expected to be received from the cottage: interest, taxes, repairs, insurance, and depreciation. The ratio will be used to determine the amount of expenses that are deductible and, thus, Amy's taxable income for the year.

For the tax manager to whom you report, prepare work papers in which you discuss the calculation method. Also, draft a memo to the file dealing with the results of your research.

I:15-66 Look up *Summit Publishing Company,* 1990 PH T.C. Memo ¶90,288 (T.C. Memo 1990-288), 59 TCM 833, and *J.B.S. Enterprises,* 1991 PH T.C. Memo ¶91,254 (T.C. Memo 1991-254), 61 TCM 2829, and answer the following questions:

a. What was the principal issue in these cases?
b. What factors did the Tax Court consider in resolving the central issue?
c. How are the facts of these cases similar? How are they dissimilar?

I:15-67 Your supervisor would like to set up a single Sec. 401(k) plan exclusively for the managers of your organization. Concerned that this arrangement might not meet the requirements for a qualified plan, he has asked you to request a determination letter from the IRS. In a brief memorandum, address the following issues:

a. What IRS pronouncements govern requests for determination letters?
b. What IRS forms must be filed with the request?
c. What information must be provided in the request?
d. What actions must accompany the filing?

CHAPTER

16

CORPORATIONS



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Define the types of entities that can be classified as a corporation for federal income tax purposes
2. Examine specific rules that apply to corporations
3. Calculate the corporate income tax liability
4. Apply the nonrecognition of gain or loss rules for corporate capitalizations
5. Understand the significance of earnings and profits
6. Determine the tax consequences of noncash distributions and stock redemptions
7. Understand the tax implications of a corporate liquidation for the liquidating corporation and its shareholders
8. Describe tax planning considerations for corporations
9. Describe compliance and procedural considerations for corporations

CHAPTER OUTLINE

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ADDITIONAL COMMENT

In 2017, total federal tax collections were $3,417 billion. Corporate income taxes accounted for 9.9% of federal tax revenues. Noncorporate (individual, trust, estate, etc.) income taxes accounted for 54.7% of federal tax revenues.

A business may be organized and operated as a **sole proprietorship, C corporation, S corporation, partnership, limited liability company (LLC)**, or **limited liability partnership (LLP)**. These business forms fall into two major categories: taxable entities and flow-through entities. The latter category also is referred to as tax conduits or pass-through entities. Sole proprietorships and C corporations fall into the taxable entity category although sole proprietorships are subject to a single level of tax, while C corporations are subject to two levels of tax. A sole proprietorship is not taxed directly because it is not considered to be a separate legal entity. Rather, the individual owner is taxed directly and reports the sole proprietorship's business income and expenses on Schedule C of Form 1040 (U.S. Individual Income Tax Return). The C corporation also is taxed directly and reports its tax results on Form 1120 (U.S. Corporation Income Tax Return). In addition, the corporation's shareholders are taxed if the C corporation pays dividends to them or if the shareholders sell their stock at a gain.[1] In this way, the C corporation organizational form results in two levels of taxation: once at the corporate level when income is earned and again at the shareholder level when income is distributed.

Despite its double taxation and sometimes complicated legal form, the corporation has the dual advantages of facilitating external financing and limiting the shareholders' legal liability. Some tax analysts question whether the burden of corporate taxation is borne directly by the corporate enterprise. These analysts argue that, depending on market conditions and terms of trade, the corporate enterprise might be able to shift the burden to consumers in the form of higher prices, employees in the form of lower salaries and wages, tenants in the form of higher rents, and shareholders in the form of lower dividends and stock values.

Flow-through entities, such as S corporations, partnerships, and limited liability companies, entail only one level of taxation at the ownership level. Accordingly, the entities themselves are not taxed, and the income and losses pass through to the shareholders of the S corporation, the partners of the partnership, or the members of the limited liability company. The owners then report the pass-through items on their separate tax returns and may offset a pro rata share of entity losses against their separate income. Some of these entities, such as S corporations and limited liability companies, offer the advantage of limiting all of their owners' legal liability. Such a feature is advantageous, especially where the business incurs extraordinary liability. Nevertheless, flow-through entities involve certain legal complexities and restrictions, which is one disadvantage of this form of organization. A comparison of the number of tax returns filed and taxable income for the four major business forms through tax year 2017 can be found in Table I:16-1.

This chapter explores the tax consequences of forming, operating, and liquidating a C corporation. Chapter I:17 discusses the basic tax rules pertaining to flow-through entities, and Table I:17-2 at the end of that chapter compares the alternative forms of business organizations. Detailed coverage of these two areas of taxation are reserved for this text's companion volume titled *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*.

DEFINITION OF A CORPORATION

OBJECTIVE 1

Define the types of entities that can be classified as a corporation for federal income tax purposes

Under Treasury Regulations,[2] a business entity with two or more owners may be classified as either a corporation or a partnership. An entity having only one owner may be classified as a corporation or a sole proprietorship. A business entity is a corporation if it is organized under a federal or state statute that refers to the entity as incorporated or as a corporation, body corporate, body politic, joint-stock company, or joint-stock association. Corporations also include insurance companies, state-chartered banks, and business entities wholly owned by a state or political subdivision. In general, with rare exceptions if a business entity incorporates, it is taxed as a corporation.

[1] A corporate liquidation is treated as a sale in which a shareholder receives cash and/or other assets from the liquidating corporation in exchange for his or her stock. The shareholder's recognized gain or loss upon a liquidating distribution generally is capital in character (IRC Sec. 331(a)). This topic is explored in greater detail in a later section of this chapter.

[2] Reg. Secs. 301.7701-1, -2, and -3.

▼ TABLE I:16-1
Comparison—Types of Returns

	Number of Returns Filed (in millions)				
Taxpayer Class	2017	2016	2015	2014	2013
Individuals	150.691	150.711	148.841	147.445	145.996
Partnerships	4.046	4.006	3.883	3.799	3.686
S corporations	4.843	4.832	4.717	4.643	4.566
C corporations[a, b]	2.050	2.208	2.216	2.221	2.248
Estates and Trusts	2.995	3.207	3.203	3.206	3.192

IRS, *Data Book*, 2017.
[a]The number shown includes returns for various types of domestic and foreign corporations and associations.
[b]Tax-exempt organizations filed 1,463,000 Form 990 series returns in 2013, 1,467,000 in 2014, 1,580,000 in 2015, 1,500,000 in 2016, and 1,528,000 in 2017.

On the other hand, if the business entity has two or more owners and is organized as a partnership, limited liability company, or limited liability partnership, the entity can elect to be *taxed* as either a partnership or corporation. The "check-the-box" regulations replace prior entity classification rules that involved subjective judgment and opened the door to manipulation.

EXAMPLE I:16-1 ▶ Al and Jane incorporate a business in Delaware. Because it is legally incorporated, the business is taxed as a corporation. Bill and Max form a limited liability company in Florida. For federal income tax purposes, the limited liability company can elect to be taxed as a corporation or a partnership. ◀

SIMILARITIES AND DIFFERENCES BETWEEN THE TAXATION OF CORPORATIONS AND INDIVIDUALS

Similarities. The computation of corporate taxable income is similar to that of sole proprietorship income. For example, under Sec. 162 corporations can deduct ordinary and necessary business expenses. They also may exclude from gross income items such as tax-exempt interest and life insurance proceeds. Corporations also can deduct interest (subject to limitations), depreciation, and other business-related expenses in a manner similar to that of unincorporated businesses.

In general, the IRC authorizes all taxpayers to use one of three methods of accounting—the accrual method, the cash method, and the hybrid method.[3] However, with certain exceptions C corporations generally must use the accrual method of accounting unless they meet certain conditions. Sec. 448 permits corporations engaged in a farming business, qualified personal service corporations, and entities having less than $26 million in gross receipts for each of the three prior tax years to use the cash method of accounting.[4] To simplify recordkeeping requirements for small businesses, Rev. Proc. 2002-28 permits qualified small businesses to adopt the cash method of accounting instead of the accrual method.[5]

[3] For a more complete discussion of accounting methods, see Chapter I:11.
[4] Sec. 448(b).
[5] Rev. Proc. 2002-28, 2002-1 C.B. 815 as modified by Rev. Proc. 2012-20, 2012-14 I.R.B. 700 and Rev. Proc. 2018-57, 2018-49 IRB 827. An eligible business has gross receipts of $10 million or less for all prior three-taxable year periods and not prohibited under Sec. 448 from otherwise using the cash method of accounting.

Corporations are entitled to many of the tax benefits available to sole proprietorships. C corporations can elect to claim the Sec. 179 expensing deduction that is available to sole proprietorships and partnerships. They also are eligible to claim the first-year bonus depreciation when available. In addition, owners of small corporations are eligible for a special exclusion of part or all of their gain on the sale of qualifying stock under Sec. 1202. Since 2003, capital gains rates on individuals have been lowered, thereby reducing the effective cost of selling a stock investment. Most investors will pay a 15% marginal tax rate on a stock gain. Similarly, most dividend income earned by individuals is now taxed at the same low rate.

ADDITIONAL COMMENT

According to a Tax Foundation estimate, Fortune 500 companies spend an average of $2.4 million per year on income-tax compliance. Approximately 70% is attributable to the federal income tax, especially provisions relating to foreign-source income and the alternative minimum tax.

Differences. One principal difference in computing corporate taxable income compared to individual taxable income is that personal, consumption-type expenditure write-offs apply solely to individuals. A few differences are worth noting:

- Computation of *adjusted gross income* (AGI) applies only to individuals.
- Corporations are not entitled to the standard deduction.
- Corporations are entitled to a dividends-received deduction of 50%, 65%, or 100% for qualifying dividends.
- Dividends received by an individual from a domestic corporation are typically taxed at 15%, although the rate for some taxpayers is 0% or 20%. The 0% rate applies only to single individuals whose taxable income falls below $39,375, while the 20% rate applies to single individuals with taxable income over $434,550, and the 15% rate applies to single individuals with taxable income between those numbers. The taxable income thresholds for the preferential rates for married filing jointly are $78,750 and $488,850 and for head of household are $52,750 and $461,700.
- Corporations are not allowed preferential tax treatment for net long-term capital gains nor are they allowed to deduct net capital losses against ordinary income. Individuals are allowed preferential tax treatment for net long-term capital gains and may deduct up to $3,000 per year of net capital losses against ordinary income.
- Corporate charitable contribution deductions are limited to 10% of taxable income (with certain adjustments described on page I:16-7 of this chapter), whereas individual charitable contribution deductions generally are limited to 60% of AGI.

ADDITIONAL COMMENT

Because dividends are subject to the 3.8% surtax on net investment income beginning in 2013, the overall rate on qualified dividends for some taxpayers is 23.8%.

SPECIFIC RULES APPLICABLE TO CORPORATIONS

OBJECTIVE 2

Examine specific rules that apply to corporations

CAPITAL GAINS AND LOSSES

The rules for netting long- and short-term capital gains and losses, netting Sec. 1231 (i.e., business fixed assets) gains and losses, and capital gain and loss holding periods are the same for both corporations and individuals. The netting process can be summarized as follows (see Schedule D of Form 1120–Capital Gains and Losses available on the IRS website):

- Long-term capital gains (LTCGs) are netted against long-term capital losses (LTCLs).
- Short-term capital gains (STCGs) are netted against short-term capital losses (STCLs).
- A net long-term capital gain (NLTCG) is then offset against a net short-term capital loss (NSTCL).
- A net long-term capital loss (NLTCL) is then offset against a net short-term capital gain (NSTCG).
- Following this initial netting process, if a corporation reports both a NLTCG and a NSTCG, both the NSTCG and the NLTCG are taxed at ordinary income rates.
- NSTCGs are netted against NLTCLs, and any excess is taxed at ordinary income rates.
- NLTCLs and NSTCLs may not be deducted from ordinary income.

EXAMPLE I:16-2 ▶ Gulf Corporation realizes the following capital gains and losses during the current year:

LTCG	$15,000
LTCL	5,000
STCG	3,000
STCL	8,000

Gulf has a $10,000 NLTCG and a $5,000 NSTCL. The NLTCG is offset against the NSTCL, resulting in a $5,000 net capital gain that is taxed at ordinary income rates. ◀

EXAMPLE I:16-3 ▶ High Corporation realizes the following capital gains and losses during the current year:

LTCG	$15,000
LTCL	5,000
STCG	10,000
STCL	8,000

High has a $10,000 NLTCG and a $2,000 NSTCG. Both the $2,000 NSTCG and the $10,000 NLTCG are taxed at ordinary income rates. ◀

EXAMPLE I:16-4 ▶ Huge Corporation realizes the following capital gains and losses during the current year:

LTCG	$ 5,000
LTCL	15,000
STCG	8,000
STCL	10,000

Huge Corporation has a $10,000 NLTCL and a $2,000 NSTCL. In computing its current year taxable income, Huge may not deduct either net loss against its ordinary income. ◀

SELF-STUDY QUESTION

What are the major differences in the taxation of the capital gains and losses of individuals and cor- porations?

Corporate Capital Loss Limitations. For corporations, neither a NLTCL nor a NSTCL is deductible against ordinary income in the year it is incurred. Instead, it is eligible for a 3-year carryback and 5-year carryforward and may be offset against capital gains in those years.[6] Both the NSTCL and the NLTCL are treated as STCLs for purposes of the carryback and carryforward. The corporate capital loss limitations and carryback-carryforward rules differ from those applicable to noncorporate taxpayers (see the discussion in Chapter I:5).[7]

EXAMPLE I:16-5 ▶ Assume the same facts as in Example I:16-4. The $10,000 NLTCL and the $2,000 NSTCL are nondeductible in the current year. The $12,000 ($10,000 + $2,000) is carried back as a STCL to the third previous year. If the net gains in the carryback years are insufficient to absorb the $12,000 STCL, the excess is carried over up to 5 years. ◀

ANSWER

First, an individual can offset $3,000 of capital losses against ordinary income. Second, an individual has an indefinite carryforward instead of a 3-year carryback and a 5-year carryforward that applies to corporations. Third, all corporate capital loss carrybacks and carryforwards are treated as STCLs. Finally, noncorporate taxpayers receive a preferential tax rate on most net capital gains. This preferential tax rate is 0%, 15%, or 20%, depending on the taxpayer's income level. However, taxpayers whose modified AGI exceeds $200,000 ($250,000 for married filing jointly) have to apply an additional 3.8% rate to net investment income. For a more complete discussion, see Chapter I:5.

DIVIDENDS-RECEIVED DEDUCTION

Corporations may deduct 65% of dividends received from a domestic corporation if the recipient corporation owns 20% or more of the voting power and value of the dividend-paying corporation's stock.[8] If a corporation owns less than 20% of the dividend-paying corporation's stock, the deduction is 50% of dividends received. The percentage increases to 100% if the dividend is received from an 80%-or-more-owned corporation for which a consolidated tax return election has not been made. This deduction mitigates the onerous effects of triple taxation, where one corporation (a subsidiary) pays dividends to a corporate shareholder (its parent corporation), which in turn distributes an equal amount to its shareholders.

The following table sets forth the dividends-received deduction percentages.

Percentage of Stock Owned	*Dividends-Received Deduction*
Less than 20%	50%
20% through 79.99%	65%
80% or more	100%

[6] Secs. 1211(a) and 1212(a).

[7] Noncorporate taxpayers (e.g., individuals) can deduct up to $3,000 of net capital losses against ordinary income annually. Unused capital losses of a noncorporate taxpayer are carried over (but not carried back) for an indefinite time period and retain their character as long- or short-term.

[8] The dividends-received deduction rules are set forth in Secs. 243 and 246.

SELF-STUDY QUESTION

Calculate the maximum effective tax rate on dividends received by a corporation from a second corporation that is less than 20%- owned.

ANSWER

The maximum effective tax rate is 10.5% (50% dividend inclusion times the corporate tax rate of 21%).

The 65% and 50% **dividends-received deductions** are subject to the following limitations:

- The dividends-received deduction is limited to 65% (or 50%) of taxable income computed without regard to the net operating loss (NOL) deduction, the dividends-received deduction, or capital loss carrybacks to the limitation year.
- The limitation does not apply if the corporation generates an NOL in the current year after taking the dividends-received deduction determined under the general rules.
- The dividends-received deduction is not available if the distributing corporation's stock is held by the distributee for 45 or fewer days within the 90-day period that commences 45 days before the ex-dividend date.

EXAMPLE I:16-6 ▶ King Corporation reports the following income and expense items during the current year:

Net income from operations	$ 50,000
Dividends from two 20%-owned corporations	200,000

The dividends-received deduction determined under the general rule is $130,000 (0.65 × $200,000 dividends). The deduction limitation is $162,500 (0.65 × $250,000 of taxable income before the dividends-received deduction). Because the limitation ($162,500) exceeds the dividends-received deduction determined under the general rule ($130,000), the entire $130,000 dividends-received deduction is allowed. ◀

EXAMPLE I:16-7 ▶ Assume the same facts as in Example I:16-6, except that the corporation incurred a $10,000 net loss from operations. The dividends-received deduction determined under the general rule is $130,000 (0.65 × $200,000 dividends). The limitation under the general rule is based on taxable income before the dividends-received deduction of $190,000 ($200,000 − $10,000). The limitation is $123,500 (0.65 × $190,000). As illustrated below, no NOL results after deducting the entire 0.65% dividends-received deduction determined under the general rule:

ADDITIONAL COMMENT

Although corporations are allowed a dividends-received deduction, they are not allowed a dividends-paid deduction in computing taxable income.

Net loss from operations	$ (10,000)
Plus: Dividends received from 20% (or more) owned corporations	200,000
Minus: Dividends-received deduction (0.65 × $200,000)	(130,000)
Taxable income as determined under the general rule	$ 60,000

Because the dividends-received deduction is limited to $123,500, the recognized taxable income for the year is $66,500 ($190,000 − $123,500). ◀

EXAMPLE I:16-8 ▶ Assume the same facts as in Example I:16-7, except that the loss from operations is $80,000. The dividends-received deduction determined under the general rule is $130,000 (0.65 × $200,000 dividends). The limitation is $78,000 (0.65 × $120,000 of taxable income before the dividends-received deduction). The limitation, however, does not apply because a $10,000 NOL results after taking the entire dividends-received deduction determined under the general rule.

ADDITIONAL COMMENT

Even though the dividends received deduction creates (or increases) an NOL, the corporation gets the full benefit of the deduction because it can carry back or carry over the NOL.

Net loss from operations	$ (80,000)
Plus: Dividends received	200,000
Minus: Dividends-received deduction (0.65 × $200,000)	(130,000)
Taxable income	$ (10,000)

Therefore, the entire $130,000 dividends-received deduction is allowed. ◀

EXAMPLE I:16-9 ▶ On June 1, Lean Corporation acquires 5% of Madison Corporation stock. Madison pays a cash dividend to all shareholders of record on June 15. Lean receives the dividend on June 20. On July 1, Lean sells its Madison stock. A dividends-received deduction is not allowed because Lean does not own the Madison stock for the required 46 days within the 90-day period that commences 45 days before the ex-dividend date (June 15). ◀

The Tax Cuts and Jobs Act of 2017 fundamentally changed the tax treatment of dividends that a U.S. corporation receives from a foreign corporation. The new law adopts a quasi-territorial tax system that allows domestic corporations to claim a 100% dividends-received deduction for dividends received from foreign subsidiaries that are owned at least 10% by the domestic corporation and have only foreign earnings. This change recognizes that host countries tax income earned locally. The dividends-received deduction is prorated in the case of foreign subsidiaries with both domestic and foreign-source earnings. This change applies to distributions made after December 31, 2017.

BOOK-TAX ACCOUNTING COMPARISON

The dividends-received deduction is a tax concept. No such expense or adjustment exists for financial reporting purposes.

NET OPERATING LOSSES

Unlike the computation of individual NOLs, the computation of a corporate **net operating loss** (NOL) does not involve adjusting nonbusiness deductions and capital gains and losses. (See Chapter I:9 for a discussion of these adjustments for individuals.[9]) In the corporate NOL computation, the full dividends-received deduction is allowed. However, no deduction for an NOL carryover or carryback from a preceding or succeeding year is allowed.

EXAMPLE I:16-10 ▶ The computation of Maine Corporation's NOL for 2019 is based on the following taxable items:

Operating income	$ 400,000
Plus: Dividends received from 20% (or more) owned corporations	300,000
Gross income	$ 700,000
Minus: Business operating expenses	(600,000)
Dividends-received deduction (0.65 × $300,000)	(195,000)
Net operating loss	$(95,000)

In general, NOLs are carried forward indefinitely to offset taxable income in future years. Thus, Maine's NOL can be carried forward until it is completely used.[10] ◀

The deduction in any year for an NOL carried forward from a preceding year depends on when the NOL was generated. NOLs generated in years beginning before January 1, 2018 are fully deductible to the extent of taxable income in the carryover year. NOLs generated after December 31, 2017 are limited to 80% of taxable income before the NOL deduction in the carryover year. Thus, for NOLs generated after December 31, 2017, the NOL deduction in the carryover year is the lesser of the aggregate NOL carryovers or 80% of taxable income computed without regard to the NOL deduction. Any amount of NOL carryover deduction disallowed because of the 80% limit carries forward indefinitely.

ADDITIONAL COMMENT

For purposes of determining the charitable contribution deduction limit, taxable income is calculated without regard to loss carrybacks, but NOL and capital loss carryovers are reflected in calculating taxable income.

CHARITABLE CONTRIBUTIONS

Some of the charitable contribution rules applicable to individuals also apply to corporations (e.g., the restriction on contributions of ordinary income property discussed in Chapter I:8).[11] The following rules apply solely to corporations:

- Under the general rule, a payment must be made before a contribution deduction is allowed. However, corporations using the accrual method of accounting may accrue a contribution deduction in the year preceding payment if before the end of the tax year the contribution is authorized by the board of directors and is made within 2½ months of the end of the tax year.
- Section 170(e) allows an increased charitable deduction for certain corporate property contributions. The increased deduction is available for (1) property used to care for the ill, needy, or infants; (2) scientific research property used by colleges or universities for research and experimentation; and (3) computer technology, software, and peripherals donated to educational institutions for use in grades kindergarten through 12. In each case the amount of the deduction equals the donor's adjusted basis in the property plus one-half of the excess of the property's FMV over its adjusted basis (not to exceed twice the property's adjusted basis).
- Corporate charitable contributions are limited to 10% of taxable income (computed without regard to the charitable contribution deduction, NOL and capital loss carry*backs*, or the dividends-received deduction).
- Unused contribution amounts are carried forward 5 years. In the carryover year, the current year's contribution amount first is deducted to the extent of the 10% limitation. Contribution carryovers from the earliest year then are deducted to the extent of any unused limitation amount.

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[9] The NOL rules are set forth in Sec. 172.

[10] In an exception to the general rules, NOLs incurred by farming businesses and insurance companies (other than life insurance companies) can be carried back to the two tax years preceding the NOL year. Losses not used in the carryback period may be carried forward, indefinitely for farming businesses and for 20 years for insurance companies. Further, NOLs incurred in tax years ending before December 31, 2017 may be carried back to the two tax years preceding the NOL year and then forward for 20 years succeeding the NOL year.

[11] Rules pertaining to charitable contributions are set forth in Sec. 170.

EXAMPLE I:16-11 ▶ Mesa Corporation reports the following results for 2019:

Taxable income (before deducting dividends-received and charitable contributions)	$130,000
Dividends-received deduction	10,000
Charitable contributions	20,000

Mesa has never incurred an NOL. The limitation on contributions is $13,000 ($130,000 × 0.10), and taxable income is $107,000 ($130,000 − $13,000 − $10,000). The $7,000 ($20,000 − $13,000) excess contribution amount carries forward 5 years (2020–2024). ◀

EXAMPLE I:16-12 ▶ Assume the same facts as in Example I:16-11 in 2020, except that taxable income (before deducting dividends-received and charitable contributions) is $220,000. The contribution limitation now is $22,000 ($220,000 × 0.10). The $20,000 charitable contribution for 2020 first is deducted to the extent of the $22,000 limitation, leaving a $2,000 unused excess. Thus, $2,000 of the carryforward from 2019 is deductible to the extent of this unused limitation, leaving a $5,000 carryforward from 2019, which may be used in tax years 2021 through 2024. ◀

COMPENSATION DEDUCTION LIMITATION FOR PUBLICLY HELD CORPORATIONS

A publicly held corporation is denied a deduction for compensation paid to its chief executive officer, its chief financial officer, and its three highest compensated officers other than the chief executive and financial officers if the compensation for that individual exceeds $1 million per year.[12] Includible compensation includes both cash and noncash benefits. The following types of compensation are not taken into account for purposes of calculating the $1 million limitation:

- Payments to a qualified retirement plan
- Tax-free employee benefits (such as employer-provided health care and Sec. 132 fringe benefits)

EXAMPLE I:16-13 ▶ Pine Corporation is a publicly held company whose securities are listed on the New York Stock Exchange. In the current year, Pine compensates its chief executive officer, Rodney, as follows: salary, $1,200,000; commissions based on sales generated by Rodney, $400,000; payments to a qualified pension plan, $25,000; and tax-free fringe benefits, $10,000. The payments to the qualified pension plan and tax-free fringe benefits are not subject to the $1 million annual deduction limitation. Thus, $600,000 ($1,600,000 − $1,000,000) of Rodney's compensation is not deductible by Pine even though Rodney is taxed on the entire $1,600,000. ◀

For a summary of the rules relating to corporate capital gains and losses, dividends-received deduction, net operating losses, charitable contribution deduction, and compensation deduction, see Topic Review I:16-1.

[12] Sec. 162(m). A publicly held corporation is any corporation issuing any class of securities required to be registered under Section 12 of the Securities Exchange Act of 1934. This corporation generally has securities listed on a national securities exchange, or has at least $5 million or more of assets and 500 or more shareholders.

TOPIC REVIEW I:16-1

Summary of Rules for Calculating Corporate Taxable Income

Capital Gains and Losses

- If a net loss results from netting long-term and short-term capital gains and losses, none of this loss can be deducted from ordinary income. Instead, the loss may be carried back 3 years and forward up to 5 years and is treated as short-term in character (i.e., STCL).
- Corporate net capital gains do not receive favorable tax treatment. The 15% preferential tax rate for net capital gains (or 0% for lower-income taxpayers and 20% for higher-income taxpayers) applies to individuals but not C corporations.

Dividends-Received Deduction

- The dividends-received deduction is 65% if the corporate shareholder owns 20% or more of stock in the domestic dividend-paying corporation, and 50% if the corporate shareholder owns less than 20%. A 100% deduction is available for dividends received from an 80%-or-more-owned member of an affiliated group that does not file a consolidated tax return.
- The dividends-received deduction is limited to 65% (or 50% as the case may be) of taxable income (after adjustments for the NOL deduction, the dividends-received deduction, and capital loss carrybacks) unless the corporate shareholder generates an NOL after deducting the full amount of dividends-received.

Charitable Contributions

- Accrual-basis corporate donors may accrue a current year deduction if the contribution is authorized by the board of directors and paid within 2½ months after the end of the current tax year.
- Corporations are allowed increased deductions for contributions of qualifying property used (1) to care for the ill, needy, or infants, (2) to conduct research or experimentation in colleges or universities, or (3) by educational institutions in grades kindergarten through 12.
- Contributions are limited to 10% of taxable income (adjusted for certain taxable items).
- Unused charitable contributions are carried forward up to 5 years.

NOL and Compensation

- In general, NOLs may be carried forward indefinitely.
- Publicly held corporations are denied a deduction for compensation exceeding $1 million paid to certain key executives.

Computation of Tax

OBJECTIVE 3

Calculate the corporate income tax liability

ADDITIONAL COMMENT

Most states impose an income tax on C corporations. Some states exempt S corporations from the state corporate income tax.

COMPUTATION OF TAXABLE INCOME

Table I:16-2 illustrates the computation of **taxable income** for a C corporation.

COMPUTATION OF REGULAR TAX

The corporate income tax rate is a flat 21% of taxable income.[13]

EXAMPLE I:16-14 ▶ Able Corporation's taxable income for the current year is $100,000. Ajax Corporation's taxable income for the current year is $335,000. The two firms' tax liabilities are $21,000 (0.21 × $100,000) and $70,350 (0.21 × $335,000).

[13] Sec. 11(b)(1).

ADDITIONAL COMMENT

For tax years beginning before January 1, 2018, the regular corporate income tax was computed according to a graduated tax rate schedule, with rates ranging from 15% for low-income corporations to 35% for high-income corporations. A special 35% flat rate applied to personal service corporations (i.e., corporations that perform services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, where substantially all of the corporate stock is held by current or retired employees or the estates of deceased employees). The Tax Cuts and Jobs Act of 2017 introduced the current flat 21% tax rate, and this rate applies to both regular and personal service corporations.

▼ TABLE I:16-2
Computation of Corporate Taxable Income

Sales	$600,000
Minus: Cost of goods sold	(300,000)
Gross profit	$300,000
Plus: Other income	
Dividends from 25%-owned corporation	$100,000
Interest	10,000
Long-term capital gain	90,000
Gross income	$500,000
Minus: Deductions:	
Salaries	$ 80,000
Repairs	20,000
Bad debts	27,000
Taxes	10,000
Contributions (subject to the 10% corporate limitation, as discussed on page I:16-7)	5,000
Depreciation	20,000
Pension and profit-sharing contributions	35,000
Total deductions	$197,000
Taxable income before special deductions	$303,000
Minus: Special deductions:	
Net operating loss deduction	(15,000)[a]
Dividends-received deduction	(65,000)[b]
Taxable income	$223,000

[a]This amount represents a net operating loss carried over from a prior year.
[b]0.65 × $100,000 = $65,000 dividends-received deduction.

THE CORPORATE ALTERNATIVE MINIMUM TAX (AMT) AND THE MINIMUM TAX CREDIT (MTC)

For tax years beginning before December 31, 2017, corporations were subject to an alternative minimum tax (AMT) similar to that for individuals (see Chapter I:14 for a discussion of the AMT for individuals). The computation of the corporate AMT involved a broader tax base and lower tax rate than the regular income tax, and its purpose was to ensure that corporate taxpayers with substantial economic income paid a minimum amount of federal tax. If a corporation's AMT liability exceeded its regular (income) tax liability, the corporation paid both the excess amount and the regular tax. However, a corporation required to pay the AMT in a given tax year was allowed to carry over the AMT amount in excess of its regular (income) tax to future years as a minimum tax credit (MTC). In any subsequent tax year where the corporation's regular (income) tax liability exceeded its AMT liability, the corporation could apply the MTC carryover to reduce its regular tax down to the amount of the AMT liability. The MTC had an indefinite life.

The Tax Cuts and Jobs Act of 2017 repealed the corporate AMT for tax years beginning after December 31, 2017. As part of the repeal, the Act provides for the accelerated use of pre-existing unused MTC carryovers. For tax years beginning in 2018 through 2020, any MTC from prior AMT years is allowed to the extent of the regular tax liability plus 50% of the excess of the MTC over the amount credited against the regular tax. This 50% excess is treated as a refundable tax credit. In years beginning in 2021, 100% of the excess will be allowed as a refundable credit.[14]

[14] Sec. 53.

EXAMPLE I:16-15 ▶ Allied Corporation's taxable income for 2019 is $100,000, resulting in a regular income tax liability of $21,000 (0.21 × $100,000). Allied also has an MTC carryover of $50,000 from prior AMT years. Allied is able to use $35,500 of the MTC carryover in 2019 [$21,000 regular tax + (0.50 × $29,000 excess MTC over regular tax)], eliminating its regular tax liability and resulting in a $14,500 refundable credit amount. Allied's remaining MTC of $14,500 is carried over indefinitely until used. ◀

PENALTY TAXES

Intended to deter otherwise abusive tax planning practices are two penalty taxes: the accumulated earnings tax and the personal holding company tax. The computation of both taxes is based on complex rules that are discussed in more detail in the companion volume to this text, *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*. These rules are summarized below.

Accumulated Earnings Tax. The **accumulated earnings tax** aims at discouraging companies from retaining excessive earnings invested in assets unrelated to business needs.[15] A company might avoid liability for this tax if its earnings are reinvested in operating assets or retained for the reasonable needs of the business. If not for this tax, closely held corporations might not pay dividends to their shareholders (thereby avoiding the double taxation of their earnings). The retained earnings then might be used for passive investment purposes.

Reasonable needs of the business are associated with numerous activities, including the following:

- ▶ Reasonably anticipated business expansion and plant replacement
- ▶ Acquiring the assets or stock (other than portfolio investments) of another business
- ▶ Providing working capital for the business
- ▶ Establishing a sinking fund to retire corporate debt
- ▶ Investing or lending to suppliers or customers

The accumulated earnings tax generally is imposed on closely held corporations. However, the tax may be imposed on a publicly held corporation if effective control is in the hands of a few related shareholders.[16]

The accumulated earnings tax base is the corporation's accumulated taxable income for a particular year. The accumulated earnings tax rate is 20%. Shareholders subject to a tax rate less than 20% on dividends can reduce the corporation's accumulated earnings tax exposure by having the corporation distribute dividends, taxed to the shareholders at a 0% or 15% rate. Accumulated taxable income is computed as follows:

Taxable income
Plus: Dividends-received deduction
Net operating loss deduction
Minus: Net capital losses
Net long-term capital gains over net short-term capital losses (less federal income tax on such net gains)
Federal income tax liability
Charitable contributions exceeding 10% corporate limitation
Deductions for dividends paid or deemed paid[17]
Accumulated earnings credit
Accumulated taxable income

ADDITIONAL COMMENT

The accumulated earnings tax can be avoided by the payment of a large enough dividend or by making an S corporation election. The accumulated earnings tax does not apply during the years the S corporation election is in effect.

The accumulated earnings credit equals the greater of (1) $250,000 minus accumulated earnings and profits (E&P) at the beginning of the year[18] or (2) the amount of E&P for the

[15] The basic rules for the accumulated earning tax are set forth in Code Secs. 531–537.
[16] Sec. 532(c) and *Golconda Mining Corp. v. CIR*, 35 AFTR 2d 75-336, 74-2 USTC ¶9845 (9th Cir., 1974).
[17] Sec. 561. The deduction for dividends paid includes dividends actually paid during the tax year and consent dividends (e.g., hypothetical dividends) where the shareholders agree to be taxed on such amounts. Under Sec. 563, dividends paid during the first 2½ months following the end of the tax year are considered paid on the last day of the preceding tax year.
[18] The $250,000 credit amount is reduced to $150,000 for service corporations engaged in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

tax year that is retained for the reasonable needs of the business. The reasonable needs of the business are determined at year-end and are reduced by accumulated E&P at the beginning of the year. Thus, only the amount of E&P that is retained to meet the increase in reasonable business needs may be claimed as a credit. (E&P is defined later in this chapter.)

EXAMPLE I:16-16 ▶ In the current year, Compact Corporation earns taxable income of $100,000. Compact's federal tax liability is $21,000, and the corporation paid $10,000 in dividends to its shareholders. Compact claims a deduction of $65,000 for $100,000 of dividends received. Accumulated E&P at the beginning of the year for the reasonable needs of the business is $200,000. Compact's reasonable needs of the business at year-end require $220,000 of funding. Accumulated taxable income and the accumulated earnings credit are computed as follows:

Taxable income		$100,000
Plus: Dividends-received deduction		65,000
Minus: Federal income tax liability		(21,000)
Dividends-paid deduction		(10,000)
Accumulated earnings credit—the greater of:		
(1) $250,000 (statutory exemption) – $200,000 (accumulated E&P at the beginning of the year)	$50,000	
(2) E&P retained for the increased reasonable needs of the business ($220,000 – $200,000)	or $20,000	(50,000)
Accumulated taxable income		$ 84,000

Compact's accumulated earnings tax liability is $16,800 (0.20 × $84,000). It pays this tax in addition to its regular income tax. Compact's total federal tax liability is $37,800 ($21,000 + $16,800). ◀

An IRS auditor will likely examine Schedules L and M-2 of Form 1120 (U.S. Corporation Income Tax Return) to determine if accumulated earnings are excessive. The auditor will examine Schedule L (the balance sheet) to identify the assets owned by the business. Substantial marketable securities, loans to shareholders, and nonbusiness assets (for example, a boat or resort condominium) might suggest that the corporation is retaining excessive earnings. The corporation could have distributed these earnings to its shareholders in the form of dividends. Loans to shareholders might suggest the corporation's reluctance to distribute its earnings. The IRS auditor will look at Schedule M-2 to see if the corporation has declared and paid any dividends to the shareholders. To avoid the accumulated earnings tax the corporation might argue that it has consistently paid dividends.

WHAT WOULD YOU DO IN THIS SITUATION?

Scott, Steve, and Sean own 100% of the outstanding stock of Sofa Corporation for all of the current year. In its first 12 years of existence, Sofa Corporation, a manufacturer of custom-made sofas, never paid a dividend to its shareholders. It preferred instead to retain its earnings for working capital, additional machinery, and short-term investments. Scott and Steve would like to borrow money from Sofa because Scott is planning to open a florist shop, and Steve needs a loan to pay off personal debts. For these reasons, Sofa will not pay a dividend in the current year. However, the company intends to pay dividends next year when the two loans have been paid off. Sofa has accumulated E&P (before any distributions) exceeding $250,000. As Sofa's tax consultant, you inform the shareholders of the possibility that the company will be liable for the accumulated earnings tax. The shareholders ask you if they should inform the IRS of potentially excessive earnings, voluntarily pay the tax, or just wait to be audited by the IRS.

a. **What advice would you give the shareholders regarding reporting the potentially excessive earnings and the payment of the tax? (See the Statements on Responsibilities in Tax Practice section in Chapter I:15 and Appendix E.)**
b. **What advice would you give the shareholders if the corporation instead reported low operating profits from its sofa-making business and met both personal holding company requirements in the current year?**

ADDITIONAL COMMENT

The personal holding company tax is imposed mechanically, whereas the accumulated earnings tax is based on a subjective standard of purpose to avoid the tax.

Personal Holding Company Tax. A corporation is considered a personal holding company if both of the following tests are met:[19]

- More than 50% of the value of its outstanding stock is owned by five or fewer individuals at some time during the last six months of the tax year.
- 60% or more of its adjusted ordinary gross income is personal holding company income. Personal holding company income consists of passive income, including dividends, interest, and in some circumstances, rent.

Many closely held corporations pass the 50% stock ownership test because of family ownership attribution rules. For example, 20 family shareholders (e.g., spouses, children, and grandchildren) may count as a single shareholder for purposes of applying the 50% and five or fewer shareholder tests.

ADDITIONAL COMMENT

The personal holding company tax can be a problem in a corporation's final year as the entity scales down its operations. The corporation may have discontinued its operations, sold its assets, and earned primarily investment income.

The personal holding company tax discourages the conversion of closely held operating companies into nonoperating companies that reinvest substantial earnings in passive investments (e.g., stocks and bonds of other companies). The tax compels a company to distribute its earnings to shareholders if the earnings are not reinvested in operating assets. Liability for the personal holding company tax does not require a tax-avoidance motive. By contrast, liability for the accumulated earnings tax does require an intent to avoid the tax on dividends.

The accumulated earnings tax cannot be imposed in the same year the corporation is deemed to be a personal holding company. Often, a corporation that gradually converts itself into a nonoperating company by reinvesting its earnings in passive investments will incur an accumulated earnings tax liability before incurring a personal holding company tax liability. However, this is not always the case. For example, a newly-formed corporation that temporarily invests surplus funds in nonoperating assets may be deemed to be a personal holding company in its first year of operation, while the $250,000 accumulated earnings credit temporarily shields the same company from the accumulated earnings tax.

Computation of Personal Holding Company Tax. The **personal holding company tax** is the product of the personal holding company tax rate times undistributed personal holding company income. Various adjustments are made to regular taxable income to derive the personal holding company tax base. These adjustments are similar to those made in calculating the accumulated earnings tax, as illustrated in Example I:16-16. The personal holding company tax rate is 20%.

EXAMPLE I:16-17 ▶ Crane Corporation has four shareholders who together own more than 50% of the value of Crane stock at all times during the current year. More than 60% of Crane's adjusted gross income is personal holding company income (dividends, interest, etc.). Crane is a personal holding company for the current year because both the stock ownership and the income tests are met. Crane receives a $25,000 dividend for which it claims a $16,250 dividends-received deduction. It pays $18,750 of dividends to its shareholders. Crane has $200,000 of regular taxable income and a $42,000 regular tax liability.

Crane's personal holding company tax is computed as follows:

ADDITIONAL COMMENT

The personal holding company tax, like the accumulated earnings tax, can be avoided by paying a large enough dividend or by making an S corporation election. A timely S corporation election precludes the corporation from being classified as a personal holding company for the years it is in effect.

Regular taxable income	$200,000
Adjustments:	
Federal income tax liability	(42,000)
Dividends-received deduction	16,250
Dividends-paid deduction[20]	(18,750)
Undistributed personal holding company income	$155,500
Times: Personal holding company tax rate	× 0.20
Personal holding company tax	$ 31,100

[19] The basic rules for personal holding companies are set forth in Secs. 541–547.

[20] Secs. 547 and 561. The dividends-paid deduction is available for dividends paid during the tax year, dividends paid within 2½ months following the end of the tax year (subject to certain limitations), consent dividends, and dividends paid within 90 days following an IRS determination that a personal holding company tax is owed (i.e., deficiency dividends). Deficiency dividends are not allowed in computing the accumulated earnings tax.

TOPIC REVIEW I:16-2

Comparison of the Two Corporate Penalty Taxes

Item	Accumulated Earnings Tax—Sec. 531	Personal Holding Company (PHC) Tax—Sec. 541
Reason for imposing the penalty tax	To discourage companies from retaining excessive earnings if such earnings are invested in nonoperating assets. A primary purpose is to compel the distribution of excessive earnings.	To discourage the conversion of closely held operating companies into passive investment companies. A primary purpose is to compel the distribution of passive income.
Elements of the tax formula	The tax base is regular taxable income plus or minus certain adjustments. The tax computation involves subjective judgment because the accumulated earnings credit (which often reduces the tax base to zero) is a function of retaining earnings for the reasonable needs of the business.	The determination of whether a corporation is a personal holding company and the computation of the tax is mechanical. Once the corporation is deemed to be a PHC, its tax base is regular taxable income plus or minus certain adjustments.
Computation of tax	Adjustments are made to taxable income for items such as the dividends- received deduction, the dividends-paid deduction, the federal income tax liability, and the accumulated earnings credit (see Example I:16-16). The tax rate is 20% of accumulated taxable income.	Adjustments are made to regular taxable income for items such as the dividends-received deduction, dividends-paid deduction, and the federal income tax liability to derive undistributed PHC income (see Example I:16-17). The tax rate is 20% of undistributed PHC income.

Crane's total federal tax liability is $73,100 ($42,000 + $31,100). Payment of the $31,100 personal holding company tax may be avoided if Crane distributes all of the personal holding company income to its shareholders. Special rules allow personal holding companies to distribute this income and avoid the personal holding company tax even after the corporation's year-end. Crane shareholders then pay the regular income tax on the dividend distribution. ◄

Topic Review I:16-2 compares the accumulated earnings tax and personal holding company tax rules.

ADDITIONAL COMMENT

Historically, the potential tax savings resulting from dividing a business into two or more corporations included making strategic use of the graduated tax rate structure (i.e., apportioning taxable income to the corporation(s) with lower tax rates). The flat 21% corporate income tax rate provided by the Tax Cuts and Jobs Act of 2017 eliminates this strategy. Nonetheless, mitigation of tax avoidance through other tax attributes remains an objective of the tax rules for controlled groups.

COMPUTATION OF TAX FOR CONTROLLED GROUPS

Shareholders in one corporation could realize substantial tax savings by dividing the business into two or more corporations. These tax savings result from the corporations' benefitting from duplicate use of tax attributes, such as the Sec. 179 expense limitation and the accumulated earnings credit. To prevent this type of tax avoidance, a **controlled group** must apportion tax attributes among group members as if only one corporation exists.[21] An equal apportionment to each member is required unless all group members consent to a disproportionate allocation. A controlled group, as discussed below, is a group of corporations that are, in general, owned by the same shareholder or group of shareholders. Controlled groups may be classified into three types: brother-sister, parent-subsidiary, and combined. These three types are discussed below.

[21] Sec. 1561.

Brother-Sister Controlled Group. The IRC sets forth two definitions of a **brother-sister controlled group**. This textbook will refer to them as the 80%-50% definition and the 50%-only definition. Under the 80%-50% definition, a brother-sister controlled group exists if the following conditions are met:

ADDITIONAL COMMENT

In practice, brother-sister corporations are associated with one or a small number of taxpayers, owning several small, closely-held corporations.

- Five or fewer individuals, estates, or trusts own at least 80% of the voting power or value of all classes of stock of each corporation.[22]
- The shareholders commonly own more than 50% of the total voting power or value of all classes of stock. For the purpose of this condition, stock is counted only to the extent that each shareholder owns an identical interest in each corporation.[23] The term *identical interest* means the smallest overlapping percentage of stock owned by the shareholder in any corporation included in the brother-sister group.

Thus, under the 80%-50% definition, the five or fewer shareholders not only must have more than 50% common ownership in the corporations, but also must own at least 80% of the stock in each brother-sister corporation. This definition is narrow because the shareholders must meet two tests.

The 50%-only definition is broader because the five or fewer shareholders must satisfy only the 50% common ownership test. Consequently, in situations where the 50%-only definition applies, more corporations may be deemed to be members of a controlled group than under the 80%-50% definition. The 50%-only definition applies for apportioning the accumulated earnings credit. The 80%-50% definition applies for other purposes, such as apportioning the Sec. 179 expense limitation.

EXAMPLE I:16-18 ▶ The single classes of stock in First, Second, and Third Corporations are owned by Amir, Beth, Carol, Dawn, and Edith as follows:

	Corporation			
Individuals	*First*	*Second*	*Third*	*Identical Interest*
Amir	40%	20%	20%	20%
Beth	30	30	60	30
Carol	10	40	10	10
Dawn	10	10	—	—
Edith	10	—	10	—
Total	100%	100%	100%	60%

This group meets both the 80%-50% test and the 50%-only test. The 80%-50% test is met because five or fewer individuals own at least 80% of First, Second, and Third stocks and because Amir, Beth, and Carol own 80% of First stock and 90% of Second and Third stocks. For purposes of the 80% test the stock ownership of Dawn and Edith is not counted because they do not own stock in each of the three corporations. The 50% test also is met because common ownership exceeds 50% (60% of identical interests). For purposes of the 50%-only test, the stock ownership of Dawn and Edith is not counted because they do not own stock in each of the three corporations. In this example, the 50%-only test also is met. ◀

Parent-Subsidiary Controlled Groups. A **parent-subsidiary controlled group** exists if the following conditions are met:

- A common parent corporation owns at least 80% of the stock in at least one subsidiary.[24]
- At least 80% of the stock in each other member of the controlled group is owned by other members of the controlled group.

[22] The 80% test is met if 80% or more of the total combined voting power of all classes of voting stock *or* at least 80% of the total value of all classes of stock of each corporation is held by five or fewer shareholders on December 31. To be counted for the 80% test, a shareholder must own stock in each corporate member of the brother-sister controlled group.

[23] Sec. 1563(a)(2).

[24] Sec. 1563(a)(1).

EXAMPLE I:16-19 ▶ Federal Corporation owns 100% of Apex Corporation stock and 30% of Giant Corporation stock. Apex also owns 50% of Giant stock. Each corporation has only one class of stock outstanding. Because Federal owns at least 80% of Apex stock, it is the common parent of the Federal-Apex-Giant parent-subsidiary controlled group. Giant also is a member of the controlled group because at least 80% of Giant stock is owned by members of the controlled group (Federal and Apex together own 80% [30% + 50%]). The parent-subsidiary controlled group consists of Federal, Apex, and Giant. ◀

Combined Controlled Groups. A combined controlled group exists if the following two conditions involving three or more corporations are met:

- A common parent owns at least 80% of at least one subsidiary (a parent-subsidiary group), and
- The common parent is a member of a brother-sister controlled group.[25]

Based on the facts of Example I:16-19, a combined controlled group would have existed if Federal was a member of a brother-sister controlled group that also included National, a situation that would have resulted from Viki's owning 100% of the single classes of stock of Federal and National. Then, Federal, National, Apex, and Giant would have constituted a combined controlled group and would have had to apportion the various tax benefits.

BOOK-TAX ACCOUNTING COMPARISON

Corporations eligible to file a consolidated tax return may differ from those eligible to report on a consolidated financial accounting basis. 80% stock ownership is needed to file a consolidated tax return while only 50% stock ownership is needed to issue a consolidated financial statement.

CONSOLIDATED RETURNS

Corporations that are members of a parent-subsidiary affiliated group are eligible to file a consolidated tax return if they elect to do so under the consolidated return Treasury Regulations. Note, however, that an affiliated group is not the same as a controlled group. (See Chapter C:8 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* for a detailed discussion of the requirements for filing a consolidated tax return.) Brother-sister controlled groups never can file consolidated tax returns. The parent-subsidiary members of a combined controlled group might constitute an affiliated group and thus could elect to file a consolidated tax return. Although the parent's sister corporation is a member of the same controlled group, the parent's sister may not join in the consolidated tax return election. Once the election is made, IRS permission to discontinue filing on a consolidated basis is required.[26]

The consolidated return regulations treat the affiliated group as a single entity, thereby providing the following advantages: (1) net operating losses of one or more members can be used to offset profits of other members; (2) capital losses of one or more members can be used to offset capital gains of other members; and (3) transactions involving two or more group members are treated as occurring among divisions of a single entity, thus the taxation of profits and gains from such transactions is deferred until a subsequent transaction involving a group member and a party outside the affiliated group.



STOP & THINK

Question: P Corporation owns 100% of S-1 Corporation stock and P and S-1 Corporations each own 50% of S-2 Corporation stock. P and S-1 have owned stock in S-2 since its incorporation. Both P and S-1 are highly profitable and are subject to the flat 21% corporate tax rate. S-2 has generated a net operating loss (NOL) in each year of its existence. Would filing a consolidated tax return benefit P, S-1, and S-2?

Solution: Filing a consolidated return would benefit the corporations because S-2's current year losses can be used to offset P's and S-1's current year profits. Because S-2 has never earned a profit, it would not be able to use the NOL if it filed a separate return. In addition, S-2's prior year losses might be used to offset profits reported by S-1 in current year and future year consolidated tax returns. Filing a consolidated return allows the NOLs of one or more members of an affiliated group to offset the profits of other members and reduce the group's overall tax liability.

[25] Sec. 1563(a)(3).

[26] Reg. Sec. 1.1502-75(c).

TRANSFERS OF PROPERTY TO CONTROLLED CORPORATIONS

OBJECTIVE 4

Apply the nonrecognition of gain or loss rules for corporate capitalizations

Section 351 permits investors to defer recognition of gain or loss on the transfer of property to a corporation. The property may be transferred when a new corporation is formed or when additional capital is contributed to an existing corporation. Without the Sec. 351 nonrecognition rules, an investor, sole proprietorship, or partnership might be discouraged from incorporating because the transfer of appreciated property to the corporation would constitute a taxable event, thereby resulting in a recognized gain.

SECTION 351 NONRECOGNITION REQUIREMENTS

KEY POINT

The nonrecognition provisions of Sec. 351 are mandatory rather than elective if all its conditions are met.

The deferral of gain or loss under Sec. 351 can be justified because the assets merely have been transferred to a corporation that is controlled by the transferors. In addition, the transferors do not have the wherewithal-to-pay the tax on the gains that otherwise would be recognized because they receive only stock in the transferee (controlled) corporation. Section 351 prevents recognition of losses on transfers of property that have declined in value.

ADDITIONAL COMMENT

In Sec. 351 transactions, the term "transferor" refers to the shareholder, and the term "transferee" refers to the controlled corporation.

Gain or loss is not recognized if all the following conditions are met:

- Property (other than services) is transferred to the corporation solely in exchange for stock in the transferee corporation.[27]
- Immediately after the exchange, the transferor-shareholders in the aggregate control the transferee corporation through ownership of at least 80% of its stock.[28]
- If a transferor receives money or property (other than stock in the transferee corporation), the transferor recognizes gain (but not loss) equal to the lesser of the "boot" (i.e., money plus the FMV of nonstock property) received or the realized gain.[29] In addition, a corporation that transfers appreciated property (other than its own stock or debt obligations) to the transferor-shareholders also recognizes gain on the exchange.[30]
- The character of any gain recognized by the transferor depends on the type of property transferred as follows: capital gain on capital assets, Sec. 1231 gain on Sec. 1231 property, and ordinary income on other property (e.g., inventory).
- Depreciation is not recaptured in a Sec. 351 transfer unless the transferor recognizes gain on the depreciable property transferred.[31]

EXAMPLE I:16-20 ▶ Carlos and Fred merge their sole proprietorships by forming the Miami Corporation. Carlos transfers to Miami land and a building with a $50,000 adjusted basis and a $100,000 FMV in exchange for 40% of Miami stock. Fred transfers to Miami equipment with a $60,000 adjusted basis and a $150,000 FMV in exchange for 60% of Miami stock. Miami is controlled by Carlos and Fred because immediately after the exchange together they own at least 80% of Miami's single class of stock. Carlos and Fred recognize no gain because all of the Sec. 351 requirements are met and they received no property other than Miami stock. The depreciation recapture potential on the building and equipment is inherited by Miami. ◀

EXAMPLE I:16-21 ▶ Gail and Gary form Michigan Corporation. Gail transfers inventory with a $50,000 adjusted basis and a $100,000 FMV to Michigan in exchange for $20,000 cash and 50% of Michigan stock worth $80,000. Michigan generated the cash through bank borrowings. Gary transfers equipment with a $150,000 adjusted basis and a $100,000 FMV in exchange for 50% of stock worth

[27] Section 351(d) provides that services do not qualify as "property." Thus, if an individual transfers services in exchange for stock, the individual is not deemed to be a transferor for purposes of meeting the 80% control requirement, unless the individual also transfers sufficient property. The rendering of services results in the service provider's recognizing ordinary income equal to the FMV of the services rendered.

[28] Sec. 368(c). "Control" means the ownership of at least 80% of the total combined voting power of all classes of stock and at least 80% of the total number of shares of all other classes of stock.

[29] Sec. 351(b). Recognized gain is calculated on an asset-by-asset basis.

[30] Secs. 351(f) and 311(b).

[31] Secs. 1245(b)(3) and 1250(d)(3). The transferee corporation recaptures depreciation if it subsequently sells or disposes of the asset.

$80,000 and a Michigan 10-year note valued at $20,000. The Section 351 requirements are met because property is transferred by the two transferors who together control more than 80% of the Michigan stock immediately after the exchange. The tax consequences to Gail and Gary are as follows:

	Gail	*Gary*
FMV of stock received	$ 80,000	$ 80,000
Plus: Cash or note received	20,000	20,000
Amount realized	$100,000	$100,000
Minus: Adjusted basis of property transferred	(50,000)	(150,000)
Gain (loss) realized	$ 50,000	$ (50,000)
Gain (loss) recognized	$ 20,000	$ —0—

Gail's recognized gain is the lesser of the $20,000 boot she received or her $50,000 realized gain. This gain is ordinary in character because Gail transferred inventory. Because Gary realized a loss, he recognizes no gain or loss even though he received $20,000 of boot. ◀

BASIS CONSIDERATIONS

ADDITIONAL COMMENT

When different classes of stock are received in a Sec. 351 exchange, the total substituted basis must be allocated among the different classes in proportion to their relative FMVs.

Stock Received by the Transferor. In Sec. 351 transactions, substituted basis rules apply to stock received by the transferors and carryover basis rules apply to property transferred to the corporation. The transferor's stock basis is computed as follows:

	Basis of property transferred to the corporation
Plus:	Any gain recognized by the transferor on the exchange (e.g., as a result of boot received)
Minus:	Amount of money received (including any transferor liabilities assumed by the transferee corporation)
	FMV of any noncash boot property received
	Basis of stock received[32]

Any boot property received by the transferor takes a FMV basis.

EXAMPLE I:16-22 ▶ George and Gina form New Corporation. George transfers to New land and a building with a $60,000 adjusted basis and a $100,000 FMV in exchange for 50% of New stock. Gina transfers equipment with a $120,000 adjusted basis and a $100,000 FMV for 50% of New stock. George realizes a $40,000 gain, and Gina realizes a $20,000 loss. However, George and Gina recognize no gain or loss because the Sec. 351 requirements have been met. George's basis in his New stock is $60,000, and Gina's basis in her New stock is $120,000. ◀

STOP & THINK

Question: In Example I:16-22, George and Gina recognized no gain or loss. Why does this treatment represent tax deferral rather than permanent nonrecognition?

Solution: George's $40,000 unrecognized gain is reflected in a $60,000 stock basis that is $40,000 *below* its $100,000 FMV. Thus, if George immediately sells his stock for its FMV, he recognizes the $40,000 deferred gain ($100,000 selling price − $60,000 stock adjusted basis). Similarly, Gina's $20,000 unrecognized loss is reflected in a $120,000 stock basis that is $20,000 *above* its $100,000 FMV. Thus, if Gina immediately sells her stock for its FMV, she recognizes the $20,000 deferred loss ($100,000 selling price − $120,000 stock adjusted basis). In this way, the substituted basis rules ensure that realized gains and losses are deferred.

[32] Sec. 358(a).

BOOK-TAX ACCOUNTING COMPARISON

Financial accounting requires that the corporation record the transferred assets at their fair market values.

Property Received by Transferee Corporation. Generally, carryover basis rules apply to property received by the transferee corporation. The basis of this property is computed as follows:

Transferor's adjusted basis in property
Plus: Gain recognized by the transferor
Basis of property to the transferee corporation[33]

EXAMPLE I:16-23 ▶ In a tax-free exchange under Sec. 351, North Corporation receives property with a $60,000 adjusted basis and a $100,000 FMV. If no gain is recognized on the transfer, the transferor's $60,000 adjusted basis becomes the transferee corporation's asset basis, as well as the shareholder's stock basis. If the transferor instead had recognized a $10,000 gain because she received boot (e.g., cash), North's asset basis would have been $70,000 ($60,000 adjusted basis in the transferor's hands + $10,000 gain recognized by the transferor), and the transferor's stock basis would still have been $60,000 ($60,000 adjusted basis + $10,000 gain recognized – $10,000 FMV of boot received). ◀

A special IRC provision is intended to discourage investors from attempting to generate double losses by transferring loss property to a corporation in connection with a Sec. 351 exchange.[34] In general, if the FMV of contributed property is less than the shareholder's adjusted basis in such property, the transferee corporation is required to use the FMV of the loss property as its asset basis.

TREATMENT OF LIABILITIES

TYPICAL MISCONCEPTION

When a corporation assumes a shareholder's liabilities and the shareholder recognizes no gain, one might mistakenly assume that the shareholder's stock basis is not reduced by the liabilities assumed.

Nonrecognition of Gain. Section 357(a) provides for the nonrecognition of gain upon the transferee corporation's assumption of liabilities or its taking property subject to liabilities. Accordingly, under the general rule, shareholders recognize no gain when they transfer liabilities to a controlled corporation. The shareholders, however, must reduce their stock basis by the amount of liabilities assumed or acquired. This rule is logical because, if a shareholder transfers net assets of $10,000 (i.e., gross assets of $100,000 and liabilities of $90,000), the net contributivon to capital is only $10,000 even though the shareholder has transferred $100,000 in gross assets.

EXAMPLE I:16-24 ▶ In a transaction qualifying as tax-free under Sec. 351, Ira transfers land with an $80,000 adjusted basis and a $100,000 FMV to Mega Corporation in exchange for 100% of Mega stock with a $60,000 FMV. The transferred property is subject to a $40,000 liability that the corporation assumes. The tax consequences to Ira are as follows:

FMV of stock received	$ 60,000
Plus:Liability assumed by Mega	40,000
Amount realized	$100,000
Minus: Adjusted basis of property transferred	(80,000)
Gain realized by Ira	$ 20,000
Gain recognized by Ira	$ –0–
Adjusted basis of property transferred	$ 80,000
Minus: Liability assumed by Mega	(40,000)
Ira's adjusted basis in Mega stock received	$ 40,000

In addition, Mega takes an $80,000 carryover basis in the land. ◀

[33] Sec. 362(a).

[34] Sec. 362(e).

Exceptions. Two exceptions to the general rule of Sec. 357 require gain recognition upon the transfer of liabilities to a corporation. The first exception relates to the nature of the exchange. If the principal purpose for the assumption of the liabilities is tax avoidance or if the transaction does not have a bona fide business purpose, all of the transferor's liabilities assumed by the transferee corporation are treated as boot, potentially resulting in gain recognition.[35]

EXAMPLE I:16-25 ▶ In a transaction purportedly meeting the requirements of Sec. 351, Helen transfers to Orlando Corporation land and a building with a $70,000 adjusted basis and a $100,000 FMV in exchange for 100% of Orlando stock. Shortly before the transfer, Helen mortgages the property for $60,000 and uses the mortgage loan to pay off personal debts. The corporation then assumes the $60,000 mortgage and issues to Helen stock worth $40,000. The mortgage assumption lacks a bona fide business purpose because it is intended to place cash in Helen's hands without her recognizing gain under the boot rules. Consequently, for the purpose of determining gain recognized, Helen must treat the entire $60,000 liability assumed as boot. The tax consequences to Helen are as follows:

FMV of stock received	$ 40,000
Plus: Liability assumed by Orlando	60,000
Amount realized	$100,000
Minus: Adjusted basis of property transferred	(70,000)
Gain realized	$ 30,000
Gain recognized	$ 30,000
Adjusted basis of property transferred	$ 70,000
Plus: Gain recognized	30,000
Minus: Liability assumed by Orlando	(60,000)
Adjusted basis of stock received	$ 40,000

Although total boot is $60,000 (the liability assumed), Helen's recognized gain does not exceed her $30,000 realized gain. In addition, the stock basis equals its FMV because Helen recognizes the entire realized gain, with no gain to defer. Finally, Orlando's basis in the land and building is $100,000 ($70,000 adjusted basis in the transferor's hands + $30,000 gain recognized by the transferor). ◀

REAL-WORLD EXAMPLE

Customer deposits representing obligations to perform future services were considered liabilities. Because these liabilities exceeded the basis of the assets transferred to the corporation, gain was recognized. *William P. Orr,* 78 T.C. 1059 (1982).

A second exception applies to excess liabilities. If a transferor's total liabilities assumed by the transferee corporation exceeds the total basis of assets (including cash) transferred by that transferor, the transferor must recognize gain to the extent of the excess.[36] Without this rule, the transferor would take a negative basis in the stock received. Gain is recognized because the transferor has derived a net economic benefit to the extent the liabilities assumed exceed the adjusted basis of the transferred assets.

EXAMPLE I:16-26 ▶ In a transaction otherwise qualifying as tax-free under Sec. 351 Jack transfers to Maple Corporation assets with a $60,000 adjusted basis and a $100,000 FMV. Simultaneously, Maple assumes $75,000 of Jack's liabilities. Jack recognizes a $15,000 gain because the liabilities assumed by Maple exceed the basis of the assets transferred ($75,000 − $60,000). The character of Jack's recognized gain depends on the type(s) of property (capital assets, Sec. 1231 property,

[35] Sec. 357(b).

[36] Sec. 357(c). Accounts receivable and accounts payable with a zero basis for a cash basis transferor are disregarded for purposes of Sec. 357(c). (See Sec. 357(c)(3).)

inventory, etc.) Jack transferred.[37] Jack's net economic benefit from the exchange is $15,000 ($75,000 liabilities assumed by Maple − $60,000 adjusted basis of assets transferred). Jack's basis in the stock received is zero ($60,000 asset adjusted basis + $15,000 gain recognized − $75,000 liabilities assumed). Because Jack's realized gain is $40,000 of which he recognizes $15,000, only $25,000 of the gain is deferred ($25,000 FMV of stock − $0 basis). Maple's basis in the assets is increased from $60,000 to $75,000 because of Jack's $15,000 recognized gain. ◀

Topic Review I:16-3 summarizes the general rules relating to the transfer of property to a controlled corporation.

CORPORATE CAPITAL STRUCTURE

ADDITIONAL COMMENT

Thin capitalization is primarily a problem for closely-held corporations where the shareholders also hold the debt. It is not normally a problem for large publicly-held corporations.

A corporation may be capitalized with both equity (generally common or preferred stock) and debt. The use of debt in the capital structure offers the following advantages:

- Interest on debt is deductible by the corporation (subject to limitations), while dividends on stock are not deductible.
- Stock redemptions may result in dividend or capital gain recognition by the shareholders (see pages I:16-25 through I:16-27), while debt repayment represents a tax-free return of capital.

If the corporation is too thinly capitalized (e.g., excessive debt relative to equity), the IRS may attempt to recharacterize part or all of the debt as equity and deny the corporation an interest deduction.

TOPIC REVIEW I:16-3

Sec. 351 Requirements, Gain Recognition Rules, and Basis Rules

- Sec. 351 nonrecognition treatment requires an exchange of property solely for stock. The transferor-shareholders must control (i.e., 80% or more stock ownership) the corporation immediately after the exchange.
- Nonqualifying property (e.g., cash, noncash property, or debt obligations of the transferee corporation) received by the transferors is treated as boot.
- The transferors recognize gain equal to the lesser of the boot received or the realized gain.
- Generally, the transferors recognize no gain if they transfer liabilities to a controlled corporation. Exceptions to the nonrecognition rule apply if (1) the principal purpose of the liability transfer is tax avoidance, (2) no bona fide business purpose for the transfer exists, or (3) total liabilities assumed by the corporation exceed the transferor's adjusted basis in the transferred assets.
- Substituted basis rules referencing the basis of the asset(s) transferred apply to the stock received by the transferors. Generally, carryover basis rules apply to property contributed to the transferee corporation. However, if the FMV of the property is less than the carryover basis, the corporation must use a FMV basis.

EARNINGS AND PROFITS

OBJECTIVE 5

Understand the significance of earnings and profits

CALCULATION OF EARNINGS AND PROFITS

Earnings and profits (E&P) measures a C corporation's economic ability to pay dividends out of its current and accumulated earnings without impairing its capital. If the corporation has no E&P, a distribution is treated as a tax-free return of capital, and possibly a capital gain, rather than a taxable dividend.

[37] Reg. Sec. 1.357-2(a).

Current E&P is calculated by making various adjustments to the corporation's regular taxable income.[38] This calculation, as well as the determination of accumulated E&P, is set forth in Table I:16-3.

EXAMPLE I:16-27 ▶

Park Corporation, an accrual method taxpayer, reports $100,000 of taxable income in the current year. Its tax accountant made the following adjustments to derive current E&P and the addition to accumulated E&P:

BOOK-TAX ACCOUNTING COMPARISON

E&P is similar to retained earnings in financial accounting although numerous differences exist between the two accounts. For example, issuance of a stock dividend usually reduces retained earnings but does not affect E&P.

Taxable income	$100,000
Plus:	
Tax-exempt bond interest	2,000
Key officer life insurance proceeds (nontaxable)	10,000
Dividends-received deduction	20,000
MACRS depreciation in excess of ADS depreciation	15,000
Percentage depletion in excess of cost depletion	10,000
	$157,000
Minus:	
Federal income taxes accrued[a]	(21,000)
Net capital losses	(5,000)
Key officer life insurance premiums (not deductible because the corporation is the beneficiary)	(2,000)
Charitable contributions exceeding the 10% limitation	(3,000)
Fine for overweight trucks on city streets	(5,000)
Current E&P	$121,000
Minus:Money distribution	(5,000)
Addition to accumulated E&P	$116,000

[a]*An accrual method of accounting corporation reduces its E&P by its accrued federal income taxes for the tax year. A cash method of accounting corporation reduces its E&P by its actual federal income taxes paid during the tax year.*

SELF-STUDY QUESTION

Should Sue, an individual, consider transferring her $100,000 in municipal bonds to her controlled C corporation?

ANSWER

No; although the interest income on the municipal bond is excludable from the corporation's taxable income, the tax-exempt interest creates E&P for a C corporation, which causes a cash distribution to Sue to be taxable as a dividend.

To derive E&P, regular taxable income is increased by nontaxable income—the tax-exempt bond interest and the life insurance proceeds—received by Park. Taxable income also is increased for deductions claimed when calculating regular taxable income but not allowed when calculating E&P. Two of these deductions do not represent economic outlays—the dividends-received deduction and percentage depletion in excess of cost. Another adjustment represents a timing difference that will reverse in later tax years—MACRS depreciation in excess of Alternative Depreciation System (ADS) depreciation. Regular taxable income is reduced by negative adjustments for economic outlays that are not deductible in calculating regular taxable income. These E&P reductions include federal income taxes, capital losses in excess of capital gains, key officer life insurance premiums, excess charitable contributions, and fines. ◀

CURRENT VERSUS ACCUMULATED E&P

Current and accumulated E&P must be distinguished because tracing rules determine whether a distribution is made out of current or accumulated E&P. For example, a distribution to shareholders is deemed to be made first out of current E&P and is therefore taxed as a dividend, even if accumulated E&P is negative. Accumulated E&P represents the total of all prior years' undistributed current E&P as of the first day of the tax year. Distributions are deemed to be made out of accumulated E&P only after the current E&P balance (if any) is exhausted.[39]

[38] These adjustments are set forth in Sec. 312 and the related Treasury Regulations.

[39] Reg. Sec. 1.316-2.

▼ **TABLE I:16-3**
Calculation of Earnings and Profits

Regular taxable income	
Plus:	Exclusions from regular taxable income:
	Tax-exempt interest
	Life insurance proceeds where the corporation is the beneficiary
	Recoveries of bad debts and other prior-year deductions for which the corporation received no tax benefit
	Federal income tax refunds from prior years
Plus:	Income deferred to a later year for taxable income purposes:
	Deferred gain on installment sales
	Deferred gain on like-kind exchanges
Plus or minus:	Adjustments for items that must be recomputed:
	Income on long-term contracts based on percentage of completion method rather than completed contract method
	Excess of pre-ACRS accelerated depreciation over straight-line depreciation
	Excess of ACRS depreciation over straight-line ACRS depreciation with an extended recovery period
	Excess of regular MACRS depreciation over Alternative Depreciation System (ADS) depreciation
	Excess of percentage depletion over cost depletion
Plus:	Deductions not allowed in computing E&P:
	Dividends-received deduction
	NOL carryovers, charitable contribution carryovers, and capital loss carryovers from prior years
Minus:	Expenses and losses not deductible in computing regular taxable income:
	Federal income taxes
	Life insurance premiums where the corporation is the beneficiary
	Excess capital losses not deductible in current year
	Excess charitable contributions not deductible in current year
	Expenses related to production of tax-exempt income
	Nondeductible losses on related party sales
	Nondeductible penalties and fines
	Nondeductible political contributions
Current E&P (or E&P deficit)	
Minus:	Distributions to shareholders (but not in excess of current E&P)
Addition to accumulated E&P (if any)	

EXAMPLE I:16-28 ▶ Pacific Corporation, a calendar-year taxpayer, reports a $100,000 accumulated E&P deficit and $30,000 of current E&P as of January 1. Pacific makes a $40,000 distribution to its shareholders. In the distribution, $30,000 is treated as a taxable dividend to the extent of current E&P, and the remaining $10,000 is treated as a tax-free return of capital (to the extent that Pacific's shareholders have stock basis) because of the accumulated E&P deficit, which is not increased as a result of the tax-free distribution. ◀

If a shareholder's stock basis is reduced to zero because of a property distribution treated as a tax-free return of capital, the excess of the distribution amount over this basis is treated as a capital gain.

EXAMPLE I:16-29 ▶ Peach Corporation, a calendar-year taxpayer, has one shareholder, Georgia, who has owned her Peach stock for several years. At the beginning of the current year, Peach has $30,000 of current E&P and $20,000 of accumulated E&P. Georgia's stock basis is $10,000. At the end of the current year, Peach distributes $65,000 to Georgia. The $65,000 distribution is reported as follows:

Taxable dividend paid out of current E&P	$30,000
Taxable dividend paid out of accumulated E&P	20,000
Total taxable dividend	$50,000
Tax-free return of capital	10,000
Long-term capital gain	5,000
Total distribution	$65,000

In addition, Georgia's stock basis is reduced to zero because of the $10,000 portion treated as a return of capital. ◀

If the distributing corporation has a current E&P deficit and a positive accumulated E&P balance, the current deficit and accumulated E&P balance are netted as of the distribution date.[40] The current E&P deficit for the year is prorated on a daily basis unless a nonratable allocation is more appropriate.

EXAMPLE I:16-30 ▶ On January 1 of the current (nonleap) year, Prime Corporation, a calendar-year taxpayer, has a $100,000 positive accumulated E&P balance and a $35,500 current E&P deficit. Prime makes a $30,000 distribution to its shareholders on July 1 (the 182nd day of the year). Because the current deficit is allocated ratably over the year unless the corporation can show that a nonratable allocation is more appropriate, E&P as of July 1 is $82,201 [$100,000 accumulated E&P − (183/365 × $35,500 current E&P deficit)]. The entire $30,000 distribution is taxable as a dividend. ◀

Noncash Distributions

OBJECTIVE 6

Determine the tax consequences of noncash distributions and stock redemptions

Tax Consequences to the Shareholders

Occasionally, a corporation distributes noncash property (i.e., assets other than its stock or stock rights) to its shareholders. If noncash property is distributed, the following tax consequences generally ensue:

- The distribution amount equals the FMV of the property (reduced by any associated liabilities).
- The distribution amount is treated as a taxable dividend if the corporation has sufficient E&P.
- The basis of the distributed property equals its FMV (without reduction for any associated liabilities).

EXAMPLE I:16-31 ▶ Red Corporation distributes land and a building having a $50,000 adjusted basis and a $100,000 FMV to its sole shareholder, Irene. Red has current and accumulated E&P exceeding $100,000. The property is subject to a $40,000 mortgage, which Irene assumes. The amount distributed to Irene is $60,000 ($100,000 FMV − $40,000 liability). Irene reports a $60,000 taxable dividend because the corporation has E&P exceeding the distribution amount. Irene's basis in the property is its $100,000 FMV. ◀

REAL-WORLD EXAMPLE

A distribution of $20 Double Eagle gold coins was a noncash distribution rather than a money distribution because the gold coins were withdrawn from circulation and had numismatic value. *Warren C. Cordner v. U.S.*, 49 AFTR 2d 82-1353, 82-1 USTC ¶9275 (9th Cir., 1982).

Tax Consequences to the Distributing Corporation

As a general rule, the corporation recognizes no gain or loss upon distributing noncash property to its shareholders.[41] However, if a corporation distributes appreciated noncash property, the corporation is treated as if it sold the property to the shareholder for its

[40] Reg. Sec. 1.316-2(b).

[41] Sec. 311(a).

FMV immediately before the distribution and thus recognizes any realized gain.[42] On the other hand, a corporation does not recognize loss when it distributes depreciated noncash property, even though the sale of such property might otherwise have resulted in a deductible tax loss.

EXAMPLE I:16-32 ▶ Rocket Corporation distributes to its shareholder Peter $75,000 in cash, along with land having a $50,000 adjusted basis and a $60,000 FMV. Rocket recognizes $10,000 ($60,000 − $50,000) of gain on the land distribution. Alternatively, if the land had a $60,000 adjusted basis and a $50,000 FMV, the corporation would not have recognized the $10,000 ($50,000 − $60,000) realized loss. ◀

If the property distributed is subject to a liability that exceeds the property's basis, for the purpose of calculating gain, the FMV of such property is deemed to be the greater of the actual FMV or the amount of the liability.[43]

EXAMPLE I:16-33 ▶ Assume the same facts as in Example I:16-32 except that the land is subject to a $70,000 mortgage. Rocket recognizes a $20,000 ($70,000 − $50,000) gain on the distribution because the mortgage exceeds the land's FMV. ◀

STOP & THINK

Question: What are the tax consequences of a pro rata stock dividend, that is, a corporation's issuing additional shares of its own single class of stock to existing shareholders?

Solution: The shareholder's economic position does not change as a result of the stock dividend. Although the shareholders receive additional shares of stock, they still own the same proportion of stock in the corporation. Consequently, they realize no economic gain on the stock dividend. Accordingly, they spread the basis of their old shares over their old and new shares, thereby decreasing the per share basis while leaving the total basis unchanged. In addition, the corporation recognizes no gain or loss and does not reduce its E&P balance. Some stock dividends, such as those involving a shareholder election to receive either stock or cash, are taxable.[44] (See Chapter 4 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts.*)

STOCK REDEMPTIONS

Two possible tax consequences ensue when a corporation repurchases (redeems) some of its outstanding stock:

- The redemption is treated as a taxable dividend to the shareholder to the extent of the corporation's E&P
- The redemption is treated as a sale of stock, generally resulting in the shareholder recognizing capital gain or loss

The first prescribed treatment is intended to discourage corporations from paying a disguised dividend in the form of a stock redemption taxable as a capital gain. For example, the corporation might redeem 10% of its sole shareholder's stock rather than pay a cash dividend. After the redemption, the shareholder continues to own all of the outstanding stock, retains the same degree of control over the corporation, and holds the distributed money or other property. Taxing the redemption as a sale would reduce the tax burden on the shareholder without reducing his/her ownership interest.

ADDITIONAL COMMENT

Because an incremental 3.8% rate applies to net investment income for taxpayers whose modified AGI exceeds $200,000 ($250,000 for married filing jointly), some taxpayers may pay a higher rate than 15% or 20% on their net capital gains.

The second prescribed tax treatment is significant because individual shareholders are generally subject to a 15% or 20% maximum rate on their net capital gains. In addition, sale treatment is preferable if the shareholders have unused capital losses or capital loss carryovers that otherwise would be of limited tax benefit. Moreover, sale treatment affords shareholders a tax-free recovery of their stock investment. Such a tax-free recovery does not result if the distribution is treated as a dividend.

[42] Sec. 311(b).
[43] Secs. 311(b)(2) and 336(b).
[44] Sec. 305(b).

EXAMPLE I:16-34 ▶ Ajax Corporation has two equal shareholders, Rita and Harry. Each shareholder has owned 10 shares of Ajax stock for several years. Each share has a $100 basis and a $150 FMV. Ajax, which has sufficient E&P, redeems 5 shares from each shareholder for the $150 FMV. As a result of the redemption, Rita and Harry each recognize $750 ($150 FMV × 5 shares) of dividend income because each still owns 50% of Ajax stock. Rita's total $1,000 basis in her stock is not decreased as a result of the dividend treatment. On the other hand, her per share basis increases from $100 ($1,000 ÷ 10 shares) to $200 ($1,000 ÷ 5) per share.

If instead, Ajax redeems 5 of Rita's shares but none of Harry's, Rita has substantially reduced her proportionate ownership interest in Ajax. Consequently, she is entitled to sale treatment and recognizes a $250 capital gain calculated as follows:

Redemption proceeds ($150 × 5)	$750
Minus: Basis of stock redeemed ($100 × 5)	(500)
Capital gain	$250

The capital gain is generally long-term and is taxed at a preferential rate (for most taxpayers, 15%). Moreover, only $250 is taxed in the case of sale treatment as opposed to $750 in the case of dividend treatment. In the former case, Rita's total $1,000 basis is reduced to $500. The basis of her 5 shares redeemed offsets the $750 redemption amount. Rita's per share basis remains at $100 ($500 ÷ 5 shares) after the redemption. Example I:16-35 on page I:16-27 explains why the first redemption warrants dividend treatment while the second redemption warrants sale treatment. ◀

DETERMINING WHETHER A REDEMPTION IS A DIVIDEND OR CAPITAL GAIN

A redemption is treated as an exchange taxed as a capital gain or loss if any of the following conditions are met:[45]

- The redemption is substantially disproportionate with respect to the shareholder's interest [Sec. 302(b)(2)].
- The redemption is not essentially equivalent to a dividend [Sec. 302(b)(1)].[46]
- The redemption completely terminates the shareholder's interest [Sec. 302(b)(3)].

SELF-STUDY QUESTION

Why might a corporate shareholder prefer to have a redemption treated as a dividend rather than as an exchange?

ANSWER

The corporate shareholder would be eligible for a 50%, 65%, or 100% dividends-received deduction with respect to any redemption treated as a dividend.

Substantially Disproportionate. Constructive stock ownership rules apply to determine whether a redemption is substantially disproportionate.[47] **Constructive stock ownership** means that the redeemed shareholder is considered to own the stock of certain related parties. These related parties include family members, partnerships and corporations in which the shareholder owns an interest, and trusts and estates of which the shareholder is a beneficiary.

For a redemption to be substantially disproportionate, all of the following tests must be met immediately after the redemption:

- The shareholder must own less than 80% of his or her former percentage of voting stock (including stock held by related parties).
- The shareholder must own less than 80% of his or her former percentage of common (voting and nonvoting) stock (including stock held by related parties).
- The shareholder must own less than 50% of all the voting stock (including stock held by related parties).

Under Sec. 302(b)(2) a redemption of solely nonvoting stock will not qualify for capital gains treatment.

Not Essentially Equivalent to a Dividend. A redemption that is not essentially equivalent to a dividend results in a meaningful reduction in the shareholder's interest.[48] In determining whether a meaningful reduction has occurred, the IRS looks at the shareholder's interest in the following: (1) voting power, (2) participation in earning and profits, and (3) share

[45] Sec. 302.

[46] For example, sale treatment has been allowed where the redeemed shareholder's voting control, right to share in current earnings, and right to receive corporate assets upon liquidation have been significantly reduced. Ordinarily, this occurs when a shareholder's majority interest is converted to a 50% interest, a majority interest is converted to a minority (less than 50%) interest, or a minority interest is significantly reduced. (See, for example, Rev. Ruls. 75-502 and 76-364 cited in footnotes 55 and 56.)

[47] Sec. 318.

[48] *U.S. v. Maclin P. Davis*, 25 AFTR 2d 70-827, 70-1 USTC ¶9289 (USSC, 1970).

of net assets upon liquidation.[49] This approach usually is adopted if the redemption fails the objective tests for a substantially disproportionate redemption. Specifically, if a shareholder's interest falls below 50% after the redemption, but the redemption does not meet the 80% test, the shareholder might argue that the redemption is not essentially equivalent to a dividend. For example, a reduction in ownership from 27% to 22% fails the 80% test for substantially disproportionate redemptions (80% × 27% = 21.6%) but could be regarded as a meaningful reduction in the shareholder's interest.[50]

EXAMPLE I:16-35 ▶ In Example I:16-34, the redemption of both Rita and Harry's stock failed the substantially disproportionate test. For Rita and Harry to pass the test, each shareholder's current ownership percentage must be less than 80% of his or her former ownership percentage, or 40% (80% × 50% prior ownership) and less than 50% on an absolute basis. After the redemption, Rita and Harry each still own exactly 50% of Ajax's single class of stock, thereby failing both the 80% and 50% tests.

On the other hand, the redemption of only Rita's 5 shares qualifies for sale treatment because, after the redemption, Rita owns 331/3% (5 shares Rita still owns ÷ 15 total shares outstanding) of Ajax's single class of stock. Thus, Rita's post-redemption ownership is less than the 40% and 50% thresholds, thereby making the redemption substantially disproportionate. ◀

EXAMPLE I:16-36 ▶ Jane owns 60 shares of Fast Corporation's single class of stock. Her mother owns 20 additional shares of Fast stock. The remaining 20 Fast shares are owned by Peter, who is unrelated to Jane or her mother. Fast redeems 30 shares of Jane's stock for $100,000. Jane's percentage interest before the redemption is 80% [(60 + 20 shares) ÷ 100 shares]. Immediately after the redemption, her percentage interest is 71.4% [(30 + 20 shares) ÷ 70 shares]. To meet the 80% test, Jane's interest must be less than 64% (80% × 80%). Therefore, Jane does not meet the 80% test. Also, Jane does not meet the 50% test because she does not own less than 50% of Fast stock after the redemption. Both tests must be met for the redemption to qualify as substantially disproportionate. Jane likely will not qualify for Sec. 302(b)(1) "not essentially equivalent to a dividend" treatment because she has not reduced her stock interest to 50% or less. Therefore, the $100,000 is treated as a dividend and is taxable to Jane to the extent of Fast's E&P. ◀

Complete Termination. Under Sec. 302(b)(3), a complete termination of a shareholder's stock interest also qualifies for capital gain or loss treatment. At first glance, this rule appears redundant because the substantially disproportionate rule also applies to a redemption that results in a complete termination of a shareholder's interest. However, the complete termination provision permits a waiver of the family ownership attribution rules. These rules are waived if the former shareholder files an agreement with the IRS that for 10 years he or she will acquire no interest other than that as a creditor of the corporation.[51]

EXAMPLE I:16-37 ▶ Assume the same facts as in Example I:16-36 except that Fast Corporation redeems all of Jane's 60 shares for $200,000, and Jane's basis in her shares is $90,000. The family ownership attribution rules are waived if Jane agrees not to acquire any interest in Fast for 10 years. Jane's interest is deemed to be completely terminated, and the redemption is treated as a sale of stock, thus eligible for capital gains treatment. Jane recognizes a capital gain of $110,000 ($200,000 − $90,000). If the waiver is not effective because Jane remains an employee of Fast, the substantially disproportionate tests would be applied to determine whether the redemption qualifies as an exchange. Jane would be deemed to own 50% of the stock (20 shares owned ÷ 40 outstanding shares) immediately after the redemption. Thus, the substantially disproportionate test would not be met. Without an effective waiver, the redemption does not qualify as a complete termination because Jane is deemed to own her mother's stock. Consequently, the redemption would be treated as a dividend unless it could qualify for sale treatment under the Sec. 302(b)(1) "not-essentially-equivalent-to-a-dividend" test. ◀

REAL-WORLD EXAMPLE

All of a father's stock in a corporation was redeemed, and his children were the remaining shareholders. Then the father entered into a long-term contract with the corporation to perform consulting and advisory services. The contract represented an interest in the corporation and the family attribution rules were not waived. Rev. Rul. 70-104, 1970-1 C.B. 66.

[49] Rev. Rul. 75-502, 1975-2 C.B. 111.
[50] Rev. Rul. 76-364, 1976-2 C.B. 91.
[51] Sec. 302(c)(2). The former shareholder cannot serve as an officer, director, or employee for at least 10 years and must notify the IRS if additional stock is acquired (other than by bequest or inheritance). If such stock is subsequently acquired, it usually causes the redemption to be recharacterized as a dividend.

CORPORATE DISTRIBUTIONS IN COMPLETE LIQUIDATION

OBJECTIVE 7

Understand the tax implications of a corporate liquidation for the liquidating corporation and its shareholders

Sometimes shareholders may wish to terminate a corporation's existence. A complete liquidation is similar to a stock redemption except that all (rather than a portion) of the corporation's stock is redeemed. In a complete liquidation, the assets are either distributed in kind to the shareholders in exchange for their stock or sold for cash, which is then distributed to the shareholders in exchange for their stock. The liquidated corporation usually is dissolved under state law.

Surprisingly, the reasons for a complete termination are not always associated with unprofitable operations. For example, a highly-successful closely-held company may have management continuity problems because key officers and shareholders are approaching retirement age. Also, for reasons of organizational management, a parent corporation may wish to liquidate a subsidiary and continue its operations as a separate division of the parent.

TYPICAL MISCONCEPTION

It is sometimes assumed that corporate liquidation always is associated with the discontinuance of business activities. Sometimes, however, the business is operated as a limited liability company, partnership, or sole proprietorship after the liquidation.

TAX CONSEQUENCES TO THE LIQUIDATING CORPORATION

Distribution of Assets. In a liquidation, the liquidating corporation is treated as if it had sold its assets for their FMV to its shareholders and thus recognizes gain or loss.[52] If the distributed property is subject to a liability, the FMV of the property is deemed to be the greater of the property's actual FMV or the amount of the liability.

EXAMPLE I:16-38 ▶ In a complete liquidation, Southern Corporation distributes the following assets to its share- holders:

- Inventory: $12,000 basis, $20,000 FMV
- Investment land: $5,000 basis, $40,000 FMV, subject to a $30,000 liability
- Marketable securities: $20,000 basis, $15,000 FMV

Southern recognizes $8,000 ($20,000 − $12,000) of ordinary income on the distribution of the inventory, $35,000 ($40,000 − $5,000) of capital gain on the distribution of the land, and $5,000 ($15,000 − $20,000) of capital loss on the distribution of the marketable securities. ◀

Sale of Assets. The tax consequences of an asset sale closely parallel those of a liquidating distribution. If a corporation sells its assets in a complete liquidation and then distributes the sales proceeds to its shareholders, all gain or loss realized on the sale is recognized by the corporation.

Limitation on Loss Recognition. Under the general rule, upon liquidating, the corporation recognizes both gains and losses. To prevent abuses, three special rules limit the recognition of losses. First, a liquidating subsidiary recognizes neither gain nor loss when it distributes property to its parent. In addition, a liquidating subsidiary recognizes gain (but not loss) when it distributes property to minority shareholders. (The special rules applying to the liquidation of a subsidiary are set forth below.) Second, a liquidating corporation recognizes no loss when it distributes property to a related person, unless the property is distributed ratably to all shareholders and the property was not contributed in a Sec. 351 transaction or otherwise as capital within the preceding five years. Finally, losses are not recognized upon the sale, exchange, or distribution of property where the property was contributed in a Sec. 351 transaction or otherwise as capital, the principal purpose of which was loss recognition. These special loss limitations are explained further in Chapter C:6 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts.*

[52] Sec. 336.

Tax Attributes. Tax attributes, such as NOL carryovers, E&P balances, capital loss carryovers, and tax credits, are extinguished in a corporate liquidation.

TAX CONSEQUENCES TO THE SHAREHOLDERS

KEY POINT

An appraisal may be necessary to determine the FMV of the distributed assets.

Under the general rule for complete liquidations, shareholders are deemed to have sold their stock to the corporation in exchange for money or other property.[53] If the stock is a capital asset, the shareholder recognizes capital gain or loss equal to (1) the money plus the FMV of other property distributed to the shareholder less (2) the adjusted basis of the shareholder's stock.[54] The value of property distributed to a shareholder is its FMV on the distribution date.[55]

EXAMPLE I:16-39 ▶ In a complete liquidation, Sun Corporation distributes land with a $70,000 adjusted basis and a $100,000 FMV to shareholder John, in exchange for his Sun stock. John's adjusted basis in the stock is $40,000. Joan, another shareholder, receives $100,000 cash for her shares. Joan's adjusted basis in her stock is $120,000. John recognizes a $60,000 ($100,000 − $40,000) capital gain. Joan recognizes a $20,000 ($100,000 − $120,000) capital loss. The basis of the land received by John is $100,000 (the land's FMV on the distribution date). ◀

SECTION 332: LIQUIDATION OF A SUBSIDIARY CORPORATION

KEY POINT

Section 351 permits a parent corporation to incorporate a sub- sidiary corporation tax-free. Section 332 permits a parent corporation to liquidate a controlled subsidiary corporation without adverse tax results where the subsidiary's property has significantly appreciated in value.

Gain and Loss Considerations. Section 332 carves out an exception to the general rule that gain or loss is recognized in a liquidating distribution. Under this exception, neither a parent nor its 80% or more owned subsidiary recognizes gain or loss when the parent liquidates the subsidiary.[56] In a Sec. 332 liquidation, the subsidiary usually is dissolved, and its assets and liabilities transferred to the parent. The Section 332 nonrecognition rule is mandatory, not elective, if its requirements are met.

For nonrecognition treatment, the subsidiary must:

- Distribute all its assets to the parent in complete liquidation within a single tax year.
- Make a series of distributions resulting in a complete liquidation over a three-year period that commences at the close of the tax year in which the first liquidating distribution is made.

If a minority interest also is liquidated, the exception does not apply. The subsidiary recognizes gain (but not loss) on property distributed to a minority shareholder. In addition, the minority shareholder(s), recognize(s) gain or loss.

KEY POINT

A parent corporation whose basis for its subsidiary's stock exceeds the tax basis of its share of the subsidiary's net assets loses the tax benefit of the economic loss if the subsidiary is liquidated under the Sec. 332 rules.

Basis Considerations. The basis of the subsidiary's assets carry over to the parent, and the adjusted basis of the parent's stock in the subsidiary disappears.[57] This rule could create inequities because the parent may have paid an amount for the subsidiary stock that is greater (or less) than the parent's basis in the subsidiary's net assets.

EXAMPLE I:16-40 ▶ Several years ago Tampa Corporation acquired 100% of Top Corporation stock for $100,000. In the current year, Top is liquidated, and assets having a $130,000 FMV and a $50,000 basis are transferred to Tampa. Upon receiving the assets, Tampa recognizes no gain or loss. Tampa's $100,000 basis in the Top stock disappears, and Tampa takes only a $50,000 basis in the Top assets. Tampa would recognize an $80,000 ($130,000 − $50,000) gain should it sell the assets for their $130,000 FMV immediately after the liquidation. The character of the gain would depend on the type of assets received by Tampa. ◀

When these carryover basis rules apply, the parent corporation also inherits the tax attributes of the subsidiary.[58] For example, the liquidated subsidiary's NOL and capital

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[53] Sec. 331(a)(1).

[54] Certain losses on the sale of small business stock are ordinary in character if the requirements of Sec. 1244 are met (see Chapter I:9).

[55] Sec. 334(a).

[56] Under Sec. 1504(a)(2), the parent corporation must own at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total value of all classes of stock.

[57] Sec. 334(b)(1).

[58] Sec. 381.

loss carryovers and E&P balances carry over to the parent. In addition, the subsidiary recognizes no gain under the depreciation recapture rules. Instead, this recapture potential remains with the subsidiary assets distributed to the parent.

Topic Review I:16-4 summarizes the complete liquidation rules.

Tax planning considerations

OBJECTIVE 8

Describe tax planning considerations for corporations

CAPITAL STRUCTURE AND SECTION 1244

As mentioned earlier in the chapter, the issuance of long-term debt to capitalize a profitable closely-held C corporation could bolster the corporation's total economic returns and thus increase share values. However, if the corporation is no longer profitable and goes bankrupt, the corporate debt becomes worthless and is treated by noncorporate shareholders as nonbusiness bad debt. As is discussed in Chapter I:9, nonbusiness bad debt is deductible as a short-term capital loss subject to the $3,000 per year limitation.

TOPIC REVIEW I:16-4

Distributions in Complete Liquidation

Sec. 331 General Liquidation Rules	Liquidating Corporation	Shareholders
Gain or loss recognition	Gain or loss equal to the FMV of the property distributed less the property's adjusted basis generally is recognized.	Capital gain or loss equal to the amount of money plus the FMV of other property received less the shareholder's basis of stock in the liquidating corporation is recognized.
Exception to the gain or loss rule	Losses are not recognized on distributions of property to related parties, or property acquired in certain tax-free transactions, where the principal purpose for the transaction is tax avoidance.	Sec. 1244 ordinary loss treatment is available only to individual shareholders.
Basis considerations	Not applicable.	The basis of noncash property received is its FMV.
Tax attributes	Tax attributes (e.g., NOL carryovers and E&P) disappear upon liquidation.	Not applicable.
Sec. 332 Subsidiary Corporation Liquidation Rules	**Subsidiary**	**Parent**
General requirements	The subsidiary is liquidated, and its assets and liabilities are transferred to its minority shareholders and parent.	Sec. 332 is mandatory. The parent must own at least 80% of subsidiary stock.
Gain or loss recognition	No gain or loss is recognized on the transfer of assets to the parent. Gain but not loss is recognized on distributions to minority shareholders.	The parent recognizes no gain or loss. Minority shareholders recognize gain or loss.
Basis considerations	None.	The basis of subsidiary assets carry over to the parent. Minority shareholders take a FMV basis in the assets they receive.
Tax attributes	Tax attributes are extinguished in the liquidation.	Tax attributes (e.g., NOL carryovers and E&P) are inherited by the parent.

As an alternative to debt, shareholders could capitalize the corporation with stock (equity). If certain conditions are met, this stock would be Sec. 1244 stock (small business corporation stock, see Chapter I:9 for details). If it becomes worthless, the shareholder may deduct up to $50,000 ($100,000 on a joint return) of its value as an ordinary loss. From a tax perspective, ordinary loss treatment is generally preferable to capital loss treatment that applies to nonbusiness bad debts.

The two principal components of capital structure clearly yield different results, depending on whether the corporation is profitable or unprofitable. Thus, deciding how to capitalize a corporation ultimately involves an evaluation of its potential profitability. If the owners of a new corporation believe the venture will be profitable, they should prefer debt because of the deductibility of interest payments. Because few entrepreneurs assume that their business will be unsuccessful, advising them to capitalize it with substantially more equity than debt might be difficult.

DIVIDEND POLICY

ADDITIONAL COMMENT

The reasonableness of a salary payment is a question of fact to be determined in each case. No formula can be used to determine a reasonable amount of compensation.

Dividends paid out of E&P are taxable to shareholders and nondeductible by the corporation. Consequently, in a closely held corporation, where ownership and management are the same, the owner-managers may wish to increase shareholder-employee compensation rather than increase dividends. Likewise, a shareholder may wish to lease property to the corporation instead of contribute it as capital. Even though the increased salary or rental payments are taxable to the shareholders (as are dividends), the corporation may deduct them as long as the amounts are reasonable.

EXAMPLE I:16-41 ▶ Mario and Nancy are equal owners of highly profitable Texas Corporation, which has substantial E&P. Mario and Nancy are the key officers. Each is paid $150,000 compared to $200,000 paid to others in similar positions. To increase earnings distributions to the owners, additional salary of $50,000 might be paid to both Mario and Nancy (rather than increase dividends by the same amount) because the corporation can deduct salary but not dividends. The salary payments result in a single level of taxation, while the dividend payments result in double taxation. The additional $50,000 compensation would subject the employer and the two shareholders to additional payroll taxes (e.g., the 1.45% Medicare portion of the FICA tax; there is no ceiling on the Medicare tax base). ◀

USE OF LOSSES

A corporation should carefully plan how to use its net operating loss and capital loss carryovers. For example, the sale of appreciated business assets could result in a Sec. 1231 gain that could offset capital loss carryovers. Net Sec. 1231 gains are treated as capital in character. Alternatively, as a result of depreciation recapture, the sale of assets could give rise to ordinary income. Such income could be offset by expiring NOLs.

If a business expects to generate net operating losses or capital losses during its start-up phase, an S corporation election might be desirable because the losses flow thru to the shareholders' separate returns. The S corporation election might be terminated when the corporation becomes profitable so that C corporation treatment is preferred. (See Chapter I:17 for a discussion of S corporations.)

CHARITABLE CONTRIBUTIONS

REAL-WORLD EXAMPLE

An accrual basis corporation that attempted to treat a contribution paid within 2½ months following year-end as a charitable contribution in the earlier year was denied a charitable contribution deduction because no written declaration of the resolution of the board of directors authorizing the contribution was attached to the return. *Donald G. Griswold,* 39 T.C. 620 (1962).

Many owners of closely held corporations prefer to make charitable contributions through their corporations rather than as individuals because the corporations might be able to take a larger deduction. An accrual method corporation may accelerate a charitable contribution deduction if its board of directors approves the contribution before year-end, and the corporation makes the contribution within 2½ months of the corporation's tax year-end. The alternative to a corporate contribution could be a nondeductible dividend payment to the owner(s) who make(s) (an) individual contribution(s).

DIVIDENDS-RECEIVED DEDUCTION

Corporate shareholders may deduct 65% (in some cases, 50%) of dividends received. However, this deduction is limited to 65% (in some cases, 50%) of taxable income

unless the deduction creates or increases an NOL. Thus, a substantial scale-down of the dividends-received deduction may result if taxable income (before this deduction) is positive, but negligible. If the limitation is likely to diminish the magnitude of the deduction, the corporation might either accelerate business deductions into the current year or postpone the recognition of income to a later year. Either measure could result in the generation of an NOL that renders the limitation inapplicable. (See Examples I:16-7 and I:16-8.)

REDUCED TAXES ON TAXPAYER STOCK SALES

IRC Section 1202(a)(1) permits noncorporate investors to exclude up to 50% of any gain realized on the sale or exchange of small business stock. This exclusion applies only to stock issued by C corporations that meet certain requirements; i.e., a stock holding period of five years or more, the use of at least 80% of the corporation's assets in the active conduct of a business, and a corporate asset value of $50 million or less at the time of stock issuance.

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 9

Describe compliance and procedural considerations for corporations

FILING REQUIREMENTS

A corporation must file Form 1120 (U.S. Corporation Income Tax Return) even if the corporation exists for only part of the year. Supplementing this form is a separate Schedule D that reports capital gains and losses. Corporations with less than $250,000 of gross receipts and less than $250,000 in assets can avoid reporting on Schedules L, M-1, and M-2 of their Form 1120.

The regular due date for the corporate return is the fifteenth day of the fourth month of the tax year (e.g., April 15 for calendar-year corporations).[59] Corporations can obtain an automatic 6-month extension by filing Form 7004 (Application for Automatic Extension of Time to File Corporation Income Tax Return). For corporations that use a June 30 fiscal year, the Surface Transportation Act of 2015 provides a seven-month extension for the due date of the return. In all of these cases, if an extension is granted, the full amount of the estimated tax must be paid on or before the initial due date (e.g., April 15 for calendar-year corporations).

KEY POINT

All corporations must file an income tax return. The filing requirements are not based on minimum amounts of gross income, as in the case of individual taxpayers.

Quarterly estimated tax payments must be made on the fifteenth day of the fourth, sixth, ninth, and twelfth months of the tax year. In general, the total required estimated tax payments are the lesser of 100% of the corporation's tax liability for the current year or 100% of the tax shown on the preceding year's return.[60] However, a corporation need not base the quarterly payments on the preceding year's tax liability if that liability was zero.[61] The corporation is subject to a nondeductible penalty to the extent the quarterly payments are less than the actual amounts due.

Through its e-file program, the IRS has developed an electronic procedure for filing Forms 1120 and 1120S. For tax years ending on or after December 31, 2005, corporations with at least $10 million in assets that file at least 250 returns annually are required to file electronically. Corporations not required to file electronically may choose to do so voluntarily. Currently, an amended tax return cannot be filed electronically.

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[59] The Surface Transportation Act provides an exception for corporations with a June 30 fiscal year. These corporations will continue to file a return by the fifteenth day of the third month of the tax year until tax years beginning after December 31, 2025.

[60] Exceptions are provided for large corporations and corporations that earn their income unevenly during the tax year. Large corporations—those with taxable income exceeding $1 million in any of the three preceding tax years—must make quarterly estimated tax payments based on 100% of the tax shown on their current year return. Alternatively, they are permitted to make their first-quarter payment based on 100% of the preceding year's tax liability [Sec. 6655(d)]. Section 6655(e) permits corporations to use an annualized income installment method, or seasonally adjusted installment method if the latter installments are less than the normally-required installment [Sec. 6655(e)].

[61] Rev. Rul. 92-54 1992-2 C.B. 320.

BOOK-TAX ACCOUNTING COMPARISON

The Schedule M-1 adjustments highlight the differences between financial accounting and tax accounting.

SCHEDULE M-1 AND M-2 RECONCILIATIONS

Schedule M-1 is used to reconcile financial accounting net income with taxable income before certain deductions (the NOL and dividends-received deductions). Figure I:16-1 shows a completed Schedule M-1 based on the following adjustments:

Net income per books	$100,000
Plus:	
Federal income tax liability	3,000
Net capital losses	2,000
Nondeductible premiums on life insurance covering key officers	4,000
Minus:	
Tax-exempt interest income	(9,000)
Excess of tax depreciation over financial accounting depreciation	(75,000)
Taxable income (before certain deductions)	$ 25,000

KEY POINT

Many small corporations who file Form 1120 are not required to complete Schedules M-1 and M-2. The exception is applicable to companies with gross receipts and assets below $250,000.

Schedule M-2 reconciles retained earnings (for financial accounting purposes) at the beginning of the year with retained earnings at year-end. This reconciliation accounts for changes in the balance sheet reported on Schedule L, or for items of income, gain, or loss components of retained earnings that have not been reported as part of net income. Figure I:16-2 illustrates a completed Schedule M-2 based on the above facts and the following assumptions: a $140,000 retained earnings balance on January 1, $100,000 of net income for financial accounting purposes, and the payment of a $40,000 cash dividend.

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income per Return**
Note: The corporation may be required to file Schedule M-3 (see instructions).

1	Net income (loss) per books	100,000	7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books	3,000		Tax-exempt interest $ 9,000	
3	Excess of capital losses over capital gains	2,000			9,000
4	Income subject to tax not recorded on books this year (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):		a	Depreciation $ 75,000	
a	Depreciation $		b	Charitable contributions $	
b	Charitable contributions $				
c	Travel and entertainment $				
	Premium on Life Insurance 4,000	4,000	9	Add lines 7 and 8	84,000
6	Add lines 1 through 5	109,000	10	Income (page 1, line 28)—line 6 less line 9	25,000

FIGURE I:16-1 ▶ FORM 1120, SCHEDULE M-1

Schedule M-2 **Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)**

1	Balance at beginning of year	140,000	5	Distributions: a Cash	40,000
2	Net income (loss) per books	100,000		b Stock	
3	Other increases (itemize):			c Property	
			6	Other decreases (itemize):	
			7	Add lines 5 and 6	40,000
4	Add lines 1, 2, and 3	240,000	8	Balance at end of year (line 4 less line 7)	200,000

FIGURE I:16-2 ▶ FORM 1120, SCHEDULE M-2

SCHEDULE M-3 RECONCILIATION

Schedule M-3 (Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More) reconciles a C corporation's book-tax differences. Reg. Sec. 1.6011-4(b)(6), defines significant book-tax difference in terms of a transaction with respect to which the amount of any item or items of income, gain, expense, or loss for tax purposes differs by more than $10 million in any tax year from the amount of the same item for book purposes. The amount of an item for book purposes is determined under Generally Accepted Accounting Principles.

Each member of an affiliated group must file a separate Schedule M-3. The entire group must file a consolidated Schedule M-3. The IRS is likely to use this schedule as a tool to determine whether or not to audit a corporation. A sample Schedule M-3 is presented on pages I:16-35 to I:16-37.

MAINTENANCE OF E&P RECORDS

Companies are not required to compute E&P on their tax return. They should, however, maintain adequate records of E&P items because the limitations period for contesting these items is indefinite, and the taxpayer has the burden of proof. Thus, if the IRS discovers that a company has current or accumulated E&P and treats a distribution as a taxable dividend rather than a tax-free return of capital, the taxpayer must show that the prescribed IRS treatment is erroneous.

Form 5452 (Corporate Report of Nondividend Distributions) must be filed by any corporation that makes a return-of-capital distribution. This form requires a computation of E&P and a schedule of differences between taxable income and E&P. This form also requires a year-by-year computation of accumulated E&P.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:16-1 William Bonney and Pat Garrett incorporate Sales, Inc. on January 1, of the current year, under the laws of the State of Florida.

a. How should the new corporation be regarded under the check-the-box rules?

b. Are any entity elections available for Sales, Inc. under the IRC or the check-the-box rules?

c. How would your answers to Parts a and b change (if at all) should William Bonney be the sole shareholder of Sales, Inc.?

I:16-2 Under the present tax system, C corporation income is taxed twice, once when earned and again when the shareholders receive dividends or sell their stock. Nevertheless, the C corporation form is widely used in the United States, especially for large enterprises. Why would an entrepreneur choose C corporation status instead of one of the flow-through entity forms?

I:16-3 Some tax analysts contend that many corporations can shift the burden of corporate taxation to consumers in the form of higher prices. In what other ways might a corporation attempt to shift the burden (e.g., to employees, tenants, and/or shareholders)?

I:16-4 For most individual investors, net long-term capital gains and dividends are taxed at the same rate. Yet, in some circumstances, an investor's generating long-term capital gains is more advantageous than earning a dividend. What are these circumstances and why?

I:16-5 Acorn Corporation has a $5,000 NSTCG and a $9,000 NLTCL in the current year. Last year, Acorn had a $3,000 NLTCG. No other capital gains or losses were reported in prior tax years.

a. Do the NSTCG and NLTCL have to be offset against one another in the current year?

b. Is any portion of the NLTCL deductible in the current year?

c. What loss carryback or carryover rules should be applied to any unused capital losses incurred in the current year?

I:16-6 C corporations are allowed a dividends received deduction (DRD) for dividends received from domestic corporations.

a. What is the purpose of the DRD?

b. Does the taxable income limitation on the DRD serve any purpose?

c. What additional tax liability is incurred by a C corporation when it receives $10,000 of dividend income from a 10%-owned domestic

SCHEDULE M-3 (Form 1120)

Department of the Treasury
Internal Revenue Service

Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More

▶ Attach to Form 1120 or 1120-C.
▶ Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123

2018

Name of corporation (common parent, if consolidated return) | **Employer identification number**

Check applicable box(es): (1) ☐ Non-consolidated return (2) ☐ Consolidated return (Form 1120 only)
(3) ☐ Mixed 1120/L/PC group (4) ☐ Dormant subsidiaries schedule attached

Part I Financial Information and Net Income (Loss) Reconciliation (see instructions)

1a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
☐ **Yes.** Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
☐ **No.** Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.

b Did the corporation prepare a certified audited non-tax-basis income statement for that period?
☐ **Yes.** Skip line 1c and complete lines 2a through 11 with respect to that income statement.
☐ **No.** Go to line 1c.

c Did the corporation prepare a non-tax-basis income statement for that period?
☐ **Yes.** Complete lines 2a through 11 with respect to that income statement.
☐ **No.** Skip lines 2a through 3c and enter the corporation's net income (loss) per its books and records on line 4a.

2a Enter the income statement period: Beginning MM/DD/YYYY Ending MM/DD/YYYY

b Has the corporation's income statement been restated for the income statement period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☐ **No.**

c Has the corporation's income statement been restated for any of the five income statement periods immediately preceding the period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☐ **No.**

3a Is any of the corporation's voting common stock publicly traded?
☐ **Yes.**
☐ **No.** If "No," go to line 4a.

b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock . . . . . ☐☐☐☐☐

c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock . . . . . ☐☐☐☐☐☐☐☐☐

4a	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1 .	**4a**	
b	Indicate accounting standard used for line 4a (see instructions): (1) ☐ GAAP (2) ☐ IFRS (3) ☐ Statutory (4) ☐ Tax-basis (5) ☐ Other (specify) _____		
5a	Net income from nonincludible foreign entities (attach statement)	**5a**	( )
b	Net loss from nonincludible foreign entities (attach statement and enter as a positive amount) . . .	**5b**	
6a	Net income from nonincludible U.S. entities (attach statement)	**6a**	( )
b	Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	**6b**	
7a	Net income (loss) of other includible foreign disregarded entities (attach statement)	**7a**	
b	Net income (loss) of other includible U.S. disregarded entities (attach statement)	**7b**	
c	Net income (loss) of other includible entities (attach statement)	**7c**	
8	Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement)	**8**	
9	Adjustment to reconcile income statement period to tax year (attach statement)	**9**	
10a	Intercompany dividend adjustments to reconcile to line 11 (attach statement)	**10a**	
b	Other statutory accounting adjustments to reconcile to line 11 (attach statement)	**10b**	
c	Other adjustments to reconcile to amount on line 11 (attach statement)	**10c**	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10 .	**11**	

Note: Part I, line 11, must equal Part II, line 30, column (a) or Schedule M-1, line 1 (see instructions).

12 Enter the total amount (not just the corporation's share) of the assets and liabilities of all entities included or removed on the following lines.

		Total Assets	Total Liabilities
a	Included on Part I, line 4 ▶		
b	Removed on Part I, line 5 ▶		
c	Removed on Part I, line 6 ▶		
d	Included on Part I, line 7 ▶		

FIGURE I:16-3A ▶ FORM 1120, SCHEDULE M-3

Schedule M-3 (Form 1120) 2018 Page **2**

Name of corporation (common parent, if consolidated return) | **Employer identification number**

Check applicable box(es): **(1)** ☐ Consolidated group **(2)** ☐ Parent corp **(3)** ☐ Consolidated eliminations **(4)** ☐ Subsidiary corp **(5)** ☐ Mixed 1120/L/PC group
Check if a sub-consolidated: **(6)** ☐ 1120 group **(7)** ☐ 1120 eliminations

Name of subsidiary (if consolidated return) | **Employer identification number**

Part II Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return (see instructions)

Income (Loss) Items (Attach statements for lines 1 through 12)	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1 Income (loss) from equity method foreign corporations				
2 Gross foreign dividends not previously taxed				
3 Subpart F, QEF, and similar income inclusions				
4 Gross-up for foreign taxes deemed paid				
5 Gross foreign distributions previously taxed				
6 Income (loss) from equity method U.S. corporations				
7 U.S. dividends not eliminated in tax consolidation				
8 Minority interest for includible corporations				
9 Income (loss) from U.S. partnerships				
10 Income (loss) from foreign partnerships				
11 Income (loss) from other pass-through entities				
12 Items relating to reportable transactions				
13 Interest income (see instructions)				
14 Total accrual to cash adjustment				
15 Hedging transactions				
16 Mark-to-market income (loss)				
17 Cost of goods sold (see instructions)	( )			( )
18 Sale versus lease (for sellers and/or lessors)				
19 Section 481(a) adjustments				
20 Unearned/deferred revenue				
21 Income recognition from long-term contracts				
22 Original issue discount and other imputed interest				
23a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
e Abandonment losses				
f Worthless stock losses (attach statement)				
g Other gain/loss on disposition of assets other than inventory				
24 Capital loss limitation and carryforward used				
25 Other income (loss) items with differences (attach statement)				
26 **Total income (loss) items.** Combine lines 1 through 25				
27 **Total expense/deduction items** (from Part III, line 39)				
28 Other items with no differences				
29a Mixed groups, see instructions. All others, combine lines 26 through 28				
b PC insurance subgroup reconciliation totals				
c Life insurance subgroup reconciliation totals				
30 **Reconciliation totals.** Combine lines 29a through 29c				

Note: Line 30, column (a), must equal Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.

Schedule M-3 (Form 1120) 2018

FIGURE I:16-3B ▶ FORM 1120, SCHEDULE M-3

Schedule M-3 (Form 1120) 2018 Page 3

Name of corporation (common parent, if consolidated return) | Employer identification number

Check applicable box(es): (1) ☐ Consolidated group (2) ☐ Parent corp (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corp (5) ☐ Mixed 1120/L/PC group
Check if a sub-consolidated: (6) ☐ 1120 group (7) ☐ 1120 eliminations

Name of subsidiary (if consolidated return) | Employer identification number

Part III Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items (see instructions)

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense				
2 U.S. deferred income tax expense				
3 State and local current income tax expense				
4 State and local deferred income tax expense				
5 Foreign current income tax expense (other than foreign withholding taxes)				
6 Foreign deferred income tax expense				
7 Foreign withholding taxes				
8 Interest expense (see instructions)				
9 Stock option expense				
10 Other equity-based compensation				
11 Meals and entertainment				
12 Fines and penalties				
13 Judgments, damages, awards, and similar costs				
14 Parachute payments				
15 Compensation with section 162(m) limitation				
16 Pension and profit-sharing				
17 Other post-retirement benefits				
18 Deferred compensation				
19 Charitable contribution of cash and tangible property				
20 Charitable contribution of intangible property				
21 Charitable contribution limitation/carryforward				
22 Domestic production activities deduction (see instructions)				
23 Current year acquisition or reorganization investment banking fees				
24 Current year acquisition or reorganization legal and accounting fees				
25 Current year acquisition/reorganization other costs				
26 Amortization/impairment of goodwill				
27 Amortization of acquisition, reorganization, and start-up costs				
28 Other amortization or impairment write-offs				
29 Reserved				
30 Depletion				
31 Depreciation				
32 Bad debt expense				
33 Corporate owned life insurance premiums				
34 Purchase versus lease (for purchasers and/or lessees)				
35 Research and development costs				
36 Section 118 exclusion (attach statement)				
37 Section 162(r)–FDIC premiums paid by certain large financial institutions (see instructions)				
38 Other expense/deduction items with differences (attach statement)				
39 **Total expense/deduction items.** Combine lines 1 through 38. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive				

Schedule M-3 (Form 1120) 2018

FIGURE I:16-3C ▶ FORM 1120, SCHEDULE M-3

corporation? From a 25%-owned domestic corporation? From a more-than-80% owned domestic corporation?

d. What is the effective tax rate on the dividend income? Hint: the effective tax rate equals the increase in a C corporation's tax liability divided by the additional gross income that it reports.

I:16-7 What conditions must be met for an accrual-basis corporation to deduct a charitable contribution in a year before it is made?

I:16-8 Acorn Corporation is publicly traded on the American Stock Exchange. Its chief executive officer, Carl, currently receives an annual salary of $1 million. The board of directors is considering increasing his compensation by $200,000.

a. What are the income tax consequences to Acorn if Carl's salary is increased to $1,200,000?

b. What alternatives might be considered to increase Carl's annual compensation that would produce more favorable tax consequences for Acorn?

I:16-9 Current tax law imposes a $1 million limitation on the deductibility of executive compensation. Should such limitation be retained or repealed? Give reasons for your opinion.

I:16-10 Collins Corporation paid a $30,000 alternative minimum tax in 2017. What AMT benefit (if any) is available to reduce federal income taxes paid in the current tax year or in a future tax year?

I:16-11 The accumulated earnings tax is effectively a penalty on corporations.

a. What is the purpose of the accumulated earnings tax?

b. Why does the "reasonable needs of the business" exception either reduce or eliminate the accumulated earnings tax burden for many corporations?

I:16-12 Acme Corporation is a highly profitable closely held corporation that has never paid a dividend. During the past five years, after-tax earnings of $200,000 per year have been retained in the business. All of the earnings ($1 million) have been reinvested in operating assets and to finance an expansion of the business. Is the corporation subject to the accumulated earnings tax because no dividends have been paid?

I:16-13 The personal holding company tax imposes a penalty on corporations.

a. What is the purpose of the personal holding company tax?

b. Two tests are used to classify a corporation as a personal holding company. What are these tests, and how do they serve the purpose of the personal holding company tax?

I:16-14 In terms of a corporation's incurring liability for the tax, what is the difference between the personal holding company tax and the accumulated earnings tax? Do both taxes require a tax avoidance motive?

I:16-15 Why are controlled groups of corporations required to apportion among group members tax attributes such as the Sec. 179 expense limitation and accumulated earnings credit?

I:16-16 Discuss the underlying rationale for the nonrecognition of gain or loss in a Sec. 351 transaction.

I:16-17 Corporate formation transactions are either taxable or tax-free events depending on whether the requirements of Sec. 351 are met. Debate the pros and cons of the following statement: All corporate formations should be treated as taxable events. Teams of two to four persons should conduct the debate. A summary of items for the "pro" and "con" positions should be presented.

I:16-18 **a.** Brett Nelson transfers a building having a $75,000 FMV and a $30,000 adjusted basis to Gator Corporation. An advantage of the asset transfer under Sec. 351 is that Brett can defer his $45,000 ($75,000 FMV – $30,000 adjusted basis) realized gain. What disadvantages accrue to Gator as a result of the post-transfer aspects of the transaction?

b. Assume the same facts as in Part a except that the building's FMV is instead $30,000 and its adjusted basis is $75,000. What tax disadvantage results from the transfer as presently structured? Are there any suggestions that you can offer to Brett to improve his tax benefits?

c. Explain why the basis of gain property that is contributed to a corporation in a Sec. 351 exchange is not equal to its FMV on the date of the exchange. Is the basis of the property that is contributed to the corporation adjusted when gain is recognized by the transferor?

d. How would your answers to Part a change if Brett Nelson transferred a $25,000 mortgage along with the land and received stock having a value less than the amount of the liability?

I:16-19 Carmen transfers land and a building having a $60,000 adjusted basis and a $100,000 FMV to Bass Corporation in a transaction ostensibly qualifying as tax-free under Sec. 351. Immediately before the exchange, Carmen incurs a $50,000 mortgage on the property. The mortgage is assumed by the corporation, and the mortgage proceeds are used by Carmen to remodel her personal residence.

a. What are the likely tax consequences of the asset transfer?

b. What is the rationale for this result?

I:16-20 Sato, Jose, and Satish form a new corporation. Each individual contributes $100,000 in appreciated property and receives a one-third (equity) ownership interest. Jose and Satish also lend the corporation $250,000 cash in exchange for two 30-year notes (debt) bearing annual interest at a below-market rate of 3.5%.

a. From the corporation's and the shareholders' perspectives, what are the principal advantages of capitalizing with debt as opposed to equity?
b. What are the tax consequences to Sato, Jose, and Satish if the property transfer meets the requirements of Sec. 351?
c. What tax consequences to the corporation and its shareholders would ensue if the IRS recharacterizes the debt as equity?

I:16-21 Chang and George, high income taxpayers, are starting a new business that manufactures and sells explosives. They expect the business to sustain $500,000 in losses in its first two years of operation, then gradually generate profits. Given their high income level, the nature of their business, and its projected operating results, what entity form(s) might Chang and George find advantageous, and why?

I:16-22 Under current tax law, a corporation may deduct interest (subject to limitations) but not dividends paid to shareholders. What potential problems are created by this disparate treatment? Should the law be changed to either disallow the interest deduction or allow a dividends-paid deduction?

I:16-23 Why is it generally preferable to structure the redemption of a shareholder's stock to meet the substantially disproportionate test or the complete termination test rather than the not-essentially-equivalent-to-a-dividend requirement?

I:16-24 Compare the three types of redemptions (i.e., substantially disproportionate, not essentially equivalent to a dividend, and complete termination of shareholder interest) in terms of the following features:
a. Often permissible, even where percentage stock ownership does not decrease by more than 80%.
b. Constructive ownership rules may be waived under certain conditions.
c. Treated as an exchange taxed as a capital gain or loss.
d. Stock not surrendered in exchange for corporate distribution.

I:16-25 If the requirements for a complete termination of a shareholder's interest are met, should not the substantially disproportionate redemption re- quire- ments also be met? What is the major difference between these two requirements?

I:16-26 How does the liquidation of a controlled subsidiary differ from the liquidation of a corporation owned by a single individual? What is the reason for the difference?

I:16-27 A corporate formation can take place tax-free when an individual transfers the assets of a business to a corporation and no boot property is distributed by the corporation to the shareholder. A corporate liquidation, on the other hand, is taxable to both the liquidating corporation and its shareholder(s). Why does the tax law differentiate between the two transactions?

I:16-28 Why is Sec. 1244, which pertains to small business corporation stock, in the tax code? What advantages and disadvantages are afforded to owners of Sec. 1244 stock?

I:16-29 Why is it generally preferable to increase salaries, interest, or rental payments to employee-shareholders in a closely held corporation rather than increase dividends?

I:16-30 What advantages and disadvantages accrue to a corporation and its shareholders of (1) electing C corporation status for the business, or (2) electing S corporation status?

I:16-31 Explain the purpose of Schedule M-3 in corporate income tax reporting. Explain which C corporations must file this form and which C corporations need not file this form.

I:16-32 Besides M-1 and M-2, what other schedules are incorporated in Form 1120, and what do they purport to report? *(Hint: go to* www.irs.gov. *Retrieve and review the form.)*

ISSUE IDENTIFICATION QUESTIONS

I:16-33 Acorn Corporation is a very profitable closely held corporation that is owned solely by Helen, age 55, who plans to retire in 10 years. Management continuity is a problem because neither the existing employees nor Helen's children are interested in or capable of managing the company. Acorn has never paid a dividend and does not intend to do so in the future because dividends are not deductible by the corporation and would be taxable to the shareholders. Helen does not wish to expand the business and plans to have the corporation reinvest its earnings in securities. What tax issues should Helen consider in the short run? In the long run?

I:16-34 Hugo and Helga each own unincorporated businesses. They plan to form a corporation to which they would transfer all of their business assets and liabilities in exchange for all of the corporation's stock. Hugo's assets have substantially appreciated over time. A transfer of all of his assets and liabilities would result in an excess of liabilities over the adjusted basis of the assets. Helga has substantial unrealized losses on some of her business properties (e.g., land and a building). Her tax accountant has recommended that she sell the

properties to a third party or to the corporation to recognize capital losses or Sec. 1231 losses that could be used to offset personal capital or ordinary gains. The sales proceeds then could be invested in the new corporation. What tax issues should Hugo and Helga consider with respect to the asset transfer, the organizational expenditures, the capital structure, and other aspects of the corporate formation?

I:16-35 Eastern Corporation is formed by John and Joy with an initial capitalization of $500,000. Two alternative capitalization plans are being considered: (1) John and Joy, who are unrelated, each would receive $200,000 of 8% 15-year bonds and $50,000 of Eastern stock, or (2) John and Joy each would receive $250,000 of Eastern stock. John's business assets that would be transferred to Eastern have significantly appreciated over time, and John does not want to recognize any gain on the transfer of these assets. Organizational costs of $3,000 are expected to be incurred. What tax issues should John and Joy consider with respect to the asset transfer, the organizational expenditures, the capital structure, and other aspects of the corporate formation?

PROBLEMS

I:16-36 *Capital Gains and Losses.* First Corporation, in its fifth year of operations, realizes the following capital gains and losses in the current year:

LTCG	$20,000
LTCL	(8,000)
STCG	16,000
STCL	(40,000)

Taxable income (exclusive of the capital gains and losses) is $60,000.

a. What is First's net capital gain or loss?
b. What is First's taxable income for the current year?
c. Assuming that the gains and losses reported in the current year are the first capital gains and losses ever reported by the corporation and then that the corporation had reported an excess of capital gains over capital losses in its prior tax years, explain the tax treatment of any unused capital losses

I:16-37 *Capital Loss Carrybacks and Carryovers.* Federal Corporation realizes the following net capital losses in 2019:

STCL	$ 80,000
LTCL	120,000

NLTCGs were incurred in 2016 through 2018 as follows:

2016	$20,000
2017	20,000
2018	60,000

a. What are the amount and character of any capital loss carryback to 2016 through 2018?
b. What treatment should be accorded any unused capital loss amount after the carry-back?
c. What is the character of any unused capital loss carryovers?

I:16-38 *Netting of Gains and Losses.* For each of the four independent scenarios below, compute the additional amount of income tax (or tax savings if a loss) that would result from current gains and losses for (a) Able Corporation that is taxed at the 21% marginal tax rate or (b) a sole proprietorship whose ordinary income is taxed at a 37% rate and long-term capital gains, at a 20% rate. (Ignore the 3.8% net investment income tax for higher-income taxpayers for this problem.)

Scenario	*LTCG or (LTCL)*	*STCG or (STCL)*	*Sec. 1231 Gains*	*Sec. 1231 Losses*
1	$10,000	$ 5,000	$10,000	$ 5,000
2	$10,000	$ 15,000	$20,000	$ 5,000
3	$10,000	$(15,000)	$ –0–	$15,000
4	$20,000	$ 5,000	$10,000	$15,000

I:16-39 ***Dividends-Received Deduction.*** During the current year, Florida Corporation reports the following results:

Net income from operations	$100,000
Dividend from a 20%-owned corporation (qualifying for the dividends-received deduction)	200,000

a. What is the amount of Florida's dividends-received deduction?
b. How would your answer to Part a change if Florida instead reported a $20,000 loss from operations?
c. How would your answer to Parts a and b change if the dividend income were instead from a 10%-owned corporation and the loss from operations in Part b were instead $130,000?

I:16-40 ***Dividends-Received Deduction.*** Calculate the dividends-received deduction and taxable income for each independent scenario below. Assume there are no other income or deduction items.
a. During the current year, Purple Corporation reports $260,000 of gross income from operations and $170,000 of allowable business deductions. In addition, Purple receives dividends of $200,000 from Blue Corporation. Purple owns 25% of Blue and the dividends qualify for the dividends-received deduction.
b. During the current year, Yellow Corporation reports $160,000 of gross income from operations and $180,000 of allowable business deductions. In addition, Yellow receives dividends of $220,000 from Green Corporation. Yellow owns 15% of Green common stock and the dividends qualify for the dividends-received deduction.

I:16-41 ***Net Operating Losses.*** Alpha Corporation reports $500,000 of gross income from business operations and $625,000 of allowable business deductions. It also received from a domestic corporation $150,000 in dividends for which it is entitled to a 65% dividends-received deduction. What is Alpha's taxable income reported on Form 1120?

I:16-42 ***Charitable Contributions.*** On May 15 of the current year, the board of directors of Georgia Corporation authorized a $40,000 donation to a qualified charity. The corporation donated the $40,000 to the charity on December 1 of the current year. It made no other charitable contributions during the year. Georgia reports the following results for the current year:

Taxable income (before the dividends-received deduction and charitable contributions)	$250,000
Dividends-received deduction	10,000

a. What amount of charitable contributions is deductible in the current year?
b. How are any excess contributions treated?

I:16-43 ***Corporate Tax Rates.*** Calculate Ajax Corporation's regular tax liability for the following amounts of taxable income:
a. $90,000
b. $300,000
c. $5 million
d. $12 million
e. $20 million
f. Alternatively, for Parts a, b, and c above, compute Ajax's regular tax liability if it were a personal service corporation.

I:16-44 ***Corporate Tax Rates.*** In December of the current year, Colorado Corporation considers a sale of certain corporate assets that would result in the recognition of a $50,000 LTCG. Colorado's controller estimates that taxable income for the current year will be $60,000 (excluding the LTCG). She also estimates that taxable income for next year will be $200,000 (excluding the LTCG).
a. What is Colorado's tax liability for the two years if the assets are sold in the current year?
b. What is Colorado's tax liability for the two years if the assets are sold next year?
c. Should Colorado sell the assets in the current year or next year? Explain.

I:16-45 *Accumulated Earnings Tax.* The IRS is auditing Crane Corporation, a manufacturer of widgets, to determine whether the company is liable for the accumulated earnings tax in a prior tax year. Crane is owned by 20 shareholders who are unrelated and was not a personal holding company in the year in question. Crane reported the following results for the current year:

Taxable income	$150,000
Federal income taxes	31,500
Dividends-received deduction	85,000
Dividend paid on June 1	20,000

The accumulated E&P balance on January 1 is $180,000, and the company can justify the retention of the $180,000 of E&P at the beginning of the year plus $80,000 of earnings earned in the current year in terms of meeting its reasonable business needs. In fact, all of the January 1 earnings were retained for the reasonable needs of the business.

a. What is Crane's accumulated taxable income?
b. What is Crane's accumulated earnings tax liability?
c. If Crane potentially owes the accumulated earnings tax, what steps can it take to reduce or eliminate the liability?

I:16-46 *Personal Holding Company Tax.* Delta Corporation is being reorganized as an investment company because its retained earnings have been used for passive investments. The company is owned by three shareholders, and more than 60% of its income is personal holding company income. George, the president of Delta believes that personal holding company status is not detrimental because the company has paid dividends to its shareholders for several years and therefore should not be liable for any penalty tax.

Delta reports the following results for the current year:

Taxable income	$50,000
Federal income tax liability	10,500
Dividends paid	6,000
Dividends-received deduction	80,000

a. Do you agree or disagree with George? Explain.
b. What is Delta's personal holding company tax liability, if any, for the current year?
c. How could Delta avoid liability for the personal holding company tax?

I:16-47 *Controlled Group.* Alfred, Barbara, and Cathy own stock in First, Second, and Third Corporations as follows:

Individuals	*First*	*Second*	*Third*
Alfred	40%	40%	40%
Barbara	30%	60%	30%
Cathy	30%	–0–	30%

Which corporations are members of a brother-sister controlled group under the 80%-50% test?

I:16-48 *Corporate Formation.* In the current year, Jack, Karen, Latoya, and Marc transfer the following property to Giant Corporation (an existing corporation), which is owned equally by the four transferors.

- Jack transfers land and a building with a $60,000 adjusted basis and a $100,000 FMV for additional Giant stock having an $80,000 FMV and $20,000 of marketable securities having an adjusted basis of $15,000 in Giant's hands. $10,000 of MACRS straight-line depreciation on the building was claimed by Jack prior to the transfer.
- Karen transfers equipment with a $120,000 adjusted basis and a $100,000 FMV for additional Giant stock having an $80,000 FMV and a $20,000 20-year Giant note. $25,000 of MACRS depreciation on the equipment was claimed by Karen prior to the transfer.
- Latoya transfers inventory with a $70,000 adjusted basis and a $100,000 FMV for additional Giant stock having an $80,000 FMV and $20,000 cash.
- Marc transfers land with a $30,000 adjusted basis and a $100,000 FMV, subject to a $40,000 mortgage, which Giant assumes, for additional Giant stock having a $60,000 FMV.

a. What amount and character of gain or loss does Jack recognize? What is Jack's basis in the Giant stock and the marketable securities? What is Giant's basis in the land and building?
b. What amount and character of gain or loss does Karen recognize? What is Karen's basis in the Giant stock and note? What is Giant's basis in the equipment?
c. What amount and character of gain or loss does Latoya recognize? What is Latoya's basis in the Giant stock? What is Giant's basis in the inventory?
d. What amount and character of gain or loss does Marc recognize? What is Marc's basis in the Giant stock? What is Giant's basis in the land?
e. What amount and character of gain or loss does Giant recognize on the distribution of its stock, note, and other property to its shareholders?

I:16-49 ***Corporate Formation.*** Linda and Cynthia decide to form a corporation in a transaction that meets the requirements of Sec. 351. Linda transfers machinery she has held for several years with a basis of $45,000 and a fair market value of $70,000 for 60% of the new corporation's stock. The machinery was originally purchased for $100,000 and is subject to a liability of $10,000 that the corporation has agreed to assume. Cynthia transfers land held for investment with a basis of $32,000 and a fair market value of $40,000 for the remaining 40% of the corporation's stock.
a. Determine Linda's basis in her shares and any gain or loss recognized.
b. Determine Cynthia's basis in her shares and any gain or loss recognized.

I:16-50 ***Corporate Formations: Transfer of Liabilities.*** In a transaction that meets the requirements of Sec. 351, Matt transfers to Hill Corporation land with a $600,000 adjusted basis and a $1,000,000 FMV that was used in his business. The land is subject to an $800,000 mortgage, which Hill assumes. Matt receives 100% of Hill stock.
a. What amount and character of gain or loss are recognized by Matt?
b. What is Matt's basis in the Hill stock?
c. What is Hill's basis in the land?

I:16-51 ***Earnings and Profits (E&P).*** During the current year, Nevada Corporation distributed $100,000 in cash to its sole shareholder. Because the corporation has a $300,000 accumulated E&P deficit at the beginning of the current year and only $30,000 of taxable income in the current year, Nevada's controller believes that the distribution should be treated as a tax-free return of capital to the shareholder. Your investigation reveals the following information that may have an effect on the computation of current E&P:

Federal income tax liability	$ 6,300
Dividends-received deduction	60,000
Excess of MACRS depreciation over Alternative Depreciation System depreciation	30,000
Excess charitable contributions	9,000

a. What is Nevada's current E&P?
b. How much (if any) of the $100,000 cash distribution is taxable as a dividend to the sole shareholder?
c. What is the amount of Nevada's accumulated E&P balance (deficit) on the last day of the current year?

I:16-52 ***Earnings and Profits (E&P).*** North Corporation has $200,000 of accumulated E&P at the beginning of the current year. North distributed $300,000 cash during the current year to its shareholders. The company's operating results for the current year are as follows:

Taxable income	$100,000
Tax-exempt bond interest	10,000
Dividends-received deduction	7,000
Federal income tax liability	21,000
Net capital losses	27,000

a. What is North Corporation's current E&P?
b. How much of the $300,000 cash distribution is taxable as a dividend?
c. What is North's accumulated E&P balance (deficit) at the end of the current year?

I:16-53 ***Earnings and Profits (E&P).*** At the beginning of the current year Ohio Corporation has a $40,000 accumulated E&P balance and a $73,000 current E&P deficit. The corporation distributes $60,000 cash to its sole shareholder on May 5. The shareholder's tax basis in her Ohio stock at the beginning of the year is $325,000.

a. What amount of the $60,000 distribution is taxable as a dividend (assume a ratable allocation of the deficit)?
b. What are the amount and character of any nondividend distributions to the share-holder?
c. What is the amount of Ohio's accumulated E&P balance (deficit) on the last day of the year?

I:16-54 ***Property Distributions.*** Old Corporation has liquidity problems but wants to maintain its existing dividend policy. Old distributes investment land to its two shareholders. The land has a $30,000 adjusted basis and a $100,000 FMV. Old has an E&P balance of $300,000 (excluding the effects of the distribution). Nancy receives 50% of the land, and Palm Corporation receives the remaining 50%. Assume no taxable income or loss from current year operations.
a. What distribution amount is taxable to Nancy and Palm?
b. What is the basis of the property to Nancy and Palm?
c. What are the income tax consequences of the distribution to Old?

I:16-55 ***Property Distributions.*** Without liquidating, Park Corporation distributes equipment with a $70,000 adjusted basis and a $80,000 FMV to Pam. The equipment is subject to a $25,000 mortgage assumed by Pam. Park has $300,000 of E&P (excluding the distribution).
a. How much gain (if any) does Park recognize on the distribution of the equipment?
b. What distribution amount is taxable as a dividend to Pam?
c. What is Pam's basis in the equipment?

I:16-56 ***Withdrawing Earnings from a Business.*** Galadriel Corporation reports pre-tax earnings of $500,000 during the current year. The corporation wishes to distribute $100,000 to Gabby, its sole owner and CEO, in a manner that will minimize taxes for Galadriel and Gabby. The corporation is subject to the regular corporate tax rates. Gabby's tax rate is a flat 37%. Ignoring FICA employment taxes paid by the corporation and Gabby, compare the after-tax income reported if the $100,000 is paid to Gabby as (1) salary and (2) as a qualifying dividend.

I:16-57 ***Stock Redemptions.*** Private Corporation redeems some of its stock from Jane, a major shareholder. Before the redemption Jane owns 50 of the 100 outstanding shares, and her daughter Jill owns 40 shares. The remaining ten shares are owned by unrelated individuals. Private redeems for $600,000 in cash 40 of Jane's shares, having a $200,000 basis. Private has $900,000 of current and accumulated E&P. Jane's basis in her remaining ten shares is $50,000.
a. What are the tax consequences of the redemption to Jane?
b. What is Jane's basis in her remaining ten shares after her 40 shares are redeemed?
c. How would your answers to Parts a and b change if Jane and Jill were not related?

I:16-58 ***Stock Redemption.*** Prime Corporation redeems some of its stock from two of its shareholders on the same date. Frank and his son Sam own 50 and 20 shares, respectively, of the 100 shares outstanding before the redemption. The remaining 30 shares are owned by unrelated individuals. Prime redeems for $50,000 10 of Frank's shares having a $15,000 basis. All of Sam's shares, having a $30,000 basis, are redeemed for $100,000. Sam files an agreement with the IRS that he will acquire no interest in the corporation other than as a creditor for 10 years. Prime has current and accumulated E&P of $200,000.
a. What are the tax consequences of the redemption to Frank and Sam?
b. What are the tax consequences of the redemption to Sam if he does not file the agreement or if he violates the agreement during the 10-year period?

I:16-59 ***Corporate Liquidation.*** Queen Corporation adopts a plan of complete liquidation on January 1 of the current year. The corporation sells the assets listed below to King Corporation during the current year. This sale is followed by the assumption of Queen's liabilities by King Corporation and a single liquidating distribution of $1,200,000 cash to Ahmed (Queen's sole shareholder) on December 12 of the current year. Ahmed has a $400,000 basis in his Queen stock, which he has held for seven years. The following facts are relevant:

- Inventory costing $600,000 is sold to customers for $1,000,000.
- Depreciable fixed assets with a $2,000,000 adjusted basis are sold for $3,000,000. Depreciation recapture under Sec. 1245 is $800,000.
- Land held as a capital asset with a $4,000,000 adjusted basis is sold for $5,000,000.

a. What are the tax consequences of the liquidation to Queen?
b. What are the tax consequences to Ahmed upon his receiving the liquidating distribution?
c. How would your answers to Parts a and b change if the assets were instead distributed to Ahmed in exchange for his Queen stock and Ahmed then proceeded to sell the assets for the prices indicated above?

I:16-60 ***Corporate Liquidation.*** Several years ago, Tampa Corporation acquired 100% of Union Corporation stock for $1,000,000. In the current year, Tampa liquidates Union and receives all of its assets and liabilities. Tampa continues to operate Union as a division. On the liquidation date, the basis and FMV of Union's assets are $700,000 and $2,500,000, respectively. Union also has $100,000 of liabilities that were owed to third parties and E&P of $125,000 on the liquidation date.
a. How much gain or loss does Union recognize as a result of the liquidation?
b. What is Tampa's basis in the Union assets?
c. What Union tax attributes (if any) carry over to Tampa?

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:16-61 Sandra and John, unrelated individuals, own all of Alpha and Beta corporation stock. John owns 60% of Alpha stock and 40% of Beta stock. Sandra owns 40% of Alpha stock and 60% of Beta stock. For five years, Alpha has conducted manufacturing activities and sold machine parts primarily in the eastern United States. Alpha reported $75,000 of operating profits in each of the last two years. Alpha's operating profits are expected to grow to $150,000 during the next five years. Alpha still has $100,000 of NOLs that must be used before it incurs federal income tax liability.

One-fourth of Alpha's output is sold to Beta, which is attempting to establish a market niche for reselling Alpha products in the southwestern United States. In the start-up phase of this effort, Beta incurred $200,000 of NOLs. Under the sales arrangement with Alpha, the best that Beta can hope to do in the short run is break-even.

What suggestions can you offer Sandra and John about the short-term possibility of offsetting Alpha and Beta's NOLs against the profits that Alpha expects to earn and minimizing their overall tax liabilities if both businesses become profitable? Sandra has specifically asked about merging the two companies into a single entity so that the losses of one entity can offset the profits of the other and defer federal income taxes. Sandra indicates that the two companies were created for non-tax reasons. The operating situation has changed, and according to Sandra, now may be the time to consolidate the entities. John is not sure that combining the two businesses is a good idea.

I:16-62 Penny and Rick, equal partners in a partnership, recently attended a business-planning seminar held in their town. While at the seminar they learned about limiting their personal liability by using the corporate form of business association. Penny and Rick's business has incurred product liability because it manufactures replacement parts for motorcycles. The most important information that Penny and Rick acquired from the seminar was the tax and legal advantages of incorporating their partnership business. According to a speaker at the seminar, incorporation would protect Penny and Rick from losing their personal wealth if someone sued them. Following a phone call from the partners to set up an appointment, you have scheduled a meeting with Rick and Penny for this afternoon. In preparation for the meeting you draft a list of points to discuss with the couple. What kinds of tax and non-tax strategies should you include in this list?

I:16-63 Peter Martin owned an equity interest in retail hardware stores for a nationwide chain. The eleven stores operate in a single midwestern state under the name Martin Corporation. Peter has been the chief financial officer of the company for 15 years. His retirement plans call for him to take his pension from Martin in six months and play golf in sunny Gainesville, Florida. Since Peter's son and daughter will be operating the company, Peter will probably drop by the office to see family and old friends and to provide management advice. Peter will continue to serve on Martin's board of directors. The Martin stock is owned as follows: Peter and his wife Jaclyn, 25%; Peter's son and daughter-in-law, 25%; Peter's daughter and son-in-law, 25%. All six individuals serve on Martin's board of directors, along with six outside directors. The outside directors and Martin employees (other than those listed above) own the remaining 25% of the stock. Peter is thinking about his post-retirement years. He would like to withdraw money from the company, in addition to his pension and board of directors compensation. He would like to redeem some of his stockholdings each year. What advice can you provide Peter about the tax consequences of the redemption(s)?

I:16-64 Gertrude, age 67 and widowed, owns 50 acres of land on the Chattahoochee River that she and her husband purchased for $10,000 when they were newlyweds in 1980. The land is near Atlanta and is now worth at least $1,500,000 if sold undivided. Gertrude is considering selling the land to her wholly owned ABC Corporation for its $1,500,000 market value. Alternatively, Gertrude is considering transferring ownership of the land to ABC in exchange for additional ABC stock.

ABC will subdivide the land and sell it off as 50 one-acre lots with total proceeds of the lot sales expected to be at least $3,000,000. Land development costs will be approximately $300,000 and sales commissions will be 5% of the sales price.

Analyze the tax implications of Gertrude's two choices. Assume that Gertrude's marginal tax rate on ordinary income is 37% and that she has never generated capital gains. Assume that ABC would recognize ordinary income on the lot sales taxed at the marginal tax rate of 21%. (Ignore the 3.8% net investment income tax for higher-income taxpayers for this problem.)

TAX FORM/RETURN PREPARATION PROBLEMS

I:16-65 The financial accounting balance sheet for Zane, a retail sales corporation, as of the end of the current year is as follows:

Assets	
Cash	$ 50,000
Accounts receivable	20,000
Inventory	10,000
Land	20,000
Buildings (net of $30,000 accumulated depreciation)	100,000
Equipment (net of $50,000 accumulated depreciation)	150,000
Intangibles	60,000
Total assets	$410,000

Liabilities & Owner's Equity	
Accounts payable	$ 40,000
Mortgage payable (short-term)	40,000
Long-term debt	60,000
Capital stock	100,000
Retained earnings	170,000[a]
Total liabilities and stockholders' equity	$410,000

[a]The retained earnings balance at the beginning of the current year was $70,000. Beginning inventory was $15,000. Dividends in the amount of $25,000 were paid.

Using the accrual method Zane reports the following financial accounting operating results for the current year:

Sales	$550,000
Minus: Costs of goods sold	(350,000)
Gross profit	$200,000
Dividend income from a 20%-owned domestic corporation	75,000
Net long-term capital gains	150,000
Total income	$425,000
Expenses:	
Salaries (including officer's salary of $40,000)	$120,000
Repairs	30,000
Bad debts	10,000
State and local taxes	20,000
Amortization	5,000
Contributions	35,000
Depreciation (straight-line)	40,000
Total expenses (before federal income tax expense)	$260,000
Operating profit	$165,000
Minus: Provision for federal income taxes	(40,000)
Net income	$125,000

All dividends qualify for the dividends-received deduction. In addition, the following items should be taken into account:

Current-year estimated tax payments	$15,000
MACRS depreciation for tax purposes	60,000

Prepare a current year Form 1120 (U.S. Corporation Income Tax Return) for Zane. Disregard beginning-of-the-year balance sheet amounts other than retained earnings. Also, leave spaces blank on Form 1120 for information not provided.

I:16-66 Huge Corporation reports the following balance sheet for the current year:

	Beginning of Year	*End of Year*
Cash	$ 40,000	$ 70,000
Accounts receivable	23,000	21,500
Inventories	26,000	53,000
Marketable securities	30,000	30,000
Investment in 100%-owned subsidiary	100,000	115,000
Depreciable assets	100,000	100,000
Less: Accumulated depreciation	(20,000)	(30,000)
Total assets	$299,000	$359,500
Accounts payable	$ 50,000	$ 80,000
Short-term loans payable	20,000	35,000
Mortgage payable	80,000	79,000
Common stock	1,000	1,000
Additional paid-in capital	49,000	49,000
Retained earnings	99,000	115,500
Total liabilities and stockholders' equity	$299,000	$359,500

Huge reports the following income and expenses for the year:

Sales	$720,000
Purchases	570,000
Dividend from 100%-owned subsidiary	30,000
Dividend from less-than-20%-owned corporation	10,000
Salaries (including officers' salaries of $30,000)	90,000
Repairs	12,000
Contributions	60,000
State and local taxes	7,500
Interest expense	11,000
Financial accounting depreciation	10,000
MACRS depreciation	17,490
Federal income tax expense per books	10,000

In addition, Huge reported an NOL carryover of $12,000 from the preceding year and paid current year estimated taxes of $10,000. Huge files its tax return separately (i.e., it does not consolidate its subsidiary).

Prepare a current year Form 1120 (U.S. Corporation Income Tax Return) for Huge. Leave spaces blank on Form 1120 for information not provided. Note: You should prepare a schedule of net income per books to complete Line 1 of Schedule M-1.

CASE STUDY PROBLEMS

I:16-67 Frank, Paul, and Sam are considering merging their respective unincorporated businesses into a new C corporation called FPS. Frank would transfer land and a building with a $50,000 adjusted basis and $100,000 FMV to the corporation in exchange for $100,000 of FPS common stock. Paul would transfer inventory with an adjusted basis of $60,000 and $100,000 FMV in exchange for $50,000 of FPS stock and $50,000 of FPS 10-year notes. Sam would contribute equipment with an adjusted basis of $80,000 and $60,000 FMV along with legal services worth $40,000 in exchange for $100,000 of FPS stock.

Prepare a client memo that details the tax consequences of the transactions to FPS, Frank, Paul, and Sam.

I:16-68 Beth, who is married, is the sole shareholder of Pet Store Inc., a C corporation. She also manages the store. She wishes to expand the business, but the corporation needs additional capital for her to do so. Fortunately, she has saved $50,000 cash and plans to contribute it to the corporation. However, she does not know whether to contribute the cash in exchange for additional stock or lend the cash in exchange for a note.

Prepare a client memo that explains the tax consequences and requirements of each alternative so that Beth can make an informed decision.

TAX RESEARCH PROBLEMS

I:16-69 The income tax laws for a particular state depend on the business entity's organizational status. Answer the following four questions using the web site for a particular department of state (for example, Florida's information can be found at http://dos.state.fl.us/).

a. What business entity forms are permitted in the state selected?
b. Must a business that uses one of the basic business forms (for example, corporation, partnership, or LLC) organized and operating in the state register with a state agency? If so, which agency?
c. Must a business that uses one of the basic business forms that is organized outside of the state (for example, Georgia) but which operates in the state (for example, Florida) register with an agency in the state of organization? In the state in which it operates? In both states?
d. Does the state selected impose an income tax on corporations organized in the state? On foreign corporations (corporations formed outside of the state selected) who conduct part or all of their business in their home state and part in the state selected?

I:16-70 Charlie Corporation acquired 100% of Delta Corporation common stock on July 1 of the current tax year. Prior to the acquisition, Delta supplied Charlie with about 50% of the raw materials and other components used in producing its plastic toys. Delta will continue to be Charlie's major supplier as well as a supplier to other toy makers. Both corporations have been profitable for years and expect to be profitable after the acquisition. Charlie's CEO asks you if the two corporations, filing a single consolidated tax return would be less costly (in terms of both taxes paid and filing fees) than their filing two separate tax returns. How do you respond to this inquiry?

I:16-71 Ted is the sole shareholder of Zero Corporation. Before his retirement from the company, he gave 100 shares of Zero stock to his son. A few months later, Ted sold his remaining 1,900 shares to Zero for $2 million. The company has E&P exceeding $2 million. Ted's basis in his 2,000 shares before the two transfers was $80,000. Ted requested a waiver of the Sec. 318 attribution rules and treated the redemption of Zero stock as a long-term capital gain. Ted also agreed to serve as a consultant to the company. The terms of the agreement are that Ted will be paid as an independent contractor $175 per hour plus expenses. The agreement does not specify a minimum number of hours of services to be provided each month. Three years later the IRS audits Ted's return and argues that the redemption should be treated as a dividend under Sec. 301. Have the Sec. 302(c)(2) requirements that permit a waiver of the family attribution rules been met?

A partial list of research sources is:

- Secs. 302(c)(2) and (b)(3)
- Reg. Sec. 1.302-4
- *Estate of Milton S. Lennard v. CIR,* 61 T.C. 554 (1974)
- *William M. Lynch v. CIR,* 58 AFTR 2d 86-5970, 86-2 USTC ¶9731 (9th Cir., 1986)

I:16-72 Beth in Case Study Problem I:16-68 also wants to know whether she can make a $50,000 capital contribution to the corporation without the corporation's issuing additional shares. If so, should she have the corporation issue the shares or not? Assume that Beth's basis in her stock is $40,000 and that she files a joint return with her husband.

A partial list of research sources is:

- Sec. 1244(d)(1)(B)
- Reg. Secs. 1.1244(c)-1(b) and 1.1244(d)-2(a)
- *Sol Lessinger v. CIR,* 63 AFTR 2d 89-1055, 89-1 USTC ¶9254 (2nd Cir., 1989)
- *James D. Pierce,* 1989 PH T.C. Memo ¶89,647, 58 TCM 865 (1989).

I:16-73 In 2016, Peter purchased 150 shares of Able Manufacturing Corporation stock for $75,000. Able is a C corporation that has 40 shareholders. None of the other 39 shareholders own more than 5% of the 5,000 shares outstanding. No events have occurred that have changed either the number of shares of stock that Peter owns, or Peter's total basis in his shares. Peter is unhappy with Able's management. It is now Spring 2019 and Peter would like to sell part or all of his Able stock and reinvest the proceeds in the stock of another small corporation. At present, his total unrealized gain is $300,000. Peter was told by his stockbroker that he may be eligible to exclude part or all of his profit on the sale of the Able shares from current taxable income. What advice on reducing the tax cost of the sale can you give him?

A partial list of research sources is:

- Sec. 1(h)
- Sec. 1202
- Sec. 1044
- Sec. 1045
- Sec. 1244

I:16-74 Erin Brinson founded BCD Corporation in 1991 with a contribution of $50,000 cash. The entity has always been a C corporation and Erin has not made any other capital contributions nor has BCD made any distributions. When she retired in 2019, Erin transferred ownership of BCD to her son, Evan, and two other employees. Evan now owns 60% of BCD stock and the two other employees each own 20%. The transaction was consummated by BCD redeeming 90% of Erin's shares for a $2,000,000 note payable over the next 15 years and Evan and the two other employees' buying the remaining 10% for notes totaling $250,000 payable over the next 15 years. All notes bear market rates with interest and principal payable twice a year on a regular basis. Erin owned the building in which BCD operates. As part of this transaction, Erin agreed to a new 5-year lease to BCD at market rental rates. How should the transfers of stock in BCD be taxed? Must Erin take measures to qualify for the most favorable tax treatment?

A partial list of research sources is:

- Sec. 302(b)
- Reg. Sec. 1.302
- Rev. Rul. 77-467, 1977-2 CB 92
- *Hurst*, 124 TC 16 (2005)

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CHAPTER

17

PARTNERSHIPS AND S CORPORATIONS



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Compare and contrast the various types of pass-through entities
2. Determine the tax implications of forming and operating a partnership, including partnership distributions
3. Explain the requirements for electing and maintaining S corporation status, and apply operating rules for S corporations
4. Identify tax planning opportunities for partnerships and S corporations
5. Comply with procedural and reporting requirements for partnerships and S corporations

CHAPTER OUTLINE

Types of Pass-Through Entities...17-2
Taxation of Partnerships...17-4
Taxation of S Corporations...17-21
Tax Planning Considerations...17-33
Compliance and Procedural Considerations...17-35

Pass-through or conduit business entities, such as partnerships, S corporations, limited liability companies, and limited liability partnerships, have the major advantage of entailing only one level of taxation.[1] These legal organizational forms thus represent an interesting blend of what tax theorists call the entity and aggregate theories of taxation. In some ways, they are treated as entities separate from their owners. For example, the entity files a tax return (for information purposes), makes elections pertaining to accounting periods and methods, and computes the results of business operations. In other ways, however, a pass-through entity is treated as a mere aggregation of its owners. For example, the entity is generally not taxed, and the entity's income, deductions, losses, and credits are allocated to the owners based on their proportionate ownership or some other allocation arrangement. These allocated items then pass through to the owners to be reported in their own tax returns.

KEY POINT

Pass-through entities (also called flow-through entities) entail taxation only at the ownership level. This single level of taxation is achieved by (1) exempting the entity from taxation; (2) passing income, deductions, losses, and credits through to the owners; and (3) adjusting the basis of the owner's interest in the entity.

Aside from exempting pass-through entities from entity level taxation, the tax law preserves the single level of taxation in another important way: basis adjustments made to the owner's interest in the entity. Each owner obtains an original basis in his or her ownership interest upon acquiring the interest via formation of the entity, purchase of the entity interest, gift of the entity interest, etc. Subsequently, the owner's basis increases if the entity earns income or if the owner contributes additional money or property to the entity. Conversely, the owner's basis decreases if the entity incurs a loss or if the entity distributes money or property to the owner. In short, the owner's basis increases as the entity expands, and the owner's basis decreases as the entity contracts. Without these basis adjustments, the owner could be subject to double taxation upon selling his or her interest or upon the liquidation of the entity.

EXAMPLE I:17-1 ▶ Conduit Company is a pass-through entity with two owners, George and Flo. Each owner has a $10,000 original basis in the entity. In its first year of operations, Conduit earns $30,000, which is allocated $15,000 to each owner. Thus, each owner reports $15,000 in his or her individual tax return even though the entity does not distribute the earnings to the owners. At the beginning of the second year, Flo sells her interest to Fred for $25,000. If Flo did not get an increased basis adjustment for her $15,000 of earnings, she would recognize a $15,000 ($25,000 selling price − $10,000 basis in the entity) gain on the sale of her interest, which taxes her twice on the $15,000. However, both George and Flo do increase their bases to $25,000 ($10,000 original basis + $15,000 share of entity earnings) at the end of the first year. Therefore, when Flo sells her interest for $25,000, she incurs no addition taxable gain ($25,000 selling price − $25,000 basis in the entity = $0 gain). ◀

The next section of this chapter briefly describes the four basic types of pass-through business entities. Afterward, the chapter provides more detail on the tax treatment of partnerships and S corporations.

TYPES OF PASS-THROUGH ENTITIES

OBJECTIVE 1

Compare and contrast the various types of pass-through entities

PARTNERSHIPS

Of the pass-through business entities, partnerships have been around the longest. The IRC defines a **partnership** as "a syndicate, group, pool, joint venture, or other unincorporated organization" that carries on any business, financial operation, or venture. The definition of a partnership, however, does not include a trust, estate, or corporation.[2] A partner is a member of such syndicate, group, pool, joint venture, or organization, and the partner can be an individual, corporation, trust, or estate. Unlike a corporation, which must file incorporation documents with the state, partnerships require no legal documentation although states do have laws that govern the rights and restrictions of partnerships and model their laws on the Uniform Partnership Act, Revised Uniform Partnership Act,

[1] Trusts and estates also are conduit entities to some extent in that they are not taxed on income that is distributed. Trusts and estates are not generally used to conduct business activities. Income taxation of trusts and estates is discussed in Chapter C:14 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*.

[2] Secs. 761(a) and 7701(a)(2).

REAL-WORLD EXAMPLE

For 2015, 3.71 million domestic partnerships filed returns. Of these, 407,000 were limited partnerships, and 2.51 million were limited liability companies. On average, partnerships had 7.3 partners, limited partnerships had 29.3 partners, and average limited liability companies had 4.3 members.

Uniform Limited Partnership Act, or Revised Limited Partnership Act. A partnership must have at least two partners but can have an unlimited number beyond two.

A partnership can be either a general partnership or a limited partnership. In a general partnership, each partner has unlimited liability for partnership debts. Thus, these partners are at risk for more than their investment in the partnership. In a limited partnership, at least one partner must be a general partner, and at least one partner must be a limited partner. As in a general partnership, the general partners are liable for all partnership debts, but the limited partners are liable only to the extent of their investment plus any amount they commit to contribute to the partnership if called upon. Moreover, limited partners may not participate in the management of the partnership.

A major document for a partnership is the partnership agreement. In this agreement, the partners set out the terms of how the partnership will operate and how income, deductions, losses, and credits will be allocated to the partners. The partners, therefore, should take great care in drafting this agreement.

A partnership files an annual information return with the IRS. This return, Form 1065 (U.S. Partnership Return of Income), reports the results of the partnership's operations and indicates the separate income, deduction, loss, and credit items that pass through to the partners. A sample Form 1065 appears in Appendix B of the *Comprehensive* and *Corporations, Partnerships, Estates & Trusts* volumes.

REAL-WORLD EXAMPLE

S corporation returns represented 69.2% of all corporate tax returns filed in 2017. The total number of S corporations has grown from 735,000 returns filed in 1985 to 4.8 million in 2017.

S CORPORATIONS

An **S corporation** is so designated because rules pertaining to this entity are located in Subchapter S of the Internal Revenue Code (IRC). S corporations are corporations that have elected to be treated by the tax laws as pass-through entities. Similar to partnerships, therefore, S corporations are not taxed, and income, deduction, loss, and credit items pass through to the shareholders. These entities, however, still are corporations so that corporate tax rules apply to them unless overridden by the Subchapter S provisions.[3] As with C corporations, the shareholders enjoy limited liability, but S corporations offer less flexibility than do partnerships. For example, the number and type of shareholders are limited, and the shareholders cannot agree to allocate income, deduction, loss, and credit items in a way that differs from their proportionate stock ownership.

To achieve S corporation status, the corporation must file an S election, and its shareholders must consent to that election. An electing S corporation files an information return, Form 1120S (U.S. Income Tax Return for an S Corporation), which reports the results of the corporation's operations and indicates the separate income, deduction, loss, and credit items that pass through to the shareholders. A sample Form 1120S appears in Appendix B of the *Comprehensive* and *Corporations, Partnerships, Estates & Trusts* volumes.

ADDITIONAL COMMENT

The LLC type of entity has been legislatively adopted by all 50 states.

LIMITED LIABILITY COMPANIES

A qualifying **limited liability company** (**LLC**) combines the best features of a partnership and a corporation even though it is neither. Specifically, it provides the limited liability protection of a corporation for all the LLC's owners, called members. An LLC can have an unlimited number of members who can be individuals, corporations, estates, or trusts.

An LLC may elect to be taxed as either a corporation or a partnership under the check-the-box regulations.[4] Under these Treasury Regulations, an LLC with more than one member is treated as a partnership unless the LLC affirmatively elects to be classified as a corporation. In most cases, LLCs will prefer to be classified as a partnership because of the tax advantages of that organizational form. Assuming the LLC opts for its default partnership classification, it annually files Form 1065 (U.S. Partnership Return of Income). Nevertheless, an LLC is not legally a partnership; it just is treated as one for tax purposes. A single member LLC may choose to be taxed as a corporation or

[3] Sec. 1371(a)(1).

[4] Reg. Secs. 301.7701-1 through -4.

to be disregarded for tax purposes. If the entity is disregarded, income earned by the single member LLC is generally taxed to its owner under the sole proprietorship rules.

ADDITIONAL COMMENT

Another variation is the limited liability limited partnership (LLLP). The LLLP is a partnership formed under a state's limited partnership laws but that can elect under the state's laws to provide the general partners with limited liability.[5]

LIMITED LIABILITY PARTNERSHIPS

A **limited liability partnership (LLP)** is a partnership form that is particularly attractive to professional service partnerships, such as public accounting firms. As a result, many professional firms have adopted the LLP form, primarily to limit legal liability. Under state LLP laws, partners are liable for their own acts and the acts of individuals under their direction. However, LLP partners are not liable for the negligence or misconduct of other partners. Thus, from a liability perspective, an LLP partner is like a limited partner with respect to other partners' acts but like a general partner with respect to his or her own acts.

TAXATION OF PARTNERSHIPS

OBJECTIVE 2

Determine the tax implications of forming and operating a partnership, including partnership distributions

FORMATION OF A PARTNERSHIP

Upon forming a partnership, the partners often contribute property (e.g., money, business equipment, and inventory previously used in a proprietorship) or services to the partnership. In exchange for this property and/or services, the partners receive an interest in the partnership. For each partner, a **partnership interest** represents an equity interest similar to corporate stock and is a capital asset.

Section 721: Nonrecognition Rules. Section 721 prevents the recognition of gain or loss upon either the transfer of property in exchange for a partnership interest or subsequent transfers of property by the partners in exchange for a pro rata increase in their partnership interests. Without this nonrecognition provision, gain on a transfer of appreciated property would be recognized, and the partners might not have sufficient liquidity (e.g., cash) to pay the tax. In addition, the transfer of property to the partnership represents a mere change in ownership form, which is not a recognition event under the tax laws. Finally, the depreciation recapture rules do not apply if no gain is recognized under Sec. 721.

KEY POINT

The nonrecognition provisions of Sec. 721 apply not only at the time of the formation of a partnership but also to subsequent capital contributions.

The following exceptions to the Sec. 721 nonrecognition rules should be noted:

- The Sec. 721 nonrecognition of gain or loss rules do not apply if the partner acts in a capacity other than as partner. For example, if a partner sells property to the partnership in an arm's-length transaction, the sale would be taxable.[6]
- If a partner contributes services instead of cash or property in exchange for an unrestricted partnership interest, the fair market value (FMV) of the services is taxed as compensation to the contributing partner because services do not qualify as property.[7]
- The contributing partner recognizes gain if liabilities transferred to the partnership exceed the partner's basis in the partnership.[8]
- The contributing partner recognizes gain if the partnership would be treated as an investment company had it incorporated under Sec. 351.[9]

KEY POINT

The substituted basis of the partnership interest is consistent with the nonrecognition of gain or loss.

Basis of a Partnership Interest. If the Sec. 721 nonrecognition rules apply, Sec. 722 provides a substituted basis rule for determining the basis of a partnership interest. In a simple case where no liabilities exist, the basis of the contributing partner's

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[5] For a detailed discussion, see Shop Talk, "Service Firms Practicing as LLLPs: What are the Tax Consequences?," *Journal of Taxation,* August 2005.

[6] Reg. Sec. 1.721-1(a).

[7] Reg. Sec. 1.721-1(b)(1). In May 2005, the IRS issued proposed regulations which would bring partnership interests issued in exchange for services under Sec. 83 rules. If and when these regulations become final, they will significantly change the taxation of a partnership interest received for services.

[8] (See Example I:17-4 and the discussion of the partnership basis rules.)

[9] Sec. 721(b). The partnership is considered to be an investment company if 80% or more of the transferred assets (excluding cash and nonconvertible debt obligations) consist of marketable stocks or securities. This restriction prevents investors from diversifying their portfolios by creating a partnership through a nontaxable transfer of securities in exchange for a partnership interest.

partnership interest equals the sum of money contributed plus the adjusted basis of other property transferred to the partnership.

EXAMPLE I:17-2 ▶ Allen contributes business equipment having a $10,000 FMV and a $4,000 adjusted basis to the ABC Partnership in exchange for a 30% interest in the partnership. The basis of Allen's partnership interest is $4,000 because he recognizes no gain or loss on the asset transfer under Sec. 721. ◀

If a contributing partner renders services to the partnership in exchange for a partnership interest, the contributing partner's basis equals the amount of income recognized from rendering the services (i.e., the FMV of the services).[10] The FMV basis is permitted because the partner recognizes ordinary income equal to the FMV of the services.

EXAMPLE I:17-3 ▶ Angela contributes property having a $10,000 FMV and a $4,000 adjusted basis and renders services valued at $10,000 in exchange for a 60% interest in the ABC Partnership. Section 721 protects Angela from gain recognition on the property transfer. However, Angela recognizes $10,000 of ordinary income for the services rendered. Thus, the basis of Angela's partnership interest equals $14,000 ($4,000 adjusted basis of the property plus the $10,000 FMV of the services). ◀

ADDITIONAL COMMENT

A partner's basis in the partnership interest commonly is called "outside basis."

Section 752 Basis Adjustments. A partner's basis for his or her partnership interest includes the partner's ratable share of partnership liabilities as well as the basis attributable to any property and services contributed to the partnership. In addition, the following rules apply if a partnership assumes a partner's liability or if the partner transfers property to the partnership subject to a liability:

- An increase in partnership liabilities is treated as a cash contribution by all partners, which increases their bases by their share of the assumed liabilities.
- The partnership's assumption of a partner's liability is treated as a cash distribution to the partner whose liability it assumed, which decreases that partner's basis in the partnership.

EXAMPLE I:17-4 ▶ Brad contributes a building to a newly formed partnership, BCD Partnership, in exchange for a one-third interest in the partnership. The building has a $90,000 FMV, an $80,000 adjusted basis, and is subject to a $60,000 mortgage. The partnership assumes the mortgage but has no other liabilities. Carol and Dale each contribute $30,000 of cash for a one-third interest in the partnership. After the contributions, the partners have the following bases in their partnership interests:

	Brad	*Carol*	*Dale*
Adjusted basis of property or amount of cash contributed	$80,000	$30,000	$30,000
Plus: Share of mortgage assumed by the partnership ($60,000 × 1/3 to each)	20,000	20,000	20,000
Minus: Decrease in Brad's personal liabilities	(60,000)	–0–	–0–
Basis in partnership interest	$40,000	$50,000	$50,000

◀

Under the general rules of Sec. 752, a partner's basis in the partnership interest increases by the partner's share of any changes in the partnership's liabilities during the year. For example, if total partnership liabilities (including accounts and notes payable, mortgages, bank loans, etc.) increase during the year from $100,000 to $200,000, the basis of a partner with a 50% interest in the partnership increases by $50,000 ($100,000 increase in liabilities × 0.50).

Negative Basis Rule. The basis of a partnership interest cannot be negative. Therefore, Sec. 731 requires recognition of gain in situations where a negative basis would otherwise occur.

EXAMPLE I:17-5 ▶ Becky transfers property having a $100,000 FMV and a $25,000 adjusted basis, which is subject to a $60,000 mortgage, in exchange for a one-third interest in the BCD Partnership. The

[10] Reg. Sec. 1.722-1. Also, see footnote 7.

partnership owes no other liabilities. Becky, Cindy, and Dan each have a one-third interest in the partnership. The $60,000 reduction in Becky's individual liabilities is treated as a distribution of money. Thus, Becky recognizes a $15,000 gain because the distribution exceeds her $45,000 ($25,000 + $20,000) basis in the partnership interest. Becky's basis in the partnership interest is zero after the distribution. The basis is computed as follows:

Adjusted basis of property transferred	$ 25,000
Plus: Becky's share of the mortgage assumed by the partnership ($60,000 × 1/3)	20,000
Basis before deemed distribution	45,000
Minus: Decrease in Becky's individual liabilities	(60,000)
Becky's basis in the partnership interest (cannot be negative)	$ –0–

The cash deemed distributed in excess of Becky's predistribution basis causes her to recognize a $15,000 ($60,000 – $45,000) gain. Becky reduces her basis to zero by the deemed distribution because her basis in the partnership interest cannot be less than zero. ◀

STOP & THINK

Question: In Example I:17-5, Becky transferred property subject to a liability exceeding the property's adjusted basis. How does the treatment of excess liabilities in a partnership differ from the treatment when such property is transferred to a corporation?

Solution: In a corporate situation, the shareholder recognizes gain to the extent that total liabilities exceed the total basis of property transferred by that shareholder. Thus, had Becky transferred the same property to a corporation in a Sec. 351 transaction, she would have recognized gain for the entire $35,000 ($60,000 mortgage – $25,000 adjusted basis) excess liability. In a partnership, however, the transferor partner recognizes gain only if the deemed money distribution associated with the liability exceeds the partner's basis in the partnership interest. Thus, in Example I:17-5, Becky recognized only a $15,000 gain. If she had substantial basis in an existing partnership, she would have recognized no gain.

Holding Period for a Partnership Interest. If a partner contributes only cash to the partnership in exchange for a partnership interest, the holding period begins the day after the partner acquires the interest. If the partner contributes property, the holding period for the partnership interest generally includes the holding period of the contributed property. However, if the contributed property is other than a capital asset or Sec. 1231 property, the holding period begins on the date the partnership interest is acquired.[11]

EXAMPLE I:17-6 ▶ In the current year, Johanna contributes business machinery to the JK Partnership in exchange for a partnership interest. Johanna originally acquired the machinery on March 12, 2015. Because the machinery is Sec. 1231 property, Johanna's holding period for her partnership interest also begins on March 12, 2015 (the date she acquired the machinery). If Johanna had contributed inventory instead of machinery, the holding period would begin the day after the inventory contribution date. ◀

ADDITIONAL COMMENT

When property that has been held for personal use is contributed to a partnership, the basis equals the lesser of the property's FMV or adjusted basis on the contribution date.

Basis of Partnership Assets. Section 723 provides a carryover basis rule for property contributed to the partnership. Generally the partnership's basis in the property is the same as that of the transferor partner, even if the contributing partner recognizes gain. Without this rule, partners could increase the basis of their property for depreciation and subsequent sale purposes merely by contributing appreciated property to a partnership. When the carryover basis rule applies, the partnership's holding period for the property includes the period the property was held by the contributing partner.[12]

EXAMPLE I:17-7 ▶ In the current year, Carlos contributes equipment with a $6,000 adjusted basis and an $8,000 FMV to the CDE Partnership and receives a one-third interest in the partnership. Carlos acquired the equipment on January 17, 2016. CDE's basis for the equipment is $6,000, its adjusted basis in the hands of the contributing partner. Carlos recognizes no gain due to the Sec. 721

[11] Reg. Sec. 1.1223-1(a).

[12] Sec. 1223(2) and Reg. Sec. 1.723-1.

nonrecognition rules. CDE's holding period for the equipment also begins on January 17, 2016 because it includes Carlos' holding period for the property. ◀

ADDITIONAL COMMENT

A partnership's basis in its assets commonly is called "inside basis."

An individual who contributes property encumbered with a liability to a partnership may have to recognize gain on the transfer if the deemed cash distribution from the partnership's assumption of the liability exceeds the partner's basis in the partnership (see Example I:17-5). The adjusted basis of Becky's partnership interest in Example I:17-5 is reduced by this release from the liability (but not below zero). It is not increased by the gain Becky recognizes, however, because the gain recognition is due to a distribution of money on the release from the liability and not from the contribution of the property to the partnership. For a similar reason, the partnership does not increase its basis in contributed property by the partner's recognized gain.[13]

BOOK-TAX ACCOUNTING COMPARISON

For many items, the partnership must maintain separate sets of records for tax purposes, partnership "book" purposes, and financial accounting (GAAP) purposes.

Book Accounting Considerations. Like all publicly traded entities, publicly traded partnerships must produce financial statements prepared in accordance with GAAP. However, one of the most confusing aspects of partnership tax accounting is that Treasury Regulations require the maintenance of another set of accounting "books" based on the requirements of Reg. Sec. 1.704-1(b)(2)(iv). These regulations for properly maintaining partnership capital accounts mandate "book" accounting that is similar (but not identical) to GAAP financial accounting partnership rules. Under these partnership book rules, the carryover basis rules used in taxation do not apply for book accounting. For example, if property is contributed to a partnership, its book value is recorded at the contributed property's FMV while the tax basis is recorded as a carryover. This book accounting in the regulations is a measure of the economic investment each partner has made to the partnership. This book accounting treatment in the regulations results in differences between the tax bases and book values of contributed assets. These differences between tax and book values will be important in our study of special allocations (page I:17-9). Just remember that when the text mentions book accounting for partnerships, it is the accounting required by Reg. Sec. 1.704-1(b)(2)(iv) and not financial statements prepared according to GAAP.

EXAMPLE I:17-8 ▶

BOOK-TAX ACCOUNTING COMPARISON

The difference between book value and tax basis also causes GAAP, book, and tax depreciation to differ if a partner contributes depreciable property.

Anwar contributes cash of $30,000 and Beth contributes land having a $30,000 FMV and a $20,000 adjusted basis to the AB Partnership. Each partner receives a 50% interest in the partnership. For book accounting purposes, the cash and land are each recorded at $30,000. For tax purposes, the carryover basis of the land to the partnership is $20,000. The partnership realizes no gain or loss for book accounting purposes if it later sells the land for $30,000. However, the partnership recognizes a $10,000 gain under the tax rules because the land's adjusted basis for tax purposes is only $20,000. The $10,000 precontribution gain must be allocated to Beth. (See the section titled Special Allocations on page I:17-9 for a discussion of precontribution gains and losses.) ◀

Topic Review I:17-1 highlights the nonrecognition of gain or loss provisions and basis rules.

ADDITIONAL COMMENT

If a partnership claims the amortization deduction in its first year, the partnership is deemed to have properly made the election. If the partnership chooses to forgo the deemed election, it can elect to capitalize the expenditures (without amortization) on a timely filed tax return for the tax year the partnership begins business. See Reg. Sec. 1.709-1.

Organizational and Syndication Fees. A partnership can deduct up to $5,000 of costs of organizing the partnership in the year the partnership begins business. The deduction is limited to the lesser of (1) the amount of organizational expenditures or (2) $5,000, reduced by the amount by which such organizational expenditures exceed $50,000. Any organizational expenditures exceeding the first year deduction can be deducted ratably over the 180 month period beginning with the month the partnership begins business.[14] Organizational expenditures that qualify for this amortization treatment include items such as the attorney's fees for drafting the partnership agreement, the accountant's fees for setting up the financial record system, and filing fees.

The partnership must capitalize expenses attributable to syndicating the partnership. These expenses, however, are *not* amortizable. **Syndication fees** are expenses incurred to promote and market partnership interests (usually associated with tax-sheltered limited partnership interests). Examples of nondeductible syndication fees include brokerage and registration fees, legal fees of the underwriter and issuer, and printing costs associated with the prospectus and promotional materials.

[13] Rev. Rul. 84-15, 1984-1 C.B. 158.

[14] These rules are contained in Sec. 709.

TOPIC REVIEW I:17-1

Section 721 Formations: Nonrecognition of Gain or Loss Rules

- Neither the partnership nor the partners recognize gain or loss on the transfer of property to a partnership in exchange for a partnership interest or an increase in a partnership interest.
- A partner's basis in his or her partnership interest is adjusted upward for the following items:
  - Amount of cash contributed to the partnership
  - Adjusted basis of noncash property contributed
  - FMV of services contributed
  - Section 752 adjustment for liabilities
- The partnership's basis in transferred property carries over from the transferor partners.
- With exceptions pertaining to contributions of cash and ordinary income property, a partner's holding period for his or her partnership interest includes the holding period of the contributed property.
- The partnership's holding period in contributed property includes the transferor's holding period.
- The nonrecognition rules do not apply to services contributed. The contributing partner recognizes ordinary income equal to the FMV of the services, and the partner's basis in the partnership interest is increased by the amount of income recognized from rendering the services.
- The depreciation recapture rules generally do not apply to contributed property. Instead, the depreciation recapture potential carries over to the partnership.

PARTNERSHIP OPERATIONS

The partnership tax return (Form 1065) provides information regarding the measurement and reporting of income, deductions, losses, and credits that pass through to the partners. Certain separately stated items (e.g., capital gains and losses, charitable contributions, and Sec. 1231 gains and losses) pass through to the partners without losing their identity. Such items must be separately stated because their tax effect depends on the partner's particular tax situation. These items are reported on Schedules K and K-1 of the partnership return. Schedule K reports tax information for the entire partnership, and a separate Schedule K-1 summarizes the results for each partner.

ADDITIONAL COMMENT

Many states impose an income tax on each nonresident partner's share of income produced by the partnership in that state, which can cause a partner to file several state income tax returns when a partnership conducts business in those states.

Items that do not have special tax effect are netted at the partnership level and are reported on page 1 of Form 1065. The netting of such items results in partnership ordinary income or ordinary loss, which then is allocated to the partners depending on the profit and loss sharing ratios contained in the partnership agreement. Table I:17-1 (on the next page) contains a list of commonly encountered separately stated items and items that make up partnership ordinary income or loss.

EXAMPLE I:17-9 ▶ The EFG Partnership has three equal partners and incurs the following items in the current year:

Gross profit from operations	$500,000
Long-term capital gain	12,000
Tax-exempt interest income	3,000
Short-term capital loss	4,500
Business deductions	210,000
Depreciation deductions	50,000

These items are classified as follows:

Partnership ordinary income:	
Gross profit from operations	$ 500,000
Minus: Business deductions	(210,000)
Depreciation	(50,000)
Partnership ordinary income	$ 240,000

Separately stated items:	
Long-term capital gain	$ 12,000
Short-term capital loss	(4,500)
Tax-exempt income	3,000

The partnership reports ordinary income or loss items on page 1 of Form 1065. It reports the separately stated items (as well as the $240,000 total partnership ordinary income) on Schedule K of Form 1065. It also prepares a separate Schedule K-1 for each partner that reports to the partner that partner's share of partnership items. In this example, each partner's Schedule K-1 reports one-third of the partnership ordinary income ($80,000 each) and one-third of each separately stated item. The partners then use the Schedule K-1 information to prepare their own tax returns. ◀

SPECIAL ALLOCATIONS

ADDITIONAL COMMENT

In general, partnership income or loss is allocated according to the partnership agreement, which can be amended any time up to the due date for filing the partnership return.

Section 704 permits partners some latitude in allocating income, deductions, losses, and credits among the individual partners. Special allocations are unique to partnerships and permit flexible arrangements among the partners for sharing specific income and loss items. A partner's distributive share of such items generally is determined by the partnership agreement. However, the special allocation provisions restrict the partners' freedom to shift tax benefits among individual partners. For example, the special allocation must have substantial economic effect (e.g., it cannot be a tax sham). In addition, a special allocation must be made for property contributed by the partners when determining the allocation of depreciation deductions and the amount of gain or loss recognized when the partnership eventually sells the property. Essentially, the allocation of the depreciation deductions and the amount of recognized gain or loss must take into account the difference between the partnership's basis for the contributed property and the property's FMV at the time of the contribution.

▼ **TABLE I:17-1**

Segregation of Ordinary Income and Separately Stated Items

Items	Separately Stated Items (Schedules K and K-1)	Partnership Ordinary Income (or Loss) (Page 1 of Form 1065)
Sales minus cost of goods sold (gross profit)		X
Salaries and wage expense		X
Guaranteed payments to partners[a]	X	X
Tax, bad debt, and repair expenses		X
Charitable contributions	X	
Investment income (interest, dividends, etc.) and expense	X	
Foreign income taxes paid or accrued	X	
Specially allocated income, deduction, loss, gain, and credit items that differ from the general profit and loss allocation ratios	X	
Tax-exempt interest income	X	
Capital gains and losses	X	
Sec. 1245 and Sec. 1250 depreciation recapture		X
Unrecaptured Sec. 1250 gain	X	
Sec. 1231 gains or losses	X	
Sec. 179 expensing	X	
Tax credits	X	
Tax preference items	X	

[a]Guaranteed payments appear in both columns because the partnership deducts them to arrive at partnership ordinary income (or loss), and they are reported separately and are taxable to the partner who receives the payments.

WHAT WOULD YOU DO IN THIS SITUATION?

Alex and Alicia plan to form a partnership in the current year with each partner making an equal capital contribution to the partnership. The partnership agreement will specify that the partners share equally in partnership profits and losses. Among other things, the partnership will invest in taxable and tax-exempt bonds. The partners expect the taxable and tax-exempt bonds each to generate $2,500 of interest per year. For the next several years, Alex expects to be in the 12% tax bracket and Alicia expects to be in the 32% individual tax bracket. Without a special allocation, each partner would be allocated $1,250 of each type interest. Instead, however, they want a special allocation in the partnership agreement that allocates (1) all $2,500 of taxable interest to Alex plus $150 ($1,250 × 0.12) of tax-exempt interest to compensate him for the additional taxes owed on the extra $1,250 of taxable interest and (2) the remaining $2,350 ($2,500 − $150) of tax-exempt interest to Alicia. Alex and Alicia seek your advice on the propriety of this special allocation. Hint: Prepare a schedule of after-tax interest income to the partners with and without the special allocation.

EXAMPLE I:17-10 ▶ Clay and Dana formed an equal partnership five years ago. Clay contributed cash of $100,000, and Dana contributed land having a $60,000 adjusted basis and a $100,000 FMV. The partnership's basis for the land is $60,000 (Dana's carryover basis). If the partnership sells the land in the current year for $110,000, it recognizes $50,000 ($110,000 − $60,000) of gain. If a special allocation of the gain were not required, Clay and Dana each would be allocated $25,000 of the gain based on their equal profit and loss sharing ratios. The special allocation rules, however, require $45,000 of the gain to be allocated to Dana ($40,000 appreciation accruing before her transfer of property to the partnership plus $5,000, which is one-half of the $10,000 of post-contribution appreciation). The remaining $5,000 of post-contribution gain is allocated to Clay [($110,000 − $100,000) × 0.50]. ◀

ADDITIONAL COMMENT

Under the varying interest regulations, extraordinary items include, among other things, the sale of capital assets or Sec. 1231 property not in the ordinary course of business. These items are allocated based on the partners' interest in the partnership on the date of the transaction. Cash basis items include, among other things, taxes, interest, and payments for services or use of property for which the partnership uses the cash basis method of accounting. These items must be prorated even if the partnership uses the interim closing method.

ALLOCATION OF PARTNERSHIP INCOME, DEDUCTIONS, LOSSES, AND CREDITS TO PARTNERS

If a partner's interest in the partnership changes during the year (e.g., due to the sale of a partnership interest or the entry of a new partner who contributes property to the partnership in exchange for an interest), all the partners must determine their distributive share of the partnership income, deductions, losses, and credits according to their varying interests in the partnership during the year.[15] Treasury Regulations prescribe two basic methods for applying the varying interest rule: (1) the interim closing method, whereby the partnership closes its books at the time of the variation and allocates items accordingly or (2) an elective proration method, whereby the partnership prorates items on either a calendar day, semi-monthly, or monthly convention.[16] Special rules apply to extraordinary items and so-called cash basis items.

EXAMPLE I:17-11 ▶ Colleen and Dan are equal partners in the CDE Partnership, which uses the calendar year as its tax year. On December 1 of the current year, Ed contributes $50,000 cash for a one-third interest in the partnership. The partnership reports $21,900 of ordinary income for the current tax year ending on December 31. The partners agree to the proration method with a calendar day convention. Thus, the variation is deemed to occur at the end of the day on December 1. Accordingly, the partners report their shares of the partnership loss as follows (assuming a non-leap year).

Partner		*Income Allocation*
Colleen	1/2 × $21,900 × 335/365	$10,050
	1/3 × $21,900 × 30/365	600
	Colleen's share of income	$10,650
Dan	Same as Colleen	10,650
Ed	1/3 × $21,900 × 30/365	600
	Total allocation of income	$21,900

◀

[15] Sec. 706(d)(1).

[16] Reg. Sec. 1.706-4.

BASIS ADJUSTMENTS FOR OPERATING ITEMS

KEY POINT

Although the basis of C corporation stock is not likely to change over time, the basis of a partnership interest is subject to frequent adjustment.

Under Sec. 705, the basis of each partnership interest is adjusted to reflect the partner's share of income and deduction items. This basis adjustment is necessary to ensure the single level of taxation of partnerships. Basis adjustments for income and deduction items are made currently regardless of whether the partners receive an actual distribution from the partnership. In addition, each partner's basis in the partnership interest is adjusted for capital contributions, withdrawals, and changes in liabilities that occur during the year. Each partner's basis is increased by the partner's distributive share of partnership ordinary income and separately stated income and gain items. The basis of the partnership interest is increased whether the income is taxable to the partners or is tax-exempt.[17]

A partner's basis is decreased (but not below zero) by partnership distributions and by the partner's distributive share of partnership ordinary loss, separately stated losses and deductions, and expenditures that are nondeductible in computing partnership ordinary income or loss (e.g., charitable contributions made by the partnership).

Partners also increase their basis by their share of partnership liabilities. That share depends on whether the partnership liabilities are recourse or nonrecourse. A recourse liability is one where the lender has recourse to all partnership assets as well as general partners' other assets for satisfaction of the loan. In other words, the lender has recourse to the general partners, so they have what is called the economic risk of loss. Thus, recourse liabilities are allocated to the partners based on their economic risk of loss. A nonrecourse liability is one where the lender has recourse only to specified partnership property, such as real estate, for satisfaction of the loan. In other words, the lender has no recourse to the partners. Nonrecourse liabilities are allocated based on the partners' profit sharing percentages.

EXAMPLE I:17-12 ▶ David and Edith form a partnership in the current year and share profits and losses equally. However, David is a general partner, and Edith is a limited partner. Thus, David has all the economic risk of loss for recourse liabilities. The partnership agreement provides for no special allocations. The following transactions occur during the year:

- David contributes land having a $60,000 basis and a $100,000 FMV in exchange for his initial partnership interest.
- At the end of the year, the partnership has $100,000 of nonrecourse liabilities and $30,000 of recourse liabilities.
- The partnership earns $50,000 of ordinary income.
- The partnership earns $5,000 of tax-exempt interest income.
- The partnership incurs $10,000 of capital losses.
- The partnership makes a $15,000 charitable contribution.
- The partnership distributes $20,000 in cash to David.

David's year-end basis is determined as follows:

Capital contribution of land (adjusted basis)		$ 60,000
Plus:	Share of partnership nonrecourse liabilities ($100,000 × 0.50)	50,000
	Share of partnership recourse liabilities ($30,000 × 1.00)	30,000
	Share of ordinary income ($50,000 × 0.50)	25,000
	Share of tax-exempt interest income ($5,000 × 0.50)	2,500
Minus:	Distribution to David	(20,000)
	Share of charitable contribution ($15,000 × 0.50)	(7,500)
	Share of capital losses ($10,000 × 0.50)	(5,000)
David's basis at the end of the current year		$135,000

◀

STOP & THINK

Question: Why do partners increase the basis of their partnership interests by their share of tax-exempt income?

Solution: Increasing the basis ensures that the income will retain its tax-exempt character when the partnership income is subsequently distributed in the form of cash or the partner's interest in the partnership is sold or exchanged.

[17] If the partnership includes oil and gas properties, an increase in basis is made for the excess of percentage depletion claimed over the basis of the property subject to depletion, and a reduction in basis is made for the depletion deduction claimed under Sec. 611.

SPECIAL DEDUCTIONS AND LIMITATIONS

Qualified Business Income Deduction. For tax years beginning after 2017, the tax law allows a deduction for qualified business income (sometimes referred to as the "pass-through deduction").[18] The deduction reduces taxable income (instead of adjusted gross income), but taxpayers can take the deduction regardless of whether they claim the standard deduction or itemized deductions. The deduction pertains to the taxpayer's qualified business income from a partnership, S corporation, or sole proprietorship, as well as to a percentage of the taxpayer's qualified REIT and publicly traded partnership income. The purpose of the deduction is to bring the tax rates on these types of businesses somewhat in line with the tax rate applicable to corporations.

In general, the deduction is limited to the lesser of: (1) the combined qualified business income (combined QBI) of the taxpayer or (2) 20% of the excess of taxable income (without regard to the QBI deduction) over any net capital gain. Qualified business income (QBI) is defined as the net amount of items of income, gain, deduction, and loss for the trade or business, plus 20% of qualified REIT dividends and 20% of qualified publicly traded partnership income. Excluded from this definition are investment-related items such as capital gains and losses, dividends, and interest income as well as any employee compensation and guaranteed payments that the taxpayer receives from the entity.

Generally, QBI includes only income from a U.S. trade or business. In addition, taxpayers in service-related businesses (e.g., law, accounting, healthcare, and consulting) are eligible for the deduction only if their taxable income is less than a threshold amount ($160,700 for 2019 or $157,500 for 2018 for single taxpayers and $321,400 for 2019 or $315,000 for 2018 for married taxpayers filing jointly). This provision also imposes limitations based on W-2 wages. Combined QBI is further defined as the lesser of:

1. 20% of qualified business income, or
2. The greater of the following:
   - 50% of W-2 wages allocable to the taxpayer by the business, or
   - 25% of allocable W-2 wages plus 2.5% of the allocable share of the unadjusted basis of qualified property immediately after it has been acquired.

The W-2 limitations, however, do not apply to those businesses that meet the same taxable income thresholds as those for service-related businesses (that is, $160,700 for single taxpayers and $321,400 for married taxpayers filing jointly, with the same inflation and phase out provisions as mentioned previously).

For partnerships and S corporations, the QBI deduction is applied at the partner or shareholder level. Accordingly, each partner or shareholder takes into account his or her share of entity levels of items in calculating his or her QBI deduction.

EXAMPLE I:17-13 ▶ The AB Partnership has two equal partners, Able and Baker. In the current year, the partnership earns $300,000 of ordinary income (all business) and recognizes a $20,000 long-term capital gain. Able is married and files a joint tax return and claims the standard deduction. Other than partnership items, Able has only a $2,000 short-term capital loss at the individual level. Able's taxable income is calculated as follows (ignoring the deduction for one-half of self-employment tax):

Share of partnership ordinary income		$150,000
Share of partnership long-term capital gain	$10,000	
Minus: Short-term capital loss	(2,000)	
Net capital gain		8,000
Adjusted gross income		$158,000
Minus: Standard deduction		(24,400)
QBI deduction		(25,120)
Taxable income		$108,480

Excess taxable income without regard to the net capital gain and QBI deduction is $125,600 ($150,000 − $24,400). Thus, the QBI deduction is the lesser of:

Combined QBI ($150,000 × 0.20)	$30,000 or
20% of excess taxable income ($125,600 × 0.20)	$25,120

◀

[18] Sec. 199A.

Limitation on Net Business Interest. For tax years beginning after 2017, the tax law limits the deductibility of business interest in a given year to the sum of the following amounts:[19]

- Business interest income
- 30% of adjusted taxable income (but not less than zero)
- Floor plan financing interest for motor vehicles

Adjusted taxable income for this purpose means taxable income computed without regard to:

- Income, gain, deduction, or loss not allocable to a trade or business
- Business interest or business interest income (i.e., amounts allocable to a trade or business)
- Any NOL (carryover) deduction
- The qualified business income deduction
- For years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion
- Any other adjustments provided by the Treasury Department

Taxpayers meeting the $26 million in 2019 ($25 million in 2018) gross receipts test for small businesses, however, are exempt from this limitation.

For partnerships and S corporations, the limitation applies at the entity level and is taken into account in computing partnership or S corporation ordinary (non-separately stated) income or loss. At the partner or S corporation shareholder (owner) level, adjusted taxable income for computing the interest limitation for interest incurred outside the partnership or S corporation does not include pass-through items from the entity, but the owner's adjusted taxable income is increased by the owner's share of the entity's "excess taxable income." Excess taxable income arises when the interest limitation at the entity level exceeds the entity's net interest and is a mechanism for increasing an owner's adjusted taxable income to take advantage of the unused limitation that occurred at the entity level. In this situation,

Excess taxable income = (Excess limit/Limit) × Adjusted taxable income

If net interest is limited at the entity level, the excess interest does not carryover at the entity level. Instead, each owner is allocated a share of the excess interest as a pass-through item to be carried to the owner's succeeding tax year in which the owner is allocated excess taxable income from the same entity. The following example demonstrates these rules.[20] ◀

EXAMPLE I:17-14 ▶ The AB Partnership has two equal partners. Assume no taxpayer qualifies for the small business exception (even though the example uses small numbers for convenience). The partnership earns $24,000 of non-interest ordinary income. The limitation on business interest in this case would be $7,200 ($24,000 x 0.30). Now, consider three independent levels of business interest expense ($7,200, $4,800, and $9,200) as shown in the following table:

Interest Expense	*Deductible Amount*	*Partnership Ord. Inc.*	*Partner Share*	*Excess Interest*	*Excess Limit*
$7,200	$7,200	$16,800	$8,400	$ -0-	$ -0-
4,800	4,800	19,200	9,600	-0-	2,400
9,200	7,200	16,800	8,400	2,000	-0-

If the partners incurred business interest expense from sources other than the AB partnership, they would not be allowed to include their share of partnership items in adjusted taxable income at the partner level to increase partner-level limitations. This rule prevents the partners from using partnership pass-through income to allow additional interest deduction at the partner level beyond that intended by the limitation provision.

[19] Sec. 163(j).

[20] See the Conference Report to the Tax Cuts and Jobs Act of 2017.

Limitation on Net Business Interest. For tax years beginning after 2017, the tax law limits the deductibility of business interest in a given year to the sum of the following amounts:[19]

- Business interest income
- 30% of adjusted taxable income (but not less than zero)
- Floor plan financing interest for motor vehicles

Adjusted taxable income for this purpose means taxable income computed without regard to:

- Income, gain, deduction, or loss not allocable to a trade or business
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- Any other adjustments provided by the Treasury Department

Taxpayers meeting the $26 million in 2019 ($25 million in 2018) gross receipts test for small businesses, however, are exempt from this limitation.

For partnerships and S corporations, the limitation applies at the entity level and is taken into account in computing partnership or S corporation ordinary (non-separately stated) income or loss. At the partner or S corporation shareholder (owner) level, adjusted taxable income for computing the interest limitation for interest incurred outside the partnership or S corporation does not include pass-through items from the entity, but the owner's adjusted taxable income is increased by the owner's share of the entity's "excess taxable income." Excess taxable income arises when the interest limitation at the entity level exceeds the entity's net interest and is a mechanism for increasing an owner's adjusted taxable income to take advantage of the unused limitation that occurred at the entity level. In this situation,

Excess taxable income = (Excess limit/Limit) × Adjusted taxable income

If net interest is limited at the entity level, the excess interest does not carryover at the entity level. Instead, each owner is allocated a share of the excess interest as a pass-through item to be carried to the owner's succeeding tax year in which the owner is allocated excess taxable income from the same entity. The following example demonstrates these rules.[20] ◀

EXAMPLE I:17-14 ▶ The AB Partnership has two equal partners. Assume no taxpayer qualifies for the small business exception (even though the example uses small numbers for convenience). The partnership earns $24,000 of non-interest ordinary income. The limitation on business interest in this case would be $7,200 ($24,000 x 0.30). Now, consider three independent levels of business interest expense ($7,200, $4,800, and $9,200) as shown in the following table:

Interest Expense	*Deductible Amount*	*Partnership Ord. Inc.*	*Partner Share*	*Excess Interest*	*Excess Limit*
$7,200	$7,200	$16,800	$8,400	$ -0-	$ -0-
4,800	4,800	19,200	9,600	-0-	2,400
9,200	7,200	16,800	8,400	2,000	-0-

If the partners incurred business interest expense from sources other than the AB partnership, they would not be allowed to include their share of partnership items in adjusted taxable income at the partner level to increase partner-level limitations. This rule prevents the partners from using partnership pass-through income to allow additional interest deduction at the partner level beyond that intended by the limitation provision.

[19] Sec. 163(j).

[20] See the Conference Report to the Tax Cuts and Jobs Act of 2017.

In the second case, however, each partner's adjusted taxable income is increased by the partner's share of excess taxable income. Excess taxable income is $8,000 ($2,400/$7,200 × $24,000), and each partner's share is $4,000. This increase in adjusted taxable income is the basis for the 30% limit at the partner level, so the increased limit is $1,200 ($4,000 × 0.30). Note that this formulation is a fairly complicated way to increase the partner's limit by the partner's share of the partnership excess limit, in this case $1,200 = $2,400 x 0.50.

Finally, in the third case, each partner's share of excess interest ($1,000 each) carries over at the partner level to offset that partner's excess taxable income from the same partnershipin a subsequent year. The excess interest reduces the partner's basis in the partnership in the year it occurs, not in a carryover year when it is used.

These rules apply in a similar manner to an S corporation and its shareholders. Also, the partners (or shareholders) also may qualify for the business income deduction. ◀

LIMITATIONS ON LOSSES AND RESTORATION OF BASIS

BOOK-TAX ACCOUNTING COMPARISON

Although a partner's basis in his or her partnership interest may not go below zero, a partner's book capital account (equity) may be negative.

Although a partner's distributive share of the partnership's ordinary loss and any separately stated losses and deductions passes through to the partner, Sec. 704(d) limits deductibility of the losses to the partner's adjusted basis in his or her partnership interest as determined at the end of the partnership's tax year.[21] All positive and negative adjustments referred to in Example I:17-12 (except the loss) are made before the limitation is considered. If the loss limitation rule did not apply, the partner's interest could have a negative basis. Any unused losses and deductions carry over indefinitely and are allowed in subsequent years when the partner again has a positive basis in his or her partnership interest.

EXAMPLE I:17-15 ▶ Ellen, who has a 50% interest in the EF Partnership, has a $10,000 basis in her partnership interest at the end of Year 1 (before deducting her share of losses). The EF Partnership incurs a $50,000 ordinary loss in Year 1. Ellen's share of the loss is $25,000 ($50,000 × 0.50), but Ellen can deduct only $10,000 in Year 1. The remaining $15,000 of loss carries over to Year 2. The deductible loss reduces Ellen's partnership basis to zero at the end of Year 1. ◀

EXAMPLE I:17-16 ▶ Assume the same facts as in Example I:17-15 except in Year 2 Ellen's share of partnership liabilities increases by $5,000, Ellen's share of Year 2 ordinary income is $5,000, and Ellen makes a $5,000 additional capital contribution. Ellen's basis increases by a total of $15,000 due to the three items. Therefore, in Year 2, she deducts the $15,000 loss carryover from Year 1. The deduction reduces Ellen's partnership basis to zero at the end of Year 2. A zero tax basis for a partnership interest does not necessarily mean that the interest is worthless. The FMV of the partnership's net assets and accounting book value, nevertheless, may be substantial. ◀

TAX STRATEGY TIP

Taxpayers can control to a limited degree when they use partnership and S corporation losses in their individual tax returns. If loss pass-throughs exceed the partner's end-of-year basis in his or her investment, the loss will not be deductible until the partner again has basis in his or her investment. If a taxpayer incurs a loss in the current year and wants to deduct the loss on next year's personal tax return, he or she must make an additional capital contribution after year-end. Alternatively, a shareholder can loan money to his or her S corporation before year-end to ensure having sufficient basis to use the loss currently. A partner can make similar capital contributions. A partnership (but not an S corporation) can control the timing of the loss deductions for its partners through additional borrowings it makes prior to the end of the tax year.

Topic Review I:17-2 summarizes the allocation and basis rules.

Passive Activity Loss Limitations. The passive activity loss limitations discussed in Chapter I:9 apply to partners who do not materially participate in the business of the partnership. The passive activity loss rules apply at the *partner* level, that is, each partner must determine whether he or she materially participates in the partnership. If a loss is determined to be passive, a partner may not deduct the loss against either earned income or portfolio income (e.g., dividends and interest) but may deduct the loss only against other passive income. These rules are highly significant and play a major role in determining the deductibility of partnership losses by partners.

Limitation on Excess Business Losses. For tax years beginning after 2017 and before January 2026, the tax law imposes a limitation on excess business losses, applicable to noncorporate taxpayers.[22] The IRC defines an **excess business loss** as the excess of:

- The aggregate deductions for the year attributable to trades and businesses, over
- The sum of aggregate gross income or gain attributable to such trades or businesses, plus $255,000 ($510,000 for married taxpayers filing jointly) in 2019 ($250,000/$500,000 in 2018).

[21] Three other rules also restrict the deductibility of losses. The at-risk rules contained in Sec. 465 limit loss deductions to the partner's at-risk basis. In addition, Sec. 469 contains passive activity loss rules that disallow virtually all net passive activity losses, and Sec. 461(l) limits the deductibility of excess business losses. These restrictions are discussed in Chapter I:9 of this text and in Chapter C:9 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*.

[22] Sec. 461(l).

TOPIC REVIEW I:17-2

Allocation Rules and Basis Adjustments

- When a partner contributes property to a partnership, any unrecognized precontribution gain or loss must be allocated to the contributing partner when the partnership sells the property.
- Partnership income, gains, deductions, losses, and credits are allocated to the partners on a daily basis based on each partner's interest in the partnership.
- Special allocations of income, gains, deductions, losses, and credits are permitted as long as they have substantial economic effect.
- Basis in the partnership interest is increased by the partner's share of ordinary income, separately stated income items, and tax-exempt income. Basis is reduced by a partner's share of ordinary loss, separately stated deductions and losses, and nondeductible expenditures. Basis also is adjusted for capital contributions, distributions, and changes in partnership liabilities. Basis cannot be decreased below zero.
- Ordinary losses and separately stated deduction and loss items that exceed a partner's basis carry over indefinitely until the partner again has a positive basis in his or her partnership interest.

The $255,000 ($510,000) is adjusted for inflation annually. Any disallowed excess business loss carries over as a net operating loss subject to the 80% of taxable income limitation on NOLs in the carryover year.

For partnerships and S corporations, the limitation applies at the partner or shareholder level, with each partner or shareholder taking into account his or her share of entity level items of income, gain, deduction, or loss. However, the new limitation applies after the application of the Sec. 469 passive activity loss limitation.

EXAMPLE I:17-17 ▶ Carl is single and is a one-third partner in the CDE Partnership, which engages in active businesses. In the current year, the partnership incurs a $900,000 ordinary loss, $300,000 of which is Carl's share. Carl also receives $500,000 of salary from his consulting business. Carl's excess business loss is $45,000 ($300,000 − $255,000 threshold). Thus, he can offset $255,000 of the partnership pass-through loss against his salary, but the remaining $45,000 carries over as an NOL to his next taxable year. ◀

TRANSACTIONS BETWEEN A PARTNER AND THE PARTNERSHIP

Sometimes a partner may independently engage in transactions with the partnership. For example, a partner may sell property to the partnership rather than make a capital contribution of the property. In such transactions, the partner is treated as an outside independent party.[23] Thus, a partner recognizes gain or loss on the sale of property to the partnership, and the partnership receives a cost basis equal to the amount of consideration paid. Because the partner and the partnership are not truly independent parties, abuse of this provision is possible. For example, the partners might want to recognize losses by selling certain assets at a loss to the partnership while still retaining those assets in the partnership. Alternatively, a partner may wish to sell certain depreciable business assets (Sec. 1231 property) at a gain taxable to the partner at favorable capital gains rates while the partnership receives a stepped-up FMV basis in the assets for depreciation purposes. Section 707(b) forestalls such potential abuses by disallowing losses and by providing ordinary income (rather than capital gain) treatment under the following circumstances:

[23] Rules for transactions taking place between a partner and the partnership are found in Sec. 707.

ADDITIONAL COMMENT

Defining a partner's interest in a partnership is not always an easy matter. These determinations become difficult if a partner has varying interests in different types of income.

- Losses are disallowed on sales or exchanges between a partner and the partnership if the partner owns more than a 50% interest in the partnership. A loss also is disallowed if a sale or exchange of property occurs between two partnerships in which the same persons own more than a 50% interest. The Sec. 267 constructive ownership rules apply to determine whether the 50% test is met. If the purchaser (i.e., the partner or the partnership) of the property later sells the asset to an outsider, the gain recognized is reduced by the previously disallowed loss.
- Gains are treated as ordinary income (rather than capital gains) if the partner owns (directly or indirectly) more than a 50% interest in the partnership and if the exchanged asset is not a capital asset in the transferee's hands.[24] Again, the Sec. 267(b) constructive ownership rules apply.

EXAMPLE I:17-18 ▶ Ira has a 60% interest in the HI Partnership. Ira sells land with a $100,000 adjusted basis to the partnership for its $60,000 FMV. Ira does not recognize the $40,000 ($60,000 − $100,000) loss because Ira owns more than a 50% interest in the partnership. The partnership takes a $60,000 cost basis in the land. If the partnership later sells the land to an outsider for $110,000, the partnership recognizes only $10,000 of gain because the $50,000 ($110,000 − $60,000) realized gain is reduced by Ira's $40,000 previously disallowed loss. ◀

EXAMPLE I:17-19 ▶ Helen has a 90% interest in the HI Partnership. Helen sells a building used in her business with a $60,000 adjusted basis to the HI Partnership for its FMV of $100,000. After the purchase, the partnership continues to use the building in its business activities. Before the sale, Helen had taken straight-line depreciation. Had Helen instead sold the building to an outsider, she would have recognized $40,000 of unrecaptured Sec. 1231 gain, which usually receives capital gain treatment. However, Helen's $40,000 gain is treated as ordinary income because she sold the building to a partnership in which she owns a more than 50% interest, and the building is not a capital asset to the partnership. The ordinary income does not qualify for a reduced tax rate, nor can it be used to offset capital losses. HI Partnership takes a $100,000 cost basis in the building. ◀

ADDITIONAL COMMENT

A partner generally has to make estimated tax payments to cover the income and self-employment taxes on a guaranteed payment.

Guaranteed Payments. Even though a partner does not qualify as an employee of the partnership for tax purposes, the partnership agreement may provide for fixed salary payments that are not based on partnership income. Generally, the partnership deducts such payments as guaranteed payments to arrive at partnership ordinary income. They are includible in the partner's gross income in the tax year received. The partnership also can make guaranteed payments in lieu of interest payments on the amount of the partner's capital investment. Such payments are deductible by the partnership to arrive at partnership ordinary income and are includible in the partner's gross income.

EXAMPLE I:17-20 ▶ José owns a 40% interest in the JKL Partnership. The partnership agreement provides that José is to receive a fixed salary of $20,000 plus 10% interest on his average capital balance. The partnership makes no guaranteed payments to the other partners. If his average capital balance for the year is $50,000, the partnership would pay $5,000 (0.10 × $50,000) of interest as a guaranteed payment. If partnership ordinary income is $10,000 before deducting the guaranteed payments, the partnership ordinary loss is $15,000 ($10,000 income − $25,000 of guaranteed payments to José). José reports $25,000 of ordinary income for the year, consisting of the $20,000 salary and the $5,000 interest. He also reports a $6,000 ($15,000 × 0.40) ordinary loss. The other partners in total report a $9,000 ($15,000 × 0.60) ordinary loss. ◀

ADDITIONAL COMMENT

Although José receives a fixed "salary," he is not considered to be an employee of the partnership. The "salary" is treated as self-employment income. Moreover, the guaranteed payment is not qualified business income for the QBI deduction, so any amounts allocated to guaranteed payments reduces the QBI deduction.

PARTNERSHIP DISTRIBUTIONS

A distribution of cash or property from the partnership to a partner generally is treated as a nontaxable return of capital. This treatment closely parallels the nontaxable consequences resulting from a capital contribution of property made in exchange for a partnership interest under Sec. 721.

A distribution may result in a reduction of a partner's capital interest in the partnership. This type of distribution is called a **nonliquidating distribution**. The partnership may

[24] Gains also are converted to ordinary income if the sale is between two partnerships in which the same persons own directly or indirectly more than a 50% interest in the partnership. In determining the 50% ownership rule, the Sec. 267 constructive ownership rules apply.

KEY POINT

The adjusted basis of a property distributed by a partnership generally measures the taxability of the distribution. The difference between the property's FMV and basis can be important, however, in determining the property's basis when the partnership distributes multiple properties.

wish to liquidate a partner's entire interest due to retirement, death, or other business reasons. These distributions are called **liquidating distributions**. In such cases, the liquidating distribution is treated as a sale or exchange of the partnership interest.

Due to the complex nature of this topic, this chapter includes only an abbreviated coverage of these materials, and the discussion of liquidating distributions is omitted. Chapter C:10 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* includes detailed coverage of these topics.

Nonliquidating Distributions. As a general rule, neither the partner nor the partnership recognize gain or loss if the partnership distributes money or other property to the partner.[25] Such nonliquidating distributions usually are treated as nontaxable returns of capital. If the amount of money received by the partner exceeds the partner's basis for the partnership interest, however, the partner recognizes gain to the extent of the excess.[26] If the partnership distributes property other than money (e.g., land and machinery) to the partner, the basis of the partnership interest is reduced by the adjusted basis of the distributed assets. As previously mentioned, neither the partnership nor the distributee partner recognize gain or loss even if the adjusted basis of the distributed property exceeds the partner's basis in his or her partnership interest. In this case, the basis of the property to the partner is reduced to equal the basis of the partnership interest. If the partnership distributes both money and property, the money distribution reduces the basis of the partnership interest before any adjustment for the property distribution.

SELF-STUDY QUESTION

Carl, a partner with a $10,000 basis in the ABC Partnership, receives property having a FMV of $20,000 and a basis of $8,000 in a nonliquidating distribution. How much gain does Carl recognize?

ANSWER

None. A partner recognizes gain only when the amount of cash distributed exceeds the basis of the partnership interest.

EXAMPLE I:17-21 ▶ Jane receives a nonliquidating distribution of $10,000 cash from the JK Partnership. At the distribution date, Jane's basis in her partnership interest is $8,000. Of the $10,000 distribution, $8,000 is a nontaxable free return of capital, which reduces Jane's basis to zero. The remaining $2,000 is a capital gain.[27] ◀

EXAMPLE I:17-22 ▶ Jeff receives a nonliquidating distribution of land having a $6,000 adjusted basis and a $10,000 FMV from the JK Partnership. Jeff's predistribution basis in his partnership interest is $8,000. Neither Jeff nor the partnership recognize gain or loss on the distribution. Jeff's basis in the land is $6,000, and his basis in his partnership interest is reduced by $6,000 (the adjusted basis of the property distributed). Thus, following the distribution, Jeff's basis in his partnership interest is $2,000 ($8,000 – $6,000). ◀

EXAMPLE I:17-23 ▶ Jean receives from the JK Partnership a nonliquidating distribution of $5,000 cash plus land having a $6,000 adjusted basis and a $10,000 FMV. Jean's predistribution basis in her partnership interest is $8,000. Her basis initially is reduced by the $5,000 cash distribution to reflect a nontaxable return of capital treatment. The remaining $3,000 basis in her partnership interest is allocated to the land, and neither Jane nor the partnership recognize gain or loss on the distribution. Jean's basis for her partnership interest is zero after the distribution. ◀

Topic Review I:17-3 summarizes the gain or loss recognition rules relating to nonliquidating distributions.

SALE OF A PARTNERSHIP INTEREST

ADDITIONAL COMMENT

A sale of a partnership interest is treated as a sale even though the sale results in the termination of the partnership. For example, if one partner in a two-person partnership sells his or her interest to the other partner, the transaction is treated as a sale.

Recognition of Gain or Loss. A partnership interest is a capital asset similar to a corporate security. It may be sold or exchanged as existing partners retire or withdraw from the business. The remaining partners may acquire the selling partner's interest, or the outgoing partner may sell the interest to an outsider.

Capital gain or loss generally arises from the sale of a partnership interest because the interest is a capital asset in the hands of the selling partner. For noncorporate partners,

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[25] Sections 731 through 733 contain the partnership distribution rules. Distribution of marketable securities also can trigger gain recognition.

[26] Exceptions apply if unrealized receivables and inventory items, referred to as Sec. 751 assets, remain in the partnership or are distributed to the partner. In such instances, the partnership and/or the partner may recognize gain on the distribution.

[27] A portion of this gain may be converted to ordinary income if Jane's share of any Sec. 751 assets (i.e., unrealized receivables and substantially appreciated inventory items) held by the partnership changes as a result of the cash distribution.

TOPIC REVIEW I:17-3

Nonliquidating Distributions

- Generally, neither the partner nor the partnership recognize gain or loss on a nonliquidating distribution of money or other property. However, if the distributed money exceeds the distributee partner's basis in the partnership interest, the partner recognizes gain on the excess. For this purpose, any release from partnership liabilities is treated as money distributed to the partner.
- The partner's basis in the partnership interest is reduced (but not below zero) by the amount of money distributed. If the partnership distributes property other than money, the following two points apply.
  - If the adjusted basis of distributed property does not exceed the partner's basis in the partnership interest (after reduction for money distributions), the basis of the distributed property carries over to the partner, and the partner's basis in the partnership interest is reduced by the distributed property's adjusted basis.
  - If the adjusted basis of distributed property exceeds the partner's basis in the partnership interest (after reduction for money distributions), the distributed property takes a basis equal to the partner's remaining basis in the partnership interest, and the partner's basis in the partnership interest is reduced to zero.

ADDITIONAL COMMENT

The applicable long-term capital gains tax rate can be 0%, 15%, or 20% depending on the taxpayer's filing status and taxable income level. See the Quick Reference section of the text for threshold levels. In addition, an incremental 3.8% rate applies to net investment income for taxpayers whose modified AGI exceeds $200,000 ($250,000 for married filing jointly).

the long-term capital gain is taxed at the applicable capital gains rate. In this case, a partnership is viewed as an entity separate and distinct from the partners. However, under Sec. 751, a partner is considered to own a proportionate interest in each partnership asset (i.e., the partnership is viewed as a conduit), which results in part capital gain and part ordinary income treatment depending on the character of the underlying assets.

Under the general rules of Sec. 741, gain or loss is measured by the difference between the amount realized and the selling partner's adjusted basis in the partnership interest. The amount realized includes the partner's share of partnership liabilities from which the partner is released as a result of the sale. The basis of the partnership interest also is adjusted by the selling partner's distributive share of partnership income or loss, which must be computed up to the sale date.

EXAMPLE I:17-24 ▶ On October 1, Jesse sells his interest in the JK Partnership to Paula, an outsider, for $150,000 cash plus release from $30,000 of partnership liabilities. Jesse's basis in his partnership interest is $74,000 before taking into account his distributive share of partnership income for the period ending on the sale date and his share of any increase in partnership liabilities during the same period. For the current year, Jesse's share of the partnership income for the period up to the date of sale is $20,000, and his share of increased partnership liabilities is $6,000. Thus, at the sale date, Jesse's basis in his partnership interest is $100,000 ($74,000 basis on January 1 + $20,000 share of partnership income + $6,000 share of increased partnership liabilities). The amount realized on the sale is $180,000 ($150,000 selling price + $30,000 liability release). Thus, Jesse recognizes an $80,000 gain on the sale, which is capital gain unless ordinary income is triggered under Sec. 751. (See Example I:17-25 for an illustration of Sec. 751 treatment.) ◀

Section 751 Ordinary Income Treatment. Ordinary income rather than capital gain treatment may result under Sec. 751 if a partnership has unrealized receivables or inventory items when the partner sells a partnership interest. A sale of Sec. 751 assets by the partnership results in ordinary income, which passes through to the partners. Thus, this rule prevents a partner from converting ordinary income into capital gain by selling or liquidating the partnership interest before the partnership sells or collects on the Sec. 751 assets. Section 751 assets include the following:

- Inventory items include the traditional definition of inventory plus any other property except capital assets and Sec. 1231 property
- Unrealized receivables for services rendered or goods delivered, such as accounts receivable of a cash method partnership (i.e., receivables having a zero basis)
- Unrealized receivables also include Sec. 1245 and 1250 depreciation recapture potential (i.e., amounts that would be recaptured as ordinary income if Sec. 1245 or 1250 property were sold by the partnership) or recapture potential arising under certain other IRC sections

EXAMPLE I:17-25 ▶ Joy's basis in her partnership interest is $100,000, and the amount realized on its sale is $180,000, which results in an $80,000 gain. The cash basis partnership has accounts receivable with a zero basis and a $30,000 FMV. Joy's share of these receivables is $10,000. Thus, $10,000 of the amount realized on the sale of the partnership interest is attributed to Joy's share of the accounts receivable. Because her share of the receivables has a zero basis and a $10,000 FMV, $10,000 ($10,000 − $0) of the gain is ordinary income to Joy as though she had sold her share of the receivables. The remaining $70,000 ($80,000 − $10,000) of gain from the sale of Joy's partnership interest is a capital gain. ◀

ADDITIONAL COMMENT

In addition to the rates described in the adjoining paragraph, an incremental 3.8% rate applies to net investment income for taxpayers whose modified AGI exceeds $200,000 ($250,000 for married filing jointly).

Other Special Treatments. In addition to Sec. 751 ordinary income treatment, Sec. 1(h) applies various other tax rates on the sale of a partnership interest. First, a 28% rate applies to gain a partner would have recognized had the partnership sold any collectibles. Second, a 25% rate applies to unrecaptured Sec. 1250 gain a partner would have recognized had the partnership sold its Sec. 1250 property (i.e., depreciable real property). These two special rules are in lieu of the 15% or 20% rate that generally applies to capital gains of a partner selling his or her partnership interest. Thus, any gain on the sale of a partnership interest allocable to these items will be taxed at a 25% or 28% tax rate rather than 15% or 20%.

OPTIONAL AND MANDATORY BASIS ADJUSTMENTS

Section 754 provides an election that permits a basis adjustment to the assets of a continuing partnership when a partner sells or exchanges a partnership interest or when certain distributions occur. This election, made by the partnership, prevents inequities that might arise because the basis of partnership assets are not adjusted under general partnership tax accounting rules. The election is binding for all future years unless the IRS consents to a revocation of the election. In addition, a partnership may have to make mandatory basis adjustments in certain circumstances even if a Sec. 754 election is not in effect.

EXAMPLE I:17-26 ▶ Jim acquires Antonio's one-third partnership interest in the ABC Partnership for $40,000. The partnership's balance sheet on the sale date includes the following:

	Adjusted Basis	*FMV*
Assets:		
Cash	$20,000	$ 20,000
Accounts receivable	10,000	10,000
Inventory	15,000	20,000
Depreciable assets	15,000	85,000
Total	$60,000	$135,000
Liabilities	$15,000	$ 15,000
Capital accounts:		
Antonio	15,000	40,000
Beth	15,000	40,000
Carmen	15,000	40,000
Total	$60,000	$135,000

If the partnership has a Sec. 754 election in effect, Jim's optional basis adjustment equals the difference between his basis in the partnership interest of $45,000 ($40,000 amount paid + $5,000 of ABC's liabilities) and his $20,000 ($60,000 × 1/3) share of basis in the underlying partnership assets. Thus, Jim steps up the basis of his share of partnership assets from $20,000 to $45,000. The election does not affect the remaining partners' underlying basis in partnership assets.

The election would be favorable only to Jim because his share of the appreciated partnership assets (inventories and depreciable assets) would be stepped up by $25,000, based on the relative amounts of appreciation for each asset. Jim then would be entitled to additional depreciation deductions on the increased basis of the depreciable assets. In addition, Jim would receive an increased basis for calculating gain on the sale of the inventory. If this election were not in effect and the inventory were sold, Jim would report $1,667 (1/3 × $5,000) gain from the sale of his one-third interest in the inventory even though he paid $6,667 (1/3 × $20,000) for such interest. ◀

Once the election is in effect, its application may be detrimental because a downward adjustment is required if the amount paid for a partnership interest is less than the adjusted basis of the assets (i.e., the assets have declined rather than appreciated in value).

In addition, the IRC contains provisions to prevent shifting of losses using the optional basis adjustment mechanism. Under these rules, the partnership must make a mandatory basis adjustment following a transfer of partnership interest, whether or not the partnership has made a Sec. 754 election, if (1) the partnership's basis in its partnership property is more than $250,000 above the FMV for partnership property (i.e., a built-in loss of $250,000 or more) or (2) the transferee partner would be allocated a loss of more than $250,000 if the partnership were to sell its assets for their FMV immediately after the transfer. This rule, and a similar rule related to distributions, are an attempt to prevent taxpayers from transferring losses on partnership property or on property contributed to a partnership.

PARTNERSHIP ELECTIONS

Tax Year Restrictions. When a partnership's tax year ends, each partner's distributive share of the partnership income (including guaranteed payments) is reported on each partner's Form 1040 (or Form 1120 for corporate partners). With no restrictions about partnership tax year ends, this rule would allow significant deferral of partnership income. Thus, if a partnership's tax year ends on January 31 and the partners report on a calendar year ending December 31, partnership income earned from February 1 of Year 1 through December 31 of Year 1 (as well as partnership income earned in January of Year 2) is reported in the partners' Year 2 federal income tax returns (filed in Year 3). This situation results in an effective 11-month income deferral.

EXAMPLE I:17-27 ▶ Kim is admitted to the ABC Partnership on April 1 of Year 1. Kim is a calendar-year taxpayer who previously was an employee of the partnership from January 1 of Year 1 until her admission to the partnership. Kim's earnings as an employee for the three-month period are $8,000. She received monthly distributions of $3,000 for the last nine months of the year that represent draws against her share of estimated partnership income for the partnership year ending January 31 of Year 2. Kim's distributive share of the partnership income for the period April 1 of Year 1 through January 31 of Year 2 is $60,000. Because distributions to a partner are treated as made on the last day of the partnership's tax year (January 31 of Year 2) and because the partnership tax year ends after December 31 of Year 1, Kim's income for Year 1 is only $8,000 (her salary as an employee for the first three months of Year 1). Kim reports her $60,000 share of partnership income for the year ending January 31 of Year 2, on her Year 2 tax return, which she files in Year 3. ◀

ADDITIONAL COMMENT

Partnerships having only individual partners usually have calendar tax years. The three-step test most often comes into play when the partnership has one or more fiscal year corporate partners.

To prevent or minimize opportunities for deferring partnership income as illustrated in Example I:17-27, Sec. 706 provides the following requirements on the selection of a tax year by the partnership:

- A partnership uses the tax year of the one or more partners who, in aggregate, own a majority interest (more than 50%) in the partnership. This majority interest tax year rule is determined on the first day of the partnership's existing tax year.
- If partners having a majority interest in the partnership do not have the same tax year, the partnership uses the same tax year as *all* of its principal partners (a **principal partner** has a 5% or greater interest in the partnership).
- If the principal partners do not have the same tax year and no majority of its partners have the same tax year, the partnership uses the tax year that allows the "least aggregate deferral." (See Chapter C:9 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* for a detailed discussion of this requirement.)

EXAMPLE I:17-28 ▶ ABC Partnership has one corporate partner, Ace Corporation, with a fiscal year-end of March 31. Ace Corporation has a 25% interest in the ABC Partnership. The other partners are individuals with a calendar year for tax purposes, none of whom has a 5% or more interest in the ABC Partnership. ABC Partnership must use a calendar year for tax purposes (the tax year of the individual partners who in aggregate own a 75% majority interest). ◀

SELF-STUDY QUESTION

Ace and Buckeye, corporate partners in the ABC Partnership, have September 30 year-ends. Craig, an individual partner, uses the calendar year. Ace, Buckeye, and Craig have equal one-third interests in the partnership. What tax year must the newly-organized partnership adopt?

ANSWER

It must adopt a September 30 year-end because it must use the tax year of the two corporate partners that together own a majority interest (two-thirds in this case).

The rules given above have three exceptions. First, a partnership with all calendar year partners can adopt or change to a fiscal year if it can convince the IRS that a business purpose exists for the choice. For example, if the partnership owns a ski resort, it probably could make a good case for closing the partnership tax year on May 31, shortly after the ski season ends, rather than on December 31, which is in the middle of the ski season. However, the IRS must agree that a valid business purpose exists for using the fiscal year.

Second, a partnership may adopt or change to a fiscal year-end if the business recognizes 25% or more of its annual gross receipts in the last two months of the fiscal year, with this being the case for three consecutive 12-month periods. Third, a partnership may elect a maximum three-month deferral if it agrees to make a special tax payment each year that approximates the income deferral benefit.[28] The net effect of these rules is to restrict any deferral opportunities for partnerships in choosing their tax year-end.

(See Chapter C:9 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* for a detailed discussion of partnership tax years.)

Cash Method of Accounting Restrictions. A partnership may elect with its first tax return any method of accounting that clearly reflects income. Unlike the tax year election, partnerships may elect an accounting method without regard to the methods used by its partners. The two most commonly used methods are the cash method and the accrual method. Under the cash method, the partnership reports income as received and expenses when actually paid. Under the accrual method, the partnership reports income when earned even if the cash has not yet been received. Similarly, the partnership reports expenses when incurred, not when actually paid.

Congress understands that the cash method does not always reflect the economic realities of a business. However, Congress also concedes that the cash method is much simpler to use than the accrual method. Because of its simplicity, the cash method still is an option, but Congress has restricted its use. For example, partnerships that have a C corporation for a partner and that have average gross receipts exceeding $25 million during the prior three years are not allowed to use the cash method of accounting.[29] Tax shelters, no matter what their size, may not use the cash method under any circumstances. (See Chapter I:11 for a discussion of permissible accounting methods.)

TAXATION OF S CORPORATIONS

OBJECTIVE 3

Explain the requirements for electing and maintaining S corporation status, and apply operating rules for S corporations

QUALIFICATION REQUIREMENTS

To qualify as an S corporation, a business must meet the definition of a small business corporation.[30] To meet this definition, the entity[31]:

- Must be a domestic (U.S.) corporation rather than a foreign corporation
- Must not be an ineligible corporation[32]
- Must not have more than 100 shareholders[33]

[28] Secs. 444 and 7519.

[29] Sec. 448(a)(2). Section 448(b) provides exceptions for farming businesses and certain qualified personal service corporations.

[30] These qualification rules are in Sec. 1361.

[31] An S corporation does not have to be a corporation. Under the check-the-box regulations, a noncorporate entity can make an S election, in which case the entity is automatically deemed to have elected to be treated as a corporation under the check-the-box regulations. (See Reg. Secs. 301.7701-1, -2, and -3 that describe the tax consequences of a noncorporate entity electing to be taxed under the check-the-box regulations.) Most LLCs and partnerships will not make an S election because of the additional benefits available with the more liberal partnership tax rules.

[32] Ineligible corporations include insurance companies, certain financial institutions, U.S. possessions corporations, and Domestic International Sales Corporations.

[33] Members of a single family are counted as one shareholder.

- ▶ Must have only individuals, estates, certain kinds of trusts, and certain kinds of tax-exempt organizations as shareholders
- ▶ Must not have a nonresident alien as a shareholder
- ▶ Must issue only one class of stock

ADDITIONAL COMMENT

Some states do not recognize the S election for state income tax purposes, which results in the payment of state income taxes by S corporations.

All the above requirements must be met for the initial election to be made. Once the corporation makes an S election, the requirements must be met on every day of each tax year the S election is in effect. Otherwise, the election terminates.

100-Shareholder Limitation. The S corporation rules place no restriction on the amount of an S corporation's assets or income. Nevertheless, most large, publicly-traded corporations have more than 100 shareholders and therefore are not eligible for S corporation status.

Members of a family count as one shareholder for the 100-shareholder limitation. Members of a family include a common ancestor, the lineal descendants of the common ancestor, and the spouses (or former spouses) of the lineal descendants or common ancestor. The common ancestor must not be more than six generations removed from the youngest shareholder at the time the corporation makes the election. This is a surprisingly large group treated as a single shareholder. For example, if the common ancester marries only once and has two children, and each of his descendants does the same, the generation that is six generations removed from the common ancestor includes 64 direct descendants and their 64 spouses. Also, the common ancestor need not be living at the time of the election. The requirement is only that the group of individuals who are to be treated as one family shareholder must have a common ancestor no more than six generations removed.

SELF-STUDY QUESTION

At any one time, how many different individuals could be shareholders in a single S corporation?

ANSWER

The number could be huge because 100 different families could be shareholders.

EXAMPLE I:17-29 ▶ Adobe Corporation, a qualifying S corporation, has 100 shareholders, including both Brad and Vanessa, who are married and are counted as one shareholder. No other shareholders are members of one family. Brad dies and wills his stock to his two best friends, who do not already own Adobe stock. Before the estate distributes the stock, the estate and Vanessa count as one shareholder, and the S corporation remains qualified under the 100-shareholder limitation. Adobe becomes disqualified as an S corporation when the estate distributes the stock to the two friends because the corporation then has 102 shareholders. ◀

TAX STRATEGY TIP

The lower a shareholder's marginal tax rate is in relation to the C corporation tax rate, the more attractive is the S corporation election.

Type of Shareholder Restrictions. A qualifying shareholder must be an individual (other than a nonresident alien), estate, qualifying trust, or qualifying tax-exempt organization.[34] Thus, a C corporation or a partnership may not own stock in an S corporation. If a C corporation or partnership were permitted to own stock, the 100-shareholder limitation easily could be avoided through indirect ownership of the S corporation stock through another corporation or partnership having many shareholders or partners.

Subsidiaries of S Corporations. Although an S corporation may not have a corporate shareholder, it may own stock of a C corporation. If this stock ownership equals or exceeds 80%, however, the S corporation (parent) and the C corporation (subsidiary) are considered an affiliated group under Sec. 1504. Nevertheless, an S corporation may not file a consolidated tax return with its 80%-owned subsidiaries.[35] In addition, an S corporation may have a Qualified Subchapter S Subsidiary (QSub).[36] The subsidiary is a QSub if the parent S corporation owns 100% of the QSub stock and elects to treat the QSub as such. Under this election, the QSub is not treated as a separate corporation for income tax purposes. Instead, all assets, liabilities, income, deductions, and credits of the QSub are treated as those of the parent S corporation.

[34] Qualifying trusts include voting trusts, Sec. 678 grantor trusts, electing small business trusts, and qualified Subchapter S trusts. Qualifying tax-exempt organizations include qualified retirement plan trusts and charitable organizations. (See Chapter C:11 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* for a discussion of these trusts.)

[35] Sec. 1504(a)(8).

[36] Sec. 1361(b)(3).

One Class of Stock Restriction. An S corporation can have only one class of stock outstanding. This requirement simplifies problems that otherwise would result from determining how corporate income and losses should be allocated to the shareholders.

TAX STRATEGY TIP

If a corporation needs to issue preferred stock for estate planning reasons (e.g., freezing the value of the stock), the S corporation is not an available choice because the preferred stock is a second class of stock.

The requirement for one class of stock, however, can be troublesome if an S corporation is thinly capitalized (i.e., significant amounts of debt exist in the capital structure) because the debt may in fact be equity and represent a second class of stock. To reduce the uncertainty regarding the second class of stock issue, a safe-harbor rule provides that straight debt shall not be treated as a second class of stock if it meets certain requirements. To qualify as straight debt, the interest rate cannot be contingent on profits,[37] the debt cannot be convertible into stock, and the creditor must be either a person otherwise eligible to be an S corporation shareholder or a person actively and regularly engaged in the business of lending money.

Aside from the debt issue, Treasury Regulations provide that a corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. This test is based on the corporate charter, articles of incorporation, bylaws, applicable state law, and any binding agreements relating to distribution or liquidation proceeds.[38] Nevertheless, shares of common stock can have different voting rights without violating the one-class-of-stock restriction.

EXAMPLE I:17-30 ▶ Dale is the sole owner of an S corporation. For estate tax planning purposes, Dale wishes to make gifts of certain shares of the corporation's stock to his children while still retaining control of the company. A class of S corporation common stock with limited or no voting rights may be issued to Dale in exchange for a capital contribution. Dale can subsequently make gifts of this new stock to his children without disqualifying the S election. ◀

ELECTION REQUIREMENTS

The corporation files an election for S corporation status, and all shareholders who own stock on the date of the S election must consent to the election.[39] The election and consent are filed with the IRS on Form 2553 (Election by a Small Business Corporation). Shareholders who own stock during any part of the tax year including the election date must consent to the election even if they are not shareholders on the election date. A shareholder who sells his or her stock during the year but before the election will receive an allocation of the S corporation's income or loss for the portion of the election year he or she owned the stock.

A corporation may make the election in the tax year preceding the election year or on or before the fifteenth day of the third month of the election year. An election after the fifteenth day of the third month of the election year is treated as made for the next tax year. Once made, the election remains in effect until revoked or terminated.

The tax law, however, provides some relief for improper elections. First, if the corporation misses the deadline for making the S election, the IRS can treat the election as timely if the IRS determines that the corporation had reasonable cause for making the late election. Second, if the election was ineffective because the corporation inadvertently failed to qualify as a small business corporation or because it inadvertently failed to obtain shareholder consents, the IRS can nevertheless honor the election if the corporation and shareholders take steps to correct the deficiency within a reasonable time period.

EXAMPLE I:17-31 ▶ Circle Corporation is a calendar year C corporation. To elect S corporation status for Year 2, it must file the election any time in Year 1 (the preceding year) or during the period January 1 through March 15 of Year 2. If Circle makes the election on March 31 of Year 2, the corporation remains a C corporation for all of Year 2 and becomes an S corporation in Year 3. However, if Circle can show reasonable cause for making the late election, the IRS may allow the election to be effective for Year 2. ◀

[37] The interest rate, however, may vary with the prime rate or a similar factor unrelated to the debtor corporation.

[38] Reg. Sec. 1.1361-1(l).

[39] Election and termination rules are in Sec. 1362.

TAX STRATEGY TIP

S corporations have been around since the 1960s. Limited liability companies (LLC) and limited liability partnerships (LLP) have become quite popular since the mid-1990s. Sometimes, shareholders may want to change their S corporation to an LLC or LLP. Careful planning is essential to avoid unintended results. Changing from an S corporation to an LLC can be costly because the S corporation is liquidated for income tax purposes. Shareholders may recognize substantial gains in addition to legal and accounting costs in making the transition.

TERMINATION CONDITIONS

Revocation of S Corporation Status. A corporation may terminate an S election either voluntarily via a revocation or involuntarily by failing to continue to meet the requirements for a small business corporation (e.g., if on any day in any year the S corporation has more than 100 shareholders or issues a second class of stock). A voluntary revocation requires consents from shareholders owning more than 50% of the corporation's stock.

General Effective Date. Under the general rules, a revocation is effective for the entire tax year if the corporation files a statement on or before the fifteenth day of the third month of the tax year. If the corporation files the revocation after this date (e.g., after March 15 for a calendar year S corporation), the effective date is the first day of the next tax year.

EXAMPLE I:17-32 ▶ Shareholders owning more than 50% of the stock of a qualifying calendar year S corporation consent to a voluntary revocation statement filed by the corporation on March 12 of Year 1. Because the corporation filed the revocation on or before March 15, it is taxed as a C corporation for all of Year 1. If the corporation does not file the revocation until March 16 of Year 1, it continues to be treated as an S corporation during Year 1, and it becomes a C corporation in Year 2. ◀

KEY POINT

An election to be treated as an S corporation becomes effective only as of the beginning of a tax year, but a termination can become effective before the end of the normal tax year.

Specified Revocation Date. The law provides an exception when the corporation and its shareholders specify a prospective revocation date. In this case, the revocation takes effect as of the specified date. If the corporation specifies a prospective date other than the first day of a tax year, the revocation results in a short tax year for the final S corporation tax return and a short tax year for the initial C corporation tax return. In this case, the income or loss is allocated between the two short years on a prorated daily basis.[40]

EXAMPLE I:17-33 ▶ Assume the same facts as in Example I:17-32 except that the corporation specifies a prospective termination date of July 1 of Year 1. The revocation is effective as of this date, and the corporation files an S corporation short-period return for the period January 1 through June 30 of Year 1, and files a C corporation short-period return for the period July 1 through December 31 of Year 1. The income or loss is prorated to each return on a daily basis. Unless extended, the S corporation return is due September 15 of Year 1, and the C corporation return is due March 15 of Year 2. ◀

Involuntary and Inadvertent Terminations. An S corporation may involuntarily lose its special tax status and revert to a C corporation if it fails to meet the small business corporation requirements or if it has excessive amounts of passive (investment) income for each year in a three-year period (i.e., more than 25% of gross receipts).[41] However, if the IRS deems that the termination was inadvertent and the S corporation or its shareholders take the necessary steps within a reasonable time period to restore its small business corporation status, the S corporation status is considered to have been continuously in effect.

EXAMPLE I:17-34 ▶ A calendar year S corporation adds an unqualified shareholder on June 4. The S corporation status terminates on June 3. The corporation files a short-period S corporation tax return for the period January 1 through June 3 and files a C corporation tax return for the period from June 4 through December 31. Income or loss is prorated to the two tax returns on a daily basis. ◀

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[40] The first day of the C corporation tax year is the day on which the revocation occurs. Under Sec. 1377(a)(2), a special election may be made to use the interim closing method (i.e., the books are closed as of the termination date) if all affected shareholders consent to this method.

[41] The passive income restrictions apply solely to S corporations that were previously taxed as C corporations in pre-election years and have accumulated Subchapter C earnings and profits from those years on the last day of three consecutive S corporation tax years. Thus, a corporation that elects S corporation status in its initial tax year and continually retains such status is not subject to the restrictions. If the restrictions apply and the S corporation has passive income exceeding 25% of its gross receipts for three consecutive tax years, the S election automatically terminates on the first day of the fourth tax year. In addition, a penalty tax equal to 35% of the corporation's excess net passive income is imposed during each year of the three-year period.

EXAMPLE I:17-35 ▶ Assume the same facts as in Example I:17-34 except the termination is deemed to be inadvertent, and the violation of shareholder requirements is corrected within a reasonable time period. The S corporation status is considered to have been continuously in effect, and no C corporation tax return is required. A single S corporation tax return will be filed for the year. ◀

Election After Termination. If an S corporation terminates its election either by ceasing to be a small business corporation or by revocation, the corporation may not reelect S corporation status for five years unless the IRS consents to an early reelection.

Topic Review I:17-4 summarizes the S corporation qualification, election, and termination rules.

S CORPORATION OPERATIONS

Income, gains, losses, deductions, and credits pass through to the S corporation's shareholders in a manner similar to the partnership rules. Some common separately stated items include:

- Short-term and long-term capital gains and losses
- Sec. 1231 gains and losses
- Unrecaptured Sec. 1250 gains
- Charitable contributions[42]
- Credits
- Interest on investment indebtedness
- AMT adjustments and tax preference items
- Foreign taxes paid or accrued
- Dividends and other portfolio income

Table I:17-1, appearing earlier in this chapter, provides a list of comparable items for partnerships. These separately stated items are segregated from the computation of ordinary income (or loss) because each item affects the tax returns of the various shareholders differently, depending on their particular tax situation. The residual income or loss amount (i.e., the amount remaining after removing the separately stated items) represents the S corporation's ordinary income (or loss). Separately stated items and S corporation ordinary income (or loss) pass through to the shareholders as of the last day of the S corporation's tax year.[43] The S corporation computes its ordinary income (or loss) on page 1 of Form 1120S (U.S. Income Tax Return for an S Corporation), and it reports all items on Schedule K of that return. Then, the corporation prepares a Schedule K-1, which reports to each shareholder his or her share of the S corporation items. The shareholders use the Schedule K-1 information to prepare their individual tax returns (Form 1040).

ADDITIONAL COMMENT

A shareholder of a corporation also can be an employee of the corporation. Payments with respect to the employment status are considered salary whereas payments with respect to ownership of stock are treated as corporate distributions.

The tax treatment of some S corporation items is similar to that for C corporations. For example, the S corporation deducts salaries paid to its shareholders in the calculation of ordinary income or loss and not as a separately stated item on Schedule K-1. In addition, S Corporations can deduct up to $5,000 in organizational expenditures in the year in which business begins. The deduction is limited to the lesser of the organizational expenditures or $5,000, reduced by the amount by which such organizational expenditures exceed $50,000. Any excess organizational expenditures may be amortized over 180 months beginning with the month the S Corporation's business begins. S corporations, however, are not entitled to certain other corporate deductions, such as the dividends-received deduction or the net operating loss deduction because dividends and net operating losses pass through to the S corporation's shareholders.

ADDITIONAL COMMENT

A corporation is deemed to make the election to deduct and amortize organizational expenditures unless it chooses to forgo the election.

[42] The IRS has ruled in Rev. Rul. 2000-43, 2000-2 C.B. 333, that charitable contributions made by an S corporation cannot be reported using the accrual method permitted for C corporations under Sec. 170(a)(2).

[43] Sec. 1363. Special rules apply if the S election terminates during the tax year. These rules are beyond the scope of this text.

TOPIC REVIEW I:17-4

S Corporation Qualification, Election, and Termination Rules

Qualification Requirements

- An S corporation must be a domestic corporation.
- A maximum of 100 shareholders are allowed. Members of a family count as one shareholder, and each beneficiary of a qualifying trust is a separate shareholder.
- Only individuals (citizens or resident aliens), estates, certain kinds of trusts, and certain kinds of tax-exempt organizations can be shareholders. No corporate or general partnership shareholders are permitted.
- Only one class of stock generally may be issued and outstanding. Multiple classes of stock can be used if the only difference between the classes is voting rights.
- Certain corporations that maintain special tax statuses are ineligible.
- If an S corporation has an 80%-or-more-owned subsidiary, it cannot file a consolidated tax return with that subsidiary. Special rules apply to a Qualified Subchapter S Subsidiary (QSub).

Election Requirements

- All shareholders on the S election date must consent to the election and the corporation must file Form 2553. To be effective for the election year, the corporation must file the S election and consent form on or before the fifteenth day of the third month of the election year. Otherwise, the election is effective for the next tax year.
- The IRS can waive the election deadline if the corporation shows reasonable cause for late filing.
- The IRS can grant relief for improper elections if they are inadvertent and subsequently corrected.

Termination Rules

- To effect a voluntary revocation, shareholders owning more than 50% of the S corporation's stock must consent. The revocation is effective for the entire year if made on or before the fifteenth day of the third month of the tax year. Otherwise, the revocation is effective the first day of the next tax year unless the corporation specifies a prospective revocation.
- An involuntary termination occurs if (1) the S corporation fails to meet any of the small business corporation requirements (e.g., it has more than 100 shareholders) or (2) it has excessive passive investment income in a three-year period (assuming the corporation has prior C corporation accumulated E&P). If the IRS deems the involuntary termination to be inadvertent, the S corporation status is considered to have been continuously in effect provided the corporation and shareholders correct the defect.
- Aside from the inadvertent termination exception, a corporation may not reelect S corporation status for five years after a termination or revocation.

EXAMPLE I:17-36 ▶ Ajax Corporation, an S corporation owned equally by Linda and Hal, reports the following operating results for the current year (a non-leap year):

Sales	$10,000
Minus: Cost of goods sold	(2,000)
Gross profit	$ 8,000
Plus: Long-term capital gains	3,000
Total income	$11,000
Minus: Administrative expenses	(800)
Repairs	(200)
Sec. 1231 losses	(1,100)
Charitable contributions	(900)
Net income	$ 8,000

SELF-STUDY QUESTION

Compare the manner in which income of an S corporation is allocated among the shareholders to the manner in which partnership income is allocated among the partners.

ANSWER

In the case of an S corporation, the income must be allocated based on the percentage of stock owned on a daily basis. Partners have much greater flexibility. The partnership agreement serves as the basis for allocation, with special allocations being permitted. No special allocations are permitted for an S corporation.

The S corporation reports these items on its tax return as follows:

	Schedule K			
	Ordinary Income	*Separately Stated Items*	*Linda's K-1*	*Hal's K-1*
Sales	$10,000			
Cost of goods sold	(2,000)			
Administrative expenses	(800)			
Repairs	(200)			
Total ordinary income	$ 7,000		$3,500	$3,500
Long-term capital gains		$3,000	1,500	1,500
Sec. 1231 losses		(1,100)	(550)	(550)
Charitable contributions		(900)	(450)	(450)

Linda and Hal each report $3,500 of ordinary income plus 50% of each separately stated item on their individual tax returns. ◀

Income, gains, losses, deductions, credits, and other separately stated items are allocated to the shareholders based on the number of shares of stock owned on each day of the S corporation's tax year. Thus, if a shareholder sells S corporation stock during the year, ordinary income (or loss) and separately stated items are allocated on a daily basis to the seller and purchaser of the stock.[44]

EXAMPLE I:17-37 ▶ Assume the same facts as in Example I:17-36 except Linda sells her stock to Mark on the 181st day of the tax year. Income through the date of the transfer is allocated to Linda. Thus, Linda reports $1,736 [0.50 × (181 ÷ 365) × $7,000] of the ordinary income and a similar portion of each separately stated item. Mark reports the ordinary income and separately stated items for the remainder of the year. The sale does not affect the way Hal reports his share of the income. ◀

BASIS ADJUSTMENTS TO S CORPORATION STOCK

Usually, a shareholder's original basis for S corporation stock is either the amount paid for the stock or a substituted basis from a nontaxable transaction (e.g., a Sec. 351 corporate formation).[45] Adjustments subsequently are made for ordinary income (or loss) and separately stated items that pass through to the shareholders, as well as additional capital contributions by shareholders and distributions to shareholders.[46] These basis adjustments apply in the following order: (1) positive adjustments for contributions, S corporation ordinary income, and separately stated income and gain items; (2) negative adjustments for distributions; and (3) negative adjustments for S corporation ordinary loss and separately stated deduction and loss items.

EXAMPLE I:17-38 ▶ During the current year, Juan pays $40,000 for 100 shares of Allied Corporation stock. Allied is a calendar year S corporation. Juan's share of Allied's current year ordinary income is $10,000. In addition, his share of separately stated items includes $4,000 of long-term capital gains and $2,000 of Sec. 1231 losses. Allied also distributes $5,000 cash to Juan during the year. Juan's basis in the S corporation stock on December 31 is computed as follows:

Original basis (cost)		$40,000
Plus:	Share of ordinary income	10,000
	Share of long-term capital gains	4,000
Minus:	Cash distribution to Juan	(5,000)
	Share of Sec. 1231 losses	(2,000)
Basis of stock on December 31		$47,000 ◀

[44] If the corporation makes a special election under Sec. 1377(a)(2), the income is allocated according to the accounting methods used by the S corporation (instead of on a daily basis) when a shareholder terminates his or her interest during the tax year.

[45] The death or gift tax basis rules also may be used to determine the initial basis for S corporation stock.

[46] Sec. 1367.

The logic behind these basis adjustments is the same as for partnerships. They prevent double taxation of income or double deductions for losses.

EXAMPLE I:17-39 ▶ Kayla is in the 37% tax bracket for ordinary income and faces a 23.8% tax rate on long-term capital gains (including the 3.8% tax on net investment income). She plans to form Alpha Corporation by contributing $100,000 in exchange for Alpha stock. Alpha will invest the contributed funds in its business operations. During the next ten years, Kayla expects Alpha to earn $900,000 of ordinary business income before taxes. At the end of the ten-year period, Kayla plans to sell her Alpha stock. If Alpha operates as an S corporation, Kayla will recognize $900,000 of pass-through income on which she must pay taxes. Assuming she will qualify for the 20% qualified business income deduction, her pass-through income effectively will be taxed at 29.6% [37% × (1 − 0.20)]. So that Kayla will have sufficient cash to pay these taxes, Alpha will distribute $266,400 ($900,000 × 0.296) over the ten-year period. On the other hand, if Alpha operates as a C corporation, it will pay taxes at its 21% tax rate and will make no distributions to Kayla. Thus, Alpha will incur $189,000 ($900,000 × 0.21) of taxes over the ten-year period. If an S corporation, Alpha's value at the end of ten years will be 733,600 ($100,000 contribution + $900,000 pretax earnings − $266,400 distributed). If a C corporation, its value will be $811,000 ($100,000 contribution + $900,000 pretax earnings − $189,000 corporate taxes paid). Thus, Kayla will sell the stock at one of these amounts, depending on whether Alpha operates as an S corporation or a C corporation. The results of these alternatives are as follows:

	S Corporation with Stock Basis Adjustments	*C Corporation with No Stock Basis Adjustments*
Selling price of stock	$ 733,600	$811,000
Original contribution	$ 100,000	$100,000
Kayla's pass-through income	900,000	–0–
Distributions to Kayla	(266,400)	–0–
Adjusted basis of Alpha stock	$ 733,600	$100,000
Gain on sale of stock	$ –0–	$711,000
Times: Capital gains tax rate	0.238	0.238
Tax on capital gain	$ –0–	$169,218
After-tax proceeds (selling price – tax)	$ 733,600	$641,782

Thus, the S corporation results in the higher after-tax proceeds primarily because its shareholder is subject to only one level of taxation rather than the double taxation afforded by the C corporation, that is, the corporate-level tax and the tax upon selling the C corporation stock. Essentially, with the qualified business income deduction, the S corporation income is taxed at 29.6% [37% × (1 − 0.20)], while the C corporation income is taxed at 39.8% [21% + 23.8% × (1 − 0.21)]. ◀

S CORPORATION LOSSES AND LIMITATIONS

An ordinary loss and any separately stated loss and deduction items of an S corporation are allocated among the shareholders based on the number of shares of stock owned on each day of the S corporation's tax year.[47] The last day of the S corporation's tax year determines when the shareholders report the loss on their tax return.[48] Most S corporations must use a calendar tax year, although an S corporation can use a fiscal year if that year can be shown to be a natural business year because the corporation's operations are cyclical.

EXAMPLE I:17-40 ▶ Sigma Corporation is an S corporation whose tax year ends on January 31 of each year because Sigma has a natural business year that ends on that date. All of its shareholders report their taxes using a calendar year. Sigma reports a $100,000 ordinary loss for the 12-month period ending January 31 of Year 2. The shareholders report the entire loss on their calendar Year 2 returns. ◀

[47] Sec. 1366(a)(1).

[48] The same rule applies for reporting ordinary income and separately stated income and gain items.

KEY POINT

An S corporation shareholder gets debt basis, separate from stock basis, for amounts the shareholder lends directly to the corporation, but the shareholder gets no basis for corporate liabilities owed to third parties. This treatment differs from that of partnership liabilities.

A shareholder's deduction for ordinary losses and separately stated items cannot exceed his or her basis for the S corporation stock plus the debt basis for any shareholder loans made to the S corporation.[49] A shareholder, however, obtains no debt basis for corporate-level liabilities even if he or she guarantees them. The following rules apply in determining the deductibility of ordinary loss and separately stated loss items:

- Positive basis adjustments increase stock basis for ordinary income or separately stated income or gain items incurred during the year before ordinary losses, and separately stated losses and deductions reduce stock basis.
- The shareholder's deduction for pass-through losses is limited to the sum of (1) stock basis after the above positive adjustments and after distributions but before negative adjustments for losses and deductions and (2) the shareholder's debt basis.[50]
- A shareholder's pass-through loss first reduces the shareholder's stock basis (but not below zero).
- If the loss exceeds the shareholder's stock basis, the remaining pass-through loss reduces the shareholder's debt basis (but not below zero).
- If the loss exceeds both the stock and debt basis, the shareholder carries over the excess loss and deducts it in a subsequent year when the shareholder again has basis in the stock or debt.

ADDITIONAL COMMENT

The loss carryover period is indefinite but does not transfer to another taxpayer if the shareholder disposes of all his or her stock or if the shareholder dies. Furthermore, if the S election terminates, the loss must be used against any basis of the former S corporation stock by the end of a one-year post- termination transition period.

EXAMPLE I:17-41 ▶ Matt owns 20% of the stock of an S corporation. His stock basis is $18,000 at the end of Year 1 after adjustments for separately stated income and gain items. Matt also loans the S corporation $12,000 during Year 1. The S corporation incurs a $200,000 ordinary loss in Year 1. Matt's share of the ordinary loss is $40,000 (0.20 × $200,000). Matt's deduction and carryover of the unused loss are as follows:

Basis in stock	$ 18,000
Minus: Ordinary loss applied against stock basis	(18,000)
Basis in stock after ordinary loss	$ –0–
Debt basis in loan	$ 12,000
Minus: Ordinary loss applied against debt basis	(12,000)
Debt basis in loan after ordinary loss	$ –0–
Share of ordinary loss	$ 40,000
Minus: Loss allowed in Year 1 ($18,000 + $12,000)	(30,000)
Carryover of ordinary loss to Year 2	$ 10,000 ◀

If a shareholder's basis is insufficient to absorb the entire amount of ordinary loss (and separately stated loss and deduction items), the pass-through of each item is pro rated. For example, if a shareholder's basis is $5,000 and he or she has a $6,000 ordinary loss and a $4,000 capital loss, the total deduction is limited to $5,000. This deduction consists of a $3,000 [($6,000 ÷ $10,000) × $5,000] ordinary loss and a $2,000 [($4,000 ÷ $10,000) × $5,000] capital loss. The shareholder also has a $3,000 ($6,000 − $3,000) ordinary loss carryover and a $2,000 ($4,000 − $2,000) capital loss carryover.

Restoration of Basis. If a shareholder's debt basis is reduced by a loss deduction, subsequent net increases in a future year initially increase the debt basis until that basis reduction is fully restored. Any excess positive adjustment then increases the shareholder's stock basis.

[49] Sec. 1366(d)(1). The deductible loss is treated as a deduction for AGI on an individual shareholder's tax return. S corporation shareholders also are subject to special limitations on losses and deductions that pass through from the S corporation (e.g., at-risk limitations under Sec. 465 and passive activity losses under Sec. 469). (See Chapter C:11 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* for a discussion of these additional limitations.)

[50] Secs. 1366(d)(1)(A) and 1367(a)(2).

EXAMPLE I:17-42 ▶ Assume the same facts as in Example I:17-41, and in Year 2 the S corporation's ordinary income is $140,000. Matt's share of the income is $28,000 (0.20 × $140,000). The $28,000 of income earned in Year 2 permits Matt to deduct the $10,000 ordinary loss carryover from Year 1. Matt's net increase is $18,000 ($28,000 − $10,000 loss carryover). Thus, Matt restores debt basis by $12,000, its original amount. The remaining $16,000 of income increases stock basis. Accordingly, stock and debt basis are adjusted as follows:

	Stock Basis	*Debt Basis*
Basis at beginning of year	$ –0–	$ –0–
Plus: Income for the year ($28,000)	16,000	12,000
Minus: Loss carryover from prior year	(10,000)	–0–
Basis at end of year	$ 6,000	$12,000

◀

ADDITIONAL COMMENT

In a manner similar to partners, S corporation shareholders may be subject to the passive activity loss limitations on their pass-through losses if they do not materially participate in the S corporation's business. See Chapter I:9 for a detailed discussion of the passive activity loss limitations rules.

If the debt basis is not fully restored, gain results when the corporation repays the loan. If the loan is in the form of a note, the repayment results in a capital gain because the note constitutes a capital asset.[51] However, ordinary income results if the loan is an unsecured advance.[52]

Special Deductions and Limitations. An S corporation and its shareholders are subject to the rules regarding the qualified business income deduction, the limitation on net business interest, and the limitation on excess business losses. These topics were covered in the partnership section of this chapter and apply in a similar way to S corporations and their shareholders.

Topic Review I:17-5 summarizes the basic tax rules for S corporation shareholders.

OTHER S CORPORATION CONSIDERATIONS

Distributions of Cash and Property to Shareholders. A money or property distribution made by an S corporation to its shareholders is treated as a return of capital if the S corporation has no accumulated earnings and profits from pre-S corporation years.[53] As such, the amount of money or FMV of the noncash property distributed to a shareholder reduces the basis of the shareholder's S corporation stock. If distributions exceed the shareholder's stock basis, the excess is treated as a capital gain if the stock is a capital asset.[54]

ADDITIONAL COMMENT

Another important difference between partnerships and S corporations involves the tax consequences of property distributions. An S corporation recognizes gain if it distributes appreciated property to its shareholders, but a partnership would not recognize such gain. Also, the property's FMV is used for S corporation distributions while the property's adjusted basis is used for partnership distributions.

The S corporation recognizes gain (but not loss) if it distributes noncash property to its shareholders.[55] The distribution is treated as if the corporation sold the property to the shareholders at its FMV. The gain passes through to the shareholders who increase their stock basis accordingly. The distributed property's FMV then reduces the shareholders' stock bases.

TOPIC REVIEW I:17-5

Basic Tax Rules for S Corporation Shareholders

- Ordinary losses and separately stated loss and deduction items are allocated to shareholders on a per share per day basis.
- Shareholders may be eligible for the 20% qualified business income deduction.
- Limitations on net business interest and excess business losses may apply.
- The last day of the S corporation's tax year determines the year in which the shareholders report their share of income, gain, deductions, losses, credits, and other separately stated items.
- Basis cannot be reduced below zero. Positive basis adjustments are made for ordinary income and separately stated income or gain items before basis reductions for distributions, ordinary losses, and separately stated loss and deduction items.
- Losses initially reduce the shareholder's stock basis (but not below zero). Any excess losses then reduce a shareholder's basis in debt owed by the S corporation to the shareholder.
- Unused losses are suspended and carried over until the shareholder again has basis to absorb the losses.
- Net positive basis adjustments in subsequent years initially increase the shareholder's debt basis until fully restored. Any additional positive basis adjustments increase the shareholder's basis in S corporation stock.

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[51] Rev. Rul. 64-162, 1964-1 C.B. 304.

[52] Rev. Rul. 68-537, 1968-2 C.B. 372.

[53] The tax consequences of property distributions to an S corporation's shareholders are discussed in Chapter C:11 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*.

[54] Sec. 1368(b). The S corporation also can have accumulated E&P from a tax year in which it was taxed as a C corporation. The tax consequences of a distribution made by an S corporation having accumulated E&P are complex. These rules are beyond the scope of this text but are discussed in Chapter C:11 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*.

[55] Sec. 311(b).

EXAMPLE I:17-43 ▶ Austin Corporation, an S corporation, distributes land (a capital asset) to its sole shareholder Sue. The land has a $10,000 basis and a $90,000 FMV. Prior to the distribution, Sue's stock basis is $200,000. The S corporation recognizes an $80,000 capital gain, which passes through to Sue. Sue increases her Austin stock basis by the $80,000 pass-through gain and decreases it by the $90,000 FMV of the distribution. Thus, after the distribution, her stock basis is $190,000, and her basis in the land is $90,000 (its FMV). ◀

Tax Year Restrictions. S corporations must use a calendar year unless the corporation can establish a business purpose (i.e., a natural business year) for choosing a fiscal year-end.[56] These year-end restrictions prevent shareholders from deferring pass-through income for up to 11 months (e.g., if a January 31 fiscal year-end were permitted). Also, like a partnership, an S corporation may elect a maximum three-month deferral if it agrees to make a special tax payment each year that approximates the deferral benefit.

ADDITIONAL COMMENT

For purposes of calculating which shareholders own more than 2% of the S corporation's outstanding stock, the Sec. 318 attribution rules apply.

Treatment of Fringe Benefits. S corporation shareholders who own more than 2% of the outstanding stock are not eligible for some nontaxable corporate employee fringe benefits, including the following examples:

- The group term life insurance exclusion for premiums paid for up to $50,000 coverage (Sec. 79)
- The exclusion from income for premiums paid for accident and health insurance and medical reimbursement plans (Secs. 105 and 106)[57]
- The exclusion for cafeteria plan benefits (Sec. 125)
- Meals and lodging furnished for the convenience of the employer (Sec. 119)

A more-than-2% shareholder includes the fringe benefits listed above in gross income as compensation, which is deductible by the S corporation. Amounts received by a shareholder owning 2% or less of the S corporation's stock are excluded from the shareholder's gross income and deductible by the corporation as they would be for an employee of a C corporation.

EXAMPLE I:17-44 ▶ Bass Corporation, an S corporation, pays health insurance and group term life insurance premiums for its employee-owner group, all of whom own more than 2% of the Bass stock. The owner-employees include the premiums in their gross income, and the S corporation deducts the premiums. Employee-shareholders who own more than 2% of the S corporation's stock can deduct 100% of the amount includible in gross income as being paid for medical insurance for themselves, their spouses, and their dependents.[58] The premiums would not be included in the gross income of employees who did not own any Bass stock, or who owned 2% or less of the Bass stock. ◀

Many S corporation fringe benefits are not subject to special treatment for a more-than-2% shareholder. A partial list of such fringe benefits includes:

- Stock options
- Nonqualified deferred compensation
- Compensation for injuries and sickness (Sec. 104)
- Educational assistance programs (Sec. 127)
- Dependent care assistance programs (Sec. 129)
- Certain fringe benefits (Sec. 132)

The employee reports these fringe benefits under the general gross income inclusion rule applicable to the fringe benefit, and the corporation deducts them as ordinary business expenses under Sec. 162.

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[56] Sec. 1378(b).

[57] Rev. Rul. 91-26, 1991-1 C.B. 184, clarified by Ann. 92-16, 1992-5 I.R.B. 53. Rules similar to those applying to more than 2% S corporation shareholders will apply to all partners in a partnership. The payment is deductible by the partnership and includible in the partner's gross income. Notice 2008-1, 2008-1 C.B. 251, eases the for-AGI deductibility of health insurance premiums.

[58] Sec. 162(l)(1) and (5).

Corporate Tax on Built-in Gains. A 21% corporate tax on built-in gains applies if a corporation that previously was a C corporation elects S corporation status.[59] The built-in gains tax does not apply to a corporation that always has been an S corporation or that elected S corporation status before 1987. A built-in gain exists if the FMV of an asset exceeds its adjusted basis on the day the S election becomes effective. If the corporation sells an asset with a built-in gain within the five-year recognition period beginning on the effective date for the election, the S corporation pays tax on the built-in gain. Built-in losses existing on the first day of the S election period can reduce built-in gains. Any appreciation on the asset that occurs after conversion from a C corporation to an S corporation is subject to the regular S corporation pass-through rules but is not taxed under the built-in gains tax. Assets acquired after the first day of the S corporation election period also are exempt from the built-in gains tax.

EXAMPLE I:17-45 ▶ Beach Corporation, an accrual basis taxpayer, incorporated four years ago and subsequently elected S corporation status beginning January 1 of last year. On January 1 of last year, Beach owned land with a $50,000 basis and a $200,000 FMV. Beach sold the land this year for $225,000. Thus, Beach reports a total gain of $175,000 ($225,000 – $50,000). The first $150,000 of the gain is subject to the built-in gains tax at the corporate level and passes through to the shareholders. The remaining $25,000 of post-conversion appreciation also is subject to the regular S corporation pass-through rules but is not subject to the built-in gains tax. In addition, the built-in gains tax paid by the corporation passes through as a loss to the shareholders. ◀

KEY POINT

Congress enacted the built-in gains tax to prevent C corporations from avoiding double taxation in a corporate liquidation or asset sale by electing S corporation status immediately before the liquidation or sale.

Tax on Excess Net Passive Income. A 21% excess net passive income tax applies when an S corporation has passive investment income for the tax year that exceeds 25% of its gross receipts and, at the close of the tax year, the S corporation has E&P that accumulated while it was a C corporation.[60]

EXAMPLE I:17-46 ▶ Acorn Corporation made an S election last year after having been a C corporation for several years. Acorn has accumulated C corporation E&P at the end of the current year. During the current year, Acorn's excess net passive income is $10,000, comprised of dividends and interest. The excess net passive income tax is $2,100 ($10,000 × 0.21). The tax reduces (on a pro rata basis) the passive income items (e.g., dividends and interest) that pass through to Acorn's shareholders. ◀



STOP & THINK

Question: Suppose shareholders of an S corporation wanted to convert the business into a limited liability company (LLC). What tax obstacles might they encounter?

Solution: The shareholders would have to liquidate the corporation and recontribute the assets to the LLC. Because the S corporation must comply with general corporate tax rules, the liquidation will cause gain and loss recognition at the corporate level for property distributed (Sec. 336). This gain (loss) will pass through to the shareholders and be taxable (deductible) to them. In addition, the liquidation might trigger the corporate level tax on built-in gains (Sec. 1374). Thus, conversion from an S corporation to an LLC could have adverse tax consequences. Contrast these major tax obstacles with the conversion of a partnership to an LLC. The IRS has ruled that the conversion of a partnership to an LLC is a nontaxable event.[61]

Sale of S Corporation Stock. If an S corporation shareholder sells his or her stock, he or she recognizes a capital gain. Unlike under the partnership rules discussed earlier, the S corporation shareholder does not have to convert any of the gain to ordinary income as under Sec. 751 or to unrecaptured Sec. 1250 gain under Sec. 1(h). If the S corporation owns collectibles, however, gain attributable to those assets would be subject to the

[59] Sec. 1374. This discussion is only a sketch of these complex rules.

[60] Sec. 1375(a). These rules are discussed in greater detail in Chapter C:11 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*.

[61] Rev. Rul. 95-37, 1995-1 C.B. 130.

28% capital gains tax rate.[62] Aside from this exception and other rare exceptions, the shareholder's gain would be taxed at the applicable capital gains rate if he or she has held the stock for more than one year.

Tax Planning Considerations

OBJECTIVE 4

Identify tax planning opportunities for partnerships and S corporations

USE OF OPERATING LOSSES

Often, the decision to select a particular form of business organization involves both tax and nontax issues. For example, owners may prefer the corporate form because of nontax attributes such as limited liability, the relative freedom to transfer ownership interests, and the ability to raise outside equity capital.

In many instances, however, the tax attributes dominate, making the partnership or S corporation form preferable to the C corporation. If the owners expect operating losses in the initial years of operation, they may prefer the partnership (or LLC) form to either the C corporation or the S corporation form of organization. In a C corporation, the operating losses do not benefit the shareholders directly and may be of no benefit if the corporation cannot generate sufficient profits in future years to offset the loss carryovers.[63] In a partnership, the losses pass through to the partners, limited by their basis for the partnership interest. The basis of a partner's interest, however, includes his or her share of partnership liabilities. In contrast, an S corporation's ability to pass through losses is limited to the shareholder's basis in the stock and any shareholder loans to the corporation. Other S corporation liabilities are not included in determining the shareholder's loss limitation. Thus, the partnership (or LLC) form of conducting business may provide its owners a greater opportunity to deduct losses than does the S corporation form.

EXAMPLE I:17-47 ▶ Mary and Marty are considering whether to operate a new business venture as a C corporation, S corporation, LLC, or a partnership. Regardless of the form chosen, Mary and Marty will materially participate in the business. Mary and Marty plan to invest $50,000 of equity and raise an additional $50,000 from outside creditors (e.g., accounts payable and a mortgage). They expect initial losses of $20,000 per year for five years. Three alternatives are available. If they use a C corporation, the corporate losses are not deductible (i.e., the corporation has net operating loss carryovers of $100,000 after the five-year period). If they elect S corporation status, Mary and Marty can deduct only $50,000 because the general corporate debt is not included in their stock basis. The remaining $50,000 loss carries over indefinitely at the shareholder level unless the shareholders lend $50,000 of additional funds to the corporation (instead of having the corporation borrow these amounts from outside creditors) or make $50,000 of additional capital contributions. If they form a partnership or LLC, Mary and Marty can deduct the full $100,000 of losses because their basis includes their ratable share of the partnership's liabilities.[64] Assuming Mary and Marty have sufficient other sources of income to absorb the losses, the value of these additional deductions in the first five years favors the partnership or LLC form of organization. A nontax factor that might influence the decision is the limited liability protection offered by the corporate or LLC forms. ◀

STOP & THINK

Question: Paul, a single taxpayer, owns a business that produces $50,000 of annual profits. If the business were incorporated, it could justify retaining all of its earnings and pay little or no dividends. Paul also has $180,000 of taxable income from other sources. Should Paul organize the business as an S corporation or as a C corporation?

Solution: Although many factors would be involved, one important tax factor is that Paul's $50,000 of income from the business would be taxed at 32–35% marginal tax rates (in 2019) if the business is an S corporation because the $50,000 increases his taxable

[62] Reg. Sec. 1.1(h)-1. An incremental 3.8% rate also applies to net investment income for taxpayers whose modified AGI exceeds $200,000 ($250,000 for married filing jointly).

[63] In a C corporation, net operating losses carry back two years and over 20 years if arising before 2018. If arising after 2017, NOLs carry over indefinitely with no carryback allowed

[64] Taxpayers also must satisfy the at risk rules of Sec. 465, the passive activity loss rules of Sec. 469, and the excess business loss limitations of Sec. 361(l). These topics are discussed in Chapter I:9.

income to $230,000. If Paul claims the 20% QBI deduction, these marginal tax rates effectively would be 25.6% [32% × (1 − 0.20)] to 28% [35% × (1 − 0.20)]. In contrast, the C corporation tax rate is 21% of taxable income. Thus, with Paul's facts, the marginal tax rate on the $50,000 is lower with the C corporation form even after considering the QBI deduction for S corporation qualified business income. Additional taxation would result with the C corporation form, however, if Paul withdrew profits as a dividend or recognized a capital gain upon selling his stock or liquidating the corporation.

INCOME SHIFTING AMONG FAMILY MEMBERS

Subject to gift tax rules and restrictions, an attractive tax planning strategy is to shift income from higher tax bracket family members to children or others who are subject to lower tax rates. With an S corporation, parents may gift nonvoting common stock and shift income to their children if the children are not subject to the kiddie tax. Thus, a portion of the S corporation income is taxed to the children even though the parents retain all voting rights for the corporate stock. A partnership interest also may be gifted to other family members. However, the IRS generally does not recognize the family member as a partner where capital (e.g., inventory, plant, and equipment) is a material income-producing factor unless the individual is the real owner of the interest and has dominion and control over it. If property is given to a child subject to the kiddie tax, income above certain levels will be subject to a modified version of the estate and trust income tax rates (see Chapter I:2).

With an S corporation or a partnership, family members (e.g., children) can be hired as employees. Thus, income may be shifted to lower tax bracket family members. The kiddie tax rules discussed previously have no effect on earned income even if derived from a parent's business. In a partnership and an S corporation, however, the IRS will reallocate income to reflect the value of the services and capital contributions if the entity pays unreasonable salaries.[65]

EXAMPLE I:17-48 ▶ Paul, the sole owner of an S corporation, gifts 20% of the corporation's stock equally to his children Kelly, age 25, and Joslyn, age 12. The S corporation's ordinary income is $100,000 after deducting a $10,000 salary paid to Paul. If a reasonable salary for Paul's services is $50,000, the IRS may reduce ordinary income by the additional $40,000 of salary to $60,000 ($100,000 − $40,000) and increase Paul's taxable compensation to $50,000. Thus, the share of ordinary income that passes through to the children is reduced from $20,000 (0.20 × $100,000) to $12,000 (0.20 × $60,000). Kelly's $6,000 ([$60,000 × 0.20] × 0.50) of income is taxed at her regular tax rate because she is not subject to the kiddie tax. On the other hand, $3,900 ($6,000 − $2,100) of Joslyn's income is taxed at special rates based on the estate and trust income tax rates. ◀

ADDITIONAL COMMENT

The Sec. 754 election may be revoked only with the approval of the IRS. The IRS, however, will not approve a revocation if the primary purpose is to avoid stepping down the basis of partnership assets.

OPTIONAL BASIS ADJUSTMENT ELECTION UNDER SEC. 754

A basis adjustment election under Sec. 754 usually is desirable for an incoming partner whose partnership interest cost more than the tax basis of his or her share of partnership assets. The excess amount increases the new partner's basis for his or her interest in the partnership's assets. If the partnership made a Sec. 754 election in a prior year, the election continues in effect and automatically applies to subsequent years. When made, all partners must agree to the election because the partnership makes the election rather than the individual partner.

Therefore, before consummating a sale, an incoming partner should attempt to obtain assurances from the remaining partners that the partnership will make the election in the current year if the election is not already in effect. The partnership makes the election by attaching a statement to a timely filed tax return for the year the transaction occurs. The partnership cannot make a retroactive election for prior years.[66] A Sec. 754 election, however, may have adverse effects in subsequent years if the amount paid for a partnership interest is less than the tax basis of partnership assets because the incoming partner

[65] Secs. 1366(e) and 704(e).

[66] Reg. Sec. 1.754-1(b).

must reduce his or her share of basis in partnership assets. However, if the partnership assets have a built-in loss exceeding $250,000 or if the incoming partner would be allocated more than a $250,000 loss if the partnership were to sell its assets at their FMV, the downward basis adjustment would be mandatory even without the Sec. 754 election. See Chapter C:10 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* for additional coverage of this topic.

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 5

Comply with procedural and reporting requirements for partnerships and S corporations

PARTNERSHIP FILING REQUIREMENTS AND ELECTIONS

Partnerships must file Form 1065 (U.S. Return of Partnership Income) on or before the fifteenth day of the third month following the close of its tax year (by March 15 for a calendar year partnership). The partnership, however, can obtain an automatic six-month extension by filing Form 7004 (Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns). The IRS imposes penalties for failure to file a timely or complete partnership return.

Partnership Elections. The partnership makes most elections affecting the computation of partnership income. These elections include:

REAL-WORLD EXAMPLE

A partnership reported its capital gain on a sale in one tax year rather than on the installment basis. The partners could not use the installment method because this is a partnership election. *George Rothenberg,* 48 T.C. 369 (1967).

- Selection of a tax year
- Selection of an overall accounting method
- Inventory valuation method
- Depreciation methods
- Amortization method for organizational expenditures
- Optional basis adjustments under Sec. 754

An election made at the partnership level is binding on all partners.

In addition, each partner also makes certain elections. The common elections falling into this category are the partners' own accounting periods and methods and the election to take a credit or deduction for foreign income taxes.

REPORTING PARTNERSHIP ITEMS ON FORM 1065

A partnership reports ordinary income or loss on page 1 of Form 1065 while Schedule K summarizes all the separately stated items (e.g., capital gains and losses, tax credits, and charitable contributions). Schedule K also includes guaranteed payments made to partners and the partnership's ordinary income or loss, even though reported on page 1. The partnership prepares a separate Schedule K-1 for each partner. The Schedule K-1 reports each partner's share of the Schedule K items, depending on the agreed upon ratio for sharing income, deduction, loss, and credit items. This schedule becomes the primary input for preparing each partner's federal income tax return.

A partnership also must prepare a balance sheet (Schedule L), a reconciliation of income per books with income per tax (Schedule M-1), and an analysis of capital accounts (Schedule M-2). A partnership must file Schedule M-3 in lieu of Schedule M-1 if any one of the following conditions holds: (1) the amount of total assets reported in Schedule L exceeds $10 million; (2) the amount of adjusted total assets equals or exceeds $10 million, where adjusted total assets equal the Schedule L amount plus the following items that appear in Schedule M-2: (a) capital distributions made during the year, (b) net book loss for

the year, and (c) other adjustments; (3) total receipts equal or exceed $35 million; or (4) a reportable entity partner owns at least a 50% interest in the partnership on any day of the tax year, where a reportable entity partner is one that had to file its own Schedule M-3.

ADDITIONAL COMMENT

Because calendar year S corporation returns are due on March 15, a six-month extension runs to September 15, which is one month prior to the extended due date for individuals. This equalizes treatment of S corporations with partnerships as discussed on the previous page.

S CORPORATION FILING REQUIREMENTS AND ACCOUNTING METHOD ELECTIONS

An S corporation must file its corporate tax return no later than the fifteenth day of the third month following the end of the tax year. The S corporation reports its results on Form 1120S (U.S. Income Tax Return for an S Corporation). An S corporation can obtain an automatic six-month extension of time for filing its tax return by filing Form 7004 (Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns).

The S corporation, rather than the shareholders, makes the accounting method elections used to compute ordinary income or loss and the separately stated items. As with a partnership, the corporation makes these elections independently of the accounting method elections made by its shareholders.

REPORTING S CORPORATION ITEMS ON FORM 1120S

Page 1 of Form 1120S summarizes the ordinary income and deduction items for the S corporation. If the corporation owes any tax due to the excess net passive income tax or the ≠built-in gains tax, such amounts also are reported on page 1 of the return. Schedule K lists the separately stated items and ordinary income or losses for the S corporation, S corporation distributions, and selected other items. The corporation prepares a Schedule K-1 for each shareholder reflecting his or her share of the ordinary income (loss) and separately stated items. The Schedule K-1 becomes the basis for preparing each shareholder's federal income tax return. The S corporation also must prepare a balance sheet (Schedule L) and a reconciliation of income per books with income per tax (Schedule M-1). An S corporation must file Schedule M-3 in lieu of Schedule M-1 if the amount of total assets reported in Schedule L equals or exceeds $10 million.

COMPARISON OF ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS

Table I:17-2 provides a comparison of sole proprietorships, partnerships, S corporations, and C corporations. The partnership comments also apply to entities treated as partnerships for tax purposes such as LLCs or LLPs.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:17-1 Distinguish between the partnership, S corporation, and C corporation forms regarding the following:

- **a.** Incidence of taxation on the organization's business income
- **b.** Taxation of distributions to owners
- **c.** Application of the conduit and separate entity concepts of taxation
- **d.** Limitation on number and type of owners.

I:17-2 Explain how the following types of business entities are treated under the check-the-box regulations. What alternative treatments are available other than the default classification?

- **a.** Corporation
- **b.** Partnership (general and limited)
- **c.** Limited liability company (LLC)
- **d.** Limited liability partnership (LLP)

I:17-3 Anya is considering whether to become a limited partner in a real estate investment partnership by making a $10,000 investment. The limited partnership will generate substantial operating losses for its first five years. Discuss the advantages and disadvantages of the entity electing to be taxed as a C corporation versus being treated as a partnership or S corporation.

▼ **TABLE I:17-2**
Comparison of Alternative Forms of Business Organizations

Attributes	Sole Proprietorship	Partnership	S Corporation	C Corporation
Application of the separate entity versus the conduit (pass-through) concepts.	Single level of taxation. The proprietor is the same person as the individual taxpayer. The sole proprietor reports proprietorship income, gains, deductions, losses, and credits in his or her individual tax return.	Conduit with a single level of taxation. The partnership is not taxed. Instead, its income, gains, deductions, losses, and credits pass through to the partners to be taxed in their tax returns.	Conduit with a single level of taxation. Similar to a partnership in that its income, gains, deductions, losses, and credits pass through to the shareholders to be taxed in their tax returns. In special cases, the S corporation may pay entity level taxes on built-in gains and excess net passive income.	Entity with double taxation. The corporation is taxed at the entity level, and its shareholders are taxed again when they receive dividends, sell their stock, or liquidate the corporation.
Applicable income tax rates	Individual tax rates apply to the proprietorship's income, which is included in the propri- etor's total taxable income.	Individual tax rates apply to individual partners; corporate tax rates apply to corporate partners; and estate and trust tax rates apply to fiduciary partners.	Individual tax rates apply to individual shareholders; estate and trust tax rates apply to fiduciary shareholders.	A 21% flat tax rate applies to a corporation's taxable income. Individual, corporate, or estate and trust tax rates apply to shareholders receiving dividends from the C corporation. Qualified dividends are taxed at the applicable capital gains rate (see the Quick Reference section of the text).
Ownership restrictions	By definition, a sole proprietorship can have only one owner.	A partnership must have at least two partners and can have an unlimited number of partners; these partners can be individuals, corporations, estates, or trusts.	An S corporation can have up to 100 shareholders (with members of a family counting as one). Shareholders are limited to individuals, estates, certain trusts, and certain tax-exempt organizations.	A C corporation can have an unlimited number of shareholders of any type.
Personal liability	The sole proprietor is liable for debts of the proprietorship.	General partners have unlimited liability. Limited partners have liability to the extent of their investment.	Shareholders have limited liability.	Shareholders have limited liability.
Other nontax factors	A sole proprietorship has management continuity problems and may have difficulty raising outside capital.	A partnership has management continuity problems and restrictions on the transfer of partnership interests. It may have difficulty raising outside capital although limited partners, who are pure investors, mitigate this problem.	S corporations have the same characteristics as C corporations. An additional cost may arise if the state income tax law does not recognize the conduit form of taxation and taxes the S corporation as a C corporation.	Along with limited liability, C corporations have continuity of life, centralized management, and free transferability of ownership interests. These factors may outweigh the disadvantages of double taxation.

▼ **TABLE I:17-2 (Continued)**
Comparison of Alternative Forms of Business Organizations

Attributes	Sole Proprietorship	Partnership	S Corporation	C Corporation
Basis	A sole proprietor has basis in the business's assets but has no basis in the entity.	A partnership has basis in its assets, and its partners have basis in their partnership interests. A partner's basis includes his or her share of partnership liabilities. A partner's basis is adjusted for his or her share of partnership transactions.	An S corporation has basis in its assets. Shareholders have basis in their stock and a separate debt basis in their loans to the corporation. A shareholder's basis does not include corporate level liabilities. A shareholder's stock basis is adjusted for his or her share of corporate transactions. Debt basis is adjusted downward for pass-through losses and increased for restora- tions.	A C corporation has basis in its assets, and shareholders have basis in their stock. Stock basis is adjusted upward only for additional contributions to the corporation and downward for distributions that exceed the corporation's E&P.
Qualified business income deduction	A sole proprietor may qualify for the business income deduction.	A partner may qualify for the business income deduction.	A shareholder may qualify for the business income deduction.	A C corporation and its shareholders are not eligible for the qualified business income deduction.
Treatment of losses	Assuming the at-risk and passive activity loss limitations do not apply, shareholders still may be subject to the limitation on excess business losses. Unused proprietor NOLs carry over indefinitely subject to the 80% of taxable income limitation.	Partners' pass-through losses are limited to the basis of their partnership interests. At-risk, passive activity loss, and excess business loss limitations also may apply.	Shareholders' pass-through losses are limited to their stock and debt basis. At-risk, passive activity loss, and excess business loss limitations also may apply.	C corporation losses do not pass through to its shareholders. Unused corporate level NOLs carry over indefinitely subject to the 80% of taxable income limitation.
Choice of accounting methods	The sole proprietor can elect the cash or accrual method for business items. However, the accrual method for sales and purchases is required if inventory is a material income producing factor.	Partnerships can elect the cash or accrual method unless they are tax shelters or have a C corporation as a partner, in which case they must use the accrual method. Also, the accrual method for sales and purchases is required if inventory is a material income producing factor.	S corporations can elect the cash or accrual method unless they are tax shelters, in which case they must use the accrual method. Also, the accrual method for sales and purchases is required if inventory is a material income producing factor.	C corporations must use the accrual method unless they are personal service corporations or have annual gross receipts less than $26 million, in which case they can elect the cash or accrual method.
Choice of tax year	A sole proprietorship must use the same tax year as the sole proprietor, usually a calendar year.	The tax year is restricted to that of the majority partners, principal partners, or the least aggregate deferral. The partnership can use a fiscal year if it establishes a business purpose (e.g., a natural business cycle). Other special rules allow a tax year resulting in a maximum three-month deferral.	The tax year is restricted to a calendar year unless the corporation establishes a business purpose (e.g., a natural business cycle) for a fiscal year. Other special rules allow a tax year resulting in a maximum three-month deferral.	C corporations can use a calendar year or any fiscal year. Personal service corporations, however, face restrictions similar to those for S corporations.

▼ TABLE I:17-2 (Continued)
Comparison of Alternative Forms of Business Organizations

Attributes	Sole Proprietorship	Partnership	S Corporation	C Corporation
Employment-related tax con- siderations	A sole proprietor is not considered an employee of the business and must pay self-employment taxes on business earnings. Special tax treatment for corporate fringe benefits, such as group term life insur- ance, are not available to the proprietor.	A partner is not considered an employee of the partnership and must pay self-employment taxes on business earnings. Special tax treatment for corporate fringe benefits, such as group term life insurance, are not available to the partners.	Same as partnerships for shareholders owning more than 2% of the S corporation's stock. S corporation shareholders may be treated as employees, however, for Social Security tax purposes if they receive a salary.	A shareholder- employee may be treated as an employee for Social Security tax and fringe benefits purposes.

I:17-4 Paula transfers two assets to a partnership in separate transactions:
- **a.** Land with a $60,000 adjusted basis and a $100,000 FMV in exchange for a 20% interest in the partnership.
- **b.** A machine with a $50,000 adjusted basis and a $40,000 FMV. The partnership signs a note for $40,000 as consideration for the exchange.

Explain whether Paula recognizes gain or loss for either or both of these transactions, and discuss the reason for any difference in tax treatment.

I:17-5 In the current year, Penny contributes machinery to a partnership in exchange for a minority partnership interest. She acquired the machinery five years earlier. It now has a $50,000 adjusted basis and a $90,000 FMV. What are Penny's basis and holding period for the partnership interest? What is the partnership's basis and holding period for the machine? Why are the partnership formation rules structured in their current format?

I:17-6 Compare the Sec. 721 partnership formation rules for a new partnership with the Sec. 351 corporate formation rules for a new C corporation.

I:17-7 How is Mario's basis in his accrual method partnership interest affected by each of the following changes in partnership assets and liabilities (assuming he has a 50% interest in the partnership)?
- **a.** Mario contributes a building with a $100,000 FMV, and a $70,000 adjusted basis. The building is subject to a $50,000 mortgage, which the partnership assumes.
- **b.** The partnership's accounts payable increase by $50,000 during the tax year.
- **c.** The partnership pays off a $40,000 bank note that was outstanding for several years.
- **d.** The partnership distributes $10,000 cash each to Mario and his partner.

I:17-8 Sally contributes farm machinery with a $150,000 FMV, a $125,000 basis, and a $50,000 note owed to the AB Bank to a new partnership in exchange for a 25% partnership interest. Total partnership liabilities after Sally's contribution are $340,000. What gain or loss do Sally and the partnership recognize on the property contribution to the partnership? What is the partnership's basis and holding period in the machinery? What is Sally's basis in her partnership interest? How would your answers to this problem change (if at all) had Sally's asset contribution instead been made to an existing corporation for a 25% stock interest?

I:17-9 Assume the same basic facts as in Problem I:17-8. How would your answer change if the entity is a new corporation with all owners making property contributions? The corporation makes a timely election to be treated as an S corporation beginning with its first year.

I:17-10 What are the tax consequences to a partner who contributes liabilities that exceed the total basis of assets transferred to a new partnership in exchange for a partnership interest? How does your answer change if the same assets and liabilities are instead transferred to form a new C corporation?

I:17-11 What inequities might result if partners were not required to make special allocations for pre- contribution gains and losses on noncash property contributed to a partnership?

I:17-12 Indicate whether a partner's basis in the partnership interest increases, decreases, or is not affected by the partner's share of the following operating items:
- **a.** Ordinary income
- **b.** Ordinary loss
- **c.** Tax-exempt income
- **d.** Capital loss
- **e.** Capital gain
- **f.** Charitable contribution made by the partnership
- **g.** Distributions of cash to the partners
- **h.** Distributions of appreciated noncash property to the partners
- **i.** Guaranteed payments

I:17-13 Phyllis owns a 30% interest in the PQR Partnership and has a $20,000 basis in her partnership interest (before adjustments for Phyllis's share of current year partnership income or loss). During the current year, the PQR Partnership reports a $100,000 ordinary loss and no change in partnership liabilities. Phyllis materially participates in the business in the current year.

a. What amount of the loss can Phyllis deduct in the current year?
b. What is Phyllis's basis in her partnership interest at the end of the current year?
c. What happens to Phyllis's unused ordinary loss (if any)?
d. What advice can you give Phyllis about reducing the amount of unused loss (if any) that was not deductible in the current year?

I:17-14 Ralph sells an asset to the RST Partnership at a loss. In which of the following situations does he recognize a loss?

a. Ralph owns a 20% direct interest in the partnership, and his son also owns a 20% interest.
b. Ralph owns a 35% direct interest in the partnership, and his daughter also owns a 35% interest.
c. Ralph owns a 35% direct interest in the partnership, and his 100%-owned C corporation also owns a 35% interest.

I:17-15 Jose owns a 60% interest in the JKL Partnership. What are the amount and character of the recognized gain or loss in each of the following situations?

a. Jose sells common stock held as an investment with a $1,000 adjusted basis and a $3,000 FMV to the partnership. Jose held the stock for more than one year as an investment before the sale. The partnership also held the stock as an investment after the sale.
b. Jose sells a parcel of land held for investment purposes with a $10,000 adjusted basis and a $25,000 FMV to the partnership. The land is used in the partnership's business.
c. The partnership sells Jose a building used in its business with a $100,000 adjusted basis and a $60,000 FMV.

I:17-16 Marsha is a 30% partner in the MNO partnership. Niles and Oprah each have a 35% interest in the partnership. The partnership earns $100,000 from ordinary operations before considering a $10,000 guaranteed payment to Marsha. How much income does each partner report from the partnership?

I:17-17 The SJ Partnership, in which Sandy and Jack are equal partners, reported the following income and losses in the current year:

Interest from municipal bonds	$ 30,000
Interest from corporate bonds	25,000
LTCL from stock sale	20,000
Net income from operations	125,000

How do the partners treat these items?

I:17-18 Explain the circumstances that cause a partner to recognize gain or loss if the partnership distributes money or other property in a nonliquidating partnership distribution.

I:17-19 Explain why a partner who sells his or her interest in the partnership for cash must include his or her share of the partnership liabilities in the amount realized from the sale.

I:17-20 What are the tax consequences to a partner who sells his or her partnership interest if the partnership has Sec. 751 assets (i.e., unrealized receivables or inventory items)? What is the reason for this result?

I:17-21 Why did Congress enact the 20% qualified business income deduction?

I:17-22 Explain why a relatively small business operating as a pass-through entity would not cause its owner(s) to be subject to the limitation on excess business losses should the entity generate losses.

I:17-23 What are the primary advantages of using an S corporation instead of a C corporation?

I:17-24 What are the tax consequences to an S corporation and its shareholders if one of the requirements for a small business corporation is not met at some time in a tax year?

I:17-25 An S corporation issues straight debt obligations to its shareholders. Is it possible for the debt to be treated as a second class of stock, which would terminate the S election? Explain.

I:17-26 Andrew sells his Ajax Corporation stock to Angela on March 1. On March 15, Ajax elects S corporation status for the current year. Ajax is a calendar year taxpayer. Which shareholder(s) must consent to the election? Why? Which shareholder(s) receive an allocation of the S corporation's profits? Losses? For what time period is the allocation received by each shareholder?

I:17-27 An S corporation's shareholder wants the corporation to voluntarily revoke the S election. What percentage of the stock interests must agree to the revocation? When is the revocation effective?

I:17-28 Under what conditions will an S corporation involuntarily lose its special tax status and revert to being a C corporation? What remedies are available if the S corporation termination is deemed to be inadvertent?

I:17-29 Indicate whether the following items are reported on the tax return of an S corporation as part of

ordinary income (or loss) or as separately stated items:

a. Repairs
b. Long-term capital gains
c. Short-term capital losses
d. Section 1231 gains
e. Tax-exempt interest income
f. Tax credits
g. Tax preference items
h. Salary paid to an S corporation shareholder

I:17-30 Explain why the basis of S corporation stock is increased by the stockholder's share of ordinary income and separately stated gain and income items and reduced by the stockholder's share of an ordinary loss and separately stated loss and deduction items.

I:17-31 Anne has a $10,000 basis in her S corporation stock on January 1 of the current year. On March 1 of the current year, Anne lends the corporation $8,000. Her share of the S corporation's ordinary loss for the current year (which has not yet ended) is expected to be $28,000. Anne expects her marginal tax rate to be 12% in the current year. She expects that her marginal tax rate will increase to 32% next year, and she anticipates substantial profits for the S corporation next year. Advise Anne regarding the deductibility of her share of the losses and the desirability of making additional capital contributions or loans to the S corporation in either year.

I:17-32 Allied Corporation, an S corporation, is considering making a distribution of land to its sole shareholder. Allied acquired the land three years ago and used it in its business activities. The land now has a $30,000 adjusted basis and a $130,000 FMV. Allied has been an S corporation since its inception 12 years ago. Explain the tax consequences of the land distribution to the corporation and to the shareholder.

I:17-33 Barry and Bart are considering whether to start a new manufacturing business. Alternative forms of business organization being considered include operating as a partnership, a limited liability company, an S corporation, or a C corporation. Barry and Bart are calendar year taxpayers but would like to use a January 31 year-end for the business to obtain an 11-month income deferral. Discuss the implications and restrictions of operating under each alternative form of business organization being considered.

I:17-34 Assume the same facts as in Problem I:17-33 except Barry and Bart instead are considering the treatment of fringe benefits. Barry and Bart want to provide group term life insurance and accident and health insurance for themselves and their employees and plan to make the premium payments from business funds. Explain any restrictions that apply to each form of business organization.

I:17-35 Explain the circumstances in which an S corporation is subject to taxation at the corporate level.

ISSUE IDENTIFICATION QUESTIONS

I:17-36 Bert and José plan to combine their unincorporated businesses by forming a partnership. Bert has substantially appreciated business assets. Moreover, if he transfers all the business' liabilities and assets, the liabilities will exceed the adjusted basis of the assets but not their FMV. José will render services to the entity in addition to transferring his business assets. What tax issues should Bert and José consider?

I:17-37 Helen and Helga are equal partners in the HH Partnership. However, Helen devotes most of her time managing the business and believes that she should be given additional compensation in the form of a guaranteed payment. Currently, the partnership is operating at a break-even point (i.e., zero ordinary income and no separately stated items of income or loss). The basis of each partner's partnership interest also is negligible. Helen has requested a $40,000 guaranteed payment as compensation for her additional efforts. What tax issues should Helen and Helga consider?

I:17-38 Coastal Corporation has been a C corporation for several years and has substantial earnings and profits. Its tangible business assets are highly appreciated, and the corporation has paid no dividends for several years. The board of directors and its key shareholders are now recommending making an S election, selling the appreciated property, and paying a substantial cash distribution in the initial S corporation tax year. What tax issues should Coastal and its shareholders consider?

PROBLEMS

I:17-39 ***Formation of Partnership and Treatment of Liabilities.*** Andrea, Robert, and Agatha form the ARA Partnership as equal general partners. Andrea contributes land with a $20,000 basis and a $40,000 FMV along with cash of $60,000. Andrea has held the land for two years as an investment. Robert contributes equipment with a $50,000 adjusted basis and

a $100,000 FMV. Robert has used the equipment in his sole proprietorship for three years and has claimed $40,000 of accelerated depreciation. Agatha contributes accounts receivable from her sole proprietorship with a zero basis and a $45,000 FMV along with cash of $35,000. In addition, Agatha set up the accounting system for the business. She normally would charge $20,000 to do the same job for a client. On the first day of business, the partnership borrows $90,000 (recourse debt) from their bank to begin the business. The partners have equal risk of loss for these liabilities.

a. How much gain, loss, or income must each partner recognize on the formation of the partnership? What is the character of any gain, loss, or income recognized?
b. How much gain, loss, income, or deduction will the ARA Partnership recognize on the formation?
c. What is the partnership's basis in its property on the day the business begins?
d. What is each partner's basis in his or her partnership interest?

I:17-40 ***Formation of a Partnership and Treatment of Liabilities.*** Bonnie, Carlos, and Dale form the BCD Partnership as equal partners. Bonnie contributes land and a building having a $50,000 adjusted basis and a $200,000 FMV that is subject to a $100,000 mortgage assumed by the partnership. The land and the building originally cost $200,000, with $180,000 allocated to the building and $20,000 allocated to the land. Bonnie had claimed $150,000 of straight-line depreciation on the building. Carlos contributes cash of $100,000, and Dale contributes land (a capital asset) having a $200,000 adjusted basis and a $100,000 FMV. All assets have been held for more than one year. Assume the partners have an equal economic risk of loss.

a. What are the amount and character of Bonnie's recognized gain or loss on the transfer?
b. What is Bonnie's basis in her partnership interest?
c. What is Carlos's basis in his partnership interest?
d. What are the amount and character of Dale's recognized gain or loss on the transfer?
e. What is Dale's basis in his partnership interest?
f. What is the partnership's basis for each of the contributed properties?

I:17-41 ***Formation of a Partnership and Treatment of Liabilities.*** In the current year, Dana transfers to the DE Partnership land and a building having a total $25,000 adjusted basis and an $80,000 FMV. In addition, the property is subject to a $70,000 mortgage. The land and the building cost $105,000 when Dana acquired them in 1990, and Dana has claimed $80,000 of straight-line depreciation on the building. The land and building originally cost $20,000 and $85,000, respectively. Dana, who is active in the management of the partnership, receives a one-half interest in the partnership. Assume the partners' economic risk of loss is equal to their interest in the partnership.

a. What are the amount and character of Dana's recognized gain or loss on the transfer?
b. What is Dana's basis in her partnership interest?
c. When does Dana's holding period for the partnership interest begin?
d. What is the basis of the contributed properties to the DE Partnership?

I:17-42 ***Formation of a Partnership and Loss Limitation.*** Dan, who is active in the management of the partnership, contributes $10,000 in cash to the newly formed DEF Partnership for a 10% interest in the partnership. The partners transfer no liabilities to the partnership. During the partnership's first year, DEF borrows $75,000 from a bank and is liable for accounts payable amounting to $180,000 at the end of the current year. The DEF Partnership incurs a $400,000 ordinary loss during the current year.

a. How much of the ordinary loss may Dan deduct on his individual tax return?
b. What is Dan's basis in his partnership interest at the end of the current year?
c. How much of the loss (if any) carries over to future years?

I:17-43 ***Expenses of Forming a Partnership.*** The ABC Partnership, a calendar year entity, is formed and begins business on July 1 of the current year. ABC incurs the following expenditures on the date the partnership is formed:

Legal fees incident to the organization of the partnership	$ 6,000
Printing costs associated with the syndication of the partnership	4,000
Brokerage fees associated with underwriting efforts to sell limited partnership interests	5,000
Legal fees associated with asset transfers by three partners	10,000
Accounting services incurred during the organizational period	3,000

a. What is the appropriate tax treatment (i.e., capitalization, capitalization subject to amortization, or immediate expensing) for each of these items?
b. How much amortization should the partnership deduct for the current year?

I:17-44 ***Pass-Through of Income and Separately Stated Items.*** Damien and Donna are equal partners in the DD Partnership. The passive activity loss, at-risk, and excess business loss limitation rules are not applicable to the partners. The partnership reports the following items on its Schedule K during the current year:

Ordinary loss	$10,000
Long-term capital gains	40,000
Research and experimentation credit	4,000
AMT tax preference items	6,000
Distribution to the partners	25,000

Damien's basis in his partnership interest is $80,000 at the beginning of the current year. The DD Partnership's liabilities increased by $20,000 during the current year.

a. What amounts should Damien report on his individual tax return as a result of DD Partnership's activities?
b. What is Damien's basis in his partnership interest after taking into account the Schedule K items?

I:17-45 ***Special Allocations on Contributed Property.*** Ed contributes land (a capital asset) having a $60,000 adjusted basis and a $100,000 FMV, and Gail contributes $100,000 cash to the EG Partnership. Ed and Gail each receive 50% interests in the partnership. Two years later the partnership sells the land (still a capital asset) for $110,000. What are the amount and character of the EG Partnership's gain or loss? How much of EG's gain or loss is allocated to Ed? To Gail? Are the results equitable?

I:17-46 ***Loss Allocations—Varying Interest Rule.*** Alice and Bruce are equal partners in the calendar year AB Partnership. On November 1 of the current year, Carl joined the partnership by making a $100,000 cash contribution in exchange for a one-third interest. Alice and Bruce's partnership interests are each reduced to one-third. The AB Partnership reports a $109,500 ordinary loss for the tax year ending on December 31. Assuming the partners agree to the proration method with a calendar day convention and that the current year is a non-leap year, how much of the partnership's loss is allocated to Alice, Bruce, and Carl?

I:17-47 ***Basis of a Partnership Interest.*** Anita has a one-half interest in the AB Partnership. Anita's basis in her interest at the beginning of the current year is $75,000. During the year, the following events occur:

- Partnership liabilities increase by $50,000.
- Partnership earns $60,000 of ordinary income.
- Partnership recognizes $20,000 of capital losses.
- Partnership incurs $3,000 of nondeductible expenses.
- Partnership earns $10,000 of tax-exempt interest.
- Anita withdraws $15,000 in cash.
- Anita contributes land having a $20,000 adjusted basis and a $100,000 FMV as an additional capital contribution without increasing her interest in the partnership.

a. What gain (if any) does Anita recognize on the transfer of the land to the partnership?
b. What is Anita's basis in her partnership interest at the end of the current year?

I:17-48 ***Partnership Losses and Basis.*** Keith has a one-half interest in the KL Partnership. His basis in the partnership interest at the end of the current year (before deducting his share of partnership losses) is $40,000. His share of the partnership's ordinary loss in the current year is $180,000. Next year, Keith makes a $60,000 additional capital contribution, and the partnership's ordinary income is $100,000. Assume that no change occurs in Keith's partnership interest as a result of the capital contribution and that he materially participates in the business. Partnership liabilities do not change.

a. How much ordinary loss can Keith deduct in the current year?
b. What is Keith's basis in his partnership interest at the end of the current year?
c. How much ordinary income or loss does Keith report next year?
d. What is Keith's basis in his partnership interest at the end of next year?
e. How much loss can Keith use in future years? What has to happen to enable him to use the loss?

I:17-49 *Transactions Between the Partners and the Partnership.* Kevin has a 30% interest in the KLM Partnership. Louis (Kevin's son) also has a 30% interest. An individual unrelated to either Kevin or Louis holds the remaining 40% interest. Kevin sells the following assets to the partnership during the year:

- Common stock (a capital asset held more than one year) having a $10,000 basis and a $25,000 FMV and selling price.
- Land (a Sec. 1231 asset) having a $100,000 adjusted basis and a $60,000 FMV and selling price.
- Machine having a $50,000 adjusted basis and a $70,000 FMV and selling price. The original cost of the machine was $60,000, and Kevin deducted $10,000 in MACRS depreciation before the transfer.

a. What are the amount and character of Kevin's recognized gain or loss on the sale of the common stock? The land? The machine?
b. What gain or loss would the partnership recognize if it sells the land two years later for $90,000?

I:17-50 *Guaranteed Payments and Qualified Business Income Deduction.* Laura and Mark are equal partners in the LM Partnership. Laura receives a $35,000 guaranteed payment in the current year and also withdraws $15,000 of her partnership capital in cash. Partnership ordinary income is $100,000 after deducting the guaranteed payments for the current year. Assume that Laura is single and has salary income from other sources such that her marginal tax rate is 24%. Also assume that, because she has other income, 20% of qualified business income will be less than 20% of excess taxable income.

a. What amount must Laura include in her gross income, and what is her taxable amount and after-tax income for the current year taking into account the qualified business income deduction?
b. How would your answer change if Laura did not receive the guaranteed payment?

I:17-51 *Nonliquidating Distributions.* Lynn's basis in her partnership interest is $9,000 when she receives a nonliquidating distribution of $5,000 cash and land having a $6,000 adjusted basis and a $12,000 FMV.

a. What gain or loss does the partnership recognize when making the distribution?
b. What are the amount and character of the income or gain Lynn must recognize on the distribution?
c. What is Lynn's basis in the land?
d. What is Lynn's basis in her partnership interest after the distribution?

I:17-52 *Sale of a Partnership Interest.* The balance sheet of the ABC Partnership at December 31 of the current year is as follows:

	Adjusted Basis	*FMV*
Assets:		
Cash	$ 10,000	$ 10,000
Accounts receivable	20,000	20,000
Inventory	15,000	21,000
Land, buildings, and machinery	60,000	84,000[a]
Total	$105,000	$135,000
Liabilities and capital:		
Accounts payable	$ 5,000	$ 5,000
Notes payable	10,000	10,000
Allen's capital account (1/3)	30,000	40,000
Beth's capital account (1/3)	30,000	40,000
Candace's capital account (1/3)	30,000	40,000
Total	$105,000	$135,000

[a]Assume that $3,000 would be ordinary income under the depreciation recapture rules and $5,400 would be unrecaptured Sec. 1250 gain if the partnership sold the assets.

All partners have an equal interest in the partnership. Allen sells his partnership interest to an outsider on December 31 of the current year for $40,000. Allen's basis in the partnership interest is $35,000 (which includes Allen's share of partnership liabilities).

a. What amount does Allen realize on the sale?
b. What are the amount and character of Allen's recognized gain or loss on the sale?

I:17-53 ***Reporting Partnership Income.*** Rita, a calendar year taxpayer, is an employee of the RST Partnership, which has a June 30 year-end. The partnership pays Rita a salary of $2,500 per month for the period January 1 through June 30, 2019. On July 1, 2019, she joins the partnership and receives monthly drawings (distributions) of $2,500 for the 12-month period ending June 30, 2020. The drawings reflect her approximate share of partnership income for the period July 1, 2019, through June 30, 2020. On June 30, 2020, Rita's share of partnership ordinary income is $40,000.

a. What amount of income does Rita report on her 2019 individual tax return?
b. What amount of income does Rita report on her 2020 individual tax return?
c. Which part (if any) of Rita's income is subject to Social Security taxes?

I:17-54 ***Qualified Business Income Deduction and Net Business Interest Limitation.*** Charlene is an equal partner in the CD Partnership. The partnership does not qualify as a small business under the $25 million gross receipts test. The partnership incurred the following items for the current year. Ignore the deduction for one-half of self-employment tax.

Gross receipts	$ 30,000,000
Minus: Cost of goods sold	(21,000,000)
Gross profit	$ 9,000,000
General business expenses	2,400,000
Salary expense (W-2 wages)	1,600,000
Depreciation expense	1,000,000
Interest expense	2,000,000

Charlene is married and files a joint tax return, has no other sources of income, and claims the standard deduction. Calculate the partnership's ordinary income for the current year and Charlene's taxable income.

I:17-55 ***S Corporation Terminations.*** Which of the following events will cause termination or revocation of the S election for a calendar year corporation? When is the termination or revocation effective? (Assume all other requirements for an S election are met and that any termination is not inadvertent.)

a. Best Corporation has 100 qualifying S corporation shareholders. Sam dies on October 13, and the estate holds his stock for the rest of the year.
b. Assume the same facts as in Part a except the estate distributes the stock to Sam's child before the end of the tax year. Sam's child did not previously own any Best stock.
c. Best issues nonvoting common stock to Susan's two children during the current year. Susan's children did not previously own any Best stock.
d. Shareholders Susan, Ted, and Tim, who own 60% of the Best stock, file the necessary form on October 1 to revoke the election as of this date. All three shareholders are calendar year taxpayers.

I:17-56 ***S Corporation Ordinary Income and Separately Stated Items.*** The income statement for Central Corporation, an S corporation, reports the following:

Sales	$260,000
Cost of goods sold	(60,000)
Repair expense	(5,000)
Depreciation expense	(20,000)
Salary expense	(30,000)
Long-term capital losses	(15,000)
Charitable contributions	(5,000)
Sec. 1231 losses	(8,000)
Net income per tax books	$117,000

a. What is Central's ordinary income (or loss) for the year?
b. Which of the above items appear as separately stated items on Schedule K?
c. Carol owns 50% of Central's stock, which has a $75,000 basis (before taking into account any of the items listed above). What is Carol's stock basis after all adjustments for Carol's share of Central's ordinary income or loss and separately stated items?
d. What is Carol's combined qualified business income (QBI)?

I:17-57 ***Basis of S Corporation Stock.*** Cathy is a 40% shareholder of City Corporation. City is a calendar year S corporation. Cathy acquired her stock on January 1 of the current year for $80,000. In the current year, City reports the following results of operations, cash distributions, and salary payments:

Ordinary income allocable to Cathy	$30,000
Salary payments to Cathy	40,000
Long-term capital loss allocable to Cathy	5,000
Cash distributions to Cathy	17,000

a. What is Cathy's stock basis at the end of the current year?
b. What amounts should Cathy include in her individual tax return for the current year? Will the salary Cathy pays to herself affect her qualified business income deduction?

I:17-58 ***S Corporation and Partnership Losses.*** In the current year, Harold and Faye form Entity Company by each contributing $50,000 to the company in exchange for a 50% ownership interest. In addition, the company borrows $40,000 from First Bank. In the current year, the company incurs a $110,000 loss from operations.

a. How much of the loss can each partner deduct in the current year if Entity is a partnership, and what is each partner's basis in his or her partnership interest at the end of the year?
b. How much of the loss can each shareholder deduct in the current year if Entity is an S corporation, and what is each shareholder's basis in his or her stock at the end of the year?

I:17-59 ***S Corporation Losses, Stock Basis, and Debt Basis.*** Chris owns one-third of Coastal Corporation's stock, and he materially participates in the business. Coastal, an S corporation, uses the calendar year as its tax year. On January 1 of the current year, Chris's stock basis is $25,000, and he has a $10,000 loan outstanding to the corporation. In the current year, Coastal reports a $180,000 ordinary loss.

a. What amount of loss can Chris deduct on his individual tax return?
b. What is Chris's basis in his stock and debt at December 31?
c. How much of the loss (if any) carries over to subsequent years?
d. If Coastal reports ordinary income of $90,000 during the next year, what is Chris's basis in his stock and debt at the end of next year?

I:17-60 ***S Corporation Basis for Stock and Debt.*** Because of earlier losses, Cindy has a zero basis in her S corporation stock and a zero basis in her $10,000 loan to the corporation. During the current year, Cindy acquires additional shares of the S corporation stock for $8,000, and her share of the S corporation income is $7,000.

a. What are Cindy's stock and debt bases on December 31?
b. What are the tax consequences to Cindy if the corporation fully repays her loan (secured by a note) on January 1 of the following year?

I:17-61 ***S Corporation Distributions and Stock Basis.*** Control Corporation distributes $11,000 cash to shareholder Craig whose stock basis is $8,000 before this year's income or the distribution. Craig's share of ordinary income for the current year is $1,000, and the corporation has no separately stated items. Control always has been an S corporation.

a. What are the tax consequences of the distribution (i.e., amount and character of income or gain to Control and Craig)?
b. What is Craig's stock basis at the end of the tax year?

I:17-62 ***S Corporation and Partnership Property Distributions.*** Omega Company has two equal owners, William and Mary. Prior to a property distribution, each owner has a $200,000 basis in his or her ownership interest. In the current year, Omega distributes property to William having a $50,000 FMV and a $30,000 basis and distributes property to Mary having a $50,000 FMV and a $60,000 basis. The property is a capital asset. In Parts a and b, determine Omega's gain or loss recognized (if any), the owners' gain or loss recognized (if any), and the owners' basis in his or her ownership interest after the distribution.

a. Omega is partnership.
b. Omega is an S corporation.
c. In the S corporation case, is distributing the loss property to Mary a good idea? Why or why not?

I:17-63 ***S Corporation Distributions and Basis of Property.*** Compact Corporation, an S corporation, distributes land used in its business to Clay, its sole shareholder. The land has a $75,000 adjusted basis and a $125,000 FMV. Clay assumes a $20,000 mortgage secured by the land distributed to him. Immediately before the distribution, Clay's basis in the

Compact stock is $170,000, which includes his share of ordinary income and separately stated items for the current year (other than any gains or losses recognized because of the distribution). Compact always has been an S corporation.

a. What are the tax consequences of the distribution to Compact and Clay?
b. What is Clay's basis in the land?
c. How would your answer to Part a change if the land instead had a $100,000 adjusted basis and a $75,000 FMV?

I:17-64 ***S Corporation Fringe Benefits.*** Copper Corporation formed two years ago and immediately elected S corporation status. In the current year, the corporation pays the following insurance premiums for its employees:

Group term life insurance for shareholder-employees, all of whom own more than 2% of the stock	$3,000
Accident, health, and medical reimbursement plan insurance premiums for shareholder-employees, all of whom own more than 2% of the stock	5,000
Group term life insurance premiums for employees who are not shareholders	1,000
Accident, health, and medical reimbursement plan insurance premiums for employees who are not shareholders	2,000

a. What tax consequences result from Copper's payment of the insurance premiums?
b. What are the tax consequences to the shareholder-employees and to the employees who are not shareholders?

I:17-65 ***S Corporation Built-in Gains Tax.*** Delta Corporation made an S election on January 1 of the current year. Delta had been a C corporation since its inception in 2003. The corporation has the following operating results during the current year:

Ordinary income	$200,000
Long-term capital gains	130,000

The adjusted basis and FMV of capital assets held on January 1 and sold during the current year were $200,000 and $320,000, respectively, as of January 1 of the year in which the corporation's S election became effective.

a. Is Delta Corporation subject to the built-in gains tax under Sec. 1374? Explain.
b. What is the corporation's tax liability on the built-in gain (if applicable)?
c. How would your answers to Parts a and b change if Delta Corporation instead had made its S election effective January 1, 2005?

COMPREHENSIVE PROBLEM

I:17-66 Charles is a 60% partner in CD Partnership, a calendar year partnership. For 2019, Charles received a Schedule K-1 that reported his share of partnership items as follows:

Partnership ordinary income	$105,000
Tax-exempt income	1,000
Qualified dividend income	3,000
Short-term capital loss	20,000
Sec. 1231 loss	17,000
Charitable contributions	2,000
Cash distribution	60,000
Guaranteed payment	40,000

In addition, Charles and his wife, Charlene, had the following items relating to activities outside the partnership:

Charlene's salary	$80,000
Long-term capital gain	49,000
Interest income from corporate bonds	5,000
Mortgage interest expense	12,000
State income taxes	8,000
Property taxes on home	3,000
Charitable contributions	5,500
Withholding on Charlene's salary	18,000
Estimated tax payments (paid one-fourth on each of the quarterly due dates)	24,000

Charles and Charlene have two dependent children, ages 7 and 9, and file a joint tax return. Calculate the following items for Charles and Charlene. (Ignore the deduction for one-half of self-employment tax.)

a. Adjusted gross income (AGI)
b. Taxable income
c. Tax liability
d. Taxes due or refund

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

I:17-67 Joann and Bob, both single taxpayers in their mid-40s, own an employment business. The firm finds temporary employment for students in the college town of Gainesville, Florida. They have operated the business as a two-person equal partnership for five years. Profits have grown in each of the first five years until the partnership earns approximately $300,000 per year. Bob's parents operate a small grocery store in Nebraska and have successfully used the C corporation form for many years. They have become confused with all the new business forms—limited liability companies, limited liability partnerships, S corporations, etc.—that people have recommended to them. Bob mentions that he and Joann each has been taking $60,000 out of his and Joann's business each year as distributions. They have come to you for help in determining whether their partnership form of business is the way to operate the business in the future. What strategies can you develop for improving Joann's and Bob's personal and business tax positions?

I:17-68 Peter, Paul, and Mary plan to create a new business that buys, restores, and sells classic cars. The three individuals have been involved in a number of business deals dating back to the 1990s. Each individual has a net worth of at least $2 million. Peter has located an old auto dealership to be the showroom for the classic cars. Paul has restored many classic cars so he has developed the network for purchasing restorable cars. Mary is a well-established promoter of new businesses and is in charge of determining the business plan, selecting the entity form, obtaining the external financing, and hiring the firm's accountant. She also will handle most of the day-to-day management. Mary has narrowed the business entity choice down to a partnership, C or S corporation, or limited liability company. You have talked with Mary about this project at length in three different meetings. She wants your advice about selecting the appropriate business entity for the business. Prepare a short list of the pros and cons of using each of the four business forms and be prepared to make a final recommendation to Mary at your next meeting with her.

I:17-69 Steve and Erin started a general partnership to do landscaping and sell gardening supplies. Both will work in the business full time and need to withdraw approximately $40,000 a year each to live on. The partnership has purchased substantial capital assets that it will hold until the cash from their sale is needed in the business. For the first five years of operations, the partnership expects to earn approximately $140,000 of ordinary income each year before distributions to the two owners. Assume that the entire amount of ordinary income will qualify for the business income deduction, without being limited by 20% of excess taxable income. Steve and Erin are single taxpayers and have income from other sources so their partnership earnings will be taxed at a 22% marginal rate. Should the two set up $40,000 guaranteed payments for each, or should they take out the $40,000 as draws from their distributive shares of partnership income? Ignore self-employment taxes in your analysis as the self-employment taxes would be the same in either case.

I:17-70 Five years ago, Abigail invested $400,000 for a 25% interest in Crab Tree Partnership. The partnership has incurred losses every year and by the beginning of this year, her

outside basis in Crab Tree has declined to $20,000 including her share of liabilities. The partnership is predicted to have losses of $200,000 this year. Abigail has come to you for both tax and non-tax advice about whether or not she should increase her basis by $30,000, either by increasing their recourse debt or by contributing an additional $30,000 to the partnership. Provide Abigail with some of the tax and non-tax factors she should consider when making this decision.

TAX FORM/RETURN PREPARATION PROBLEMS

I:17-71 The XYZ Partnership reports the following items during 2018:

Sales	$400,000
Cost of goods sold	120,000
Dividends—all qualified	6,000
Interest income on certificate of deposit held as an investment	2,000
Tax-exempt interest	1,500
Salaries to employees	130,000
Federal employment taxes	9,000
Rental expense	5,000
Guaranteed payments to partners	40,000
Net long-term capital gain	12,000
Net short-term capital loss	5,000
Repairs	3,000
MACRS depreciation	10,000
Section 1231 losses	8,000
Charitable contributions	3,500
Amortization of organizational expenditures	1,000
Research and experimentation credit	2,500
Cash distributions to partners	20,000

Calculate ordinary income (or loss) by completing page 1 of Form 1065, and complete Schedule K (Partners' Shares of Income, Credits, Deductions, etc.). Leave spaces blank on Form 1065 if information is not provided.

I:17-72 Eagle Corporation, an S corporation, reports the following items during 2018:

Sales	$500,000
Cost of goods sold	150,000
Dividends—all qualified	7,000
Interest income on certificate of deposit held as an investment	2,500
Tax-exempt interest income	1,200
Employees' salaries (other than officers)	90,000
Federal employment taxes	6,000
Rental expense	8,000
Officers' salaries (all shareholders)	40,000
Net long-term capital gain	8,000
Net short-term capital loss	10,000
Repairs	2,000
MACRS depreciation	12,000
Section 1231 losses	4,000
Charitable contributions	2,000
Amortization of organizational expenditures	1,000
Research and experimentation credit	3,500
Cash distributions to shareholders	12,000

Calculate ordinary income (or loss) by completing page 1 of Form 1120S, and complete Schedule K (Shareholders' Shares of Income, Credits, Deductions, etc.). Leave spaces blank on Form 1120S if information is not provided.

CASE STUDY PROBLEMS



I:17-73 Peggy, Phil, and Ralph each have unincorporated accounting practices, and they wish to pool their resources and operate as a single business entity. Peggy owns a building that has appreciated in value since she purchased it eight years ago. They intend to use this building for their office. Other than the building, they own office equipment, computer equipment, and furniture, none of which is worth more than book value. They all have substantial outstanding accounts receivable with a zero basis because each individual uses the cash method of accounting. Each individual has substantial amounts of portfolio income (i.e., dividends and interest) earned outside of their business activities. Under the plan, accounts payable with a zero basis from the unincorporated accounting practices would be transferred to the new entity.

Each accountant has two or three employees. They all agree on the importance of providing benefits to their employees, such as group health insurance, group term life insurance, and a retirement plan of some kind. Additionally, they wish to have their staff participate in the profits of the company and have some form of equity interest in the company.

Peggy, Phil, and Ralph use different computerized accounting and billing systems. They also have different documentation requirements for their client files. The computerized accounting records, billing records, and client files will all have to be consolidated from three systems to one system. The conversion will take place over a period of time. For this reason, they anticipate reporting a loss for their first tax year.

Peggy, Phil, and Ralph have agreed that they want to operate as a pass-through entity because they wish to avoid double taxation, and they want to use the losses from the first year immediately. They have come to you for advice. Prepare a client memo comparing the pros and cons of operating the accounting practice as a partnership or an S corporation.

I:17-74 Dan is the partial owner of an S corporation that currently has 100 shareholders. In March of the current year, Dan sold some of his S corporation stock to each of his two adult children. In August, Dan redeemed the stock he sold because he is in the midst of a divorce and was fearful of the consequences associated with giving voting rights for his business to his children. Dan informs you, his tax consultant, of the stock sale and subsequent redemption. You explain to Dan that by selling the stock he created 102 shareholders between the months of March and August and that the S election had been terminated on the day preceding the date on which the corporation first had more than 100 shareholders. Dan tells you that he sees no reason to inform the IRS of the termination because he bought back the stock within the same tax year, and the IRS probably would not discover the event. What are your responsibilities as a CPA under the SSTS rules as mandated by the AICPA concerning the S election termination? (See the *Statements on Standards for Tax Services* in Appendix E for a discussion of these issues.) What advice can you offer Dan concerning reinstatement of the S election under the rules for inadvertent terminations?

TAX RESEARCH PROBLEMS

I:17-75 Sandra is an employee of the Beach Group, an organization active in the Florida real estate industry. Sandra finds real estate property on Miami Beach and subsequently organizes partnerships to acquire and finance the property. Sandra was particularly interested in one building in the Art Deco district that was to be purchased and renovated. She gathered interested investors who formed the Deco Partnership, consisting of two general partners and several limited partners. In exchange for her services in organizing the partnership, Sandra received a 3% limited partnership interest only in the profits of the Deco Partnership. As part of the agreement, the profits interest was transferable only at the discretion of the general partners. Based on the uncertainty in the South Florida real estate industry at the time, the partners could not estimate whether profits or losses would be generated when the renovation was completed in three years. Based on these facts, will Sandra's receipt of the limited partnership interest be a taxable event?

A partial list of research sources is:

- Sec. 721
- Reg. Sec. 1.721-1(a)
- *William G. Campbell v. CIR*, 68 AFTR 2d 91-5425, 91-2 USTC ¶50,420 (8th Cir., 1991)

- *Sol Diamond v. CIR,* 33 AFTR 2d 74-852, 74-1 USTC ¶9306 (7th Cir., 1974)
- Rev. Proc. 93-27, 1993-2 C.B. 343
- Notice 2005-43, 2005-43 C.B. 1221

I:17-76 Chuck, Cindy, and Clay are equal shareholders of Able Corporation common stock. Able was incorporated in the current year. Able elects to be treated as an S corporation starting in its initial year. Chuck, Cindy, and Clay each contributed $10,000 cash to Able in exchange for their common stock. Able borrows $60,000 from a bank, and Chuck, Cindy, and Clay personally guaranteed the corporation's loan. In the current year, Able suffers a $90,000 ordinary loss. How much of the corporation's loss can Chuck, Cindy, and Clay deduct? (Assume the at-risk and passive activity loss limitation rules do not apply.)

A partial list of research sources is:

- Sec. 1366(d)(1)
- *Estate of Daniel Leavitt v. CIR,* 63 AFTR 2d 89-1437, 89-1 USTC ¶9332 (4th Cir., 1989)
- *Edward M. Selfe v. U.S.,* 57 AFTR 2d 86-464, 86-1 USTC ¶9115 (11th Cir., 1986)
- *Dennis E. Bolding v. U.S.,* 80 AFTR 2d 97-5481, 97-2 USTC ¶50,553 (7th Cir., 1997).

I:17-77 In January 2019, Joey contributed investment land he had held two years with a FMV of $6,000 and an adjusted basis of $10,000, and Rachel contributed $6,000 cash to form the Green Partnership as equal general partners. During 2019, the partnership earned ordinary income of $10,000 and made no distributions. On January 1, 2020, while the partnership still held the land, Joey sold his interest in the partnership to Phoebe for $11,000. In April 2020, Green partnership sold for $5,400 the land that Joey contributed. What are the tax consequences of these transactions?

A partial list of research resources includes:

- Sec. 721
- Sec. 704(c)
- Sec. 705
- Sec. 741
- Reg. Sec. 1.704-1(c)

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CHAPTER

18

TAXES AND INVESTMENT PLANNING



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Apply the investment models to various investment alternatives
2. Use the investment models to make entity choices and compensation decisions
3. Recognize the role of implicit taxes in investment decisions

CHAPTER OUTLINE

Investment Models...18-2
Other Applications of Investment Models...18-15
Implicit Taxes and Clienteles...18-24

This chapter has been derived from a book originally written by Myron S. Scholes and Mark A. Wolfson and takes what has become known as the Scholes-Wolfson approach to investment strategy.[1] Consequently, the chapter differs significantly from other chapters in this text. First, the chapter does not present details of tax law. Instead, it introduces a conceptual framework for understanding how taxes affect basic investment decisions. Second, the chapter develops and illustrates models for determining the after-tax outcomes of various investment alternatives. Although these models may look strange at first, they become familiar and manageable after some study and practice. Third, the chapter extends the models' application to the pass-through versus C corporation choice and the current salary versus deferred compensation decision. Fourth, the chapter introduces the role of implicit taxes as well as explicit taxes in investment decisions. As demonstrated later, the before-tax rate of return of a tax-favored asset will be reduced by market forces as investors increase their demand for these investments. This reduced rate of return is an implicit tax that investors need to consider when making their decisions.

INVESTMENT MODELS

OBJECTIVE 1

Apply the investment models to various investment alternatives

The investment models described in this chapter fall into four categories depending on how investment earnings are taxed. We refer to these models as follows:

- The Current Model—Investment earnings are taxed currently.
- The Deferred Model—Investment earnings are taxed at the end of the investment period.
- The Exempt Model—Investment earnings are exempt from explicit taxation.
- The Pension Model—The initial investment is deductible or excludable from gross income, and the entire accumulation, not just earnings, is taxed at the end of the investment period.

KEY POINT

Future values are necessary to compare all amounts at the same point in time. This comparable time frame is critical in evaluating alternative investment opportunities.

These models in their basic form reflect the following assumptions:

- The investment's before-tax rate of return is constant over the investment period.
- The investor's marginal tax rate is constant over the investment period.
- Investment earnings are reinvested at the same rate of return as earned by the original investment.
- The investor knows future rates of returns and tax rates with certainty.
- The investor incurs no transaction costs.

ADDITIONAL COMMENT

This chapter ignores the additional 3.8% tax rate on net investment income that could apply to taxpayers having modified AGI exceeding $200,000 ($250,000 for married filing jointly).

The models can be modified, however, to accommodate changes to these assumptions. For example, we later show how to adapt the Current Model for changing tax rates (see Example I:18-5).

For simplicity, this chapter generally uses the following individual marginal tax rates for ordinary income: 40%, 35%, 30%, 25%, and 15%. Although these rates do not conform exactly to current tax rates, they are sufficient to demonstrate the concepts in this chapter. Moreover, the current rates are temporary, at least for now. In addition, the chapter assumes a 20%, 15%, or 0% capital gains tax rate for transactions not subject to the Sec. 1202 exclusion. For regular C corporations, the chapter uses the actual current tax rate of 21% since that rate is more permanent than the individual tax rates.

THE CURRENT MODEL

The Current Model gives the future value of an investment having the following characteristics:

- Only after-tax dollars are invested.
- The earnings on the investment are taxed annually (currently); thus, the reinvested earnings grow at the after-tax rate of return.

[1] M. S. Scholes, M. A. Wolfson, M. M. Erickson, M. L. Hanlon, E. L. Maydew, and T. J. Shevlin, *Taxes and Business Strategy: A Planning Approach*, Fifth Edition (Upper Saddle River, NJ: Pearson Education, Inc., 2015).

Common examples of investments taxed this way are savings accounts, money market funds, and taxable bonds, if the investor reinvests the after-tax earnings annually.

Investment with No Taxation. Before developing the Current Model, however, we first illustrate how an investment grows when compounded annually in a no-tax situation, and we introduce the notions of before-tax dollars and the before-tax rate of return. We then show the relationship between before-tax dollars and after-tax dollars and between before-tax and after-tax rates of return. Finally, we incorporate these concepts into the Current Model.

EXAMPLE I:18-1 ▶ Carla, an individual investor, lives in a land of no taxation and earns $1,000 of salary. She invests this amount in a bond that pays interest at 10% per year and holds the bond for three years, reinvesting the interest annually at the same 10% return. The following schedule details the investment's cash flow over the three years:

ADDITIONAL COMMENT

The rates of return used in this chapter do not attempt to reflect the actual returns in the current economy. A 10% rate of return is used often in examples and problems for computational ease in demonstrating the concepts in this chapter.

(1) Year	(2) Cumulative Investment at Beginning of Year	(3) Interest Income[a]	(4) Cumulative Investment at End of Year[b]
1	$1,000	$100	$1,100
2	1,100	110	1,210
3	1,210	121	1,331

[a]Column 2 × 10%
[b]Column 2 + Column 3

Thus, at the end of three years, the $1,000 original investment accumulates to $1,331. ◀

ADDITIONAL COMMENT

Definitions of variables:
- ATA: After-tax accumulation
- BT$: Before-tax dollars
- AT$: After-tax dollars
- BTROR or R: Before-tax rate of return
- ATROR or r: After-tax rate of return
- t: Marginal tax rate, generally
- t_o: Marginal tax rate at time of investment
- t_n: Marginal tax rate at end of investment horizon
- n: Investment horizon

Also see Topic Review I:18-1 on page I:18-16.

The three-year accumulation determined in Example also can be calculated as follows: $\$1,000\ (1.1)^3 = \$1,331$, which is $1,000 compounded at 10% for three years. Thus, the general form of the compounding formula is:

$$\text{Accumulation} = \text{BT\$}(1 + \text{R})^n$$

In this formula, BT$ stands for before-tax dollars invested. For instance, in Example I:18-1, Carla invested the entire $1,000 because taxes did not reduce her salary. Also in the formula, R is the before-tax rate of return (BTROR). Again, this return is a before-tax percentage because, as in Example I:18-1, the interest on the investment is not taxed. Consequently, the investor can reinvest all the interest with nothing siphoned away as taxes. Finally, n equals the number of years the investor holds the investment or, in other words, n represents the investment horizon. Thus, the formula gives the future value (accumulation) of before-tax dollars invested for n years while earning a BTROR equal to R.

The Current Model. Now assume our investor is subject to taxation at marginal tax rate t. In this case, any earned income, such as salary, will be subject to taxes, leaving only after-tax dollars available for investment.

EXAMPLE I:18-2 ▶ Assume the same facts as Example I:18-1 except Carla's $1,000 salary is subject to tax, and her marginal tax rate is 40%. That is, t = 40% or 0.4. In this case, Carla has only $600 to invest. This amount is computed as follows:

TAX STRATEGY TIP

Although this chapter focuses on federal income taxes, a taxpayer must consider all applicable taxes when making investment decisions.

Salary before taxes	$1,000
Minus: Taxes ($1,000 × 0.4)	(400)
After-tax dollars available to invest	$ 600

◀

The $600 amount determined in Example I:18-2 also can be calculated as follows:

$$\begin{aligned}\text{After-tax dollars} &= \$1,000 - (\$1,000 \times 0.4) \\ &= \$1,000\ (1 - 0.4) \qquad \text{(Factoring out the \$1,000 salary)} \\ &= \$1,000 \times 0.6 = \$600\end{aligned}$$

In general, then, the relationship between before-tax dollars (BT$) and after-tax dollars (AT$) can be expressed as follows:

$$AT\$ = BT\$(1 - t)$$

ADDITIONAL COMMENT

An easy way to remember that r is the ATROR and R is the BTROR is that taxation shrinks big R down to little r.

Now assume that the interest our investor earns also is taxed at her marginal tax rate. The following example shows the impact on the investor's after-tax cash flows.

EXAMPLE I:18-3 ▶

Carla (from the two previous examples) again earns $1,000 of salary, but because of taxation at 40%, she has only $600 to invest, as shown in Example I:18-2. She invests the $600 in a bond for three years that yields 10% interest per year before taxes. However, in this case, the interest income also is taxed at 40%. The following schedule details the investment's cash flow over the three years:

(1)	(2)	(3)	(4)	(5)	(6)
Year	Cumulative Investment at Beginning of Year	Before-Tax Interest Income[a]	Tax on Interest[b]	After-Tax Interest Income[c]	Cumulative Investment at End of Year[d]
1	$600.00	$60.00	$24.00	$36.00	$636.00
2	636.00	63.60	25.44	38.16	674.16
3	674.16	67.42	26.97	40.45	714.61

[a]Column 2 × 10%
[b]Column 3 × 40%
[c]Column 3 − Column 4
[d]Column 2 + Column 5

◀

In Example I:18-3, after-tax interest in Column 5 for Year 1 also can be calculated as follows:

$$\begin{aligned} \text{After-tax interest} &= \$600(0.1) - \$600(0.1)(0.4) \\ &= \$600(0.1)\,(1 - 0.4) \qquad \text{(Factoring out the \$600 after-tax salary and the 10\% before-tax rate of return)} \\ &= \$600(0.1)(0.6) \\ &= \$600(.06) = \$36 \end{aligned}$$

ADDITIONAL COMMENT

An easy way to remember that r is the ATROR and R is the BTROR is that taxation shrinks big R down to little r.

Thus, although the BTROR is 10%, the after-tax rate of return (ATROR) is only 6%. In general, the relationship between the BTROR and the ATROR can be expressed as follows:

$$r = R(1 - t)$$

As before, R equals the BTROR, and t equals the investor's marginal tax rate. The new variable, r, equals the ATROR, which is easy to remember because taxes reduce big R to little r.

With knowledge of this ATROR, the three-year accumulation in Example I:18-3 also can be calculated as follows: After-tax accumulation (ATA) = $600 $(1.06)^3$ = $714.61, which is $600 compounded at 6% for three years. Thus, the general form of the after-tax compounding formula is:

The Current Model:

$$ATA = AT\$(1 + r)^n \text{ or}$$
$$ATA = AT\$[1 + R(1 - t)]^n$$

Note that, because of current taxation, investments conforming to the Current Model provide no deferral advantages because all earnings are taxed currently. As demonstrated later in this chapter, the other three models reflect certain tax advantages.

EXAMPLE I:18-4 ▶ At the beginning of Year 1, Harry invests $5,000 (AT$) in a money market fund that pays a 5% annual return before taxes. Harry's marginal tax rate is 30%, and he allows all after-tax earnings to remain in the money market fund. That is, he withdraws only enough cash to pay taxes on the fund's annual earnings. The following table shows Harry's after-tax accumulation for various investment horizons. In this table, note that Harry's ATROR equals 3.5%, which is 5% (1 − 0.30). Thus, the Current Model appears as $5,000 $[1 + 0.05 (1 - 0.30)]^n$ or $5,000 $(1.035)^n$.

Investment Horizon (n)	*Computation*	*After-Tax Accumulation*
5 years	$5,000 $(1.035)^5$	$5,938.43
10 years	$5,000 $(1.035)^{10}$	$7,052.99
20 years	$5,000 $(1.035)^{20}$	$9,948.94

◀

Changes to Assumptions. As stated earlier, the Current Model (as well as other models) assumes that R and t are constant over the investment period. However, the model can be modified to accommodate changes to these assumptions. This modification is accomplished by breaking the model into separate components, as demonstrated in the next example.

EXAMPLE I:18-5 ▶ At the beginning of Year 1, Dan invests $5,000 (AT$) in a money market fund that pays a 5% annual return before taxes. He plans to leave the after-tax earnings in the fund for 15 years. Dan expects his marginal tax rate to be 25% over the next five years but expects his tax rate to be 35% for the subsequent ten years. Thus, his ATROR for the first five years equals 3.75%, which is 5% (1 − 0.25). For the remaining ten years, his ATROR equals 3.25%, which is 5% (1 − 0.35). Dan's after-tax accumulation (ATA) after 15 years is calculated as follows:

$$ATA = \$5{,}000(1.0375)^5(1.0325)^{10} = \$8{,}275.82$$

Note that the first part of this calculation, $5,000 $(1.0375)^5$ = $6,010.50, gives the accumulation after the five years during which Dan's tax rate is 25%. This accumulation then continues to grow at the 3.25% ATROR for the remaining ten years as follows: $6,010.50 $(1.0325)^{10}$ = $8,275.82. ◀

THE DEFERRED MODEL

KEY POINT

Deferral is beneficial because the tax dollars not used currently to pay tax can be reinvested to help generate additional earnings.

The Deferred Model gives the future value of an investment having the following characteristics:

- Only after-tax dollars are invested (as with the Current Model).
- The earnings on the investment are not taxed annually; thus, they grow at the BTROR.
- The accumulated earnings are taxed at the end of the investment horizon when the investor cashes out of the investment; thus, taxation of these earnings is deferred.

The traditional nondeductible IRA described in Chapter I:7 is a classic example of the Deferred Model. Recall that, if the taxpayer or the taxpayer's spouse is covered by an employer-sponsored qualified retirement plan and the taxpayer's AGI exceeds a specified amount,[2] the taxpayer may not deduct contributions to a traditional IRA. Moreover, if the taxpayer's AGI exceeds another threshold,[3] the taxpayer may not contribute to a Roth IRA. Nevertheless, a taxpayer precluded from making *deductible* contributions to a traditional IRA or contributions to a Roth IRA still may make *nondeductible* contributions up to $6,000 (in 2019) per year to a traditional IRA. These nondeductible contributions are after-tax dollars.

EXAMPLE I:18-6 ▶ Marsha is in the 35% tax bracket and is ineligible to make deductible or Roth IRA contributions. Nevertheless, she wishes to contribute the maximum $6,000 to a traditional nondeductible IRA. She wants to know how much taxable salary she must earn to have $6,000 left for the contribution. Recall that AT$ = BT$(1 − t). Rearranging these terms gives BT$ = AT$/(1 − t).

[2] In 2019 for a taxpayer covered by an employer plan, this AGI amount is $123,000 for married filing jointly and $74,000 for other taxpayers except those married filing separately. If the taxpayer is not covered by an employer plan but his or her spouse is covered, the AGI amount is $203,000.

[3] The AGI amount in 2019 is $203,000 for married filing jointly and $137,000 for other taxpayers except those married filing separately.

In other words, we can "gross up" after-tax dollars by dividing after-tax dollars by one minus the tax rate. Accordingly, the before-tax dollars necessary to yield $6,000 after taxes equals $9,231, which is $6,000/(1 − 0.35). Thus, Marsha must earn $9,231 of salary before taxes. The tax on this amount equals $3,231, which is $9,231 × 0.35, leaving $6,000 available for contribution to the nondeductible IRA. ◀

EXAMPLE I:18-7 ▶ Suppose Marsha makes the $6,000 contribution to a traditional nondeductible IRA in the current year and makes no subsequent contributions. Suppose further that investments in the IRA yield 8% per year before taxes and that Marsha allows her investment to accumulate in the IRA for 15 years. At the end of 15 years, she withdraws all amounts from the IRA, at which time her marginal tax rate still is 35%. The following calculation demonstrates one way to determine Marsha's after-tax accumulation in the IRA:

(1) Before-tax accumulation in the IRA [$6,000(1.08)^{15}]	$19,033
(2) Minus: Original contribution	(6,000)
(3) Accumulated earnings before taxes	$13,033
(4) Times: Tax rate	0.35
(5) Tax on accumulated earnings	$ 4,562
(6) After-tax accumulation (Line 1 − Line 5)	$14,471 ◀

The calculation in Example I:18-7 also can be formulated as follows:

$$\text{ATA} = \$6{,}000(1.08)^{15} - [\$6{,}000(1.08)^{15} - \$6{,}000] \times 0.35$$

The first term, $6,000 $(1.08)^{15}$, gives the total before-tax accumulation; the subtraction in brackets gives the accumulated before-tax earnings; and the multiplication by 35% gives the tax on the accumulated earnings. Subtracting these taxes from the first term gives the total after-tax accumulation. Factoring out the $6,000 investment results in the following expression (which yields a $14,471 after-tax accumulation):

$$\text{ATA} = \$6{,}000\{(1.08)^{15} - [(1.08)^{15} - 1] \times 0.35\}$$

Substituting our general symbols into this expression yields the following model, the component parts of which are shown in Figure I:18-1:

$$\text{ATA} = \text{AT}\$\{(1 + \text{R})^{n} - [(1 + \text{R})^{n} - 1] \times t_{n}\}$$

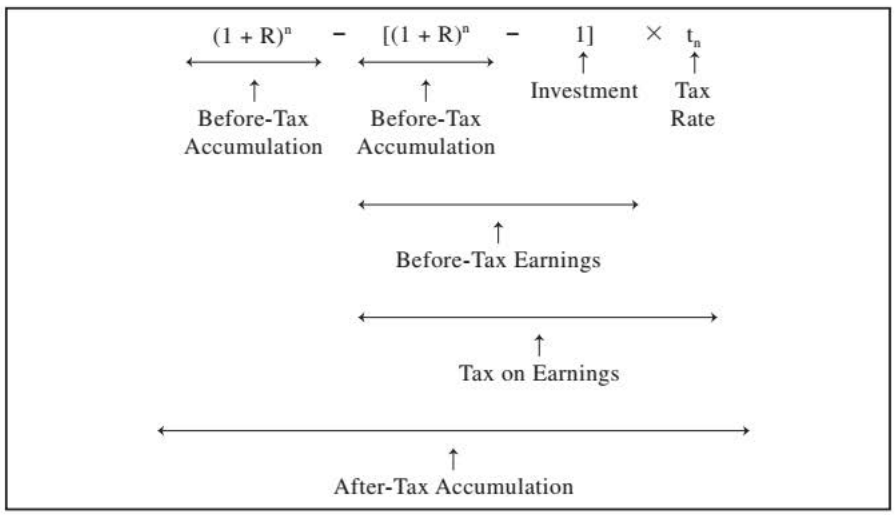


FIGURE I:18-1 ▶ DEFERRED MODEL BEFORE ALGEBRAIC SIMPLIFICATION

The subscript n on the tax rate emphasizes that the rate in Year n applies rather than the rate in the investment year or any intervening year. To make the model easier to use computationally, we can simplify this model algebraically with the following three steps. Multiplying through by t_n yields:

$$ATA = AT\$\{(1 + R)^n - [t_n (1 - R)^n - t_n]\}$$

Carrying the first minus sign through yields:

$$ATA = AT\$[(1 + R)^n - t_n (1 + R)^n + t_n]$$

Factoring out $(1 + R)^n$ yields:

The Deferred Model:

$$ATA = AT\$[(1 + R)^n(1 - t_n) + t_n]$$

We call this model the Deferred Model because the tax on investment earnings is deferred until the investor cashes out of the investment. This characteristic causes the Deferred Model investment to outperform the Current Model investment given equal BTRORs and constant tax rates.

EXAMPLE I:18-8 ▶ Phillip can invest $1,000 (AT$) directly in a taxable bond outside an IRA, or he can contribute the $1,000 to a traditional nondeductible IRA and invest in the same bond through the IRA vehicle. In either case, the bond yields an annual 10% BTROR. Phillip's marginal tax rate is 35%, and he expects it to remain so for the entire investment horizon. The two alternatives give the following after-tax accumulations after 20 years:

Bond outside the IRA (Current Model):

$$\$1{,}000[1 + 0.1(1 - 0.35)]^{20} = \$1{,}000(1.065)^{20} = \$3{,}523.65$$

Bond inside the IRA (Deferred Model):

$$\$1{,}000[(1.1)^{20} \times (1 - 0.35) + 0.35] = \$4{,}722.87$$

The Deferred Model investment outperforms the Current Model investment because, within the IRA, the interest on the bond grows at the BTROR (10%), with taxation deferred until Year 20. ◀

Annualized ATROR. As we explained earlier, the ATROR in the Current Model is $r = R(1 - t)$. That is, an investment that fits the Current Model yields this ATROR annually. The annual ATROR is a useful number for comparison to annual ATRORs of other models. However, the annual ATROR of other models, such as the Deferred Model, is not always obvious. Therefore, to determine this comparable number, we compute a variable called the annualized ATROR. The annualized ATROR is the rate of return that would cause a Current Model investment to yield the same accumulation per after-tax dollar invested as does the model under consideration.

For example, we derive the annualized ATROR for the Deferred Model as follows:

$$(1 + r_{ann})^n = [(1 + R)^n(1 - t_n) + t_n]$$

Here, the left-hand side of the equation is the Current Model investment compounding at the annualized ATROR, which we symbolize as r_{ann}. The right-hand side is the Deferred Model with one after-tax dollar invested. Taking the nth root of each side yields:

$$(1 + r_{ann}) = [(1 + R)^n(1 - t_n) + t_n]^{1/n}$$

Subtracting 1 from each side yields:

$$r_{ann} = [(1 + R)^n (1 - t_n) + t_n]^{1/n} - 1$$

The general form for this relationship, which can be used for any model, is:

> Annualized ATROR:
> $$r_{ann} = [\text{Accumulation per AT\$ invested}]^{1/n} - 1$$

EXAMPLE I:18-9 ▶ Consider the same facts as in Example I:18-8. The annualized ATROR for the investment outside the IRA is 6.5%. No additional computation is necessary because the model already is in the Current Model form. The accumulation per AT$ invested inside the IRA (the Deferred Model) can be determined two ways. First, divide the total accumulation ($4,722.87) by the $1,000 (AT$) invested, which yields 4.72287. Alternatively, compute the accumulation per AT$ as follows: $[(1.1)^{20}(1 - 0.35) + 0.35] = 4.72287$. The annualized ATROR, then, is computed as follows: $r_{ann} = (4.72287)^{1/20} - 1 = 0.0807128$ or 8.07128%. Thus, on an annualized basis, a 20-year investment outside the IRA (the Current Model) yields 6.5% after taxes, while a 20-year investment inside the IRA (the Deferred Model) yields 8.07128% after taxes. To check this result, simply put the 8.07128% annualized ATROR in the Current Model to see that it yields the same result as did the Deferred Model.

$$\text{ATA} = \$1{,}000(1.0807128)^{20} = \$1{,}000(4.72287) = \$4{,}722.87$$ ◀

Capital Assets. The Deferred Model also describes the after-tax growth of a capital asset. For example, suppose a stock grows annually at rate R and does not pay dividends, that is, the stock is strictly a growth stock. In n years, the stock will be worth $(1 + R)^n$. If the investor then sells the stock for its fair market value (FMV), the investor pays tax on the capital gain. Consequently, the tax on the gain is deferred until the investor sells the asset, which reflects the realization principle of taxation. Moreover, the capital gain may be taxed at a preferential capital gains tax rate. Thus, when applied to capital assets, the Deferred Model provides two tax advantages: deferral and a preferential tax rate.

When Figure I:18-1 is applied to this situation, the before-tax accumulation represents the selling price at the FMV, and the before-tax earnings represent the capital gain.

EXAMPLE I:18-10 ▶ Brian purchases stock for $5,000. The stock appreciates (grows) at an 8% rate before taxes. Brian sells the stock ten years later for $10,795, which is $5,000 $(1.08)^{10}$. At the time of sale, his regular tax rate is 40%, but his long-term capital gains tax rate is 20%. One way to calculate Brian's after-tax proceeds is as follows:

(1) Selling price [$5,000(1.08)^{10}]	$10,795
(2) Minus: Original investment (basis)	(5,000)
(3) Long-term capital gain	$ 5,795
(4) Times: Long-term capital gains tax rate	0.20
(5) Tax on capital gain	$ 1,159
(6) After-tax proceeds (Line 1 – Line 5)	$ 9,636

Alternatively, the after-tax proceeds can be determined quickly with the Deferred Model as follows:

$$\text{ATA} = \$5{,}000 \times [(1.08)^{10}(1 - 0.20) + 0.20] = \$9{,}636$$ ◀

Comparing Current and Deferred Models. As mentioned earlier, a Deferred Model investment always outperforms a Current Model investment if BTRORs are constant over time and equal across models and if tax rates also are constant and equal. However, when these conditions are not present, the models must be compared to determine which is preferable. One way to make this comparison is to set up a spreadsheet of the various alternatives.

EXAMPLE I:18-11 ▶ As in Example I:18-8, assume that Phillip can invest $1,000 (AT$) in a taxable bond either outside or inside a traditional nondeductible IRA. The bond yields 10% per year before taxes, and Phillip's marginal tax rate is 35%. Assume also that Phillip will be younger than 59½ when he withdraws the funds from the IRA. As described in Chapter I:7, a taxpayer who withdraws

ADDITIONAL COMMENT

For traditional IRAs, minimum withdrawals must begin when a taxpayer reaches age 70½. Otherwise, the taxpayer faces a 50% penalty on the difference between the minimum required distribution and the actual distribution.

amounts from a traditional IRA before reaching age 59½ generally must pay a 10% penalty tax on the taxable portion of the withdrawal. This penalty, in effect, increases the applicable tax rate in the Deferred Model. Thus, the following models apply (the Deferred Model with no penalty is repeated for comparison):

Bond outside the IRA (Current Model):

$$\$1{,}000\,[1 + 0.1\,(1 - 0.35)]^n = \$1{,}000\,(1.065)n$$

Bond inside the IRA (Deferred Model)—No penalty:

$$\$1{,}000\,[(1.1)^n \times (1 - 0.35) + 0.35]$$

Bond inside the IRA (Deferred Model)—With penalty:

$$\$1{,}000\,[(1.1)^n \times (1 - 0.45) + 0.45]$$

Notice that the 10% penalty effectively increases the marginal tax rate to 45%. Given the 10% penalty, which investment is better, the Current Model or the Deferred Model? The answer depends on the length of the investment horizon. Table I:18-1 schedules the after-tax accumulations and related annualized ATRORs for various investment horizons (n) from one to 20 years.

Before considering the penalty situation, observe the no penalty case. For all values of n above one, the Deferred Model investment produces a greater after-tax accumulation than does the Current Model investment (compare Columns 2 and 3). This result also is apparent

▼ **TABLE I:18-1**
Comparison of Current and Deferred Models

	After-Tax Accumulations			Annualized ATRORs[d]		
(1)	(2)	(3)	(4)	(5)	(6)	(7)
n	Current Model[a]	Deferred Model No Penalty[b]	Deferred Model with Penalty[c]	Current Model	Deferred Model No Penalty	Deferred Model with Penalty
1	$1,065	$1,065	$1,055	6.5%	6.500%	5.500%
2	1,134	1,137	1,116	6.5	6.607	5.617
3	1,208	1,215	1,182	6.5	6.711	5.733
4	1,286	1,302	1,255	6.5	6.813	5.848
5	1,370	1,397	1,336	6.5	6.913	5.961
6	1,459	1,502	1,424	6.5	7.009	6.073
7	1,544	1,617	1,522	6.5	7.103	6.182
8	1,655	1,743	1,629	6.5	7.195	6.289
9	1,763	1,883	1,747	6.5	7.283	6.394
10	1,877	2,036	1,876	6.5	7.368	6.497
11	1,999	2,205	2,019	6.5	7.451	6.597
12	2,129	2,390	2,176	6.5	7.531	6.694
13	2,267	2,594	2,349	6.5	7.608	6.789
14	2,415	2,818	2,539	6.5	7.682	6.881
15	2,572	3,065	2,747	6.5	7.753	6.970
16	2,739	3,337	2,977	6.5	7.822	7.057
17	2,917	3,635	3,230	6.5	7.888	7.140
18	3,107	3,964	3,508	6.5	7.952	7.221
19	3,309	4,325	3,814	6.5	8.013	7.299
20	3,524	4,723	4,150	6.5	8.071	7.375

[a] $\$1{,}000(1.065)^n$
[b] $\$1{,}000\,[(1.1)^n(1 - 0.35) + 0.35]$
[c] $\$1{,}000\,[(1.1)^n(1 - 0.45) + 0.45]$
[d] $[(\text{ATA per AT\$})^{1/n} - 1] \times 100$

in the annualized ATRORs. For all values of n above one, the Deferred Model investment produces an annualized ATROR greater than 6.5% (compare Columns 5 and 6). Moreover, the greater the n, the greater the annualized ATROR from the Deferred Model investment. This result occurs because tax deferral increases as the investment horizon lengthens. Thus, the longer the deferral, the better the annualized ATROR produced by the Deferred Model investment.

Now compare the Current Model to the Deferred Model with the 10% penalty. For investment horizons up to ten years, the Current Model investment outperforms the Deferred Model investment, while for horizons greater than ten years, the Deferred Model investment beats the Current Model investment (compare Columns 2 and 4). This result can be seen more easily with the annualized ATRORs, where beginning in Year 11, the annualized ATRORs for the Deferred Model investment exceed 6.5% (compare Columns 5 and 7). The Current Model investment is better for short horizons because the applicable tax rate is 35% rather than 45% (rate + penalty). However, after ten years, the deferral benefit of the Deferred Model investment overcomes the penalty's detrimental effect. Thus, if an investor has a long enough investment horizon, a traditional nondeductible IRA subject to the 10% penalty may be the preferred method of accumulating savings, assuming the investor is ineligible for the Roth IRA. ◀

THE EXEMPT MODEL

The Exempt Model gives the future value of an investment having the following characteristics:

- Only after-tax dollars are invested (as with the Current and Deferred Models).
- Earnings on the investment are exempt from explicit taxation (unlike the Current and Deferred Models).

In fact, the Exempt Model is a special case of either the Current Model or the Deferred Model with the tax rate equal to zero. Consequently, the investment grows at the BTROR and appears as follows:

The Exempt Model:

$$ATA = AT\$(1 + R)^n$$

REAL-WORLD EXAMPLE

In 2016, individual taxpayers earned $33 billion of interest from tax-exempt investments.

State and local government obligations, such as municipal bonds, are classic examples of the Exempt Model. Section 103 excludes interest on these instruments from gross income.

EXAMPLE I:18-12 ▶ Carmen invests $10,000 (AT$) in tax-exempt municipal bonds, which yield 5% per year. She reinvests the interest and holds the bonds for ten years. Thus, the investment accumulates to $16,288.95, which is $10,000 $(1.05)^{10}$. ◀

Other examples of the Exempt Model are the Roth IRA (see Chapter I:7) and the Roth option for Sec. 401(k) and Sec. 403(b) plans. Like the traditional nondeductible IRA, the Roth IRA does not allow a deduction for contributions. However, upon withdrawals, the accumulated earnings are not taxed. We will say more about the Roth IRA after developing the Pension Model.

STOP & THINK

Question: Does the Exempt Model imply that no taxation occurs in the tax system for investments of this type?

Solution: No. Taxation occurs because the taxpayer invests after-tax dollars, which means the invested amount comes from some taxable source. If no taxation occurred at all, the model would appear as Accumulation = BT$ $(1 + R)^n$, which is the situation described on page I:18-3 just after Example I:18-1.

THE PENSION MODEL

The Pension Model gives the future value of an investment in a qualified retirement plan having the following characteristics:

- Before-tax dollars are invested (unlike the previous three models).
- The annual earnings on the investment grow at the BTROR (as with the Deferred and Exempt Models).
- The entire accumulation, not just the earnings, is taxed at the end of the investment horizon when the investor cashes out of the plan.

Thus, the Pension Model provides two levels of tax deferral. First, salary or earned income contributed to the plan escapes taxation when contributed but is taxed later upon withdrawal. Second, earnings on the underlying investment are not taxed while in the plan but also are taxed later upon withdrawal. This double deferral contrasts with the Deferral Model, in which only the taxes on investment earnings are deferred.

Deductible IRAs and H.R. 10 plans described in Chapter I:7 are classic examples of the Pension Model. The taxpayer deducts the IRA or H.R. 10 contribution from gross income, the underlying investments grow at before-tax rates of return, and the taxpayer later includes any withdrawals in gross income.

EXAMPLE I:18-13 ▶ Frank, whose marginal tax rate is 35%, earns $1,000 of salary and wishes to contribute this amount to a deductible IRA (Pension Model). He may do so because he can deduct the $1,000 contribution from gross income, leaving the entire $1,000 available for contribution. If, instead, Frank contributes to a traditional nondeductible IRA (Deferred Model) or a Roth IRA (Exempt Model), he can contribute only $650 because he must pay $350 of taxes on the $1,000 salary. Thus, Frank can contribute $1,000 before-tax dollars to a deductible IRA as contrasted with $650 after-tax dollars to a traditional nondeductible IRA or a Roth IRA. ◀

Other examples of the Pension Model include cash or deferred arrangements, commonly known as Sec. 401(k) plans, and tax-deferred annuities, sometimes referred to as Sec. 403(b) plans. Both of these type plans operate through a salary reduction agreement whereby the employee elects to have a specified amount of his or her salary contributed to the plan. The employee excludes the amount of salary contributed to the plan from his or her gross income. However, annual contributions are limited to $19,000 (in 2019).[4] As with IRA and H.R. 10 plans, the underlying investments in Sec. 401(k) and Sec. 403(b) plans grow at before-tax rates of return, and the employee later includes any withdrawals in gross income. Withdrawals before the employee reaches age 59 1/2, however, are subject to a 10% penalty in addition to the tax. Although most employers can offer Sec. 401(k) plans, only educational institutions and certain tax-exempt organizations may provide Sec. 403(b) plans.

Employer-sponsored qualified retirement plans also fit the Pension Model. In this case, the employer makes a deductible contribution on the employee's behalf, and the employee excludes the contribution from gross income. Upon retirement, the employee's retirement payments are fully taxed.

EXAMPLE I:18-14 ▶ Frank in Example I:18-13 makes the $1,000 contribution to a deductible IRA. The investment in the IRA will earn 10% per year before taxes, and Frank will withdraw all accumulated amounts from the IRA after 20 years. He expects his tax rate to be 25% at that time, and he will not be subject to the 10% penalty for early withdrawals. The following calculation demonstrates one way to determine Frank's after-tax accumulation in the IRA:

Before-tax accumulation in the IRA [$1,000(1.1)^{20}]	$6,728
Minus: Tax on withdrawn accumulation ($6,728 × 0.25)	(1,682)
Accumulated earnings after taxes	$5,046

◀

The calculation in Example I:18-14 also can be formulated as follows:

$$\text{ATA} = \$1{,}000(1.1)^{20} - [\$1{,}000(1.1)^{20}] \times 0.25$$

[4] Section 402(g) imposes this dollar limitation. In addition, Sec. 414(v) increases the limitation for taxpayers age 50 or older. This additional catch-up limitation is $6,000 in 2019. Percentage of compensation limitations also apply to contributions to Sec. 401(k) and Sec. 403(b) plans, but these limitations are complex and beyond the scope of this chapter. (See Chapter I:7 and Secs. 403(b) and 415(c).)

Factoring out the before-tax accumulation of $\$1{,}000(1.1)^{20}$ yields the following expression:

$$ATA = \$1{,}000(1.1)^{20}(1 - 0.25)$$

Substituting our general symbols into this expression yields:

The Pension Model:

$$ATA = BT\$(1 + R)^n(1 - t_n) \text{ or}$$

$$ATA = AT\$\left[\frac{1}{(1 - t_0)}(1 + R)^n(1 - t_n)\right]$$

Recall that BT$ = AT$/(1 – t). That is, before-tax dollars equal after-tax dollars grossed up by one minus the tax rate. Thus, the second form of the Pension Model is equivalent to the first form. The second form, however, has the same format as the other three models: AT$ times a future value formula. This format allows the investor to compare all four models without considering a specific level of investment because each model in this format is stated in terms of the after-tax accumulation per AT$ invested. In these models, t_o is the tax rate in Year 0, and t_n is the tax rate in Year n.

EXAMPLE I:18-15 ▶ Given four options listed below, Beth wants to know the after-tax accumulation and annualized ATROR of each.

- Current Model: R = 10%, t = 25%, n = 5
- Deferred Model: R = 9%, t_n = 35%, n = 5
- Exempt Model: R = 8%, n = 5
- Pension Model: R = 10%, t_o = 25%, t_n = 35%, n = 5

The results of the four options are as follows:

Model	*Computation*	*After-Tax Accumulation*	*Annualized ATROR*
Current	$[1 + 0.1(1 - 0.25)]^5$	1.4356	7.50%
Deferred	$(1.09)^5(1 - 0.35) + 0.35$	1.3501	6.19%
Exempt	$(1.08)^5$	1.4693	8.00%
Pension	$[1/(1 - 0.25)](1.1)^5(1 - 0.35)$	1.3958	6.90% ◀

ADDITIONAL COMMENT

The tax rates (t_o and t_n) in these comparisons are those faced by a particular individual because of changing tax laws and/or because of an individual's changing circumstances, e.g., levels of income at the time of investment versus at the end of the investment horizon.

Comparing Exempt and Pension Models. With equal BTRORs, constant tax rates (i.e., $t_o = t_n$), and no limitation on contributions, the Exempt and Pension Models are equivalent because the $1/(1 - t_o)$ and $(1 - t_n)$ terms cancel out, leaving the Pension Model (second form) to appear as $AT\$(1 + R)^n$. However, if t_o and t_n differ for a particular individual, this equivalency disappears. Thus, the following relationships hold:

- If $t_o = t_n$, ATA per Exempt Model = ATA per Pension Model.
- If $t_o > t_n$, ATA per Exempt Model < ATA per Pension Model.
- If $t_o < t_n$, ATA per Exempt Model > ATA per Pension Model.

EXAMPLE I:18-16 ▶ Consider the following situations:

- R = 10%, t_o = 30%, t_n = 30%, n = 10
- R = 10%, t_o = 40%, t_n = 30%, n = 10
- R = 10%, t_o = 30%, t_n = 40%, n = 10

The after-tax accumulations (ATAs) for the three situations are as follows:

Situation	*Exempt Model*	*Pension Model*
t_o = 30%, t_n = 30%	$(1.1)^{10} = 2.5937$	$[1/(1 - 0.30)](1.1)^{10}(1 - 0.30) = 2.5937$
t_o = 40%, t_n = 30%	$(1.1)^{10} = 2.5937$	$[1/(1 - 0.40)](1.1)^{10}(1 - 0.30) = 3.0260$
t_o = 30%, t_n = 40%	$(1.1)^{10} = 2.5937$	$[1/(1 - 0.30)](1.1)^{10}(1 - 0.40) = 2.2232$ ◀

Deductible IRA Versus Roth IRA. The Exempt and Pension models can be used to compare investment in a traditional deductible IRA versus a Roth IRA. If the amount of before-tax dollars available for investment does not exceed the $6,000 limitation (in 2019),[5] the comparative results are similar to those in Example I:18-16.

EXAMPLE I:18-17 ▶

Marcy has $6,000 of salary before taxes available for contribution to either a traditional deductible IRA or a Roth IRA. The underlying investments will earn a 10% BTROR. After ten years, Marcy plans to withdraw the entire accumulation without penalty. If her marginal tax rate is 30% in the contribution year, she can contribute either $6,000 (BT$) to the deductible IRA or $4,200 (AT$) to the Roth IRA. If her marginal tax rate upon withdrawal is 30%, she will have the following after tax accumulations under each alternative:

Roth IRA: [$4,200(1.1)^{10}]	$10,894
Deductible IRA: [$6,000(1.1)^{10}(1 – 0.30)]	$10,894

TAX STRATEGY TIP

When given a choice between a Roth IRA and a traditional *non*deductible IRA, the taxpayer always should choose the Roth IRA. However, if the taxpayer's AGI exceeds the limitation for contributions to a Roth IRA, the taxpayer can contribute to a traditional nondeductible IRA and then immediately roll over the traditional IRA contribution into a Roth IRA. The Roth rollover (also called a conversion) has no AGI limitation.

Thus, with constant tax rates, the two alternatives yield the same after-tax accumulation.

If Marcy's current tax rate is 40%, and her later tax rate is 30%, the two alternatives yield the following after-tax accumulations:

Roth IRA: [$3,600(1.1)^{10}]	$ 9,337
Deductible IRA: [$6,000(1.1)^{10}(1 – 0.30)]	$10,894

Thus, with decreasing tax rates, the deductible IRA yields the better result.

Finally, if Marcy's current tax rate is 30%, and her later tax rate is 40%, the two alternatives yield the following after-tax accumulations:

Roth IRA: [$4,200(1.1)^{10}]	$10,894
Deductible IRA: [$6,000(1.1)^{10}(1 – 0.4)]	$ 9,337

Thus, with increasing tax rates, the Roth IRA yields the better result. ◀

In Example I:18-17, the before-tax dollars available for contribution did not exceed the $6,000 limitation on IRA contributions. However, suppose the taxpayer wishes to compare a $6,000 contribution to a deductible IRA with a $6,000 contribution to a Roth IRA. In this case, the two contributions are not equivalent because the taxpayer makes the contribution to the deductible IRA with before-tax dollars and to the Roth IRA with after-tax dollars. To have $6,000 after-tax dollars available for a Roth IRA contribution, the taxpayer must have $6,000/(1 – t_o) before-tax dollars available for investment. If the taxpayer has this amount available and contributes $6,000 to a deductible IRA, the taxpayer will have some available funds left over for investment outside the deductible IRA.[6]

EXAMPLE I:18-18 ▶

Mark wants to contribute $6,000 to either a deductible IRA or a Roth IRA. His current marginal tax rate is 30%. To contribute $6,000 (AT$) to a Roth IRA, his before-tax dollars available for investment must be $8,571, which is computed as BT$ = $6,000/(1 – 0.30). On the other hand, if he contributes $6,000 (BT$) to a deductible IRA, he has $2,571 ($8,571 – $6,000) remaining. This $2,571 is subject to tax so that, after taxes at 30%, Mark will have $1,800 (AT$) [$2,571(1 – 0.30)] remaining for investment outside the IRA.

A convenient short-cut method to determine the amount remaining for outside investment is to multiply the $6,000 deduction by the tax rate to arrive at the tax savings from the traditional IRA deduction. Specifically, the $6,000 deduction will generate $1,800 of tax savings for outside investment, computed as $6,000 × 0.30 = $1,800. This shortcut, however, works only if the taxpayer considers contributing the maximum amount to the deductible or Roth IRA. ◀

Given the previous discussion, the deductible IRA versus Roth IRA decision can be framed as follows:

---

[5] For taxpayers age 50 or older, the limitation is increased by $1,000 in 2019, called a catchup limitation.

[6] Participants in Sec. 401(k) and Sec. 403(b) plans can opt to have their elective deferrals treated as Roth contributions. For a detailed analysis of this decision, see K. E. Anderson and D. P. Murphy, "The New Roth Option for 401(k) and 403(b) Plans: A Decision Framework," *Journal of Financial Service Professionals*, January 2002, pp. 45–56.

Roth IRA	$\$6{,}000(1 + R)^n$
Versus	
Deductible IRA	$\$6{,}000(1 + R)^n(1 - t_n)$
Plus	
Outside Investment	$\$6{,}000(t_o)[1 + R(1 - t)]^n$

In this framework, $\$6{,}000(t_o)$ is the tax savings from the traditional IRA deduction, which the taxpayer invests in an investment conforming to the Current Model. If the taxpayer's outside investment conforms to the Deferred Model or some other model, the alternative model can be substituted for the Current Model in this decision framework.

EXAMPLE I:18-19 ▶ Helen wishes to invest $6,000 in either a deductible IRA or a Roth IRA. The underlying investments will earn a 10% BTROR. After ten years, Helen plans to withdraw the entire accumulation without penalty. Her marginal tax rate is 30% in the contribution year, and she expects her marginal tax rate upon withdrawal to be 30%. If she contributes to the deductible IRA, she will invest the tax savings in an investment yielding a 10% BTROR and which is currently taxable at 30%. The alternative investments yield the following results:

Roth IRA [$\$6{,}000(1.1)^{10}$]	$15,562
Deductible IRA [$\$6{,}000(1.1)^{10}(1 - 0.30)$]	$10,894
Plus: Outside investment [$\$6{,}000(0.30)(1.07)^{10}$]	3,541
Total	$14,435

With constant tax rates, the Roth IRA produces the better result because, with the deductible IRA, part of the investment goes to an outside investment taxed less favorably than the IRA. Note also that, because the $6,000 limitation is after-tax dollars for the Roth IRA but before-tax dollars for the deductible IRA, constant tax rates no longer produce equivalent results.

Suppose instead that Helen expects her tax rate to be 15% when she withdraws the IRA accumulation. In this case, the alternative investments yield the following results:

Roth IRA [$\$6{,}000(1.1)^{10}$]	$15,562
Deductible IRA [$\$6{,}000(1.1)^{10}(1 - 0.15)$]	$13,228
Plus: Outside investment [$\$6{,}000(0.30)(1.07)^{10}$]	3,541
Total	$16,769

Thus, with a reduced tax rate in the withdrawal year, the deductible IRA (plus the outside investment) yields the better result. ◀

MULTIPERIOD STRATEGIES

All previous examples assumed a single amount invested for a specified time period. However, suppose an investor wants to invest a certain amount each year over several years. In this case, the investor may optimize his or her after-tax accumulation by investing in one type of investment in early years and another type investment in late years.

EXAMPLE I:18-20 ▶ For the next 15 years, Jack wishes to invest $10,000 (AT$) at the beginning of each year into either nondividend paying stock that increases in value at 8% per year before taxes or a taxable bond that yields 10% per year before taxes. Jack's regular tax rate is 30%, but he pays only 15% on long-term capital gains. Jack wants to know which asset to invest in for each of the 15 years. The following models apply to this situation:

Stock (Deferred Model):

$$\$10{,}000[(1.08)^n(1 - 0.15) + 0.15]$$

Taxable bond (Current Model):

$$\$10{,}000[1 + 0.1(1 - 0.30)]^n = \$10{,}000(1.07)^n$$

Table I:18-2 schedules the alternatives for each year. The stock produces the larger after-tax accumulations for investments made in Years 1 through 9. For Years 10 through 15, however, the taxable bonds outperform the stock. Consequently, Jack should invest in stock for each of

▼ TABLE I:18-2
Multiperiod Investments

(1) Year	(2) n	(3) Amount Invested	(4) Stock[a] (Deferred Model)	(5) Taxable Bond[b] (Current Model)	(6) Greater of Column 4 or 5
1	15	$10,000	$ 28,463	$ 27,590	$ 28,463
2	14	10,000	26,466	25,785	26,466
3	13	10,000	24,617	24,098	24,617
4	12	10,000	22,904	22,522	22,904
5	11	10,000	21,319	21,049	21,319
6	10	10,000	19,851	19,672	19,851
7	9	10,000	18,492	18,385	18,492
8	8	10,000	17,233	17,182	17,233
9	7	10,000	16,068	16,058	16,068
10	6	10,000	14,988	15,007	15,007
11	5	10,000	13,989	14,026	14,026
12	4	10,000	13,064	13,108	13,108
13	3	10,000	12,208	12,250	12,250
14	2	10,000	11,414	11,449	11,449
15	1	10,000	10,680	10,700	10,700
Total ATA with no switching			$271,756	$268,881	
Total ATA with switching strategy					$271,953

[a] $10,000 [(1.08)^n(1 – 0.15) + 0.15]
[b] $10,000 (1.07)^n

the first nine years and hold the stock for the rest of the 15-year investment horizon. For the remaining six years, he should invest in taxable bonds. This switching strategy maximizes the total after-tax accumulation compared to investing in either stock or bonds for the entire 15-year period (compare Column 4 and 5 totals to Column 6 total).

The stock outperforms the taxable bonds for the first nine years even though the taxable bonds yield a higher BTROR than does the stock. This result occurs because the deferral benefit outweighs the lower BTROR for long investment horizons. ◀

SUMMARY AND COMPARISON OF BASIC INVESTMENT MODELS

Topic Review I:18-1 summarizes the models along with simple examples. In the examples, each model assumes an investment earning 10% before taxes and assumes a constant 30% tax rate. With these assumptions, the Exempt and Pension Models outperform the Current and Deferred Models, and the Deferred Model outperforms the Current Model.

OTHER APPLICATIONS OF INVESTMENT MODELS

OBJECTIVE 2

Use the investment models to make entity choices and compensation decisions

In the previous section of this chapter, we developed four investment models and applied them to currently taxable investments, capital gains assets, tax-exempt bonds, and retirement plans. In this section, we present two additional applications: (1) the Roth conversion decision and (2) the pass-through entity versus C corporation form of business operations.

TOPIC REVIEW I:18-1

Summary of Investment Models

Investment Model	Initial Income	Investment Earnings or Capital Gain	Examples[a]	ATA	ATA/AT$	r_{ann}
Current: $AT\$[1 + R(1-t)]^n$ — or — $AT\$(1+r)^n$	Taxed currently	Taxed annually	$\$700(1.07)^5$	$ 981.79	1.4026[b]	7.00%
Deferred: $AT\$[(1+R)^n(1-t_n) + t_n]$	Taxed currently	Tax deferred	$\$700[(1.1)^5(0.7) + 0.30]$	$ 999.15	1.4274[c]	7.38%
Exempt: $AT\$(1+R)^n$	Taxed currently	Tax exempt	$\$700(1.1)^5$	$1,127.36	1.6105[d]	10.00%
Pension: $BT\$(1+R)^n(1-t_n)$ — or — $AT\$\left[\frac{1}{(1-t_o)}(1+R)^n(1-t_n)\right]$	Tax deferred	Tax deferred	$\$1,000(1.1)^5(0.7)$ — or — $\$700(1/0.7)(1.1)^5(0.7)$	$1,127.36	1.6105[e]	10.00%

Definitions of Variables:
ATA = After-tax accumulation (future value of an investment)
BT$ = Before-tax dollars
AT$ = After-tax dollars
R = Before-tax rate of return (BTROR)
r = After-tax rate of return (ATROR)
r_{ann} = Annualized ATROR
n = Investment horizon
t = Marginal tax rate, generally and for Current Model
t_o = Marginal tax rate in the year of investment (Year 0) for Pension Model
t_n = Marginal tax rate at the end of the investment horizon (Year n) for Deferred and Pension Models

[a]Initial before-tax income (BT$) = $1,000; AT$ = $1,000(0.7) = $700; R = 10%; $t = t_o = t_n = 30\%$; n = 5
[b]Also: $(1.07)^5 = 1.4026$
[c]Also: $(1.1)^5(0.7) + 0.30 = 1.4274$
[d]Also: $(1.1)^5 = 1.6105$
[e]Note that the $1,127.36 after-tax accumulation is divided by $700, not $1,000, because $700 is the after-tax dollar equivalent of $1,000 before taxes.
Also: $(1/0.7)(1.1)^5(0.7) = 1.6105$

ROTH CONVERSION DECISION

An individual may roll over distributions from a tradition IRA to a Roth IRA without regard to AGI levels. Also, amounts in traditional 401(k), 403(b), and 457(k) plans can be rolled over to optional Roth 401(k), 403(b), and 457(k) plans. When referring to optional Roth 401(k), 403(b), and 457(k) plans, the text will simply refer to Roth 401(k) plans, with this term encompassing all three optional plans. The rollover does not have to entail an actual distribution, however, in that the individual can implement the conversion with an in-plan rollover. An individual may want to effect a Roth conversion for several reasons.

- Individual tax rates might be high enough in retirement to justify avoiding them with Roth tax-exempt income.
- An individual can continue to make contributions to a Roth IRA after attaining age 70½.
- Roth IRAs do not require minimum distributions once the individual attains age 70½ (however, Roth 401(k) plans do retain the minimum distribution requirement).
- The Roth tax-exempt income does not count toward Social Security or Medicare premium thresholds.

The decision models in this section focus primarily on the first bullet item, that is, the tax rate structure the individual faces at the time he or she is considering converting versus the tax rate upon withdrawing the amounts accumulated in the Roth IRA or Roth 401(k) plan. The tax rates are important at the time of conversion because the conversion is a taxable event. The tax rates upon withdrawal are important because retaining a traditional IRA or 401(k) plan entails paying taxes at the time of withdrawal. Thus, conversion to a Roth triggers a current tax but avoids later taxation while retaining a traditional deductible IRA defers current taxation but entails taxation upon withdrawing accumulated amounts. The discussion and examples henceforth will address the Roth IRA conversion decision,

but the models are applicable to the Roth 401(k) plan conversion as well.[7] However, the option of paying the conversion tax from 401(k) funds may not be available because of plan restrictions on withdrawals prior to retirement.

The following concepts and assumptions apply to the decision model, and Table I:18-3 provides the definitions of variables used in the models.

- The models compare the after-tax accumulation (ATA) of retaining the traditional IRA with the ATA of converting the traditional IRA to a Roth IRA.
- The ATA of retaining the traditional IRA is the future value of the IRA accumulation minus the taxes paid upon withdrawal.
- The ATA of the converted Roth IRA is the future value of the IRA accumulation minus the future value (opportunity cost) of the tax paid upon conversion.
- The models assume a conversion with the conversion tax paid from outside taxable sources (investments) or from the IRA itself, with no penalty in either case.
- For comparability, the models assume a lump-sum distribution at the end of the investment horizon.

Retention Model. The model for retaining the existing traditional IRA is as follows:

$$ATA = V_k(1 + R)^n - t_n[V_k(1 + R)^n - B_k]$$

The expression to the left of the minus sign calculates the before-tax accumulation in the IRA at time n. The expression to the right of the minus sign reduces the before tax accumulation by the tax on the withdrawal at time n. Note that this formulation is a variation of the Pension Model.

Conversion Models. The models for converting to the Roth IRA are as follows:

With Conversion Tax Paid from Outside Source:

$$ATA = V_k(1 + R)^n - CT_k(1 + r)^n$$

With Conversion Tax Paid from IRA Funds:

$$ATA = V_k(1 + R)^n - CT_k(1 + R)^n$$

Where $CT_k = t_k (V_k - B_k)$ (assuming no early withdrawal penalty)

▼ TABLE I:18-3
Definitions of Variables

Variable	Definition
V	Value of traditional IRA at conversion
B	Basis in traditional IRA at conversion. An IRA will have basis to the extent the individual made nondeductible contributions to a traditional IRA.
R	Before-tax rate of return on assets inside the IRA, assumed the same for all years
CT	Amount of conversion tax upon conversion
r	Annualized after-tax rate of return on investments outside the IRA, which represents the opportunity cost of paying tax on the IRA conversion from sources outside the IRA
t	Marginal tax rate for ordinary income
n	Years in investment period from time of conversion to lump-sum liquidation in year n; also used as subscript to denote year n
k	Subscript on relevant variables to denote year of conversion

[7] For a comprehensive analysis of the optional Roth 401(k) conversion decision, see K. E. Anderson and D. S. Hulse, "In-Plan Rollovers from Traditional 401(k), 403(b), and 457(b) Plans to Roth Accounts: A Decision Framework," *Journal of Financial Service Professionals*, September 2013, pp. 89–98.

Again, the expression to the left of the minus sign in each model calculates the before-tax accumulation in the IRA at time n. The expression to the right of the minus sign reduces the before-tax accumulation by the conversion tax paid at the time of conversion times a future value term. The conversion tax needs to be formulated as a future value so all amounts are compared in the same time frame. The future value term also represents the opportunity cost of paying the conversion tax currently and thereby losing the earnings on the tax amount diverted from its investment source. Note that the two models differ by the rate of return used to determine this opportunity cost. If the conversion tax is paid from an outside source, the taxpayer forfeits the ATROR that could be earned on that amount. The model assumes this source is a taxable account rather than from another IRA. On the other hand, if the conversion tax is paid from the IRA itself, the taxpayer forfeits the BTROR that could be earned in the IRA.

EXAMPLE I:18-21 ▶ Beth currently has a traditional IRA to which she made deductible contributions in the IRA's early years. Later, however, Beth was no longer eligible for the deduction but continued to make nondeductible contributions. By the current year, the IRA will have accumulated in value to \$100,000 (V_k = \$100,000), and \$10,000 of the contributions will have been nondeductible (B_k = \$10,000). Beth is in a 25% tax bracket and expects her tax rate to remain at that level for the next 20 years ($t_k = t_n = 0.25$). Beth can earn an 8% BTROR ($R = 0.08$) on investments in the IRA and a 6% ATROR ($r = 0.06$) on investments outside the IRA. Beth plans to cash out the IRA in 20 years ($n = 20$) with no early withdrawal penalty. Her two options yield the following results:

Retain Existing Traditional IRA:

$$ATA = \$100{,}000(1.08)^{20} - 0.25[\$100{,}000(1.08)^{20} - \$10{,}000] = \$352{,}072$$

Convert to Roth IRA:

$$CT_k = 0.25(\$100{,}000 - \$10{,}000) = \$22{,}500$$

$$ATA = \$100{,}000(1.08)^{20} - \$22{,}500(1.06)^{20} = \$393{,}935$$

Therefore, Beth should convert to the Roth IRA. ◀

EXAMPLE I:18-22 ▶ Assume the same facts as in Example I:18-21 except Beth expects her tax rate upon withdrawal to be 15% ($t_n = 0.15$).

Retain Existing Traditional IRA:

$$ATA = \$100{,}000\ (1.08)^{20} - 0.15[\$100{,}000\ (1.08)^{20} - \$10{,}000] = \$397{,}681$$

Convert to Roth IRA:

$$CT_k = 0.25(\$100{,}000 - \$10{,}000) = \$22{,}500$$

$$ATA = \$100{,}000(1.08)^{20} - \$22{,}500(1.06)^{20} = \$393{,}935$$

In this case, retaining the traditional IRA edges out converting to a Roth IRA. However, if the dollar difference is small, the Roth IRA still could be the better choice based on other factors, such as not requiring minimum distributions. ◀

EXAMPLE I:18-23 ▶ Assume the same facts as in Example I:18-22 except Beth uses IRA funds to pay the conversion tax.

Retain Existing Traditional IRA:

$$ATA = \$100{,}000(1.08)^{20} - 0.15[\$100{,}000(1.08)^{20} - \$10{,}000] = \$397{,}681$$

Convert to Roth IRA:

$$CT_k = 0.25(\$100{,}000 - \$10{,}000) = \$22{,}500$$

$$ATA = \$100{,}000(1.08)^{20} - \$22{,}500(1.08)^{20} = \$361{,}224$$

In this case, a large dollar difference presents much more support for the retention decision than does the result in Example I:18-22. This large difference occurs because of the higher opportunity cost associated with the conversion tax. ◀

Factors that Bias the Decision Toward a Roth Conversion. Several observations can be made about which factors might bias the decision toward converting to the Roth IRA rather than retaining the traditional IRA. These factors are as follows:

- A high tax rate in the withdrawal year (t_n) relative to the tax rate in the conversion year (t_k). Converting allows the traditional IRA to avoid the high tax rate in the withdrawal year.
- A high ratio of IRA basis (B_k) to IRA value (V_k). A high basis reduces the conversion tax.
- Use of funds outside the IRA to pay conversion tax (CT) and a low ATROR (r). Paying from outside sources reduces the opportunity cost of converting to a Roth IRA.

PASS-THROUGH ENTITY VERSUS C CORPORATION

Chapter I:16 described how the government taxes C corporations and their shareholders, and Chapter I:17 introduced the tax consequences of operating as a pass-through entity. Pass-through entities include partnerships, limited liability companies (LLCs), limited liability partnerships (LLPs), and S corporations. A pass-through entity's primary characteristic is that income escapes taxation at the entity level and passes through to be taxed at the ownership level. Another key feature of the pass-through entity is that the owners may deduct 20% of qualified business income that passes through to the owners from the entity (see Chapter I:17 for details and limitations). Corporate income, on the other hand, is taxed once at the entity level and again at the owner level. Taxation at the owner level occurs when the corporation distributes its earnings, when the shareholder sells his or her stock, or when the corporation liquidates.

ADDITIONAL COMMENT

As the income and deductions pass through to the owners of partnerships and S corporations, they retain their character. For example, ordinary income at the entity level is ordinary income to the owner, and capital gains at the entity level pass through as capital gains.

In this section, we show that the Current Model describes a pass-through entity and that a variation of the Deferred Model describes a C corporation. These models can be used to decide which form of business is best from a tax perspective. At first, one might think the pass-through entity is the better form because it avoids double taxation. But, in fact, the better alternative depends on a combination of factors, specifically, rates of returns, the corporate tax rate, the owner's tax rate, the entity's expected life span (investment horizon), and the availability of the qualified business income (QBI) deduction for owners of pass-through entities.

The Pass-Through Model. To keep matters simple, we assume an S corporation with only one shareholder. The one-owner assumption allows us to focus on the entity decision without worrying about distributive shares and differential individual tax rates among owners. The model also applies to an S corporation, a partnership, an LLC, or an LLP with more than one owner. In addition, the model applies to a sole proprietorship because that form of business also entails one level of taxation.

EXAMPLE I:18-24 ▶ Assume the following facts. Rebecca forms an S corporation by contributing $10,000 to the corporation in exchange for all the corporation's stock. The S corporation invests in assets that produce a 10% BTROR per year. At the end of each year, the S corporation distributes cash to Rebecca equal to the taxes she must pay on the S corporation's pass-through earnings. The corporation reinvests the remaining earnings in its business. Rebecca's tax rate is 40%. For this example, assume that Rebecca does not claim the QBI deduction (see Example I:18-25 for results with the QBI deduction). Immediately after the end of the second year, the S corporation liquidates, selling the assets and distributing the cash proceeds to Rebecca. Because the corporation reinvested its retained earnings, the total basis of the corporation's assets increased as well. Assuming the FMV of the assets increased similarly, the sale produces no realized gain at the entity level. The following schedule shows the results of these transactions at the entity and owner levels:

	Year 1	*Year 2*
Entity level:		
Investment at beginning of year	$10,000	$10,600
Plus: Earnings on investment (10% × investment)	1,000	1,060
Minus: Distribution to shareholder (40% × earnings)	(400)	(424)
Investment at end of year	$10,600	$11,236

	Year 1	Year 2
Owner level:		
Stock basis at beginning of year	$10,000	$10,600
Plus: Increase due to pass-through income	1,000	1,060
Minus: Decrease due to distribution	(400)	(424)
Stock basis at end of year	$10,600	$11,236

Upon liquidation, the S corporation sells the assets and distributes the $11,236 to Rebecca. Because Rebecca's stock basis equals $11,236, she recognizes no additional gain on the liquidation. Thus, after two years, she ends up with $11,236 on a $10,000 original investment. ◀

In Example I:18-24, the S corporation could reinvest only its earnings after paying the shareholder's tax. Thus, the investment grew at a 6% ATROR, which is 10% (1 – 0.4). Consequently, the shareholder's after-tax accumulation also can be calculated as follows: ATA = $10,000(1.06)^2 = $11,236. From the owner's viewpoint, then, the pass-through entity resembles the Current Model. In general terms, the owner's after-tax accumulation can be expressed as:

The Pass-Through Model:

$$ATA = Contribution[1 + R_f(1 - t_p)]^n$$

In this model, R_f equals the pass-through entity's BTROR, t_p is the owner's marginal tax rate (p is for personal), and n is the investment horizon. If the owner claims the 20% QBI deduction, t_p will equal the owner's ordinary tax rate times (1 − 0.20), assuming the QBI deduction is not limited by 20% of excess taxable income. Although Example I:18-24 assumes a liquidating distribution at the end of the investment, the same result would have occurred had the owner sold her ownership interest (stock in this case) to another party.

ADDITIONAL COMMENT

The subscript f could be thought of as flow-through entity, as pass-through entities sometimes are called that.

EXAMPLE I:18-25 ▶ Assume the same facts as in Example I:18-24 except Rebecca claims the QBI deduction. In this case, her tax rate effectively is 32%[40% × (1 − 0.20)].

ADDITIONAL COMMENT

Example I:18-25 and other examples in this chapter assume that the QBI deduction is not limited to 20% of excess taxable income.

	Year 1	Year 2
Entity level:		
Investment at beginning of year	$10,000	$10,680
Plus: Earnings on investment (10% × investment)	1,000	1,068
Minus: Distribution to shareholder (32% × earnings)	(320)	(342)
Investment at end of year	$10,680	$11,406
Owner level:		
Stock basis at beginning of year	$10,000	$10,680
Plus: Increase due to pass-through income	1,000	1,068
Minus: Decrease due to distribution	(320)	(342)
Stock basis at end of year	$10,680	$11,406

Upon liquidation in this case, the S corporation sells the assets and distributes the $11,406 to Rebecca. Because Rebecca's stock basis equals $11,406, she recognizes no additional gain on the liquidation. Thus, after two years, she ends up with $11,406 on a $10,000 original investment, which is an amount greater than in Example I:18-24 because the QBI deduction effectively reduced her marginal tax rate. The tax reduction in turn increases the amount of earnings the S corporation could retain and reinvest in its business. In other words the investment in this case grew at a 6.8% ATROR, which is 10%(1 − 0.32), rather than 6%, which is 10% (1 − 0.40). Using the pass-through model yields the same result as follows: $10,000 $(1.068)^2$ = $11,406. ◀

The C Corporation Model. Again, to keep matters simple, we assume a C corporation with only one shareholder, and we further assume that the corporation retains all earnings after paying corporate level taxes. That is, the corporation pays no dividends. The model could be modified to reflect annual dividend payments, but such a model becomes extremely complicated and is beyond the scope of this chapter.

EXAMPLE I:18-26 ▶ Assume the same facts as in Example I:18-24 except Rebecca forms a C corporation instead of an S corporation. In this case, the corporation makes no annual distributions to Rebecca. Instead, the corporation pays its own taxes at a 21% rate and reinvests the after-tax retained earnings. Thus, the shareholder has no owner-level taxes until the corporation liquidates. Rebecca's ordinary tax rate remains 40%, but her capital gains tax rate is 20%. As in Example I:18-24, the sale prior to liquidation produces no realized gain at the entity level. The following schedule shows the results of these transactions at the entity and owner levels (assuming Sec. 1202 does not apply):

	Year 1	*Year 2*
Entity level:		
Investment at beginning of year	$10,000	$10,790
Plus: Earnings on investment (10% × investment)	1,000	1,079
Minus: Corporate taxes (21% × earnings)	(210)	(227)
Investment at end of year	$10,790	$11,642
Owner level:		
Stock basis	$10,000	$10,000
(1) Liquidation proceeds		$11,642
(2) Minus: Stock basis		(10,000)
(3) Capital gain on liquidation		$ 1,642
(4) Times: Long-term capital gains tax rate		0.20
(5) Tax on capital gain		$ 328
(6) After-tax proceeds (Line 1 – Line 5)		$11,314

Because the corporation is a C corporation, Rebecca makes no adjustments to her stock basis, which remains at $10,000. Consequently, she recognizes a capital gain upon liquidation, and after two years she ends up with $11,314 on a $10,000 original investment. ◀

In Example I:18-26, the C corporation was able to reinvest only its after-tax earnings. Thus, at the corporate level, the investment grew at a 7.9% ATROR, which is 10% (1 − 0.21). Consequently, the corporate-level accumulation before distribution to the shareholders can be calculated as follows: $\$10{,}000[1 + 0.1(1 - 0.21)]^2 = \$10{,}000(1.079)^2 = \$11{,}642$. In general terms, this expression is: Contribution$[1 + R_c(1 - t_c)]^n$, or Contribution $(1 + r_c)^n$. This formulation is a variation of the Current Model, where R_c is the corporation's BTROR, r_c is the corporation's ATROR, and t_c is the corporation's tax rate.

Upon liquidation, the shareholder receives the corporate-level accumulation and pays tax at rate t_p on the difference between the distribution and her stock basis. Thus, the shareholder's after-tax accumulation in Example I:18-26 can be formulated as follows:

$$\text{ATA} = \$10{,}000(1.079)^2 - [\$10{,}000(1.079)^2 - \$10{,}000] \times 0.20$$

The first term, $\$10{,}000(1.079)^2$, gives the corporate-level after-tax accumulation; the subtraction in brackets gives the shareholder's liquidation gain before shareholder-level taxes; and the multiplication by 20% gives the tax on the liquidation gain. Subtracting this tax from the first term gives the shareholder's total after-tax accumulation on the

investment in the C corporation. Factoring out the $10,000 contribution yields the following expression:

$$ATA = \$10{,}000\{(1.079)^2 - [(1.079)^2 - 1] \times 0.20\}$$

Substituting our general symbols into this expression yields the following model, which is a variation of the Deferred Model shown earlier in Figure I:18-1:

$$ATA = \text{Contribution}\{(1 + r_c)^n - [(1 + r_c)^n - 1] \times t_p\}$$

As done earlier with the Deferred Model, we can simplify this model algebraically to obtain:

ADDITIONAL COMMENT

If the 100% Sec. 1202 exclusion applies, t_p in this model will equal zero, and the model reduces to ATA = Contribution $(1 + r_c)^n$ or Contribution $[1 + R_c (1 - t_c)]$.

The C Corporation Model:

$$ATA = \text{Contribution}[(1 + r_c)^n(1 - t_p) + t_p] \text{ or}$$
$$ATA = \text{Contribution}\{[1 + R_c(1 - t_c)]^n(1 - t_p) + t_p\}$$

In the first form of this model, the corporation's ATROR (r_c) plays the same role as the BTROR plays in the Deferred Model developed earlier in this chapter. More specifically, in terms used in Example I:18-10, r_c is the appreciation (growth) rate of the shareholder's stock investment, assuming the stock value reflects increases in the corporation's after-tax retained earnings. Thus, the corporation's ATROR functions as the shareholder's BTROR on his or her stock investment. The second form of the C Corporation Model emphasizes that the corporate-level accumulation (the Current Model) is embedded in the shareholder's after-tax accumulation model (the Deferred Model). Topic Review I:18-2 summarizes these models.

Comparing the Pass-Through and C Corporation Models. Given these two models, an owner can compare whether operating as a pass-through entity or a C corporation provides the better result.

EXAMPLE I:18-27 ▶

ADDITIONAL COMMENT

For qualified small business stock (Sec. 1202 stock) acquired after February 17, 2009 and before September 28, 2010, the exclusion is 75%. For qualified Sec. 1202 stock acquired after September 27, 2010, the exclusion percentage is 100%. In any case, the five-year holding period requirement applies. The text discussion assumes a 100% exclusion if Sec. 1202 applies.

Assume the following facts. Mark forms Wolfson Corporation by contributing $5 million in exchange for the corporation's stock. The corporation expects to earn 18% per year before taxes on this investment. The corporate tax rate is 21%, and Mark's individual tax rate on ordinary income is 35%. If Mark claims the QBI deduction, his effective marginal tax rate is 28% [35% × (1 − 0.20)]. On capital gains other than Sec. 1202 gains, Mark's tax rate is 20%. If Wolfson stock qualifies as small business stock under Sec. 1202, any gain recognized on disposition of the stock after a five-year holding period qualifies for a 100% exclusion. Wolfson can operate either as an S corporation or a C corporation. If the corporation elects S corporation status, each year it will distribute exactly enough cash for Mark to pay taxes on any pass-through income, and it will reinvest the remaining earnings in the business. If the corporation operates as a C corporation, it will make no annual distributions, reinvesting all after-tax earnings in the business. In either case, the corporation will operate for at least six years and then liquidate at the end of the investment horizon. Mark wants to know how long he must operate the corporation to make the C corporation form better than the S corporation form. Table I:18-4 gives Mark's after-tax accumulation for each alternative.

In Table I:18-4, Columns 1 and 2 show results for the S corporation with and without Mark claiming the QBI deduction, and Columns 3 and 4 show results for the C corporation with and without the 100% Sec. 1202 exclusion. The C corporation with the Sec. 1202 exclusion beats both cases of the S corporation for all holding periods because the 21% C corporation tax rate is less than either version of Mark's individual tax rate (35% or 28%). The C corporation without the Sec. 1202 exclusion also beats the S corporation with no QBI deduction for all holding periods. If Mark claims the QBI deduction, however, the C corporation without the Sec.1202 exclusion does not beat the S corporation with the QBI deduction unless the corporation operates for at least 19 years. ◀

▼ **TABLE I:18-4**
S Corporation Versus C Corporation

Years of Operation (n)	(1) S Corporation[a] (QBI Deduction)	(2) S Corporation[b] (No QBI Deduction)	(3) C Corporation[c] (100% Exclusion)	(4) C Corporation[d] (No Exclusion)
6	$10,387,669	$ 9,711,561	$11,102,555	$ 9,882,044
7	11,733,911	10,847,814	12,681,338	11,145,071
8	13,254,626	12,117,008	14,484,625	12,587,700
9	14,972,425	13,534,698	16,544,338	14,235,471
10	16,912,852	15,118,257	18,896,943	16,117,555
11	19,104,757	16,887,094	21,584,089	18,267,271
12	21,580,734	18,862,883	24,653,346	20,722,677
13	24,377,597	21,069,841	28,159,052	23,527,242
14	27,536,934	23,535,012	32,163,269	26,730,615
15	31,105,720	26,288,609	36,736,886	30,389,509
16	35,137,021	29,364,376	41,960,871	34,568,697
17	39,690,779	32,800,008	47,927,707	39,342,166
18	44,834,704	36,637,609	54,743,027	44,794,422
19	50,645,282	40,924,209	62,527,486	51,021,989
20	57,208,911	45,712,341	71,418,894	58,135,115
21	64,623,186	51,060,685	81,574,661	66,259,729
22	72,998,350	57,034,786	93,174,578	75,539,662

[a]For all n, ATA = $5,000,000[1 + 0.18(1 − 0.28)]^n

[b]For all n, ATA = $5,000,000[1 + 0.18(1 − 0.35)]^n

[c]For n = 1 through 5, ATA = $5,000,000{[1 + 0.18(1 − 0.21)]^n(1 − 0.20) + 0.20}

For n > 5, $5,000,000[1 + 0.18(1 − 0.21)]^n

[d]For all n, ATA = $5,000,000{[1 + 0.18(1 − 0.21)]^n(1 − 0.20) + 0.20}

STOP & THINK

Question: Assume that a pass-through entity and a C corporation earn the same BTROR, that is, $R_f = R_c$. Also assume the Sec. 1202 exclusion does not apply, but remember that the owner's tax rate (t_p) can be his or her ordinary tax rate or (1 – 0.20) times the owner's ordinary tax rate depending on whether or not the owner claims the QBI deduction. Given the following comparisons of the corporate tax rate (t_c) and the owner's tax rate (t_p), can you tell from just looking at the two models which entity form is better from a tax perspective?

Comparison 1: $t_c = t_p$
Comparison 2: $t_c > t_p$
Comparison 3: $t_c < t_p$

Solution: In Comparisons 1 and 2, the pass-through entity is always better than the C corporation (given $R_f = R_c$). In Comparison 3, however, the answer is not obvious. Consider the two models:

Pass-through: $[1 + R_f(1 - t_p)]^n$
C corporation: $[1 + R_c(1 - t_c)]^n(1 - t_p) + t_p$

Notice that, if $R_f = R_c$ and $t_c = t_p$, the bracketed terms in the two models will be equal, which means the pass-through entity accumulation equals the corporate-level accumulation. The C corporation, however, entails additional taxation at the shareholder level,

TOPIC REVIEW I:18-2

Pass-Through and C Corporation Models

Pass-Through Model:

$$ATA = Contribution[1 + R_f(1 - t_p)]^n$$

C Corporation Model:

$$ATA = Contribution[(1 + r_c)^n(1 - t_p) + t_p]$$

or

$$ATA = Contribution\{[1 + R_c(1 - t_c)]^n(1 - t_p) + t_p\}$$

Definitions of Variables:
R_f = Pass-through entity's BTROR
R_c = C corporation's BTROR
t_p = Owner's marginal tax rate (adjusted for capital gain rate or QBI deduction, if applicable)
t_c = C corporation's marginal tax rate
r_c = C corporation's ATROR
n = Investment horizon

which is represented by the terms following the bracketed term. This additional tax makes the C corporation worse than the pass-through entity. If $t_c > t_p$, the bracketed term in the C corporation model accumulates to a lesser amount than does the pass-through model, and the shareholder-level tax just makes matters worse. Thus, the pass-through entity again is the preferred form. Finally, if $t_c < t_p$, the bracketed term in the C corporation model accumulates to a greater amount than does the pass-through model, but the shareholder level tax lessens the overall benefit. However, whether the overall effect causes the C corporation to be better than the pass-through entity depends on how much t_p exceeds t_c and on how long the investment horizon (n) is. Thus, the answer is not obvious.

Example I:18-27 and the above analysis show that the entity choice decision can be a complex one involving personal tax rates, the C corporation tax rate, the Sec. 1202 exclusion, the QBI deduction, the BTROR, and the investment horizon. The pass-through and C corporation models presented in this section can help with that decision because they incorporate the key variables that affect the outcome.

IMPLICIT TAXES AND CLIENTELES

OBJECTIVE 3

Recognize the role of implicit taxes in investment decisions

Several of the investment vehicles we modeled earlier have certain tax benefits compared to other investments. For example, interest earned on tax-exempt investments, such as state and local bonds, is excluded from gross income. The Exempt Model reflects this tax benefit. As another example, assets that generate long-term capital gains also are tax favored. The taxation of the capital gain is deferred until realization, and then the realized gain may be subject to the applicable capital gains tax rate. The Deferred Model, when applied to capital gain assets, reflects this preferential taxation. For the sake of simplicity, however, this section focuses on tax-exempt bonds to introduce the concept of implicit taxes and clientele effects.

Implicit Taxes. Consider what happens in the marketplace for tax-favored assets. Given a choice between a fully-taxable investment and a tax-favored investment, investors will prefer the tax-favored investment, assuming the two investments are equally risky. This preference manifests itself as an increased demand for the tax-favored investment, thereby driving up the asset's price. The increased price, in turn, causes the asset's BTROR to decrease. For example, the BTROR on a bond with an unlimited life (a perpetuity) is as follows:

$$BTROR = \frac{\text{Annual cash flow}}{\text{Bond's price}}$$

If the bond's price increases, the BTROR must decrease.

The difference between the BTRORs of the fully-taxable and tax-favored investments is an implicit tax, which can be expressed as follows:

$$IT = R_b - R_e$$

In this formula, IT stands for implicit tax, R_b is the BTROR on a fully-taxable benchmark investment, and R_e is the BTROR on a tax-favored investment having the same risk level as the benchmark. (Later in this chapter, we will show the problem with comparing investments of unequal risk.) Dividing the implicit tax by the benchmark BTROR (R_b) converts the implicit tax (IT) to an implicit tax *rate* (t_I), expressed as follows:

$$t_I = \frac{R_b - R_e}{R_b}$$

EXAMPLE I:18-28 ▶ Maria invests $1,000 in a taxable bond that yields a 10% BTROR and another $1,000 in a tax-exempt bond that yields a 7.5% BTROR (i.e., $R_b = 10\%$, and $R_e = 7.5\%$). Maria's marginal tax rate is 25% (i.e., $t = 25\%$). The two investments yield the following earnings each year:

	Taxable Bond	*Tax-Exempt Bond*
Before-tax interest	$100	$75
Minus: Explicit tax on interest	(25)	0
After-tax interest	$ 75	$75

Although the tax-exempt bond is free from explicit taxation, it reflects a 2.5% implicit tax, which is $R_b - R_e = 10\% - 7.5\% = 2.5\%$. Here, we express the implicit tax as a 2.5% reduction in the BTROR. Stated in dollars, the implicit tax is $\$1{,}000 \times 0.025 = \$25$. Thus, Maria incurs a $25 explicit tax on the taxable bond and a $25 implicit tax on the tax-exempt bond. Maria's implicit tax *rate* on the tax-exempt bond is 25%, calculated as follows:

$$t_I = \frac{R_b - R_e}{R_b} = \frac{10\% - 7.5\%}{10\%} = 0.25 \text{ or } 25\%$$

Thus, Maria incurs a 25% explicit tax *rate* on the taxable bond and a 25% implicit tax *rate* on the tax-exempt bond.

Maria's ATROR on each bond is 7.5%. For the taxable bond, the ATROR is calculated as follows: $r_b = R_b(1 - t) = 10\%(1 - 0.25) = 7.5\%$. For the tax-exempt bond, the ATROR is the same as the BTROR. ◀

REAL-WORLD EXAMPLE

Tax return filings show that high income taxpayers invest in tax-exempt bonds more than do lower income taxpayers. Recent IRS data show that taxpayers with AGI over $100,000 report about three times as much tax-exempt interest as do taxpayers with AGI under $100,000.

Equilibrium Condition and Clienteles. The degree to which R_e falls in relation to R_b depends on the marginal investor's tax rate. By definition, marginal investors are indifferent between fully-taxable and tax-favored investments. As marginal investors compete for a tax-favored investment, supply and demand forces drive up its price (and reduce its BTROR) to the point where the ATRORs of the fully-taxable and tax-favored investments are equal. That is, in equilibrium for marginal investors, the ATRORs for investments meet the following condition: $r_b = r_e$. For example, in Example I:18-28, Maria is a marginal investor because $r_b = r_e = 7.5\%$. Thus, Maria is indifferent between the two investments. (Note that, for tax-exempt bonds, $r_e = R_e$.)

In Example I:18-28, Maria incurred a 25% tax rate on each investment, explicit on the fully-taxable bond and implicit on the tax-exempt bond. Thus, Maria did not realize a tax benefit on the tax-exempt bond. In fact, the term *tax-exempt* is a misnomer when implicit taxes are considered. The issuer of the tax-exempt bond, however, received a tax subsidy in the form of a reduced interest rate. Therefore, the transaction works as though Maria paid a tax while the bond issuer received a subsidy.

This result leads to the following question: Can any investor benefit from tax-exempt bonds? In a flat-rate tax system where only one tax rate prevails, the answer is no because all investors are marginal investors. In a progressive tax rate system, however, the answer is yes for an investor whose marginal tax rate exceeds that of the marginal investor. In this situation, investors form natural clienteles for the alternative investments.

EXAMPLE I:18-29 ▶ Assume the same facts as in Example I:18-28, where Maria is the indifferent marginal investor. Consider two other investors, Silvia and Bob. Silvia's tax rate is 40%, and Bob's tax rate is 15%. If Silvia invested in a fully-taxable bond, her ATROR would be as follows: $r_b = 10\%(1 - 0.4) = 6\%$. Consequently, Silvia will prefer the tax-exempt bond that yields a 7.5% ATROR (which also equals its BTROR). Silvia's high tax rate puts her in the clientele for tax-exempt bonds. By investing in the tax-exempt bond, Silvia converts her 40% explicit tax rate into a 25% implicit tax rate, thereby giving her the higher ATROR.

If Bob invests in the fully-taxable bond, his ATROR will be as follows: $r_b = 10\%(1 - 0.15) = 8.5\%$. Thus, Bob prefers the fully-taxable bond because he obtains an 8.5% ATROR rather than 7.5% from the tax-exempt bond. Bob's low tax rate puts him in the clientele for taxable bonds. If he mistakenly invests in the tax-exempt bond, he will convert a 15% explicit tax rate into a 25% implicit tax rate. Therefore, he should avoid the tax-exempt bond. ◀

TAX STRATEGY TIP

Example I:18-29 highlights a key planning concept. Investors must consider the ATRORs of investments in making their investment decisions. Doing so will ensure that all tax effects are accounted for, including implicit as well as explicit taxes.

Risky Assets. A key requirement for calculating the implicit tax rate on a tax-favored investment is that the risk level be the same as the benchmark investment. The BTROR of a risky asset has two components, the riskless return and a risk premium. This relationship can be formulated as follows:

$$\tilde{R} = R + P$$

In this formula, $\tilde{R}$ is the risky return, R is the riskless return, and P is the risk premium. Investors who invest in risky assets require this premium as an incentive to make the investment. If the benchmark investment is a fully-taxable, riskless bond, the tax-favored investment's BTROR must be adjusted to remove this risk premium to obtain an accurate measure of the implicit tax rate.

EXAMPLE I:18-30 ▶ A tax-exempt bond issued by Troubled City is highly risky and therefore yields a 12% BTROR, which is composed of a 7% riskless return and a 5% risk premium. A riskless benchmark investment yields a 10% BTROR. Computing the implicit tax rate with the 12% return yields the following incorrect (and negative) implicit tax rate:

$$t_I = \frac{R_b - \tilde{R}_e}{R_b} = \frac{10\% - 12\%}{10\%} = -0.2 \text{ or } -20\%$$

The correct implicit tax rate is calculated with the risk-adjusted return as follows:

$$t_I = \frac{R_b - R_e}{R_b} = \frac{10\% - 7\%}{10\%} = 0.30 \text{ or } 30\%$$ ◀

Summary. Market forces drive down the BTRORs of tax-favored assets. This reduced return is an implicit tax. Thus, potential tax benefits to a marginal investor are competed away, thereby providing an implicit subsidy to the asset's issuer or seller. Investors whose tax rate exceeds that of the marginal investor, however, still can reap some benefit through the clientele effect. Topic Review I:18-3 summarizes the implicit tax rate formula.

TOPIC REVIEW I:18-3

Implicit Taxes

Implicit tax:
$IT = R_b - R_e$

Implicit tax rate:

$$t_I = \frac{R_b - R_e}{R_b}$$

Equilibrium condition for marginal investor:

$r_b = r_e$.

Definitions of Variables:
IT = Implicit tax
t_I = Implicit tax rate
R_b = BTROR on a fully-taxable benchmark investment
R_e = Risk-adjusted BTROR on a tax-favored investment
r_b = ATROR on a fully-taxable benchmark investment
r_e = Risk-adjusted ATROR on a tax-favored investment

PROBLEM MATERIALS

DISCUSSION QUESTIONS

I:18-1 What is the primary distinguishing feature that causes the Current Model, Deferred Model, and Pension Model to differ?

I:18-2 What is an annualized ATROR, and why is it useful?

I:18-3 Why might an investment in a capital asset be preferable to an investment that is fully taxed currently even though the capital asset's BTROR is less than that of the fully-taxable investment?

I:18-4 Suppose a taxpayer is trying to decide between saving outside an IRA or saving through a traditional IRA. If the taxpayer needs the savings before reaching age 59½, should he or she necessarily avoid the IRA because of the 10% early withdrawal penalty? Why or why not? If the taxpayer must make a withdrawal before age 59½, which IRA might be better, the traditional IRA or the Roth IRA?

I:18-5 How does the length of the investment horizon affect the annualized ATROR of an investment conforming to the Deferred Model?

I:18-6 Under what conditions are the Exempt Model and Pension Model equivalent? Under what conditions would one model perform better than the other? How does the $6,000 limitation on deductible and Roth IRA contributions (in 2019) affect the comparison of these two vehicles?

I:18-7 What characteristics of a C corporation cause the shareholder's stock investment to conform to the Deferred Model?

I:18-8 What is a key factor that drives the decision to convert from a traditional IRA to a Roth IRA?

I:18-9 What are some key factors that affect the decision to operate as a pass-through entity versus a C corporation?

I:18-10 Why might an investment conforming to the Exempt Model have a lower BTROR than would an equivalent-risk investment conforming to the Current Model?

I:18-11 What is an implicit tax, and how does it arise?

I:18-12 What forces cause ATRORs of various investments to be equal for marginal investors?

I:18-13 What is a clientele effect, and what conditions are necessary for it to occur?

I:18-14 An article that appeared in a financial publication several years ago made a statement similar to the following:

At the highest federal tax rates, interest from private sector investments are taxed at 40%, capital gains at 20%, while interest from state and local debt instruments isn't taxed at all.

What problem do you see with the author's statement?

I:18-15 Why would a flat-rate tax system eliminate clientele effects?

I:18-16 Why might the BTROR on a tax-favored investment be higher than the BTROR on a fully-taxable investment even though implicit tax theory says that it should be lower?

I:18-17 We have discussed implicit taxes using tax- exempt bonds as an example, and we have mentioned capital gains assets as another case where implicit taxes might occur. Give one or two other specific tax provisions that might cause implicit taxes to arise. In so doing, explain:

- How the implicit tax is manifested (e.g., increased prices, reduced returns, increased costs, etc.).
- Who "pays" the implicit tax.
- Who "receives" the implicit subsidy.

PROBLEMS

I:18-18 ***Tax-Exempt Bond.*** Laura, who is in the 35% tax bracket, notices that tax-exempt municipal bonds are yielding a 7% return. What before-tax rate of return on a fully-taxable bond must Laura obtain to make her prefer the taxable bond over the tax- exempt bond?

I:18-19 ***After-Tax Rates of Return.*** Suppose a bond is taxable for both federal and state purposes. Let R_b = the BTROR on the bond, t_{fed} = the federal tax rate, and t_{st} = the state tax rate. Determine the ATROR (i.e., after federal and state taxes) if:

a. The state tax is *not* deductible for either federal or state purposes.

b. The state tax *is* deductible for federal but not for state purposes.
After algebraic simplification, each answer should take the form: R_b( ), with the rest of the answer inside the parentheses.

c. After determining the formulas for Parts a and b, determine the ATRORs assuming that the BTROR (R_b) is 8%, the federal tax rate (t_{fed}) is 40%, and the state tax rate (t_{st}) is 6%.

I:18-20 ***Investment Models.*** David can make a single investment in one of three alternatives. The first investment conforms to the Current Model, the second investment conforms to the Deferred Model, and the third investment conforms to the Pension Model. The investment horizon is seven years, and the BTROR for each alternative is 10%. David will incur no penalties upon withdrawal.

a. Assuming David's tax rate will be 15% for all seven years, what is the accumulation and annualized ATROR for each investment? Which alternative should David choose?

b. Assuming David's tax rate will be 15% for the first six years but will be 25% in the seventh year, what is the accumulation and annualized ATROR for each investment? Which alternative should David choose?

I:18-21 ***Investment Models.*** Mark is considering investing in either a tax-exempt municipal bond that yields 7% or a nondeductible IRA that contains investments that yield 10% before taxes. (Mark is ineligible to contribute to a Roth IRA.) Mark's current tax rate is 35%, and he plans to make a single investment now with a 15-year investment horizon.

a. Using after-tax accumulations and annualized ATRORs, show that the nondeductible IRA outperforms the municipal bonds assuming Mark's tax rate remains at 35%. Assume no additional penalty upon withdrawal from the IRA.

b. How high would Mark's tax rate have to rise in Year n to make the municipal bond more attractive than the nondeductible IRA? Assume the 7% and 10% BTRORs remain constant over time.

I:18-22 ***Investment Models and IRAs.*** Brenda has $6,000 of before-tax dollars available for a one-time investment. She is in the 25% bracket and expects to remain in this bracket indefinitely. She can invest directly in a taxable bond yielding 8% before taxes, or she can open an IRA and invest in the bond within the IRA. She knows that she will need the accumulated funds before she reaches age 59½. Thus, if she invests in an IRA, she will incur a 10% penalty on taxable amounts withdrawn from the IRA. Note: The two parts to this problem are best solved using a spreadsheet.

a. If she invests in an IRA that allows immediate deduction of contributed amounts (i.e., a traditional deductible IRA), how many years must she wait before the IRA is a better vehicle than direct investment in the bond outside the IRA?

b. How many years must she wait if she invests in a Roth IRA? Reminder: Withdrawals from a Roth IRA first come from contributions and are a nontaxable return of capital. However, if Brenda withdraws the *entire* accumulation before she attains age 59½, the accumulated earnings will be fully taxable and also subject to the 10% early withdrawal penalty. Hence, in this situation, the Roth IRA operates exactly like a traditional nondeductible IRA (the Deferred Model instead of the Exempt Model).

I:18-23 ***Investment Planning.*** Martha, who is in the 35% tax bracket, has $40,000 of before-tax income with which she wants to make a one-time investment. She wants to put $20,000 of this income in a deductible H.R. 10 plan, and she wants to invest any remaining after-tax income outside the H.R. 10 plan. Assume that Martha has sufficient self-employment income such that her contribution does not exceed the H.R. 10 contribution limit. Two investments are available: (1) a taxable bond yielding a 10% BTROR and (2) a nondividend paying stock that appreciates at a 10% annual rate before taxes. She is considering two alternatives:

1. Have the H.R. 10 plan invest in the stock, and Martha will invest in the bond outside the H.R. 10 plan.
2. Have the H.R. 10 plan invest in the bond, and Martha will invest in the stock outside the H.R. 10 plan.

The investment horizon is ten years with tax rates constant over this period. Capital gains upon sale of stock outside the H.R. 10 plan are taxed at 15%. However, if the stock is placed in the H.R. 10 plan, the H.R. 10 plan will sell the stock after ten years and distribute the proceeds to Martha, triggering ordinary income recognition to Martha. Assume no early withdrawal penalties on H.R. 10 plan distributions. Determine the total after-tax accumulation of Alternative 1 and of Alternative 2. Which of the two alternatives should Martha choose?

I:18-24 ***Roth IRA Versus Deductible IRA.*** Harry wants to contribute either $6,000 (BT$) to a traditional deductible IRA or $6,000 (AT$) to a Roth IRA. His current tax rate is 30% for ordinary income and 15% for capital gains. He expects his IRA investment to earn a 12% BTROR, and he plans to withdraw the IRA accumulation in 25 years, at which time he will be over age 59½. If he contributes to a deductible IRA, he will invest the tax savings from the deduction in a nondividend paying stock that he expects to grow at a 12% BTROR. Harry will sell the stock at the same time he withdraws the IRA accumulation.

a. Compare the two alternatives assuming that, at the time of withdrawal, Harry's tax rate will be 30% for ordinary income and 15% for capital gains.

b. Compare the two alternatives assuming that, at the time of withdrawal, Harry's tax rate will be 15% for ordinary income and 0% for capital gains.

I:18-25 ***Roth IRA Versus Deductible IRA.*** Beth wants to contribute to either a traditional deductible IRA or a Roth IRA. However, she can afford to contribute only $5,400 after-tax dollars to a Roth IRA even though the maximum contribution is $6,000. Alternatively, she can contribute a comparable amount to a deductible IRA plus an outside investment if necessary. (Remember that deductible IRA contributions are made with before-tax dollars and are limited to $6,000.) Beth's current tax rate is 25%, and she expects her tax rate to remain at 25% throughout the investment period. In addition, she expects her IRA investment to earn a 10% BTROR, and she plans to withdraw the IRA accumulation in 30 years, at which time she will be over age 59½. Any outside investment will conform to the Current Model earning a 10% BTROR. Determine the after-tax accumulation from each IRA alternative. Which of the two IRA types will give Beth the greater after-tax accumulation?

I:18-26 ***Multiperiod Investment Strategy.*** Given the following facts and assumptions, determine what investment strategy Karen should follow to maximize accumulations and how much she will have accumulated at the *beginning* of Year 10 (including her last paycheck).

- Karen's ordinary tax rate is 25%, and her long-term capital gains tax rate is 15%. These rates will remain constant over her investment horizon.
- Karen earns $50,000 per year, which she receives on the first day of each year.
- Karen saves all her income after paying income taxes on her earnings. Taxes are payable immediately upon receiving her paycheck.
- At the beginning of each year, Karen can invest her savings in any of three vehicles:
  1. A money market fund yielding 6% per year before taxes,
  2. A traditional deductible IRA that yields 6% per year before taxes, and/or
  3. Capital assets that grow at 5.21% per year before taxes.
- IRA contributions are limited to $6,000 per year and are deductible up to that amount. Assume this limit applies to all years under consideration.
- At the beginning of Year 10, Karen saves no more income. Instead, she withdraws any IRA and/or money market accumulations and sells her capital assets for their accumulated FMV before taxes. She also receives a $50,000 paycheck at the beginning of Year 10.

- IRA accumulations are taxable immediately upon withdrawal with no additional penalty.
- Ignore itemized deductions, standard deductions, exemptions, etc.

I:18-27 ***Roth Versus Traditional IRA Decision.*** Your client has a traditional deductible IRA to which he has deducted all contributions. Thus, the IRA has zero basis ($B_k = 0$). The client is considering converting to a Roth IRA with the conversion tax to be paid from an outside currently taxable source. In any case, the client intends to cash out of the IRA in n years with no early withdrawal penalty. Using the traditional IRA retention versus Roth conversion models, derive a general formula to help the client determine how high a future tax rate (t_n) must be to cause the Roth conversion to be preferable to retaining the traditional IRA. That is, derive a formula indicating that a Roth conversion is better when:

$$t_n > [\text{right hand side of formula}].$$

The client has not yet determined the value of any variables (except $B_k = 0$) and just wants as simple a general formula as possible in which the client later can insert actual values.

I:18-28 ***Proprietorship Versus C Corporation.*** Myron has $10,000 to invest in a business. He can either (1) operate as a sole proprietor or (2) form a regular C corporation by contributing the $10,000 in exchange for corporate stock. In either case, the $10,000 will be invested in business assets and will earn a 10% BTROR for the first five years and an 18% BTROR for years six through 15. All after-tax earnings will be reinvested in the business. If Myron uses the corporate form, the corporation will liquidate at the end of the investment horizon. Myron's personal tax rate is 40%; the corporate tax rate is 21%; and the tax rate on capital gains for individuals is 20% (assume no Sec. 1202 exclusion for gain on the sale of small business stock). Determine whether Myron should operate as a sole proprietor or form a C corporation if the investment horizon is 15 years. For the sole proprietorship, do the analysis with and without the qualified business income (QBI) deduction. Show the after-tax accumulation and annualized after-tax rate of return for each alternative.

I:18-29 ***Pass-Through Versus C Corporation.*** Twelve years ago, your client formed a C corporation with a $100,000 investment (contribution). The corporation's BTROR (R_c) has been and will continue to be 10%. The corporate tax rate (t_c) has been 35% for the last 12 years, but because of a tax law change, the corporation's tax rate will be 21% for the foreseeable future. The corporation pays no dividends and reinvests all after-tax earnings in its business. Thus, the corporation's value grows at its ATROR. Your client's marginal ordinary tax rate (t_p) has been 33%, and her capital gains rate has been 15%. Because of the same tax law change, your client's ordinary tax rate dropped to 24% at the beginning of this year and will stay at that level indefinitely. Her capital gains tax rate will remain at 15%. Assume the corporate stock does not qualify for the Sec. 1202 exclusion for gain on the sale of small business stock. Your client wants you to consider three alternatives:

1. Continue the business in C corporation form for the next 20 years and liquidate at that time (32 years in total).
2. Liquidate the C corporation at the end of the 12-year period, invest the after-tax proceeds in a sole proprietorship, and operate as a sole proprietorship for the next 20 years. Your client will claim the 20% QBI deduction in the sole proprietorship case.
3. Make an S corporation election effective at the beginning of this year, operate as an S corporation for the next 20 years, and liquidate the S corporation at that time (32 years in total). Your client will claim the 20% QBI deduction in the S corporation case.

Regarding Alternatives 2 and 3, the sole proprietorship's or S corporation's BTROR (R_p) also will be 10% for the next 20 years. Earnings from the sole proprietorship or S corporation will be taxed currently at your client's ordinary tax rate (adjusted for the QBI deduction percentage), and your client will withdraw just enough from the business to pay her taxes. The remaining after-tax earnings will remain in the business until the end of the investment horizon (20 years from now). Show the results of each alternative along with supporting models and calculations. Which alternative should your client adopt? Ignore the accumulated earnings tax for C corporations.

I:18-30 ***Pass-Through Versus C Corporation.*** Assume the corporation in Problem I:18-29 had been an S corporation for its first 12 years, during which it distributed just enough cash for the shareholder to pay taxes on the pass-through income. Thus, the S corporation reinvested after-tax income. However, during those 12 years, your client could not claim the QBI deduction. Now that the corporate tax rate is 21%, your client is considering

revoking its S election and operating as a C corporation for the remaining 20 years with no dividend distributions. Show the results of remaining an S corporation, with the QBI deduction available going forward, versus revoking the election. Also show supporting models and calculations. Which alternative should the corporation adopt? Ignore the accumulated earnings tax for C corporations.

I:18-31 ***S Corporation Versus C Corporation.*** Consider the following facts:

$$\begin{aligned} R_f &= R_c = 18\% \\ t_c &= 21\% \\ t_p &= 37\% \text{ for ordinary income} \\ &= 20\% \text{ for capital gains} \\ n &= 6, 15, \text{ or } 50 \text{ years} \end{aligned}$$

Other information:

- The corporation is formed with a $10,000 contribution.
- The corporation pays no dividends.
- The entities reinvest their after-tax earnings.

Using the format below, compare after-tax accumulations for each investment horizon. Should the corporation make the S election for any of these investment horizons?

	Years (n)		
	6	*15*	*50*
S corporation (t_p = 37% with no QBI ded.)			
C corporation (no Sec. 1202 exclusion)			
S corporation (t_p = 37% (1 – 0.20) = 29.6% with QBI ded.)			
C corporation (100% Sec. 1202 exclusion)			

I:18-32 ***Implicit Tax Rates and Clientele Effects.*** Terry's marginal tax rate is 30%. He can invest in a taxable bond yielding 7.5% before taxes. What is the implicit tax rate on a tax-exempt bond of equivalent risk that yields 6%?

a. Which bond should Terry invest in? Why?

b. How would your answer to Part a change if Terry's statutory marginal tax rate were 15%?

I:18-33 ***Implicit Tax Rates and Clientele Effects.*** Consider three taxpayers who are in the following tax brackets:

Alice	25%
Brad	35%
Camille	40%

The BTROR on a benchmark investment is 10% (i.e., R_b = 10%). Compute the equilibrium BTROR and the implicit tax rate on a tax-exempt bond under each of the following three alternative assumptions.

a. Alice is the marginal investor.

b. Brad is the marginal investor.

c. Camille is the marginal investor.

d. Which taxpayer (Alice, Brad, or Camille) would Camille like to see be the marginal investor? Why?

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QUICK REFERENCE: 2019 TAX RATE SCHEDULES AND OTHER KEY NUMBERS

2019 TAX RATE SCHEDULES

INDIVIDUAL TAXPAYERS

Single [§1(c)]:

If taxable income is:	The tax is:
Not over $9,700	10% of taxable income
Over $9,700 but not over $39,475	$970.00, plus 12% of the excess over $9,700
Over $39,475 but not over $84,200	$4,543.00, plus 22% of the excess over $39,475
Over $84,200 but not over $160,725	$14,382.50, plus 24% of the excess over $84,200
Over $160,725 but not over $204,100	$32,748.50, plus 32% of the excess over $160,725
Over $204,100 but not over $510,300	$46,628.50, plus 35% of the excess over $204,100
Over $510,300	$153,798.50, plus 37% of the excess over $510,300

Head of Household [§1(b)]:

If taxable income is:	The tax is:
Not over $13,850	10% of taxable income
Over $13,850 but not over $52,850	$1,385.00, plus 12% of the excess over $13,850
Over $52,850 but not over $84,200	$6,065.00, plus 22% of the excess over $52,850
Over $84,200 but not over $160,700	$12,962.00, plus 24% of the excess over $84,200
Over $160,700 but not over $204,100	$31,322.00, plus 32% of the excess over $160,700
Over $204,100 but not over $510,300	$45,210.00, plus 35% of the excess over $204,100
Over $510,300	$152,380.00, plus 37% of the excess over $510,300

Married, Filing Joint and Surviving Spouse [§1(a)]:

If taxable income is:	The tax is:
Not over $19,400	10% of taxable income
Over $19,400 but not over $78,950	$1,940.00, plus 12% of the excess over $19,400
Over $78,950 but not over $168,400	$9,086.00, plus 22% of the excess over $78,950
Over $168,400 but not over $321,450	$28,765.00, plus 24% of the excess over $168,400
Over $321,450 but not over $408,200	$65,497.00, plus 32% of the excess over $321,450
Over $408,200 but not over $612,350	$93,257.00, plus 35% of the excess over $408,200
Over $612,350	$164,709.50, plus 37% of the excess over $612,350

Married, Filing Separate [§1(d)]:

If taxable income is:	The tax is:
Not over $9,700	10% of taxable income
Over $9,700 but not over $39,475	$970.00, plus 12% of the excess over $9,700
Over $39,475 but not over $84,200	$4,543.00, plus 22% of the excess over $39,475
Over $84,200 but not over $160,725	$14,382.50, plus 24% of the excess over $84,200
Over $160,725 but not over $204,100	$32,748.50, plus 32% of the excess over $160,725
Over $204,100 but not over $306,175	$46,628.50, plus 35% of the excess over $204,100
Over $306,175	$82,354.75, plus 37% of the excess over $306,175

Capital Gains and Dividends

Capital gains and losses are assigned to baskets. Five possible tax rates will apply to most capital gains and losses:

- Ordinary income tax rates (up to 37% in 2019) for gains on assets held one year or less
- 28% rate on collectibles gains and includible Sec. 1202 gains
- Preferential tax rates for gains on assets held for more than one year and qualified dividends based on the taxpayer's taxable income and filing status as shown in the following table:

Preferential Rate	Single	Filing Jointly	Head of Household	Estates & Trusts
0%	Up to $39,375	Up to $78,750	Up to $52,750	Up to $2,650
15%	> $39,375 but ≤ $434,550	> $78,750 but ≤ $488,850	> $52,750 but ≤ $461,700	> $2,650 but ≤ $12,750
20%	Over $434,550	Over $488,850	Over $461,700	Over $12,750

Note: The net investment income of higher income taxpayers (modified AGI greater than $200,000 for single and $250,000 for married filing jointly) also may be subject to an additional tax of 3.8%. Net investment income includes dividends and capital gains, along with other types of investment income.

Social Security Tax—2019

Category	Rate	Dollar Limit
OASDI	6.2%	$132,900
Medicare*	1.45%	First $200,000 of wages ($250,000 for joint returns)
	2.35%	Wages greater than $200,000 ($250,000 for joint returns)

* Only the employee is required to pay the additional Medicare tax on wages above $200,000 ($250,000 for joint returns). The employer pays Medicare tax of 1.45% on all wages.

Self-Employment Tax—2019

Category	Rate	Dollar Limit
OASDI	12.4%	$132,900
Medicare	2.9%	First $200,000 of self-employment income ($250,000 combined self-employment income for joint returns)
	3.8%	Self-employment income greater than $200,000 ($250,000 for joint returns)

Alternative Minimum Tax—2019

If AMTI minus the exemption amount is:		The tax is:	
Over—	But Not Over—		Of the Amount Over—
$0	$194,800*	26%	$0
$194,800*		$50,648* + 28%	$194,800

*$97,400 and $25,324 for married taxpayers filing separately.

AMT exemption amounts (before phase-outs and other adjustments):

Unmarried individuals (other than surviving spouses)	$71,700
Married individuals filing joint returns and surviving spouses	111,700
Married individuals filing separate returns	55,850
Estates and trusts	25,000

STANDARD DEDUCTION

Filing Status	
Married individuals filing joint returns and surviving spouses	$24,400
Heads of households	18,350
Unmarried individuals (other than surviving spouses and heads of households)	12,200
Married individuals filing separate returns	12,200
Additional standard deduction for the aged and the blind	
Individual who is married and surviving spouses	1,300*
Individual who is unmarried and not a surviving spouse	1,650*
Taxpayer claimed as dependent on another taxpayer's return: Greater of (1) earned income plus $350, or (2) $1,100.	

*These amounts are $2,600 and $3,300, respectively, for a taxpayer who is both aged and blind.

2019 TAX RATE SCHEDULES

ESTATES AND TRUSTS [§1(e)]:

If taxable income is:	The tax is:
Not over $2,600	10% of taxable income
Over $2,600 but not over $9,300	$260.00, plus 24% of the excess over $2,600
Over $9,300 but not over $12,750	$1,868.00, plus 35% of the excess over $9,300
Over $12,750	$3,075.50, plus 37% of the excess over $12,750

CORPORATIONS [§11(b)]—Post-2017: Tax is 21% of taxable income.

CORPORATIONS [§11(b)]—Pre-2018

If Taxable Income Is:		The Tax Is:	
Over—	But Not Over—		Of the Amount Over—
$ 0	$ 50,000	15%	$ 0
50,000	75,000	$ 7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333		6,416,667 + 35%	18,333,333

UNIFIED CREDIT AMOUNT FOR ESTATE AND GIFT TAX

Year of Gift/Year of Death	Amount of Credit	Basic Exclusion Amount
January through June, 1977	$ 30,000 (6,000)b	$ 120,666 (30,000)[b]
July through December, 1977	30,000	120,666
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,563
1981	47,000	175,625
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 through 1997	192,800	600,000
1998	202,050	625,000
1999	211,300	650,000
2000 and 2001	220,550	675,000
2002 and 2003	345,800	1,000,000
2004 and 2005	555,800 (345,800)[a]	1,500,000 (1,000,000)[a]
2006, 2007, and 2008	780,800 (345,800)[a]	2,000,000 (1,000,000)[a]
2009	1,455,800 (345,800)[a]	3,500,000 (1,000,000)[a]
2010	1,730,800[b] (330,800)[a]	5,000,000[b] (1,000,000)[a]
2011	1,730,800	5,000,000
2012	1,772,800	5,120,000
2013	2,045,800	5,250,000
2014	2,081,800	5,340,000
2015	2,117,800	5,430,000
2016	2,125,800	5,450,000
2017	2,141,800	5,490,000
2018	4,417,800	11,180,000
2019	4,505,800	11,400,000

[a] The numbers in parentheses represent the credit and exemption equivalent amounts for the gift tax.
[b] This amount applied if the executor opted to have the estate subject to the estate tax and FMV basis rule in 2010.

UNIFIED TRANSFER TAX RATES

For Transfers Made in 1984 Through 2001:*

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over $10,000	18% of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20% of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22% of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24% of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26% of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28% of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30% of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32% of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34% of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37% of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39% of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41% of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43% of the excess of such amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45% of the excess of such amount over $1,500,000.
Over $2,000,000 but not over $2,500,000	$780,800, plus 49% of the excess of such amount over $2,000,000.
Over $2,500,000 but not over $3,000,000	$1,025,800, plus 53% of the excess of such amount over $2,500,000.
Over $3,000,000	$1,290,800, plus 55% of the excess of such amount over $3,000,000.

* For decedents dying after 2001 and gifts made after 2001, the maximum tax rates are as follows:
Note: The rates in the above schedule still apply to amounts less than the amounts in the second column of the below schedule.

Year	If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
2002	Over $2,500,000	$1,025,800, plus 50% of the excess of such amount over $2,500,000.
2003	Over $2,000,000	$780,800, plus 49% of the excess of such amount over $2,000,000.
2004	Over $2,000,000	$780,800, plus 48% of the excess of such amount over $2,000,000.
2005	Over $2,000,000	$780,800, plus 47% of the excess of such amount over $2,000,000.
2006	Over $2,000,000	$780,800, plus 46% of the excess of such amount over $2,000,000.
2007–2009	Over $1,500,000	$555,800, plus 45% of the excess of such amount over $1,500,000.
2010	Over $500,000**	$155,800, plus 35% of the excess of such amount over $500,000.**
2011–2012	Over $500,000	$155,800, plus 35% of the excess of such amount over $500,000.
2013 and after	Over $1,000,000	$345,800, plus 40% of the excess of such amount over $1,000,000.

** Gift tax only unless the executor opted to have the estate subject to the estate tax and FMV basis rule in 2010.

2018 TAX TABLES AND RATE SCHEDULES

2019 WITHHOLDING TABLES (PARTIAL)

2018 Tax Table



See the instructions for line 11a to see if you must use the Tax Table below to figure your tax.

Example. Mr. and Mrs. Brown are filing a joint return. Their taxable income on Form 1040, line 10, is $25,300. First, they find the $25,300-25,350 taxable income line. Next, they find the column for married filing jointly and read down the column. The amount shown where the taxable income line and filing status column meet is $2,658. This is the tax amount they should enter in the entry space on Form 1040, line 11a.

Sample Table

At Least	But Less Than	Single	Married filing jointly*	Married filing separately	Head of a household
		Your tax is—			
25,200	25,250	2,837	2,646	2,837	2,755
25,250	25,300	2,843	2,652	2,843	2,761
25,300	25,350	2,849	(2,658)	2,849	2,767
25,350	25,400	2,855	2,664	2,855	2,773

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
0	5	0	0	0	0
5	15	1	1	1	1
15	25	2	2	2	2
25	50	4	4	4	4
50	75	6	6	6	6
75	100	9	9	9	9
100	125	11	11	11	11
125	150	14	14	14	14
150	175	16	16	16	16
175	200	19	19	19	19
200	225	21	21	21	21
225	250	24	24	24	24
250	275	26	26	26	26
275	300	29	29	29	29
300	325	31	31	31	31
325	350	34	34	34	34
350	375	36	36	36	36
375	400	39	39	39	39
400	425	41	41	41	41
425	450	44	44	44	44
450	475	46	46	46	46
475	500	49	49	49	49
500	525	51	51	51	51
525	550	54	54	54	54
550	575	56	56	56	56
575	600	59	59	59	59
600	625	61	61	61	61
625	650	64	64	64	64
650	675	66	66	66	66
675	700	69	69	69	69
700	725	71	71	71	71
725	750	74	74	74	74
750	775	76	76	76	76
775	800	79	79	79	79
800	825	81	81	81	81
825	850	84	84	84	84
850	875	86	86	86	86
875	900	89	89	89	89
900	925	91	91	91	91
925	950	94	94	94	94
950	975	96	96	96	96
975	1,000	99	99	99	99

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
1,000					
1,000	1,025	101	101	101	101
1,025	1,050	104	104	104	104
1,050	1,075	106	106	106	106
1,075	1,100	109	109	109	109
1,100	1,125	111	111	111	111
1,125	1,150	114	114	114	114
1,150	1,175	116	116	116	116
1,175	1,200	119	119	119	119
1,200	1,225	121	121	121	121
1,225	1,250	124	124	124	124
1,250	1,275	126	126	126	126
1,275	1,300	129	129	129	129
1,300	1,325	131	131	131	131
1,325	1,350	134	134	134	134
1,350	1,375	136	136	136	136
1,375	1,400	139	139	139	139
1,400	1,425	141	141	141	141
1,425	1,450	144	144	144	144
1,450	1,475	146	146	146	146
1,475	1,500	149	149	149	149
1,500	1,525	151	151	151	151
1,525	1,550	154	154	154	154
1,550	1,575	156	156	156	156
1,575	1,600	159	159	159	159
1,600	1,625	161	161	161	161
1,625	1,650	164	164	164	164
1,650	1,675	166	166	166	166
1,675	1,700	169	169	169	169
1,700	1,725	171	171	171	171
1,725	1,750	174	174	174	174
1,750	1,775	176	176	176	176
1,775	1,800	179	179	179	179
1,800	1,825	181	181	181	181
1,825	1,850	184	184	184	184
1,850	1,875	186	186	186	186
1,875	1,900	189	189	189	189
1,900	1,925	191	191	191	191
1,925	1,950	194	194	194	194
1,950	1,975	196	196	196	196
1,975	2,000	199	199	199	199

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
2,000					
2,000	2,025	201	201	201	201
2,025	2,050	204	204	204	204
2,050	2,075	206	206	206	206
2,075	2,100	209	209	209	209
2,100	2,125	211	211	211	211
2,125	2,150	214	214	214	214
2,150	2,175	216	216	216	216
2,175	2,200	219	219	219	219
2,200	2,225	221	221	221	221
2,225	2,250	224	224	224	224
2,250	2,275	226	226	226	226
2,275	2,300	229	229	229	229
2,300	2,325	231	231	231	231
2,325	2,350	234	234	234	234
2,350	2,375	236	236	236	236
2,375	2,400	239	239	239	239
2,400	2,425	241	241	241	241
2,425	2,450	244	244	244	244
2,450	2,475	246	246	246	246
2,475	2,500	249	249	249	249
2,500	2,525	251	251	251	251
2,525	2,550	254	254	254	254
2,550	2,575	256	256	256	256
2,575	2,600	259	259	259	259
2,600	2,625	261	261	261	261
2,625	2,650	264	264	264	264
2,650	2,675	266	266	266	266
2,675	2,700	269	269	269	269
2,700	2,725	271	271	271	271
2,725	2,750	274	274	274	274
2,750	2,775	276	276	276	276
2,775	2,800	279	279	279	279
2,800	2,825	281	281	281	281
2,825	2,850	284	284	284	284
2,850	2,875	286	286	286	286
2,875	2,900	289	289	289	289
2,900	2,925	291	291	291	291
2,925	2,950	294	294	294	294
2,950	2,975	296	296	296	296
2,975	3,000	299	299	299	299

(Continued)

* This column must also be used by a qualifying widow(er).

(Continued on page T-3)

2018 Tax Table — *Continued*

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
3,000					
3,000	3,050	303	303	303	303
3,050	3,100	308	308	308	308
3,100	3,150	313	313	313	313
3,150	3,200	318	318	318	318
3,200	3,250	323	323	323	323
3,250	3,300	328	328	328	328
3,300	3,350	333	333	333	333
3,350	3,400	338	338	338	338
3,400	3,450	343	343	343	343
3,450	3,500	348	348	348	348
3,500	3,550	353	353	353	353
3,550	3,600	358	358	358	358
3,600	3,650	363	363	363	363
3,650	3,700	368	368	368	368
3,700	3,750	373	373	373	373
3,750	3,800	378	378	378	378
3,800	3,850	383	383	383	383
3,850	3,900	388	388	388	388
3,900	3,950	393	393	393	393
3,950	4,000	398	398	398	398
4,000					
4,000	4,050	403	403	403	403
4,050	4,100	408	408	408	408
4,100	4,150	413	413	413	413
4,150	4,200	418	418	418	418
4,200	4,250	423	423	423	423
4,250	4,300	428	428	428	428
4,300	4,350	433	433	433	433
4,350	4,400	438	438	438	438
4,400	4,450	443	443	443	443
4,450	4,500	448	448	448	448
4,500	4,550	453	453	453	453
4,550	4,600	458	458	458	458
4,600	4,650	463	463	463	463
4,650	4,700	468	468	468	468
4,700	4,750	473	473	473	473
4,750	4,800	478	478	478	478
4,800	4,850	483	483	483	483
4,850	4,900	488	488	488	488
4,900	4,950	493	493	493	493
4,950	5,000	498	498	498	498
5,000					
5,000	5,050	503	503	503	503
5,050	5,100	508	508	508	508
5,100	5,150	513	513	513	513
5,150	5,200	518	518	518	518
5,200	5,250	523	523	523	523
5,250	5,300	528	528	528	528
5,300	5,350	533	533	533	533
5,350	5,400	538	538	538	538
5,400	5,450	543	543	543	543
5,450	5,500	548	548	548	548
5,500	5,550	553	553	553	553
5,550	5,600	558	558	558	558
5,600	5,650	563	563	563	563
5,650	5,700	568	568	568	568
5,700	5,750	573	573	573	573
5,750	5,800	578	578	578	578
5,800	5,850	583	583	583	583
5,850	5,900	588	588	588	588
5,900	5,950	593	593	593	593
5,950	6,000	598	598	598	598
6,000					
6,000	6,050	603	603	603	603
6,050	6,100	608	608	608	608
6,100	6,150	613	613	613	613
6,150	6,200	618	618	618	618
6,200	6,250	623	623	623	623
6,250	6,300	628	628	628	628
6,300	6,350	633	633	633	633
6,350	6,400	638	638	638	638
6,400	6,450	643	643	643	643
6,450	6,500	648	648	648	648
6,500	6,550	653	653	653	653
6,550	6,600	658	658	658	658
6,600	6,650	663	663	663	663
6,650	6,700	668	668	668	668
6,700	6,750	673	673	673	673
6,750	6,800	678	678	678	678
6,800	6,850	683	683	683	683
6,850	6,900	688	688	688	688
6,900	6,950	693	693	693	693
6,950	7,000	698	698	698	698
7,000					
7,000	7,050	703	703	703	703
7,050	7,100	708	708	708	708
7,100	7,150	713	713	713	713
7,150	7,200	718	718	718	718
7,200	7,250	723	723	723	723
7,250	7,300	728	728	728	728
7,300	7,350	733	733	733	733
7,350	7,400	738	738	738	738
7,400	7,450	743	743	743	743
7,450	7,500	748	748	748	748
7,500	7,550	753	753	753	753
7,550	7,600	758	758	758	758
7,600	7,650	763	763	763	763
7,650	7,700	768	768	768	768
7,700	7,750	773	773	773	773
7,750	7,800	778	778	778	778
7,800	7,850	783	783	783	783
7,850	7,900	788	788	788	788
7,900	7,950	793	793	793	793
7,950	8,000	798	798	798	798
8,000					
8,000	8,050	803	803	803	803
8,050	8,100	808	808	808	808
8,100	8,150	813	813	813	813
8,150	8,200	818	818	818	818
8,200	8,250	823	823	823	823
8,250	8,300	828	828	828	828
8,300	8,350	833	833	833	833
8,350	8,400	838	838	838	838
8,400	8,450	843	843	843	843
8,450	8,500	848	848	848	848
8,500	8,550	853	853	853	853
8,550	8,600	858	858	858	858
8,600	8,650	863	863	863	863
8,650	8,700	868	868	868	868
8,700	8,750	873	873	873	873
8,750	8,800	878	878	878	878
8,800	8,850	883	883	883	883
8,850	8,900	888	888	888	888
8,900	8,950	893	893	893	893
8,950	9,000	898	898	898	898
9,000					
9,000	9,050	903	903	903	903
9,050	9,100	908	908	908	908
9,100	9,150	913	913	913	913
9,150	9,200	918	918	918	918
9,200	9,250	923	923	923	923
9,250	9,300	928	928	928	928
9,300	9,350	933	933	933	933
9,350	9,400	938	938	938	938
9,400	9,450	943	943	943	943
9,450	9,500	948	948	948	948
9,500	9,550	953	953	953	953
9,550	9,600	959	958	959	958
9,600	9,650	965	963	965	963
9,650	9,700	971	968	971	968
9,700	9,750	977	973	977	973
9,750	9,800	983	978	983	978
9,800	9,850	989	983	989	983
9,850	9,900	995	988	995	988
9,900	9,950	1,001	993	1,001	993
9,950	10,000	1,007	998	1,007	998
10,000					
10,000	10,050	1,013	1,003	1,013	1,003
10,050	10,100	1,019	1,008	1,019	1,008
10,100	10,150	1,025	1,013	1,025	1,013
10,150	10,200	1,031	1,018	1,031	1,018
10,200	10,250	1,037	1,023	1,037	1,023
10,250	10,300	1,043	1,028	1,043	1,028
10,300	10,350	1,049	1,033	1,049	1,033
10,350	10,400	1,055	1,038	1,055	1,038
10,400	10,450	1,061	1,043	1,061	1,043
10,450	10,500	1,067	1,048	1,067	1,048
10,500	10,550	1,073	1,053	1,073	1,053
10,550	10,600	1,079	1,058	1,079	1,058
10,600	10,650	1,085	1,063	1,085	1,063
10,650	10,700	1,091	1,068	1,091	1,068
10,700	10,750	1,097	1,073	1,097	1,073
10,750	10,800	1,103	1,078	1,103	1,078
10,800	10,850	1,109	1,083	1,109	1,083
10,850	10,900	1,115	1,088	1,115	1,088
10,900	10,950	1,121	1,093	1,121	1,093
10,950	11,000	1,127	1,098	1,127	1,098
11,000					
11,000	11,050	1,133	1,103	1,133	1,103
11,050	11,100	1,139	1,108	1,139	1,108
11,100	11,150	1,145	1,113	1,145	1,113
11,150	11,200	1,151	1,118	1,151	1,118
11,200	11,250	1,157	1,123	1,157	1,123
11,250	11,300	1,163	1,128	1,163	1,128
11,300	11,350	1,169	1,133	1,169	1,133
11,350	11,400	1,175	1,138	1,175	1,138
11,400	11,450	1,181	1,143	1,181	1,143
11,450	11,500	1,187	1,148	1,187	1,148
11,500	11,550	1,193	1,153	1,193	1,153
11,550	11,600	1,199	1,158	1,199	1,158
11,600	11,650	1,205	1,163	1,205	1,163
11,650	11,700	1,211	1,168	1,211	1,168
11,700	11,750	1,217	1,173	1,217	1,173
11,750	11,800	1,223	1,178	1,223	1,178
11,800	11,850	1,229	1,183	1,229	1,183
11,850	11,900	1,235	1,188	1,235	1,188
11,900	11,950	1,241	1,193	1,241	1,193
11,950	12,000	1,247	1,198	1,247	1,198

(Continued)

* This column must also be used by a qualifying widow(er).

(Continued on page T-4)

2018 Tax Table — *Continued*

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
12,000					
12,000	12,050	1,253	1,203	1,253	1,203
12,050	12,100	1,259	1,208	1,259	1,208
12,100	12,150	1,265	1,213	1,265	1,213
12,150	12,200	1,271	1,218	1,271	1,218
12,200	12,250	1,277	1,223	1,277	1,223
12,250	12,300	1,283	1,228	1,283	1,228
12,300	12,350	1,289	1,233	1,289	1,233
12,350	12,400	1,295	1,238	1,295	1,238
12,400	12,450	1,301	1,243	1,301	1,243
12,450	12,500	1,307	1,248	1,307	1,248
12,500	12,550	1,313	1,253	1,313	1,253
12,550	12,600	1,319	1,258	1,319	1,258
12,600	12,650	1,325	1,263	1,325	1,263
12,650	12,700	1,331	1,268	1,331	1,268
12,700	12,750	1,337	1,273	1,337	1,273
12,750	12,800	1,343	1,278	1,343	1,278
12,800	12,850	1,349	1,283	1,349	1,283
12,850	12,900	1,355	1,288	1,355	1,288
12,900	12,950	1,361	1,293	1,361	1,293
12,950	13,000	1,367	1,298	1,367	1,298
13,000					
13,000	13,050	1,373	1,303	1,373	1,303
13,050	13,100	1,379	1,308	1,379	1,308
13,100	13,150	1,385	1,313	1,385	1,313
13,150	13,200	1,391	1,318	1,391	1,318
13,200	13,250	1,397	1,323	1,397	1,323
13,250	13,300	1,403	1,328	1,403	1,328
13,300	13,350	1,409	1,333	1,409	1,333
13,350	13,400	1,415	1,338	1,415	1,338
13,400	13,450	1,421	1,343	1,421	1,343
13,450	13,500	1,427	1,348	1,427	1,348
13,500	13,550	1,433	1,353	1,433	1,353
13,550	13,600	1,439	1,358	1,439	1,358
13,600	13,650	1,445	1,363	1,445	1,363
13,650	13,700	1,451	1,368	1,451	1,369
13,700	13,750	1,457	1,373	1,457	1,375
13,750	13,800	1,463	1,378	1,463	1,381
13,800	13,850	1,469	1,383	1,469	1,387
13,850	13,900	1,475	1,388	1,475	1,393
13,900	13,950	1,481	1,393	1,481	1,399
13,950	14,000	1,487	1,398	1,487	1,405
14,000					
14,000	14,050	1,493	1,403	1,493	1,411
14,050	14,100	1,499	1,408	1,499	1,417
14,100	14,150	1,505	1,413	1,505	1,423
14,150	14,200	1,511	1,418	1,511	1,429
14,200	14,250	1,517	1,423	1,517	1,435
14,250	14,300	1,523	1,428	1,523	1,441
14,300	14,350	1,529	1,433	1,529	1,447
14,350	14,400	1,535	1,438	1,535	1,453
14,400	14,450	1,541	1,443	1,541	1,459
14,450	14,500	1,547	1,448	1,547	1,465
14,500	14,550	1,553	1,453	1,553	1,471
14,550	14,600	1,559	1,458	1,559	1,477
14,600	14,650	1,565	1,463	1,565	1,483
14,650	14,700	1,571	1,468	1,571	1,489
14,700	14,750	1,577	1,473	1,577	1,495
14,750	14,800	1,583	1,478	1,583	1,501
14,800	14,850	1,589	1,483	1,589	1,507
14,850	14,900	1,595	1,488	1,595	1,513
14,900	14,950	1,601	1,493	1,601	1,519
14,950	15,000	1,607	1,498	1,607	1,525
15,000					
15,000	15,050	1,613	1,503	1,613	1,531
15,050	15,100	1,619	1,508	1,619	1,537
15,100	15,150	1,625	1,513	1,625	1,543
15,150	15,200	1,631	1,518	1,631	1,549
15,200	15,250	1,637	1,523	1,637	1,555
15,250	15,300	1,643	1,528	1,643	1,561
15,300	15,350	1,649	1,533	1,649	1,567
15,350	15,400	1,655	1,538	1,655	1,573
15,400	15,450	1,661	1,543	1,661	1,579
15,450	15,500	1,667	1,548	1,667	1,585
15,500	15,550	1,673	1,553	1,673	1,591
15,550	15,600	1,679	1,558	1,679	1,597
15,600	15,650	1,685	1,563	1,685	1,603
15,650	15,700	1,691	1,568	1,691	1,609
15,700	15,750	1,697	1,573	1,697	1,615
15,750	15,800	1,703	1,578	1,703	1,621
15,800	15,850	1,709	1,583	1,709	1,627
15,850	15,900	1,715	1,588	1,715	1,633
15,900	15,950	1,721	1,593	1,721	1,639
15,950	16,000	1,727	1,598	1,727	1,645
16,000					
16,000	16,050	1,733	1,603	1,733	1,651
16,050	16,100	1,739	1,608	1,739	1,657
16,100	16,150	1,745	1,613	1,745	1,663
16,150	16,200	1,751	1,618	1,751	1,669
16,200	16,250	1,757	1,623	1,757	1,675
16,250	16,300	1,763	1,628	1,763	1,681
16,300	16,350	1,769	1,633	1,769	1,687
16,350	16,400	1,775	1,638	1,775	1,693
16,400	16,450	1,781	1,643	1,781	1,699
16,450	16,500	1,787	1,648	1,787	1,705
16,500	16,550	1,793	1,653	1,793	1,711
16,550	16,600	1,799	1,658	1,799	1,717
16,600	16,650	1,805	1,663	1,805	1,723
16,650	16,700	1,811	1,668	1,811	1,729
16,700	16,750	1,817	1,673	1,817	1,735
16,750	16,800	1,823	1,678	1,823	1,741
16,800	16,850	1,829	1,683	1,829	1,747
16,850	16,900	1,835	1,688	1,835	1,753
16,900	16,950	1,841	1,693	1,841	1,759
16,950	17,000	1,847	1,698	1,847	1,765
17,000					
17,000	17,050	1,853	1,703	1,853	1,771
17,050	17,100	1,859	1,708	1,859	1,777
17,100	17,150	1,865	1,713	1,865	1,783
17,150	17,200	1,871	1,718	1,871	1,789
17,200	17,250	1,877	1,723	1,877	1,795
17,250	17,300	1,883	1,728	1,883	1,801
17,300	17,350	1,889	1,733	1,889	1,807
17,350	17,400	1,895	1,738	1,895	1,813
17,400	17,450	1,901	1,743	1,901	1,819
17,450	17,500	1,907	1,748	1,907	1,825
17,500	17,550	1,913	1,753	1,913	1,831
17,550	17,600	1,919	1,758	1,919	1,837
17,600	17,650	1,925	1,763	1,925	1,843
17,650	17,700	1,931	1,768	1,931	1,849
17,700	17,750	1,937	1,773	1,937	1,855
17,750	17,800	1,943	1,778	1,943	1,861
17,800	17,850	1,949	1,783	1,949	1,867
17,850	17,900	1,955	1,788	1,955	1,873
17,900	17,950	1,961	1,793	1,961	1,879
17,950	18,000	1,967	1,798	1,967	1,885
18,000					
18,000	18,050	1,973	1,803	1,973	1,891
18,050	18,100	1,979	1,808	1,979	1,897
18,100	18,150	1,985	1,813	1,985	1,903
18,150	18,200	1,991	1,818	1,991	1,909
18,200	18,250	1,997	1,823	1,997	1,915
18,250	18,300	2,003	1,828	2,003	1,921
18,300	18,350	2,009	1,833	2,009	1,927
18,350	18,400	2,015	1,838	2,015	1,933
18,400	18,450	2,021	1,843	2,021	1,939
18,450	18,500	2,027	1,848	2,027	1,945
18,500	18,550	2,033	1,853	2,033	1,951
18,550	18,600	2,039	1,858	2,039	1,957
18,600	18,650	2,045	1,863	2,045	1,963
18,650	18,700	2,051	1,868	2,051	1,969
18,700	18,750	2,057	1,873	2,057	1,975
18,750	18,800	2,063	1,878	2,063	1,981
18,800	18,850	2,069	1,883	2,069	1,987
18,850	18,900	2,075	1,888	2,075	1,993
18,900	18,950	2,081	1,893	2,081	1,999
18,950	19,000	2,087	1,898	2,087	2,005
19,000					
19,000	19,050	2,093	1,903	2,093	2,011
19,050	19,100	2,099	1,908	2,099	2,017
19,100	19,150	2,105	1,914	2,105	2,023
19,150	19,200	2,111	1,920	2,111	2,029
19,200	19,250	2,117	1,926	2,117	2,035
19,250	19,300	2,123	1,932	2,123	2,041
19,300	19,350	2,129	1,938	2,129	2,047
19,350	19,400	2,135	1,944	2,135	2,053
19,400	19,450	2,141	1,950	2,141	2,059
19,450	19,500	2,147	1,956	2,147	2,065
19,500	19,550	2,153	1,962	2,153	2,071
19,550	19,600	2,159	1,968	2,159	2,077
19,600	19,650	2,165	1,974	2,165	2,083
19,650	19,700	2,171	1,980	2,171	2,089
19,700	19,750	2,177	1,986	2,177	2,095
19,750	19,800	2,183	1,992	2,183	2,101
19,800	19,850	2,189	1,998	2,189	2,107
19,850	19,900	2,195	2,004	2,195	2,113
19,900	19,950	2,201	2,010	2,201	2,119
19,950	20,000	2,207	2,016	2,207	2,125
20,000					
20,000	20,050	2,213	2,022	2,213	2,131
20,050	20,100	2,219	2,028	2,219	2,137
20,100	20,150	2,225	2,034	2,225	2,143
20,150	20,200	2,231	2,040	2,231	2,149
20,200	20,250	2,237	2,046	2,237	2,155
20,250	20,300	2,243	2,052	2,243	2,161
20,300	20,350	2,249	2,058	2,249	2,167
20,350	20,400	2,255	2,064	2,255	2,173
20,400	20,450	2,261	2,070	2,261	2,179
20,450	20,500	2,267	2,076	2,267	2,185
20,500	20,550	2,273	2,082	2,273	2,191
20,550	20,600	2,279	2,088	2,279	2,197
20,600	20,650	2,285	2,094	2,285	2,203
20,650	20,700	2,291	2,100	2,291	2,209
20,700	20,750	2,297	2,106	2,297	2,215
20,750	20,800	2,303	2,112	2,303	2,221
20,800	20,850	2,309	2,118	2,309	2,227
20,850	20,900	2,315	2,124	2,315	2,233
20,900	20,950	2,321	2,130	2,321	2,239
20,950	21,000	2,327	2,136	2,327	2,245

(Continued)

* This column must also be used by a qualifying widow(er).

(Continued on page T-5)

2018 Tax Table — *Continued*

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
21,000					
21,000	21,050	2,333	2,142	2,333	2,251
21,050	21,100	2,339	2,148	2,339	2,257
21,100	21,150	2,345	2,154	2,345	2,263
21,150	21,200	2,351	2,160	2,351	2,269
21,200	21,250	2,357	2,166	2,357	2,275
21,250	21,300	2,363	2,172	2,363	2,281
21,300	21,350	2,369	2,178	2,369	2,287
21,350	21,400	2,375	2,184	2,375	2,293
21,400	21,450	2,381	2,190	2,381	2,299
21,450	21,500	2,387	2,196	2,387	2,305
21,500	21,550	2,393	2,202	2,393	2,311
21,550	21,600	2,399	2,208	2,399	2,317
21,600	21,650	2,405	2,214	2,405	2,323
21,650	21,700	2,411	2,220	2,411	2,329
21,700	21,750	2,417	2,226	2,417	2,335
21,750	21,800	2,423	2,232	2,423	2,341
21,800	21,850	2,429	2,238	2,429	2,347
21,850	21,900	2,435	2,244	2,435	2,353
21,900	21,950	2,441	2,250	2,441	2,359
21,950	22,000	2,447	2,256	2,447	2,365
22,000					
22,000	22,050	2,453	2,262	2,453	2,371
22,050	22,100	2,459	2,268	2,459	2,377
22,100	22,150	2,465	2,274	2,465	2,383
22,150	22,200	2,471	2,280	2,471	2,389
22,200	22,250	2,477	2,286	2,477	2,395
22,250	22,300	2,483	2,292	2,483	2,401
22,300	22,350	2,489	2,298	2,489	2,407
22,350	22,400	2,495	2,304	2,495	2,413
22,400	22,450	2,501	2,310	2,501	2,419
22,450	22,500	2,507	2,316	2,507	2,425
22,500	22,550	2,513	2,322	2,513	2,431
22,550	22,600	2,519	2,328	2,519	2,437
22,600	22,650	2,525	2,334	2,525	2,443
22,650	22,700	2,531	2,340	2,531	2,449
22,700	22,750	2,537	2,346	2,537	2,455
22,750	22,800	2,543	2,352	2,543	2,461
22,800	22,850	2,549	2,358	2,549	2,467
22,850	22,900	2,555	2,364	2,555	2,473
22,900	22,950	2,561	2,370	2,561	2,479
22,950	23,000	2,567	2,376	2,567	2,485
23,000					
23,000	23,050	2,573	2,382	2,573	2,491
23,050	23,100	2,579	2,388	2,579	2,497
23,100	23,150	2,585	2,394	2,585	2,503
23,150	23,200	2,591	2,400	2,591	2,509
23,200	23,250	2,597	2,406	2,597	2,515
23,250	23,300	2,603	2,412	2,603	2,521
23,300	23,350	2,609	2,418	2,609	2,527
23,350	23,400	2,615	2,424	2,615	2,533
23,400	23,450	2,621	2,430	2,621	2,539
23,450	23,500	2,627	2,436	2,627	2,545
23,500	23,550	2,633	2,442	2,633	2,551
23,550	23,600	2,639	2,448	2,639	2,557
23,600	23,650	2,645	2,454	2,645	2,563
23,650	23,700	2,651	2,460	2,651	2,569
23,700	23,750	2,657	2,466	2,657	2,575
23,750	23,800	2,663	2,472	2,663	2,581
23,800	23,850	2,669	2,478	2,669	2,587
23,850	23,900	2,675	2,484	2,675	2,593
23,900	23,950	2,681	2,490	2,681	2,599
23,950	24,000	2,687	2,496	2,687	2,605
24,000					
24,000	24,050	2,693	2,502	2,693	2,611
24,050	24,100	2,699	2,508	2,699	2,617
24,100	24,150	2,705	2,514	2,705	2,623
24,150	24,200	2,711	2,520	2,711	2,629
24,200	24,250	2,717	2,526	2,717	2,635
24,250	24,300	2,723	2,532	2,723	2,641
24,300	24,350	2,729	2,538	2,729	2,647
24,350	24,400	2,735	2,544	2,735	2,653
24,400	24,450	2,741	2,550	2,741	2,659
24,450	24,500	2,747	2,556	2,747	2,665
24,500	24,550	2,753	2,562	2,753	2,671
24,550	24,600	2,759	2,568	2,759	2,677
24,600	24,650	2,765	2,574	2,765	2,683
24,650	24,700	2,771	2,580	2,771	2,689
24,700	24,750	2,777	2,586	2,777	2,695
24,750	24,800	2,783	2,592	2,783	2,701
24,800	24,850	2,789	2,598	2,789	2,707
24,850	24,900	2,795	2,604	2,795	2,713
24,900	24,950	2,801	2,610	2,801	2,719
24,950	25,000	2,807	2,616	2,807	2,725
25,000					
25,000	25,050	2,813	2,622	2,813	2,731
25,050	25,100	2,819	2,628	2,819	2,737
25,100	25,150	2,825	2,634	2,825	2,743
25,150	25,200	2,831	2,640	2,831	2,749
25,200	25,250	2,837	2,646	2,837	2,755
25,250	25,300	2,843	2,652	2,843	2,761
25,300	25,350	2,849	2,658	2,849	2,767
25,350	25,400	2,855	2,664	2,855	2,773
25,400	25,450	2,861	2,670	2,861	2,779
25,450	25,500	2,867	2,676	2,867	2,785
25,500	25,550	2,873	2,682	2,873	2,791
25,550	25,600	2,879	2,688	2,879	2,797
25,600	25,650	2,885	2,694	2,885	2,803
25,650	25,700	2,891	2,700	2,891	2,809
25,700	25,750	2,897	2,706	2,897	2,815
25,750	25,800	2,903	2,712	2,903	2,821
25,800	25,850	2,909	2,718	2,909	2,827
25,850	25,900	2,915	2,724	2,915	2,833
25,900	25,950	2,921	2,730	2,921	2,839
25,950	26,000	2,927	2,736	2,927	2,845
26,000					
26,000	26,050	2,933	2,742	2,933	2,851
26,050	26,100	2,939	2,748	2,939	2,857
26,100	26,150	2,945	2,754	2,945	2,863
26,150	26,200	2,951	2,760	2,951	2,869
26,200	26,250	2,957	2,766	2,957	2,875
26,250	26,300	2,963	2,772	2,963	2,881
26,300	26,350	2,969	2,778	2,969	2,887
26,350	26,400	2,975	2,784	2,975	2,893
26,400	26,450	2,981	2,790	2,981	2,899
26,450	26,500	2,987	2,796	2,987	2,905
26,500	26,550	2,993	2,802	2,993	2,911
26,550	26,600	2,999	2,808	2,999	2,917
26,600	26,650	3,005	2,814	3,005	2,923
26,650	26,700	3,011	2,820	3,011	2,929
26,700	26,750	3,017	2,826	3,017	2,935
26,750	26,800	3,023	2,832	3,023	2,941
26,800	26,850	3,029	2,838	3,029	2,947
26,850	26,900	3,035	2,844	3,035	2,953
26,900	26,950	3,041	2,850	3,041	2,959
26,950	27,000	3,047	2,856	3,047	2,965
27,000					
27,000	27,050	3,053	2,862	3,053	2,971
27,050	27,100	3,059	2,868	3,059	2,977
27,100	27,150	3,065	2,874	3,065	2,983
27,150	27,200	3,071	2,880	3,071	2,989
27,200	27,250	3,077	2,886	3,077	2,995
27,250	27,300	3,083	2,892	3,083	3,001
27,300	27,350	3,089	2,898	3,089	3,007
27,350	27,400	3,095	2,904	3,095	3,013
27,400	27,450	3,101	2,910	3,101	3,019
27,450	27,500	3,107	2,916	3,107	3,025
27,500	27,550	3,113	2,922	3,113	3,031
27,550	27,600	3,119	2,928	3,119	3,037
27,600	27,650	3,125	2,934	3,125	3,043
27,650	27,700	3,131	2,940	3,131	3,049
27,700	27,750	3,137	2,946	3,137	3,055
27,750	27,800	3,143	2,952	3,143	3,061
27,800	27,850	3,149	2,958	3,149	3,067
27,850	27,900	3,155	2,964	3,155	3,073
27,900	27,950	3,161	2,970	3,161	3,079
27,950	28,000	3,167	2,976	3,167	3,085
28,000					
28,000	28,050	3,173	2,982	3,173	3,091
28,050	28,100	3,179	2,988	3,179	3,097
28,100	28,150	3,185	2,994	3,185	3,103
28,150	28,200	3,191	3,000	3,191	3,109
28,200	28,250	3,197	3,006	3,197	3,115
28,250	28,300	3,203	3,012	3,203	3,121
28,300	28,350	3,209	3,018	3,209	3,127
28,350	28,400	3,215	3,024	3,215	3,133
28,400	28,450	3,221	3,030	3,221	3,139
28,450	28,500	3,227	3,036	3,227	3,145
28,500	28,550	3,233	3,042	3,233	3,151
28,550	28,600	3,239	3,048	3,239	3,157
28,600	28,650	3,245	3,054	3,245	3,163
28,650	28,700	3,251	3,060	3,251	3,169
28,700	28,750	3,257	3,066	3,257	3,175
28,750	28,800	3,263	3,072	3,263	3,181
28,800	28,850	3,269	3,078	3,269	3,187
28,850	28,900	3,275	3,084	3,275	3,193
28,900	28,950	3,281	3,090	3,281	3,199
28,950	29,000	3,287	3,096	3,287	3,205
29,000					
29,000	29,050	3,293	3,102	3,293	3,211
29,050	29,100	3,299	3,108	3,299	3,217
29,100	29,150	3,305	3,114	3,305	3,223
29,150	29,200	3,311	3,120	3,311	3,229
29,200	29,250	3,317	3,126	3,317	3,235
29,250	29,300	3,323	3,132	3,323	3,241
29,300	29,350	3,329	3,138	3,329	3,247
29,350	29,400	3,335	3,144	3,335	3,253
29,400	29,450	3,341	3,150	3,341	3,259
29,450	29,500	3,347	3,156	3,347	3,265
29,500	29,550	3,353	3,162	3,353	3,271
29,550	29,600	3,359	3,168	3,359	3,277
29,600	29,650	3,365	3,174	3,365	3,283
29,650	29,700	3,371	3,180	3,371	3,289
29,700	29,750	3,377	3,186	3,377	3,295
29,750	29,800	3,383	3,192	3,383	3,301
29,800	29,850	3,389	3,198	3,389	3,307
29,850	29,900	3,395	3,204	3,395	3,313
29,900	29,950	3,401	3,210	3,401	3,319
29,950	30,000	3,407	3,216	3,407	3,325

(Continued)

* This column must also be used by a qualifying widow(er).

(Continued on page T-6)

2018 Tax Table — *Continued*

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
30,000					
30,000	30,050	3,413	3,222	3,413	3,331
30,050	30,100	3,419	3,228	3,419	3,337
30,100	30,150	3,425	3,234	3,425	3,343
30,150	30,200	3,431	3,240	3,431	3,349
30,200	30,250	3,437	3,246	3,437	3,355
30,250	30,300	3,443	3,252	3,443	3,361
30,300	30,350	3,449	3,258	3,449	3,367
30,350	30,400	3,455	3,264	3,455	3,373
30,400	30,450	3,461	3,270	3,461	3,379
30,450	30,500	3,467	3,276	3,467	3,385
30,500	30,550	3,473	3,282	3,473	3,391
30,550	30,600	3,479	3,288	3,479	3,397
30,600	30,650	3,485	3,294	3,485	3,403
30,650	30,700	3,491	3,300	3,491	3,409
30,700	30,750	3,497	3,306	3,497	3,415
30,750	30,800	3,503	3,312	3,503	3,421
30,800	30,850	3,509	3,318	3,509	3,427
30,850	30,900	3,515	3,324	3,515	3,433
30,900	30,950	3,521	3,330	3,521	3,439
30,950	31,000	3,527	3,336	3,527	3,445
31,000					
31,000	31,050	3,533	3,342	3,533	3,451
31,050	31,100	3,539	3,348	3,539	3,457
31,100	31,150	3,545	3,354	3,545	3,463
31,150	31,200	3,551	3,360	3,551	3,469
31,200	31,250	3,557	3,366	3,557	3,475
31,250	31,300	3,563	3,372	3,563	3,481
31,300	31,350	3,569	3,378	3,569	3,487
31,350	31,400	3,575	3,384	3,575	3,493
31,400	31,450	3,581	3,390	3,581	3,499
31,450	31,500	3,587	3,396	3,587	3,505
31,500	31,550	3,593	3,402	3,593	3,511
31,550	31,600	3,599	3,408	3,599	3,517
31,600	31,650	3,605	3,414	3,605	3,523
31,650	31,700	3,611	3,420	3,611	3,529
31,700	31,750	3,617	3,426	3,617	3,535
31,750	31,800	3,623	3,432	3,623	3,541
31,800	31,850	3,629	3,438	3,629	3,547
31,850	31,900	3,635	3,444	3,635	3,553
31,900	31,950	3,641	3,450	3,641	3,559
31,950	32,000	3,647	3,456	3,647	3,565
32,000					
32,000	32,050	3,653	3,462	3,653	3,571
32,050	32,100	3,659	3,468	3,659	3,577
32,100	32,150	3,665	3,474	3,665	3,583
32,150	32,200	3,671	3,480	3,671	3,589
32,200	32,250	3,677	3,486	3,677	3,595
32,250	32,300	3,683	3,492	3,683	3,601
32,300	32,350	3,689	3,498	3,689	3,607
32,350	32,400	3,695	3,504	3,695	3,613
32,400	32,450	3,701	3,510	3,701	3,619
32,450	32,500	3,707	3,516	3,707	3,625
32,500	32,550	3,713	3,522	3,713	3,631
32,550	32,600	3,719	3,528	3,719	3,637
32,600	32,650	3,725	3,534	3,725	3,643
32,650	32,700	3,731	3,540	3,731	3,649
32,700	32,750	3,737	3,546	3,737	3,655
32,750	32,800	3,743	3,552	3,743	3,661
32,800	32,850	3,749	3,558	3,749	3,667
32,850	32,900	3,755	3,564	3,755	3,673
32,900	32,950	3,761	3,570	3,761	3,679
32,950	33,000	3,767	3,576	3,767	3,685
33,000					
33,000	33,050	3,773	3,582	3,773	3,691
33,050	33,100	3,779	3,588	3,779	3,697
33,100	33,150	3,785	3,594	3,785	3,703
33,150	33,200	3,791	3,600	3,791	3,709
33,200	33,250	3,797	3,606	3,797	3,715
33,250	33,300	3,803	3,612	3,803	3,721
33,300	33,350	3,809	3,618	3,809	3,727
33,350	33,400	3,815	3,624	3,815	3,733
33,400	33,450	3,821	3,630	3,821	3,739
33,450	33,500	3,827	3,636	3,827	3,745
33,500	33,550	3,833	3,642	3,833	3,751
33,550	33,600	3,839	3,648	3,839	3,757
33,600	33,650	3,845	3,654	3,845	3,763
33,650	33,700	3,851	3,660	3,851	3,769
33,700	33,750	3,857	3,666	3,857	3,775
33,750	33,800	3,863	3,672	3,863	3,781
33,800	33,850	3,869	3,678	3,869	3,787
33,850	33,900	3,875	3,684	3,875	3,793
33,900	33,950	3,881	3,690	3,881	3,799
33,950	34,000	3,887	3,696	3,887	3,805
34,000					
34,000	34,050	3,893	3,702	3,893	3,811
34,050	34,100	3,899	3,708	3,899	3,817
34,100	34,150	3,905	3,714	3,905	3,823
34,150	34,200	3,911	3,720	3,911	3,829
34,200	34,250	3,917	3,726	3,917	3,835
34,250	34,300	3,923	3,732	3,923	3,841
34,300	34,350	3,929	3,738	3,929	3,847
34,350	34,400	3,935	3,744	3,935	3,853
34,400	34,450	3,941	3,750	3,941	3,859
34,450	34,500	3,947	3,756	3,947	3,865
34,500	34,550	3,953	3,762	3,953	3,871
34,550	34,600	3,959	3,768	3,959	3,877
34,600	34,650	3,965	3,774	3,965	3,883
34,650	34,700	3,971	3,780	3,971	3,889
34,700	34,750	3,977	3,786	3,977	3,895
34,750	34,800	3,983	3,792	3,983	3,901
34,800	34,850	3,989	3,798	3,989	3,907
34,850	34,900	3,995	3,804	3,995	3,913
34,900	34,950	4,001	3,810	4,001	3,919
34,950	35,000	4,007	3,816	4,007	3,925
35,000					
35,000	35,050	4,013	3,822	4,013	3,931
35,050	35,100	4,019	3,828	4,019	3,937
35,100	35,150	4,025	3,834	4,025	3,943
35,150	35,200	4,031	3,840	4,031	3,949
35,200	35,250	4,037	3,846	4,037	3,955
35,250	35,300	4,043	3,852	4,043	3,961
35,300	35,350	4,049	3,858	4,049	3,967
35,350	35,400	4,055	3,864	4,055	3,973
35,400	35,450	4,061	3,870	4,061	3,979
35,450	35,500	4,067	3,876	4,067	3,985
35,500	35,550	4,073	3,882	4,073	3,991
35,550	35,600	4,079	3,888	4,079	3,997
35,600	35,650	4,085	3,894	4,085	4,003
35,650	35,700	4,091	3,900	4,091	4,009
35,700	35,750	4,097	3,906	4,097	4,015
35,750	35,800	4,103	3,912	4,103	4,021
35,800	35,850	4,109	3,918	4,109	4,027
35,850	35,900	4,115	3,924	4,115	4,033
35,900	35,950	4,121	3,930	4,121	4,039
35,950	36,000	4,127	3,936	4,127	4,045
36,000					
36,000	36,050	4,133	3,942	4,133	4,051
36,050	36,100	4,139	3,948	4,139	4,057
36,100	36,150	4,145	3,954	4,145	4,063
36,150	36,200	4,151	3,960	4,151	4,069
36,200	36,250	4,157	3,966	4,157	4,075
36,250	36,300	4,163	3,972	4,163	4,081
36,300	36,350	4,169	3,978	4,169	4,087
36,350	36,400	4,175	3,984	4,175	4,093
36,400	36,450	4,181	3,990	4,181	4,099
36,450	36,500	4,187	3,996	4,187	4,105
36,500	36,550	4,193	4,002	4,193	4,111
36,550	36,600	4,199	4,008	4,199	4,117
36,600	36,650	4,205	4,014	4,205	4,123
36,650	36,700	4,211	4,020	4,211	4,129
36,700	36,750	4,217	4,026	4,217	4,135
36,750	36,800	4,223	4,032	4,223	4,141
36,800	36,850	4,229	4,038	4,229	4,147
36,850	36,900	4,235	4,044	4,235	4,153
36,900	36,950	4,241	4,050	4,241	4,159
36,950	37,000	4,247	4,056	4,247	4,165
37,000					
37,000	37,050	4,253	4,062	4,253	4,171
37,050	37,100	4,259	4,068	4,259	4,177
37,100	37,150	4,265	4,074	4,265	4,183
37,150	37,200	4,271	4,080	4,271	4,189
37,200	37,250	4,277	4,086	4,277	4,195
37,250	37,300	4,283	4,092	4,283	4,201
37,300	37,350	4,289	4,098	4,289	4,207
37,350	37,400	4,295	4,104	4,295	4,213
37,400	37,450	4,301	4,110	4,301	4,219
37,450	37,500	4,307	4,116	4,307	4,225
37,500	37,550	4,313	4,122	4,313	4,231
37,550	37,600	4,319	4,128	4,319	4,237
37,600	37,650	4,325	4,134	4,325	4,243
37,650	37,700	4,331	4,140	4,331	4,249
37,700	37,750	4,337	4,146	4,337	4,255
37,750	37,800	4,343	4,152	4,343	4,261
37,800	37,850	4,349	4,158	4,349	4,267
37,850	37,900	4,355	4,164	4,355	4,273
37,900	37,950	4,361	4,170	4,361	4,279
37,950	38,000	4,367	4,176	4,367	4,285
38,000					
38,000	38,050	4,373	4,182	4,373	4,291
38,050	38,100	4,379	4,188	4,379	4,297
38,100	38,150	4,385	4,194	4,385	4,303
38,150	38,200	4,391	4,200	4,391	4,309
38,200	38,250	4,397	4,206	4,397	4,315
38,250	38,300	4,403	4,212	4,403	4,321
38,300	38,350	4,409	4,218	4,409	4,327
38,350	38,400	4,415	4,224	4,415	4,333
38,400	38,450	4,421	4,230	4,421	4,339
38,450	38,500	4,427	4,236	4,427	4,345
38,500	38,550	4,433	4,242	4,433	4,351
38,550	38,600	4,439	4,248	4,439	4,357
38,600	38,650	4,445	4,254	4,445	4,363
38,650	38,700	4,451	4,260	4,451	4,369
38,700	38,750	4,459	4,266	4,459	4,375
38,750	38,800	4,470	4,272	4,470	4,381
38,800	38,850	4,481	4,278	4,481	4,387
38,850	38,900	4,492	4,284	4,492	4,393
38,900	38,950	4,503	4,290	4,503	4,399
38,950	39,000	4,514	4,296	4,514	4,405

(Continued)

* This column must also be used by a qualifying widow(er).

(Continued on page T-7)

2018 Tax Table — *Continued*

If line 10 (taxable income) is—		And you are—				If line 10 (taxable income) is—		And you are—				If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
39,000						**42,000**						**45,000**					
39,000	39,050	4,525	4,302	4,525	4,411	42,000	42,050	5,185	4,662	5,185	4,771	45,000	45,050	5,845	5,022	5,845	5,131
39,050	39,100	4,536	4,308	4,536	4,417	42,050	42,100	5,196	4,668	5,196	4,777	45,050	45,100	5,856	5,028	5,856	5,137
39,100	39,150	4,547	4,314	4,547	4,423	42,100	42,150	5,207	4,674	5,207	4,783	45,100	45,150	5,867	5,034	5,867	5,143
39,150	39,200	4,558	4,320	4,558	4,429	42,150	42,200	5,218	4,680	5,218	4,789	45,150	45,200	5,878	5,040	5,878	5,149
39,200	39,250	4,569	4,326	4,569	4,435	42,200	42,250	5,229	4,686	5,229	4,795	45,200	45,250	5,889	5,046	5,889	5,155
39,250	39,300	4,580	4,332	4,580	4,441	42,250	42,300	5,240	4,692	5,240	4,801	45,250	45,300	5,900	5,052	5,900	5,161
39,300	39,350	4,591	4,338	4,591	4,447	42,300	42,350	5,251	4,698	5,251	4,807	45,300	45,350	5,911	5,058	5,911	5,167
39,350	39,400	4,602	4,344	4,602	4,453	42,350	42,400	5,262	4,704	5,262	4,813	45,350	45,400	5,922	5,064	5,922	5,173
39,400	39,450	4,613	4,350	4,613	4,459	42,400	42,450	5,273	4,710	5,273	4,819	45,400	45,450	5,933	5,070	5,933	5,179
39,450	39,500	4,624	4,356	4,624	4,465	42,450	42,500	5,284	4,716	5,284	4,825	45,450	45,500	5,944	5,076	5,944	5,185
39,500	39,550	4,635	4,362	4,635	4,471	42,500	42,550	5,295	4,722	5,295	4,831	45,500	45,550	5,955	5,082	5,955	5,191
39,550	39,600	4,646	4,368	4,646	4,477	42,550	42,600	5,306	4,728	5,306	4,837	45,550	45,600	5,966	5,088	5,966	5,197
39,600	39,650	4,657	4,374	4,657	4,483	42,600	42,650	5,317	4,734	5,317	4,843	45,600	45,650	5,977	5,094	5,977	5,203
39,650	39,700	4,668	4,380	4,668	4,489	42,650	42,700	5,328	4,740	5,328	4,849	45,650	45,700	5,988	5,100	5,988	5,209
39,700	39,750	4,679	4,386	4,679	4,495	42,700	42,750	5,339	4,746	5,339	4,855	45,700	45,750	5,999	5,106	5,999	5,215
39,750	39,800	4,690	4,392	4,690	4,501	42,750	42,800	5,350	4,752	5,350	4,861	45,750	45,800	6,010	5,112	6,010	5,221
39,800	39,850	4,701	4,398	4,701	4,507	42,800	42,850	5,361	4,758	5,361	4,867	45,800	45,850	6,021	5,118	6,021	5,227
39,850	39,900	4,712	4,404	4,712	4,513	42,850	42,900	5,372	4,764	5,372	4,873	45,850	45,900	6,032	5,124	6,032	5,233
39,900	39,950	4,723	4,410	4,723	4,519	42,900	42,950	5,383	4,770	5,383	4,879	45,900	45,950	6,043	5,130	6,043	5,239
39,950	40,000	4,734	4,416	4,734	4,525	42,950	43,000	5,394	4,776	5,394	4,885	45,950	46,000	6,054	5,136	6,054	5,245
40,000						**43,000**						**46,000**					
40,000	40,050	4,745	4,422	4,745	4,531	43,000	43,050	5,405	4,782	5,405	4,891	46,000	46,050	6,065	5,142	6,065	5,251
40,050	40,100	4,756	4,428	4,756	4,537	43,050	43,100	5,416	4,788	5,416	4,897	46,050	46,100	6,076	5,148	6,076	5,257
40,100	40,150	4,767	4,434	4,767	4,543	43,100	43,150	5,427	4,794	5,427	4,903	46,100	46,150	6,087	5,154	6,087	5,263
40,150	40,200	4,778	4,440	4,778	4,549	43,150	43,200	5,438	4,800	5,438	4,909	46,150	46,200	6,098	5,160	6,098	5,269
40,200	40,250	4,789	4,446	4,789	4,555	43,200	43,250	5,449	4,806	5,449	4,915	46,200	46,250	6,109	5,166	6,109	5,275
40,250	40,300	4,800	4,452	4,800	4,561	43,250	43,300	5,460	4,812	5,460	4,921	46,250	46,300	6,120	5,172	6,120	5,281
40,300	40,350	4,811	4,458	4,811	4,567	43,300	43,350	5,471	4,818	5,471	4,927	46,300	46,350	6,131	5,178	6,131	5,287
40,350	40,400	4,822	4,464	4,822	4,573	43,350	43,400	5,482	4,824	5,482	4,933	46,350	46,400	6,142	5,184	6,142	5,293
40,400	40,450	4,833	4,470	4,833	4,579	43,400	43,450	5,493	4,830	5,493	4,939	46,400	46,450	6,153	5,190	6,153	5,299
40,450	40,500	4,844	4,476	4,844	4,585	43,450	43,500	5,504	4,836	5,504	4,945	46,450	46,500	6,164	5,196	6,164	5,305
40,500	40,550	4,855	4,482	4,855	4,591	43,500	43,550	5,515	4,842	5,515	4,951	46,500	46,550	6,175	5,202	6,175	5,311
40,550	40,600	4,866	4,488	4,866	4,597	43,550	43,600	5,526	4,848	5,526	4,957	46,550	46,600	6,186	5,208	6,186	5,317
40,600	40,650	4,877	4,494	4,877	4,603	43,600	43,650	5,537	4,854	5,537	4,963	46,600	46,650	6,197	5,214	6,197	5,323
40,650	40,700	4,888	4,500	4,888	4,609	43,650	43,700	5,548	4,860	5,548	4,969	46,650	46,700	6,208	5,220	6,208	5,329
40,700	40,750	4,899	4,506	4,899	4,615	43,700	43,750	5,559	4,866	5,559	4,975	46,700	46,750	6,219	5,226	6,219	5,335
40,750	40,800	4,910	4,512	4,910	4,621	43,750	43,800	5,570	4,872	5,570	4,981	46,750	46,800	6,230	5,232	6,230	5,341
40,800	40,850	4,921	4,518	4,921	4,627	43,800	43,850	5,581	4,878	5,581	4,987	46,800	46,850	6,241	5,238	6,241	5,347
40,850	40,900	4,932	4,524	4,932	4,633	43,850	43,900	5,592	4,884	5,592	4,993	46,850	46,900	6,252	5,244	6,252	5,353
40,900	40,950	4,943	4,530	4,943	4,639	43,900	43,950	5,603	4,890	5,603	4,999	46,900	46,950	6,263	5,250	6,263	5,359
40,950	41,000	4,954	4,536	4,954	4,645	43,950	44,000	5,614	4,896	5,614	5,005	46,950	47,000	6,274	5,256	6,274	5,365
41,000						**44,000**						**47,000**					
41,000	41,050	4,965	4,542	4,965	4,651	44,000	44,050	5,625	4,902	5,625	5,011	47,000	47,050	6,285	5,262	6,285	5,371
41,050	41,100	4,976	4,548	4,976	4,657	44,050	44,100	5,636	4,908	5,636	5,017	47,050	47,100	6,296	5,268	6,296	5,377
41,100	41,150	4,987	4,554	4,987	4,663	44,100	44,150	5,647	4,914	5,647	5,023	47,100	47,150	6,307	5,274	6,307	5,383
41,150	41,200	4,998	4,560	4,998	4,669	44,150	44,200	5,658	4,920	5,658	5,029	47,150	47,200	6,318	5,280	6,318	5,389
41,200	41,250	5,009	4,566	5,009	4,675	44,200	44,250	5,669	4,926	5,669	5,035	47,200	47,250	6,329	5,286	6,329	5,395
41,250	41,300	5,020	4,572	5,020	4,681	44,250	44,300	5,680	4,932	5,680	5,041	47,250	47,300	6,340	5,292	6,340	5,401
41,300	41,350	5,031	4,578	5,031	4,687	44,300	44,350	5,691	4,938	5,691	5,047	47,300	47,350	6,351	5,298	6,351	5,407
41,350	41,400	5,042	4,584	5,042	4,693	44,350	44,400	5,702	4,944	5,702	5,053	47,350	47,400	6,362	5,304	6,362	5,413
41,400	41,450	5,053	4,590	5,053	4,699	44,400	44,450	5,713	4,950	5,713	5,059	47,400	47,450	6,373	5,310	6,373	5,419
41,450	41,500	5,064	4,596	5,064	4,705	44,450	44,500	5,724	4,956	5,724	5,065	47,450	47,500	6,384	5,316	6,384	5,425
41,500	41,550	5,075	4,602	5,075	4,711	44,500	44,550	5,735	4,962	5,735	5,071	47,500	47,550	6,395	5,322	6,395	5,431
41,550	41,600	5,086	4,608	5,086	4,717	44,550	44,600	5,746	4,968	5,746	5,077	47,550	47,600	6,406	5,328	6,406	5,437
41,600	41,650	5,097	4,614	5,097	4,723	44,600	44,650	5,757	4,974	5,757	5,083	47,600	47,650	6,417	5,334	6,417	5,443
41,650	41,700	5,108	4,620	5,108	4,729	44,650	44,700	5,768	4,980	5,768	5,089	47,650	47,700	6,428	5,340	6,428	5,449
41,700	41,750	5,119	4,626	5,119	4,735	44,700	44,750	5,779	4,986	5,779	5,095	47,700	47,750	6,439	5,346	6,439	5,455
41,750	41,800	5,130	4,632	5,130	4,741	44,750	44,800	5,790	4,992	5,790	5,101	47,750	47,800	6,450	5,352	6,450	5,461
41,800	41,850	5,141	4,638	5,141	4,747	44,800	44,850	5,801	4,998	5,801	5,107	47,800	47,850	6,461	5,358	6,461	5,467
41,850	41,900	5,152	4,644	5,152	4,753	44,850	44,900	5,812	5,004	5,812	5,113	47,850	47,900	6,472	5,364	6,472	5,473
41,900	41,950	5,163	4,650	5,163	4,759	44,900	44,950	5,823	5,010	5,823	5,119	47,900	47,950	6,483	5,370	6,483	5,479
41,950	42,000	5,174	4,656	5,174	4,765	44,950	45,000	5,834	5,016	5,834	5,125	47,950	48,000	6,494	5,376	6,494	5,485

(Continued)

* This column must also be used by a qualifying widow(er).

(Continued on page T-8)

2018 Tax Table — *Continued*

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
48,000					
48,000	48,050	6,505	5,382	6,505	5,491
48,050	48,100	6,516	5,388	6,516	5,497
48,100	48,150	6,527	5,394	6,527	5,503
48,150	48,200	6,538	5,400	6,538	5,509
48,200	48,250	6,549	5,406	6,549	5,515
48,250	48,300	6,560	5,412	6,560	5,521
48,300	48,350	6,571	5,418	6,571	5,527
48,350	48,400	6,582	5,424	6,582	5,533
48,400	48,450	6,593	5,430	6,593	5,539
48,450	48,500	6,604	5,436	6,604	5,545
48,500	48,550	6,615	5,442	6,615	5,551
48,550	48,600	6,626	5,448	6,626	5,557
48,600	48,650	6,637	5,454	6,637	5,563
48,650	48,700	6,648	5,460	6,648	5,569
48,700	48,750	6,659	5,466	6,659	5,575
48,750	48,800	6,670	5,472	6,670	5,581
48,800	48,850	6,681	5,478	6,681	5,587
48,850	48,900	6,692	5,484	6,692	5,593
48,900	48,950	6,703	5,490	6,703	5,599
48,950	49,000	6,714	5,496	6,714	5,605
49,000					
49,000	49,050	6,725	5,502	6,725	5,611
49,050	49,100	6,736	5,508	6,736	5,617
49,100	49,150	6,747	5,514	6,747	5,623
49,150	49,200	6,758	5,520	6,758	5,629
49,200	49,250	6,769	5,526	6,769	5,635
49,250	49,300	6,780	5,532	6,780	5,641
49,300	49,350	6,791	5,538	6,791	5,647
49,350	49,400	6,802	5,544	6,802	5,653
49,400	49,450	6,813	5,550	6,813	5,659
49,450	49,500	6,824	5,556	6,824	5,665
49,500	49,550	6,835	5,562	6,835	5,671
49,550	49,600	6,846	5,568	6,846	5,677
49,600	49,650	6,857	5,574	6,857	5,683
49,650	49,700	6,868	5,580	6,868	5,689
49,700	49,750	6,879	5,586	6,879	5,695
49,750	49,800	6,890	5,592	6,890	5,701
49,800	49,850	6,901	5,598	6,901	5,707
49,850	49,900	6,912	5,604	6,912	5,713
49,900	49,950	6,923	5,610	6,923	5,719
49,950	50,000	6,934	5,616	6,934	5,725
50,000					
50,000	50,050	6,945	5,622	6,945	5,731
50,050	50,100	6,956	5,628	6,956	5,737
50,100	50,150	6,967	5,634	6,967	5,743
50,150	50,200	6,978	5,640	6,978	5,749
50,200	50,250	6,989	5,646	6,989	5,755
50,250	50,300	7,000	5,652	7,000	5,761
50,300	50,350	7,011	5,658	7,011	5,767
50,350	50,400	7,022	5,664	7,022	5,773
50,400	50,450	7,033	5,670	7,033	5,779
50,450	50,500	7,044	5,676	7,044	5,785
50,500	50,550	7,055	5,682	7,055	5,791
50,550	50,600	7,066	5,688	7,066	5,797
50,600	50,650	7,077	5,694	7,077	5,803
50,650	50,700	7,088	5,700	7,088	5,809
50,700	50,750	7,099	5,706	7,099	5,815
50,750	50,800	7,110	5,712	7,110	5,821
50,800	50,850	7,121	5,718	7,121	5,827
50,850	50,900	7,132	5,724	7,132	5,833
50,900	50,950	7,143	5,730	7,143	5,839
50,950	51,000	7,154	5,736	7,154	5,845
51,000					
51,000	51,050	7,165	5,742	7,165	5,851
51,050	51,100	7,176	5,748	7,176	5,857
51,100	51,150	7,187	5,754	7,187	5,863
51,150	51,200	7,198	5,760	7,198	5,869
51,200	51,250	7,209	5,766	7,209	5,875
51,250	51,300	7,220	5,772	7,220	5,881
51,300	51,350	7,231	5,778	7,231	5,887
51,350	51,400	7,242	5,784	7,242	5,893
51,400	51,450	7,253	5,790	7,253	5,899
51,450	51,500	7,264	5,796	7,264	5,905
51,500	51,550	7,275	5,802	7,275	5,911
51,550	51,600	7,286	5,808	7,286	5,917
51,600	51,650	7,297	5,814	7,297	5,923
51,650	51,700	7,308	5,820	7,308	5,929
51,700	51,750	7,319	5,826	7,319	5,935
51,750	51,800	7,330	5,832	7,330	5,941
51,800	51,850	7,341	5,838	7,341	5,950
51,850	51,900	7,352	5,844	7,352	5,961
51,900	51,950	7,363	5,850	7,363	5,972
51,950	52,000	7,374	5,856	7,374	5,983
52,000					
52,000	52,050	7,385	5,862	7,385	5,994
52,050	52,100	7,396	5,868	7,396	6,005
52,100	52,150	7,407	5,874	7,407	6,016
52,150	52,200	7,418	5,880	7,418	6,027
52,200	52,250	7,429	5,886	7,429	6,038
52,250	52,300	7,440	5,892	7,440	6,049
52,300	52,350	7,451	5,898	7,451	6,060
52,350	52,400	7,462	5,904	7,462	6,071
52,400	52,450	7,473	5,910	7,473	6,082
52,450	52,500	7,484	5,916	7,484	6,093
52,500	52,550	7,495	5,922	7,495	6,104
52,550	52,600	7,506	5,928	7,506	6,115
52,600	52,650	7,517	5,934	7,517	6,126
52,650	52,700	7,528	5,940	7,528	6,137
52,700	52,750	7,539	5,946	7,539	6,148
52,750	52,800	7,550	5,952	7,550	6,159
52,800	52,850	7,561	5,958	7,561	6,170
52,850	52,900	7,572	5,964	7,572	6,181
52,900	52,950	7,583	5,970	7,583	6,192
52,950	53,000	7,594	5,976	7,594	6,203
53,000					
53,000	53,050	7,605	5,982	7,605	6,214
53,050	53,100	7,616	5,988	7,616	6,225
53,100	53,150	7,627	5,994	7,627	6,236
53,150	53,200	7,638	6,000	7,638	6,247
53,200	53,250	7,649	6,006	7,649	6,258
53,250	53,300	7,660	6,012	7,660	6,269
53,300	53,350	7,671	6,018	7,671	6,280
53,350	53,400	7,682	6,024	7,682	6,291
53,400	53,450	7,693	6,030	7,693	6,302
53,450	53,500	7,704	6,036	7,704	6,313
53,500	53,550	7,715	6,042	7,715	6,324
53,550	53,600	7,726	6,048	7,726	6,335
53,600	53,650	7,737	6,054	7,737	6,346
53,650	53,700	7,748	6,060	7,748	6,357
53,700	53,750	7,759	6,066	7,759	6,368
53,750	53,800	7,770	6,072	7,770	6,379
53,800	53,850	7,781	6,078	7,781	6,390
53,850	53,900	7,792	6,084	7,792	6,401
53,900	53,950	7,803	6,090	7,803	6,412
53,950	54,000	7,814	6,096	7,814	6,423
54,000					
54,000	54,050	7,825	6,102	7,825	6,434
54,050	54,100	7,836	6,108	7,836	6,445
54,100	54,150	7,847	6,114	7,847	6,456
54,150	54,200	7,858	6,120	7,858	6,467
54,200	54,250	7,869	6,126	7,869	6,478
54,250	54,300	7,880	6,132	7,880	6,489
54,300	54,350	7,891	6,138	7,891	6,500
54,350	54,400	7,902	6,144	7,902	6,511
54,400	54,450	7,913	6,150	7,913	6,522
54,450	54,500	7,924	6,156	7,924	6,533
54,500	54,550	7,935	6,162	7,935	6,544
54,550	54,600	7,946	6,168	7,946	6,555
54,600	54,650	7,957	6,174	7,957	6,566
54,650	54,700	7,968	6,180	7,968	6,577
54,700	54,750	7,979	6,186	7,979	6,588
54,750	54,800	7,990	6,192	7,990	6,599
54,800	54,850	8,001	6,198	8,001	6,610
54,850	54,900	8,012	6,204	8,012	6,621
54,900	54,950	8,023	6,210	8,023	6,632
54,950	55,000	8,034	6,216	8,034	6,643
55,000					
55,000	55,050	8,045	6,222	8,045	6,654
55,050	55,100	8,056	6,228	8,056	6,665
55,100	55,150	8,067	6,234	8,067	6,676
55,150	55,200	8,078	6,240	8,078	6,687
55,200	55,250	8,089	6,246	8,089	6,698
55,250	55,300	8,100	6,252	8,100	6,709
55,300	55,350	8,111	6,258	8,111	6,720
55,350	55,400	8,122	6,264	8,122	6,731
55,400	55,450	8,133	6,270	8,133	6,742
55,450	55,500	8,144	6,276	8,144	6,753
55,500	55,550	8,155	6,282	8,155	6,764
55,550	55,600	8,166	6,288	8,166	6,775
55,600	55,650	8,177	6,294	8,177	6,786
55,650	55,700	8,188	6,300	8,188	6,797
55,700	55,750	8,199	6,306	8,199	6,808
55,750	55,800	8,210	6,312	8,210	6,819
55,800	55,850	8,221	6,318	8,221	6,830
55,850	55,900	8,232	6,324	8,232	6,841
55,900	55,950	8,243	6,330	8,243	6,852
55,950	56,000	8,254	6,336	8,254	6,863
56,000					
56,000	56,050	8,265	6,342	8,265	6,874
56,050	56,100	8,276	6,348	8,276	6,885
56,100	56,150	8,287	6,354	8,287	6,896
56,150	56,200	8,298	6,360	8,298	6,907
56,200	56,250	8,309	6,366	8,309	6,918
56,250	56,300	8,320	6,372	8,320	6,929
56,300	56,350	8,331	6,378	8,331	6,940
56,350	56,400	8,342	6,384	8,342	6,951
56,400	56,450	8,353	6,390	8,353	6,962
56,450	56,500	8,364	6,396	8,364	6,973
56,500	56,550	8,375	6,402	8,375	6,984
56,550	56,600	8,386	6,408	8,386	6,995
56,600	56,650	8,397	6,414	8,397	7,006
56,650	56,700	8,408	6,420	8,408	7,017
56,700	56,750	8,419	6,426	8,419	7,028
56,750	56,800	8,430	6,432	8,430	7,039
56,800	56,850	8,441	6,438	8,441	7,050
56,850	56,900	8,452	6,444	8,452	7,061
56,900	56,950	8,463	6,450	8,463	7,072
56,950	57,000	8,474	6,456	8,474	7,083

(Continued)

* This column must also be used by a qualifying widow(er).

(Continued on page T-9)

2018 Tax Table — *Continued*

If line 10 (taxable income) is—		And you are—				If line 10 (taxable income) is—		And you are—				If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
57,000						**60,000**						**63,000**					
57,000	57,050	8,485	6,462	8,485	7,094	60,000	60,050	9,145	6,822	9,145	7,754	63,000	63,050	9,805	7,182	9,805	8,414
57,050	57,100	8,496	6,468	8,496	7,105	60,050	60,100	9,156	6,828	9,156	7,765	63,050	63,100	9,816	7,188	9,816	8,425
57,100	57,150	8,507	6,474	8,507	7,116	60,100	60,150	9,167	6,834	9,167	7,776	63,100	63,150	9,827	7,194	9,827	8,436
57,150	57,200	8,518	6,480	8,518	7,127	60,150	60,200	9,178	6,840	9,178	7,787	63,150	63,200	9,838	7,200	9,838	8,447
57,200	57,250	8,529	6,486	8,529	7,138	60,200	60,250	9,189	6,846	9,189	7,798	63,200	63,250	9,849	7,206	9,849	8,458
57,250	57,300	8,540	6,492	8,540	7,149	60,250	60,300	9,200	6,852	9,200	7,809	63,250	63,300	9,860	7,212	9,860	8,469
57,300	57,350	8,551	6,498	8,551	7,160	60,300	60,350	9,211	6,858	9,211	7,820	63,300	63,350	9,871	7,218	9,871	8,480
57,350	57,400	8,562	6,504	8,562	7,171	60,350	60,400	9,222	6,864	9,222	7,831	63,350	63,400	9,882	7,224	9,882	8,491
57,400	57,450	8,573	6,510	8,573	7,182	60,400	60,450	9,233	6,870	9,233	7,842	63,400	63,450	9,893	7,230	9,893	8,502
57,450	57,500	8,584	6,516	8,584	7,193	60,450	60,500	9,244	6,876	9,244	7,853	63,450	63,500	9,904	7,236	9,904	8,513
57,500	57,550	8,595	6,522	8,595	7,204	60,500	60,550	9,255	6,882	9,255	7,864	63,500	63,550	9,915	7,242	9,915	8,524
57,550	57,600	8,606	6,528	8,606	7,215	60,550	60,600	9,266	6,888	9,266	7,875	63,550	63,600	9,926	7,248	9,926	8,535
57,600	57,650	8,617	6,534	8,617	7,226	60,600	60,650	9,277	6,894	9,277	7,886	63,600	63,650	9,937	7,254	9,937	8,546
57,650	57,700	8,628	6,540	8,628	7,237	60,650	60,700	9,288	6,900	9,288	7,897	63,650	63,700	9,948	7,260	9,948	8,557
57,700	57,750	8,639	6,546	8,639	7,248	60,700	60,750	9,299	6,906	9,299	7,908	63,700	63,750	9,959	7,266	9,959	8,568
57,750	57,800	8,650	6,552	8,650	7,259	60,750	60,800	9,310	6,912	9,310	7,919	63,750	63,800	9,970	7,272	9,970	8,579
57,800	57,850	8,661	6,558	8,661	7,270	60,800	60,850	9,321	6,918	9,321	7,930	63,800	63,850	9,981	7,278	9,981	8,590
57,850	57,900	8,672	6,564	8,672	7,281	60,850	60,900	9,332	6,924	9,332	7,941	63,850	63,900	9,992	7,284	9,992	8,601
57,900	57,950	8,683	6,570	8,683	7,292	60,900	60,950	9,343	6,930	9,343	7,952	63,900	63,950	10,003	7,290	10,003	8,612
57,950	58,000	8,694	6,576	8,694	7,303	60,950	61,000	9,354	6,936	9,354	7,963	63,950	64,000	10,014	7,296	10,014	8,623
58,000						**61,000**						**64,000**					
58,000	58,050	8,705	6,582	8,705	7,314	61,000	61,050	9,365	6,942	9,365	7,974	64,000	64,050	10,025	7,302	10,025	8,634
58,050	58,100	8,716	6,588	8,716	7,325	61,050	61,100	9,376	6,948	9,376	7,985	64,050	64,100	10,036	7,308	10,036	8,645
58,100	58,150	8,727	6,594	8,727	7,336	61,100	61,150	9,387	6,954	9,387	7,996	64,100	64,150	10,047	7,314	10,047	8,656
58,150	58,200	8,738	6,600	8,738	7,347	61,150	61,200	9,398	6,960	9,398	8,007	64,150	64,200	10,058	7,320	10,058	8,667
58,200	58,250	8,749	6,606	8,749	7,358	61,200	61,250	9,409	6,966	9,409	8,018	64,200	64,250	10,069	7,326	10,069	8,678
58,250	58,300	8,760	6,612	8,760	7,369	61,250	61,300	9,420	6,972	9,420	8,029	64,250	64,300	10,080	7,332	10,080	8,689
58,300	58,350	8,771	6,618	8,771	7,380	61,300	61,350	9,431	6,978	9,431	8,040	64,300	64,350	10,091	7,338	10,091	8,700
58,350	58,400	8,782	6,624	8,782	7,391	61,350	61,400	9,442	6,984	9,442	8,051	64,350	64,400	10,102	7,344	10,102	8,711
58,400	58,450	8,793	6,630	8,793	7,402	61,400	61,450	9,453	6,990	9,453	8,062	64,400	64,450	10,113	7,350	10,113	8,722
58,450	58,500	8,804	6,636	8,804	7,413	61,450	61,500	9,464	6,996	9,464	8,073	64,450	64,500	10,124	7,356	10,124	8,733
58,500	58,550	8,815	6,642	8,815	7,424	61,500	61,550	9,475	7,002	9,475	8,084	64,500	64,550	10,135	7,362	10,135	8,744
58,550	58,600	8,826	6,648	8,826	7,435	61,550	61,600	9,486	7,008	9,486	8,095	64,550	64,600	10,146	7,368	10,146	8,755
58,600	58,650	8,837	6,654	8,837	7,446	61,600	61,650	9,497	7,014	9,497	8,106	64,600	64,650	10,157	7,374	10,157	8,766
58,650	58,700	8,848	6,660	8,848	7,457	61,650	61,700	9,508	7,020	9,508	8,117	64,650	64,700	10,168	7,380	10,168	8,777
58,700	58,750	8,859	6,666	8,859	7,468	61,700	61,750	9,519	7,026	9,519	8,128	64,700	64,750	10,179	7,386	10,179	8,788
58,750	58,800	8,870	6,672	8,870	7,479	61,750	61,800	9,530	7,032	9,530	8,139	64,750	64,800	10,190	7,392	10,190	8,799
58,800	58,850	8,881	6,678	8,881	7,490	61,800	61,850	9,541	7,038	9,541	8,150	64,800	64,850	10,201	7,398	10,201	8,810
58,850	58,900	8,892	6,684	8,892	7,501	61,850	61,900	9,552	7,044	9,552	8,161	64,850	64,900	10,212	7,404	10,212	8,821
58,900	58,950	8,903	6,690	8,903	7,512	61,900	61,950	9,563	7,050	9,563	8,172	64,900	64,950	10,223	7,410	10,223	8,832
58,950	59,000	8,914	6,696	8,914	7,523	61,950	62,000	9,574	7,056	9,574	8,183	64,950	65,000	10,234	7,416	10,234	8,843
59,000						**62,000**						**65,000**					
59,000	59,050	8,925	6,702	8,925	7,534	62,000	62,050	9,585	7,062	9,585	8,194	65,000	65,050	10,245	7,422	10,245	8,854
59,050	59,100	8,936	6,708	8,936	7,545	62,050	62,100	9,596	7,068	9,596	8,205	65,050	65,100	10,256	7,428	10,256	8,865
59,100	59,150	8,947	6,714	8,947	7,556	62,100	62,150	9,607	7,074	9,607	8,216	65,100	65,150	10,267	7,434	10,267	8,876
59,150	59,200	8,958	6,720	8,958	7,567	62,150	62,200	9,618	7,080	9,618	8,227	65,150	65,200	10,278	7,440	10,278	8,887
59,200	59,250	8,969	6,726	8,969	7,578	62,200	62,250	9,629	7,086	9,629	8,238	65,200	65,250	10,289	7,446	10,289	8,898
59,250	59,300	8,980	6,732	8,980	7,589	62,250	62,300	9,640	7,092	9,640	8,249	65,250	65,300	10,300	7,452	10,300	8,909
59,300	59,350	8,991	6,738	8,991	7,600	62,300	62,350	9,651	7,098	9,651	8,260	65,300	65,350	10,311	7,458	10,311	8,920
59,350	59,400	9,002	6,744	9,002	7,611	62,350	62,400	9,662	7,104	9,662	8,271	65,350	65,400	10,322	7,464	10,322	8,931
59,400	59,450	9,013	6,750	9,013	7,622	62,400	62,450	9,673	7,110	9,673	8,282	65,400	65,450	10,333	7,470	10,333	8,942
59,450	59,500	9,024	6,756	9,024	7,633	62,450	62,500	9,684	7,116	9,684	8,293	65,450	65,500	10,344	7,476	10,344	8,953
59,500	59,550	9,035	6,762	9,035	7,644	62,500	62,550	9,695	7,122	9,695	8,304	65,500	65,550	10,355	7,482	10,355	8,964
59,550	59,600	9,046	6,768	9,046	7,655	62,550	62,600	9,706	7,128	9,706	8,315	65,550	65,600	10,366	7,488	10,366	8,975
59,600	59,650	9,057	6,774	9,057	7,666	62,600	62,650	9,717	7,134	9,717	8,326	65,600	65,650	10,377	7,494	10,377	8,986
59,650	59,700	9,068	6,780	9,068	7,677	62,650	62,700	9,728	7,140	9,728	8,337	65,650	65,700	10,388	7,500	10,388	8,997
59,700	59,750	9,079	6,786	9,079	7,688	62,700	62,750	9,739	7,146	9,739	8,348	65,700	65,750	10,399	7,506	10,399	9,008
59,750	59,800	9,090	6,792	9,090	7,699	62,750	62,800	9,750	7,152	9,750	8,359	65,750	65,800	10,410	7,512	10,410	9,019
59,800	59,850	9,101	6,798	9,101	7,710	62,800	62,850	9,761	7,158	9,761	8,370	65,800	65,850	10,421	7,518	10,421	9,030
59,850	59,900	9,112	6,804	9,112	7,721	62,850	62,900	9,772	7,164	9,772	8,381	65,850	65,900	10,432	7,524	10,432	9,041
59,900	59,950	9,123	6,810	9,123	7,732	62,900	62,950	9,783	7,170	9,783	8,392	65,900	65,950	10,443	7,530	10,443	9,052
59,950	60,000	9,134	6,816	9,134	7,743	62,950	63,000	9,794	7,176	9,794	8,403	65,950	66,000	10,454	7,536	10,454	9,063

(Continued)

* This column must also be used by a qualifying widow(er).

(Continued on page T-10)

2018 Tax Table — *Continued*

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
66,000					
66,000	66,050	10,465	7,542	10,465	9,074
66,050	66,100	10,476	7,548	10,476	9,085
66,100	66,150	10,487	7,554	10,487	9,096
66,150	66,200	10,498	7,560	10,498	9,107
66,200	66,250	10,509	7,566	10,509	9,118
66,250	66,300	10,520	7,572	10,520	9,129
66,300	66,350	10,531	7,578	10,531	9,140
66,350	66,400	10,542	7,584	10,542	9,151
66,400	66,450	10,553	7,590	10,553	9,162
66,450	66,500	10,564	7,596	10,564	9,173
66,500	66,550	10,575	7,602	10,575	9,184
66,550	66,600	10,586	7,608	10,586	9,195
66,600	66,650	10,597	7,614	10,597	9,206
66,650	66,700	10,608	7,620	10,608	9,217
66,700	66,750	10,619	7,626	10,619	9,228
66,750	66,800	10,630	7,632	10,630	9,239
66,800	66,850	10,641	7,638	10,641	9,250
66,850	66,900	10,652	7,644	10,652	9,261
66,900	66,950	10,663	7,650	10,663	9,272
66,950	67,000	10,674	7,656	10,674	9,283
67,000					
67,000	67,050	10,685	7,662	10,685	9,294
67,050	67,100	10,696	7,668	10,696	9,305
67,100	67,150	10,707	7,674	10,707	9,316
67,150	67,200	10,718	7,680	10,718	9,327
67,200	67,250	10,729	7,686	10,729	9,338
67,250	67,300	10,740	7,692	10,740	9,349
67,300	67,350	10,751	7,698	10,751	9,360
67,350	67,400	10,762	7,704	10,762	9,371
67,400	67,450	10,773	7,710	10,773	9,382
67,450	67,500	10,784	7,716	10,784	9,393
67,500	67,550	10,795	7,722	10,795	9,404
67,550	67,600	10,806	7,728	10,806	9,415
67,600	67,650	10,817	7,734	10,817	9,426
67,650	67,700	10,828	7,740	10,828	9,437
67,700	67,750	10,839	7,746	10,839	9,448
67,750	67,800	10,850	7,752	10,850	9,459
67,800	67,850	10,861	7,758	10,861	9,470
67,850	67,900	10,872	7,764	10,872	9,481
67,900	67,950	10,883	7,770	10,883	9,492
67,950	68,000	10,894	7,776	10,894	9,503
68,000					
68,000	68,050	10,905	7,782	10,905	9,514
68,050	68,100	10,916	7,788	10,916	9,525
68,100	68,150	10,927	7,794	10,927	9,536
68,150	68,200	10,938	7,800	10,938	9,547
68,200	68,250	10,949	7,806	10,949	9,558
68,250	68,300	10,960	7,812	10,960	9,569
68,300	68,350	10,971	7,818	10,971	9,580
68,350	68,400	10,982	7,824	10,982	9,591
68,400	68,450	10,993	7,830	10,993	9,602
68,450	68,500	11,004	7,836	11,004	9,613
68,500	68,550	11,015	7,842	11,015	9,624
68,550	68,600	11,026	7,848	11,026	9,635
68,600	68,650	11,037	7,854	11,037	9,646
68,650	68,700	11,048	7,860	11,048	9,657
68,700	68,750	11,059	7,866	11,059	9,668
68,750	68,800	11,070	7,872	11,070	9,679
68,800	68,850	11,081	7,878	11,081	9,690
68,850	68,900	11,092	7,884	11,092	9,701
68,900	68,950	11,103	7,890	11,103	9,712
68,950	69,000	11,114	7,896	11,114	9,723

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
69,000					
69,000	69,050	11,125	7,902	11,125	9,734
69,050	69,100	11,136	7,908	11,136	9,745
69,100	69,150	11,147	7,914	11,147	9,756
69,150	69,200	11,158	7,920	11,158	9,767
69,200	69,250	11,169	7,926	11,169	9,778
69,250	69,300	11,180	7,932	11,180	9,789
69,300	69,350	11,191	7,938	11,191	9,800
69,350	69,400	11,202	7,944	11,202	9,811
69,400	69,450	11,213	7,950	11,213	9,822
69,450	69,500	11,224	7,956	11,224	9,833
69,500	69,550	11,235	7,962	11,235	9,844
69,550	69,600	11,246	7,968	11,246	9,855
69,600	69,650	11,257	7,974	11,257	9,866
69,650	69,700	11,268	7,980	11,268	9,877
69,700	69,750	11,279	7,986	11,279	9,888
69,750	69,800	11,290	7,992	11,290	9,899
69,800	69,850	11,301	7,998	11,301	9,910
69,850	69,900	11,312	8,004	11,312	9,921
69,900	69,950	11,323	8,010	11,323	9,932
69,950	70,000	11,334	8,016	11,334	9,943
70,000					
70,000	70,050	11,345	8,022	11,345	9,954
70,050	70,100	11,356	8,028	11,356	9,965
70,100	70,150	11,367	8,034	11,367	9,976
70,150	70,200	11,378	8,040	11,378	9,987
70,200	70,250	11,389	8,046	11,389	9,998
70,250	70,300	11,400	8,052	11,400	10,009
70,300	70,350	11,411	8,058	11,411	10,020
70,350	70,400	11,422	8,064	11,422	10,031
70,400	70,450	11,433	8,070	11,433	10,042
70,450	70,500	11,444	8,076	11,444	10,053
70,500	70,550	11,455	8,082	11,455	10,064
70,550	70,600	11,466	8,088	11,466	10,075
70,600	70,650	11,477	8,094	11,477	10,086
70,650	70,700	11,488	8,100	11,488	10,097
70,700	70,750	11,499	8,106	11,499	10,108
70,750	70,800	11,510	8,112	11,510	10,119
70,800	70,850	11,521	8,118	11,521	10,130
70,850	70,900	11,532	8,124	11,532	10,141
70,900	70,950	11,543	8,130	11,543	10,152
70,950	71,000	11,554	8,136	11,554	10,163
71,000					
71,000	71,050	11,565	8,142	11,565	10,174
71,050	71,100	11,576	8,148	11,576	10,185
71,100	71,150	11,587	8,154	11,587	10,196
71,150	71,200	11,598	8,160	11,598	10,207
71,200	71,250	11,609	8,166	11,609	10,218
71,250	71,300	11,620	8,172	11,620	10,229
71,300	71,350	11,631	8,178	11,631	10,240
71,350	71,400	11,642	8,184	11,642	10,251
71,400	71,450	11,653	8,190	11,653	10,262
71,450	71,500	11,664	8,196	11,664	10,273
71,500	71,550	11,675	8,202	11,675	10,284
71,550	71,600	11,686	8,208	11,686	10,295
71,600	71,650	11,697	8,214	11,697	10,306
71,650	71,700	11,708	8,220	11,708	10,317
71,700	71,750	11,719	8,226	11,719	10,328
71,750	71,800	11,730	8,232	11,730	10,339
71,800	71,850	11,741	8,238	11,741	10,350
71,850	71,900	11,752	8,244	11,752	10,361
71,900	71,950	11,763	8,250	11,763	10,372
71,950	72,000	11,774	8,256	11,774	10,383

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
72,000					
72,000	72,050	11,785	8,262	11,785	10,394
72,050	72,100	11,796	8,268	11,796	10,405
72,100	72,150	11,807	8,274	11,807	10,416
72,150	72,200	11,818	8,280	11,818	10,427
72,200	72,250	11,829	8,286	11,829	10,438
72,250	72,300	11,840	8,292	11,840	10,449
72,300	72,350	11,851	8,298	11,851	10,460
72,350	72,400	11,862	8,304	11,862	10,471
72,400	72,450	11,873	8,310	11,873	10,482
72,450	72,500	11,884	8,316	11,884	10,493
72,500	72,550	11,895	8,322	11,895	10,504
72,550	72,600	11,906	8,328	11,906	10,515
72,600	72,650	11,917	8,334	11,917	10,526
72,650	72,700	11,928	8,340	11,928	10,537
72,700	72,750	11,939	8,346	11,939	10,548
72,750	72,800	11,950	8,352	11,950	10,559
72,800	72,850	11,961	8,358	11,961	10,570
72,850	72,900	11,972	8,364	11,972	10,581
72,900	72,950	11,983	8,370	11,983	10,592
72,950	73,000	11,994	8,376	11,994	10,603
73,000					
73,000	73,050	12,005	8,382	12,005	10,614
73,050	73,100	12,016	8,388	12,016	10,625
73,100	73,150	12,027	8,394	12,027	10,636
73,150	73,200	12,038	8,400	12,038	10,647
73,200	73,250	12,049	8,406	12,049	10,658
73,250	73,300	12,060	8,412	12,060	10,669
73,300	73,350	12,071	8,418	12,071	10,680
73,350	73,400	12,082	8,424	12,082	10,691
73,400	73,450	12,093	8,430	12,093	10,702
73,450	73,500	12,104	8,436	12,104	10,713
73,500	73,550	12,115	8,442	12,115	10,724
73,550	73,600	12,126	8,448	12,126	10,735
73,600	73,650	12,137	8,454	12,137	10,746
73,650	73,700	12,148	8,460	12,148	10,757
73,700	73,750	12,159	8,466	12,159	10,768
73,750	73,800	12,170	8,472	12,170	10,779
73,800	73,850	12,181	8,478	12,181	10,790
73,850	73,900	12,192	8,484	12,192	10,801
73,900	73,950	12,203	8,490	12,203	10,812
73,950	74,000	12,214	8,496	12,214	10,823
74,000					
74,000	74,050	12,225	8,502	12,225	10,834
74,050	74,100	12,236	8,508	12,236	10,845
74,100	74,150	12,247	8,514	12,247	10,856
74,150	74,200	12,258	8,520	12,258	10,867
74,200	74,250	12,269	8,526	12,269	10,878
74,250	74,300	12,280	8,532	12,280	10,889
74,300	74,350	12,291	8,538	12,291	10,900
74,350	74,400	12,302	8,544	12,302	10,911
74,400	74,450	12,313	8,550	12,313	10,922
74,450	74,500	12,324	8,556	12,324	10,933
74,500	74,550	12,335	8,562	12,335	10,944
74,550	74,600	12,346	8,568	12,346	10,955
74,600	74,650	12,357	8,574	12,357	10,966
74,650	74,700	12,368	8,580	12,368	10,977
74,700	74,750	12,379	8,586	12,379	10,988
74,750	74,800	12,390	8,592	12,390	10,999
74,800	74,850	12,401	8,598	12,401	11,010
74,850	74,900	12,412	8,604	12,412	11,021
74,900	74,950	12,423	8,610	12,423	11,032
74,950	75,000	12,434	8,616	12,434	11,043

(Continued)

* This column must also be used by a qualifying widow(er).

(Continued on page T-11)

2018 Tax Table — *Continued*

If line 10 (taxable income) is—		And you are—				If line 10 (taxable income) is—		And you are—				If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
75,000						**78,000**						**81,000**					
75,000	75,050	12,445	8,622	12,445	11,054	78,000	78,050	13,105	9,045	13,105	11,714	81,000	81,050	13,765	9,705	13,765	12,374
75,050	75,100	12,456	8,628	12,456	11,065	78,050	78,100	13,116	9,056	13,116	11,725	81,050	81,100	13,776	9,716	13,776	12,385
75,100	75,150	12,467	8,634	12,467	11,076	78,100	78,150	13,127	9,067	13,127	11,736	81,100	81,150	13,787	9,727	13,787	12,396
75,150	75,200	12,478	8,640	12,478	11,087	78,150	78,200	13,138	9,078	13,138	11,747	81,150	81,200	13,798	9,738	13,798	12,407
75,200	75,250	12,489	8,646	12,489	11,098	78,200	78,250	13,149	9,089	13,149	11,758	81,200	81,250	13,809	9,749	13,809	12,418
75,250	75,300	12,500	8,652	12,500	11,109	78,250	78,300	13,160	9,100	13,160	11,769	81,250	81,300	13,820	9,760	13,820	12,429
75,300	75,350	12,511	8,658	12,511	11,120	78,300	78,350	13,171	9,111	13,171	11,780	81,300	81,350	13,831	9,771	13,831	12,440
75,350	75,400	12,522	8,664	12,522	11,131	78,350	78,400	13,182	9,122	13,182	11,791	81,350	81,400	13,842	9,782	13,842	12,451
75,400	75,450	12,533	8,670	12,533	11,142	78,400	78,450	13,193	9,133	13,193	11,802	81,400	81,450	13,853	9,793	13,853	12,462
75,450	75,500	12,544	8,676	12,544	11,153	78,450	78,500	13,204	9,144	13,204	11,813	81,450	81,500	13,864	9,804	13,864	12,473
75,500	75,550	12,555	8,682	12,555	11,164	78,500	78,550	13,215	9,155	13,215	11,824	81,500	81,550	13,875	9,815	13,875	12,484
75,550	75,600	12,566	8,688	12,566	11,175	78,550	78,600	13,226	9,166	13,226	11,835	81,550	81,600	13,886	9,826	13,886	12,495
75,600	75,650	12,577	8,694	12,577	11,186	78,600	78,650	13,237	9,177	13,237	11,846	81,600	81,650	13,897	9,837	13,897	12,506
75,650	75,700	12,588	8,700	12,588	11,197	78,650	78,700	13,248	9,188	13,248	11,857	81,650	81,700	13,908	9,848	13,908	12,517
75,700	75,750	12,599	8,706	12,599	11,208	78,700	78,750	13,259	9,199	13,259	11,868	81,700	81,750	13,919	9,859	13,919	12,528
75,750	75,800	12,610	8,712	12,610	11,219	78,750	78,800	13,270	9,210	13,270	11,879	81,750	81,800	13,930	9,870	13,930	12,539
75,800	75,850	12,621	8,718	12,621	11,230	78,800	78,850	13,281	9,221	13,281	11,890	81,800	81,850	13,941	9,881	13,941	12,550
75,850	75,900	12,632	8,724	12,632	11,241	78,850	78,900	13,292	9,232	13,292	11,901	81,850	81,900	13,952	9,892	13,952	12,561
75,900	75,950	12,643	8,730	12,643	11,252	78,900	78,950	13,303	9,243	13,303	11,912	81,900	81,950	13,963	9,903	13,963	12,572
75,950	76,000	12,654	8,736	12,654	11,263	78,950	79,000	13,314	9,254	13,314	11,923	81,950	82,000	13,974	9,914	13,974	12,583
76,000						**79,000**						**82,000**					
76,000	76,050	12,665	8,742	12,665	11,274	79,000	79,050	13,325	9,265	13,325	11,934	82,000	82,050	13,985	9,925	13,985	12,594
76,050	76,100	12,676	8,748	12,676	11,285	79,050	79,100	13,336	9,276	13,336	11,945	82,050	82,100	13,996	9,936	13,996	12,605
76,100	76,150	12,687	8,754	12,687	11,296	79,100	79,150	13,347	9,287	13,347	11,956	82,100	82,150	14,007	9,947	14,007	12,616
76,150	76,200	12,698	8,760	12,698	11,307	79,150	79,200	13,358	9,298	13,358	11,967	82,150	82,200	14,018	9,958	14,018	12,627
76,200	76,250	12,709	8,766	12,709	11,318	79,200	79,250	13,369	9,309	13,369	11,978	82,200	82,250	14,029	9,969	14,029	12,638
76,250	76,300	12,720	8,772	12,720	11,329	79,250	79,300	13,380	9,320	13,380	11,989	82,250	82,300	14,040	9,980	14,040	12,649
76,300	76,350	12,731	8,778	12,731	11,340	79,300	79,350	13,391	9,331	13,391	12,000	82,300	82,350	14,051	9,991	14,051	12,660
76,350	76,400	12,742	8,784	12,742	11,351	79,350	79,400	13,402	9,342	13,402	12,011	82,350	82,400	14,062	10,002	14,062	12,671
76,400	76,450	12,753	8,790	12,753	11,362	79,400	79,450	13,413	9,353	13,413	12,022	82,400	82,450	14,073	10,013	14,073	12,682
76,450	76,500	12,764	8,796	12,764	11,373	79,450	79,500	13,424	9,364	13,424	12,033	82,450	82,500	14,084	10,024	14,084	12,693
76,500	76,550	12,775	8,802	12,775	11,384	79,500	79,550	13,435	9,375	13,435	12,044	82,500	82,550	14,096	10,035	14,096	12,704
76,550	76,600	12,786	8,808	12,786	11,395	79,550	79,600	13,446	9,386	13,446	12,055	82,550	82,600	14,108	10,046	14,108	12,716
76,600	76,650	12,797	8,814	12,797	11,406	79,600	79,650	13,457	9,397	13,457	12,066	82,600	82,650	14,120	10,057	14,120	12,728
76,650	76,700	12,808	8,820	12,808	11,417	79,650	79,700	13,468	9,408	13,468	12,077	82,650	82,700	14,132	10,068	14,132	12,740
76,700	76,750	12,819	8,826	12,819	11,428	79,700	79,750	13,479	9,419	13,479	12,088	82,700	82,750	14,144	10,079	14,144	12,752
76,750	76,800	12,830	8,832	12,830	11,439	79,750	79,800	13,490	9,430	13,490	12,099	82,750	82,800	14,156	10,090	14,156	12,764
76,800	76,850	12,841	8,838	12,841	11,450	79,800	79,850	13,501	9,441	13,501	12,110	82,800	82,850	14,168	10,101	14,168	12,776
76,850	76,900	12,852	8,844	12,852	11,461	79,850	79,900	13,512	9,452	13,512	12,121	82,850	82,900	14,180	10,112	14,180	12,788
76,900	76,950	12,863	8,850	12,863	11,472	79,900	79,950	13,523	9,463	13,523	12,132	82,900	82,950	14,192	10,123	14,192	12,800
76,950	77,000	12,874	8,856	12,874	11,483	79,950	80,000	13,534	9,474	13,534	12,143	82,950	83,000	14,204	10,134	14,204	12,812
77,000						**80,000**						**83,000**					
77,000	77,050	12,885	8,862	12,885	11,494	80,000	80,050	13,545	9,485	13,545	12,154	83,000	83,050	14,216	10,145	14,216	12,824
77,050	77,100	12,896	8,868	12,896	11,505	80,050	80,100	13,556	9,496	13,556	12,165	83,050	83,100	14,228	10,156	14,228	12,836
77,100	77,150	12,907	8,874	12,907	11,516	80,100	80,150	13,567	9,507	13,567	12,176	83,100	83,150	14,240	10,167	14,240	12,848
77,150	77,200	12,918	8,880	12,918	11,527	80,150	80,200	13,578	9,518	13,578	12,187	83,150	83,200	14,252	10,178	14,252	12,860
77,200	77,250	12,929	8,886	12,929	11,538	80,200	80,250	13,589	9,529	13,589	12,198	83,200	83,250	14,264	10,189	14,264	12,872
77,250	77,300	12,940	8,892	12,940	11,549	80,250	80,300	13,600	9,540	13,600	12,209	83,250	83,300	14,276	10,200	14,276	12,884
77,300	77,350	12,951	8,898	12,951	11,560	80,300	80,350	13,611	9,551	13,611	12,220	83,300	83,350	14,288	10,211	14,288	12,896
77,350	77,400	12,962	8,904	12,962	11,571	80,350	80,400	13,622	9,562	13,622	12,231	83,350	83,400	14,300	10,222	14,300	12,908
77,400	77,450	12,973	8,913	12,973	11,582	80,400	80,450	13,633	9,573	13,633	12,242	83,400	83,450	14,312	10,233	14,312	12,920
77,450	77,500	12,984	8,924	12,984	11,593	80,450	80,500	13,644	9,584	13,644	12,253	83,450	83,500	14,324	10,244	14,324	12,932
77,500	77,550	12,995	8,935	12,995	11,604	80,500	80,550	13,655	9,595	13,655	12,264	83,500	83,550	14,336	10,255	14,336	12,944
77,550	77,600	13,006	8,946	13,006	11,615	80,550	80,600	13,666	9,606	13,666	12,275	83,550	83,600	14,348	10,266	14,348	12,956
77,600	77,650	13,017	8,957	13,017	11,626	80,600	80,650	13,677	9,617	13,677	12,286	83,600	83,650	14,360	10,277	14,360	12,968
77,650	77,700	13,028	8,968	13,028	11,637	80,650	80,700	13,688	9,628	13,688	12,297	83,650	83,700	14,372	10,288	14,372	12,980
77,700	77,750	13,039	8,979	13,039	11,648	80,700	80,750	13,699	9,639	13,699	12,308	83,700	83,750	14,384	10,299	14,384	12,992
77,750	77,800	13,050	8,990	13,050	11,659	80,750	80,800	13,710	9,650	13,710	12,319	83,750	83,800	14,396	10,310	14,396	13,004
77,800	77,850	13,061	9,001	13,061	11,670	80,800	80,850	13,721	9,661	13,721	12,330	83,800	83,850	14,408	10,321	14,408	13,016
77,850	77,900	13,072	9,012	13,072	11,681	80,850	80,900	13,732	9,672	13,732	12,341	83,850	83,900	14,420	10,332	14,420	13,028
77,900	77,950	13,083	9,023	13,083	11,692	80,900	80,950	13,743	9,683	13,743	12,352	83,900	83,950	14,432	10,343	14,432	13,040
77,950	78,000	13,094	9,034	13,094	11,703	80,950	81,000	13,754	9,694	13,754	12,363	83,950	84,000	14,444	10,354	14,444	13,052

(Continued)

* This column must also be used by a qualifying widow(er).

(Continued on page T-12)

2018 Tax Table — *Continued*

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
84,000					
84,000	84,050	14,456	10,365	14,456	13,064
84,050	84,100	14,468	10,376	14,468	13,076
84,100	84,150	14,480	10,387	14,480	13,088
84,150	84,200	14,492	10,398	14,492	13,100
84,200	84,250	14,504	10,409	14,504	13,112
84,250	84,300	14,516	10,420	14,516	13,124
84,300	84,350	14,528	10,431	14,528	13,136
84,350	84,400	14,540	10,442	14,540	13,148
84,400	84,450	14,552	10,453	14,552	13,160
84,450	84,500	14,564	10,464	14,564	13,172
84,500	84,550	14,576	10,475	14,576	13,184
84,550	84,600	14,588	10,486	14,588	13,196
84,600	84,650	14,600	10,497	14,600	13,208
84,650	84,700	14,612	10,508	14,612	13,220
84,700	84,750	14,624	10,519	14,624	13,232
84,750	84,800	14,636	10,530	14,636	13,244
84,800	84,850	14,648	10,541	14,648	13,256
84,850	84,900	14,660	10,552	14,660	13,268
84,900	84,950	14,672	10,563	14,672	13,280
84,950	85,000	14,684	10,574	14,684	13,292
85,000					
85,000	85,050	14,696	10,585	14,696	13,304
85,050	85,100	14,708	10,596	14,708	13,316
85,100	85,150	14,720	10,607	14,720	13,328
85,150	85,200	14,732	10,618	14,732	13,340
85,200	85,250	14,744	10,629	14,744	13,352
85,250	85,300	14,756	10,640	14,756	13,364
85,300	85,350	14,768	10,651	14,768	13,376
85,350	85,400	14,780	10,662	14,780	13,388
85,400	85,450	14,792	10,673	14,792	13,400
85,450	85,500	14,804	10,684	14,804	13,412
85,500	85,550	14,816	10,695	14,816	13,424
85,550	85,600	14,828	10,706	14,828	13,436
85,600	85,650	14,840	10,717	14,840	13,448
85,650	85,700	14,852	10,728	14,852	13,460
85,700	85,750	14,864	10,739	14,864	13,472
85,750	85,800	14,876	10,750	14,876	13,484
85,800	85,850	14,888	10,761	14,888	13,496
85,850	85,900	14,900	10,772	14,900	13,508
85,900	85,950	14,912	10,783	14,912	13,520
85,950	86,000	14,924	10,794	14,924	13,532
86,000					
86,000	86,050	14,936	10,805	14,936	13,544
86,050	86,100	14,948	10,816	14,948	13,556
86,100	86,150	14,960	10,827	14,960	13,568
86,150	86,200	14,972	10,838	14,972	13,580
86,200	86,250	14,984	10,849	14,984	13,592
86,250	86,300	14,996	10,860	14,996	13,604
86,300	86,350	15,008	10,871	15,008	13,616
86,350	86,400	15,020	10,882	15,020	13,628
86,400	86,450	15,032	10,893	15,032	13,640
86,450	86,500	15,044	10,904	15,044	13,652
86,500	86,550	15,056	10,915	15,056	13,664
86,550	86,600	15,068	10,926	15,068	13,676
86,600	86,650	15,080	10,937	15,080	13,688
86,650	86,700	15,092	10,948	15,092	13,700
86,700	86,750	15,104	10,959	15,104	13,712
86,750	86,800	15,116	10,970	15,116	13,724
86,800	86,850	15,128	10,981	15,128	13,736
86,850	86,900	15,140	10,992	15,140	13,748
86,900	86,950	15,152	11,003	15,152	13,760
86,950	87,000	15,164	11,014	15,164	13,772
87,000					
87,000	87,050	15,176	11,025	15,176	13,784
87,050	87,100	15,188	11,036	15,188	13,796
87,100	87,150	15,200	11,047	15,200	13,808
87,150	87,200	15,212	11,058	15,212	13,820
87,200	87,250	15,224	11,069	15,224	13,832
87,250	87,300	15,236	11,080	15,236	13,844
87,300	87,350	15,248	11,091	15,248	13,856
87,350	87,400	15,260	11,102	15,260	13,868
87,400	87,450	15,272	11,113	15,272	13,880
87,450	87,500	15,284	11,124	15,284	13,892
87,500	87,550	15,296	11,135	15,296	13,904
87,550	87,600	15,308	11,146	15,308	13,916
87,600	87,650	15,320	11,157	15,320	13,928
87,650	87,700	15,332	11,168	15,332	13,940
87,700	87,750	15,344	11,179	15,344	13,952
87,750	87,800	15,356	11,190	15,356	13,964
87,800	87,850	15,368	11,201	15,368	13,976
87,850	87,900	15,380	11,212	15,380	13,988
87,900	87,950	15,392	11,223	15,392	14,000
87,950	88,000	15,404	11,234	15,404	14,012
88,000					
88,000	88,050	15,416	11,245	15,416	14,024
88,050	88,100	15,428	11,256	15,428	14,036
88,100	88,150	15,440	11,267	15,440	14,048
88,150	88,200	15,452	11,278	15,452	14,060
88,200	88,250	15,464	11,289	15,464	14,072
88,250	88,300	15,476	11,300	15,476	14,084
88,300	88,350	15,488	11,311	15,488	14,096
88,350	88,400	15,500	11,322	15,500	14,108
88,400	88,450	15,512	11,333	15,512	14,120
88,450	88,500	15,524	11,344	15,524	14,132
88,500	88,550	15,536	11,355	15,536	14,144
88,550	88,600	15,548	11,366	15,548	14,156
88,600	88,650	15,560	11,377	15,560	14,168
88,650	88,700	15,572	11,388	15,572	14,180
88,700	88,750	15,584	11,399	15,584	14,192
88,750	88,800	15,596	11,410	15,596	14,204
88,800	88,850	15,608	11,421	15,608	14,216
88,850	88,900	15,620	11,432	15,620	14,228
88,900	88,950	15,632	11,443	15,632	14,240
88,950	89,000	15,644	11,454	15,644	14,252
89,000					
89,000	89,050	15,656	11,465	15,656	14,264
89,050	89,100	15,668	11,476	15,668	14,276
89,100	89,150	15,680	11,487	15,680	14,288
89,150	89,200	15,692	11,498	15,692	14,300
89,200	89,250	15,704	11,509	15,704	14,312
89,250	89,300	15,716	11,520	15,716	14,324
89,300	89,350	15,728	11,531	15,728	14,336
89,350	89,400	15,740	11,542	15,740	14,348
89,400	89,450	15,752	11,553	15,752	14,360
89,450	89,500	15,764	11,564	15,764	14,372
89,500	89,550	15,776	11,575	15,776	14,384
89,550	89,600	15,788	11,586	15,788	14,396
89,600	89,650	15,800	11,597	15,800	14,408
89,650	89,700	15,812	11,608	15,812	14,420
89,700	89,750	15,824	11,619	15,824	14,432
89,750	89,800	15,836	11,630	15,836	14,444
89,800	89,850	15,848	11,641	15,848	14,456
89,850	89,900	15,860	11,652	15,860	14,468
89,900	89,950	15,872	11,663	15,872	14,480
89,950	90,000	15,884	11,674	15,884	14,492
90,000					
90,000	90,050	15,896	11,685	15,896	14,504
90,050	90,100	15,908	11,696	15,908	14,516
90,100	90,150	15,920	11,707	15,920	14,528
90,150	90,200	15,932	11,718	15,932	14,540
90,200	90,250	15,944	11,729	15,944	14,552
90,250	90,300	15,956	11,740	15,956	14,564
90,300	90,350	15,968	11,751	15,968	14,576
90,350	90,400	15,980	11,762	15,980	14,588
90,400	90,450	15,992	11,773	15,992	14,600
90,450	90,500	16,004	11,784	16,004	14,612
90,500	90,550	16,016	11,795	16,016	14,624
90,550	90,600	16,028	11,806	16,028	14,636
90,600	90,650	16,040	11,817	16,040	14,648
90,650	90,700	16,052	11,828	16,052	14,660
90,700	90,750	16,064	11,839	16,064	14,672
90,750	90,800	16,076	11,850	16,076	14,684
90,800	90,850	16,088	11,861	16,088	14,696
90,850	90,900	16,100	11,872	16,100	14,708
90,900	90,950	16,112	11,883	16,112	14,720
90,950	91,000	16,124	11,894	16,124	14,732
91,000					
91,000	91,050	16,136	11,905	16,136	14,744
91,050	91,100	16,148	11,916	16,148	14,756
91,100	91,150	16,160	11,927	16,160	14,768
91,150	91,200	16,172	11,938	16,172	14,780
91,200	91,250	16,184	11,949	16,184	14,792
91,250	91,300	16,196	11,960	16,196	14,804
91,300	91,350	16,208	11,971	16,208	14,816
91,350	91,400	16,220	11,982	16,220	14,828
91,400	91,450	16,232	11,993	16,232	14,840
91,450	91,500	16,244	12,004	16,244	14,852
91,500	91,550	16,256	12,015	16,256	14,864
91,550	91,600	16,268	12,026	16,268	14,876
91,600	91,650	16,280	12,037	16,280	14,888
91,650	91,700	16,292	12,048	16,292	14,900
91,700	91,750	16,304	12,059	16,304	14,912
91,750	91,800	16,316	12,070	16,316	14,924
91,800	91,850	16,328	12,081	16,328	14,936
91,850	91,900	16,340	12,092	16,340	14,948
91,900	91,950	16,352	12,103	16,352	14,960
91,950	92,000	16,364	12,114	16,364	14,972
92,000					
92,000	92,050	16,376	12,125	16,376	14,984
92,050	92,100	16,388	12,136	16,388	14,996
92,100	92,150	16,400	12,147	16,400	15,008
92,150	92,200	16,412	12,158	16,412	15,020
92,200	92,250	16,424	12,169	16,424	15,032
92,250	92,300	16,436	12,180	16,436	15,044
92,300	92,350	16,448	12,191	16,448	15,056
92,350	92,400	16,460	12,202	16,460	15,068
92,400	92,450	16,472	12,213	16,472	15,080
92,450	92,500	16,484	12,224	16,484	15,092
92,500	92,550	16,496	12,235	16,496	15,104
92,550	92,600	16,508	12,246	16,508	15,116
92,600	92,650	16,520	12,257	16,520	15,128
92,650	92,700	16,532	12,268	16,532	15,140
92,700	92,750	16,544	12,279	16,544	15,152
92,750	92,800	16,556	12,290	16,556	15,164
92,800	92,850	16,568	12,301	16,568	15,176
92,850	92,900	16,580	12,312	16,580	15,188
92,900	92,950	16,592	12,323	16,592	15,200
92,950	93,000	16,604	12,334	16,604	15,212

(Continued)

* This column must also be used by a qualifying widow(er).

(Continued on page T-13)

2018 Tax Table — *Continued*

If line 10 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
93,000					
93,000	93,050	16,616	12,345	16,616	15,224
93,050	93,100	16,628	12,356	16,628	15,236
93,100	93,150	16,640	12,367	16,640	15,248
93,150	93,200	16,652	12,378	16,652	15,260
93,200	93,250	16,664	12,389	16,664	15,272
93,250	93,300	16,676	12,400	16,676	15,284
93,300	93,350	16,688	12,411	16,688	15,296
93,350	93,400	16,700	12,422	16,700	15,308
93,400	93,450	16,712	12,433	16,712	15,320
93,450	93,500	16,724	12,444	16,724	15,332
93,500	93,550	16,736	12,455	16,736	15,344
93,550	93,600	16,748	12,466	16,748	15,356
93,600	93,650	16,760	12,477	16,760	15,368
93,650	93,700	16,772	12,488	16,772	15,380
93,700	93,750	16,784	12,499	16,784	15,392
93,750	93,800	16,796	12,510	16,796	15,404
93,800	93,850	16,808	12,521	16,808	15,416
93,850	93,900	16,820	12,532	16,820	15,428
93,900	93,950	16,832	12,543	16,832	15,440
93,950	94,000	16,844	12,554	16,844	15,452
94,000					
94,000	94,050	16,856	12,565	16,856	15,464
94,050	94,100	16,868	12,576	16,868	15,476
94,100	94,150	16,880	12,587	16,880	15,488
94,150	94,200	16,892	12,598	16,892	15,500
94,200	94,250	16,904	12,609	16,904	15,512
94,250	94,300	16,916	12,620	16,916	15,524
94,300	94,350	16,928	12,631	16,928	15,536
94,350	94,400	16,940	12,642	16,940	15,548
94,400	94,450	16,952	12,653	16,952	15,560
94,450	94,500	16,964	12,664	16,964	15,572
94,500	94,550	16,976	12,675	16,976	15,584
94,550	94,600	16,988	12,686	16,988	15,596
94,600	94,650	17,000	12,697	17,000	15,608
94,650	94,700	17,012	12,708	17,012	15,620
94,700	94,750	17,024	12,719	17,024	15,632
94,750	94,800	17,036	12,730	17,036	15,644
94,800	94,850	17,048	12,741	17,048	15,656
94,850	94,900	17,060	12,752	17,060	15,668
94,900	94,950	17,072	12,763	17,072	15,680
94,950	95,000	17,084	12,774	17,084	15,692
95,000					
95,000	95,050	17,096	12,785	17,096	15,704
95,050	95,100	17,108	12,796	17,108	15,716
95,100	95,150	17,120	12,807	17,120	15,728
95,150	95,200	17,132	12,818	17,132	15,740
95,200	95,250	17,144	12,829	17,144	15,752
95,250	95,300	17,156	12,840	17,156	15,764
95,300	95,350	17,168	12,851	17,168	15,776
95,350	95,400	17,180	12,862	17,180	15,788
95,400	95,450	17,192	12,873	17,192	15,800
95,450	95,500	17,204	12,884	17,204	15,812
95,500	95,550	17,216	12,895	17,216	15,824
95,550	95,600	17,228	12,906	17,228	15,836
95,600	95,650	17,240	12,917	17,240	15,848
95,650	95,700	17,252	12,928	17,252	15,860
95,700	95,750	17,264	12,939	17,264	15,872
95,750	95,800	17,276	12,950	17,276	15,884
95,800	95,850	17,288	12,961	17,288	15,896
95,850	95,900	17,300	12,972	17,300	15,908
95,900	95,950	17,312	12,983	17,312	15,920
95,950	96,000	17,324	12,994	17,324	15,932
96,000					
96,000	96,050	17,336	13,005	17,336	15,944
96,050	96,100	17,348	13,016	17,348	15,956
96,100	96,150	17,360	13,027	17,360	15,968
96,150	96,200	17,372	13,038	17,372	15,980
96,200	96,250	17,384	13,049	17,384	15,992
96,250	96,300	17,396	13,060	17,396	16,004
96,300	96,350	17,408	13,071	17,408	16,016
96,350	96,400	17,420	13,082	17,420	16,028
96,400	96,450	17,432	13,093	17,432	16,040
96,450	96,500	17,444	13,104	17,444	16,052
96,500	96,550	17,456	13,115	17,456	16,064
96,550	96,600	17,468	13,126	17,468	16,076
96,600	96,650	17,480	13,137	17,480	16,088
96,650	96,700	17,492	13,148	17,492	16,100
96,700	96,750	17,504	13,159	17,504	16,112
96,750	96,800	17,516	13,170	17,516	16,124
96,800	96,850	17,528	13,181	17,528	16,136
96,850	96,900	17,540	13,192	17,540	16,148
96,900	96,950	17,552	13,203	17,552	16,160
96,950	97,000	17,564	13,214	17,564	16,172
97,000					
97,000	97,050	17,576	13,225	17,576	16,184
97,050	97,100	17,588	13,236	17,588	16,196
97,100	97,150	17,600	13,247	17,600	16,208
97,150	97,200	17,612	13,258	17,612	16,220
97,200	97,250	17,624	13,269	17,624	16,232
97,250	97,300	17,636	13,280	17,636	16,244
97,300	97,350	17,648	13,291	17,648	16,256
97,350	97,400	17,660	13,302	17,660	16,268
97,400	97,450	17,672	13,313	17,672	16,280
97,450	97,500	17,684	13,324	17,684	16,292
97,500	97,550	17,696	13,335	17,696	16,304
97,550	97,600	17,708	13,346	17,708	16,316
97,600	97,650	17,720	13,357	17,720	16,328
97,650	97,700	17,732	13,368	17,732	16,340
97,700	97,750	17,744	13,379	17,744	16,352
97,750	97,800	17,756	13,390	17,756	16,364
97,800	97,850	17,768	13,401	17,768	16,376
97,850	97,900	17,780	13,412	17,780	16,388
97,900	97,950	17,792	13,423	17,792	16,400
97,950	98,000	17,804	13,434	17,804	16,412
98,000					
98,000	98,050	17,816	13,445	17,816	16,424
98,050	98,100	17,828	13,456	17,828	16,436
98,100	98,150	17,840	13,467	17,840	16,448
98,150	98,200	17,852	13,478	17,852	16,460
98,200	98,250	17,864	13,489	17,864	16,472
98,250	98,300	17,876	13,500	17,876	16,484
98,300	98,350	17,888	13,511	17,888	16,496
98,350	98,400	17,900	13,522	17,900	16,508
98,400	98,450	17,912	13,533	17,912	16,520
98,450	98,500	17,924	13,544	17,924	16,532
98,500	98,550	17,936	13,555	17,936	16,544
98,550	98,600	17,948	13,566	17,948	16,556
98,600	98,650	17,960	13,577	17,960	16,568
98,650	98,700	17,972	13,588	17,972	16,580
98,700	98,750	17,984	13,599	17,984	16,592
98,750	98,800	17,996	13,610	17,996	16,604
98,800	98,850	18,008	13,621	18,008	16,616
98,850	98,900	18,020	13,632	18,020	16,628
98,900	98,950	18,032	13,643	18,032	16,640
98,950	99,000	18,044	13,654	18,044	16,652
99,000					
99,000	99,050	18,056	13,665	18,056	16,664
99,050	99,100	18,068	13,676	18,068	16,676
99,100	99,150	18,080	13,687	18,080	16,688
99,150	99,200	18,092	13,698	18,092	16,700
99,200	99,250	18,104	13,709	18,104	16,712
99,250	99,300	18,116	13,720	18,116	16,724
99,300	99,350	18,128	13,731	18,128	16,736
99,350	99,400	18,140	13,742	18,140	16,748
99,400	99,450	18,152	13,753	18,152	16,760
99,450	99,500	18,164	13,764	18,164	16,772
99,500	99,550	18,176	13,775	18,176	16,784
99,550	99,600	18,188	13,786	18,188	16,796
99,600	99,650	18,200	13,797	18,200	16,808
99,650	99,700	18,212	13,808	18,212	16,820
99,700	99,750	18,224	13,819	18,224	16,832
99,750	99,800	18,236	13,830	18,236	16,844
99,800	99,850	18,248	13,841	18,248	16,856
99,850	99,900	18,260	13,852	18,260	16,868
99,900	99,950	18,272	13,863	18,272	16,880
99,950	100,000	18,284	13,874	18,284	16,892

$100,000 or over use the Tax Computation Worksheet

* This column must also be used by a qualifying widow(er).

2018 Tax Rate Schedules



The Tax Rate Schedules are shown so you can see the tax rate that applies to all levels of taxable income. Don't use them to figure your tax. Instead, see the instructions for line 11a.

Schedule X—If your filing status is **Single**

If your taxable income is:		The tax is:	
Over—	*But not over—*		*of the amount over—*
$0	$9,525	..... 10%	$0
9,525	38,700	$952.50 + 12%	9,525
38,700	82,500	4,453.50 + 22%	38,700
82,500	157,500	14,089.50 + 24%	82,500
157,500	200,000	32,089.50 + 32%	157,500
200,000	500,000	45,689.50 + 35%	200,000
500,000	.....	150,689.50 + 37%	500,000

Schedule Y-1—If your filing status is **Married filing jointly** or **Qualifying widow(er)**

If your taxable income is:		The tax is:	
Over—	*But not over—*		*of the amount over—*
$0	$19,050	..... 10%	$0
19,050	77,400	$1,905.00 + 12%	19,050
77,400	165,000	8,907.00 + 22%	77,400
165,000	315,000	28,179.00 + 24%	165,000
315,000	400,000	64,179.00 + 32%	315,000
400,000	600,000	91,379.00 + 35%	400,000
600,000	.....	161,379.00 + 37%	600,000

Schedule Y-2—If your filing status is **Married filing separately**

If your taxable income is:		The tax is:	
Over—	*But not over—*		*of the amount over—*
$0	$9,525	..... 10%	$0
9,525	38,700	$952.50 + 12%	9,525
38,700	82,500	4,453.50 + 22%	38,700
82,500	157,500	14,089.50 + 24%	82,500
157,500	200,000	32,089.50 + 32%	157,500
200,000	300,000	45,689.50 + 35%	200,000
300,000	.....	80,689.50 + 37%	300,000

Schedule Z—If your filing status is **Head of household**

If your taxable income is:		The tax is:	
Over—	*But not over—*		*of the amount over—*
$0	$13,600	..... 10%	$0
13,600	51,800	$1,360.00 + 12%	13,600
51,800	82,500	5,944.00 + 22%	51,800
82,500	157,500	12,698.00 + 24%	82,500
157,500	200,000	30,698.00 + 32%	157,500
200,000	500,000	44,298.00 + 35%	200,000
500,000	.....	149,298.00 + 37%	500,000

Special Tax Rates for Capital Gains and Dividends for 2018

Capital gains and losses are assigned to baskets. Five possible tax rates will apply to most capital gains and losses:

- Ordinary income tax rates (up to 37% in 2018) for gains on assets held one year or less
- 28% rate on collectibles gains and includible Sec. 1202 gains
- Preferential tax rates for gains on assets held for more than one year and qualified dividends based on the taxpayer's taxable income and filing status as shown in the following table:

Preferential Rate	Single	Filing Jointly	Head of Household	Estates & Trusts
0%	Up to $38,600	Up to $77,200	Up to $51,700	Up to $2,600
15%	> $38,600 but ≤ $425,800	> $77,200 but ≤ $479,000	> $51,700 but ≤ $452,400	> $2,600 but ≤ $12,700
20%	Over $425,800	Over $479,000	Over $452,400	Over $12,700

Note: The net investment income of higher income taxpayers (modified AGI greater than $200,000 for single and $250,000 for married filing jointly) also may be subject to an additional tax of 3.8%. Net investment income includes dividends and capital gains, along with other types of investment income.

Combined Federal Income Tax, Employee Social Security Tax, and Employee Medicare Tax Withholding Tables

SINGLE Persons—MONTHLY Payroll Period

(For Wages Paid through December 2019)

And the wages are–		And the number of withholding allowances claimed is–										
At least	But less than	0	1	2	3	4	5	6	7	8	9	10
		The amount of income, social security, and Medicare taxes to be withheld is–										
$ 0	$317	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%
317	327	$25.63	$24.63	$24.63	$24.63	$24.63	$24.63	$24.63	$24.63	$24.63	$24.63	$24.63
327	337	27.40	25.40	25.40	25.40	25.40	25.40	25.40	25.40	25.40	25.40	25.40
337	347	29.16	26.16	26.16	26.16	26.16	26.16	26.16	26.16	26.16	26.16	26.16
347	357	30.93	26.93	26.93	26.93	26.93	26.93	26.93	26.93	26.93	26.93	26.93
357	367	32.69	27.69	27.69	27.69	27.69	27.69	27.69	27.69	27.69	27.69	27.69
367	377	34.46	28.46	28.46	28.46	28.46	28.46	28.46	28.46	28.46	28.46	28.46
377	387	36.22	29.22	29.22	29.22	29.22	29.22	29.22	29.22	29.22	29.22	29.22
387	397	37.99	29.99	29.99	29.99	29.99	29.99	29.99	29.99	29.99	29.99	29.99
397	407	39.75	30.75	30.75	30.75	30.75	30.75	30.75	30.75	30.75	30.75	30.75
407	417	41.52	31.52	31.52	31.52	31.52	31.52	31.52	31.52	31.52	31.52	31.52
417	427	43.28	32.28	32.28	32.28	32.28	32.28	32.28	32.28	32.28	32.28	32.28
427	437	45.05	33.05	33.05	33.05	33.05	33.05	33.05	33.05	33.05	33.05	33.05
437	447	46.81	33.81	33.81	33.81	33.81	33.81	33.81	33.81	33.81	33.81	33.81
447	457	48.58	34.58	34.58	34.58	34.58	34.58	34.58	34.58	34.58	34.58	34.58
457	467	50.34	35.34	35.34	35.34	35.34	35.34	35.34	35.34	35.34	35.34	35.34
467	477	52.11	36.11	36.11	36.11	36.11	36.11	36.11	36.11	36.11	36.11	36.11
477	487	53.87	36.87	36.87	36.87	36.87	36.87	36.87	36.87	36.87	36.87	36.87
487	497	55.64	37.64	37.64	37.64	37.64	37.64	37.64	37.64	37.64	37.64	37.64
497	507	57.40	38.40	38.40	38.40	38.40	38.40	38.40	38.40	38.40	38.40	38.40
507	517	59.17	39.17	39.17	39.17	39.17	39.17	39.17	39.17	39.17	39.17	39.17
517	527	60.93	39.93	39.93	39.93	39.93	39.93	39.93	39.93	39.93	39.93	39.93
527	537	62.70	40.70	40.70	40.70	40.70	40.70	40.70	40.70	40.70	40.70	40.70
537	547	64.46	41.46	41.46	41.46	41.46	41.46	41.46	41.46	41.46	41.46	41.46
547	557	66.23	42.23	42.23	42.23	42.23	42.23	42.23	42.23	42.23	42.23	42.23
557	567	67.99	42.99	42.99	42.99	42.99	42.99	42.99	42.99	42.99	42.99	42.99
567	577	69.76	43.76	43.76	43.76	43.76	43.76	43.76	43.76	43.76	43.76	43.76
577	587	71.52	44.52	44.52	44.52	44.52	44.52	44.52	44.52	44.52	44.52	44.52
587	597	73.29	45.29	45.29	45.29	45.29	45.29	45.29	45.29	45.29	45.29	45.29
597	607	75.05	46.05	46.05	46.05	46.05	46.05	46.05	46.05	46.05	46.05	46.05
607	617	76.82	46.82	46.82	46.82	46.82	46.82	46.82	46.82	46.82	46.82	46.82
617	627	78.58	47.58	47.58	47.58	47.58	47.58	47.58	47.58	47.58	47.58	47.58
627	637	80.35	48.35	48.35	48.35	48.35	48.35	48.35	48.35	48.35	48.35	48.35
637	647	82.11	49.11	49.11	49.11	49.11	49.11	49.11	49.11	49.11	49.11	49.11
647	657	83.88	49.88	49.88	49.88	49.88	49.88	49.88	49.88	49.88	49.88	49.88
657	667	85.64	50.64	50.64	50.64	50.64	50.64	50.64	50.64	50.64	50.64	50.64
667	677	87.41	52.41	51.41	51.41	51.41	51.41	51.41	51.41	51.41	51.41	51.41
677	687	89.17	54.17	52.17	52.17	52.17	52.17	52.17	52.17	52.17	52.17	52.17
687	697	90.94	55.94	52.94	52.94	52.94	52.94	52.94	52.94	52.94	52.94	52.94
697	707	92.70	57.70	53.70	53.70	53.70	53.70	53.70	53.70	53.70	53.70	53.70
707	717	94.47	59.47	54.47	54.47	54.47	54.47	54.47	54.47	54.47	54.47	54.47
717	727	96.23	61.23	55.23	55.23	55.23	55.23	55.23	55.23	55.23	55.23	55.23
727	737	98.00	63.00	56.00	56.00	56.00	56.00	56.00	56.00	56.00	56.00	56.00
737	747	99.76	64.76	56.76	56.76	56.76	56.76	56.76	56.76	56.76	56.76	56.76
747	757	101.53	66.53	57.53	57.53	57.53	57.53	57.53	57.53	57.53	57.53	57.53
757	767	103.29	68.29	58.29	58.29	58.29	58.29	58.29	58.29	58.29	58.29	58.29
767	777	105.06	70.06	59.06	59.06	59.06	59.06	59.06	59.06	59.06	59.06	59.06
777	787	106.82	71.82	59.82	59.82	59.82	59.82	59.82	59.82	59.82	59.82	59.82
787	797	108.59	73.59	60.59	60.59	60.59	60.59	60.59	60.59	60.59	60.59	60.59
797	807	110.35	75.35	61.35	61.35	61.35	61.35	61.35	61.35	61.35	61.35	61.35
807	817	112.12	77.12	62.12	62.12	62.12	62.12	62.12	62.12	62.12	62.12	62.12
817	827	113.88	78.88	62.88	62.88	62.88	62.88	62.88	62.88	62.88	62.88	62.88
827	837	115.65	80.65	63.65	63.65	63.65	63.65	63.65	63.65	63.65	63.65	63.65
837	847	117.41	82.41	64.41	64.41	64.41	64.41	64.41	64.41	64.41	64.41	64.41
847	857	119.18	84.18	65.18	65.18	65.18	65.18	65.18	65.18	65.18	65.18	65.18
857	867	120.94	85.94	65.94	65.94	65.94	65.94	65.94	65.94	65.94	65.94	65.94
867	877	122.71	87.71	66.71	66.71	66.71	66.71	66.71	66.71	66.71	66.71	66.71
877	887	124.47	89.47	67.47	67.47	67.47	67.47	67.47	67.47	67.47	67.47	67.47
887	897	126.24	91.24	68.24	68.24	68.24	68.24	68.24	68.24	68.24	68.24	68.24
897	907	128.00	93.00	69.00	69.00	69.00	69.00	69.00	69.00	69.00	69.00	69.00
907	917	129.77	94.77	69.77	69.77	69.77	69.77	69.77	69.77	69.77	69.77	69.77
917	927	131.53	96.53	70.53	70.53	70.53	70.53	70.53	70.53	70.53	70.53	70.53
927	937	133.30	98.30	71.30	71.30	71.30	71.30	71.30	71.30	71.30	71.30	71.30
937	947	135.06	100.06	72.06	72.06	72.06	72.06	72.06	72.06	72.06	72.06	72.06
947	957	136.83	101.83	72.83	72.83	72.83	72.83	72.83	72.83	72.83	72.83	72.83
957	967	138.59	103.59	73.59	73.59	73.59	73.59	73.59	73.59	73.59	73.59	73.59
967	977	140.36	105.36	74.36	74.36	74.36	74.36	74.36	74.36	74.36	74.36	74.36
977	987	142.12	107.12	75.12	75.12	75.12	75.12	75.12	75.12	75.12	75.12	75.12
987	997	143.89	108.89	75.89	75.89	75.89	75.89	75.89	75.89	75.89	75.89	75.89
997	1,007	145.65	110.65	76.65	76.65	76.65	76.65	76.65	76.65	76.65	76.65	76.65

Combined Federal Income Tax, Employee Social Security Tax, and Employee Medicare Tax Withholding Tables

SINGLE Persons—MONTHLY Payroll Period

(For Wages Paid through December 2019)

And the wages are—		And the number of withholding allowances claimed is—										
At least	But less than	0	1	2	3	4	5	6	7	8	9	10
		The amount of income, social security, and Medicare taxes to be withheld is—										
1,007	1,027	147.80	112.80	77.80	77.80	77.80	77.80	77.80	77.80	77.80	77.80	77.80
1,027	1,047	151.33	116.33	81.33	79.33	79.33	79.33	79.33	79.33	79.33	79.33	79.33
1,047	1,067	154.86	119.86	84.86	80.86	80.86	80.86	80.86	80.86	80.86	80.86	80.86
1,067	1,087	158.39	123.39	88.39	82.39	82.39	82.39	82.39	82.39	82.39	82.39	82.39
1,087	1,107	161.92	126.92	91.92	83.92	83.92	83.92	83.92	83.92	83.92	83.92	83.92
1,107	1,127	165.45	130.45	95.45	85.45	85.45	85.45	85.45	85.45	85.45	85.45	85.45
1,127	1,147	168.98	133.98	98.98	86.98	86.98	86.98	86.98	86.98	86.98	86.98	86.98
1,147	1,167	173.51	137.51	102.51	88.51	88.51	88.51	88.51	88.51	88.51	88.51	88.51
1,167	1,187	177.04	141.04	106.04	90.04	90.04	90.04	90.04	90.04	90.04	90.04	90.04
1,187	1,207	180.57	144.57	109.57	91.57	91.57	91.57	91.57	91.57	91.57	91.57	91.57
1,207	1,227	185.10	148.10	113.10	93.10	93.10	93.10	93.10	93.10	93.10	93.10	93.10
1,227	1,247	188.63	151.63	116.63	94.63	94.63	94.63	94.63	94.63	94.63	94.63	94.63
1,247	1,267	193.16	155.16	120.16	96.16	96.16	96.16	96.16	96.16	96.16	96.16	96.16
1,267	1,287	196.69	158.69	123.69	97.69	97.69	97.69	97.69	97.69	97.69	97.69	97.69
1,287	1,307	200.22	162.22	127.22	99.22	99.22	99.22	99.22	99.22	99.22	99.22	99.22
1,307	1,327	204.75	165.75	130.75	100.75	100.75	100.75	100.75	100.75	100.75	100.75	100.75
1,327	1,347	208.28	169.28	134.28	102.28	102.28	102.28	102.28	102.28	102.28	102.28	102.28
1,347	1,367	212.81	172.81	137.81	103.81	103.81	103.81	103.81	103.81	103.81	103.81	103.81
1,367	1,387	216.34	176.34	141.34	106.34	105.34	105.34	105.34	105.34	105.34	105.34	105.34
1,387	1,407	219.87	179.87	144.87	109.87	106.87	106.87	106.87	106.87	106.87	106.87	106.87
1,407	1,427	224.40	183.40	148.40	113.40	108.40	108.40	108.40	108.40	108.40	108.40	108.40
1,427	1,447	227.93	186.93	151.93	116.93	109.93	109.93	109.93	109.93	109.93	109.93	109.93
1,447	1,467	232.46	190.46	155.46	120.46	111.46	111.46	111.46	111.46	111.46	111.46	111.46
1,467	1,487	235.99	193.99	158.99	123.99	112.99	112.99	112.99	112.99	112.99	112.99	112.99
1,487	1,507	239.52	197.52	162.52	127.52	114.52	114.52	114.52	114.52	114.52	114.52	114.52
1,507	1,527	244.05	202.05	166.05	131.05	116.05	116.05	116.05	116.05	116.05	116.05	116.05
1,527	1,547	247.58	205.58	169.58	134.58	117.58	117.58	117.58	117.58	117.58	117.58	117.58
1,547	1,567	252.11	210.11	173.11	138.11	119.11	119.11	119.11	119.11	119.11	119.11	119.11
1,567	1,587	255.64	213.64	176.64	141.64	120.64	120.64	120.64	120.64	120.64	120.64	120.64
1,587	1,607	259.17	217.17	180.17	145.17	122.17	122.17	122.17	122.17	122.17	122.17	122.17
1,607	1,627	263.70	221.70	183.70	148.70	123.70	123.70	123.70	123.70	123.70	123.70	123.70
1,627	1,647	267.23	225.23	187.23	152.23	125.23	125.23	125.23	125.23	125.23	125.23	125.23
1,647	1,667	271.76	229.76	190.76	155.76	126.76	126.76	126.76	126.76	126.76	126.76	126.76
1,667	1,687	275.29	233.29	194.29	159.29	128.29	128.29	128.29	128.29	128.29	128.29	128.29
1,687	1,707	278.82	236.82	197.82	162.82	129.82	129.82	129.82	129.82	129.82	129.82	129.82
1,707	1,727	283.35	241.35	201.35	166.35	131.35	131.35	131.35	131.35	131.35	131.35	131.35
1,727	1,747	286.88	244.88	204.88	169.88	134.88	132.88	132.88	132.88	132.88	132.88	132.88
1,747	1,767	291.41	249.41	208.41	173.41	138.41	134.41	134.41	134.41	134.41	134.41	134.41
1,767	1,787	294.94	252.94	211.94	176.94	141.94	135.94	135.94	135.94	135.94	135.94	135.94
1,787	1,807	298.47	256.47	215.47	180.47	145.47	137.47	137.47	137.47	137.47	137.47	137.47
1,807	1,827	303.00	261.00	219.00	184.00	149.00	139.00	139.00	139.00	139.00	139.00	139.00
1,827	1,847	306.53	264.53	222.53	187.53	152.53	140.53	140.53	140.53	140.53	140.53	140.53
1,847	1,867	311.06	269.06	227.06	191.06	156.06	142.06	142.06	142.06	142.06	142.06	142.06
1,867	1,887	314.59	272.59	230.59	194.59	159.59	143.59	143.59	143.59	143.59	143.59	143.59
1,887	1,907	318.12	276.12	234.12	198.12	163.12	145.12	145.12	145.12	145.12	145.12	145.12
1,907	1,927	322.65	280.65	238.65	201.65	166.65	146.65	146.65	146.65	146.65	146.65	146.65
1,927	1,947	326.18	284.18	242.18	205.18	170.18	148.18	148.18	148.18	148.18	148.18	148.18
1,947	1,967	330.71	288.71	246.71	208.71	173.71	149.71	149.71	149.71	149.71	149.71	149.71
1,967	1,987	334.24	292.24	250.24	212.24	177.24	151.24	151.24	151.24	151.24	151.24	151.24
1,987	2,007	337.77	295.77	253.77	215.77	180.77	152.77	152.77	152.77	152.77	152.77	152.77
2,007	2,047	344.07	302.07	260.07	221.07	186.07	155.07	155.07	155.07	155.07	155.07	155.07
2,047	2,087	352.13	310.13	268.13	228.13	193.13	158.13	158.13	158.13	158.13	158.13	158.13
2,087	2,127	360.19	318.19	276.19	235.19	200.19	165.19	161.19	161.19	161.19	161.19	161.19
2,127	2,167	367.25	325.25	283.25	242.25	207.25	172.25	164.25	164.25	164.25	164.25	164.25
2,167	2,207	375.31	333.31	291.31	249.31	214.31	179.31	167.31	167.31	167.31	167.31	167.31
2,207	2,247	383.37	341.37	299.37	257.37	221.37	186.37	170.37	170.37	170.37	170.37	170.37
2,247	2,287	391.43	349.43	307.43	265.43	228.43	193.43	173.43	173.43	173.43	173.43	173.43
2,287	2,327	399.49	357.49	315.49	273.49	235.49	200.49	176.49	176.49	176.49	176.49	176.49
2,327	2,367	406.55	364.55	322.55	280.55	242.55	207.55	179.55	179.55	179.55	179.55	179.55
2,367	2,407	414.61	372.61	330.61	288.61	249.61	214.61	182.61	182.61	182.61	182.61	182.61
2,407	2,447	422.67	380.67	338.67	296.67	256.67	221.67	186.67	185.67	185.67	185.67	185.67
2,447	2,487	430.73	388.73	346.73	304.73	263.73	228.73	193.73	188.73	188.73	188.73	188.73
2,487	2,527	438.79	396.79	354.79	312.79	270.79	235.79	200.79	191.79	191.79	191.79	191.79
2,527	2,567	445.85	403.85	361.85	319.85	277.85	242.85	207.85	194.85	194.85	194.85	194.85
2,567	2,607	453.91	411.91	369.91	327.91	285.91	249.91	214.91	197.91	197.91	197.91	197.91
2,607 and over		Do not use this table. See page 48 for instructions.										

Combined Federal Income Tax, Employee Social Security Tax, and Employee Medicare Tax Withholding Tables

MARRIED Persons—MONTHLY Payroll Period

(For Wages Paid through December 2019)

And the wages are–		And the number of withholding allowances claimed is–										
At least	But less than	0	1	2	3	4	5	6	7	8	9	10
		The amount of income, social security, and Medicare taxes to be withheld is–										
$ 0	$983	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%	7.65%
983	994	$76.62	$75.62	$75.62	$75.62	$75.62	$75.62	$75.62	$75.62	$75.62	$75.62	$75.62
994	1,005	78.46	76.46	76.46	76.46	76.46	76.46	76.46	76.46	76.46	76.46	76.46
1,005	1,016	80.30	77.30	77.30	77.30	77.30	77.30	77.30	77.30	77.30	77.30	77.30
1,016	1,027	82.14	78.14	78.14	78.14	78.14	78.14	78.14	78.14	78.14	78.14	78.14
1,027	1,038	83.99	78.99	78.99	78.99	78.99	78.99	78.99	78.99	78.99	78.99	78.99
1,038	1,049	85.83	79.83	79.83	79.83	79.83	79.83	79.83	79.83	79.83	79.83	79.83
1,049	1,060	87.67	80.67	80.67	80.67	80.67	80.67	80.67	80.67	80.67	80.67	80.67
1,060	1,071	89.51	81.51	81.51	81.51	81.51	81.51	81.51	81.51	81.51	81.51	81.51
1,071	1,082	91.35	82.35	82.35	82.35	82.35	82.35	82.35	82.35	82.35	82.35	82.35
1,082	1,093	93.19	83.19	83.19	83.19	83.19	83.19	83.19	83.19	83.19	83.19	83.19
1,093	1,104	96.04	84.04	84.04	84.04	84.04	84.04	84.04	84.04	84.04	84.04	84.04
1,104	1,115	97.88	84.88	84.88	84.88	84.88	84.88	84.88	84.88	84.88	84.88	84.88
1,115	1,126	99.72	85.72	85.72	85.72	85.72	85.72	85.72	85.72	85.72	85.72	85.72
1,126	1,137	101.56	86.56	86.56	86.56	86.56	86.56	86.56	86.56	86.56	86.56	86.56
1,137	1,148	103.40	87.40	87.40	87.40	87.40	87.40	87.40	87.40	87.40	87.40	87.40
1,148	1,159	105.24	88.24	88.24	88.24	88.24	88.24	88.24	88.24	88.24	88.24	88.24
1,159	1,170	107.08	89.08	89.08	89.08	89.08	89.08	89.08	89.08	89.08	89.08	89.08
1,170	1,181	108.93	89.93	89.93	89.93	89.93	89.93	89.93	89.93	89.93	89.93	89.93
1,181	1,192	110.77	90.77	90.77	90.77	90.77	90.77	90.77	90.77	90.77	90.77	90.77
1,192	1,203	112.61	91.61	91.61	91.61	91.61	91.61	91.61	91.61	91.61	91.61	91.61
1,203	1,214	115.45	92.45	92.45	92.45	92.45	92.45	92.45	92.45	92.45	92.45	92.45
1,214	1,225	117.29	93.29	93.29	93.29	93.29	93.29	93.29	93.29	93.29	93.29	93.29
1,225	1,236	119.13	94.13	94.13	94.13	94.13	94.13	94.13	94.13	94.13	94.13	94.13
1,236	1,247	120.97	94.97	94.97	94.97	94.97	94.97	94.97	94.97	94.97	94.97	94.97
1,247	1,258	122.82	95.82	95.82	95.82	95.82	95.82	95.82	95.82	95.82	95.82	95.82
1,258	1,269	124.66	96.66	96.66	96.66	96.66	96.66	96.66	96.66	96.66	96.66	96.66
1,269	1,280	126.50	97.50	97.50	97.50	97.50	97.50	97.50	97.50	97.50	97.50	97.50
1,280	1,291	128.34	98.34	98.34	98.34	98.34	98.34	98.34	98.34	98.34	98.34	98.34
1,291	1,302	130.18	99.18	99.18	99.18	99.18	99.18	99.18	99.18	99.18	99.18	99.18
1,302	1,313	132.02	100.02	100.02	100.02	100.02	100.02	100.02	100.02	100.02	100.02	100.02
1,313	1,324	134.87	100.87	100.87	100.87	100.87	100.87	100.87	100.87	100.87	100.87	100.87
1,324	1,335	136.71	101.71	101.71	101.71	101.71	101.71	101.71	101.71	101.71	101.71	101.71
1,335	1,346	138.55	103.55	102.55	102.55	102.55	102.55	102.55	102.55	102.55	102.55	102.55
1,346	1,357	140.39	105.39	103.39	103.39	103.39	103.39	103.39	103.39	103.39	103.39	103.39
1,357	1,368	142.23	107.23	104.23	104.23	104.23	104.23	104.23	104.23	104.23	104.23	104.23
1,368	1,379	144.07	109.07	105.07	105.07	105.07	105.07	105.07	105.07	105.07	105.07	105.07
1,379	1,390	145.91	110.91	105.91	105.91	105.91	105.91	105.91	105.91	105.91	105.91	105.91
1,390	1,401	147.76	112.76	106.76	106.76	106.76	106.76	106.76	106.76	106.76	106.76	106.76
1,401	1,412	149.60	114.60	107.60	107.60	107.60	107.60	107.60	107.60	107.60	107.60	107.60
1,412	1,423	151.44	116.44	108.44	108.44	108.44	108.44	108.44	108.44	108.44	108.44	108.44
1,423	1,434	154.28	119.28	109.28	109.28	109.28	109.28	109.28	109.28	109.28	109.28	109.28
1,434	1,445	156.12	121.12	110.12	110.12	110.12	110.12	110.12	110.12	110.12	110.12	110.12
1,445	1,456	157.96	122.96	110.96	110.96	110.96	110.96	110.96	110.96	110.96	110.96	110.96
1,456	1,467	159.80	124.80	111.80	111.80	111.80	111.80	111.80	111.80	111.80	111.80	111.80
1,467	1,478	161.65	126.65	112.65	112.65	112.65	112.65	112.65	112.65	112.65	112.65	112.65
1,478	1,489	163.49	128.49	113.49	113.49	113.49	113.49	113.49	113.49	113.49	113.49	113.49
1,489	1,500	165.33	130.33	114.33	114.33	114.33	114.33	114.33	114.33	114.33	114.33	114.33
1,500	1,511	167.17	132.17	115.17	115.17	115.17	115.17	115.17	115.17	115.17	115.17	115.17
1,511	1,522	169.01	134.01	116.01	116.01	116.01	116.01	116.01	116.01	116.01	116.01	116.01
1,522	1,533	170.85	135.85	116.85	116.85	116.85	116.85	116.85	116.85	116.85	116.85	116.85
1,533	1,544	173.70	138.70	117.70	117.70	117.70	117.70	117.70	117.70	117.70	117.70	117.70
1,544	1,555	175.54	140.54	118.54	118.54	118.54	118.54	118.54	118.54	118.54	118.54	118.54
1,555	1,566	177.38	142.38	119.38	119.38	119.38	119.38	119.38	119.38	119.38	119.38	119.38
1,566	1,577	179.22	144.22	120.22	120.22	120.22	120.22	120.22	120.22	120.22	120.22	120.22
1,577	1,588	181.06	146.06	121.06	121.06	121.06	121.06	121.06	121.06	121.06	121.06	121.06
1,588	1,599	182.90	147.90	121.90	121.90	121.90	121.90	121.90	121.90	121.90	121.90	121.90
1,599	1,610	184.74	149.74	122.74	122.74	122.74	122.74	122.74	122.74	122.74	122.74	122.74
1,610	1,621	186.59	151.59	123.59	123.59	123.59	123.59	123.59	123.59	123.59	123.59	123.59
1,621	1,632	188.43	153.43	124.43	124.43	124.43	124.43	124.43	124.43	124.43	124.43	124.43
1,632	1,643	190.27	155.27	125.27	125.27	125.27	125.27	125.27	125.27	125.27	125.27	125.27
1,643	1,654	193.11	158.11	126.11	126.11	126.11	126.11	126.11	126.11	126.11	126.11	126.11
1,654	1,665	194.95	159.95	126.95	126.95	126.95	126.95	126.95	126.95	126.95	126.95	126.95
1,665	1,676	196.79	161.79	127.79	127.79	127.79	127.79	127.79	127.79	127.79	127.79	127.79
1,676	1,687	198.63	163.63	128.63	128.63	128.63	128.63	128.63	128.63	128.63	128.63	128.63
1,687	1,698	200.48	165.48	130.48	129.48	129.48	129.48	129.48	129.48	129.48	129.48	129.48
1,698	1,709	202.32	167.32	132.32	130.32	130.32	130.32	130.32	130.32	130.32	130.32	130.32
1,709	1,720	204.16	169.16	134.16	131.16	131.16	131.16	131.16	131.16	131.16	131.16	131.16
1,720	1,731	206.00	171.00	136.00	132.00	132.00	132.00	132.00	132.00	132.00	132.00	132.00
1,731	1,742	207.84	172.84	137.84	132.84	132.84	132.84	132.84	132.84	132.84	132.84	132.84

Combined Federal Income Tax, Employee Social Security Tax, and Employee Medicare Tax Withholding Tables

MARRIED Persons—**MONTHLY** Payroll Period

(For Wages Paid through December 2019)

And the wages are—		And the number of withholding allowances claimed is—										
At least	But less than	0	1	2	3	4	5	6	7	8	9	10
		The amount of income, social security, and Medicare taxes to be withheld is—										
1,742	1,753	209.68	174.68	139.68	133.68	133.68	133.68	133.68	133.68	133.68	133.68	133.68
1,753	1,773	212.87	177.87	142.87	134.87	134.87	134.87	134.87	134.87	134.87	134.87	134.87
1,773	1,793	216.40	181.40	146.40	136.40	136.40	136.40	136.40	136.40	136.40	136.40	136.40
1,793	1,813	219.93	184.93	149.93	137.93	137.93	137.93	137.93	137.93	137.93	137.93	137.93
1,813	1,833	223.46	188.46	153.46	139.46	139.46	139.46	139.46	139.46	139.46	139.46	139.46
1,833	1,853	226.99	191.99	156.99	140.99	140.99	140.99	140.99	140.99	140.99	140.99	140.99
1,853	1,873	230.52	195.52	160.52	142.52	142.52	142.52	142.52	142.52	142.52	142.52	142.52
1,873	1,893	234.05	199.05	164.05	144.05	144.05	144.05	144.05	144.05	144.05	144.05	144.05
1,893	1,913	237.58	202.58	167.58	145.58	145.58	145.58	145.58	145.58	145.58	145.58	145.58
1,913	1,933	241.11	206.11	171.11	147.11	147.11	147.11	147.11	147.11	147.11	147.11	147.11
1,933	1,953	244.64	209.64	174.64	148.64	148.64	148.64	148.64	148.64	148.64	148.64	148.64
1,953	1,973	248.17	213.17	178.17	150.17	150.17	150.17	150.17	150.17	150.17	150.17	150.17
1,973	1,993	251.70	216.70	181.70	151.70	151.70	151.70	151.70	151.70	151.70	151.70	151.70
1,993	2,013	255.23	220.23	185.23	153.23	153.23	153.23	153.23	153.23	153.23	153.23	153.23
2,013	2,033	258.76	223.76	188.76	154.76	154.76	154.76	154.76	154.76	154.76	154.76	154.76
2,033	2,053	262.29	227.29	192.29	157.29	156.29	156.29	156.29	156.29	156.29	156.29	156.29
2,053	2,073	265.82	230.82	195.82	160.82	157.82	157.82	157.82	157.82	157.82	157.82	157.82
2,073	2,093	269.35	234.35	199.35	164.35	159.35	159.35	159.35	159.35	159.35	159.35	159.35
2,093	2,113	272.88	237.88	202.88	167.88	160.88	160.88	160.88	160.88	160.88	160.88	160.88
2,113	2,133	276.41	241.41	206.41	171.41	162.41	162.41	162.41	162.41	162.41	162.41	162.41
2,133	2,153	279.94	244.94	209.94	174.94	163.94	163.94	163.94	163.94	163.94	163.94	163.94
2,153	2,173	283.47	248.47	213.47	178.47	165.47	165.47	165.47	165.47	165.47	165.47	165.47
2,173	2,193	287.00	252.00	217.00	182.00	167.00	167.00	167.00	167.00	167.00	167.00	167.00
2,193	2,213	290.53	255.53	220.53	185.53	168.53	168.53	168.53	168.53	168.53	168.53	168.53
2,213	2,233	294.06	259.06	224.06	189.06	170.06	170.06	170.06	170.06	170.06	170.06	170.06
2,233	2,253	297.59	262.59	227.59	192.59	171.59	171.59	171.59	171.59	171.59	171.59	171.59
2,253	2,273	301.12	266.12	231.12	196.12	173.12	173.12	173.12	173.12	173.12	173.12	173.12
2,273	2,293	304.65	269.65	234.65	199.65	174.65	174.65	174.65	174.65	174.65	174.65	174.65
2,293	2,313	308.18	273.18	238.18	203.18	176.18	176.18	176.18	176.18	176.18	176.18	176.18
2,313	2,333	311.71	276.71	241.71	206.71	177.71	177.71	177.71	177.71	177.71	177.71	177.71
2,333	2,353	315.24	280.24	245.24	210.24	179.24	179.24	179.24	179.24	179.24	179.24	179.24
2,353	2,373	318.77	283.77	248.77	213.77	180.77	180.77	180.77	180.77	180.77	180.77	180.77
2,373	2,393	322.30	287.30	252.30	217.30	182.30	182.30	182.30	182.30	182.30	182.30	182.30
2,393	2,413	325.83	290.83	255.83	220.83	185.83	183.83	183.83	183.83	183.83	183.83	183.83
2,413	2,433	329.36	294.36	259.36	224.36	189.36	185.36	185.36	185.36	185.36	185.36	185.36
2,433	2,453	332.89	297.89	262.89	227.89	192.89	186.89	186.89	186.89	186.89	186.89	186.89
2,453	2,473	336.42	301.42	266.42	231.42	196.42	188.42	188.42	188.42	188.42	188.42	188.42
2,473	2,493	339.95	304.95	269.95	234.95	199.95	189.95	189.95	189.95	189.95	189.95	189.95
2,493	2,513	343.48	308.48	273.48	238.48	203.48	191.48	191.48	191.48	191.48	191.48	191.48
2,513	2,553	348.77	313.77	278.77	243.77	208.77	193.77	193.77	193.77	193.77	193.77	193.77
2,553	2,593	355.83	320.83	285.83	250.83	215.83	196.83	196.83	196.83	196.83	196.83	196.83
2,593	2,633	362.89	327.89	292.89	257.89	222.89	199.89	199.89	199.89	199.89	199.89	199.89
2,633	2,673	370.95	334.95	299.95	264.95	229.95	202.95	202.95	202.95	202.95	202.95	202.95
2,673	2,713	379.01	342.01	307.01	272.01	237.01	206.01	206.01	206.01	206.01	206.01	206.01
2,713	2,753	387.07	349.07	314.07	279.07	244.07	209.07	209.07	209.07	209.07	209.07	209.07
2,753	2,793	394.13	356.13	321.13	286.13	251.13	216.13	212.13	212.13	212.13	212.13	212.13
2,793	2,833	402.19	363.19	328.19	293.19	258.19	223.19	215.19	215.19	215.19	215.19	215.19
2,833	2,873	410.25	370.25	335.25	300.25	265.25	230.25	218.25	218.25	218.25	218.25	218.25
2,873	2,913	418.31	377.31	342.31	307.31	272.31	237.31	221.31	221.31	221.31	221.31	221.31
2,913	2,953	426.37	384.37	349.37	314.37	279.37	244.37	224.37	224.37	224.37	224.37	224.37
2,953	2,993	433.43	391.43	356.43	321.43	286.43	251.43	227.43	227.43	227.43	227.43	227.43
2,993	3,033	441.49	399.49	363.49	328.49	293.49	258.49	230.49	230.49	230.49	230.49	230.49
3,033	3,073	449.55	407.55	370.55	335.55	300.55	265.55	233.55	233.55	233.55	233.55	233.55
3,073	3,113	457.61	415.61	377.61	342.61	307.61	272.61	237.61	236.61	236.61	236.61	236.61
3,113	3,153	465.67	423.67	384.67	349.67	314.67	279.67	244.67	239.67	239.67	239.67	239.67
3,153	3,193	472.73	430.73	391.73	356.73	321.73	286.73	251.73	242.73	242.73	242.73	242.73
3,193	3,233	480.79	438.79	398.79	363.79	328.79	293.79	258.79	245.79	245.79	245.79	245.79
3,233	3,273	488.85	446.85	405.85	370.85	335.85	300.85	265.85	248.85	248.85	248.85	248.85
3,273	3,313	496.91	454.91	412.91	377.91	342.91	307.91	272.91	251.91	251.91	251.91	251.91
3,313	3,353	504.97	462.97	420.97	384.97	349.97	314.97	279.97	254.97	254.97	254.97	254.97
3,353	3,393	512.03	470.03	428.03	392.03	357.03	322.03	287.03	258.03	258.03	258.03	258.03
3,393	3,433	520.09	478.09	436.09	399.09	364.09	329.09	294.09	261.09	261.09	261.09	261.09
3,433	3,473	528.15	486.15	444.15	406.15	371.15	336.15	301.15	266.15	264.15	264.15	264.15
3,473	3,513	536.21	494.21	452.21	413.21	378.21	343.21	308.21	273.21	267.21	267.21	267.21
3,513	3,553	544.27	502.27	460.27	420.27	385.27	350.27	315.27	280.27	270.27	270.27	270.27
3,553 and over		Do not use this table. See page 48 for instructions.										

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APPENDIX

A TAX RESEARCH WORKING PAPER FILE

INDEX TO TAX RESEARCH FILE*

Item	Page Reference
Determine the Facts	A-2
Identify the Issues	A-2
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Memorandum-to-the-File	A-6
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*Most accounting firms maintain a **client file** for each of their clients. Typically, this file contains copies of client letters, memoranda-to-the-file, relevant primary and secondary authorities, and billing information. In our case, the client file for Mercy Hospital would include copies of the following: (1) the December 12 letter to Elizabeth Feghali, (2) the December 9 memorandum-to-the-file, (3) Sec. 119, (4) Reg. Sec. 1.119-1, (5) the *Kowalski* opinion, (6) the *Standard Federal Tax Reporter* annotation, and (7) pertinent billing information.

Tax Research File

As mentioned in Chapter C:1 the tax research process entails six steps.

1. Determine the facts
2. Identify the issues
3. Locate applicable authorities
4. Evaluate these authorities
5. Analyze the facts in terms of applicable authorities
6. Communicate conclusions and recommendations to others.

Let us walk through each of these steps.

Determine the Facts Assume that we have determined the facts to be as follows:

> *Mercy Hospital maintains a cafeteria on its premises. In addition, it rents space to MacDougal's, a privately owned sandwich shop. The cafeteria closes at 8:00 p.m. MacDougal's is open 24 hours. Mercy provides meal vouchers to each of its 240 medical employees to enable them to remain on call in case of emergency. The vouchers are redeemable either at the cafeteria or at MacDougal's. Although the employees are not required to remain on or near the premises during meal hours, they generally do. Elizabeth Feghali, Mercy's Chief Administrator, has approached you with the following question: Is the value of a meal voucher includible in the employees' gross income?*

At this juncture, be sure you understand the facts before proceeding further. Remember, researching the wrong facts could produce the wrong results.

Identify the Issues Identifying the issues presupposes a minimum level of proficiency in tax accounting. This proficiency will come with time, effort, and perseverance. The central issue raised by the facts is the taxability of the meal vouchers. A resolution of this issue will hinge on the resolution of other issues raised in the course of the research.

Locate Applicable Authorities For some students, this step is the most difficult in the research process. It raises the perplexing question, "Where do I begin to look?" The answer depends on the tax resources at one's disposal, as well as one's research preferences. Four rules of thumb apply:

1. *Adopt an approach with which you are comfortable, and that you are confident will produce reliable results.*
2. *Always consult the IRC and other primary authorities.*
3. *Be as thorough as possible, taking into consideration time and billing constraints.*
4. *Make sure that the authorities you consult are current.*

One approach is to conduct a topical search. Begin by consulting the index to the Internal Revenue Code (IRC). Then read the relevant IRC section(s). If the language of the IRC is vague or ambiguous, turn to the Treasury Regulations. Read the relevant regulation section that elaborates or expounds on the IRC provision. If the language of the regulation is confusing or unclear, go to a commercial tax service. Read the relevant tax service paragraphs that explain or analyze the statutory and regulatory provisions. For references to other authorities, browse through the footnotes and annotations of the service. Then, consult these authorities directly. Finally, check the currency of the authorities consulted, with the aid of a citator.

If a pertinent court decision or IRS ruling has been called to your attention, consult this authority directly. Alternatively, browse through the status (finding) list of a tax service for references to tax service paragraphs that discuss this authority. Better still, consult a citator or status list for references to court opinions or rulings that cite the authority. If you subscribe to a computerized tax service, conduct a keyword, citation, contents, or topical search. Then, hyperlink to the authorities cited within the text of the documents retrieved. So numerous are the approaches to tax research that one is

virtually free to pick and choose. All that is required of the researcher is a basic level of skill and some imagination.

Let us adopt a topical approach to the issue of the meal vouchers. If we consult an index to the IRC, we are likely to find the heading "Meals and Lodging." Below this heading are likely to be several subheadings, some pertaining to deductions, others to exclusions. Because the voucher issue pertains to an exclusion, let us browse through these subheadings. In so doing, we will notice that most of these subheadings refer to Sec. 119. If we look up this IRC section, we will see the following passage:

Sec. 119. Meals or lodging furnished for the convenience of the employer.

(a) **Meals and lodging furnished to employee, his spouse, and his dependents, pursuant to employment.**
There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him . . . by, or on behalf of his employer for the convenience of the employer, but only if—

(1) in the case of meals, the meals are furnished on the business premises of the employer . . .

(b) **Special rules. For purposes of subsection (a)—**
(4) Meals furnished to employees on business premises where meals of most employees are otherwise excludable. All meals furnished on the business premises of an employer to such employer's employees shall be treated as furnished for the convenience of the employer if . . . more than half of the employees to whom such meals are furnished on such premises are furnished such meals for the convenience of the employer.

Section 119 appears to be applicable. It deals with meals furnished to an employee on the business premises of the employer. Our case deals with meal vouchers furnished to employees for redemption at employer-maintained and employer-rented-out facilities. But here, additional issues arise. For purposes of Sec. 119, are meal vouchers the same as "meals"? (Do not assume they are.) Are employer-maintained and employer-rented-out facilities the same as "the business premises of the employer"? (Again, do not assume they are.) And what does the IRC mean by "for the convenience of the employer"? Because the IRC offers no guidance in this respect, let us turn to the Treasury Regulations.

The applicable regulation is Reg. Sec. 1.119-1. How do we know this? Because Treasury Regulation section numbers track the IRC section numbers. Regulation Sec. 1.119-1 is the only regulation under Sec. 119. If we browse through this regulation, we will find the following provision:

(a) **Meals . . .**
(2) Meals furnished without a charge
(i) Meals furnished by an employer without charge to the employee will be regarded as furnished for the convenience of the employer if such meals are furnished for a substantial noncompensatory business reason of the employer . . .
(ii) (a) Meals will be regarded as furnished for a substantial noncompensatory business reason of the employer when the meals are furnished to the employee during his working hours to have the employee available for emergency call during his meal period . . .

(c) **Business premises of the employer.**
(1) In general. For purposes of this section, the term "business premises of the employer" generally means the place of employment of the employee . . .

Based on a reading of this provision, we might conclude that the hospital meals are furnished "for the convenience of the employer." Why? Because they are furnished for a "substantial noncompensatory business reason of the employer," namely, to have the employees available for emergency call during their meal periods. They also are furnished during the employees' working hours. Moreover, under Sec. 119(b)(4), if more than half the employees satisfy the "for the convenience of the employer" test, all employees will be regarded as satisfying the test. But are the meals furnished on "the business premises of the employer"? Under the regulation, the answer would depend. If the meals are furnished in the hospital cafeteria, they probably are furnished on "the business premises of the employer." The hospital is the place of employment of the medical employees. The cafeteria

is part of the hospital. On the other hand, if the meals are furnished at MacDougal's, they probably are not furnished on "the business premises of the employer." MacDougal's is not the place of employment of the medical employees. Nor is it a part of the hospital. Thus, Reg. Sec. 1.119-1 is enlightening with respect to two statutory terms: "for the convenience of the employer" and "the business premises of the employer." However, it is obscure with respect to the third term, "meals." Because of this obscurity, let us turn to a tax service.

Although the index to RIA's Federal Tax Coordinator 2d does not list "meal vouchers," it does list "cash allowances" as a subtopic under Meals and Lodging. Under the heading for "cash allowances" is a subheading for "in-kind requirement" and a reference to ¶H-1790. Cash allowances for meals and lodging: the "in-kind" requirement for purposes of the exclusion for meals and lodging furnished to employees. If we look up this reference, we will find the following annotation:

> The Supreme Court has held that Code Sec. 119 (which provides an exclusion for certain employer-provided meals, see ¶H-1751 et seq.) does not cover cash payments of any kind. The Supreme Court said that, by its terms, Code Sec. 119 covers meals furnished by the employer, but not cash reimbursements for meals.

The footnote in the annotation refers us to the *Kowalski* case, in which the Supreme Court decided that cash meal allowances received by an employee were not excludible from the employee's income.[1] Is the *Kowalski* case similar to our case? It might be. Let us find out. If we turn to paragraph 9748 of the second 1977 volume of *United States Tax Cases,* we will find the text of the *Kowalski* opinion. A synopsis of this opinion is present below.

In the mid-1970s, the State of New Jersey provided cash meal allowances to its state troopers. The state did not require the troopers to use the allowances exclusively for meals. Nor did it require them to consume their meals on its business premises. One trooper, Robert J. Kowalski, failed to report a portion of his allowance on his tax return. The IRS assessed a deficiency, and Kowalski took the IRS to court. In court, Kowalski argued that the meal allowances were excludible, because they were furnished "for the convenience of the employer." The IRS contended that the allowances were taxable because they amounted to compensation. The Supreme Court took up the case and sided with the IRS. The Court held that the Sec. 119 income exclusion does not apply to cash payments; it applies only to meals in kind.[2]

For the sake of illustration, let us assume that Sec. 119, Reg. Sec. 1.119-1, and the *Kowalski* case are the *only* authorities "on point." How should we evaluate them?

Evaluate Authorities Section 119 is the key authority applicable to our case. It supplies the operative rule for resolving the issue of the meal vouchers. It is vague, however, with respect to three terms: "meals," "business premises of the employer," and "for the convenience of the employer." The principal judicial authority is the *Kowalski* case. It provides an official interpretation of the term "meals." Because the U.S. Supreme Court decided *Kowalski*, the case should be assigned considerable weight. The relevant administrative authority is Reg. Sec. 1.119-1. It expounds on the terms "business premises of the employer" and "for the convenience of the employer." Because neither the IRC nor *Kowalski* explain these terms, Reg. Sec. 1.119-1 should be accorded great weight. But what if *Kowalski* had conflicted with Reg. Sec. 1.119-1? Which should be considered more authoritative? As a general rule, high court decisions "trump" the Treasury Regulations (and all IRS pronouncements for that matter). The more recent the decision, the greater its precedential weight. Had there been no Supreme Court decision and a division of appellate authority, equal weight should have been assigned to each of the appellate court decisions.

Analyze the Facts in Terms of Applicable Authorities Analyzing the facts in terms of applicable authorities involves applying the abstraction of the law to the concreteness of the facts. It entails expressing the generalities of the law in terms of the specifics of the facts. In this process, every legal condition must be satisfied for the result implied by the general

[1] *Comm. v. Kowalski, Robert J.,* 40 AFTR 2d 77-6128, 77-2 USTC ¶9748 (USSC, 1977).

[2] At this juncture, the researcher should consult a citator to determine whether *Kowalski* is still "good law," and to locate other authorities that cite *Kowalski.*

rule to ensue. Thus, in our case, the conditions of furnishing "meals," "on the business premises of the employer," and "for the convenience of the employer" must be satisfied for the value of the "meals" to be excluded from the employee's income.

When analyzing the facts in terms of case law, the researcher should always draw an *analogy* between case facts and client facts. Likewise, he or she should always draw a *distinction* between case facts and client facts. Remember, under the rule of precedent, a court deciding the client's case will be bound by the precedent of cases involving *similar* facts and issues. By the same token, it will *not* be bound by the precedent of cases involving *dissimilar* facts and issues.

The most useful vehicle for analyzing client facts is the memorandum-to-the-file (see page A-6). The purpose of this document is threefold: first, it assists the researcher in recollecting transactions long transpired; second, it apprises colleagues and supervisors of the nature of one's research; third, it provides "substantial authority" for the tax treatment of a particular item. Let us analyze the facts of our case by way of a memorandum-to-the-file. Notice the format of this document; it generally tracks the steps in the research process itself.

Communicate Conclusions and Recommendations to Others For three practical reasons, research results always should be communicated to the client *in writing*. First, a written communication can be made after extensive revisions. An oral communication cannot. Second, in a written communication, the researcher can delve into the intricacies of tax law. Often, in an oral communication, he or she cannot. Third, a written communication reinforces an oral understanding. Alternatively, it brings to light an oral misunderstanding.

The written communication usually takes the form of a client letter (see page A-7). The purpose of this letter is two-fold: first, it apprises the client of the results of one's research, and second, it recommends to the client a course of action based on these results. A sample client letter is presented below. Notice the organization of this document; it is similar to that of the memorandum-to-the-file.

Memorandum-to-the-File

Date: December 9, 20X1
From: Rosina Havacek
Re: The taxability of meal vouchers furnished by Mercy Hospital to its medical staff.

Facts

[*State only the facts that are relevant to the Issue(s) and necessary for the Analysis.*] Our client, Mercy Hospital ("Mercy"), provides meal vouchers to its medical employees to enable them to remain on emergency call. The vouchers are redeemable at Mercy's onsite cafeteria and at MacDougal's, a privately owned sandwich shop. MacDougal's rents business space from the hospital. Although Mercy does not require its employees to remain on or near its premises during their meal hours, the employees generally do. Elizabeth Feghali, Mercy's Chief Administrator, has asked us to research whether the value of the meal vouchers is taxable to the employees.

Issues

[*Identify the issue(s) raised by the facts. Be specific.*] The taxability of the meal vouchers depends on three issues: first, whether the meals are furnished "for the convenience of the employer"; second, whether they are furnished "on the business premises of the employer"; and third, whether the vouchers are equivalent to cash.

Applicable Law

[*Discuss those legal principles that both strengthen and weaken the client's case. Because the primary authority for tax law is the IRC, begin with the IRC.*] Section 119 provides that the value of meals is excludible from an employee's income if the meals are furnished for the convenience of, and on the business premises of the employer. [*Discuss how administrative and/or judicial authorities expound on statutory terms.*] Under Reg. Sec. 1.119-1, a meal is furnished "for the convenience of the employer" if it is furnished for a "substantial noncompensatory business reason." A "substantial noncompensatory business reason" includes the need to have the employee available for emergency calls during his or her meal period. Under Sec. 119(b)(4), if more than half the employees satisfy the "for the convenience of the employer" test, all employees will be regarded as satisfying the test. Regulation Sec. 1.119-1 defines "business premises of the employer" as the place of employment of the employee.

[*When discussing court cases, present case facts in such a way as to enable the reader to draw an analogy with client facts.*] A Supreme Court case, *Comm. v. Kowalski, Robert J.,* 40 AFTR 2d 77-6128, 77-2 USTC ¶9748 (USSC, 1977), discusses what constitutes "meals" for purposes of Sec. 119. In *Kowalski,* the State of New Jersey furnished cash meal allowances to its state troopers to enable them to eat while on duty. It did not require the troopers to use the allowances exclusively for meals. Nor did it require them to consume their meals on its business premises. One trooper, R.J. Kowalski, excluded the value of his allowances from his income. The IRS disputed this treatment, and Kowalski took the IRS to Court. In Court, Kowalski argued that the allowances were excludible because they were furnished "for the convenience of the employer." The IRS contended that the allowances were taxable because they amounted to compensation. The U.S. Supreme Court took up the case and decided for the IRS. The Court held that the Sec. 119 income exclusion does not apply to payments in cash.

Analysis

[*The analysis should (a) apply applicable law to the facts and (b) address the issue(s). In this section, every proposition should be supported by either authority, logic, or plausible assumptions.*]

Issue 1: The meals provided by Mercy seem to be furnished "for the convenience of the employer." They are furnished to have employees available for emergency call during their meal breaks. This is a "substantial noncompensatory reason" within the meaning of Reg. Sec. 1.119-1.

Issue 2: Although the hospital cafeteria appears to be the "business premises of the employer," MacDougal's does not appear to be. The hospital is the place of employment of the medical employees. MacDougal's is not.

Issue 3: [*In applying case law to the facts, indicate how case facts are similar to/dissimilar from client facts. If the analysis does not support a "yes-no" answer, do not give one.*] Based on the foregoing authorities, it is unclear whether the vouchers are equivalent to cash. On the one hand, they are redeemable only in meals. Thus, they resemble meals-in-kind. On the other hand, they are redeemable at more than one institution. Thus, they resemble cash. Nor is it clear whether a court deciding this case would reach the same conclusion as the Supreme Court did in *Kowalski.* In the latter case, the State of New Jersey provided its meal allowances in the form of cash. It did not require its employees to use the allowances exclusively for meals. Nor did it require them to consume their meals on its business premises. In our case, Mercy provides its meal allowances in the form of vouchers. Thus, it indirectly requires its employees to use the allowances exclusively for meals. On the other hand, it does not require them to consume their meals on its business premises.

Conclusion

[*The conclusion should (a) logically flow from the analysis, and (b) address the issue(s).*] Although it appears that the meals acquired by voucher in the hospital cafeteria are furnished "for the convenience of the employer" and "on the business premises of the employer," it is unclear whether the vouchers are equivalent to cash. If they *are* equivalent to cash, *or* if they are redeemed at MacDougal's, their value is likely to be taxable to the employees. On the other hand, if they are not equivalent to cash, *and* they are redeemed only in the hospital cafeteria, their value is likely to be excludible.

Professional Accounting Associates
2701 First City Plaza
Suite 905
Southwest City, Texas 75019

December 12, 20X1

Elizabeth Feghali, Chief Administrator
Mercy Hospital
22650 West Haven Drive
Southwest City, Texas 75527

Dear Ms. Feghali:

[*Introduction. Set a cordial tone.*] It was great to see you at last Thursday's football game. If not for that last minute fumble, the Longhorns might have taken the Big 12 Conference championship!

[*Issue/Purpose.*] In our meeting of December 6, you asked us to research whether the value of the meal vouchers that Mercy provides to its medical employees is taxable to the employees. [*Short Answer.*] I regret to inform you that if the vouchers are redeemed at MacDougal's, their value is likely to be taxable to the employees. On the other hand, if the vouchers are redeemed in the hospital cafeteria, their value is likely to be excludible from the employee's income. [*The remainder of the letter should elaborate, support, and qualify this answer.*]

[*Steps taken in deriving conclusion.*] In reaching this conclusion, we consulted relevant provisions of the Internal Revenue Code ("IRC"), applicable Treasury Regulations under the IRC, and a pertinent Supreme Court case. In addition, we reviewed the documents on employee benefits that you submitted to us at our earlier meeting.

[*Facts. State only the facts that are relevant to the issue and necessary for the analysis.*] The facts as we understand them are as follows: Mercy provides meal vouchers to its medical employees to enable them to eat while on emergency call. The vouchers are redeemable either in the hospital cafeteria or at MacDougal's. MacDougal's is a privately owned institution that rents business space from the hospital. Although Mercy's employees are not required to remain on or near the premises during their meal hours, they generally do.

[*Applicable law. State, do not interpret.*] Under the IRC, the value of meals is excludible from an employee's income if two conditions are met: first, the meals are furnished "for the convenience of the employer" and second, they are provided "on the business premises of the employer." Although the IRC does not explain what is meant by "for the convenience of the employer," "business premises of the employer," and "meals," other authorities do. Specifically, the Treasury Regulations define "business premises of the employer" to be the place of employment of the employees. The regulations state that providing meals during work hours to have an employee available for emergency calls is "for the convenience of the employer." Moreover, under the IRC, if more than half the employees satisfy the "for the convenience of the employer" test, all the employees will be regarded as satisfying the test. The Supreme Court has interpreted "meals" to mean food-in-kind. The Court has held that cash allowances do not qualify as "meals."

[*Analysis. Express the generalities of applicable law in terms of the specifics of the facts.*] Clearly, the meals furnished by Mercy are "for the convenience of the employer." They are furnished during the employees' work hours to have the employees available for emergency call. Although the meals provided in the hospital cafeteria appear to be furnished "on the business premises of the employer," the meals provided at MacDougal's do not appear to be. The hospital is the place of employment of the medical employees. MacDougal's is not. What is unclear is whether the meal vouchers are equivalent to food-in-kind. On the one hand, they are redeemable at more than one institution and thus resemble cash allowances. On the other hand, they are redeemable only in meals and thus resemble food-in-kind.

[*Conclusion/Recommendation.*] Because of this lack of clarity, we suggest that you modify your employee benefits plan to allow for the provision of meals-in-kind exclusively in the hospital cafeteria. In this way, you will dispel any doubt that Mercy is furnishing "meals," "for the convenience of the employer," "on the premises of the employer."

[*Closing/Follow Up.*] Please call me at 475-2020 if you have any questions concerning this conclusion. May I suggest that we meet next week to discuss the possibility of revising your employee benefits plan.

Very truly yours,
Professional Accounting Associates

By: Rosina Havacek, Junior Associate

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APPENDIX

B TAX FORMS

Form #	Form Title	Page No.
1040	U.S. Individual Income Tax Return	I2-8
1040	Schedule 1—Additional Income and Adjustments to Income	I2-10
1040	Schedule A—Itemized Deductions	I8-36
1040	Schedule B—Interest and Ordinary Dividends	I3-35
1040	Schedule C—-Profit or Loss from Business	B-2
1040	Schedule D—Capital Gains and Losses	I5-35
1040	Schedule SE—Self-Employment Tax	B-6
2120	Multiple Support Declaration	I2-17
2210	Underpayment of Estimated Tax by Individuals, Estates, and Trusts	B-8
2441	Child and Dependent Care Expenses	B-12
4562	Depreciation and Amortization	I10-26
4684	Casualties and Thefts	B-14
4797	Sales of Business Property	I13-25
6251	Alternative Minimum Tax—Individuals	B-16
6252	Installment Sale Income	I11-29
8283	Noncash Charitable Contributions	B-18
8582	Passive Activity Loss Limitations	B-20
8615	Tax for Certain Children Who Have Unearned Income	B-23

Note: Because of the availability of tax forms from many sources, only a limited number of forms are reprinted in this textbook. All federal forms are available from the Internal Revenue Service, either in paper form or from the IRS Web site, http://www.irs.gov.

Facts for Sole Proprietorship (Schedule C)

Andrew Lawrence is the sole proprietor of a business that operates under the name Andrew Lawrence Furniture (Business Code 337000). The proprietorship is located at 1234 First Avenue, City, ST 55555. Andrew started the business with a $200,000 capital investment on June 1, 2012. The proprietorship uses the calendar year as its tax year (the same as its proprietor) and the accrual method of accounting. The following information pertains to its 2018 activities:

A trial balance is included as part of the accompanying worksheet. Notes accompanying the account balances are presented below.

1. Cost of goods sold is determined as follows:

Inventory at beginning of year	$ 64,000
Plus: Purchases	340,800
Cost of labor	143,204
Other costs	97,000
Goods available for sale	$645,004
Minus: Inventory at end of year	(104,800)
Cost of goods sold	$540,204

The proprietorship values its inventory using the first-in, first-out method and historical costs. No change in valuing inventories occurred between the beginning and end of the tax year.

2. The proprietorship uses MACRS depreciation for tax purposes. The current year tax depreciation is $27,476. Of this amount, $15,000 is included in cost of goods sold and inventory. The AMT depreciation adjustment on post-1986 personal property is $1,514. This amount is reported on Andrew Lawrence's Form 6251 (Alternative Minimum Tax—Individuals), which is not reproduced here.

3. Using its excess funds, the proprietorship has purchased various temporary investments, including a 2% investment in Plaza Corporation stock, 50 shares of Service Corporation stock, and some tax-exempt municipal bonds. The proprietorship has held the Plaza stock for two years and sold it in July for $4,500 more than its $7,000 adjusted basis. Prior to the sale, Plaza paid a $1,000 dividend. The 50 shares of Service stock, which had been purchased during the year, was declared worthless during the year. The proprietorship recovered none of its $2,100 adjusted basis.

4. Employees other than Andrew Lawrence receive limited fringe benefits. One employee also receives a $2,000 contribution to an Individual Retirement Account paid by the proprietorship.

5. Miscellaneous expenses include $150 of expenses related to the production of the dividend income (investment interest expense).

6. The proprietorship paid no estimated taxes.

7. Balance sheet information is not provided for the sole proprietorship because it is not reported on the Schedule C. Balance sheet information, however, can be found on page 4 of the C corporation tax return.

8. For additional information, see Schedule C and the worksheet on page B-5.

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)

► Go to *www.irs.gov/ScheduleC* for instructions and the latest information.
► Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074
2018
Attachment Sequence No. 09

Name of proprietor	Social security number (SSN)
Andrew Lawrence	XXX-XX-XXXX

A Principal business or profession, including product or service (see instructions): Manufacturing Furniture

B Enter code from instructions ► 337000

C Business name. If no separate business name, leave blank.: Andrew Lawrence Furniture

D Employer ID number (EIN), (see instr.): X X X X X X X X X

E Business address (including suite or room no.) ► 1234 First Avenue
City, town or post office, state, and ZIP code: City, ST 55555

F Accounting method: (1) ☐ Cash (2) ☒ Accrual (3) ☐ 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 . . . ► ☐

I Did you make any payments in 2018 that would require you to file Form(s) 1099? (see instructions) . ☐ Yes ☒ No

J If "Yes," did you or will you file required Forms 1099? . ☐ Yes ☐ No

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 ► ☐	1	869,658
2	Returns and allowances	2	29,242
3	Subtract line 2 from line 1	3	840,416
4	Cost of goods sold (from line 42)	4	540,204
5	**Gross profit.** Subtract line 4 from line 3	5	300,212
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7	**Gross income.** Add lines 5 and 6 ►	7	300,212

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

8	Advertising	8	13,000	18	Office expense (see instructions)	18	16,000
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	2,000
10	Commissions and fees	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		a	Vehicles, machinery, and equipment	20a	36,000
12	Depletion	12		b	Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	12,476	21	Repairs and maintenance	21	4,800
14	Employee benefit programs (other than on line 19)	14	7,000	22	Supplies (not included in Part III)	22	
15	Insurance (other than health)	15		23	Taxes and licenses	23	9,840
16	Interest (see instructions):			24	Travel and meals:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel	24a	4,000
b	Other	16b	8,000	b	Deductible meals (see instructions)	24b	1,000
17	Legal and professional services	17		25	Utilities	25	
				26	Wages (less employment credits)	26	52,000
				27a	Other expenses (from line 48)	27a	18,250
				b	**Reserved for future use**	27b	
28	**Total expenses** before expenses for business use of home. Add lines 8 through 27a ►					28	184,366
29	Tentative profit or (loss). Subtract line 28 from line 7					29	115,846

30 Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions).
Simplified method filers only: enter the total square footage of: (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30 . . . 30

31 **Net profit or (loss).** Subtract line 30 from line 29. 31: 115,846
- If a profit, enter on both **Schedule 1 (Form 1040), line 12** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** (If you checked the box on line 1, see instructions). Estates and trusts, enter on **Form 1041, line 3.**
- If a loss, you **must** go to line 32.

32 If you have a loss, check the box that describes your investment in this activity (see instructions).
- If you checked 32a, enter the loss on both **Schedule 1 (Form 1040), line 12,** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on **Form 1041, line 3.**
- If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

Part III Cost of Goods Sold (see instructions)

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

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation . . . [ ] Yes [X] No

35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	64,000	
36	Purchases less cost of items withdrawn for personal use	36	340,800	
37	Cost of labor. Do not include any amounts paid to yourself	37	143,204	
38	Materials and supplies	38		
39	Other costs	39	97,000	
40	Add lines 35 through 39	40	645,004	
41	Inventory at end of year	41	104,800	
42	**Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on line 4	42	540,204	

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) ► 3 / 12 / 17

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

a Business 17,000 b Commuting (see instructions) 4,500 c Other 12,000

45 Was your vehicle available for personal use during off-duty hours? [X] Yes [ ] No

46 Do you (or your spouse) have another vehicle available for personal use? [X] Yes [ ] No

47a Do you have evidence to support your deduction? [X] Yes [ ] No

b If "Yes," is the evidence written? [X] Yes [ ] No

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

Transportation		10,400
General and administrative		3,000
Bad debts		4,000
Miscellaneous		850
48 **Total other expenses.** Enter here and on line 27a	48	18,250

Andrew Lawrence, Sole Proprietorship Reconciliation of Book and Taxable Income for Year Ending December 31, 2018

	Book Income		Adjustments		Taxable Income		Schedule	Other Tax	
Account Name	Debit	Credit	Debit	Credit	Debit	Credit	C	Forms	
Sales		$869,658				$869,658	$869,658		
Sales returns & allowances	$ 29,242				$ 29,242		(29,242)		
Cost of sales	540,204				540,204		(540,204)		
Dividends		1,000			1,000	1,000		$ 1,000	(Sch. B)
Tax-exempt interest		18,000	$18,000			0			
Gain on July stock sale		4,500				4,500		4,500	(Sch. D)
Worthless stock loss	2,100				2,100			(2,100)	(Sch. D)
Proprietor's salary[a]	36,000			$36,000	0		0	0	
Other salaries	52,000				52,000		(52,000)		
Rentals	36,000				36,000		(36,000)		
Bad debts	4,000				4,000		(4,000)		
Interest:									
Working capital loans	8,000				8,000		(8,000)		
Purchase tax-exempt bonds	2,000			2,000	0				
Employment taxes	8,320				8,320		(8,320)		
Taxes	1,520				1,520		(1,520)		
Repairs	4,800				4,800		(4,800)		
Depreciation[b]	12,000		476		12,476		(12,476)		
Charitable contributions	12,000				12,000			(12,000)	(Sch. A)
Travel	4,000				4,000		(4,000)		
Meals and entertainment[c]	5,000			4,000	1,000		(1,000)		
Office expenses	16,000				16,000		(16,000)		
Advertising	13,000				13,000		(13,000)		
Transportation expense	10,400				10,400		(10,400)		
General and administrative	3,000				3,000		(3,000)		
Pension plans[d]	2,000				2,000		(2,000)		
Employee benefit programs[e]	7,000				7,000		(7,000)		
Miscellaneous	1,000				1,000		(850)	(150)	(Form 4952)
Net profit/Taxable income	83,572		23,524		107,096				
Total	$893,158	$893,158	$42,000	$42,000	$875,158	$875,158	$115,846		

[a] The $3,000 monthly salary for Andrew Lawrence is treated as a withdrawal from the proprietorship and is not deducted on Schedule C. The salary does not reduce Schedule C income and therefore is taxed as self-employment income.
[b] MACRS depreciation is $27,476 2 $15,000 5 $12,476
[c] Of the $5,000 total, $3,000 is allocated to nondeductible entertainment and $2,000 is allocated to meals subject to the 50% disallowance for tax purposes.
[d] The pension plan expense is the same for book and tax purposes for this business. No pension expenses relate to pensions for the proprietor.
[e] The employee benefit expense is the same for book and tax purposes for this business. None relates to proprietor benefits.

SCHEDULE SE (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

► Go to *www.irs.gov/ScheduleSE* for instructions and the latest information.

► Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2018

Attachment Sequence No. **17**

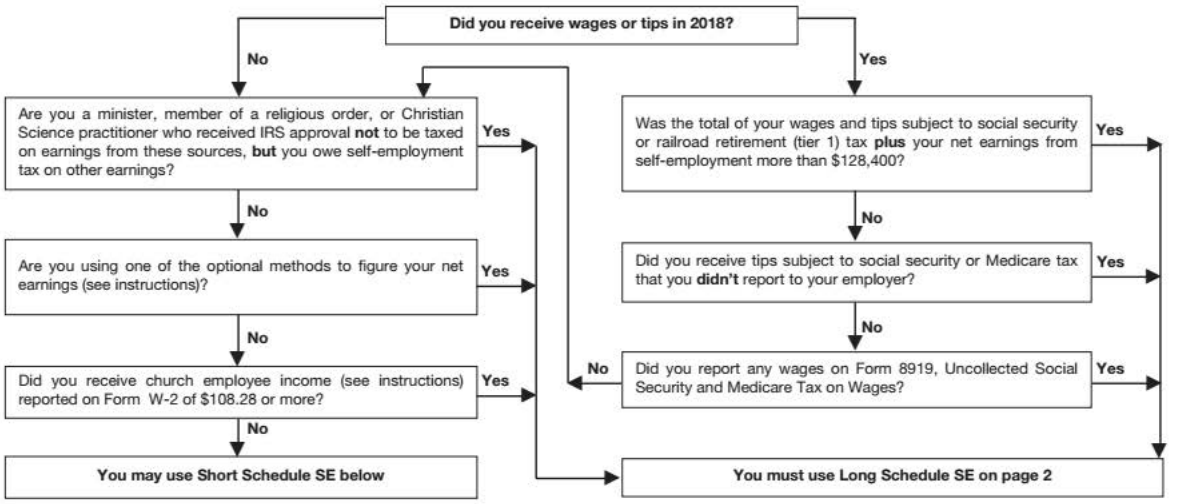
Name of person with **self-employment** income (as shown on Form 1040 or Form 1040NR)

Social security number of person with **self-employment** income ►

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

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

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



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

1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a	
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AH	1b	( )
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report	2	
3	Combine lines 1a, 1b, and 2	3	
4	Multiply line 3 by 92.35% (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 ►	4	
	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**	5	
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (0.50). Enter the result here and on **Schedule 1 (Form 1040), line 27,** or **Form 1040NR, line 27**	6	

Name of person with **self-employment** income (as shown on Form 1040 or Form 1040NR) | Social security number of person with **self-employment** income ▶

Section B—Long Schedule SE

Part I Self-Employment Tax

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

A If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had $400 or more of **other** net earnings from self-employment, check here and continue with Part I . . . . . ▶ ☐

1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A. **Note:** Skip lines 1a and 1b if you use the farm optional method (see instructions)		**1a**	
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AH		**1b**	( )
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report. **Note:** Skip this line if you use the nonfarm optional method (see instructions)		**2**	
3	Combine lines 1a, 1b, and 2		**3**	
4a	If line 3 is more than zero, multiply line 3 by 92.35% (0.9235). Otherwise, enter amount from line 3 **Note:** If line 4a is less than $400 due to Conservation Reserve Program payments on line 1b, see instructions.		**4a**	
b	If you elect one or both of the optional methods, enter the total of lines 15 and 17 here		**4b**	
c	Combine lines 4a and 4b. If less than $400, **stop;** you don't owe self-employment tax. **Exception:** If less than $400 and you had **church employee income,** enter -0- and continue ▶		**4c**	
5a	Enter your **church employee income** from Form W-2. See instructions for definition of church employee income **5a**			
b	Multiply line 5a by 92.35% (0.9235). If less than $100, enter -0-		**5b**	
6	Add lines 4c and 5b		**6**	
7	Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2018		**7**	
8a	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If $128,400 or more, skip lines 8b through 10, and go to line 11 **8a**			
b	Unreported tips subject to social security tax (from Form 4137, line 10) **8b**			
c	Wages subject to social security tax (from Form 8919, line 10) **8c**			
d	Add lines 8a, 8b, and 8c		**8d**	
9	Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11 ▶		**9**	
10	Multiply the **smaller** of line 6 or line 9 by 12.4% (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.** Multiply line 12 by 50% (0.50). Enter the result here and on **Schedule 1 (Form 1040), line 27,** or **Form 1040NR, line 27** **13**			

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

Farm Optional Method. You may use this method **only** if **(a)** your gross farm income[1] wasn't more than $7,920, **or (b)** your net farm profits[2] were less than $5,717.

14	Maximum income for optional methods		**14**	
15	Enter the **smaller** of: two-thirds (2/3) of gross farm income[1] (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 profits[3] were less than $5,717 and also less than 72.189% of your gross nonfarm income,[4] **and (b)** you had net earnings from self-employment of at least $400 in 2 of the prior 3 years. **Caution:** You may use this method no more than five times.

16	Subtract line 15 from line 14		**16**	
17	Enter the **smaller** of: two-thirds (2/3) of gross nonfarm income[4] (not less than zero) **or** the amount on line 16. Also include this amount on line 4b above		**17**	

[1] From Sch. F, line 9, and Sch. K-1 (Form 1065), box 14, code B.

[2] From Sch. F, line 34, and Sch. K-1 (Form 1065), box 14, code A—minus the amount you would have entered on line 1b had you not used the optional method.

[3] From Sch. C, line 31; Sch. C-EZ, line 3; Sch. K-1 (Form 1065), box 14, code A; and Sch. K-1 (Form 1065-B), box 9, code J1.

[4] From Sch. C, line 7; Sch. C-EZ, line 1; Sch. K-1 (Form 1065), box 14, code C; and Sch. K-1 (Form 1065-B), box 9, code J2.

Form **2210**

Department of the Treasury
Internal Revenue Service

Underpayment of Estimated Tax by Individuals, Estates, and Trusts

▶ Go to *www.irs.gov/Form2210* for instructions and the latest information.
▶ Attach to Form 1040, 1040NR, 1040NR-EZ, or 1041.

OMB No. 1545-0074

2018

Attachment Sequence No. **06**

Name(s) shown on tax return

Identifying number

Do You Have To File Form 2210?

Complete lines 1 through 7 below. Is line 7 less than $1,000?
- Yes → **Don't file Form 2210.** You don't owe a penalty.
- No ↓

Complete lines 8 and 9 below. Is line 6 equal to or more than line 9?
- Yes → You don't owe a penalty. **Don't file Form 2210** (but if box **E** in Part II applies, you must file page 1 of Form 2210).
- No ↓

You may owe a penalty. Does any box in Part II below apply?
- Yes → You **must** file Form 2210. Does box **B, C,** or **D** in Part II apply?
  - Yes → You must figure your penalty.
  - No → You **aren't** required to figure your penalty because the IRS will figure it and send you a bill for any unpaid amount. If you want to figure it, you may use Part III or Part IV as a worksheet and enter your penalty amount on your tax return, but **file only page 1 of Form 2210.**
- No → **Don't file Form 2210.** You aren't required to figure your penalty because the IRS will figure it and send you a bill for any unpaid amount. If you want to figure it, you may use Part III or Part IV as a worksheet and enter your penalty amount on your tax return, but **don't file Form 2210.**

Part I Required Annual Payment

1	Enter your 2018 tax after credits from Form 1040, line 13 (see instructions if not filing Form 1040)	1	
2	Other taxes, including self-employment tax and, if applicable, Additional Medicare Tax and/or Net Investment Income Tax (see instructions)	2	
3	Refundable credits, including the premium tax credit (see instructions)	3	( )
4	Current year tax. Combine lines 1, 2, and 3. If less than $1,000, **stop;** you don't owe a penalty. **Don't** file Form 2210	4	
5	Multiply line 4 by 90% (0.90) — 5		
6	Withholding taxes. **Don't** include estimated tax payments (see instructions)	6	
7	Subtract line 6 from line 4. If less than $1,000, **stop**; you don't owe a penalty. **Don't** file Form 2210	7	
8	Maximum required annual payment based on prior year's tax (see instructions)	8	
9	**Required annual payment.** Enter the **smaller** of line 5 or line 8	9	

Next: Is line 9 more than line 6?

- ☐ **No.** You **don't** owe a penalty. **Don't** file Form 2210 unless box **E** below applies.
- ☐ **Yes.** You may owe a penalty, but **don't** file Form 2210 unless one or more boxes in Part II below applies.
  - If box **B, C,** or **D** applies, you must figure your penalty and file Form 2210.
  - If box **A** or **E** applies (but not **B, C,** or **D**) file only page 1 of Form 2210. You **aren't** required to figure your penalty; the IRS will figure it and send you a bill for any unpaid amount. If you want to figure your penalty, you may use Part III or IV as a worksheet and enter your penalty on your tax return, but **file only page 1 of Form 2210.**

Part II Reasons for Filing. Check applicable boxes. If none apply, **don't** file Form 2210.

- **A** ☐ You request a **waiver** (see instructions) of your entire penalty due to tax reform or other reasons. You must check this box and file page 1 of Form 2210, but you aren't required to figure your penalty.
- **B** ☐ You request a **waiver** (see instructions) of part of your penalty. You must figure your penalty and waiver amount and file Form 2210.
- **C** ☐ Your income varied during the year and your penalty is reduced or eliminated when figured using the **annualized income installment method.** You must figure the penalty using Schedule AI and file Form 2210.
- **D** ☐ Your penalty is lower when figured by treating the federal income tax withheld from your income as paid on the dates it was actually withheld, instead of in equal amounts on the payment due dates. You must figure your penalty and file Form 2210.
- **E** ☐ You filed or are filing a joint return for either 2017 or 2018, but not for both years, and line 8 above is smaller than line 5 above. You must file page 1 of Form 2210, but you **aren't** required to figure your penalty (unless box **B, C,** or **D** applies).

Part III Short Method

Can You Use the Short Method?

You may use the short method if:

- You made no estimated tax payments (or your only payments were withheld federal income tax), **or**
- You paid the same amount of estimated tax on each of the four payment due dates.

Must You Use the Regular Method?

You must use the regular method (Part IV) instead of the short method if:

- You made any estimated tax payments late,
- You checked box **C** or **D** in Part II, **or**
- You are filing Form 1040NR or 1040NR-EZ and you didn't receive wages as an employee subject to U.S. income tax withholding.

Note: If any payment was made earlier than the due date, you can use the short method, but using it may cause you to pay a larger penalty than the regular method. If the payment was only a few days early, the difference is likely to be small.

10	Enter the amount from Form 2210, line 9			**10**	
11	Enter the amount, if any, from Form 2210, line 6	**11**			
12	Enter the total amount, if any, of estimated tax payments you made	**12**			
13	Add lines 11 and 12			**13**	
14	**Total underpayment for year.** Subtract line 13 from line 10. If zero or less, **stop**; you don't owe a penalty. **Don't file Form 2210 unless you checked box E in Part II**			**14**	
15	Multiply line 14 by 0.03603			**15**	
16	• If the amount on line 14 was paid **on or after** 4/15/19, enter -0-. • If the amount on line 14 was paid **before** 4/15/19, make the following computation to find the amount to enter on line 16. Amount on line 14 × Number of days paid before 4/15/19 × 0.00016			**16**	
17	**Penalty.** Subtract line 16 from line 15. Enter the result here and on Form 1040, line 23; Form 1040NR, line 76; Form 1040NR-EZ, line 26; or Form 1041, line 27. **Don't file Form 2210 unless you checked a box in Part II** ▶			**17**	

Part IV Regular Method (See the instructions if you are filing Form 1040NR or 1040NR-EZ.)

Section A—Figure Your Underpayment		Payment Due Dates (a) 4/15/18	(b) 6/15/18	(c) 9/15/18	(d) 1/15/19
18 **Required installments.** If box C in Part II applies, enter the amounts from Schedule AI, line 27. Otherwise, enter 25% (0.25) of line 9, Form 2210, in each column	18				
19 Estimated tax paid and tax withheld (see the instructions). For column (a) only, also enter the amount from line 19 on line 23. If line 19 is equal to or more than line 18 for all payment periods, stop here; you don't owe a penalty. **Don't file Form 2210 unless you checked a box in Part II**	19				
Complete lines 20 through 26 of one column before going to line 20 of the next column.					
20 Enter the amount, if any, from line 26 in the previous column	20				
21 Add lines 19 and 20	21				
22 Add the amounts on lines 24 and 25 in the previous column	22				
23 Subtract line 22 from line 21. If zero or less, enter -0-. For column (a) only, enter the amount from line 19	23				
24 If line 23 is zero, subtract line 21 from line 22. Otherwise, enter -0-	24				
25 **Underpayment.** If line 18 is equal to or more than line 23, subtract line 23 from line 18. Then go to line 20 of the next column. Otherwise, go to line 26 ▶	25				
26 Overpayment. If line 23 is more than line 18, subtract line 18 from line 23. Then go to line 20 of the next column	26				

Section B—Figure the Penalty (Use the Worksheet for Form 2210, Part IV, Section B—Figure the Penalty in the instructions.)

27 **Penalty.** Enter the total penalty from line 14 of the Worksheet for Form 2210, Part IV, Section B—Figure the Penalty. Also include this amount on Form 1040, line 23; Form 1040NR, line 76; Form 1040NR-EZ, line 26; or Form 1041, line 27. **Don't file Form 2210 unless you checked a box in Part II** ▶	27	

Schedule AI—Annualized Income Installment Method (See the instructions.)

Estates and trusts, **don't** use the period ending dates shown to the right. Instead, use the following: 2/28/18, 4/30/18, 7/31/18, and 11/30/18.

		(a) 1/1/18–3/31/18	(b) 1/1/18–5/31/18	(c) 1/1/18–8/31/18	(d) 1/1/18–12/31/18
Part I Annualized Income Installments					
1 Enter your adjusted gross income for each period (see instructions). (Estates and trusts, enter your taxable income without your exemption for each period.)	1				
2 Annualization amounts. (Estates and trusts, see instructions.)	2				
3 Annualized income. Multiply line 1 by line 2	3				
4 If you itemize, enter itemized deductions for the period shown in each column. All others enter -0-, and skip to line 7. **Exception:** Estates and trusts, skip to line 11 and enter amount from line 3	4				
5 Annualization amounts	5				
6 Multiply line 4 by line 5	6				
7 In each column, enter the full amount of your standard deduction from Form 1040, line 8. (Form 1040NR or 1040NR-EZ filers, enter -0-. **Exception:** Indian students and business apprentices, see instructions.)	7				
8 Enter the **larger** of line 6 or line 7	8				
9 Deduction for qualified business income	9				
10 Add lines 8 and 9	10				
11 Subtract line 10 from line 3	11				
12 Form 1040, 1040NR, or 1040NR-EZ filers, enter -0- in each column. (Estates and trusts, see instructions.)	12				
13 Subtract line 12 from line 11. If zero or less, enter -0-	13				
14 Figure your tax on the amount on line 13 (see instructions)	14				
15 Self-employment tax from line 36 (complete Part II below)	15				
16 Enter other taxes for each payment period including, if applicable, Additional Medicare Tax and/or Net Investment Income Tax (see instructions)	16				
17 Total tax. Add lines 14, 15, and 16	17				
18 For each period, enter the same type of credits as allowed on Form 2210, Part I, lines 1 and 3 (see instructions)	18				
19 Subtract line 18 from line 17. If zero or less, enter -0-	19				
20 Applicable percentage	20				
21 Multiply line 19 by line 20	21				
Complete lines 22–27 of one column before going to line 22 of the next column.					
22 Enter the total of the amounts in all previous columns of line 27	22				
23 Subtract line 22 from line 21. If zero or less, enter -0-	23				
24 Enter 25% (0.25) of line 9 on page 1 of Form 2210 in each column	24				
25 Subtract line 27 of the previous column from line 26 of that column	25				
26 Add lines 24 and 25	26				
27 Enter the **smaller** of line 23 or line 26 here and on Form 2210, Part IV, line 18 ►	27				
Part II Annualized Self-Employment Tax (Form 1040 and Form 1040NR filers only)					
28 Net earnings from self-employment for the period (see instructions)	28				
29 Prorated social security tax limit	29				
30 Enter actual wages for the period subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax. **Exception:** If you filed Form 4137 or Form 8919, see instructions	30				
31 Subtract line 30 from line 29. If zero or less, enter -0-	31				
32 Annualization amounts	32				
33 Multiply line 32 by the **smaller** of line 28 or line 31	33				
34 Annualization amounts	34				
35 Multiply line 28 by line 34	35				
36 Add lines 33 and 35. Enter here and on line 15 above ►	36				

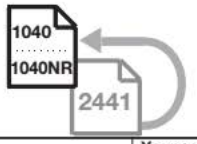
Form **2441**

Department of the Treasury
Internal Revenue Service (99)

Child and Dependent Care Expenses

▶ Attach to Form 1040 or Form 1040NR.

▶ Go to *www.irs.gov/Form2441* for instructions and the latest information.



OMB No. 1545-0074

2018

Attachment Sequence No. **21**

Name(s) shown on return

Your social security number

Part I **Persons or Organizations Who Provided the Care**—You **must** complete this part. (If you have more than two care providers, see the instructions.)

1 (a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see instructions)

Did you receive **dependent care benefits?** — **No** ▶ Complete only Part II below.
— **Yes** ▶ Complete Part III on the back next.

Caution: If the care was provided in your home, you may owe employment taxes. For details, see the instructions for Schedule 4 (Form 1040), line 60a, or Form 1040NR, line 59a.

Part II **Credit for Child and Dependent Care Expenses**

2 Information about your **qualifying person(s).** If you have more than two qualifying persons, see the instructions.

(a) Qualifying person's name First	Last	(b) Qualifying person's social security number	(c) **Qualified expenses** you incurred and paid in 2018 for the person listed in column (a)

3 Add the amounts in column (c) of line 2. **Don't** enter more than $3,000 for one qualifying person or $6,000 for two or more persons. If you completed Part III, enter the amount from line 31 3

4 Enter your **earned income.** See instructions 4

5 If married filing jointly, enter your spouse's earned income (if you or your spouse was a student or was disabled, see the instructions); **all others**, enter the amount from line 4 . 5

6 Enter the **smallest** of line 3, 4, or 5 6

7 Enter the amount from Form 1040, line 7; or Form 1040NR, line 36 7

8 Enter on line 8 the decimal amount shown below that applies to the amount on line 7

If line 7 is: Over	But not over	Decimal amount is	If line 7 is: Over	But not over	Decimal amount is
$0	15,000	.35	$29,000	31,000	.27
15,000	17,000	.34	31,000	33,000	.26
17,000	19,000	.33	33,000	35,000	.25
19,000	21,000	.32	35,000	37,000	.24
21,000	23,000	.31	37,000	39,000	.23
23,000	25,000	.30	39,000	41,000	.22
25,000	27,000	.29	41,000	43,000	.21
27,000	29,000	.28	43,000	No limit	.20

8 X .

9 Multiply line 6 by the decimal amount on line 8. If you paid 2017 expenses in 2018, see the instructions 9

10 Tax liability limit. Enter the amount from the Credit Limit Worksheet in the instructions. 10

11 **Credit for child and dependent care expenses.** Enter the **smaller** of line 9 or line 10 here and on Schedule 3 (Form 1040), line 49; or Form 1040NR, line 47 11

Part III Dependent Care Benefits

12	Enter the total amount of **dependent care benefits** you received in 2018. Amounts you received as an employee should be shown in box 10 of your Form(s) W-2. **Don't** include amounts reported as wages in box 1 of Form(s) W-2. If you were self-employed or a partner, include amounts you received under a dependent care assistance program from your sole proprietorship or partnership			12	
13	Enter the amount, if any, you carried over from 2017 and used in 2018 during the grace period. See instructions			13	
14	Enter the amount, if any, you forfeited or carried forward to 2019. See instructions			14	( )
15	Combine lines 12 through 14. See instructions			15	
16	Enter the total amount of **qualified expenses** incurred in 2018 for the care of the **qualifying person(s)**	16			
17	Enter the **smaller** of line 15 or 16	17			
18	Enter your **earned income.** See instructions	18			
19	Enter the amount shown below that applies to you. • If married filing jointly, enter your spouse's earned income (if you or your spouse was a student or was disabled, see the instructions for line 5). • If married filing separately, see instructions. • All others, enter the amount from line 18.	19			
20	Enter the **smallest** of line 17, 18, or 19	20			
21	Enter $5,000 ($2,500 if married filing separately **and** you were required to enter your spouse's earned income on line 19)	21			
22	Is any amount on line 12 from your sole proprietorship or partnership? ☐ **No.** Enter -0-. ☐ **Yes.** Enter the amount here			22	
23	Subtract line 22 from line 15	23			
24	**Deductible benefits.** Enter the **smallest** of line 20, 21, or 22. Also, include this amount on the appropriate line(s) of your return. See instructions			24	
25	**Excluded benefits.** If you checked "No" on line 22, enter the smaller of line 20 or 21. Otherwise, subtract line 24 from the smaller of line 20 or line 21. If zero or less, enter -0-			25	
26	**Taxable benefits.** Subtract line 25 from line 23. If zero or less, enter -0-. Also, include this amount on Form 1040, line 1, or Form 1040NR, line 8. On the dotted line next to Form 1040, line 1, or Form 1040NR, line 8, enter "DCB."			26	

To claim the child and dependent care credit, complete lines 27 through 31 below.

27	Enter $3,000 ($6,000 if two or more qualifying persons)	27	
28	Add lines 24 and 25	28	
29	Subtract line 28 from line 27. If zero or less, **stop.** You can't take the credit. **Exception.** If you paid 2017 expenses in 2018, see the instructions for line 9	29	
30	Complete line 2 on the front of this form. **Don't** include in column (c) any benefits shown on line 28 above. Then, add the amounts in column (c) and enter the total here.	30	
31	Enter the **smaller** of line 29 or 30. Also, enter this amount on line 3 on the front of this form and complete lines 4 through 11	31	

Form **4684**

Department of the Treasury
Internal Revenue Service

Casualties and Thefts

▶ Go to *www.irs.gov/Form4684* for instructions and the latest information.
▶ Attach to your tax return.
▶ Use a separate Form 4684 for each casualty or theft.

OMB No. 1545-0177

2018

Attachment Sequence No. **26**

Name(s) shown on tax return | **Identifying number**

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes. You must use a separate Form 4684 (through line 12) for each casualty or theft event involving personal use property. **If reporting a casualty loss sustained in 2018 from a federally declared disaster that occurred in 2016, or from Hurricane Harvey, Tropical Storm Harvey, Hurricane Irma, Hurricane Maria, or the California Wildfires, see the instructions before completing this section.**)

If the casualty or theft loss is attributable to a federally declared disaster, check here ☐ and enter the FEMA disaster declaration number. (See instructions.) _____

1 Description of properties (show type, location (city, state, and ZIP code), and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft. If you checked the box and entered the FEMA disaster declaration number above, enter the ZIP code for the property most affected on the line for Property **A**.

	Type of Property	City and State	ZIP Code	Date Acquired
Property **A**				
Property **B**				
Property **C**				
Property **D**				

		Properties A	B	C	D
2	Cost or other basis of each property	2				
3	Insurance or other reimbursement (whether or not you filed a claim) (see instructions)	3				
	Note: If line 2 is **more** than line 3, skip line 4.					
4	Gain from casualty or theft. If line 3 is **more** than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	4				
5	Fair market value **before** casualty or theft	5				
6	Fair market value **after** casualty or theft	6				
7	Subtract line 6 from line 5	7				
8	Enter the **smaller** of line 2 or line 7	8				
9	Subtract line 3 from line 8. If zero or less, enter -0-	9				

10	Casualty or theft loss. Add the amounts on line 9 in columns A through D	10	
11	Enter $100 ($500 if qualified disaster loss rules apply; see instructions)	11	
12	Subtract line 11 from line 10. If zero or less, enter -0-	12	
	Caution: Use only one Form 4684 for lines 13 through 18.		
13	Add the amounts on line 4 of all Forms 4684	13	
14	Add the amounts on line 12 of all Forms 4684. If you have losses not attributable to a federally declared disaster, see the instructions	14	
	Caution: See instructions before completing line 15.		
15	• If line 13 is **more** than line 14, enter the difference here and on Schedule D. **Do not** complete the rest of this section. • If line 13 is **equal** to line 14, enter -0- here. **Do not** complete the rest of this section. • If line 13 is **less** than line 14, and you have no qualified disaster losses subject to the $500 reduction on line 11 on any Form(s) 4684, enter -0- here and go to line 16. If you have qualified disaster losses subject to the $500 reduction, subtract line 13 from line 14 and enter the smaller of this difference or the amount on line 12 of the Form(s) 4684 reporting those losses. Enter that result here and on Schedule A (Form 1040), line 16, or Form 1040NR, Schedule A, line 7. If you claim the standard deduction, also include on Schedule A (Form 1040), line 16, the amount of your standard deduction (see the Instructions for Form 1040). Do not complete the rest of this section if all of your casualty or theft losses are subject to the $500 reduction.	15	
16	Add lines 13 and 15. Subtract the result from line 14	16	
17	Enter 10% of your adjusted gross income from Form 1040, line 7, or Form 1040NR, line 36. Estates and trusts, see instructions	17	
18	Subtract line 17 from line 16. If zero or less, enter -0-. Also, enter the result on Schedule A (Form 1040), line 15, or Form 1040NR, Schedule A, line 6. Estates and trusts, enter the result on the "Other deductions" line of your tax return	18	

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side. | Identifying number

SECTION B—Business and Income-Producing Property

Part I Casualty or Theft Gain or Loss (Use a separate Part I for each casualty or theft.)

19 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft. **See instructions if claiming a loss due to a Ponzi-type investment scheme and Section C is not completed.**

Property **A**

Property **B**

Property **C**

Property **D**

		Properties A	B	C	D
20	Cost or adjusted basis of each property	20			
21	Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3	21			
	Note: If line 20 is **more** than line 21, skip line 22.				
22	Gain from casualty or theft. If line 21 is **more** than line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	22			
23	Fair market value **before** casualty or theft	23			
24	Fair market value **after** casualty or theft	24			
25	Subtract line 24 from line 23	25			
26	Enter the **smaller** of line 20 or line 25	26			
	Note: If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.				
27	Subtract line 21 from line 26. If zero or less, enter -0-	27			
28	Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 **or** line 34 (see instructions)				28

Part II Summary of Gains and Losses (from separate Parts I)

(a) Identify casualty or theft	(b) Losses from casualties or thefts (i) Trade, business, rental or royalty property	(b) Losses from casualties or thefts (ii) Income-producing property	(c) Gains from casualties or thefts includible in income
Casualty or Theft of Property Held One Year or Less			
29	( )	( )	
	( )	( )	
30 Totals. Add the amounts on line 29 — 30	( )	( )	
31 Combine line 30, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions — 31			
32 Enter the amount from line 30, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 16, or Form 1040NR, Schedule A, line 7. (Do not include any loss on property used as an employee.) Estates and trusts, partnerships, and S corporations, see instructions — 32			
Casualty or Theft of Property Held More Than One Year			
33 Casualty or theft gains from Form 4797, line 32 — 33			
34	( )	( )	
	( )	( )	
35 Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii) — 35	( )	( )	
36 Total gains. Add lines 33 and 34, column (c) — 36			
37 Add amounts on line 35, columns (b)(i) and (b)(ii) — 37			
38 If the loss on line 37 is **more** than the gain on line 36:			
a Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships and S corporations, see the **Note** below. All others, enter this amount on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions — 38a			
b Enter the amount from line 35, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 16, or Form 1040NR, Schedule A, line 7. (Do not include any loss on property used as an employee.) Estates and trusts, enter on the "Other deductions" line of your tax return. Partnerships and S corporations, see the **Note** below. — 38b			
39 If the loss on line 37 is **less** than or **equal** to the gain on line 36, combine lines 36 and 37 and enter here. Partnerships, see the **Note** below. All others, enter this amount on Form 4797, line 3 — 39			
Note: Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 11. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 10.			

Form **6251**

Department of the Treasury
Internal Revenue Service (99)

Alternative Minimum Tax—Individuals

▶ Go to *www.irs.gov/Form6251* for instructions and the latest information.
▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2018

Attachment Sequence No. **32**

Name(s) shown on Form 1040 or Form 1040NR | **Your social security number**

Part I Alternative Minimum Taxable Income (See instructions for how to complete each line.)

1	Enter the amount from Form 1040, line 10, if more than zero. If Form 1040, line 10, is zero, subtract lines 8 and 9 of Form 1040 from line 7 of Form 1040 and enter the result here. (If less than zero, enter as a negative amount.)	1		
2a	If filing Schedule A (Form 1040), enter the taxes from Schedule A, line 7; otherwise enter the amount from Form 1040, line 8	2a		
b	Tax refund from Schedule 1 (Form 1040), line 10 or line 21	b	(	)
c	Investment interest expense (difference between regular tax and AMT)	c		
d	Depletion (difference between regular tax and AMT)	d		
e	Net operating loss deduction from Schedule 1 (Form 1040), line 21. Enter as a positive amount	e		
f	Alternative tax net operating loss deduction	f	(	)
g	Interest from specified private activity bonds exempt from the regular tax	g		
h	Qualified small business stock, see instructions	h		
i	Exercise of incentive stock options (excess of AMT income over regular tax income)	i		
j	Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	j		
k	Disposition of property (difference between AMT and regular tax gain or loss)	k		
l	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	l		
m	Passive activities (difference between AMT and regular tax income or loss)	m		
n	Loss limitations (difference between AMT and regular tax income or loss)	n		
o	Circulation costs (difference between regular tax and AMT)	o		
p	Long-term contracts (difference between AMT and regular tax income)	p		
q	Mining costs (difference between regular tax and AMT)	q		
r	Research and experimental costs (difference between regular tax and AMT)	r		
s	Income from certain installment sales before January 1, 1987	s	(	)
t	Intangible drilling costs preference	t		
3	Other adjustments, including income-based related adjustments	3		
4	**Alternative minimum taxable income.** Combine lines 1 through 3. (If married filing separately and line 4 is more than $718,800, see instructions.)	4		

Part II Alternative Minimum Tax (AMT)

5 Exemption. (If you were under age 24 at the end of 2018, see instructions.)

IF your filing status is . . .	AND line 4 is not over . . .	THEN enter on line 5 . . .
Single or head of household	$ 500,000	$ 70,300
Married filing jointly or qualifying widow(er)	1,000,000	109,400
Married filing separately	500,000	54,700

If line 4 is **over** the amount shown above for your filing status, see instructions. → 5

6	Subtract line 5 from line 4. If more than zero, go to line 7. If zero or less, enter -0- here and on lines 7, 9, and 11, and go to line 10	6	
7	• If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter. • If you reported capital gain distributions directly on Schedule 1 (Form 1040), line 13; you reported qualified dividends on Form 1040, line 3a; **or** you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (as refigured for the AMT, if necessary), complete Part III on the back and enter the amount from line 40 here. • **All others:** If line 6 is $191,100 or less ($95,550 or less if married filing separately), multiply line 6 by 26% (0.26). Otherwise, multiply line 6 by 28% (0.28) and subtract $3,822 ($1,911 if married filing separately) from the result.	7	
8	Alternative minimum tax foreign tax credit (see instructions)	8	
9	Tentative minimum tax. Subtract line 8 from line 7	9	
10	Add Form 1040, line 11a (minus any tax from Form 4972), and Schedule 2 (Form 1040), line 46. Subtract from the result any foreign tax credit from Schedule 3 (Form 1040), line 48. If you used Schedule J to figure your tax on Form 1040, line 11a, refigure that tax without using Schedule J before completing this line (see instructions)	10	
11	**AMT.** Subtract line 10 from line 9. If zero or less, enter -0-. Enter here and on Schedule 2 (Form 1040), line 45	11	

Part III Tax Computation Using Maximum Capital Gains Rates

Complete Part III only if you are required to do so by line 7 or by the Foreign Earned Income Tax Worksheet in the instructions.

12	Enter the amount from Form 6251, line 6. If you are filing Form 2555 or 2555-EZ, enter the amount from line 3 of the worksheet in the instructions for line 7	12	
13	Enter the amount from line 6 of the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 11a, or the amount from line 13 of the Schedule D Tax Worksheet in the instructions for Schedule D (Form 1040), whichever applies (as refigured for the AMT, if necessary) (see instructions). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	13	
14	Enter the amount from Schedule D (Form 1040), line 19 (as refigured for the AMT, if necessary) (see instructions). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	14	
15	If you did not complete a Schedule D Tax Worksheet for the regular tax or the AMT, enter the amount from line 13. Otherwise, add lines 13 and 14, and enter the **smaller** of that result or the amount from line 10 of the Schedule D Tax Worksheet (as refigured for the AMT, if necessary). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	15	
16	Enter the **smaller** of line 12 or line 15	16	
17	Subtract line 16 from line 12	17	
18	If line 17 is $191,100 or less ($95,550 or less if married filing separately), multiply line 17 by 26% (0.26). Otherwise, multiply line 17 by 28% (0.28) and subtract $3,822 ($1,911 if married filing separately) from the result ►	18	
19	Enter: • $77,200 if married filing jointly or qualifying widow(er), • $38,600 if single or married filing separately, or • $51,700 if head of household.	19	
20	Enter the amount from line 7 of the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 11a, or the amount from line 14 of the Schedule D Tax Worksheet in the instructions for Schedule D (Form 1040), whichever applies (as figured for the regular tax). If you did not complete either worksheet for the regular tax, enter the amount from Form 1040, line 10; if zero or less, enter -0-. If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter.	20	
21	Subtract line 20 from line 19. If zero or less, enter -0-	21	
22	Enter the **smaller** of line 12 or line 13	22	
23	Enter the **smaller** of line 21 or line 22. This amount is taxed at 0%	23	
24	Subtract line 23 from line 22	24	
25	Enter: • $425,800 if single • $239,500 if married filing separately • $479,000 if married filing jointly or qualifying widow(er) • $452,400 if head of household	25	
26	Enter the amount from line 21	26	
27	Enter the amount from line 7 of the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 11a, or the amount from line 19 of the Schedule D Tax Worksheet, whichever applies (as figured for the regular tax). If you did not complete either worksheet for the regular tax, enter the amount from Form 1040, line 10; if zero or less, enter -0-. If you are filing Form 2555 or Form 2555-EZ, see instructions for the amount to enter	27	
28	Add line 26 and line 27	28	
29	Subtract line 28 from line 25. If zero or less, enter -0-	29	
30	Enter the smaller of line 24 or line 29	30	
31	Multiply line 30 by 15% (0.15). ►	31	
32	Add lines 23 and 30	32	
	If lines 32 and 12 are the same, skip lines 33 through 37 and go to line 38. Otherwise, go to line 33.		
33	Subtract line 32 from line 22	33	
34	Multiply line 33 by 20% (0.20) ►	34	
	If line 14 is zero or blank, skip lines 35 through 37 and go to line 38. Otherwise, go to line 35.		
35	Add lines 17, 32, and 33	35	
36	Subtract line 35 from line 12	36	
37	Multiply line 36 by 25% (0.25) ►	37	
38	Add lines 18, 31, 34, and 37	38	
39	If line 12 is $191,100 or less ($95,550 or less if married filing separately), multiply line 12 by 26% (0.26). Otherwise, multiply line 12 by 28% (0.28) and subtract $3,822 ($1,911 if married filing separately) from the result	39	
40	Enter the **smaller** of line 38 or line 39 here and on line 7. If you are filing Form 2555 or 2555-EZ, do not enter this amount on line 7. Instead, enter it on line 4 of the worksheet in the instructions for line 7	40	

Form **8283**
(Rev. December 2014)
Department of the Treasury
Internal Revenue Service

Noncash Charitable Contributions

▶ **Attach to your tax return if you claimed a total deduction of over $500 for all contributed property.**
▶ **Information about Form 8283 and its separate instructions is at *www.irs.gov/form8283*.**

OMB No. 1545-0908
Attachment Sequence No. **155**

Name(s) shown on your income tax return | **Identifying number**

Note. Figure the amount of your contribution deduction before completing this form. See your tax return instructions.

Section A. Donated Property of $5,000 or Less and Publicly Traded Securities—List in this section **only** items (or groups of similar items) for which you claimed a deduction of $5,000 or less. Also list publicly traded securities even if the deduction is more than $5,000 (see instructions).

Part I **Information on Donated Property**—If you need more space, attach a statement.

1	(a) Name and address of the donee organization	(b) If donated property is a vehicle (see instructions), check the box. Also enter the vehicle identification number (unless Form 1098-C is attached).	(c) Description of donated property (For a vehicle, enter the year, make, model, and mileage. For securities, enter the company name and the number of shares.)
A		☐	
B		☐	
C		☐	
D		☐	
E		☐	

Note. If the amount you claimed as a deduction for an item is $500 or less, you do not have to complete columns (e), (f), and (g).

	(d) Date of the contribution	(e) Date acquired by donor (mo., yr.)	(f) How acquired by donor	(g) Donor's cost or adjusted basis	(h) Fair market value (see instructions)	(i) Method used to determine the fair market value
A						
B						
C						
D						
E						

Part II **Partial Interests and Restricted Use Property**—Complete lines 2a through 2e if you gave less than an entire interest in a property listed in Part I. Complete lines 3a through 3c if conditions were placed on a contribution listed in Part I; also attach the required statement (see instructions).

2a Enter the letter from Part I that identifies the property for which you gave less than an entire interest ▶ _____
If Part II applies to more than one property, attach a separate statement.

b Total amount claimed as a deduction for the property listed in Part I: **(1)** For this tax year ▶ _____
(2) For any prior tax years ▶ _____

c Name and address of each organization to which any such contribution was made in a prior year (complete only if different from the donee organization above):
Name of charitable organization (donee)

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

d For tangible property, enter the place where the property is located or kept ▶ _____

e Name of any person, other than the donee organization, having actual possession of the property ▶ _____

		Yes	No
3a	Is there a restriction, either temporary or permanent, on the donee's right to use or dispose of the donated property?		
b	Did you give to anyone (other than the donee organization or another organization participating with the donee organization in cooperative fundraising) the right to the income from the donated property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire?		
c	Is there a restriction limiting the donated property for a particular use?		

Name(s) shown on your income tax return | **Identifying number**

Section B. Donated Property Over $5,000 (Except Publicly Traded Securities)—Complete this section for one item (or one group of similar items) for which you claimed a deduction of more than $5,000 per item or group (except contributions of publicly traded securities reported in Section A). Provide a separate form for each property donated unless it is part of a group of similar items. An appraisal is generally required for property listed in Section B. See instructions.

Part I Information on Donated Property—To be completed by the taxpayer and/or the appraiser.

4 Check the box that describes the type of property donated:

- **a** ☐ Art* (contribution of $20,000 or more)
- **b** ☐ Qualified Conservation Contribution
- **c** ☐ Equipment
- **d** ☐ Art* (contribution of less than $20,000)
- **e** ☐ Other Real Estate
- **f** ☐ Securities
- **g** ☐ Collectibles**
- **h** ☐ Intellectual Property
- **i** ☐ Vehicles
- **j** ☐ Other

*Art includes paintings, sculptures, watercolors, prints, drawings, ceramics, antiques, decorative arts, textiles, carpets, silver, rare manuscripts, historical memorabilia, and other similar objects.

**Collectibles include coins, stamps, books, gems, jewelry, sports memorabilia, dolls, etc., but not art as defined above.

Note. In certain cases, you must attach a qualified appraisal of the property. See instructions.

5	(a) Description of donated property (if you need more space, attach a separate statement)	(b) If tangible property was donated, give a brief summary of the overall physical condition of the property at the time of the gift	(c) Appraised fair market value
A			
B			
C			
D			

	(d) Date acquired by donor (mo., yr.)	(e) How acquired by donor	(f) Donor's cost or adjusted basis	(g) For bargain sales, enter amount received	See instructions (h) Amount claimed as a deduction	See instructions (i) Date of contribution
A						
B						
C						
D						

Part II Taxpayer (Donor) Statement—List each item included in Part I above that the appraisal identifies as having a value of $500 or less. See instructions.

I declare that the following item(s) included in Part I above has to the best of my knowledge and belief an appraised value of not more than $500 (per item). Enter identifying letter from Part I and describe the specific item. See instructions. ► _____

Signature of taxpayer (donor) ► Date ►

Part III Declaration of Appraiser

I declare that I am not the donor, the donee, a party to the transaction in which the donor acquired the property, employed by, or related to any of the foregoing persons, or married to any person who is related to any of the foregoing persons. And, if regularly used by the donor, donee, or party to the transaction, I performed the majority of my appraisals during my tax year for other persons.

Also, I declare that I perform appraisals on a regular basis; and that because of my qualifications as described in the appraisal, I am qualified to make appraisals of the type of property being valued. I certify that the appraisal fees were not based on a percentage of the appraised property value. Furthermore, I understand that a false or fraudulent overstatement of the property value as described in the qualified appraisal or this Form 8283 may subject me to the penalty under section 6701(a) (aiding and abetting the understatement of tax liability). In addition, I understand that I may be subject to a penalty under section 6695A if I know, or reasonably should know, that my appraisal is to be used in connection with a return or claim for refund and a substantial or gross valuation misstatement results from my appraisal. I affirm that I have not been barred from presenting evidence or testimony by the Office of Professional Responsibility.

Sign Here Signature ► Title ► Date ►

Business address (including room or suite no.) | **Identifying number**

City or town, state, and ZIP code

Part IV Donee Acknowledgment—To be completed by the charitable organization.

This charitable organization acknowledges that it is a qualified organization under section 170(c) and that it received the donated property as described in Section B, Part I, above on the following date ► _____

Furthermore, this organization affirms that in the event it sells, exchanges, or otherwise disposes of the property described in Section B, Part I (or any portion thereof) within 3 years after the date of receipt, it will file **Form 8282,** Donee Information Return, with the IRS and give the donor a copy of that form. This acknowledgment does not represent agreement with the claimed fair market value.

Does the organization intend to use the property for an unrelated use? . . . . . ► ☐ Yes ☐ No

Name of charitable organization (donee)	**Employer identification number**	
Address (number, street, and room or suite no.)	City or town, state, and ZIP code	
Authorized signature	Title	Date

Form **8582**

Department of the Treasury
Internal Revenue Service (99)

Passive Activity Loss Limitations

▶ See separate instructions.
▶ Attach to Form 1040 or Form 1041.
▶ Go to *www.irs.gov/Form8582* for instructions and the latest information.

OMB No. 1545-1008

2018

Attachment Sequence No. 88

Name(s) shown on return | Identifying number

Part I 2018 Passive Activity Loss

Caution: Complete Worksheets 1, 2, and 3 before completing Part I.

Rental Real Estate Activities With Active Participation (For the definition of active participation, see **Special Allowance for Rental Real Estate Activities** in the instructions.)

1a	Activities with net income (enter the amount from Worksheet 1, column (a))	1a			
b	Activities with net loss (enter the amount from Worksheet 1, column (b))	1b	( )		
c	Prior years' unallowed losses (enter the amount from Worksheet 1, column (c))	1c	( )		
d	Combine lines 1a, 1b, and 1c			1d	

Commercial Revitalization Deductions From Rental Real Estate Activities

2a	Commercial revitalization deductions from Worksheet 2, column (a)	2a	( )		
b	Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b)	2b	( )		
c	Add lines 2a and 2b			2c	( )

All Other Passive Activities

3a	Activities with net income (enter the amount from Worksheet 3, column (a))	3a			
b	Activities with net loss (enter the amount from Worksheet 3, column (b))	3b	( )		
c	Prior years' unallowed losses (enter the amount from Worksheet 3, column (c))	3c	( )		
d	Combine lines 3a, 3b, and 3c			3d	

4	Combine lines 1d, 2c, and 3d. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Report the losses on the forms and schedules normally used	4	

If line 4 is a loss and:
- Line 1d is a loss, go to Part II.
- Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.
- Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.

Caution: If your filing status is married filing separately and you lived with your spouse at any time during the year, **do not** complete Part II or Part III. Instead, go to line 15.

Part II Special Allowance for Rental Real Estate Activities With Active Participation

Note: Enter all numbers in Part II as positive amounts. See instructions for an example.

5	Enter the **smaller** of the loss on line 1d or the loss on line 4			5	
6	Enter $150,000. If married filing separately, see instructions	6			
7	Enter modified adjusted gross income, but not less than zero (see instructions)	7			
	Note: If line 7 is greater than or equal to line 6, skip lines 8 and 9, enter -0- on line 10. Otherwise, go to line 8.				
8	Subtract line 7 from line 6	8			
9	Multiply line 8 by 50% (0.5). **Do not** enter more than $25,000. If married filing separately, see instructions			9	
10	Enter the **smaller** of line 5 or line 9			10	

If line 2c is a loss, go to Part III. Otherwise, go to line 15.

Part III Special Allowance for Commercial Revitalization Deductions From Rental Real Estate Activities

Note: Enter all numbers in Part III as positive amounts. See the example for Part II in the instructions.

11	Enter $25,000 reduced by the amount, if any, on line 10. If married filing separately, see instructions	11	
12	Enter the loss from line 4	12	
13	Reduce line 12 by the amount on line 10	13	
14	Enter the **smallest** of line 2c (treated as a positive amount), line 11, or line 13	14	

Part IV Total Losses Allowed

15	Add the income, if any, on lines 1a and 3a and enter the total	15	
16	**Total losses allowed from all passive activities for 2018.** Add lines 10, 14, and 15. See instructions to find out how to report the losses on your tax return	16	

Caution: The worksheets must be filed with your tax return. Keep a copy for your records.

Worksheet 1—For Form 8582, Lines 1a, 1b, and 1c (See instructions.)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 1a)	(b) Net loss (line 1b)	(c) Unallowed loss (line 1c)	(d) Gain	(e) Loss
Total. Enter on Form 8582, lines 1a, 1b, and 1c . . . . . ▶					

Worksheet 2—For Form 8582, Lines 2a and 2b (See instructions.)

Name of activity	(a) Current year deductions (line 2a)	(b) Prior year unallowed deductions (line 2b)	(c) Overall loss
Total. Enter on Form 8582, lines 2a and 2b . . . . . ▶			

Worksheet 3—For Form 8582, Lines 3a, 3b, and 3c (See instructions.)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 3a)	(b) Net loss (line 3b)	(c) Unallowed loss (line 3c)	(d) Gain	(e) Loss
Total. Enter on Form 8582, lines 3a, 3b, and 3c . . . . . ▶					

Worksheet 4—Use this worksheet if an amount is shown on Form 8582, line 10 or 14 (See instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Special allowance	(d) Subtract column (c) from column (a)
Total . . . . . ▶			1.00		

Worksheet 5—Allocation of Unallowed Losses (See instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Unallowed loss
Total . . . . . ▶			1.00	

Worksheet 6—Allowed Losses (See instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Unallowed loss	(c) Allowed loss
Total . . . . . ▶				

Worksheet 7—Activities With Losses Reported on Two or More Forms or Schedules (See instructions.)

Name of activity:	(a)	(b)	(c) Ratio	(d) Unallowed loss	(e) Allowed loss
Form or schedule and line number to be reported on (see instructions):					
1a Net loss plus prior year unallowed loss from form or schedule . ▶					
b Net income from form or schedule . . . . . ▶					
c Subtract line 1b from line 1a. If zero or less, enter -0- ▶					
Form or schedule and line number to be reported on (see instructions):					
1a Net loss plus prior year unallowed loss from form or schedule . ▶					
b Net income from form or schedule . . . . . ▶					
c Subtract line 1b from line 1a. If zero or less, enter -0- ▶					
Form or schedule and line number to be reported on (see instructions):					
1a Net loss plus prior year unallowed loss from form or schedule . ▶					
b Net income from form or schedule . . . . . ▶					
c Subtract line 1b from line 1a. If zero or less, enter -0- ▶					
Total . . . . . ▶			1.00		

Form **8615**

Department of the Treasury
Internal Revenue Service (99)

Tax for Certain Children Who Have Unearned Income

► **Attach to your Form 1040 or Form 1040NR.**
► **Go to *www.irs.gov/Form8615* for instructions and the latest information.**

OMB No. 1545-0074

2018

Attachment Sequence No. **33**

Name shown on return | **Your social security number**

Before you begin: If you must use the Schedule D Tax Worksheet or have income from farming or fishing, see the instructions. Also see **Pub. 929,** Tax Rules for Children and Dependents. It explains how to figure your tax using the **Schedule D Tax Worksheet** or **Schedule J** (Form 1040).

A Parent's name (first, initial, and last). **Caution:** See instructions before completing. | **B** **Parent's social security number**

Part I Net Unearned Income

1	Enter your unearned income (see instructions)	1	
2	If you **did not** itemize deductions on **Schedule A** (Form 1040 or Form 1040NR), enter $2,100. Otherwise, see instructions	2	
3	Subtract line 2 from line 1. If zero or less, **stop;** do not complete the rest of this form but **do** attach it to your return	3	
4	Enter your **taxable income** from Form 1040, line 10, or Form 1040NR, line 41. If you file Form 2555 or 2555-EZ, see the instructions	4	
5	Enter the **smaller** of line 3 or line 4. If zero, **stop;** do not complete the rest of this form but **do** attach it to your return	5	

Part II Tax

6	Subtract line 5 from line 4	6		
7	Enter the tax on the amount on line 4 (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here. If applicable, include this amount on your Form 1040, line 11, or Form 1040NR, line 42 (see instructions). If you file Form 2555 or 2555-EZ, see the instructions ► ☐		7	

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APPENDIX

C MACRS TABLES

MACRS, ADS, and ACRS Depreciation Methods Summary

System	Characteristics	Depreciation Method: MACRS	Depreciation Method: ADS	Table No.[a]: MACRS	Table No.[a]: ADS
MACRS & ADS	Personal Property:				
	1. Accounting convention	Half-year or mid-quarter	Half-year or mid-quarter[b]		
	2. Life and method				
	a. 3-year, 5-year, 7-year, 10-year	200% DB or elect straight-line	150% DB or elect straight-line	1, 2, 3, 4, 5	10, 11[c]
	b. 15-year, 20-year	150% DB or elect straight-line	150% DB or elect straight-line[d]	1, 2, 3, 4, 5	
	3. Luxury automobile limitations			6	
	Real Property:				
	1. Accounting convention	Mid-month	Mid-month		
	2. Life and method				
	a. Residential rental property	27.5 years, straight-line	30 years straight-line	7	12
	b. Nonresidential real property	39 years, straight-line[e]	40 years straight-line	9	12

System	Characteristics	ACRS
ACRS[f]	Personal Property:	
	1. Accounting convention	Half-year
	2. Life and method	
	a. 3-year, 5-year, 10-year, 15-year	150% DB or elect straight-line
	Real Property:	
	1. Accounting convention	First of month or mid-month
	2. Life	
	a. 15-year property	Placed in service after 12/31/80 and before 3/16/84
	b. 18-year property	Placed in service after 3/15/84 and before 5/9/85
	c. 19-year property	Placed in service after 5/8/85 and before 1/1/87
	3. Method	
	a. All but low-income housing	175% DB or elect straight-line
	b. Low-income housing property	200% DB or elect straight-line

[a] All depreciation tables in this appendix are based upon tables contained in Rev. Proc. 87-57, as amended.

[b] General and ADS tables are available for property lives from 2.5–50.0 years using the straight-line method. These tables are contained in Rev. Proc. 87-57 and are only partially reproduced here.

[c] The mid-quarter tables are available in Rev. Proc. 87-57, but are not reproduced here.

[d] Special recovery periods are assigned certain MACRS properties under the alternative depreciation system.

[e] A 31.5-year recovery period applied to nonresidential real property placed in service under the MACRS rules prior to May 13, 1993 (see Table 8).

[f] ACRS was effective for years 1981–1986. ACRS tables are no longer reproduced here.

▼ TABLE 1

General Depreciation System—MACRS

Personal Property Placed in Service After 12/31/86

Applicable Convention: Half-Year

Applicable Depreciation Method: 200 or 150 Percent Declining Balance Switching to Straight Line

If the Recovery Year Is:	And the Recovery Period Is: 3-Year	5-Year	7-Year	10-Year	15-Year	20-Year
	The Depreciation Rate Is:					
1	33.33	20.00	14.29	10.00	5.00	3.750
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52	12.49	11.52	7.70	6.177
5		11.52	8.93	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55	5.90	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

▼ TABLE 2

General Depreciation System—MACRS

Personal Property Placed in Service After 12/31/86

Applicable Convention: Mid-Quarter (Property Placed in Service in First Quarter)

Applicable Depreciation Method: 200 or 150 Percent Declining Balance Switching to Straight Line

If the Recovery Year Is:	And the Recovery Period Is:					
	3-Year	5-Year	7-Year	10-Year	15-Year	20-Year
	The Depreciation Rate Is:					
1	58.33	35.00	25.00	17.50	8.75	6.563
2	27.78	26.00	21.43	16.50	9.13	7.000
3	12.35	15.60	15.31	13.20	8.21	6.482
4	1.54	11.01	10.93	10.56	7.39	5.996
5		11.01	8.75	8.45	6.65	5.546
6		1.38	8.74	6.76	5.99	5.130
7			8.75	6.55	5.90	4.746
8			1.09	6.55	5.91	4.459
9				6.56	5.90	4.459
10				6.55	5.91	4.459
11				0.82	5.90	4.459
12					5.91	4.460
13					5.90	4.459
14					5.91	4.460
15					5.90	4.459
16					0.74	4.460
17						4.459
18						4.460
19						4.459
20						4.460
21						0.565

▼ TABLE 3

General Depreciation System—MACRS
Personal Property Placed in Service After 12/31/86
Applicable Convention: Mid-Quarter (Property Placed in Service in Second Quarter)
Applicable Depreciation Method: 200 or 150 Percent Declining Balance Switching to Straight Line

If the Recovery Year Is:	And the Recovery Period Is: 3-Year	5-Year	7-Year	10-Year	15-Year	20-Year
	The Depreciation Rate Is:					
1	41.67	25.00	17.85	12.50	6.25	4.688
2	38.89	30.00	23.47	17.50	9.38	7.148
3	14.14	18.00	16.76	14.00	8.44	6.612
4	5.30	11.37	11.97	11.20	7.59	6.116
5		11.37	8.87	8.96	6.83	5.658
6		4.26	8.87	7.17	6.15	5.233
7			8.87	6.55	5.91	4.841
8			3.34	6.55	5.90	4.478
9				6.56	5.91	4.463
10				6.55	5.90	4.463
11				2.46	5.91	4.463
12					5.90	4.463
13					5.91	4.463
14					5.90	4.463
15					5.91	4.462
16					2.21	4.463
17						4.462
18						4.463
19						4.462
20						4.463
21						1.673

▼ TABLE 4

General Depreciation System—MACRS

Personal Property Placed in Service After 12/31/86

Applicable Convention: Mid-Quarter (Property Placed in Service in Third Quarter)

Applicable Depreciation Method: 200 or 150 Percent Declining Balance Switching to Straight Line

If the Recovery Year Is:	And the Recovery Period Is: 3-Year	5-Year	7-Year	10-Year	15-Year	20-Year
	The Depreciation Rate Is:					
1	25.00	15.00	10.71	7.50	3.75	2.813
2	50.00	34.00	25.51	18.50	9.63	7.289
3	16.67	20.40	18.22	14.80	8.66	6.742
4	8.33	12.24	13.02	11.84	7.80	6.237
5		11.30	9.30	9.47	7.02	5.769
6		7.06	8.85	7.58	6.31	5.336
7			8.86	6.55	5.90	4.936
8			5.53	6.55	5.90	4.566
9				6.56	5.91	4.460
10				6.55	5.90	4.460
11				4.10	5.91	4.460
12					5.90	4.460
13					5.91	4.461
14					5.90	4.460
15					5.91	4.461
16					3.69	4.460
17						4.461
18						4.460
19						4.461
20						4.460
21						2.788

▼ TABLE 5

General Depreciation System—MACRS
Personal Property Placed in Service After 12/31/86
Applicable Convention: Mid-Quarter (Property Placed in Service in Fourth Quarter)
Applicable Depreciation Method: 200 or 150 Percent Declining Balance Switching to Straight Line

If the Recovery Year Is:	And the Recovery Period Is: 3-Year	5-Year	7-Year	10-Year	15-Year	20-Year
	The Depreciation Rate Is:					
1	8.33	5.00	3.57	2.50	1.25	0.938
2	61.11	38.00	27.55	19.50	9.88	7.430
3	20.37	22.80	19.68	15.60	8.89	6.872
4	10.19	13.68	14.06	12.48	8.00	6.357
5		10.94	10.04	9.98	7.20	5.880
6		9.58	8.73	7.99	6.48	5.439
7			8.73	6.55	5.90	5.031
8			7.64	6.55	5.90	4.654
9				6.56	5.90	4.458
10				6.55	5.91	4.458
11				5.74	5.90	4.458
12					5.91	4.458
13					5.90	4.458
14					5.91	4.458
15					5.90	4.458
16					5.17	4.458
17						4.458
18						4.459
19						4.458
20						4.459
21						3.901

TAX AUTHORITY UPDATE

At the time this edition went to print, the IRS had not yet released the 2019 ceiling limits. For examples and problems in the text, we assume the limits will be the same for 2019 as they were in 2018.

▼ TABLE 6

Luxury Automobile Depreciation Limits

	Year Automobile Is Placed in Service[a] 2018	2012–2017	2010–2011	2009
Maximum Allowable Depreciation (100% Business Use):				
Year 1	$10,000[b]	$3,160[c]	$3,060[d]	$2,960[e]
Year 2	16,000	5,100	4,900	4,800
Year 3	9,600	3,050	2,950	2,850
Year 4 and Each Succeeding Year	5,760	1,875	1,775	1,775

[a]For years prior to 2009, see the Revenue Procedure for the appropriate year.
[b]$18,000 in Year 1 (2018) if taxpayer claims bonus depreciation.
[c]$11,160 in Year 1 (2017, 2016, 2015, 2014, 2013, or 2012) if taxpayer claims bonus depreciation.
[d]$11,060 in Year 1 (2011 or 2010) if taxpayer claims bonus depreciation.
[e]$10,960 in Year 1 (2009) if taxpayer claims bonus depreciation.

▼ TABLE 6 (continued)

Truck and Van Depreciation Limits

	Year Truck or Van Is Placed in Service[a]								
	2018	2017	2016	2015	2014	2013	2012	2011	2010
Maximum Allowable Depreciation (100% Business Use):									
Year 1	$10,000[b]	$3,560[c]	$3,560[c]	$3,460[d]	$3,460[d]	$3,360[e]	$3,360[e]	$3,260[f]	$3,160[g]
Year 2	16,000	5,700	5,700	5,600	5,550	5,400	5,300	5,200	5,100
Year 3	9,600	3,450	3,350	3,350	3,350	3,250	3,150	3,150	3,050
Year 4 and Each Succeeding Year	5,760	2,075	2,075	1,975	1,975	1,975	1,875	1,875	1,875

[a]For years prior to 2010, see the Revenue Procedure for the appropriate year.
[b]$18,000 in Year 1 (2018) if taxpayer claims bonus depreciation.
[c]$11,560 in Year 1 (2016 and 2017) if taxpayer claims bonus depreciation.
[d]$11,460 in Year 1 (2014 and 2015) if taxpayer claims bonus depreciation.
[e]$11,360 in Year 1 (2012 and 2013) if taxpayer claims bonus depreciation.
[f]$11,260 in Year 1 (2011) if taxpayer claims bonus depreciation.
[g]$11,160 in Year 1 (2010 and 2008) if taxpayer claims bonus depreciation.

TAX AUTHORITY UPDATE

At the time this edition went to print, the IRS had not yet released the 2019 ceiling limits. For examples and problems in the text, we assume the limits will be the same for 2019 as they were in 2018.

▼ TABLE 7

General Depreciation System—MACRS
Residential Rental Real Property Placed in Service After 12/31/86
Applicable Recovery Period: 27.5 Years
Applicable Convention: Mid-Month
Applicable Depreciation Method: Straight Line

If the Recovery Year Is:	And the Month in the First Recovery Year the Property Is Placed in Service Is:											
	1	2	3	4	5	6	7	8	9	10	11	12
	The Depreciation Rate Is:											
1	3.485	3.182	2.879	2.576	2.273	1.970	1.667	1.364	1.061	0.758	0.455	0.152
2–9	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
10	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
11	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
12	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
13	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
14	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
15	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
16	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
17	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
18	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
19	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
20	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
21	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
22	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
23	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
24	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
25	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
26	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
27	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
28	1.970	2.273	2.576	2.879	3.182	3.485	3.636	3.636	3.636	3.636	3.636	3.636
29	0.000	0.000	0.000	0.000	0.000	0.000	0.152	0.455	0.758	1.061	1.364	1.667

▼ TABLE 8

General Depreciation System—MACRS

Nonresidential Real Property Placed in Service After 12/31/86 and Before 5/13/93

Applicable Recovery Period: 31.5 Years
Applicable Convention: Mid-Month
Applicable Depreciation Method: Straight Line

If the Recovery Year Is:	And the Month in the First Recovery Year the Property Is Placed in Service Is:											
	1	2	3	4	5	6	7	8	9	10	11	12
	The Depreciation Rate Is:											
1	3.042	2.778	2.513	2.249	1.984	1.720	1.455	1.190	0.926	0.661	0.397	0.132
2	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
3	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
4	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
5	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
6	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
7	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
8	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.175	3.175	3.175	3.175	3.175
9	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
10	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
11	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
12	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
13	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
14	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
15	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
16	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
17	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
18	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
19	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
20	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
21	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
22	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
23	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
24	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
25	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
26	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
27	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
28	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
29	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
30	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
31	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
32	1.720	1.984	2.249	2.513	2.778	3.042	3.175	3.174	3.175	3.174	3.175	3.174
33	0.000	0.000	0.000	0.000	0.000	0.000	0.132	0.397	0.661	0.926	1.190	1.455

▼ TABLE 9

General Depreciation System—MACRS
Nonresidential Real Property Placed in Service After 5/12/93
Applicable Recovery Period: 39 years
Applicable Depreciation Method: Straight Line

If the Recovery Year Is:	And the Month in the First Recovery Year the Property Is Placed in Service Is: 1	2	3	4	5	6	7	8	9	10	11	12
	The Depreciation Rate Is:											
1	2.461	2.247	2.033	1.819	1.605	1.391	1.177	0.963	0.749	0.535	0.321	0.107
2-39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
40	0.107	0.321	0.535	0.749	0.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

▼ TABLE 10

Alternative Depreciation System—MACRS (Partial Table)
Property Placed in Service After 12/31/86
Applicable Convention: Half-Year
Applicable Depreciation Method: 150 Percent Declining Balance Switching to Straight Line

If the Recovery Year Is:	And the Recovery Period Is: 3	4	5	7	10	12
	The Depreciation Rate Is:					
1	25.00	18.75	15.00	10.71	7.50	6.25
2	37.50	30.47	25.50	19.13	13.88	11.72
3	25.00	20.31	17.85	15.03	11.79	10.25
4	12.50	20.31	16.66	12.25	10.02	8.97
5		10.16	16.66	12.25	8.74	7.85
6			8.33	12.25	8.74	7.33
7				12.25	8.74	7.33
8				6.13	8.74	7.33
9					8.74	7.33
10					8.74	7.33
11					4.37	7.32
12						7.33
13						3.66

▼ TABLE 11

Alternative Depreciation System—MACRS (Partial Table)
Property Placed in Service After 12/31/86
Applicable Convention: Half-Year
Applicable Depreciation Method: Straight Line

If the Recovery Year Is:	And the Recovery Period Is: 3	4	5	7	10	12
	The Depreciation Rate Is:					
1	16.67	12.50	10.00	7.14	5.00	4.17
2	33.33	25.00	20.00	14.29	10.00	8.33
3	33.33	25.00	20.00	14.29	10.00	8.33
4	16.67	25.00	20.00	14.28	10.00	8.33
5		12.50	20.00	14.29	10.00	8.33
6			10.00	14.28	10.00	8.33
7				14.29	10.00	8.34
8				7.14	10.00	8.33
9					10.00	8.34
10					10.00	8.33
11					5.00	8.34
12						8.33
13						4.17

▼ TABLE 12

Alternative Depreciation System—MACRS
Real Property Placed into Service After 12/31/86
Applicable Recovery Period: 40 years
Applicable Convention: Mid-Month
Applicable Depreciation Method: Straight Line

If the Recovery Year Is:	And the Month in the First Recovery Year the Property Is Placed in Service Is: 1	2	3	4	5	6	7	8	9	10	11	12
	The Depreciation Rate Is:											
1	2.396	2.188	1.979	1.771	1.563	1.354	1.146	0.938	0.729	0.521	0.313	0.104
2 to 40	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500
41	0.104	0.312	0.521	0.729	0.937	1.146	1.354	1.562	1.771	1.979	2.187	2.396

▼ TABLE 13

Lease Inclusion Dollar Amounts for Vehicles With a Lease Term Beginning in Calendar Year 2018

REV. PROC. 2018-25 TABLE 4 *DOLLAR AMOUNTS FOR PASSENGER AUTOMOBILES WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 2018*

Fair Market Value of Passenger Automobile		Tax Year During Lease				
Over	Not Over	1st	2nd	3rd	4th	5th and Later
$50,000	$51,000	1	3	5	5	6
51,000	52,000	4	9	13	16	19
52,000	53,000	7	15	22	27	31
53,000	54,000	10	21	31	37	44
54,000	55,000	12	27	40	48	56
55,000	56,000	15	33	49	59	68
56,000	57,000	18	39	58	69	81
57,000	58,000	20	45	67	80	93
58,000	59,000	23	51	76	91	105
59,000	60,000	26	57	85	101	117
60,000	62,000	30	66	98	118	135
62,000	64,000	36	78	116	139	160
64,000	66,000	41	90	134	160	185
66,000	68,000	46	102	152	181	210
68,000	70,000	52	114	169	203	235
70,000	72,000	57	126	187	225	259
72,000	74,000	63	138	205	246	284
74,000	76,000	68	150	223	267	309
76,000	78,000	74	162	241	288	333
78,000	80,000	79	174	259	310	357
80,000	85,000	89	195	290	347	401
85,000	90,000	102	225	335	400	463
90,000	95,000	116	255	379	454	525
95,000	100,000	130	285	423	508	586
100,000	110,000	150	330	491	587	679
110,000	120,000	178	390	579	695	802
120,000	130,000	205	450	669	801	926
130,000	140,000	232	510	758	908	1,049
140,000	150,000	260	570	847	1,015	1,172
150,000	160,000	287	630	936	1,122	1,296
160,000	170,000	314	691	1,024	1,230	1,419
170,000	180,000	342	750	1,114	1,336	1,543
180,000	190,000	369	810	1,204	1,442	1,666
190,000	200,000	396	871	1,292	1,550	1,789
200,000	210,000	424	930	1,382	1,656	1,913
210,000	220,000	451	991	1,470	1,764	2,036
220,000	230,000	478	1,051	1,559	1,871	2,159
230,000	240,000	505	1,111	1,649	1,977	2,283
240,000	and over	533	1,171	1,738	2,084	2,406

TAX AUTHORITY UPDATE

At the time this edition went to print, the IRS had not yet released the 2019 lease inclusion amounts. For examples and problems in the text, we assume the limits will be the same for 2019 as they were in 2018.

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▼ TABLE 14

Lease Inclusion Dollar Amounts for Vehicles With a Lease Term Beginning in Calendar Year 2018

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54,000	55,000	12	27	40	48	56
55,000	56,000	15	33	49	59	68
56,000	57,000	18	39	58	69	81
57,000	58,000	20	45	67	80	93
58,000	59,000	23	51	76	91	105
59,000	60,000	26	57	85	101	117
60,000	62,000	30	66	98	118	135
62,000	64,000	36	78	116	139	160
64,000	66,000	41	90	134	160	185
66,000	68,000	46	102	152	181	210
68,000	70,000	52	114	169	203	235
70,000	72,000	57	126	187	225	259
72,000	74,000	63	138	205	246	284
74,000	76,000	68	150	223	267	309
76,000	78,000	74	162	241	288	333
78,000	80,000	79	174	259	310	357
80,000	85,000	89	195	290	347	401
85,000	90,000	102	225	335	400	463
90,000	95,000	116	255	379	454	525
95,000	100,000	130	285	423	508	586
100,000	110,000	150	330	491	587	679
110,000	120,000	178	390	579	695	802
120,000	130,000	205	450	669	801	926
130,000	140,000	232	510	758	908	1,049
140,000	150,000	260	570	847	1,015	1,172
150,000	160,000	287	630	936	1,122	1,296
160,000	170,000	314	691	1,024	1,230	1,419
170,000	180,000	342	750	1,114	1,336	1,543
180,000	190,000	369	810	1,204	1,442	1,666
190,000	200,000	396	871	1,292	1,550	1,789
200,000	210,000	424	930	1,382	1,656	1,913
210,000	220,000	451	991	1,470	1,764	2,036
220,000	230,000	478	1,051	1,559	1,871	2,159
230,000	240,000	505	1,111	1,649	1,977	2,283
240,000	and over	533	1,171	1,738	2,084	2,406

APPENDIX

D GLOSSARY

Ability to pay A concept in taxation that holds that taxpayers be taxed according to their ability to pay such taxes, that is, taxpayers that have sufficient financial resources should pay the tax. This concept is an integral part of vertical equity.

Accelerated Cost Recovery System (ACRS) Established by ERTA in 1981, the ACRS provides an accelerated depreciation and shorter cost-recovery period for real and personal property. The Tax Reform Act of 1986 changed the previously allowed depreciation tables and assigned recovery periods that approach the asset's true economic life. The current depreciation system is referred to as MACRS.

Accounting method The method of determining the taxable year in which income and expenses are reported for tax purposes. Generally, the same method must be used for tax purposes as is used for keeping books and records. The accounting treatment used for any item of income or expense and of specific items (e.g., installment sales and contracts) is included in this term. See also each specific accounting method.

Accounting period The period of time, usually 12 months, used by taxpayers to compute their taxable income. Taxpayers who do not keep records must use a calendar year. Taxpayers who do keep books and records may choose between a calendar year or a fiscal year. The accounting period election is made on the taxpayer's first filed return and cannot be changed without IRS consent. The accounting period may be less than 12 months if it is the taxpayer's first or final return or if the taxpayer is changing accounting periods. Certain restrictions upon the use of a fiscal year apply to partnerships, S corporations, and personal service corporations.

Accountable plan A type of employee reimbursement plan that meets two tests, (1) substantiation, and (2) return of excess reimbursement. Under an accountable plan, reimbursements are excluded from the employee's gross income and the expenses are not deductible by the employee.

Accrual method of accounting Accounting method under which income is reported and expenses are deducted when (1) all events have occurred that fix the taxpayer's right to receive the income and (2) the amount of the item can be determined with reasonable accuracy.

Accumulated earnings tax This penalty tax is intended to discourage companies from retaining excessive amounts of earnings if the funds are invested in earnings that are unrelated to the business's needs. The current tax rate is 20%.

Acquiescence policy IRS policy of announcing whether it agrees or disagrees with a regular Tax Court decision. Such statements are not issued for every case.

ACRS See Accelerated Cost Recovery System.

Active income Income that is produced by the taxpayer's involvement or participation—wages, salaries, and other business income—is considered active income. It is the opposite of passive income.

Additional depreciation The excess of the actual amount of accelerated depreciation (or cost-recovery deductions under ACRS) over the amount of depreciation that would be deductible under the straight-line method. Such depreciation applies to Section 1250 depreciable real property acquired prior to 1987.

Adjusted gross income (AGI) A measure of income that falls between gross income and taxable income. It is the income amount that is used as the basis for calculating the floor or the ceiling for numerous other tax computations.

Adjusted sales price The amount realized from the sale of a residence less any fixing-up expenses.

Ad valorem tax A tax based on the value of real property or personal property. Typically, these taxes are levied at the time of a transaction, as is the case with a sales tax or a value-added tax (VAT). However, the taxes can also be levied annually, as with a real estate tax that a local government levies annually on the value of property.

AGI See Adjusted gross income.

Alimony Payments made pursuant to divorce or separation or written agreement between spouses subject to conditions specified in the tax law. Alimony payments (as contrasted to property settlements) are deductible for AGI by the payor and are included in the gross income of the recipient if the divorce agreement was finalized by December 31, 2018. For agreements after this date, the payor is not able to deduct alimony payments, and the recipient does not include the payments in gross income.

All events test Rule holding that an accrual basis taxpayer must report an item of income (1) when all events have occurred that fix the taxpayer's right to receive the item of income and (2) when the amount of the item can be determined with reasonable accuracy. This test is not satisfied until economic performance has taken place.

Alternative minimum tax (AMT) Applies to individuals and estates and trusts only if the tentative minimum tax (TMT) exceeds the taxpayer's regular tax liability. Most taxpayers are not subject to this tax.

Amount realized The amount realized equals the sum of money plus the fair market value of all other property received from the sale or other disposition of the property less any selling expenses (e.g., commissions, advertising, deed preparation costs, and legal expenses) incurred in connection with the sale.

AMT See Alternative Minimum Tax.

Annual accounting period See Accounting period.

Annuity A series of regular payments that will continue for either a fixed period of time or until the death of the recipient. Pensions are usually paid in this way.

Applicable federal rate The rate determined monthly by the federal government which is based on the rate paid by the government on borrowed funds. The rate varies with the term of the loan. Thus, short-term loans are for a period of under three years, mid-term loans are for over three years and under nine years, and long-term loans are for over nine years.

Asset depreciation range (ADR) system of depreciation Depreciation method allowed for property placed in service before January 1, 1981. This method prescribed useful lives for various classes of assets.

Average tax rate The taxpayer's total tax liability divided by the amount of his taxable income.

Backup withholding A modified withholding system intended to prevent abusive noncompliance situations.

Bad debt Bona fide debt that is uncollectible because it is worthless. Such debts are further characterized as "business bad debts," which give rise to an ordinary deduction, and "nonbusiness bad debts," which are treated as a short-term capital loss. A determination of whether a debt is worthless is made by reference to all the pertinent evidence (e.g., the debtor's general financial condition and whether the debt is secured by collateral). Such debts are deductible subject to certain requirements.

Bona fide debt A debt that (1) arises from a valid and enforceable obligation to pay a fixed or determinable sum of money and (2) results in a debtor-creditor relationship.

Bonus depreciation Special first year depreciation on qualified property (non-real estate) placed in service during the year. The percentage of bonus depreciation has varied over time. The most recent legislation allows 100% bonus depreciation for 2019.

Boot Cash and nonlike-kind property given to complete an exchange of like-kind property where the property exchanged is not of equal value. Gain on the exchange is limited to the amount of boot received.

Brother-sister controlled group A group of two or more corporations controlled by five or fewer individuals. There are two definitions, a 80%-50% definition and a 50%-only definition. The definition to be used depends on the specific application.

Business bad debt See Bad debt.

Cafeteria plan Employer-financed plan that offers employees the option of choosing cash or statutory nontaxable fringe benefits (other than scholarships, fellowships, and Sec. 132 benefits such as discounts on merchandise). Such plans may not discriminate in favor of highly compensated individuals or their dependents or spouses.

Capital addition See Capital expenditure.

Capital asset This category of assets includes all assets except inventory, notes and accounts receivable, and depreciable property or land used in a trade or business (e.g., property, plant, and machinery).

Capital expenditure An expenditure that adds to the value of, substantially prolongs the useful life of, or adapts the property to a new or different use qualifies as a capital expenditure.

Capital gain Gain realized on the sale or exchange of a capital asset.

Capital gain dividend A distribution by a regulated investment company (i.e., a mutual fund) of capital gains realized from the sale of investments in the fund. Such dividends also include undistributed capital gains allocated to the shareholders.

Capital gain property Property that is contributed to a public charity upon which a long-term capital gain would be recognized if that property was sold at its fair market value.

Capital loss Loss realized on the sale or exchange of a capital asset.

Capital recovery A capital recovery amount is a deduction for depreciation or cost recovery. It is a factor in the determination of a property's adjusted basis.

Cash method of accounting Accounting method that requires the taxpayer to report income for the taxable year in which payments are actually or constructively received. Expenses are reported in the year they are paid. Most individuals and service businesses (i.e., businesses without inventories) use this method. Small businesses with inventories that have gross receipts of less than $26 million may also use the cash method.

Cash receipts and disbursements method of accounting See Cash method of accounting.

Casualty loss Loss that arises from an identifiable event that was sudden, unexpected, or unusual (e.g., fire, storm, shipwreck, other casualty, or theft). Subject to certain limitations and restrictions, individuals may deduct such losses from AGI. Business casualty losses are deductible for AGI.

C Corporation Form of business entity that is taxed as a separate tax-paying entity. Its income is subject to an initial tax at the corporate level. Its shareholders are subject to a second tax when dividends are paid from the corporation's earnings and profits. Under certain conditions, S corporation status may be elected for tax purposes. C corporations are sometimes referred to as "regular corporations."

Charitable contribution deduction Contributions of money or property made to qualified organizations (i.e., public charities and private nonoperating foundations) may be deducted from AGI. The amount of the deduction depends upon (1) the type of charity receiving the contribution, (2) the type of property contributed, and (3) other limitations mandated by the tax law. See also Unrelated use property.

Child tax credit A credit for individual taxpayers of $2,000 per qualifying child. A qualifying child must be a U.S. citizen, under age 17, qualify as the taxpayer's dependent, and be the taxpayer's descendent, stepchild, or foster child.

Closed-fact situation Situation or transaction that has already occurred.

Closely held C corporation For purposes of the at risk rules, a closely held C corporation is defined as a corporation where more than 50% of the stock is owned by five or fewer individuals at any time during the last half of the corporation's taxable year. These individuals may or may not be members of the same family.

Community income In any of the eight community property states, such income consists of the income from the personal efforts, investments, etc. of either spouse. Community income belongs equally to both spouses.

Compensation Payment for personal services. Salaries, wages, fees, commissions, tips, bonuses, and specialized forms of compensation such as director's fees and jury's fees fall into this category. However, certain fringe benefits and some foreign-earned income are not taxed.

Completed contract method of accounting Accounting method for long-term contracts undertaken by smaller companies. Income from the contract is reported in the taxable year in which the contract is completed. The completed contract method is limited to construction contracts undertaken by smaller companies.

Constant interest rate method Used to amortize the original issue discount ratably over the life of the bond, this method determines the amount of interest income by multiplying the interest yield to maturity by the adjusted issue price.

Constructive dividend Distribution that is intended to result in a deduction to the corporation. For example, excessive salary payments to shareholder-employees may be recharacterized as nondeductible dividends to the corporation to the extent that such amounts are not reasonable. The excess amount may be treated as dividend income to the shareholder-employees rather than as compensation provided that certain conditions are met.

Constructive receipt doctrine Rule holding that cash method taxpayers cannot turn their backs on the receipt of income if the funds are unqualifiedly made available.

Constructive stock ownership Shares that are indirectly or deemed to be owned by another shareholder due to related party situations.

Contributory pension plan A qualified pension plan to which employees make voluntary contributions.

Controlled group A controlled group is two or more separately incorporated businesses owned by the same individuals or entities. Such groups may consist of parent-subsidiary corporations, brother-sister corporations, or a combination of both (combined group).

Cost The amount paid for property in cash or the fair market value of the property given in exchange. The costs of acquiring the property and preparing it for use are included in the cost of the property.

Cost depletion method Calculation of the depletion of an asset (e.g., oil and gas properties) under which the asset's adjusted basis is divided by the estimated recoverable units to arrive at a per-unit depletion. This amount is then multiplied by the number of units sold to determine the cost depletion. This method may be alternated with the percentage depletion method as long as the calculation takes that into account.

Current year's exclusion The amount of the annuity payment that is excluded from gross income. This amount is determined by multiplying the exclusion ratio by the amount received during the year.

Customs duties A federal excise tax on imported goods.

Deductions for AGI Expenses one would see on an income statement prepared for financial accounting purposes, for example, compensation paid to employees, repairs to business property, and depreciation expenses. Certain nonbusiness deductions (e.g., deductible payments to an individual retirement account (IRA)) are also deductible for AGI.

Deductions from AGI Generally, deductions are allowed for certain personal expenses such as medical deductions and charitable contributions which are referred to as itemized deductions. Alternatively, individuals may deduct the standard deduction.

Deferred compensation Methods of compensating employees based upon their current service where the benefits are deferred until future periods (e.g., a pension plan).

Defined benefit pension plan Qualified pension plan which establishes a contribution

formula based upon actuarial techniques that are intended to fund a fixed retirement benefit amount. Thus, the amount that will be available at the time of retirement is determined when the contributions are made.

Defined contribution pension plan Qualified pension plan under which a separate account is maintained for each participant and fixed amounts are contributed based upon a specific percentage-of-compensation formula. The retirement benefits are based on the value of the participant's account at the time of retirement. Defined contribution plans for self-employed individuals are referred to as H.R. 10 plans.

Dependent care assistance program Employer-financed programs that provide care for an employee's children or other dependents. An employee may exclude up to $5,000 from gross income although the ceiling amount (i.e., $3,000 or $6,000) on the child care credit is reduced by the amount of assistance that is excluded from gross income.

DIF See Discriminant Function System.

Discriminant Function System (DIF) System used by the IRS to select individual returns for audit. This system is intended to identify those tax returns which are most likely to contain errors.

Dividends-received deduction The deduction on dividends received by corporate shareholders that attempts to mitigate the triple taxation that would occur if one corporation paid dividends to a corporate shareholder who, in turn, distributed such amounts to its individual shareholders. Certain restrictions and limitations apply to this deduction.

E&P See Earnings and profits.

Earned income credit A refundable credit that encourages lower income individuals to become gainfully employed. The credit is based on the individual's earned income.

Earnings and profits (E&P) A measure of the corporation's ability to pay a dividend from its current and accumulated earnings without an impairment of capital.

Economic performance test Economic performance occurs when the property or services to be provided are actually delivered.

Education expense Subject to certain limitations and restrictions, education expenses are deductible if they are incurred to improve or maintain the individual's existing skills.

Effective tax rate The taxpayer's total tax liability divided by his total economic income.

Electronic Filing The method of filing a tax return with the IRS by electronic means instead of paper forms.

Employee achievement award Award given under circumstances that does not create a likelihood that it is really disguised compensation. It must be in the form of tangible personal property (other than cash) and be valued at no more than $400.

Employee stock ownership plan (ESOP) A qualified stock bonus plan or combined stock bonus plan and money purchase pension plan. ESOP's are funded by contributions of the employer's stock which are held for the employees' benefit.

Employment taxes Social security (FICA) and federal and state unemployment compensation taxes.

ESOP See Employee stock ownership plan.

Estate tax Part of the federal unified transfer tax system, this tax is based upon the total property transfers an individual makes during his lifetime and at death.

Excess business loss Noncorporate taxpayers must limit their excess business losses to the aggregate deductions for the year attributable to trades and businesses, over the sum of aggregate gross income or gain attributable to such trades or business, plus $255,000 ($510,000 for married taxpayers filing jointly) in 2019. Any disallowed excess loss carries over as a net operating loss.

Excess depreciation See Additional depreciation.

Exchange A transaction in which one receives a reciprocal transfer of property rather than cash and/or a cash equivalent.

Excise taxes Federal tax on alcohol, gasoline, telephone usage, oil and gas production, etc. State and local governments may impose similar taxes on goods and services.

Exclusion Any item of income that the tax law says is not taxable.

Exclusion ratio The portion of the annuity payment that is excluded from taxation. This amount equals the investment in the contract (its cost) divided by the expected return from the annuity.

Expected return The amount which a taxpayer can expect to receive from an annuity. It is determined by multiplying the amount of the annuity's annual payment by the expected return multiple.

Expected return multiple The number of years that the annuity is expected to continue. This amount may be a stated term or for the remainder of the taxpayer's life.

Fair market value (FMV) This amount is the price at which property would change hands between a willing buyer and a willing seller where neither party is under any compulsion to buy or sell.

Federal estate tax See Estate tax.

Federal Insurance Contributions Act See FICA.

Federal Unemployment Tax Act See FUTA.

FICA Tax withheld through the payment of payroll taxes, FICA is intended to finance social security benefits for individuals who are not self-employed. Employees and employers contribute matching amounts until a federally-set annual earnings ceiling is reached. At that time, no further contributions need be made for that year. No ceiling exists for the hospital insurance (HI) portion of the tax. Self-employed individuals are subject to self-employment tax and currently receive a for AGI income tax deduction equal to 50% of their self-employment tax payments.

Field audit procedure Audit procedure generally used by the IRS for corporations or individuals engaged in a trade or business and conducted at either the taxpayer's place of business or his tax advisor's office. Generally, several items on the tax return are examined.

FIFO method of inventory valuation This flow of cost method assumes that the first goods purchased will be the first goods sold. Thus, the ending inventory consists of the last goods purchased.

Fiscal year An annual accounting period that ends on the last day of any month other than December. A fiscal year may be elected by taxpayers that keep books and records, such as businesses.

Flat tax See Proportional tax.

Foreign-earned income An individual's earnings from personal services rendered in a foreign country.

Foreign tax credit Tax credit given to mitigate the possibility of double taxation faced by U.S. taxpayers earning foreign income.

Former passive activity An activity that was formerly considered passive, but which is not considered to be passive with respect to the taxpayer for the current year.

Franchise tax State tax levy sometimes based upon a weighted average formula consisting of net worth, income, and sales.

Functional-use test A test used to determine whether property is considered similar or related in service or use for purposes of involuntary conversions of property under Sec. 1033. The functional-use test requires that the replacement property be functionally the same as the converted property.

FUTA Federal and state unemployment compensation tax.

GAAP See Generally accepted accounting principles.

Gain realized See Realized gain.

General business credit Special credit category consisting of tax credits commonly available to businesses. The more significant credit items are (1) the investment tax credit, (2) the work opportunity credit, (3) the research credit, (4) the low-income housing credit, (5) the empowerment zone employment credit, (6) the disabled access credit.

Generally accepted accounting principles (GAAP) The accounting principles that govern the preparation of financial reports to shareholders. GAAP does not apply to the tax treatment unless the method clearly reflects income. It is used only when the regulations do not specify the treatment of an item or when the regulations provide more than one alternative accounting method.

Gift tax A tax that is imposed upon the donor for transfers that are not supported by full and adequate consideration. A $15,000 annual exclusion is allowed per donee for 2018 and 2019.

Goodwill The excess of the purchase price of a business over the fair market value of all identifiable assets acquired.

Gross income All income received in cash, property, or services, from whatever source derived and from which the taxpayer derives a direct economic benefit.

Gross tax For income tax purposes, the amount determined by multiplying taxable income by the appropriate tax rate(s). The gross tax may also be found in the appropriate tax table for the taxpayer's filing status.

Half year convention An assumption with respect to depreciation that assumes that all asset acquisitions and dispositions are made at the midpoint of the tax year.

Health Savings Account Accounts that may be contributed to a fund by eligible individuals to enable such individuals to accumulate funds on a tax-free basis to pay qualified medical expenses. These accounts may only be set up by individuals who are covered under a high-deductible health plan and, within limits, are tax-deductible.

Holding period The length of time an asset is held before it is disposed of. This period is used to determine whether the gain or loss is long- or short-term.

Horizontal equity A concept in taxation that refers to the notion that similarly-situated taxpayers should be treated equally under the tax law.

H.R. 10 Plan Special retirement plan rules applicable to self-employed individuals. Such plans are often referred to as "Keogh plans."

Hybrid method of accounting Accounting method that combines the cash and accrual methods. Under this method, taxpayers can report sales and purchases under the accrual method and other income and expense items under the cash method. See also the cash method of accounting and the accrual method of accounting.

IDCs See Intangible drilling and development costs.

Imputed interest rule This rule reallocates the payments received in an installment sale between interest (fully taxable) and principal (only gain is taxable). To avoid this, the stated interest rate must equal at least 100% of the applicable federal rate as determined monthly according to the rate paid by the government on borrowed funds.

Incentive stock option plan (ISO) Stock option plan that allows executives to receive a proprietary interest in the corporation. The option to participate in this type of plan must be exercised according to certain requirements and must follow certain procedures.

Income The economic concept of income measures the amount an individual can consume during a period and remain as well off at the end of the period as at the beginning. The accounting concept of income is a measure of the income that is realized in a transaction. The tax concept of income is close to the accounting concept. It includes both taxable and nontaxable income from any source. However, it does not include a return of capital.

Incrementalism A concept in taxation that described how the tax law has been changed or modified over the years. Under incrementalism, the tax law is changed on an incremental basis rather than a complete revision basis.

Indeterminate market value If the market value of the property in question cannot be determined by the usual methods, the "open transaction" doctrine may be applied and the tax consequences may be deferred until the transaction is closed. Alternatively, the property may be valued by using the fair market value of the property that is given in the exchange (e.g., the value of the services rendered).

Individual retirement account (IRA) Contribution for AGI that is deductible if (1) neither the taxpayer nor his spouse are active participants in an employer-sponsored retirement plan or (2) certain income limitations are met. Taxpayers who do not meet these requirements may make nondeductible IRA contributions. See also Roth IRA.

Innocent spouse rule Rule that exempts a spouse from penalty or liability for the tax if such spouse had no knowledge of nor reason to know about an item of community income.

Installment sale Any disposition of property which involves receiving at least one payment after the close of the taxable year in which the sale occurs.

Installment sale method of accounting Taxpayers may use this method of accounting to reduce the tax burden from gains on the sale of property paid for in installments. Under this method, payment of the tax is deferred until the sale proceeds are collected. This method is not applicable to sales of publicly traded property or to losses.

Intangible drilling and development costs (IDCs) Expenditures made by an operator for wages, fuel, repairs, hauling supplies, and so forth, incident to and necessary for the preparation and drilling of oil and gas wells.

Intangible property Property that does not have physical substance, such as goodwill, patents, stocks and bonds, etc.

Interest The cost charged by a lender for the use of money. For example, finance charges, loan discounts, premiums, loan origination fees, and points paid by a buyer to obtain a mortgage loan are all interest expenses. The deductibility of the expense depends upon the purpose for which the indebtedness was incurred.

Internal Revenue Code (IRC) The primary legislative source and authority for tax research, planning, and compliance activities.

Internal Revenue Service (IRS) The branch of the Treasury Department that is responsible for administering the federal tax law.

Interpretative Regulations Treasury Regulations that serve to broadly interpret the provisions of the Internal Revenue Code.

***Inter vivos* gifts** Gifts made during the donor's life-time.

Investment expenses All deductions other than interest that are directly connected with the production of investment income.

Investment income Gross income from property held for investment and any net gain attributable to the disposition of such property. See also Net investment income.

Investment interest Interest expense on indebtedness incurred to purchase or carry property held for investment (e.g., income from interest, dividends, annuities, and royalties). Interest expenses incurred from passive activities are not subject to the investment interest limitations and interest incurred to purchase or carry tax-exempt securities is not deductible. Interest incurred from passive activities is subject to the passive activity loss limitation rules.

Involuntary conversion Such a conversion occurs when property is compulsorily converted into money or other property due to theft, seizure, requisition, condemnation, or partial or complete destruction. For example, an involuntary conversion occurs when the government exercises its right of eminent domain.

IRA See Individual retirement account.

IRC See Internal Revenue Code.

IRS See Internal Revenue Service.

ISO See Incentive stock option.

Itemized deductions Also known as "deductions from AGI," these personal expenditures are allowable for such items as medical expenses, state and local taxes, charitable contributions, interest on a personal residence, and casualty losses. There are specific requirements for and limitations on the deductibility of each of these items. In addition, only those taxpayers whose total itemized deductions exceed the standard deduction amount can itemize their deductions.

Joint income Income from jointly-held property.

Judicial decisions Decisions of a court of law.

Keogh plan Retirement plan for self-employed individuals. This type of plan is also known as an "H.R. 10 plan."

LCM See Lower of cost or market method of inventory valuation.

Legislative Regulations Treasury Regulations issued at the mandate of the Internal Revenue Code. Legislative regulations have a higher degree of authority than interpretative regulations.

Letter Ruling Letter rulings originate from the IRS at the taxpayer's request. They describe how the IRS will treat a proposed transaction. It is only binding on the person requesting the ruling providing the taxpayer completes the transaction as proposed in the ruling. Those of general interest are published as Revenue Rulings.

LIFO method of inventory valuation This method assumes a last-in, first out flow of cost. It results in the lowest taxable income during periods of inflation because it shows the lowest inventory value. Price indexes are used for the valuation. The information in these indexes is grouped into groups (pools) of similar items. See also Simplified LIFO method.

Like-kind exchange A direct exchange of like-kind property. The transferred property and the received property must be held for productive use either (1) in a trade or business or (2) as an investment. Nonrecognition of gain or loss is mandatory. Certain like-kind exchanges between related parties are restricted if either party disposes of the property within two years of the exchange.

Like-kind property Property with a similar nature and character. This term does not refer to either the grade or quality of the property.

Limited liability company (LLC) A corporation that is generally taxed under the partnership rules. Although similar to an S corporation, there is no limit to (1) the number of shareholders, (2) the number of classes of stock, or (3) the types of investments in related entities.

Limited liability partnerships (LLP) LLPs are taxed as partnerships but enjoy limited liability under state partnership laws (i.e., individual partners are liable for their own acts and acts of persons under their direction and control but not for negligence or misconduct by other partners).

Liquidating distribution A distribution that liquidates a partner's entire partnership interest due to retirement, death, or other business reason. Such distributions result in a capital gain or loss to the partner whose interest is liquidated. In a corporate liquidation, the liquidating corporation generally recognizes gains and losses on the distribution of the properties and its shareholders recognize capital gain or loss on the surrender of their stock.

Long-term capital gain (LTCG) Gain realized on the sale or exchange of a capital asset held longer than one year.

Long-term capital loss (LTCL) Loss realized on the sale or exchange of a capital asset held longer than one year.

Long-term contracts Building, manufacturing, installation, and construction contracts that are not completed in the same taxable year in which they are entered into. Service contracts do not qualify as long-term contracts. See also Completed contract method of accounting.

Look-back interest Interest that is assessed on any additional tax that would have been paid if the actual total cost of the contract was used to calculate the tax rather than the estimated cost. Thus, it is applicable to any contract or portion of a contract that is accounted for under either the hybrid or percentage of completion method of accounting.

Lower of cost or market method (LCM) of inventory valuation The valuation method is available to all taxpayers other than those using LIFO valuation. It is applied to each separate item in the inventory.

Marginal tax rate The tax that is applied to an incremental amount of taxable income that is added to the tax base. This rate can be used to measure the tax effect of a proposed transaction. Currently, the highest marginal tax rate for individuals is 37%.

Market value This term refers to replacement cost under the lower of cost or market inventory method. That is, it is the price at which the taxpayer can replace the goods in question. See also Fair market value.

Material participation The level of participation by a taxpayer in an activity that determines whether the activity is either passive or active. If a taxpayer does not meet the material participation requirements, the activity is treated as a passive activity.

Medical expense deduction Unreimbursed medical expenses incurred for medical procedures or treatments that are (1) legal in the locality in which they are performed and (2) incurred for the purpose of alleviating a physical or mental defect or illness that affects the body's structure or function are deductible from AGI. Out-of-pocket travel costs incurred while en route to a medical facility, certain capital expenditures affecting the sick person, premiums for medical insurance, and in-patient hospital care are also deductible. Certain restrictions and limitations apply to this deduction.

Memorandum decision Decision issued by the Tax Court. They deal with factual variations on matters which were decided in earlier cases.

Method of accounting See Accounting method.

Miscellaneous itemized deductions Certain unreimbursed employee expenses (e.g., required uniforms, travel, entertainment, and so on) fell into this category. Miscellaneous itemized deductions also included certain investment expenses, appraisal fees for charitable contributions and fees for tax return preparation. The nature of the deduction depends on whether the taxpayer is an employee or a self-employed individual. These expenses have been suspended for tax years 2018–2015 for employees.

Modified percentage of completion method A variation of the regular percentage of completion method where an election may be made to defer reporting profit from a long-term contract until at least 10% of the estimated total cost has been incurred.

Moving expense Expenses incurred in relation to employment-related job transfers. For most taxpayers, these expenses are no longer allowed after 2017.

Necessary expense Expense that is deductible under Sec. 162 because it is appropriate and helpful in the taxpayer's business. Such expenses must also qualify as ordinary.

Net business interest The business interest that can be deducted in a given tax year is limited to the sum of three amounts: (1) business interest income, (2) 30% of adjusted taxable income (but not less than zero), and (3) floor plan financing interest for automobiles. For partnerships and S corporations, the limitation is applied at the entity level.

Net investment income The excess of the taxpayer's investment income over his investment expenses. See also Investment income.

Net operating loss (NOL) A net operating loss occurs when business expenses exceed business income for any taxable year. Such losses incurred after 2017 may be carried forward indefinitely and may be subject to the 80% of taxable income limitation in the carryover year.

Net Present Value (NPV) Method used by investment analysts to determine the anticipated return on an investment. This method uses a fixed discount rate to compute the net present value of future cash flows.

News release An administrative pronouncement concerning an issue the IRS thinks the general public will be interested in. Such releases are issued in lay terms.

NOL See Net operating loss.

Net unearned income The amount of unearned income of a child under age 18 (or under 24 if a full-time student and earned income less than 1/2 of his support) that is taxed at special rates based on the rate schedule for trusts and estates.

Nonaccountable plan A type of employee reimbursement plan that does not meet either of the two tests for an accountable plan (see Accountable plan). Under a nonaccountable plan, reimbursements are included in the employee's gross income but the deduction for the expenses has been suspended for tax years 2018–2025.

Nonbusiness bad debt See Bad debt.

Noncontributory pension plan Only the employer makes contributions to this type of pension plan.

Nonliquidating distribution Distribution that reduces but does not eliminate, a partner's partnership interest. Such distributions are generally treated as tax-free returns of capital.

Nonqualified deferred compensation plan Type of plan used by employer to provide incentives or supplementary retirement benefits for executives. Such plans are not subject to the nondiscrimination and vesting rules.

Nonqualified stock option Stock option that does not meet the requirements for an incentive stock option.

Nonrefundable credit Allowances, such as the dependent child care credit, that have been created for various social, economic, and political reasons. The tax credits in this category do not result from payments made to the government in advance. Thus, they can be deducted from the tax, but they are not payable to the taxpayer in situations where the credit exceeds the tax.

NPV See Net Present Value.

Office audit procedure IRS audit of a specific item on an individual's tax return. An office audit takes place at the IRS branch office.

Open-fact situation A situation that has not yet occurred. That is, one for which the facts and events are still controllable and can be planned for.

Ordinary expense An expense that is deductible because it is reasonable in amount and bears a reasonable and proximate relationship to the income-producing activity or property.

Ordinary income property For purposes of the charitable contribution deduction, any property that would result in the recognition of ordinary income if the property were sold. Such property includes inventory, works of art or manuscripts created by the taxpayer, capital assets that have been held for one year or less, and Section 1231 property that results in ordinary income due to depreciation recapture.

Organizational expenditures The amortizable legal, accounting, filing, and other fees incidental to organizing a partnership or a corporation.

Parent-subsidiary controlled group To qualify, a common parent must own at least 80% of the stock of at least one subsidiary corporation and at least 80% of each other component member of the controlled group must be owned by other members of the controlled group.

Partnership Syndicate, group pool, joint venture, or other unincorporated organization which carries on a business or financial operation or venture.

Partnership interest The capital and/or profits interest in a partnership received in exchange for a contribution of properties or services (e.g., money or business equipment). The nature of a partnership interest is similar to that of corporate stock.

Passive activity To define what constitutes a passive activity for the purpose of applying the passive loss rules, it is necessary to (1) identify what constitutes an activity and (2) determine whether the taxpayer has materially participated in the activity. Temp. Reg. Sec. 1.469-4T contains detailed rules for making these determinations.

Passive income Income from an activity that does not require the taxpayer's material involvement or participation. Thus, income from tax shelters and rental activities fall into the category.

Passive loss Loss generated from a passive activity. Such losses are computed separately. They may be used to offset income from other passive activities, but may not be used to offset either active or portfolio income.

Percentage depletion method Depletion method for assets such as oil and gas that is equal to a specified percentage times the gross income from the property but which may not exceed 100% of the taxable income before depletion is deducted. Lease bonuses, advance royalties, and other amounts payable without regard to production may not be included in the calculation. This method is only available to small oil and gas producers and royalty owners and for certain mineral properties.

Percentage of completion method of accounting Accounting method generally used for long-term contracts under which income is reported in proportion to the amount of work that has been completed in a given year.

Personal holding company (PHC) A closely held corporation (1) that is owned by a five or fewer shareholders who own more than 50% of the corporation's outstanding stock at any time during the last half of its taxable year and (2) whose PHC income equals at least 60% of the corporation's adjusted gross income for the tax year. Certain corporations (e.g., S corporations) are exempt from this definition.

Personal holding company tax This tax is equal to 20% of the undistributed personal holding company income. It is intended to prevent closely held companies from converting an operating company into a nonoperating investment company.

Personal interest All interest other than active business interest, investment interest, interest incurred in a passive activity, qualified residence interest, and interest incurred when paying the estate tax on an installment basis. Personal interest is currently treated as a nondeductible personal expenditure. See also Interest.

Personal property Property that is other than real property, such as equipment.

Personal service corporation (PSC) A regular C corporation whose principal activity is the performance of personal services that are substantially performed by owner-employees who own more than 10% of the value of the corporation's stock.

PHC See Personal holding company.

Portfolio income Dividends, interest, annuities, and royalties not derived in the ordinary course of business. Gains and losses on property that produces portfolio income are included in such income.

Premium Tax Credit A personal tax credit for a portion of the cost of a taxpayer's health insurance premiums. To be eligible for the credit, the taxpayer must have household income between 100% and 400% of the federal poverty line. The credit is based on the excess of the qualifying premiums over what is deemed to be affordable based on the taxpayer's household income.

Primary cite The highest level official reporter which reports a particular case is called the primary cite.

Principal partner A partner owning 5% or more of the partnership profits and capital interests.

Principal residence The residence that the taxpayer occupies most of the time.

Private activity bond Obligation issued by a state of local government to finance nongovernmental activities (e.g., a sports arena).

Private Letter Ruling See Letter Ruling.

Production of income An activity of the taxpayer that is generally related to investment activities or matters connected with the determination of any tax. Generally, these expenses are not deductible, although in some instances they may be allowed *for AGI*, such as expenses connected with rental property.

Profit-sharing plan A qualified defined benefit plan which may be established in lieu of or in addition to a qualified pension plan. Contributions to a profit-sharing plan are usually based upon profits. Incidental benefits may or may not be included. In addition, the plan must meet certain requirements concerning determination of the amount and timing of the employer's contribution, how the employee wants to receive the employer's contribution, vesting, and forfeitures.

Progressive rate Tax that increases as the taxpayer's taxable income increases. The U.S. income tax on individual taxpayers is an example of a progressive tax.

Property settlement The division of property between spouses upon their separation or divorce.

Property tax Federal, state, or local tax levied on real and/or personal property (e.g., securities, a personal automobile).

Proportional tax A method of taxation under which the tax rate is the same for all taxpayers regardless of their income. State and local sales taxes are examples of this form of tax.

Proposed Regulations Issued following changes in the tax law. May or may not be amended after hearings are conducted and comments received. Proposed regulations are not binding on taxpayers.

PSC See Personal service corporation.

Qualified business income deduction This deduction for the taxpayer's qualified income from a partnership, S corporation, or sole proprietorship is designed to bring the tax rates on these businesses more in line with the reduced rates for C corporations after 2017. The deduction reduces taxable income and is generally limited to the 20% of the lesser of qualified business income or excess taxable income (before considering the qualified business income deduction).

Qualified pension plan Pension plan that includes (1) systematic and definite payments made to a pension trust based upon actuarial methods and (2) usually provides for incidental benefits such as disability, or medical insurance benefits.

Qualified plan award Employee achievement awards given under a written plan or program that does not discriminate in favor of highly compensated employees. Such awards must be in the form of tangible personal property other than cash and be worth no more than $1,600.

Qualified residence interest Interest on an indebtedness which is secured by the taxpayer's qualified residence when it is paid or accrued. A taxpayer may have two qualified residences: a principal residence and a residence that he has personally used more than the greater of 14 days or 10% of the rental days during the year.

Qualifying children A child of the taxpayer who meets the four tests of relationship, age abode, and support. A child who meets these tests qualifies as a dependent of the taxpayer.

Qualifying relative An individual who qualifies as a dependent if he or she meets the relationship, gross income, and support tests.

Readily ascertainable fair market value The fair market value of nonqualified stock options can be readily ascertained where the option is traded on an established options exchange.

Real property Property that is land or any structure permanently attached to the land, such as buildings.

Realized gain or loss The gain or loss computed by taking the amount realized from a sale of property and subtracting the property's adjusted basis.

Recovery of basis doctrine Rule that allows taxpayers to recover the basis of an asset without being taxed. Such amounts are considered a return of capital.

Refundable credit See Tax credit.

Regressive tax A form of taxation under which the tax rate decreases as the tax base (e.g., income) increases.

Regular corporation See C corporation.

Regular decision Tax Court decision that is issued on a particular issue for the first time.

Regulation See Treasury Regulation.

Replacement property Property that is acquired to replace converted property in order to retain nonrecognition of gain status. Such property must generally be functionally the same as the converted property. For example, a business machine must be replaced with a similar business machine. There are exceptions to this rule: The taxpayer-use test applies to the involuntary conversion of rental property owned by an investor; condemnations of real property held for business or investment use may be replaced by like-kind property.

Residential rental property Property from which at least 80% of the gross rental income is rental from dwelling units. Residential units include manufactured homes that are used for rental purposes, but not hotels, motels, or other establishments for transient use.

Restricted property plan Such plans are used to attract and retain key executives by giving them an ownership interest in the corporation. The income recognition rules contained in Sec. 83 govern this type of plan.

Revenue Amounts received by the taxpayer from any source. It includes both taxable and nontaxable amounts and items that are a return of capital. Although closely related to income or gross income, differences between these items do exist.

Revenue Procedure Issued by the national office of the IRS, Revenue Procedures reflect the IRS' position on compliance relating to tax preparation issues. Revenue Procedures, which are published in the Cumulative Bulletin, have less weight than Treasury Regulations.

Revenue Ruling Issued by the national office of the IRS, Revenue Rulings reflect the IRS's interpretation of a narrow tax issue. Revenue Rulings, which are published in the Cumulative Bulletin, have less weight than the Treasury Regulations.

Roth IRA An IRA in which the contributions are nondeductible, but distributions generally are not subject to tax. Therefore, all earnings in a Roth IRA are not subject to taxation.

Royalties Ordinary income arising from amounts paid for the right to use property that belongs to another and is transferred for valuable consideration (e.g., a patent right where substantially all rights are transferred).

Sale A transaction where one receives cash and/or the equivalent of cash, including the assumption of debt, in exchange for an asset.

Sales tax State or local tax on purchases. Generally, food items and medicines are exempt from such tax.

S corporation Small business corporations may elect S corporation status if they meet the 100-shareholder limitation, the type of shareholder restrictions, and the one class of stock restriction. Taxation of such corporations parallels the tax rules that apply to partnerships.

Secondary cite Citation to secondary source (i.e., unofficial reporter).

Section 401(k) plan Type of plan that is often used to supplement a company's regular qualified pension and profit-sharing plan. Such plans, which generally contain a salary reduction feature, permit the employer to receive either cash or an equivalent contribution to the company's profit-sharing plan. The amount of the contribution is limited.

Section 1231 property Real or depreciable property that is (1) held for more than one year and (2) used in a trade or business. Certain property, such as inventory, U.S. government publications, copyrights, literary, musical, or artistic compositions, and letters, are excluded from this definition.

Section 1245 property Certain property subject to depreciation and, in some cases, amortization. Depreciable personal property such as equipment is Section 1245 property. However, most real property is not.

Section 1250 property Any real property that (1) is not Section 1245 property and (2) is subject to a depreciation allowance.

Security A long-term debt obligation. Long-term is generally defined as 10 years or more.

Self-employment tax A tax imposed on self-employed individuals. The SE is comprised of two parts, (1) 12.4% for Social Security taxes (limited to a maximum amount of SE income) and (2) 2.9% for Medicare taxes (no limit on SE income). For 2019, the maximum SE income subject to the tax is $132,900 ($128,400 in 2018). The Medicare tax increases to 3.8% once the self-employment income exceeds a threshold ($200,000 for single taxpayers; $250,000 for married taxpayers).

Separate property All property that is owned before marriage and any gifts or inheritances acquired after marriage are separate property. This distinction depends on the state of residence. However, it is possible even in community property states.

Severance damages Compensation for a decline in the value of the property remaining after part of the taxpayer's property is condemned. The IRS considers such damages analogous to the proceeds from property insurance.

Shifting income The process of transferring income from one family member to another. Methods for shifting income include gifts of stock or bonds to family members who are in lower tax brackets.

Short sale An investment activity where an investor sells a security at its current price and purchases the same security at a future date. A short sale is generally used when the price of a security is expected to decline.

Short-term capital gain (STCG) Gain realized on the sale or exchange of a capital asset held for one year or less.

Short-term capital loss (STCL) Loss realized on the sale or exchange of a capital asset held for one year or less.

Simplified LIFO method This method of inventory valuation allows taxpayers to use a single LIFO pool rather than multiple pools. See also LIFO method.

Small cases procedure When taxes of $50,000 or less are in question for a particular year, the taxpayer may opt to have the case heard by a special commissioner rather than the regular Tax Court. The decision of the commissioner cannot be appealed.

Social security benefits These benefits include (1) the basic monthly retirement and disability benefits paid under social security and (2) tier-one railroad retirement benefits.

Sole proprietorship Form of business entity owned by an individual who reports all items of income, expense, on his individual return on Schedule C.

Specific write-off method of accounting Method of accounting used for bad debts. Under this method, the taxpayer deducts each bad debt individually as it becomes worthless. This is the only allowable accounting method for bad debts arising after 1986.

Splitting income The process of creating additional taxable entities, especially corporations, in order to reduce an individual's effective tax rate.

Standard deduction A floor amount set by Congress to simplify the tax computation. It is used by taxpayers who do not have enough deductions to itemize. The amount of the deduction varies according to the taxpayer's filing status, age, and vision. Taxpayers who use this standard deduction are not required to keep records.

State corporate income tax See Franchise tax.

Statements on Standards for Tax Services (SSTS) Ethical guidelines of the AICPA-Federal Tax Division for CPAs to promote high standards of tax practice.

Statute of Limitations A period of time as provided by law in which a taxpayer's return may not be changed either by the IRS or the taxpayer. The Statute of Limitations is generally three years from the later of the date the tax return is filed or its due date. There is no Statute of Limitations for a fraudulent return.

Stock bonus plan A special type of defined benefit plan under which the employer's stock is contributed to a trust. The stock is then allocated and distributed to the participants. See also Employee stock ownership plan.

Stock dividend A dividend paid in the form of stock in the corporation issuing the dividend.

Stock option plan This category includes incentive stock options and nonqualified stock option arrangements. Such plans are used to attract and retain key employees.

Substance-over-form doctrine Judicial weighing of a transaction's economic substance more heavily than its legal form.

Surviving spouse A special filing status available to widows and widowers who file a joint return for the year his or her spouse dies and for the following two years. The surviving spouse may not have remarried, must be a U.S. citizen or resident, have qualified to file a joint return for the year, and must have at least one dependent child living at home during the year.

Syndication fees The nonamortizable fees (e.g., brokerage and registration fees) incurred to promote and market partnership interests. Such fees are generally associated with tax-sheltered limited partnership interests.

Tangible property Property that has physical substance, such as land, buildings, natural resources, equipment, etc.

Tax A mandatory assessment levied under the authority of a political entity for the purpose of raising revenue to be used for public or governmental purposes. Such taxes may be levied by the federal, state, or local government.

Taxable income For individuals, taxable income is adjusted gross income reduced by deductions from adjusted gross income.

Tax base The amount to which the tax rate is applied to determine the tax due. For income tax purposes, the tax base is taxable income.

Tax benefit rule Recovery of an amount in a subsequent year that produced a tax benefit in a prior year and is thus taxable to the recipient.

Tax credit Amount that can be deducted from the gross tax to arrive at the net tax due or refund due. Prepaid amounts, that is, amounts paid to the government during the year, are tax credits. Such prepaid amounts are often referred to as "refundable credits."

Tax Deferred Bonds Bonds on which the interest is not subject to current taxation but is deferred to a future period of time, such as Series EE U.S. Savings Bonds.

Tax Exempt Bonds Bonds on which the interest is completely exempt from federal income taxation, such as state and municipal bonds.

Tax law The tax law is comprised of the Internal Revenue Code, administrative and judicial interpretations, and the committee reports issued by the Congressional committees involved in the legislative process.

Taxpayer Compliance Measurement Program (TCMP) A stratified random sample used to select tax returns for audit. The program is intended to test the extent to which taxpayers are in compliance with the law.

Taxpayer-use test A test used to determine whether property is considered similar or related in service or use for purposes of involuntary conversions of property. This test is used by owner-investors (as opposed to owner-users) of property.

Tax research Search for the best possible solution to a problem involving either a proposed or completed transaction.

Tax shelter Passive activity which may lack economic substance other than creating tax deductions and credits that enable taxpayers to reduce or eliminate the income tax liability from their regular business activities. Section 469 restricts the current use of deductions and credits arising from passive activities.

Tax year See Accounting period.

TCMP See Taxpayer Compliance Measurement Program.

Technical Advice Memorandum Such memoranda are administrative interpretations issued in the form of letter ruling. Taxpayers may request them if they need guidance about the tax treatment of complicated technical matters which are being audited.

Temporary Regulations Temporary Regulations are Treasury Regulations that are issued to provide guidance for taxpayers pending the issuance of the final regulations. They are binding upon taxpayers. Temporary Regulations are also required to be issued as proposed regulations and must expire within three years.

Testamentary gift Transfer of property made at the death of the donor (i.e., bequests, devises, and inheritances).

Total economic income The amount of the taxpayer's income, including exclusions and deductions from the tax base (e.g., tax-exempt bonds), is categorized as total economic income.

Trade or business A business activity of the taxpayer in which deductions are allowed as for AGI deductions.

Transportation expense The deductibility of this type of expense depends upon whether it is trade- or business-related, or whether it is related to the production of income. Commuting expenses are nondeductible. See also Travel expense.

Travel expense Such expenses include transportation, meals, and lodging incurred in the pursuit of a trade, business, or employment-related activity. There are limitations and restrictions on the deductibility of these expenses. See also Transportation expense.

Treasury bill Short-term (i.e., 90-day) obligation that is issued by the government at a discount from the maturity amount. The difference between the issue price and the maturity amount represents the interest income.

Treasury Regulation The principal administrative source of the federal tax law, these regulations reflect the Treasury's and the IRS's interpretation of the Internal Revenue Code. They may be either legislative or interpretative and they may be issued in either proposed, temporary, or final form.

Unfunded deferred compensation plan This type of plan is used for highly-compensated employees who wish to defer the recognition of income until future periods. Funding is generally accomplished through an escrow account for the employee's benefit.

Uniform Capitalization rules (UNICAP) The requirements under the tax law for determining inventory cost. Under UNICAP certain indirect overhead costs are required to be included in inventory for tax purposes which are generally not included for financial accounting.

Unrelated use property Capital gain property which is also tangible personal property and which is contributed to a public charity for a use that is unrelated to the charity's function. The contribution deduction (from AGI) for such property is equal to the property's fair market value minus the capital gain that would be recognized if the property was sold at that value.

Unreported decision District Court decisions that are not officially reported in the Federal Supplement. Such decisions may be reported in secondary reporters that report only tax-related cases.

U.S. Treasury Bill See Treasury bill.

Vertical equity A concept in taxation that provides that the incidence of taxation should be borne by taxpayers who have the ability to pay the tax. Taxpayers who are not similarly situated should be treated differently under the tax law.

Wash sale A wash sale results when the taxpayer (1) sells stock or securities and (2) purchases substantially identical stock or securities within the 61-day period extending from 30 days before the date of sale to 30 days after the date of sale.

Wealth transfer tax A tax imposed upon the value of property transferred during one's lifetime (i.e., a gift tax) or upon the death of the transferor (i.e., an estate tax). The tax is imposed upon the transferor of property or upon the estate.

Writ of certiorari A petition to the U.S. Supreme Court to request that the Court agree to hear a case. A writ of certiorari is requested by the party (IRS or taxpayer) that lost at the Court of Appeals level.

Zero coupon bond Bond that is issued at a cost that is substantially less than the current market rate because no interest payments are made. The original issue discount (OID) must be amortized over the term of the bond by investors using the constant rate method. Such bonds offer cash-flow advantages to corporate issuers since no cash outlay for interest is required until the bonds mature.

APPENDIX

E

AICPA STATEMENTS ON STANDARDS FOR TAX SERVICES NOS. 1–7

Note: The AICPA released revised Statements on Standards for Tax Services (SSTS) effective on January 1, 2010. These statements are enforceable standards of tax practice for AICPA members. Changes to Statements No. 1 and 7 (formerly No. 8) were substantive in nature. As a result, Interpretations No. 1-1 and 1-2 relating to former Statement No. 1 are currently being updated. The new statements as well as the old statements can be found on the AICPA website at www.aicpa.org.

PREFACE

1. Standards are the foundation of a profession. The AICPA aids its members in fulfilling their ethical responsibilities by instituting and maintaining standards against which their professional performance can be measured. Compliance with professional standards of tax practice also reaffirms the public's awareness of the professionalism that is associated with CPAs as well as the AICPA.

2. This publication sets forth enforceable tax practice standards for members of the AICPA, Statements on Standards for Tax Services (SSTSs or statements). These statements apply to all members providing tax services regardless of the jurisdictions in which they practice. Interpretations of these statements may be issued as guidance to assist in understanding and applying the statements. The SSTSs and their interpretations are intended to complement other standards of tax practice, such as Treasury Department Circular No. 230, *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, Enrolled Retirement Plan Agents, and Appraisers before the Internal Revenue Service*; penalty provisions of the Internal Revenue Code; and state boards of accountancy rules.

3. The SSTSs are written in as simple and objective a manner as possible. However, by their nature, practice standards provide for an appropriate range of behavior and need to be interpreted to address a broad range of personal and professional situations. The SSTSs recognize this need by, in some sections, providing relatively subjective rules and by leaving certain terms undefined. These terms are generally rooted in tax concepts and, therefore, should be readily understood by tax practitioners. Accordingly, enforcement of these rules, as part of the AICPA's Code of Professional Conduct Rule 201, *General Standards*, and Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 201 par. .01 and ET sec. 202 par. .01), will be undertaken on a case-by-case basis. Members are expected to comply with them.

History

4. The SSTSs have their origin in the Statements on Responsibilities in Tax Practice (SRTPs), which provided a body of advisory opinions on good tax practice. The guidelines as originally set forth in the SRTPs became more important than many members had anticipated when the guidelines were issued. The courts, the IRS, state accountancy boards, and other professional organizations recognized and relied on the SRTPs as the appropriate articulation of professional conduct in a CPA's tax practice. The SRTPs became *de facto* enforceable standards of professional practice, because state disciplinary organizations and courts regularly held CPAs accountable for failure to follow the guidelines set forth in the SRTPs.

5. The AICPA's Tax Executive Committee concluded it was appropriate to issue tax practice standards that would become a part of the AICPA's *Professional Standards*. At its July 1999 meeting, the AICPA Board of Directors approved support of the executive committee's initiative and placed the matter on the agenda of the October 1999 meeting of the AICPA's governing Council. On October 19, 1999, Council approved designating the Tax Executive Committee as a standardsetting body, thus authorizing that committee to promulgate standards of tax practice. As a result, the original SSTSs, largely mirroring the SRTPs, were issued in August 2000.

6. The SRTPs were originally issued between 1964 and 1977. The first nine SRTPs and the introduction were promulgated in 1976; the tenth SRTP was issued in 1977. The original SRTPs concerning the CPA's responsibility to sign the tax return (SRTP No. 1, *Signature of Preparers*, and No. 2, *Signature*

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of Reviewer: *Assumption of Preparer's Responsibility*) were withdrawn in 1982 after Treasury Department regulations were issued adopting substantially the same standards for all tax return preparers. The sixth and seventh SRTPs, concerning the responsibility of a CPA who becomes aware of an error, were revised in 1991. The first interpretation of the SRTPs, Interpretation No. 1-1, "Realistic Possibility Standard," was approved in December 1990. The SSTSs and Interpretation No. 1-1, "Realistic Possibility Standard," of SSTS No. 1, *Tax Return Positions*, superseded and replaced the SRTPs and their Interpretation No. 1-1, effective October 31, 2000. Although the number and names of the SSTSs, and the substance of the rules contained in each of them, remained the same as in the SRTPs, the language was revised to both clarify and reflect the enforceable nature of the SSTSs. In addition, because the applicability of these standards is not limited to federal income tax practice (as was the case with the SRTPs), the language was changed to indicate the broader scope. In 2003, in connection with the tax shelter debate, SSTS Interpretation No. 1-2, "Tax Planning," of SSTS No. 1 was issued to clarify a member's responsibilities in connection with tax planning; that interpretation became effective December 31, 2003.

7. When the original SSTSs were issued, an effort was made to keep to a minimum any changes in the language of the SSTSs from that of the predecessor SRTPs. This was done to alleviate concerns regarding the enforceability of standards that differed from the SRTPs under which members had been practicing. Since the issuance of the original SSTSs, members have asked for clarification on certain matters, such as the duplication of the language in SSTS No. 6, *Knowledge of Error: Return Preparation*, and No. 7, *Knowledge of Error: Administrative Proceedings*. Also, certain changes in federal and state tax laws have raised concerns regarding the need to revise SSTS No. 1. As a result, in 2008, the original SSTS Nos. 1–8 were updated, effective January 1, 2010. The original SSTS Nos. 6–7 were combined into the revised SSTS No. 6, *Knowledge of Error: Return Preparation and Administrative Proceedings*. The original SSTS No. 8, *Form and Content of Advice to Taxpayers*, was renumbered SSTS No. 7. In addition, various revisions were made to the language of the original SSTSs.

Ongoing Process

8. The following SSTSs and any interpretations issued thereunder reflect the AICPA's standards of tax practice and delineate members' responsibilities to taxpayers, the public, the government, and the profession. The statements are intended to be part of an ongoing process of articulating standards of tax practice for members. These standards are subject to change as necessary or appropriate to address changes in the tax law or other developments in the tax practice environment.

9. Members are encouraged to assess the adequacy of their practices and procedures for providing tax services in conformity with these standards. This process will vary according to the size of the practice and the nature of tax services performed.

10. The Tax Executive Committee promulgates the SSTSs and their interpretations. Acknowledgment is also due to the many members who have devoted their time and efforts over the years to developing and revising the AICPA's standards.

STATEMENT ON STANDARDS FOR TAX SERVICES NO. 1, *TAX RETURN POSITIONS*

Introduction

1. This statement sets forth the applicable standards for members when recommending tax return positions, or preparing or signing tax returns (including amended returns, claims for refund, and information returns) filed with any taxing authority. For purposes of these standards

a. a *tax return position* is (i) a position reflected on a tax return on which a member has specifically advised a taxpayer or (ii) a position about which a member has knowledge of all material facts and, on the basis of those facts, has concluded whether the position is appropriate.
b. a *taxpayer* is a client, a member's employer, or any other third-party recipient of tax services.

2. This statement also addresses a member's obligation to advise a taxpayer of relevant tax return disclosure responsibilities and potential penalties.

3. In addition to the AICPA, various taxing authorities, at the federal, state, and local levels, may impose specific reporting and disclosure standards with regard to recommending tax return positions or preparing or signing tax returns.[1] These standards can vary between taxing authorities and by type of tax.

Statement

4. A member should determine and comply with the standards, if any, that are imposed by the applicable taxing authority with respect to recommending a tax return position, or preparing or signing a tax return.

5. If the applicable taxing authority has no written standards with respect to recommending a tax return position or preparing or signing a tax return, or if its standards are lower than the standards set forth in this paragraph, the following standards will apply:

a. A member should not recommend a tax return position or prepare or sign a tax return taking a position unless the member has a good-faith belief that the position has at least a realistic possibility of being sustained administratively or judicially on its merits if challenged.
b. Notwithstanding paragraph 5(a), a member may *recommend a tax return position* if the member (i) concludes that there is a reasonable basis for the position and (ii) advises the taxpayer to appropriately disclose that position. Notwithstanding paragraph 5(a), a member may *prepare or sign a tax return* that reflects a position if (i) the member concludes there is a

[1] A member should refer to the current version of Internal Revenue Code Section 6694, Understatement of taxpayer's liability by tax return preparer, and other relevant federal, state, and jurisdictional authorities to determine the reporting and disclosure standards that are applicable to preparers of tax returns.

reasonable basis for the position and (ii) the position is appropriately disclosed.

6. When recommending a tax return position or when preparing or signing a tax return on which a position is taken, a member should, when relevant, advise the taxpayer regarding potential penalty consequences of such tax return position and the opportunity, if any, to avoid such penalties through disclosure.

7. A member should not recommend a tax return position or prepare or sign a tax return reflecting a position that the member knows

a. exploits the audit selection process of a taxing authority, or
b. serves as a mere arguing position advanced solely to obtain leverage in a negotiation with a taxing authority.

8. When recommending a tax return position, a member has both the right and the responsibility to be an advocate for the taxpayer with respect to any position satisfying the aforementioned standards.

Explanation

9. The AICPA and various taxing authorities impose specific reporting and disclosure standards with respect to tax return positions and preparing or signing tax returns. In a given situation, the standards, if any, imposed by the applicable taxing authority may be higher or lower than the standards set forth in paragraph 5. A member is to comply with the standards, if any, of the applicable taxing authority; if the applicable taxing authority has no standards or if its standards are lower than the standards set forth in paragraph 5, the standards set forth in paragraph 5 will apply.

10. Our self-assessment tax system can function effectively only if taxpayers file tax returns that are true, correct, and complete. A tax return is prepared based on a taxpayer's representation of facts, and the taxpayer has the final responsibility for positions taken on the return. The standards that apply to a taxpayer may differ from those that apply to a member.

11. In addition to a duty to the taxpayer, a member has a duty to the tax system. However, it is well established that the taxpayer has no obligation to pay more taxes than are legally owed, and a member has a duty to the taxpayer to assist in achieving that result. The standards contained in paragraphs 4–8 recognize a member's responsibilities to both the taxpayer and the tax system.

12. In reaching a conclusion concerning whether a given standard in paragraph 4 or 5 has been satisfied, a member may consider a well-reasoned construction of the applicable statute, well-reasoned articles or treatises, or pronouncements issued by the applicable taxing authority, regardless of whether such sources would be treated as *authority* under Internal Revenue Code Section 6662, *Imposition of accuracy-related penalty on underpayments*, and the regulations thereunder. A position would not fail to meet these standards merely because it is later abandoned for practical or procedural considerations during an administrative hearing or in the litigation process.

13. If a member has a good-faith belief that more than one tax return position meets the standards set forth in paragraphs 4–5, a member's advice concerning alternative acceptable positions may include a discussion of the likelihood that each such position might or might not cause the taxpayer's tax return to be examined and whether the position would be challenged in an examination. In such circumstances, such advice is not a violation of paragraph 7.

14. A member's determination of whether information is appropriately disclosed by the taxpayer should be based on the facts and circumstances of the particular case and the disclosure requirements of the applicable taxing authority. If a member recommending a position, but not engaged to prepare or sign the related tax return, advises the taxpayer concerning appropriate disclosure of the position, then the member shall be deemed to meet the disclosure requirements of these standards.

15. If particular facts and circumstances lead a member to believe that a taxpayer penalty might be asserted, the member should so advise the taxpayer and should discuss with the taxpayer the opportunity, if any, to avoid such penalty by disclosing the position on the tax return. Although a member should advise the taxpayer with respect to disclosure, it is the taxpayer's responsibility to decide whether and how to disclose.

16. For purposes of this statement, preparation of a tax return includes giving advice on events that have occurred at the time the advice is given if the advice is directly relevant to determining the existence, character, or amount of a schedule, entry, or other portion of a tax return.

STATEMENT ON STANDARDS FOR TAX SERVICES NO. 2, *ANSWERS TO QUESTIONS ON RETURNS*

Introduction

1. This statement sets forth the applicable standards for members when signing the preparer's declaration on a tax return if one or more questions on the return have not been answered. The term *questions* includes requests for information on the return, in the instructions, or in the regulations, whether or not stated in the form of a question.

Statement

2. A member should make a reasonable effort to obtain from the taxpayer the information necessary to provide appropriate answers to all questions on a tax return before signing as preparer.

Explanation

3. It is recognized that the questions on tax returns are not of uniform importance, and often they are not applicable to the particular taxpayer. Nevertheless, there are at least three reasons why a member should be satisfied that a reasonable effort has been made to obtain information to provide appropriate answers to the questions on the return that are applicable to a taxpayer:

a. A question may be of importance in determining taxable income or loss, or the tax liability shown on the return, in which circumstance an omission may detract from the quality of the return.

b. A request for information may require a disclosure necessary for a complete return or to avoid penalties.
c. A member often must sign a preparer's declaration stating that the return is true, correct, and complete.

4. Reasonable grounds may exist for omitting an answer to a question applicable to a taxpayer. For example, reasonable grounds may include the following:

a. The information is not readily available and the answer is not significant in terms of taxable income or loss, or the tax liability shown on the return.
b. Genuine uncertainty exists regarding the meaning of the question in relation to the particular return.
c. The answer to the question is voluminous; in such cases, a statement should be made on the return that the data will be supplied upon examination.

5. A member should not omit an answer merely because it might prove disadvantageous to a taxpayer.

6. A member should consider whether the omission of an answer to a question may cause the return to be deemed incomplete or result in penalties.

7. If reasonable grounds exist for omission of an answer to an applicable question, a taxpayer is not required to provide on the return an explanation of the reason for the omission.

STATEMENT ON STANDARDS FOR TAX SERVICES NO. 3, *CERTAIN PROCEDURAL ASPECTS OF PREPARING RETURNS*

Introduction

1. This statement sets forth the applicable standards for members concerning the obligation to examine or verify certain supporting data or to consider information related to another taxpayer when preparing a taxpayer's tax return.

Statement

2. In preparing or signing a return, a member may in good faith rely, without verification, on information furnished by the taxpayer or by third parties. However, a member should not ignore the implications of information furnished and should make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the member. Further, a member should refer to the taxpayer's returns for one or more prior years whenever feasible.

3. If the tax law or regulations impose a condition with respect to deductibility or other tax treatment of an item, such as taxpayer maintenance of books and records or substantiating documentation to support the reported deduction or tax treatment, a member should make appropriate inquiries to determine to the member's satisfaction whether such condition has been met.

4. When preparing a tax return, a member should consider information actually known to that member from the tax return of another taxpayer if the information is relevant to that tax return and its consideration is necessary to properly prepare that tax return. In using such information, a member should consider any limitations imposed by any law or rule relating to confidentiality.

Explanation

5. The preparer's declaration on a tax return often states that the information contained therein is true, correct, and complete to the best of the preparer's knowledge and belief based on all information known by the preparer. This type of reference should be understood to include information furnished by the taxpayer or by third parties to a member in connection with the preparation of the return.

6. The preparer's declaration does not require a member to examine or verify supporting data; a member may rely on information furnished by the taxpayer unless it appears to be incorrect, incomplete, or inconsistent. However, there is a need to determine by inquiry that a specifically required condition, such as maintaining books and records or substantiating documentation, has been satisfied and to obtain information when the material furnished appears to be incorrect, incomplete, or inconsistent. Although a member has certain responsibilities in exercising due diligence in preparing a return, the taxpayer has the ultimate responsibility for the contents of the return. Thus, if the taxpayer presents unsupported data in the form of lists of tax information, such as dividends and interest received, charitable contributions, and medical expenses, such information may be used in the preparation of a tax return without verification unless it appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to a member.

7. Even though there is no requirement to examine underlying documentation, a member should encourage the taxpayer to provide supporting data where appropriate. For example, a member should encourage the taxpayer to submit underlying documents for use in tax return preparation to permit full consideration of income and deductions arising from security transactions and from pass-through entities, such as estates, trusts, partnerships, and S corporations.

8. The source of information provided to a member by a taxpayer for use in preparing the return is often a pass-through entity, such as a limited partnership, in which the taxpayer has an interest but is not involved in management. A member may accept the information provided by the pass-through entity without further inquiry, unless there is reason to believe it is incorrect, incomplete, or inconsistent, either on its face or on the basis of other facts known to the member. In some instances, it may be appropriate for a member to advise the taxpayer to ascertain the nature and amount of possible exposure to tax deficiencies, interest, and penalties by taxpayer contact with management of the pass-through entity.

9. A member should make use of a taxpayer's returns for one or more prior years in preparing the current return whenever feasible. Reference to prior returns and discussion of prior-year tax determinations with the taxpayer should provide information to determine the taxpayer's general tax status, avoid the omission or duplication of items, and afford a basis for the treatment of similar or related transactions. As with the examination

of information supplied for the current year's return, the extent of comparison of the details of income and deduction between years depends on the particular circumstances.

STATEMENT ON STANDARDS FOR TAX SERVICES NO. 4, *USE OF ESTIMATES*

Introduction

1. This statement sets forth the applicable standards for members when using the taxpayer's estimates in the preparation of a tax return. A member may advise on estimates used in the preparation of a tax return, but the taxpayer has the responsibility to provide the estimated data. Appraisals or valuations are not considered estimates for purposes of this statement.

Statement

2. Unless prohibited by statute or by rule, a member may use the taxpayer's estimates in the preparation of a tax return if it is not practical to obtain exact data and if the member determines that the estimates are reasonable based on the facts and circumstances known to the member. The taxpayer's estimates should be presented in a manner that does not imply greater accuracy than exists.

Explanation

3. Accounting requires the exercise of professional judgment and, in many instances, the use of approximations based on judgment. The application of such accounting judgments, as long as not in conflict with methods set forth by a taxing authority, is acceptable. These judgments are not estimates within the purview of this statement. For example, a federal income tax regulation provides that if all other conditions for accrual are met, the exact amount of income or expense need not be known or ascertained at year end if the amount can be determined with reasonable accuracy.

4. When the taxpayer's records do not accurately reflect information related to small expenditures, accuracy in recording some data may be difficult to achieve. Therefore, the use of estimates by a taxpayer in determining the amount to be deducted for such items may be appropriate.

5. When records are missing or precise information about a transaction is not available at the time the return must be filed, a member may prepare a tax return using a taxpayer's estimates of the missing data.

6. Estimated amounts should not be presented in a manner that provides a misleading impression about the degree of factual accuracy.

7. Specific disclosure that an estimate is used for an item in the return is not generally required; however, such disclosure should be made in unusual circumstances where nondisclosure might mislead the taxing authority regarding the degree of accuracy of the return as a whole. Some examples of unusual circumstances include the following:

a. A taxpayer has died or is ill at the time the return must be filed.
b. A taxpayer has not received a Schedule K-1 for a pass-through entity at the time the tax return is to be filed.
c. There is litigation pending (for example, a bankruptcy proceeding) that bears on the return.
d. Fire, computer failure, or natural disaster has destroyed the relevant records.

STATEMENT ON STANDARDS FOR TAX SERVICES NO. 5, *DEPARTURE FROM A POSITION PREVIOUSLY CONCLUDED IN AN ADMINISTRATIVE PROCEEDING OR COURT DECISION*

Introduction

1. This statement sets forth the applicable standards for members in recommending a tax return position that departs from the position determined in an administrative proceeding or in a court decision with respect to the taxpayer's prior return.

2. For purposes of this statement, *administrative proceeding* includes an examination by a taxing authority or an appeals conference relating to a return or a claim for refund.

3. For purposes of this statement, *court decision* means a decision by any court having jurisdiction over tax matters.

Statement

4. The tax return position with respect to an item as determined in an administrative proceeding or court decision does not restrict a member from recommending a different tax position in a later year's return, unless the taxpayer is bound to a specified treatment in the later year, such as by a formal closing agreement. Therefore, the member may recommend a tax return position or prepare or sign a tax return that departs from the treatment of an item as concluded in an administrative proceeding or court decision with respect to a prior return of the taxpayer provided the requirements of Statement on Standards for Tax Services (SSTS) No. 1, *Tax Return Positions*, are satisfied.

Explanation

5. If an administrative proceeding or court decision has resulted in a determination concerning a specific tax treatment of an item in a prior year's return, a member will usually recommend this same tax treatment in subsequent years. However, departures from consistent treatment may be justified under such circumstances as the following:

a. Taxing authorities tend to act consistently in the disposition of an item that was the subject of a prior administrative proceeding but generally are not bound to do so. Similarly, a taxpayer is not bound to follow the tax treatment of an item as consented to in an earlier administrative proceeding.
b. The determination in the administrative proceeding or the court's decision may have been caused by a lack of documentation. Supporting data for the later year may be appropriate.
c. A taxpayer may have yielded in the administrative proceeding for settlement purposes or not appealed the court decision, even though the position met the standards in SSTS No. 1.

d. Court decisions, rulings, or other authorities that are more favorable to a taxpayer's current position may have developed since the prior administrative proceeding was concluded or the prior court decision was rendered.

6. The consent in an earlier administrative proceeding and the existence of an unfavorable court decision are factors that the member should consider in evaluating whether the standards in SSTS No. 1 are met.

STATEMENT ON STANDARDS FOR TAX SERVICES NO. 6, *KNOWLEDGE OF ERROR: RETURN PREPARATION AND ADMINISTRATIVE PROCEEDINGS*

Introduction

1. This statement sets forth the applicable standards for a member who becomes aware of (a) an error in a taxpayer's previously filed tax return; (b) an error in a return that is the subject of an administrative proceeding, such as an examination by a taxing authority or an appeals conference; or (c) a taxpayer's failure to file a required tax return. As used herein, the term *error* includes any position, omission, or method of accounting that, at the time the return is filed, fails to meet the standards set out in Statement on Standards for Tax Services (SSTS) No. 1, *Tax Return Positions*. The term *error* also includes a position taken on a prior year's return that no longer meets these standards due to legislation, judicial decisions, or administrative pronouncements having retroactive effect. However, an error does not include an item that has an insignificant effect on the taxpayer's tax liability. The term *administrative proceeding* does not include a criminal proceeding.

2. This statement applies whether or not the member prepared or signed the return that contains the error.

3. Special considerations may apply when a member has been engaged by legal counsel to provide assistance in a matter relating to the counsel's client.

Statement

4. A member should inform the taxpayer promptly upon becoming aware of an error in a previously filed return, an error in a return that is the subject of an administrative proceeding, or a taxpayer's failure to file a required return. A member also should advise the taxpayer of the potential consequences of the error and recommend the corrective measures to be taken. Such advice and recommendation may be given orally. The member is not allowed to inform the taxing authority without the taxpayer's permission, except when required by law.

5. If a member is requested to prepare the current year's return and the taxpayer has not taken appropriate action to correct an error in a prior year's return, the member should consider whether to withdraw from preparing the return and whether to continue a professional or employment relationship with the taxpayer. If the member does prepare such current year's return, the member should take reasonable steps to ensure that the error is not repeated.

6. If a member is representing a taxpayer in an administrative proceeding with respect to a return that contains an error of which the member is aware, the member should request the taxpayer's agreement to disclose the error to the taxing authority. Lacking such agreement, the member should consider whether to withdraw from representing the taxpayer in the administrative proceeding and whether to continue a professional or employment relationship with the taxpayer.

Explanation

7. While performing services for a taxpayer, a member may become aware of an error in a previously filed return or may become aware that the taxpayer failed to file a required return. The member should advise the taxpayer of the error and the potential consequences, and recommend the measures to be taken. Similarly, when representing the taxpayer before a taxing authority in an administrative proceeding with respect to a return containing an error of which the member is aware, the member should advise the taxpayer to disclose the error to the taxing authority and of the potential consequences of not disclosing the error. Such advice and recommendation may be given orally.

8. It is the taxpayer's responsibility to decide whether to correct the error. If the taxpayer does not correct an error, a member should consider whether to withdraw from the engagement and whether to continue a professional or employment relationship with the taxpayer. Although recognizing that the taxpayer may not be required by statute to correct an error by filing an amended return, a member should consider whether a taxpayer's decision not to file an amended return or otherwise correct an error may predict future behavior that might require termination of the relationship.

9. Once the member has obtained the taxpayer's consent to disclose an error in an administrative proceeding, the disclosure should not be delayed to such a degree that the taxpayer or member might be considered to have failed to act in good faith or to have, in effect, provided misleading information. In any event, disclosure should be made before the conclusion of the administrative proceeding.

10. A conflict between the member's interests and those of the taxpayer may be created by, for example, the potential for violating Code of Professional Conduct Rule 301, *Confidential Client Information* (AICPA, *Professional Standards*, vol. 2, ET sec. 301 par. .01) (relating to the member's confidential client relationship); the tax law and regulations; or laws on privileged communications, as well as by the potential adverse impact on a taxpayer of a member's withdrawal. Therefore, a member should consider consulting with his or her own legal counsel before deciding upon recommendations to the taxpayer and whether to continue a professional or employment relationship with the taxpayer.

11. If a member believes that a taxpayer may face possible exposure to allegations of fraud or other criminal misconduct, the member should advise the taxpayer to consult with an attorney before the taxpayer takes any action.

12. If a member decides to continue a professional or employment relationship with the taxpayer and is requested to prepare a tax return for a year subsequent to that in which the

error occurred, the member should take reasonable steps to ensure that the error is not repeated. If the subsequent year's tax return cannot be prepared without perpetuating the error, the member should consider withdrawal from the return preparation. If a member learns that the taxpayer is using an erroneous method of accounting and it is past the due date to request permission to change to a method meeting the standards of SSTS No. 1, the member may sign a tax return for the current year, providing the tax return includes appropriate disclosure of the use of the erroneous method.

13. Whether an error has no more than an insignificant effect on the taxpayer's tax liability is left to the professional judgment of the member based on all the facts and circumstances known to the member. In judging whether an erroneous method of accounting has more than an insignificant effect, a member should consider the method's cumulative effect, as well as its effect on the current year's tax return or the tax return that is the subject of the administrative proceeding.

14. If a member becomes aware of the error while performing services for a taxpayer that do not involve tax return preparation or representation in an administrative proceeding, the member's responsibility is to advise the taxpayer of the existence of the error and to recommend that the error be discussed with the taxpayer's tax return preparer. Such recommendation may be given orally.

STATEMENT ON STANDARDS FOR TAX SERVICES NO. 7, *FORM AND CONTENT OF ADVICE TO TAXPAYERS*

Introduction

1. This statement sets forth the applicable standards for members concerning certain aspects of providing advice to a taxpayer and considers the circumstances in which a member has a responsibility to communicate with a taxpayer when subsequent developments affect advice previously provided. The statement does not, however, cover a member's responsibilities when the expectation is that the advice rendered is likely to be relied on by parties other than the taxpayer.

Statement

2. A member should use professional judgment to ensure that tax advice provided to a taxpayer reflects competence and appropriately serves the taxpayer's needs. When communicating tax advice to a taxpayer in writing, a member should comply with relevant taxing authorities' standards, if any, applicable to written tax advice. A member should use professional judgment about any need to document oral advice. A member is not required to follow a standard format when communicating or documenting oral advice.

3. A member should assume that tax advice provided to a taxpayer will affect the manner in which the matters or transactions considered would be reported or disclosed on the taxpayer's tax returns. Therefore, for tax advice given to a taxpayer, a member should consider, when relevant (*a*) return reporting and disclosure standards applicable to the related tax return position and (*b*) the potential penalty consequences of the return position. In ascertaining applicable return reporting and disclosure standards, a member should follow the standards in Statement on Standards for Tax Services No. 1, *Tax Return Positions*.

4. A member has no obligation to communicate with a taxpayer when subsequent developments affect advice previously provided with respect to significant matters, except while assisting a taxpayer in implementing procedures or plans associated with the advice provided or when a member undertakes this obligation by specific agreement.

Explanation

5. Tax advice is recognized as a valuable service provided by members. The form of advice may be oral or written and the subject matter may range from routine to complex. Because the range of advice is so extensive and because advice should meet the specific needs of a taxpayer, neither a standard format nor guidelines for communicating or documenting advice to the taxpayer can be established to cover all situations.

6. Although oral advice may serve a taxpayer's needs appropriately in routine matters or in welldefined areas, written communications are recommended in important, unusual, substantial dollar value, or complicated transactions. The member may use professional judgment about whether, subsequently, to document oral advice.

7. In deciding on the form of advice provided to a taxpayer, a member should exercise professional judgment and should consider such factors as the following:

a. The importance of the transaction and amounts involved
b. The specific or general nature of the taxpayer's inquiry
c. The time available for development and submission of the advice
d. The technical complexity involved
e. The existence of authorities and precedents
f. The tax sophistication of the taxpayer
g. The need to seek other professional advice
h. The type of transaction and whether it is subject to heightened reporting or disclosure requirements
i. The potential penalty consequences of the tax return position for which the advice is rendered
j. Whether any potential applicable penalties can be avoided through disclosure
k. Whether the member intends for the taxpayer to rely upon the advice to avoid potential penalties

8. A member may assist a taxpayer in implementing procedures or plans associated with the advice offered. When providing such assistance, the member should review and revise such advice as warranted by new developments and factors affecting the transaction.

9. Sometimes a member is requested to provide tax advice but does not assist in implementing the plans adopted. Although such developments as legislative or administrative changes or future judicial interpretations may affect the advice previously provided, a member cannot be expected to communicate subsequent developments that affect such advice unless the member undertakes this obligation by specific agreement with the taxpayer.

10. Taxpayers should be informed that (*a*) the advice reflects professional judgment based upon the member's understanding of the facts, and the law existing as of the date the advice is rendered and (*b*) subsequent developments could affect previously rendered professional advice. Members may use precautionary language to the effect that their advice is based on facts as stated and authorities that are subject to change.

11. In providing tax advice, a member should be cognizant of applicable confidentiality privileges.

These Statements on Standards for Tax Services were unanimously adopted by the assenting votes of the 17 members of the 18-member Tax Executive Committee who participated in the August 6, 2009, Tax Executive Committee meeting.

Tax Executive Committee (2008–2009)

Alan R. Einhorn, *Chair*
Jeffrey R. Hoops, *Immediate Past Chair*
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Eve Elgin
Andrew D. Gibson
Cherie J. Hennig
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Patricia Thompson
Christine Turgeon
Mark Van Deveer
Richard P. Weber
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