**Acc. 433, Chapter Outline for use with Prentice Hall's Federal Taxation Corporations**


1) **Chapter 1 was not assigned!**
2) **Formation and Capital Structure**
   a) ***Taxable year***
      i) **Can pick a fiscal year (must be a month end)**
      ii) **Personal Service Corporations must generally use a calendar year**
   b) ***Different entities can exist, but they can be taxed as corporations!***
   c) ***Corporations can elect not to be taxed (S Corporation)***
   d) ***Taxable corporations are called C Corporations***
      i) **Advantages**
         (1) *Corporation pays the tax at 21%* on all income
         (2) *Shareholders are employees - thus medical expense deduction and no income to the "employee"*
         (3) *Protection from creditors (can use LLC)*
      ii) **Disadvantage**
         (1) *Second tax when corporate profits are eventually paid out*
   e) ***Partnerships (2 or more) such as limited liability companies, can elect to be treated as a corporation (Check the Box)***
   f) ***Must be legally formed***
   g) ***Taxation at formation - Section 351 states that no gain shall be on the transfer of to a controlled corporation for its stock (not debt)***
         (1) **Gain is realized, but not recognized**
         (2) **Only defers gain, and only on property, not services**
         (3) **Transferors must control the stock (80% or greater)**
         (4) **Gain if liabilities exceed basis (up to the difference)**
         (5) **Gain up to the amount of boot receive - anything received except for securities (cash, bonds, other property)**
         (6) **Section 351 is mandatory, if it applies, no loss can be taken!**
   h) ***Shareholder contributions to the corporation - The corporation does not recognize income, gain etc. on contributions to capital by the shareholder***
   i) ***Capital contributions by non-shareholders is not income, unless it is not invested in assets within 12 months. If it is, the basis of the property is reduced by the amount of the contribution***
   j) ***Worthless Stock - Section 1244 allows an ordinary loss to the original shareholders (rather than a capital loss) for up to $50,000/$100,000***

3) **The Corporate Income Tax**
   a) **The first year can not exceed 12 months.**
   b) **Accounting method**
      i) **Generally the accrual method must be used.**
         (1) **Unless gross receipts (prior three years average) is under $25,000,000**
            (a) **Under cash method, treat inventory as non incidental materials and supplies or conform to its financial accounting treatment.**
      ii) **For service business (no inventory) cash method may be used if**
         (1) *Family farm*
         (2) *Personal Service Corporation*
         (3) *Less $25,000,000 gross receipts in any prior year*

- **c) Taxable income is similar to individuals, except:**
  - **i) Capital Gains are taxable and no favorable tax rate**
  - **ii) Capital losses are not deductible**
    - ***(1) They carry back 3 years and forward 5 to offset capital gains in those years. Use them or loose them***
    - ***(2) Not elective, must carryback***
  - **iii) Organization, Syndication and start-Up expenses**
    - ***(1) Organization (business plans, lawyer's fees for article of incorporation, etc.) and start-up (also pre-opening costs) can not be expensed***
      - **(a) They each can be expensed or depreciated**
        - **(i) Expense the first $5,000 depreciate the rest over 15 years straight line.**
        - **(ii) Phase out of expensing between $50,000 and $55,000**
      - **(b) These are separate so up to $10,000 expense if you have $5,000 of each**
    - **(2) Beginning when business begins**
  - ***iv) Syndication cost (sales and promotion cost) are*** **<u>not deducible</u>**
  - **v) Charitable contributions:**
    - **(1) Deducible in the year paid**
    - **(2) Can be accrued, see book**
    - **(3) Limited to 10% of taxable income, before the charitable contribution, NOL carryback and dividends received deduction**
  - **vi) Dividend received deduction under the new 21% income tax:**
    - **(1) 50% for less than 20% ownership**
    - **(2) 65% for 20% but less than 80% ownership**
      - ***(a) Calculation is a bit strange.***
      - ***(b) It is the lesser of 50% (or 65%) of the dividends received or of taxable income***
      - ***(c) Except that the full amount of the 50% (or 65%) of dividends received can be used if it creates or increases a NOL***
      - **(d) 30 day stock holding period required**
    - **(3) 100% if 80% or greater ownership**
      - ***(a) Must hold the stock for at least 45 days***
      - ***(b) 90 days if preferred stock***

- **d) Interest deduction limitation (unless less then $25,000,000 of gross receipts**
  - **i) limited to the sum of :**
    - **(1) business interest income;**
    - **(2) 30% of the taxpayer's adjusted taxable income for the tax year; and**
    - **(3) the taxpayer's floor plan financing interest for the tax year.**
  - **ii) Any disallowed business interest deduction can be carried forward indefinitely (with certain restrictions for partnerships).**
- ***e) Net operating loss***
    - **(1) It is when taxable income is less than 0!**

The CARES Act provided a five-year carryback for **losses** earned in 2018, 2019, or **2020**, reinstating the carryback temporarily. [7] The CARES Act also suspended the **NOL** limit of 80 percent of taxable income, which means that firms may deduct their NOLs to eliminate all of their taxable income in a given **tax** year.

**(2) Losses are no longer carried back (see new Cares Act)**
**(3) Unlimited loss carry forward (they never expire)**
**(4) Limited to 80% of income in the carry forward year (See new Cares Act)**
**(5) Can elect not to carry back (must separately elect not to carry back the AMT NOL**

**f) Closely held provisions**
- **i) Sales of depreciable property from a >50% shareholder to the corporation will result in ordinary income rather than Section 1231 (capital) gain**
- **ii) Losses of any kind between the corporation and the related taxpayer are disallowed**
- **iii) Deductions that are taken by an accrual basis corporation for accruals to a related (cash basis) party are deductible in the year the cash basis shareholder reports the income (when it is paid), such as accrued salary or rent paid to a sole shareholder**

**g) Income tax liability – no more tables, flat 21%**

**h) Personal Service Corporation must pay tax at a flat 21%**
- **i) Must be personal services of shareholders, and**
- **ii) Be accounting, health, law, engineering, architecture, actuary, performing arts or consulting**

**i) Controlled groups**
- **i) Parent Sub vs.**
- **ii) Brother-Sister**

**j) Consolidated Return - Entities (Parent-Sub that are 80% owned)**
- **i) Allows adding all numbers as if it is one return**
- **ii) Must be elected by all members, then mandatory for new corps.**

**k) Estimated Taxes**
- **i) Due April, June, September and December (15th)**
- **ii) Lower of 100% of current or prior year's return (but only if the prior year had a tax!)**
- **iii) Special rules for large corporations**

**l) Due date of the return - 15th day of 3rd month (March 15th for a calendar year corporation!)**

**m) Tax Return -**
- **i) Book vs. Taxable income - Sch. M-1**
  - ***(1) Temporary or timing differences such as depreciation, bad debts,***
  - ***(2) Permanent differences such as life insurance, business meals***
- **ii) Reconcile retained earnings - Sch. M-2**

4) **Corporate Non liquidating Distributions**
   a) **Issue: Is the distribution a dividend, return of capital or capital gain?**
   b) **Non liquidating distributions are usually a dividend**
   c) **Dividend is defined as a distribution from either Current, or accumulated Earnings and Profits ("E & P")**
   d) **Earnings and profits is not defined, but similar to retained earnings**
   e) **Effect on Corporation of the distribution of property**
      i) **Gain (on appreciated property distribution) is recognized at the corporate level on property distributions to shareholders as if the property were sold for FMV**
      ii) **Loss is not recognized (should sell the asset and distribute the cash)**
   f) **Effect on Shareholder**
      i) **Amount of the distribution is FMV (Gross FMV - liabilities)**
      ii) **Basis of the property is gross FMV**
   g) **Effect on the Corporation's Earnings and Profits**
      i) **Net effect is to reduce E & P by the Adjusted Basis of the distributed property (and the federal income tax paid) because:**
      ii) **Gain increases E & P, and**
      iii) **Distributions reduces E & P by FMV**
   h) **Constructive Dividends are items that are not on the books as dividends, but which the IRS determines are, in effect dividends, such as:**
      i) **Excess compensation to shareholders**
      ii) **Loans to shareholders that are not paid back (not really loans)**
      iii) **Corporate payment of shareholder's expenses**
   i) **Stock Dividends are not taxable if all shareholders receive the same percentage of shares, thus the effect is to keep all shareholders ownership the same before and after**
      i) **For example, 1 share for each share owned**
      ii) **Taxable if any shareholder can get cash, property, or in any way have the effect of changing the percentage ownership between the shareholders**
   j) **Stock Redemptions - A repurchase of shares by the corporation - will be a dividend, unless it falls within one of the following tests:**
      i) **Substantially disproportionate - After must own (including attribution)**
         ***(1) Less than 50% of the stock***
         ***(2) Less than 80% of the prior ownership %***
      ii) **Complete termination of the shareholders interest (including attribution) - Can waive attribution on complete termination if**
         ***(1) Does not retain any interest (including as an employee) except as a creditor (to get paid)***
         ***(2) Must remain a non owner for 10 years***
         ***(3) Must agree to inform IRS if he or she does reacquire an interest***
   k) **Not essentially equivalent to a dividend - Very hard to prove given test (1) above**
   l) **Partial Liquidation - when the company sells of an independent division and distributes the proceeds**
   m) **Redemption to pay death taxes -**
      ***i) Qualifies only if the value of the stock > 35% of the adjusted gross estate***
      ***ii) Amount of the redemption that qualifies for capital gain treatment is equal to federal estate tax, state inheritance tax, funeral and administrative expense***
      ***iii) The above limits the amount, there is no requirement that the estate need the cash***
         ***(1) Because basis at death = FMV, there will be little if any gain as long as the "redemption" qualifies - if not, the distribution will be a dividend***

iv) **Attribution generally applies - Thus, a shareholder is considered to own both his/her/its own shares plus those owned by**
    (1) ***Spouse, children, grandchildren and parents***
    (2) ***Prorate from a partnership***
    (3) ***From a corporation if shareholder owns (directly or indirectly 50% or more of the stock***

5) **Other Corporate Tax Levies**
   a) **Alternative Minimum Tax repealed for 2018**
   b) **Personal Holding Company (incorporated pocket books!)**
      i) **Subject to penalty tax of 20% (the same tax as that on dividends)**
      ii) **Definition -**
         (1) ***5 or fewer shareholders own more than 50% of the stock, and***
         (2) ***personal holding company income is at least 60% of adjusted ordinary gross income for the year***
         (3) ***Attribution here is different than liquidation, includes brothers and sisters, spouse ancestors and lineal descendants***
      iii) **PHC Income**
         (1) ***Dividends (no dividends received deduction allowed)***
         (2) ***Interest***
         (3) ***Annuities***
         (4) ***Rent (as adjusted)***
      iv) **Not treated as PHC income if at least 50% of income and dividend of other PHC income over 10% is paid**
      v) **Thus, can be in the rental business and not be a PHC**
         (1) ***Royalties***
         (2) ***Produced Film Rentals***
      vi) ***Personal Service Contracts will be PHC if***
         (1) **Someone other than Corporation has the right to name the employee who is to perform the services**
         (2) **25% or more of the stock is owned by that person who can be designated**
         (3) **Applies to "Loan Out" corporations (incorporated actors and actresses)**
      vii) **Tentative tax (PHC Income) can be reduced by paying a dividend**
         (1) ***Note, no dividends received deduction***
         (2) ***Actual payment***
         (3) ***Election to treat dividends within 2 1/2 months as retroactive***
         (4) ***Consent dividend - agreeing to report the PHC income as dividends, even though not paid***
         (5) ***Deficiency Dividend - agreeing to pay a dividend when the IRS catches you - taxable in the year "paid" - but interest and penalty still apply, just not the corporate tax***
         (6) **NOL for PCH income purposes only qualifies for a one year carry forward! Thus, can have no regular tax liability, but a PHC tax the subsequent years**
   c) ***Accumulate Earnings Tax (penalty for not paying a dividend)***
      i) *Technically applies to all corporations (but generally does not apply to publicly traded companies)*

ii) **Applies on an annual basis**
   (1) **Applies if the corporation is formed or availed of to keep the profits at the corporate level rather than distributing the excess amounts (over the needed amounts) to the shareholders, where a second tax would apply)**
   (2) **What are unreasonable accumulations?**
      (a) *Loans to shareholders*
      (b) *Investments in stocks, bonds etc. having no relationship to the business*
   (3) **What are reasonable accumulations of profits?**
      (a) *Future needs (like a down payment for a building*
      (b) *Redemptions for death taxes (but only after the shareholder has died!)*
      (c) *Product liability losses*
      (d) *Inventory and business needs (Bardahl formula)*
   (4) **Other business contingencies and expansion or acquisition needs**
   (5) **Important for the Board of Directors to consider this problem**
   (6) **Determining the Tax (Accumulated Earnings Income x 15%)**
      (a) *Current taxable income + dividends received deduction*
      (b) *Less all charitable deductions - no limit*
      (c) *Less capital losses*
      (d) *(effectively taxable cash flow?)*
      (e) *Minus dividends paid (as in the PHC)*
      (f) *Minus - accumulated earnings credit*
iii) **$250,000 since inception, $150,000 for personal service corporation, or**
iv) **Amounts actually needed for the business, if higher**

6) **Corporate Liquidating Distributions**
   a) **Discontinuation of the corporation and liquidation - must cancel or redeem all the shares**
      i) **Winds up affairs**
      ii) **Pays all of its debts**
      iii) **Distributes remaining assets to its shareholders**
   b) **Shareholder tax treatment**
      i) **Treated as a sale or exchange (capital gain or loss) equal to the FMV - Adjusted Basis of the stock**
      ii) **§1244 may create ordinary loss**
      iii) **If shareholder later has to pay corporation's debts, a capital loss is permitted, not an ordinary expense (deduction)**
      iv) **No gain or loss and carryover basis, if liquidation is to a controlled parent (80% or greater owner) - since a dividend to such parent would also be tax free!**
         ***(1) Distribution must be in one tax year, or***
         ***(2) Series of transactions within 3 years of beginning***
         ***(3) All tax attributes carryover***
   c) **Corporation's tax treatment**
      i) **Any gain or loss must be recognized by the corporation on distribution of property**
      ii) **No loss if distribution is to greater than 50% shareholder**
      iii) **No gain or loss if distribution to controlled parent (80%)**
      iv) **Expenses of the liquidation are deductible**
         ***(1) If they create an NOL, it can be carried back only two years***
         ***(2) Remember to write off things like goodwill, syndication costs***
      v) **Must file Form 966 within 30 days of adoption of the plan of liquidation - not done on a timely basis all the time!**

7) **Corporate Acquisitions and Reorganizations**
   a) **Can purchase the target corporation's assets**
      i) **Then the assets are treated as new assets**
      ii) **Seller pays tax on the gain (loss)**
      iii) **Liabilities stay those of the seller, unless part of the transaction**
   b) **Can purchase stock**
      i) **Generally doesn't affect the tax basis of the underlying assets**
      ii) **Purchaser gets assets and liabilities (unknown ones!)**
      iii) **If liquidates the controlled subsidiary - carry over basis (last chapter) - If purchase price is greater than tax basis of assets, the difference disappears**
      iv) **Seller's generally get capital gain or loss on sale of stock**
      v) **May elect §338 deemed purchase of assets and deemed liquidation**
         ***(1) Must be elected***
         ***(2) Gain is reported by "selling" corporation***
         ***(3) Must acquire 80% ownership***
         ***(4) Basis in "new" company are each assets purchase price, plus liabilities***
   c) **Allocation of basis in the case of a purchase must be by category (Residual Method):**
      i) **Class I, cash, bank accounts, etc.**
      ii) **Class II, CD's US Govt securities, marketable securities**
      iii) **Class III, all other property, and then**
      iv) **Class IV, Intangible assets in the nature of Goodwill, which are now amortizable, straight line, over 15 years, such as Goodwill, going concern, turn-key value, customer lists, etc.**
      v) **Class IV is really what falls out after class I - III have been allocated based on their respective FMVs**
   d) **Tax Free Reorganizations ("purchases" that are not treated as taxable transactions) under §368(a) - (g) - If qualified then no gain or loss to anyone, except as listed below! Only applies to stock. Securities are tax free (bonds) only if used in the same face amount. In most cases the end result is a parent (acquire) and subsidiary (target). Thus, it is the form that controls, not the end result!**
      i) **- A - Statutory Merger or Acquisition (Two companies into one under state law**
         (1) The two companies become one
         (2) Great flexibility - simply must acquire 50% for stock
         (3) Any cash used is taxable boot
         (4) Can do a triangular merger
            ***(a) Set up a new subsidiary with stock of the parent***
            ***(b) Do an A reorganization (merger) into the shell company for stock of the parent***
      ii) **- B - Stock for Stock**
         (1) Solely for voting stock
         (2) Cash can be used only for fractional shares
         (3) Must acquire control, 80% of each class of stock
         (4) As in all reorganizations, the relative sizes of the two companies is not important
      iii) **- C - Asset for Stock (avoids most shareholder problems)**
         (1) Solely for voting stock of the acquiring corporation
         (2) Must acquire at least 80% of the assets for stock
         (3) Must get substantially all of the assets
            *(a) 70% of FMV of gross assets*
            *(b) 90% FMV of net assets*
         (4) "Acquired" corporation must distribute all of the stock

(5) Acquired corporation must liquidate or dissolve
(6) Can do triangular

**iv) - D - We will be doing only the divisive D - splitting up of one company into two**

(1) Split off, spin off, split ups, etc.
(2) Shareholder allocates basis to the new shares
(3) Can be pro-rata or any combination of after reorganization ownership
*(a) A could simply spin off B to all shareholder*
*(b) Jim could keep A and Mary could get all of B*
*(c) Any other combination is allowed*
(4) §355 requirements
*(a) Solely stock or securities*
*(b) Not a method of creating a disguised dividend*
*(c) Both companies must be active businesses after the split*
*(d) Each must have been active business for the past 5 years (can split one five year old business down the middle)*
(e) Must be a business purpose

**v) - E - Recapitalization**

(1) Common stock for common stock
(2) Common or preferred for preferred stock
(3) Stock for debt (except that stock for accrued interest is taxable)
(4) Bonds for new Bonds - but tax free only on like amounts of principal
*(5) Additional principal is taxable*
*(6) Can increase interest rate!*

**vi) - F - Change of**

(1) Name
(2) Form
(3) Place of Incorporation

**vii) - G - Bankruptcy reorganization – not covered in class**

**e) Judicial requirements applies to all reorganizations**

(1) Continuity of Proprietary Interest (that the shareholders continue as owners - IRS is getting more lenient on this, except in an A reorganization
(2) Continuity of Business Enterprise - the company stays in the historic business or the new company uses the acquired company's assets
(3) Business purpose - there must be a business reason for the transaction

**f) Tax Attributes generally carry over, except**

***g) §382 Change of Ownership provides that carryovers (losses, credits, etc.) are limited if***

**i) There is a shift in greater than 5% owners (except in a D) of over 50% during the testing period**

**ii) Testing period is three years (rolling, not calendar years!)**

**iii) If there is such a change, by additional shareholders or contraction, then, the loss carry over is limited to:**

(1) FMV of the stock at the time of the change, times
(2) Then long-term tax exempt interest rate
(3) This amount can be used each year or until the NOL is used up
*(4) Once freed up it can be used in a future year*
(a) Even this amount eliminated if the historic business is not continued for at least two years

8) **Chapter 8 - Consolidated returns.**
   a) **Must own 80% of the subsidiary**
   b) **Must elect (by each corporation) to be part of the initial consolidated return.**
   c) **Once elected, any new members are part of the group. They need not elect and can't elect out.**
   d) **Advantage of a consolidated return is that all calculations are made as a group. Thus, one corporation's income can offset another's loss. Same with capital gains and losses, charitable contributions limitations, etc.**
   e) **Inter-company sales are eliminated until the product is eventually sold by the group.**
   f) **Dividends received deduction is 100%**

9) **Partnership Formation and Operation**
   a) **Definition**
      i) **Group, syndicate, partnership, or unincorporated entity etc.**
      ii) **Includes limited and general partnerships, LLP's and LLC's**
      iii) **That carries on a trade or business or financial operation**
   b) **Overview:**
      i) **A partnership is not a tax paying entity**
      ii) **It simply reports total income/deductions/credits, etc. by category and then each partner pays tax on his, her or its share of each item**

NEW LAW: Generally for "amended" returns, changes are made at the partnership level and taxed at the highest tax rate. Not passed through to the partners.

      iii) **Partner's basis is equal to**
         (1) ***Original basis (cost, inheritance etc.), plus***
         (2) ***Share of liabilities***
            (a) Recourse, shared by general partners based on loss sharing
            (b) Non recourse, shared by all partners based on profit sharing
      iv) **Basis can never be less than 0.**
         (1) **Distribution - see Ch. 10**
   c) **Formation - contributions**
      i) **Non recognition - even on later (non formation) contributions**
      ii) **Exceptions:**
         (1) ***Investment partnerships***
         (2) ***Contributions followed by distributions (within 2 years)***
         (3) ***Contributions with liabilities assumed that are greater than basis***
      iii) **Treatment of liabilities**
         (1) ***Increase each partner's basis by their share of contributed liabilities***
         (2) ***Decrease contributing partner's basis by its share of liabilities assumed by the other partners***
            (a) This is treated as a cash distribution
      iv) If it is greater than basis, then there is a gain - see above!Partner's basis (outside - as differentiated from inside) equals:
         (1) Money contributed, plus
         (2) Basis of property contributed,

- v) + or - liabilities as described above
- d) Partner's holding period - carry over
  - i) Includes the time the contributed property was held
  - ii) For inventory, begins the day after contribution
- e) Partnership's basis
  - i) Same as the partner's
  - ii) Plus any gain recognized
- f) Character of the property to the partnership also carries over Section 724
  - i) Unrealized receivables,
  - ii) Inventory
  - iii) Capital loss property
- g) Contribution of Services (rather than of property)
  - i) Must recognize income
  - ii) Equal to FMV, equal to the value of the capital account
  - iii) What if they only get a profit's interest, no FMV?
  - iv) The partnership must determine what the payment relates to and treat the "expense" accordingly
- h) Organization, Syndication and Start-Up costs
  - i) Organization costs are capitalized and amortized over 60 months, if elected
    - *(1) Legal fees*
    - *(2) Accounting fees*
    - *(3) Business plan*
  - ii) Syndication fees are capitalized and can not be written off until the partnership terminated
    - *(1) Sales costs*
    - *(2) Commissions to brokers*
  - iii) Start up, may expense $5,000 and capitalize the rest and amortize straight line over 15 years. Same for pre-opening. If the total exceeds $50,000, reduced dollar for dollar. Thus, if over $55,000, it is amortized over 15 years.
    - *(1) Cost incurred prior to opening (also known as pre-opening costs. See above for start up.*
    - *(2) Often incurred in the restaurant business*
- i) Partnership's tax year - very mathematical. Must use the following order
  - i) The same tax year as one or ore of the majority partners
    - *(1) Greater than 50%*
    - *(2) Capital and profits*
  - ii) If not majority year, then the same year as all of the principal partner(s)
    - *(1) Anyone who owns 5% or more of capital or profits*
    - *(2) Don't count less than 5% owners*
  - iii) If no principal year, then the least aggregate deferral
  - iv) May also elect a tax year if there is a business purpose
    - *(1) 25% of income in the last 2 months of the year*
    - *(2) Must prove it with records, so can't elect for a new business*

v) **Section 444, may elect up to a three month deferral, but must make "required payments"**

j) **Partner (rather than partnership) elections**
   i) **Forgiveness of indebtedness income**
   ii) **Foreign tax credit versus deduction**
   iii) **Mining expenses**

k) **Partnership Taxable Income**
   i) **First determine income for the partnership without regard to how the partners share!**
   ii) **Partnership income, expense, gains, deductions, credits, etc are separated as if one were preparing an individual's or a corporate tax return.**
      (1) ***Those business items with no other tax significance are treated as ordinary income and placed on page one of the return (almost as if it were a business income (Schedule C on an individual's return)***
         (a) It does not matter if the partner is active or passive!
         (b) Sales
         (c) Cost of goods sold
         (d) Salaries
         (e) Guaranteed payments to partners (salary equivalent paid to a partner
         (f) Depreciation
         (g) Recapture of depreciation!
      (2) ***Other items, whether business or non business must be separated and reported separately, if the item could have separate tax significance to a partner - Reported on Schedule K***
         (a) Guaranteed payment on Schedule K and page 1
            *(i) the one on Sch. K is the income to be reported by the partner*
            *(ii) the one on page 1, is the deduction for the partnership*
         (b) Capital Gains and losses
            *(i) Short term*
            *(ii) Long term*
         (c) Interest income
         (d) Dividend income
         (e) Passive Activity
         (f) Foreign taxes paid, credits, etc
         (g) Tax exempt income
            1. §179 (Expense rather than depreciation)
            2. Any other item that could affect the calculation of a taxpayer's liability

l) **Distributive Share - Once the partnership's income has been determined, all items of income, loss etc. must be allocated according to each partner's distributive share (has nothing to do with cash distributions)**
   i) **Based on the partnership agreement**
   ii) **May be oral or written**
      ***(1) May be amended until the due date of the return (not in book)***
      ***(2) If oral, generally equal partners***
      ***(3) May share different items by different percentages***
   iii) **Varying interest rule - if interests change, must allocate by days**
      ***(1) Either by total for the year pro-rated, or***
      ***(2) Can close the books and allocate actual amount***

- **m) Special Allocations**
  - ***i) Can allocate all of one type of income to one partner and all of another type to a different partner***
  - ***ii) Contributed property with gain potential - the gain at time of contribution must***
- **n) Substantial Economic Effect ("SEE")**
  - i) If this applies, then the IRS will not follow the partnership agreement, because it is only for tax purposes, not real (economic)
  - ii) Not SEE if the cash distributions don't follow the capital account
    - *(1) Suppose all losses are given to A, but cash is distributed 50% each to A and B*
    - *(2) Since A and B get the same cash, regardless of their capital account, the loss allocation to A does not have SEE*
    - *(3) OK if partner's must make up their negative capital account (or minimum gain charge-back applies*
    - (4) Not SEE if the allocation does not affect cash distribution in total
      - *(a) A gets the first $10,000 of tax exempt income and B gets the first $10,000 of dividend income*
      - *(b) Not SEE because even though the capital accounts will be respected, the allocations were only for tax purposes*
- **o) Special rules for "carried interest" (capital gains for contribution of services)**
  - **i) Treats long term capital gains for the first three years as short term gains**
- **p) Basis of partner's interest (outside)**
  - **i) Beginning is based on cost, gift, inheritance, etc.**
  - **ii) Liabilities**
  - ***iii) Increase a partner's basis by an increase in liabilities***
  - ***iv) Decrease a partner's basis (and treat it as a cash distribution) for***
    - (1) a decrease in the partner's share of partnership liabilities
    - (2) a contribution of debt (% of debt taken over by the other partner's
- ***q) Allocation of partnership debt***
  - i) Recourse loans
    - *(1) Only to the general partners since they will have to pay it - shared based on loss sharing percentage*
    - *(2) Limited partners share in recourse to the extent of their obligation to contribute to capital*
    - (3) Non recourse loans
      - *(a) Shared by all partners - since the bank and creditors are left holding the bag, not the partners*
      - *(b) Sharing is therefore based no profit sharing percentages*

r) **At Risk limited to amount that a partner can loose**
   i) **capital account, plus**
   ii) **debt for which the partner is liable**
s) **Passive Activity**
   i) **Determined by each partner, not the partnership as to the ordinary income, unless**
   ii) **The partnership is passive, such as rental income**
t) **Sales of property between partners and partnership**
   i) **Loss: If more than 50% owner (including attribution) then no loss will be allowed on sales between the two**
   ii) **Gain: If more than 50% owner, then what would be capital gain or §1231 gain will be ordinary if the property is depreciable in the hands of the partnership**
u) **Most fringe benefits are not allowed as deductions, because those rules apply to employees, and partners are not employees**
v) **Guaranteed Payments (like salary to a partner)**
   i) **Can also apply to interest on loans to the partnership**
   ii) **Only applies if guaranteed**
      (1) ***Thus, if A gets the first $100,000 of profits, that is not a guaranteed payment, because if there are not profits then A doesn't get it!***
      (2) ***If A gets $100,000 guaranteed and the partnership has $20,000 profit before the guarantee, then net income is ($80,000)***
      (3) ***Guaranteed payments are on the accrual method, even if the partnership is cash basis***
      (4) ***The partner must therefore report the income, even if it is not received!***
w) **Family partnerships**
   i) **Must pay reasonable salaries**
   ii) **If not, the IRS can reallocate (deem a salary)**
x) **Tax Reporting**
   i) **Due date, 3 1/2 months (April 15th for a calendar year p/s)**
   ii) **Penalty for failure to file is stiff, $50 per month per partner, even though no tax is due**
y) **Self-employment income**
   i) **Generally equals page 1 (or ordinary income), plus guaranteed payments**
   ii) **Applies to all general partners, even if they do not participate**
      (1) ***That can be very expensive***
      (2) ***15.3%***

**10) Special Partnership Issues**

- **a) Distributions can be either Liquidating or Non-Liquidating**
- **b) Non Liquidating**
- **c) For Chart - See Appendix I**
- **d) Holding Period of property distribution is equal to partnership's holding period**
- **e) Unrealized receivables and inventory continue (inventory for 5 years) as ordinary income in the hands of the partner, even if it would be a capital asset**
- **f) Section 751 assets that are distributed in non pro rata shares may cause gain**
- **g) Termination of an interest**
  - **i) Gain only if cash exceeds basis**
  - **ii) Loss only if basis is greater than cash, plus basis of inventory and receivables and there is no other property**
- **h) Sale of a partnership interest**
  - **i) Generally treated as the sale of a capital interest**
  - **ii) Exception: Must recognize ordinary income if Section 751 assets (inventory and receivables)**
  - **iii) No adjustment made for the buying partners, unless a § 754 election is made or is in effect**
- **i) Retirement or death of a partner**
  - **i) Purchase of interest by p/s**
    - ***(1) If arm's length purchase by partnership, IRS will respect it***
    - ***(2) Not deductible by the partnership***
  - **ii) If not a purchase, can be a guaranteed payment or a distributive share, depending on the agreement**
- **j) Tax year of partner who sells or exchanges their entire interest closes on the date of sale or exchange (the partnership's year continues!)**
  - **i) Same at the time of death, so income is pro-rated at date of death**
- **k) Termination of the partnership**
  - **i) If no more business is conducted or just one partner (the other(s) is bought out)**
  - **ii) 2018 no more technical termination – But California still has it but can elect to use the federal for 2018 and thereafter**

    OLD RULE:
    - **(1) Within a 12 month period (not a tax year), there is a sale or exchange of at least 50% of the partnership interests**
    - ***(2) Must be of both capital and profits***
    - ***(3) Same interest sold twice is not counted twice***
    - ***(4) Gifts or transfers at death are not sales or exchanges***
    - **(5) If terminated, the tax year closes**
    - **(6) Treat the termination as a liquidating distribution, followed by a contribution of the assets**
- **l) Section 754 - Optional Adjustment to Basis – see handout on Black Board**
  - **i) Must be elected**
  - **ii) Once elected applies to future years**
  - **iii) Requires (allows) inside basis to be adjusted to the outside basis in the case of sales, exchanges, deaths or terminations**
    - ***(1) Adjustment is unique to the affected partner***
  - **iv) Also applies on distributions in which basis disappears**
    - ***(1) In that case, the partnership adjusts it's basis***

11) **S Corporations –**
   a) **Essentially a corporation that is treated similarly to a partnership for federal income tax purposes**
   b) **Shareholder requirements**
      i) **Maximum of 100 shareholders (husband and wife count as only 1 as do up to six (6) generations of a family)**
      ii) **Must be either individuals, estates, certain trusts, or pensions**
         (1) **Thus no partnerships or C Corporations as owners – but S Corporations can own S Corporations**
      iii) **Individuals can not be non-resident aliens**
         (1) **Non residents can own shares though qualified trust that pays the tax**
      iv) **Testamentary trusts (decedent's estates) only for two years**
   c) **Corporate requirements**
      i) **Domestic Corporation**
      ii) **One class of stock (may vary voting rights)**
      iii) **Not an ineligible corporation**
         ***(1) Banks***
         ***(2) Insurance companies***
         ***(3) Corps electing the Puerto Rican tax credit***
      iv) **Can own 100% of the stock in either an S Corporation or C Corporation subsidiary**
      v) **Debt may constitute a second class of stock**
   d) **An S Corporation that has always been an S Corp is exempt from all taxes**
      i) **Taxes will apply is the corporation was once a C Corporation if:**
      ii) **Lifo - then it must recapture the LIFO**
         ***(1) Tax is determined in the last C year by including all LIFO layers***
         ***(2) Tax is spread out over the last C year and the following 3 years***
         **(3) BIG - built in gains will be taxable as realized (limited to C corporation income**
         **(4) Excess net passive income**
            ***(a) If earnings and profits at the end of the year***
            ***(b) Then, tax will apply to net passive income***
   e) **Election (Form 2553)**
      i) **During the first 2 1/2 months applies for the whole year**
      ii) **Each first year shareholder must sign the consent**
      iii) **New shareholders (later years) consent is not needed**
   f) **Termination**
      i) **Failure to meet the requirements**
         ***(1) More than 100 shareholders***
         ***(2) Ineligible shareholders – non resident aliens***
         ***(3) Second class of stock***
         ***(4) Failure of passive income test for three consecutive years***
            (a) Excess 25% passive income (vs. gross receipts)
            (b) E & P at the end of the year
      ii) **Can elect to revoke**
         ***(1) More than 1/2 the shareholders must vote to revoke***
         ***(2) If made in first 2 1/2 months, is retroactive***
         ***(3) If made later, can chose any date***

**(4) Must generally wait 5 years to re-elect**

**g) Inadvertent termination**
   **i) IRS an waive if the shareholders fix the problem**
   **ii) IRS can fix defective elections**

**h) Taxable year**
   **i) Calendar year (Dec. 31)**
   **ii) Fiscal year if business purpose**
   **iii) Can make Section 444 election for up to three month deferral (Sept. Oct. or Nov.)**

**i) Taxable income and tax returns**
   **i) Generally the same as partnerships**
   **ii) Corporate carryovers (from prior C years, simply are held until the corporation becomes a C corporation again)**
   **iii) If appreciated property is distributed**
      ***(1) C Corp rules apply, and a taxable income applies***
         ***(a) Thus, not as good as a partnership***
      **(2) Built in Gains Tax (BIG)**
         ***(a) Applies when a C Corporation elects S status***
         ***(b) Essentially requires the corporation to determine FMV and compare to the basis of the assets***
         ***(c) As assets are sold the gain is taxed to the corporation***
         ***(d) Only applies for 10 years***

**j) Shareholder reporting**
   ***i) No special allocations as in partnership***
   ***ii) No guaranteed payments - employees exist as this is a corporation***
   ***iii) All income, deductions, etc. are allocated by stock ownership pro-rated on a daily basis***
      (1) Can use pro rate method (days)
      (2) Can elect to close the book at the time of a change
   **iv) Shareholder loss limitations**
      **(1) Limited to basis**
      **(2) Unlike partnerships, loans to the corporation do not add to basis**
      **(3) Shareholder loans to the corporation are considered basis by the shareholder who loaned the money**
      **(4) Thus, to get basis, shareholders must borrow directly from the bank and loan the loan to the S Corp.**
      **(5) Losses exceeding basis**
         ***(a) Carry over to future years***
         ***(b) In the case of a termination - can be taken if additional basis is "found" within one year (Post Termination Transition Period)***

k) **Basis**
    i) **Like a partnership is calculated at the end of each year**
    ii) **Original basis**
    iii) **Minus cash distributions**
    iv) **Plus or minus income or loss pass through**
    v) **Can include shareholder loans**
l) **Distributions - Always an S corporation or no E & P**
    i) **Tax free up to basis**
    ii) **Remainder is capital gains**
m) **Distributions - Once a C Corp and still E & P**
    i) **Tax free up to AAA (accumulated adjustments account)**
        ***(1) AAA is the net of income and deductions passed through to the shareholder, except***
        ***(2) it does not include tax exempt income***
    ii) **Next, dividend to the extent of E & P**
    iii) **Tax free up to other adjustments (tax-exempt income) and basis of stock**
    iv) **Capital Gain**
    v) **Can elect to bypass these rules and first distribute E & P**
        ***(1) Use this election if passive income for three years could cause a termination of the S election***
        ***(2) Allows the corporation to hold other appreciated assets***
        ***(3) Distribution of those assets would cause recognition of gain***
    vi) **Generally, when S Corporation terminates, cash can be distributed tax free up to AAA basis for the one year Post Termination Transition period**
    vii) **New law 2018, for post one year, distributions are treated as pro-rata from E&P and AAA**
n) **Fringe benefits**
    i) **Treated like a partnership, but 2% owners only**
    ii) **Thus, medical insurance passes through (not deductible by the corp)**
o) **Note, unlike partnerships, there is no Section 754 election, so outside basis will not equal inside basis on sales and death transfers**

12) **The Gift Tax**
a) **This is a transfer tax. A tax on the "privilege" of giving your money away.**
b) **Recipient does not have any tax liability**
c) **This is a unified tax with the estate tax**
d) **Flat 40% when lifetime gifts exceed "exemption", currently $11,180,000 for 2018**
    $11,400,000 2019
e) **Actually it is unified credit offsets the tax on taxable gifts and transfers at death up to the first $11,400,000 2019**
f) **What is a gift?**
    i) **Unlimited marital deduction (can give anything to a spouse without a tax**
    ii) **Gift splitting -**
        ***(1) Election required***
        ***(2) Gift by one spouse is treated as given equally by both***

g) **Tax is on cumulative lifetime and death transfers (not yearly)**
h) **A gift is a transfer for less than adequate and full consideration in money or money's worth. Gifts are of property, not services**
i) **Bargain sales to family or friends are partial gifts**
j) **Exemptions**
   i) **Direct payment of tuition**
   ii) **Direct payment of medical expense**
   iii) **Support (legally required)**
   iv) **Political gifts (but not for estate tax)**
   v) **Payments as part of a divorce**
k) **Qualified disclaimers**
   i) **If you are supposed to inherit and you refuse to take, then it is really a gift to those who receive the inheritance, unless**
   ii) **Irrevocable disclaimer, in writing**
   iii) **Within nine months of the transfer**
   iv) **Can't accept any benefit from the property**
   v) **Property passes without any direction by the disclaimant**
l) **A gift only occurs when the donee parts with dominion and control**
   i) **Revocable trusts are therefore not gifts, until they become irrevocable**
   ii) **Even irrevocable trusts are not gifts if the donor retains control**
m) **Valuing Gifts**
   i) **FMV at the time of the gift**
   ii) **FMV = Willing buyer and willing seller price**
   iii) **One can retain a life estate and transfer the remainder, with only the remainder being a gift**
n) **Joint tenancy bank accounts**
   i) **Goes to the survivor at death**
   ii) **Gift when funds are withdrawn in excess of the contribution**
o) **Other Joint Tenancy Property are gifts when set up (of 1/2)**
p) **Insurance**
   i) **Just naming a beneficiary is not a gift, if the owner can change beneficiaries**
   ii) **If existing policy is transferred, FMV is cost of a similar policy**
q) **General Power of Appointment**
   i) **Exists if one has a power to appoint to himself, his creditors, her estate or the creditors of her estate**
   ii) **A gift exists when the power is exercised in favor of someone else (thus giving your money away)**
   iii) **Exercising a limited power of appointment is not a gift**
r) **Net gifts - FMV less gift tax paid by donee**
s) **Annual Exclusions - $15,000 2020 per year only for gift tax**
   i) ***per donee***
   ii) ***per year***
   iii) ***present interest only***
   iv) For child, if receives by age 21
   v) Crummey trust (has one month to take it)
t) **Marital deduction is unlimited in amount!**
   i) **Outright to spouse**
   ii) **Can not be a terminable interest, unless it is Qualified**
u) **QTIP - Qualified Terminable Interest Property**
   i) ***To spouse***

*(1) Income for life at least annually*
*(2) No one other than spouse can receive distributions*
*(3) (Not in book) spouse must be able to demand the property is income producing*
*(4) Elect it for gift tax or estate tax*

ii) Effect is to give a gift tax marital deduction
(1) Effect of election is to treat it as the spouses property

***iii) At spouse's death, the grantor can name the remainder beneficiary***

**v) Charitable contributions are allowed in any amount**

**i) Split interests gifts are allowed to charity**

***ii) Such as a remainder interest***
***(1) Done in order to get a present income tax deduction***
***(2) Done in order to have any gains on sale of trusts assets avoid present income tax***

**w) Determining gift tax liability**

**i) It is a cumulative tax**
**ii) Add current gift to all future (taxable) gifts**
**iii) Determine the tax - tax on prior years gifts = net tax**

**x) Unified Credit**

**i) No tax for 2020 up to $11,580,000 equivalent of lifetime gifts or estate or combination.**
**ii) Technically = credit that offset the tax on that size gift/estate**

**y) Basis of property received by gift**

**i) Lower of FMV or Adjusted Basis at time of gift + % gift tax**
**ii) Adjustment for gift tax paid is based on gift to related to appreciation only**
***(1) Gift Tax X (appreciation/FMV less exclusions or deductions)***
***(2) Can not exceed FMV***

**z) Below Market Loans (Interest Free Loans) Very complicated!**

**i) Treats the transaction as a fiction in which interest is actually paid in an amount equal to the correct interest rate, less the amount actually paid**
**ii) For family members**
***(1) Treats borrower as paying interest***
***(2) Treats lender as making a gift of the interest to the borrower***
***(3) Net effect***
(a) Borrower - Interest expense (may be deductible)
(b) Lender - Gift + Interest income
***(4) Exceptions:***
(a) Less than $10,000 loans (combined)
(b) Less than $100,000 and borrowers investments income is less than $1,000

**aa) Filing requirements**

**i) Form 709**
**ii) Annual tax return, due April 15th**
**iii) Penalty for undervaluing gifts (even if appraisal)**
***(1) Reported amount is 25% but less than 50% of real value = 20%***
***(2) Reported amount is less than 25% of the real value = 40%***

*bb) Statute of limitations*

**i) Three years if return is filed and adequate disclosure of the item is present**

**ii) Six years if more than 25% understatement of value**

**13) The Estate Tax**

**a) No tax for 2020 of combination of lifetime gifts and value of the estate if less than $11,580,000 equivalent = $ 4,577,800 credit**

**b) Tax on amounts over $11,580,000 at 40% - No California inheritance tax**

**i) Lifetime gifts + Estate Tax**

**ii) Value of estate (taxable) at death**

**(1) Tax on transferring property at death - Includes all assets, including ones not even owned by the decedent**

**iii) Unified credit applied to taxable estate**

**(1) Imposed after taking into consideration lifetime gifts - Add adjusted taxable gifts**

**(2) Is a net tax, thus some expenses, debts reduce the taxable estate**

**(3) Tax and credits, see gift tax above**

**iv) Value of estate or gift**

**(1) Generally fair market value, date of death**

***(a) Life insurance on decedent is valued at the policy amount***

***(b) Listed stocks equal to average of the high and low for the day, if weekend, average of high and low on Friday and Monday***

***(c) Discount from FMV may be allowed for minority interest in closely held company***

***(d) Real estate - FMV (no deduction for possible sales commissions)***

**(2) Alternative Valuation Date may be elected**

***(a) Six months after death***

***(b) If property is distributed or sold within the six months, then the value is as of the date of sale or distribution***

***(c) Can be elected only if:***

(i) The gross estate is reduced, and

(ii) The tax is reduced

**c) Specific Property**

**i) Family Owned Business = $1,300,000 less the credit equivalent (650,000)**

**ii) Property in which decedent had an interest (§2033)**

***(1) All property owned***

***(2) Includes cars, jewelry, stocks, houses, insurance, etc.***

***(3) Included property in U.S. or foreign property***

**iii) Dower or courtesy rights (marital rights)**

**d) Transfers by the decedent during life (§2035 - 2038)**

**i) Gifts within 3 years of death (gifts in contemplation of death)**

***(1) Generally FMV at time of gift***

***(2) If a life insurance policy, then value of the policy***

***(3) Gift tax gross up - gift tax paid on gift is included in gross estate***

***(a) Example: Suppose $1,000,000 cash gift two years before death, with $150,000 gift tax, then***

**(i) $150,000 is brought back into the estate**

**ii) Retained life estate - if decedent transferred the interest but retains an interest during lifetime, the whole value is included in the gross estate**

***(1) Can include income interest retained (possession or enjoyment)***

***(2) Includes simply the power to designate who will enjoy the income***

- ***(3) Retaining voting rights is enough to pull it back into the estate***
- ***(4) Lifetime retention also includes any period which does not, in fact, end before death***
- ***(5) Reversion to decedent is enough***
  - (a) If another person must survive him or her, and
  - (b) Decedent's reversionary interest is greater than 5%

**iii) Revocable transfers are included in the estate**

- ***(1) Because nothing has been given away if it can be revoked***
- ***(2) Generally not a gift (except as transfers are made)***
- ***(3) Typically used in Revocable Living Trusts***
- ***(4) Also includes the right to designate beneficiaries or change them***

**iv) Retirement benefits are included if they will continue after death**

**v) Jointly owned property (see gift tax above)**

- ***(1) Goes directly to survivor!***
- ***(2) If to spouse, then 1/2 in the estate, but an offsetting marital deduction***
- ***(3) If to others, than the amount included in the estate is equal to 100%, unless it can be proved how much the survivor contributed***

***e) Trusts set up by someone other than decedents may be included in decedent' estate if decedent had a general power of appointment (rather than special or limited power)***

- ***i) Defined as the power to appoint to self, estate, creditors, or creditors of the estate***

ii) **Limited power is not included, such as the power to appoint among brothers and sisters (since decedent couldn't appoint to self)**

f) **Life insurance on decedent is included at payout amount, if decedent had "incidence of ownership"**

g) **Possession of QTIP**

   i) **If the decedent's spouse left the decedent (second to die) an interest for life and a QTIP election was made, the property is included in the second to die's estate at its then FMV**

   ii) **If no election was made, it is not included (which is the case for the trust with the exemption equivalent amount ($5,000,000)**

h) **Deductions**

   i) **Mortgages**

   ii) **Debts (master card, bank loans, etc.)**

   iii) **Final medical bills can be taken either on the final income tax return or on the estate tax return**

   iv) **Funeral bills can only be taken on the estate tax return**

   v) **Executor's and attorney's fees for administration**

   vi) **Final tax return amount due (if a refund, that is additional property)**

   vii) **State death taxes (used to be a credit, now a deduction)**

i) **Losses - while the estate is being administered**

   i) **Thefts, etc.**

   ii) **Can also sell stocks at a loss and take it**

   iii) **Must select whether to take the loss on the income tax return or on the estate tax return**

j) **Charitable contributions are deductible up to 100% of the estate - must be reduced by any amount of the estate tax the charity must pay**

k) **Marital Deduction – reduces the taxable estate**

   i) **Unlimited (up to 100% of the estate)**

   ii) **Must be outright transfer or QTIP election**

   iii) **May be by devise or bequest, dower or curtesy, joint tenancy, etc.**

   iv) **QTIP – Do you make a QTIP, even if no taxable estate? Maybe**

      ***(1) Spouse receives all the income at least annually***

      ***(2) No person other than the spouse can appoint the property during the spouses life***

      ***(3) Election to treat as QTIP***

      ***(4) Spouse has the ability to make the property productive (in case the spouse is not the trustee - not in book)***

      ***(5) The effect of the election is to tax the value of the QTIP trust in the surviving spouse's estate when he/she dies***

         (a) The value is added to the actual estate of the decedent

         (b) The tax must be paid by the trust (at the highest marginal rates, unless elected otherwise)

      **(6) Typical QTIP: To my wife for life and then to my children**

      **(7) Should probably leave the exemption amount without claiming the marital deduction by either**

         ***(a) Giving that amount to someone other than the surviving spouse, or***

         ***(b) Putting the property in trust for Spouse and not making a QTIP election***

l) **Calculation**
   i) **Add gross estate plus the adjusted taxable gifts to get the estate tax base**
   ii) **Calculate the tax – unified credit which offsets the tax up to $11,400,000 2019**
   iii) **Subtract the amount of the gift tax (payable on the prior gifts)**
   iv) **Subtract the unified credit $ 4,505,800 credit ( = $11,180,000 value)**
   v) ***Credit for multiple estates: If the same assets go through two estates, there can be two taxes.***
      (1) ***100% credit 0-2 years,***
      (2) ***80% 3-4,***
      (3) ***60% 5-6 etc.***
   vi) **Foreign death tax credit for foreign property**

m) **Deferral of tax if**
   i) **Reasonable cause**
   ii) **Closely held business §6166**
      (1) ***Included in the gross estate***
      (2) ***Must be at least 35% of the adjusted gross estate***
      (3) ***15 or less owners of the business***
      (4) ***Deferral is based on the tax owed on the business (pro-rated)***
      (5) ***Interest only first 5 years***
      (6) ***Tax and interest for next 10 years***
      (7) ***(not in book) since the interest is a debt of the decedent, it is deductible, when paid, thus every year, you must amend the return to deduct the interest and recalculate the estate tax***

n) **Redemption to pay death taxes**
   i) ***Allows capital gains on the redemption***
   ii) ***Since stock is FMV date of death, little if any gain will result***
   iii) ***Stock must exceed 35% of adjusted gross estate***
   iv) ***Maximum amount of redemption =***
      (1) Death taxes
      (2) Funeral and administrative expense
         (a) ***Can be redeemed even if the estate has adequate resources to pay the taxes and expense***

o) **Generation Skipping Transfer Tax (very complicated!)**
   i) **Purpose is to prevent avoiding a second estate tax by passing property directly to grandchildren or their equivalent**
   ii) **Tax is therefore 55% on such transfers (plus the original tax to the decedent)**
   iii) **Exemption = $11,400,000 per decedent 2019**

p) **Compliance**
   i) **Due Date = 9 months after date of death**
   ii) **Up to six month extension (to file, not to pay)**
   iii) **Documents required**
      (1) ***Will***
      (2) ***QTIP property***
      (3) ***Appraisals for real estate***
      (4) ***Life Insurance statement***

14) **Income taxation of Trusts and Estates**
   a) **Tax Rates 2020:**

| | |
|---|---|
| Marginal Rate | Estates & Trusts |

| | |
|---|---|
| 10% | 0–$2,600 |
| 24% | $2,601–$9,450 |
| 35% | $9,451–$12,950 |
| 37% | Over $12,951 |

| **<u>If taxable income is</u>:** | **<u>The tax is</u>:** |
|---|---|
| Not over $2,600 | 10% of taxable income |
| Over $2,600 - $9,450 | $260 plus 24% over $2,600 |
| Over $9,450 - $12,950 | $1,904 plus 35% over $9,450 |
| Over $12,950 | $3,129 plus 37% over $12,950 |

- i) **Property is transferred into a trust to create the trust**
- ii) **Person funding the trust is the known by various names**

b) ***Grantor***
- i) ***Settlor***
- ii) ***Trustor***

c) **If set up during life, it is a inter vivos trust**
d) **If set up at death, it is a testamentary trust**
e) **The property is know either as**
- i) ***Trust property***
- ii) ***Trust res***
- iii) ***Trust corpus***

f) **A trust (unless a grantor trust) is a separate tax paying entity**
g) **Estates come into being if a decedent dies with property that need to be administered**
- i) **The person taking charge is the executor, if named in the will, or**
- ii) **The administrator, if appointed by a court**

h) **The estate is a separate taxpaying entity**
i) **Trusts can be created**
- i) **To manage property and distribute income**
- ii) **If revocable during life, not a taxpaying entity, but a legal entity**
- iii) ***These are set up for non tax reasons***
- iv) ***Generally to avoid probate costs***
- v) ***Property transfers at death to the named beneficiary or becomes part of a then irrevocable trust, terms as listed in the revocable trust***

j) **Taxation of trust or estates is essentially the same**
- i) **They are taxpayers**
- ii) **Pay tax on taxable income**
- iii) **They receive a deduction for income distributed to a beneficiary**
  - ***(1) Income only***
  - ***(2) Losses or deductions can not be distributed, although they can be netted against income***
  - ***(3) Thus, it is sort of a combination of partnership and corporate taxation, some income is taxed to the beneficiary (if distributed) and the rest is taxed to the trust***

k) **Fiduciary Accounting! (debits and credits?)**
   i) **There are actually two income statements and balance sheets**
      (1) ***One for principal (corpus) - the property belonging to the trust***
      (2) ***One for income - the property (income) payable to a beneficiary***

l) Trust Accounting Income TAI is a measuring stick of how much the beneficiary gets if the trust provides "All income for life to my spouse"
   i) **What is income?**
      (1) ***Interest***
      (2) ***Dividends***
      (3) ***Rents (net)***
      (4) ***Interest expense***
   ii) **What is principal – the original trust or estate property, plus**
      (1) ***Capital gains***
      (2) ***Capital losses***
      (3) ***Taxes on capital gains***
      (4) ***Amounts not distributed?***
   iii) **What may be either?**
      (1) ***Depreciation***
      (2) ***Fiduciary expenses must be allocated***
   iv) **Trust terms may override these general rules**

m) **Calculation of DNI, Trust Accounting income, taxable income, etc.**
   i) **SEE APPENDIX II**
   ii) **Trusts are entitled to a distribution deduction**
      (1) **Depends on type of trusts**
      (2) **Simple trust - all income**
         (a) ***One that is required to distribute all income currently***
         (b) ***No charitable beneficiary***
         (c) ***$300 exemption***
         (d) ***Taxable income is usually = Capital Gains - $300!***
      (3) **Complex trust - income actually distributed, or**
         (a) ***Income distributed with 65 days of year end for which an election is made***
         (b) ***Any other trust that is not a simple trust***
         (c) ***$100 exemption, or***
         (d) ***$300 exemption if distributes all income***
   iii) **Estates are entitled to a $600 exemption**

n) **DNI**
   i) **Ceiling on which a beneficiary can be taxed, even if he/she receives more than that**
   ii) **Also represents the maximum that the trust can deduct for payments to a beneficiary**
   iii) **The character of the income passes through to the beneficiary**
      (1) ***Interest is interest***
      (2) ***Dividends are dividends***
      (3) ***(netted by expense***
         (a) ***Suppose $5,000 of dividends and $500 of tax return prep fees***
            (i) Pass through is $4,500 (net)
            (ii) There will be an AMT adjustment of $500
            (iii) 2% misc. itemized reduction does not apply to those fees that only exist because this is a trust or estate, such as tax prep. fees
   iv) ***Capital Gains are not included (unless part of income in the trust document)***
   v) ***Major difference between DNI and TAI***

(1) Expenses chargeable to Corpus reduce DNI but don't reduce TAI
(2) Thus, if $5,000 interest and $500 state taxes
    *(a) DNI = $4,500*
    *(b) TAI = $5,000 (beneficiary gets $5,000 but pays tax on $4,500!)*

**o) Distributions of Principal are not taxable!**
- **i) Suppose DNI = $5,000 and the trust says, give $100,000 to my son in 1999**
  - ***(1) Tax is on $5,000***
  - ***(2) The rest is simply as tax free distribution of Corpus***
- **ii) That is the same as if the father had died and left $100,000 in a bank account and in 1999 the son withdrew it (no tax on a withdrawal)**

**p) Losses can not be passed out from a trust to a beneficiary**
- **i) Exception in the final year**
- **ii) Capital losses also can not be passed out until the final year**

**q) Beneficiaries pay tax on the amount received (limited to DNI)**
- **i) In simple trusts = on current income even if they don't get it**
- **ii) In complex trusts only what they get or 65 day election**
- **iii) Exceptions:**
  - ***(1) Separate Share Rule - if it is really two trust, then it is treated that way***
  - ***(2) Specific Bequests are not taxable distributions, unless they for more than three distributions***
    - (a) Thus, gifts of a car or jewelry are not taxable
    - (b) Gifts of $100,000 are not taxable
    - (c) Gifts of $100,000 for five years is taxable, up to DNI each year

**r) Income in Respect of a Decedent (IRD)**
- **i) Amounts that would have been ordinary income or capital gain when (not if) received prior to death**
- **ii) Thus, no step up to fair market value date of death**
- **iii) Includes**
  - ***(1) Unpaid salary or bonus***
  - ***(2) Installment sale income***
  - ***(3) Accrued but unpaid interest***
  - ***(4) Declared but unpaid dividends***
- **iv) Thus, will be taxable to the trust, estate or beneficiary that receives it**

**s) Grantor Trust Provisions**
- **i) Effect of grantor trust status is that the income is taxed to the grantor, not to the beneficiary**
- **ii) Revocable trusts are grantor trusts**
- **iii) Trusts whose chances of reverting to the grantor exceed 5%**
- **iv) Retention of administrative powers by the grantor**
- **v) Retention of rights to income in grantor or spouse**
- **vi) Retention of control over others enjoyment**
- ***vii) Grantor's ability to pick between alternative beneficiaries***
  - ***(1) If only a trustee, it is ok to have those rights!***
  - ***(2) Grantor can keep the power to change trustees!***

**t) Year Ends**

  **i) Trusts - Calendar year**

  **ii) Estates - Fiscal year can be elected**

  **iii) Revocable living trusts may elect to be included with the estate and therefore pick a fiscal year, but there is only one combined tax return**

**u) Due date = 15th day of fourth month (Estate = April 15th)**

APPENDIX I

| | |
|---|---|
| 1. Basis (outside) | |
| 2. Less: Cash distribution<br>(or reduction in liabilities) | |
| 3. If Negative = gain. If positive = remaining basis | |
| 4. Less partnership's basis in distributed property (can not exceed basis in 3 above | |
| 5. Remaining basis for adjustment for the partner's K-1 (share of income, loss etc.)r | |

A. Liquidating

| | |
|---|---|
| 1. Basis (outside) | |
| 2. Less: Cash distribution<br>(or reduction in liabilities) | ( ) |
| 3. If Negative = gain.<br>If positive = remaining basis | |
| 4. Less partnership's basis in distributed property: Inventory and Receivables only - Can not exceed partner's basis | ( ) |
| 5. Remaining basis<br>If no other property is received, then loss is recognized<br>If other property is received, partner's basis is allocated to the property received based on partnership's relative basis | |

APPENDIX II - Trust Taxation Chart

| Trust | Simpl | | | | | |
|---|---|---|---|---|---|---|
| Item | Trust | Inco | Prin. | Alloc. | Tax | DNI |
| Dividends | 30,00 | YES | | | YES | YES |
| Rental | 5,000 | YES | | | YES | YES |
| Tax | 15,00 | YES | | YES | NO | YES |
| Rental | (1,00 | YES | | | YES | YES |
| Trustee's | (1,20 | No | YES | YES | YES | YES |
| Tax return | (500) | YES | No | | YES | YES |
| Capital | 12,00 | | YES | | YES | YES |
| Fed. Est. | (2,60 | | YES | | NO | NO |
| Exemption | | | | | YES | YES |
| DNI | | | | | | 0 |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Total | 56,70 | | | | | |

| Trust | | | | | | |
|---|---|---|---|---|---|---|
| Simple | | | | Alloc. | Tax | |
| Item | Trust | Inco | Prin. | Exem | Retur | DNI |
| | | | | | | |
| Dividends | 30,00 | 30,00 | | | 30,00 | 30,00 |
| Rental | 5,000 | 5,000 | | | 5,000 | 5,000 |
| Tax | 15,00 | 15,00 | | (360) | | 14,64 |
| Rental | (1,00 | (1,00 | | | (1,00 | (1,00 |
| Trustee's | (1,20 | | (1,2 | (360) | (840) | (840) |
| Tax return | (500) | (500) | | | (500) | (500) |
| Capital | 12,00 | | 12,0 | | 12,00 | 0 |
| Fed. Est. | (2,60 | | (2,6 | | 0 | 0 |
| Exemption | | | | | (300) | 0 |
| DNI | | | | | (32,6 | 0 |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Total | 56,70 | 48,50 | 8,20 | (720) | 11,70 | 47,30 |
| Tax | | | | | | (14,6 |
| | | | | | | ----- |
| DNI | | | | | | 32,66 |

Updated as of 07/28/2018 – but only quickly. Use at your own risk!