



## ★ CHAPTER THREE ★

# TAXABLE ENTITIES, TAX FORMULA, INTRODUCTION TO PROPERTY TRANSACTIONS

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### LEARNING OBJECTIVES

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Upon completion of this chapter you will be able to:

- ▶ Identify the entities that are subject to the Federal income tax
- ▶ Explain the basic tax treatment of individuals, corporations, partnerships, S corporations, and fiduciary taxpayers (trusts and estates)
- ▶ Understand the basic tax formulas to be followed in computing the tax liability for individuals and corporations
- ▶ Define many of the basic terms used in the tax formula such as gross income, adjusted gross income, taxable income, exclusion, deduction, and credit
- ▶ Calculate the gain or loss on the disposition of property and explain the tax consequences, including the special treatment of capital gains and losses

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### CHAPTER OUTLINE

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## INTRODUCTION

The amount of income tax ultimately paid by any taxpayer is determined by applying the many rules comprising our income tax system. This chapter examines some of the fundamental features of this system. They are

- ▶ *Taxable Entities*—those entities that are subject to taxation and those that are merely conduits
- ▶ *Tax Formulas*—the mathematical relationships used to compute the tax for the various taxable entities
- ▶ *Property Transactions*—the tax treatment of sales, exchanges, and other dispositions of property

This chapter, in covering the essentials, provides a bird’s-eye view of the entire income tax system. For many, this may be sufficient. This one chapter may contain enough tax law and have more than enough detail for some. Nevertheless, it is just part of the picture. Many of the details as well as the conceptual basis for some of these provisions are left to later chapters. This can be frustrating to those who want more or know that more exists, but the major purpose of this chapter is to establish the basic framework in which the implications of any particular transaction on taxable income can be assessed. To this end, the chapter gives not only a brief description of what is taxable and what is deductible but also a glimpse of such complex topics as the passive loss rules and the alternative minimum tax. Remember, the goal is not necessarily to provide a detailed discussion of all the rules but to provide a foundation so that problems, pitfalls, and opportunities can be recognized.

## THE TAXABLE ENTITY

The income tax must be imposed on the income of some type of entity. Unfortunately, there is no uniform agreement on what is the theoretically correct unit of taxation. There are a variety of legal, economic, social, and natural entities that Congress could select: individuals (natural persons), family units, households (those living together), sole proprietorships, partnerships, corporations, trusts, estates, governments, religious groups, nonprofit organizations, and other voluntary or cooperative associations. Despite the disagreement over which of these or other entities are the proper choices, Congress has provided that only certain entities are responsible for actually paying the tax. According to the Code, individuals, most corporations, and fiduciaries (estates and trusts) are taxable entities. Other entities, such as sole proprietorships, partnerships, and so-called “S” corporations, are not required to pay tax on any taxable income they might have. Instead, the taxable income of these entities is allocated to their owners, who bear the responsibility for paying any tax that may be due.

**Example 1.** R and S are equal partners in a partnership that had taxable income of \$50,000 in the current year. The partnership does not pay tax on the \$50,000. Rather, the income is allocated equally between R and S. Thus, both R and S will report \$25,000 of partnership income on their individual returns and pay the required tax.

In the following sections, the general tax treatment of the taxable entities—individuals, corporations, and fiduciaries—is explained along with the treatment of partnerships and “S” corporations. The specific tax treatment of entities other than individuals is discussed separately in later chapters. However, it should be emphasized

that many of the tax rules applying to one entity also apply to other entities. These similarities are pointed out as the various rules are discussed.

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## TAXABLE ENTITIES

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### INDIVIDUAL TAXPAYERS

**Citizens and Residents of the United States.** Section 1 of the Internal Revenue Code provides that a tax is imposed on the taxable income of all individuals. As might be expected, the term *individual* generally applies to U.S. citizens. However, it also includes persons who are *not* U.S. citizens but who are considered residents, so-called *resident aliens*. Thus, if Prince Harry decides to move to New York to escape the tabloids of London, he could be subject to U.S. taxes even though he is not a U.S. citizen. The same could be said for a Japanese citizen working for Honda in Marysville, Ohio or a Canadian citizen who lives and works in Detroit. Whether these people are residents requires application of a complicated test.<sup>1</sup> The key point to remember is that foreign citizens who are not merely visiting but stay for an extended period must worry about the need for filing.<sup>2</sup> As discussed below, the tax would be levied on both their U.S. income and any foreign income.

**Foreign Taxpayers.** Individuals who are not U.S. citizens and who do not qualify as residents may be subject to U.S. tax. These persons, referred to as *nonresident aliens*, are taxed on certain types of income that are received from U.S. sources.<sup>3</sup> If the income is derived from a trade or business carried on in the United States, that income is taxed in the same way as it is for a citizen or resident. Most other income earned in the United States is taxed at a flat rate of 30 percent. However, there are a number of special rules that must be observed.

**Age.** It should be noted that the age of an individual is not a factor in determining if he or she is a taxpaying entity. Whether the individual is eight years old or eighty years old, he or she is still subject to tax on any taxable income received. Contrary to the belief of some people, a child's income is taxed to the child and not the parent. As explained later, age may have an impact on *both* the method of computing the tax and the amount of tax owed; it does not, however, impact the individual's status as a taxpayer.

**Sole Proprietorship.** Another aspect of individual taxation requiring consideration is the taxation of sole proprietorships. For financial accounting purposes, the business activities of the proprietor are treated as distinct from other activities. The sole proprietorship is considered a separate accounting entity for which separate records and reports are maintained. For tax purposes, however, the sole proprietorship is not a separate entity subject to tax. The sole proprietorship does not file its own tax return. Rather, the income and deductions of the proprietorship are reported on the individual's personal income tax return along with any other tax items. In essence, the sole proprietorship serves as a conduit; that is, any income it has flows through to the individual.

**Example 2.** K is employed as an accounting professor at State University, where she earns a salary of \$102,000. K also operates a consulting practice as a sole

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<sup>1</sup> See § 7701(b) for a definition of the "substantial presence test" that is used to determine if an individual is a resident alien and subject to U.S. tax.

<sup>2</sup> Reg. § 1.871-2(b).

<sup>3</sup> § 871.

proprietorship, which earned net income of \$15,000 during the year. The sole proprietorship does not file a separate return and pay tax. Instead, K reports the sole proprietorship's income along with her salary on her individual return (Form 1040) and pays both the income and self-employment taxes required. The operations of the sole proprietorship are reported on a special form, Schedule C, which accompanies Form 1040. (See Appendix for a copy of Schedule C.)

**Worldwide Income.** The Federal income tax on individuals applies not only to domestic (U.S.) source income, but also to income from foreign sources. It is therefore possible to have foreign source income taxed by more than one country (e.g., the foreign country and the United States). Several provisions exist to prevent or minimize double taxation, however. For example, U.S. citizens and residents living abroad may take either a direct reduction in U.S. tax (foreign tax credit)<sup>4</sup> or deduct such taxes.<sup>5</sup>

In lieu of taking a credit or deduction for foreign taxes, a U.S. citizen who works abroad may exclude from his or her U.S. income certain amounts of income earned abroad.<sup>6</sup> The exclusion is adjusted annually for inflation and for 2008 is \$87,600. To qualify, the taxpayer (referred to as an *expatriate*) must either be a bona fide resident of a foreign country (or countries) all year or be physically present in a foreign country for 330 days in any 12 consecutive months.

**Example 3.** Z, a U.S. citizen, is an aircraft mechanic who was temporarily assigned to a lucrative job in Seoul, South Korea. Z lived in Seoul all of 2008 except for two weeks when he came back to the United States to visit relatives. From his Korean job, he earned \$95,000 in 2008. Because Z was present in the foreign country for at least 330 days during 12 consecutive months, he meets the physical presence test and may exclude \$87,600 of his \$95,000 salary. The remaining \$7,400 plus any other income, such as dividends and interest, are subject to tax.

In addition to the relief measures mentioned above, taxpayers may exclude, subject to certain limitations, allowances (in-kind or cash) for foreign housing. Also, tax treaties often exist that deal with the problem of double taxation by the United States and foreign countries.

### CORPORATE TAXPAYERS

Section 11 of the Code imposes a tax on all corporations. The tax applies to both domestic corporations and foreign corporations with trades or businesses operated in the United States.<sup>7</sup> Although § 11 requires all corporations to pay tax, other provisions in the law specifically exempt certain types of corporations from taxation. For example, a corporation organized not for profit, but for religious, charitable, scientific, literary, educational, or certain other purposes, generally is not taxable.<sup>8</sup> However, if a nonprofit organization conducts a business unrelated to the purpose for which its exemption was granted, any taxable income resulting from that business would be subject to tax.<sup>9</sup> In addition to the special provisions governing taxation of nonprofit corporations, the rules applying to S corporations vary from those applying to C or "regular" corporations as explained below.

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<sup>4</sup> § 901.

<sup>5</sup> § 164(a).

<sup>6</sup> § 911(a).

<sup>7</sup> § 882(a). See Chapter 19 for more details.

<sup>8</sup> § 501(a).

<sup>9</sup> § 501(b).

The overall income tax treatment of corporations is quite similar to that of individuals. In fact, all of the basic rules governing income, exclusions, deductions, and credits apply to individuals as well as C corporations and, for that matter, fiduciaries. For example, the general rule concerning what is deductible, found in § 162, allows *all* taxpayers a deduction for trade or business expenses. Similarly, § 103 provides that *all* taxpayers are allowed to exclude interest income from state and local bonds. Although many of the general rules are the same for both individuals and corporations, there are several key differences.

The most obvious difference can be seen by comparing the corporate and individual formulas for determining taxable income as found in Exhibits 3-1 and 3-2. The concepts of adjusted gross income and itemized deductions common to the individual tax formula are conspicuously absent from the corporate formula. Other major differences in determining taxable income involve the treatment of particular items, such as dividend income and charitable contributions. These and other differences are discussed in detail in Chapter 19. It should be emphasized once again, however, that most of the basic rules apply whether the taxpayer is a corporation or an individual.

One difference in the taxation of individuals and corporations that is not apparent from the basic formula, but which should be noted, concerns the tax rates that each uses in computing the tax liability (see the inside back cover of the text). A comparison of the individual and corporate tax rates shows a somewhat similar progression: 10 to 35 percent for individuals and 15 to 39 percent for corporations. But note that the rates apply at quite different levels of income.

Perhaps the most critical aspect of corporate taxation that is generally not shared with any other taxable entity concerns the potential for double taxation. When a corporation receives income and subsequently distributes that income as a dividend to its shareholders, the effect is to tax the income twice: once at the corporate level and again at the shareholder level. Double taxation can occur because the corporation is not allowed to deduct any dividend payments to its shareholders. As one might suspect, many have questioned the equity of this treatment, arguing that it penalizes those who elect to do business in the corporate form. Note, however, that this treatment is consistent with the fact that the corporation is considered a separate legal entity. Moreover, it is often argued that the corporation and its owners in reality do not bear the burden of the corporate tax. According to the argument, corporations are able to shift the tax burden either to consumers by charging higher prices or to employees by paying lower wages. In addition, those who reject the double tax theory often note that closely held corporations, whose owners may also be employees of the business, are able to avoid double taxation to the extent they can characterize any corporate distributions as deductible salary payments rather than nondeductible dividends. Whether in fact double taxation does or does not occur, it appears that this feature, which has been part of the U.S. tax system since its inception, is unlikely to change in the immediate future.

Special rules apply to the formation of a corporation, corporate dividend distributions, and distributions made to shareholders in exchange for their stock. Penalty taxes also may be assessed against corporations that try to shelter income from high personal tax rates by accumulating it in the corporation, rather than making dividend distributions. These topics and others related to the income taxation of corporations and their owners are discussed in Chapter 19.

## FIDUCIARY TAXPAYERS

A *fiduciary* is a person who is entrusted with property for the benefit of another, the *beneficiary*. The individual or entity that acts as a fiduciary is responsible for managing and administering the entrusted property, at all times faithfully performing the required duties with the utmost care and prudence.

Two types of fiduciary relationships are the trust and the estate. The trust is a legal entity created when the title of property is transferred by a person (the *grantor*) to the fiduciary

(the *trustee*). The trustee is required to implement the instructions of the grantor as specified in the trust agreement. Typically, the property is held in trust for a minor or some other person until he or she reaches a certain age or until some specified event occurs.

An estate is also recognized as a legal entity, established by law when a person dies. Upon the person's death, his or her property generally passes to the estate, where it is administered by the fiduciary until it is distributed to the beneficiaries. Both trusts and estates are treated as taxpaying entities.

The Code specifically provides for a tax on the taxable income of estates and trusts.<sup>10</sup> Determining the tax for such entities is very similar to determining the tax for individuals, with one major exception.<sup>11</sup> When distributions are made to beneficiaries, the distributed income is generally taxed to the beneficiary rather than to the estate or trust.<sup>12</sup> In essence, the trust or estate is permitted to reduce its taxable income by the amount of the distribution—acting as a *conduit*, since the distributed income flows through to the beneficiaries.

**Example 4.** T is the trustee of a trust established for the benefit of A and B. The trust generated \$4,000 of income subject to tax for the current year and no distributions were made to either A or B during the year. The trustee files an annual fiduciary tax return for the year and pays the tax based on the \$4,000 taxable amount.

**Example 5.** Assume that for the next year the trust in *Example 4* had \$10,000 of income subject to tax and that distributions of \$2,000 each were made to A and B. The trustee files an annual trust return for the year and pays a tax based on \$6,000 (\$10,000 taxable income – \$4,000 distribution). A and B each include \$2,000 in their income tax returns for the year.

Distributions made by a trust or estate from its corpus (also called the trust property or principal), including undistributed profits from prior years, generally are not taxable to the beneficiary.<sup>13</sup> This is because these distributions are part of a gift or inheritance or have been taxed previously. Similarly, the trust or estate is not entitled to deductions for these nontaxable distributions.<sup>14</sup>

## PARTNERSHIPS

A partnership is a conduit for Federal income tax purposes. This means that the partnership itself is not subject to Federal income tax and that all items of partnership income, expense, gain, loss, or credit pass through to the partners and are given their tax effect at the partner level.<sup>15</sup> The partnership is required to file an information return (Form 1065) reporting the results of the partnership's transactions and how those results are divided among the partners. Each partner's share of the various items are reported to the partner on Schedule K-1. Using this information, the partners each report their respective shares of the items on their own tax returns.<sup>16</sup> Because partners pay taxes on their shares of the partnership income regardless of whether it is distributed, distributions made by the partnership generally are not taxable to the partners.<sup>17</sup>

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<sup>10</sup> §§ 1(e) and 641(a).

<sup>11</sup> § 641(b).

<sup>12</sup> §§ 651 and 661.

<sup>13</sup> § 662.

<sup>14</sup> § 661. For further information on the income taxation of fiduciaries, see *Corporate, Partnership, Estate and Gift Taxation*, 2009 Edition, Chapter 15.

<sup>15</sup> § 701.

<sup>16</sup> § 702(a).

<sup>17</sup> § 731(a).

**Example 6.** For its current calendar year, EG Partnership had taxable income of \$18,000. During the year, each of its two equal partners received cash distributions of \$4,000. The partnership is not subject to tax, and each partner must include \$9,000 in his annual income tax return, despite the fact that each partner actually received less than this amount in cash. The distributions normally are not taxable since they represent previously taxed income. The partnership must file an annual information return reporting the results of its operations and the effect of these operations on each partner.

A characteristic of a partnership (as well as an S corporation) that deserves special emphasis is the treatment of losses. If a business is typical, it will take several years of operation before it can be declared a profitable venture. Until that time, expenses normally exceed revenues and the result is a net loss. In the case of a conduit entity such as a partnership, that net loss flows through to the owners, who are generally allowed to offset it against any other income they may have. In contrast, if a regular C corporation sustains a loss, referred to as a net operating loss, or NOL, the shareholders do not benefit from that loss directly. A C corporation is allowed, like individuals, to use the loss to offset taxable income of prior or subsequent years. Generally, losses are carried back two years and forward 20 years. For example, the taxpayer would first carry back the loss to the second prior year and offset it against any taxable income. In such case, the taxpayer would file a claim for a tax refund. Any remaining loss is carried to the first prior year. Any remaining loss is carried forward for 20 years. The key point to remember is that the losses of a partnership flow through and thus may provide immediate benefit, whereas those of a C corporation do not flow through and can be used only if the corporation has income in other tax years.

In some respects, the partnership is treated as a separate entity for tax purposes. For example, many tax elections are made by the partnership,<sup>18</sup> and a partnership interest generally is treated as a single asset when sold.<sup>19</sup> On the other hand, transactions between the partners and partnership are sometimes treated as if the partner was an independent third party and sometimes special rules apply.<sup>20</sup> For example, an individual partner who performs services for the partnership in his or her role as a partner is generally not considered an employee for tax purposes. Such payments are not considered salaries or wages. Consequently, the payments are not subject to withholding or employment taxes and are not reported to the partner at the end of the year on form W-2. Instead, these so-called “guaranteed payments” are reported to the partner on a Schedule K-1 and are subject to self-employment taxes. Consistent with this approach, a partner often does not qualify for the favorable tax treatment of employee fringe benefits (see Chapter 6). In addition, a partner’s share of any trade or business income of the partnership is generally subject to self-employment taxes. These and other controlling provisions related to the Federal income tax treatment of partnerships are introduced in Chapter 19.

### **ELECTING SMALL BUSINESS CORPORATIONS: “S” CORPORATIONS**

The Internal Revenue Code allows certain closely held corporations to elect to be treated as conduits (like partnerships) for Federal income tax purposes. The election is made pursuant to the rules contained in Subchapter S of the Code.<sup>21</sup> For this reason, such corporations are referred to as *S corporations*. Not all corporations are eligible to

<sup>18</sup> § 703(b).

<sup>19</sup> § 741 states that the sale or exchange of an interest in a partnership shall generally be treated as the sale of a capital asset.

<sup>20</sup> § 707(a).

<sup>21</sup> §§ 1361 through 1379.

elect S status. The only corporations that qualify are those that have 100 or fewer shareholders and meet certain other tests.

If a corporation elects S corporation status, it is taxed in virtually the same fashion as a partnership. Like a partnership, the S corporation's items of income, expense, gain, or loss pass through to the shareholders to be given their tax effect at the shareholder level. Salaries and wages of shareholders who work for the corporation and other employees are reported on a Form W-2 and are subject to withholding of income taxes and FICA (that is matched by the employer corporation). Although employees generally qualify for favorable treatment of fringe benefits, shareholder-employees owning 2 percent or more of the corporation's stock do not. As a result, the value of any fringe benefits, such as medical insurance coverage, is taxable as compensation to the employee-shareholder (who is allowed to deduct it).

The S corporation files an information return (Form 1120S) similar to that of a partnership, reporting the results of the corporation's transactions and how those results are allocated among the shareholders. The individual shareholders report their respective shares of the various items on their own tax returns. Chapter 19 contains an introductory discussion of the taxation of S corporations and their shareholders.

### **LIMITED LIABILITY COMPANIES**

All 50 states and the District of Columbia have passed legislation creating a relatively new form of business entity: the limited liability company (LLC). What is this new creature and how is it taxed? Perhaps the best characterization of an LLC is that it is a cross between a partnership and a corporation. LLCs are created under state law by filing articles of organization. The owners of an LLC are called members and can be individuals, partnerships, regular corporations, S corporations, trusts, or other LLCs. Although some states allow single-member LLCs, two or more members usually form the entity. Like a corporation, an LLC can act on its own behalf and sue and be sued. Also like a corporation, members generally possess limited liability except that they may be liable for their own acts of malpractice in those states that allow professionals to form LLCs.

The tax law does not specifically address the tax treatment of an LLC. Initially, this omission caused some uncertainty as to whether an LLC should be taxed as a corporation or a partnership. To eliminate this confusion, the Treasury issued the so-called check-the-box regulations.<sup>22</sup> Under these rules, an LLC with two or more owners is treated as a partnership for tax purposes unless it elects to be treated as a corporation (i.e., the LLC is a partnership unless it checks the box on Form 8832 to be treated as a regular C corporation). An LLC with only one member is disregarded and treated as a sole proprietorship, unless it elects to be treated as a corporation.

The treatment of LLCs for self-employment tax purposes has also produced some confusion. As noted above, in the case of a partnership, a partner's share of partnership income is generally self-employment income subject to self-employment taxes. However, this rule is true only for general partners. Historically, limited partners have been treated differently on the theory that their role is similar to that of an investor rather than someone who is actively involved in the business. Consequently, a limited partner's share of partnership income has been viewed more similar to investment income (e.g., dividends and interest) than business income. Section 1402 (a)(13) reflects this line of reasoning, providing that a limited partner's share of partnership income is not subject to self-employment tax. However, based on this approach, it was not clear whether a member of an LLC was to be treated like a limited partner, in which case the LLC's income would escape employment taxes. Hoping to eliminate this potential loophole, proposed regulations created new rules to test limited partners as well as LLC

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<sup>22</sup> Reg. § 301.7701-3.



members. Under the proposed regulations, a limited partner or LLC member must treat his or her share of income as self-employment income if any of the following tests are met:<sup>23</sup>

1. The individual has personal liability for the debts of or claims against the business by reason of being a partner. This rule should rarely apply to a member of an LLC.
2. The individual has authority to contract on behalf of the entity.
3. The individual participates in the entity's trade or business for more than 500 hours during the year.
4. Substantially all of the activities of the entity involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

Although these proposals provide needed guidance, they were heavily criticized. As a result, Congress intervened in 1997, passing legislation that postponed their implementation.<sup>24</sup> Since that time there has been no further action and the treatment of LLCs for purposes of self-employment taxes is still unresolved.

### **CHECK YOUR KNOWLEDGE**

**Review Question 1.** Section 1 of the Internal Revenue Code imposes a tax on all individuals. If taken literally, this would mean that the United States taxes not only Oprah Winfrey but also Fidel Castro and Elton John. Are these foreign citizens subject to U.S. tax?

The U.S. income tax generally applies to the worldwide income of U.S. citizens and resident aliens. As a result, it would not apply to Mr. Castro and Mr. John since they are not citizens and do not live in the United States. The key question for an alien is whether the individual could be considered a resident. Whether a foreign citizen is considered a resident is normally based on the period of time he or she is present in the United States. For this purpose, an alien who is a mere transient (e.g., a foreigner who vacations in the United States) is not a resident.

Although foreign citizens such as Castro and John usually are not subject to U.S. tax, they can be. Nonresident aliens are taxed on their income from U.S. sources. Based on this rule, income earned from a job or a business in the United States is subject to U.S. tax. In addition, nonresident aliens who receive investment income from U.S. sources, such as dividends on U.S. stocks, normally must pay U.S. taxes on such income.

**Review Question 2.** Child actors and actresses have made millions of dollars from their movie appearances (e.g., Hannah Montana, Macaulay Culkin).

- a. Must these children file their own returns and report the income, or do their parents simply include it on their return?

Although there are some special rules that can apply, parents normally do not report the income of their children on their return. A child is treated as a taxable entity, separate and distinct from his or her parents. Consequently, if a child's income exceeds the filing requirement threshold, he or she must usually file a return.

<sup>23</sup> Prop. Reg. § 1.1402(a)-2(h).

<sup>24</sup> See § 935 of the Tax Reform Act of 1997.

- b. Do you think there could be any advantage derived from the fact that a child is a separate taxpayer?

Besides all of the other things that children are—both good and bad—they can also be mini-tax shelters. Since they are separate taxpayers, they have their own set of tax rates and other tax characteristics. Therefore, to the extent that parents are able to shift income from the parents' high bracket to the child's low bracket (and still control the use of the income), taxes can be saved. These opportunities and some limitations that restrict such schemes are discussed more fully in Chapter 4 and Chapter 5.

**Review Question 3.** After all these years, Bob decided to start his own business: Bob's Bar and Grill. He has even convinced his wife, Jane, to help. Bob has everything ready but still must decide what form the business should take. Originally, he did not even think about it. Bob simply thought he would operate the business as a sole proprietorship.

- a. If Bob does pursue this course, will he need to file a separate return for the business?

A sole proprietorship is not considered a separate taxable entity. Instead, all of the information related to the proprietorship is included on the individual's personal tax return. The results of operation are summarized on Schedule C. The net profit or loss is transferred from Schedule C to page 1 of Form 1040. In addition, since such income is also subject to self-employment tax, the net profit is also transferred to Schedule SE, where the special computation is made. It is important to note that either Bob or Jane can be the proprietor—but not both. If Jane is to be the proprietor, she must own the business. If Jane wishes to compensate Bob, she can pay him a salary or wages. However, if Bob and Jane both wish to be owners, they must use another form of business.

- b. After Bob and Jane talked to their attorney, it was clear that they did not want to be a general partnership (where each and every partner is liable for partnership obligations) or a sole proprietorship. Why?

Typically, individuals want to protect their personal assets from the liabilities of risky ventures. While insurance may provide some protection, most individuals want the added safety of limited liability that only the corporate or LLC form offers. A *limited* partnership allows some partners protection, but this business form requires that there must be at least one *general* partner (who would have unlimited liability).

- c. At first Bob and Jane thought they would be a corporation. But according to their accountant, this new thing called an LLC allows business owners to achieve what he believes is tax nirvana. What is all the fuss about LLCs? Can you not get the same thing with S corporations? What do you think? How are LLCs taxed? What form of business organization seems best for Bob and Jane's business?

The beauty of an LLC is that all of the owners have limited liability yet the entity is usually taxed like a partnership. As a result, all of the income, as well as any loss, flows through to the partners. The significance of this treatment is twofold. First, if any loss occurs, it can be used to offset any other income Bob and Jane may have. If a C corporation is chosen, early losses do not provide any benefit until the business starts to make money. The NOL carryback feature for

corporations is useless, because the business is brand new. Moreover, if it is like most businesses, Bob and Jane's operation will experience losses—at least until the clientele develop a love for Bob's cooking. The second attraction of an LLC is the fact that its income avoids the double tax that can occur with C corporations. But why opt for an LLC? Is not this same treatment available with an S corporation? In this regard, the LLC is virtually identical to an S corporation, but there are many differences that some argue make the LLC more attractive. The only difference that can be gleaned from the discussion above is that an S corporation is limited to 100 shareholders while a partnership or LLC can have an unlimited number of owners. This may be irrelevant for Bob and Jane but could be extremely important for some businesses (e.g., a large public accounting firm). Another difference concerns the type of owner allowed. For example, an S corporation can generally have only individuals (and no nonresident aliens) as shareholders, but there are no restrictions on the type of partner or member that a partnership or an LLC can have. This too may be unimportant for Bob and Jane but there are still other considerations too technical to touch on here.

As a practical matter, prior to the advent of the LLC, most advisers would have suggested that Bob and Jane choose to be an S corporation. Since 1986 S corporations have generally been the most popular form of conducting business—at least when there were no more than the maximum shareholders allowed—because they were the only form of business that offered limited liability to all of its owners and a single level of tax. But the advent of the LLC changes all of this. As time passes, it will be interesting to see if LLCs become more popular than S corporations. In any event, they provide yet one more option for the business owner to select.

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## TAX FORMULA

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Computing an income tax liability is normally uncomplicated, requiring only a few simple mathematical calculations.<sup>25</sup> These steps, referred to as the tax formula, are shown in Exhibits 3-1 and 3-2. The tax formula is presented here in two forms: the simpler general formula that establishes the basic concepts as applicable to corporate taxpayers (Exhibit 3-1) and the more complex formula for individual taxpayers (Exhibit 3-2). The formulas in Exhibits 3-1 and 3-2 are useful references while studying the various aspects of Federal income tax law in the subsequent chapters. To make such reference easier, both formulas are reproduced on the inside back cover of the text.

The tax formula for each type of entity is incorporated into the Federal income tax forms. Exhibit 3-1 may be compared with Form 1120 (the annual income tax return for corporations) and Exhibit 3-2 with Form 1040 (the return for individuals). These forms are included in Appendix B at the back of the text.

Examination of the two formulas reveals the importance of tax terms such as *gross income*, *deductions*, and *exemptions*. Each of these terms and countless others used in the tax law have very specific meanings. Indeed, as later chapters will show, taxpayers often have been involved in litigation solely to determine the definition of a particular term. For this reason, close attention must be given to the terminology used in taxation.

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<sup>25</sup> §§ 1 and 63.

**EXHIBIT 3-1****Tax Formula for Corporate Taxpayers**

<b>Total Income (from whatever source)</b> .....	\$xxx,xxx
Less: Exclusions from gross income .....	<u>– xx,xxx</u>
<b>Gross income</b> .....	\$xxx,xxx
Less: Deductions .....	<u>– xx,xxx</u>
<b>Taxable income</b> .....	\$xxx,xxx
Applicable tax rates .....	<u>xx%</u>
<b>Gross tax</b> .....	\$ xx,xxx
Less: Tax credits and prepayments .....	<u>– x,xxx</u>
<b>Tax due (or refund)</b> .....	<u><u>\$ xx,xxx</u></u>

**EXHIBIT 3-2****Tax Formula for Individual Taxpayers**

<b>Total income (from whatever source)</b> .....	\$xxx,xxx
Less: Exclusions from gross income .....	<u>– xx,xxx</u>
<b>Gross income</b> .....	\$xxx,xxx
Less: Deductions <b>for</b> adjusted gross income .....	<u>– xx,xxx</u>
<b>Adjusted gross income</b> .....	\$xxx,xxx
Less: 1. The larger of:	
a. Standard deduction .....	\$x,xxx
or .....	or
b. Total itemized deductions .....	\$x,xxx
2. Number of personal and dependency exemptions × exemption amount .....	<u>– x,xxx</u>
<b>Taxable income</b> .....	\$xxx,xxx
Applicable tax rates (from Tables or Schedules X, Y, or Z) .....	<u>xx%</u>
<b>Gross income tax</b> .....	\$ xx,xxx
Plus: Additional taxes (e.g., self-employment taxes and recapture of tax credits) .....	+ x,xxx
Less: Tax credits and prepayments .....	<u>– x,xxx</u>
<b>Tax due (or refund)</b> .....	<u><u>\$ xx,xxx</u></u>

**ANALYZING THE TAX FORMULA**

**Income.** The tax computation begins with a determination of the taxpayer's total income, both taxable and nontaxable. As the formula in Exhibit 3-2 suggests, income is defined very broadly to include income from any source.<sup>26</sup> The list of typical income

<sup>26</sup> § 61(a).

items in Exhibit 3-3 illustrates its comprehensive nature. A specific definition of income is developed in Chapter 5.

**Exclusions.** Although the starting point in calculating the tax is determining total income, not all of the income identified is taxable. Over the years, Congress has specifically exempted certain types of income from taxation, often in an attempt to accomplish some specific goal.<sup>27</sup> In tax terminology, income exempt from taxation and thus not included in a taxpayer's gross income is referred to as an "exclusion." Exhibit 3-4 shows a sample of the numerous items that can be excluded when determining gross income. Exclusions are discussed in detail in Chapter 6.

**Gross Income.** The amount of income remaining after the excludable items have been removed is termed *gross income*. When completing a tax return, gross income is usually the only income disclosed, because excluded income normally is not reported.

### EXHIBIT 3-3

#### Partial List of Items Included in Gross Income

Alimony and separate maintenance payments	Income from rental operations
Annuities	Income in respect of a decedent
Awards	Interest
Bonuses	Pensions and other retirement benefits
Commissions	Prizes and gambling or lottery winnings
Debts forgiven to debtor by a creditor	Pro rata share of income of a partnership
Dividends from corporations	Pro rata share of income of an S corporation
Employee expense reimbursements	Punitive damages
Fees and other compensation for personal services	Rewards
Gains from illegal transactions	Royalties
Gains from transactions in property	Salaries and wages
Gross profit from sales	Social Security benefits (zero or a portion)
Hobby income	Tips and gratuities
Income from an interest in an estate or trust	Trade or business income
	Unemployment compensation

### EXHIBIT 3-4

#### Partial List of Exclusions from Gross Income

Amounts received from employer-financed health and accident insurance to the extent of expenses	Interest on most state and local government debt
Amounts received from health, accident, and disability insurance financed by the taxpayer	Meals and lodging furnished for the convenience of one's employer
Amounts received under qualified educational assistance plans	Personal damage awards
Certain specified employee fringe benefits	Premiums paid by employer on group-term life insurance (for coverage up to \$50,000)
Child support payments received	Proceeds of life insurance paid on death
Contributions by employer to employer-financed accident and health insurance coverage	Proceeds of borrowing
Dependent care assistance provided by employer	Qualified transportation plan benefits
Gifts and inheritances	Scholarship and fellowship grants (but only for tuition, fees, books, and supplies)
Improvements by lessee to lessor's property	Social Security benefits (within limits)
	Veteran's benefits
	Welfare payments

<sup>27</sup> See Chapter 6 for a discussion of the social and economic reasons for excluding certain items of income from taxation.

**Example 7.** E is divorced and has custody of her only child. E's income for the current year is from the following sources:

Salary .....	\$34,000
Alimony from former spouse .....	12,000
Child support for child .....	6,000
Interest from First Savings & Loan .....	1,200
Interest on U.S. Government Treasury Bonds .....	1,600
Interest on State of Texas Bonds .....	<u>2,000</u>
 Total .....	 <u>\$56,800</u>

Even though E's total income is \$56,800, her gross income for tax purposes is only \$48,800 because the child support and the interest income from the State of Texas are excluded. All the other items are included in gross income. Note that the interest from the Federal government is taxable, even though interest from state and local governments is generally excluded from gross income.

**Deductions.** *Deductions* are those items that are subtracted from gross income to arrive at taxable income. The deductions normally allowed may be classified into two major groups:

1. *Business and Production-of-Income Expenses*—deductions for expenses related to carrying on a trade or business or some other income-producing activity, such as an investment.<sup>28</sup>
2. *Certain Personal Expenses*—deductions for a few expenses of an individual taxpayer that are primarily personal in nature, such as charitable contributions and medical expenses.<sup>29</sup>

Observe that the Code allows a deduction only for business or investment expenses. Personal expenses—other than a handful of special items—are not deductible. As someone once said, the Code's treatment of deductions is relatively simple: the costs of earning a living are deductible but the costs of living are not. The problem is determining into which category the expense falls.

A trade or business is an activity that is entered into for profit and involves significant taxpayer participation, either personally or through agents. It typically involves providing goods or services to customers, clients, or patients. If the activity qualifies as a trade or business, all the costs normally associated with operating the business are generally deductible. In most cases, it is easy to determine whether a taxpayer is engaged in a trade or business, but not always. For example, consider a taxpayer who travels around the world looking for antiques and incurs \$10,000 of travel expenses but ultimately sells one item for a \$100 profit. In this situation, the taxpayer might argue that he has a \$9,900 loss from the activity that he should be able to offset against other income. On the other hand, it could easily be argued that the taxpayer was not really trying to make a profit. In such case, the IRS may deny the taxpayer's deduction. In these and similar situations, the determination of whether the taxpayer is truly in a trade or business must be based on all the facts and circumstances.

<sup>28</sup> §§ 162 and 212.

<sup>29</sup> §§ 170 and 213.

Interestingly, the Code also takes the view that an individual who is employed is in the business of providing services. This is an extremely important assumption since it enables employees to deduct their business expenses (e.g., professional dues, subscriptions, and similar costs).

Although business expenses are deductible, the line between a deductible business expense and a nondeductible personal expense is not always clear. For this reason, the Code often contains additional rules or requires certain conditions to be met to ensure that the expense is truly for business. For example, the Code addresses the personal element of business meals and entertainment that are not reimbursed by limiting the deduction to only 50 percent of their cost. Similarly, expenses related to education, travel, transportation, moving or a home office are not deductible unless they meet a laundry list of requirements. Most of these special rules are discussed in detail in Chapter 8.

The rental of real estate is generally not considered to be a trade or business, unless the tenants are transient (i.e., stay for short periods of time, as in a hotel or motel) or there are extraordinary services provided to tenants (e.g., a nursing home). Nevertheless, the expenses are normally deductible as expenses related to an income-producing activity and are classified as deductions for adjusted gross income.

As one might suspect at this point, Congress is quite cautious in granting deductions. There are rules, rules, and more rules that try to ensure that only true business expenses are deductible. The tax law is particularly concerned about deduction of losses (i.e., the excess of deductions over revenues) from activities in which the taxpayer has an interest. The problem became particularly acute in the 1970s and 1980s, when certain activities were designed primarily to generate tax losses (tax shelter limited partnerships and rental real estate were the biggest culprits). In an attempt to eliminate widespread abuse, Congress enacted the so-called *passive loss* rules in 1986. These highly complex rules generally limit the deduction of losses from activities, including rental real estate, in which the taxpayer is a mere investor and does not materially participate. The passive loss rules are covered in detail in Chapter 12.

**Classifying Deductions.** A comparison of the general tax formulas used by corporations and by individuals reveals some differences in the treatment of deductions. For a corporate taxpayer, all deductions are subtracted directly from gross income to arrive at taxable income. In contrast, the individual formula divides deductions into two groups:<sup>30</sup> one group of deductions is allowed to reduce gross income, resulting in what is referred to as *adjusted gross income* (A.G.I.), while a second group is subtracted from A.G.I. As explained more fully below, the first group of deductions is generally composed of certain business expenses and other special items. The deductions in this group are referred to as deductions *for* adjusted gross income. The second group of expenses consists of two categories of allowable deductions: (1) deductions *from* adjusted gross income, and (2) deductions for personal and dependency exemptions. Deductions from adjusted gross income, normally referred to as *itemized deductions*, may be deducted only if they exceed a stipulated amount known as the *standard deduction* (e.g., in 2008 \$5,450 for single taxpayers and \$10,900 for married taxpayers filing jointly). The deduction for any personal and dependency exemptions claimed (e.g., \$3,500 per exemption in 2008) is deductible regardless of the amount of other deductions.

<sup>30</sup> § 62.

Dividing deductions into two groups is done primarily for administrative convenience. Congress substantially reduced the number of individuals who claim itemized deductions because such deductions need to be reported only if they exceed the taxpayer's standard deduction. This reduction in the number of tax returns with itemized deductions significantly reduced the IRS audit procedures involving individual taxpayers. In recent years, only 25–35 percent of taxpayers have itemized their deductions. Since corporate taxpayers have only business deductions, no special grouping was needed and thus the term *adjusted gross income* does not exist in the corporate formula.

**Adjusted Gross Income.** The amount of an individual taxpayer's adjusted gross income (A.G.I.) serves two primary purposes. First, it is simply a point of reference used for classifying deductions: deductions are classified as either for or from A.G.I. Second, the calculation of many deductions, credits and other tax items is made with reference to A.G.I. For example, medical expenses are deductible only if they exceed 7.5 percent of A.G.I., while personal casualty losses may be deducted only if they exceed 10 percent of A.G.I. In addition, recent changes in the tax law make A.G.I. even more important for some taxpayers. As explained below, most itemized deductions and the deduction for exemptions are reduced if adjusted gross income exceeds certain levels.

**Example 8.** This year proved to be very difficult for T; his divorce became final, and shortly thereafter he became very sick. For the year, he earned \$45,000 and paid \$5,000 in alimony to his ex-wife and \$10,000 for medical expenses that were not reimbursed by insurance. T's A.G.I. is \$40,000 (\$45,000 – \$5,000) because alimony is a deduction for A.G.I. As computed below, T's medical expense deduction is limited to \$7,000 because he is allowed to deduct only the amount that exceeds 7.5% of his A.G.I.

Medical expenses (unreimbursed) .....		\$10,000
Adjusted gross income .....	\$40,000	
Times:.....	<u>× 7.5%</u>	
Threshold.....	\$ 3,000	<u>(3,000)</u>
Deductible medical expenses .....		<u>\$ 7,000</u>

**Deductions for Adjusted Gross Income.** Code § 62 specifically lists the deductions that are subtracted from gross income to determine A.G.I. This listing is a potpourri of items, as illustrated in Exhibit 3-5. Over the years, this group of deductions has gone by various names. For example, practitioners often refer to this category of deductions as being “above the line”—the line being A.G.I. Some commentators and authors label these as deductions from gross income. For years, the Form 1040 listed these deductions as “adjustments” to income, although this label is no longer used (see Form 1040 in Appendix B). This text will use the “deduction for” terminology. Classification of a deduction as one for A.G.I. is significant for numerous reasons, as explained fully in Chapter 7. The most important of these reasons, however, is that unlike itemized deductions, deductions for A.G.I. need not exceed a minimum level before they are subtracted when computing taxable income.



### EXHIBIT 3-5

#### List of Deductions for Adjusted Gross Income

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Alimony and separate maintenance payments paid  
 Attorney fees and court costs related to unlawful discrimination cases  
 Certain deductions of life tenants and income beneficiaries of property  
 Certain portion of lump-sum distributions from pension plans subject to the special averaging convention  
 Certain required repayments of supplemental unemployment compensation benefits  
 Contributions to health savings accounts  
 Contributions to pension, profit sharing, and other qualified retirement plans on behalf of a self-employed individual  
 Contributions to the retirement plan of an electing Subchapter S corporation on behalf of an employee/shareholder  
 Deduction for domestic production activities  
 Deductions attributable to property held for the production of rents and royalties (reported on Schedule E)  
 Educator expenses  
 Individual retirement account contributions (within limits)  
 Losses from the sale or exchange of property  
 Moving expenses  
 One-half of any self-employment tax  
 Penalties for premature withdrawal of deposits from time savings accounts  
 Reforestation expenses  
 Reimbursed trade or business expenses of employees  
 State and local official's deductible expenses  
 Student loan interest  
 Trade or business deductions of self-employed individuals (including deductions claimed on Schedule C and unreimbursed expenses of qualified performing artists)  
 Tuition payments up to \$4,000 for some students

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**Itemized Deductions and the Standard Deduction.** Itemized deductions are all deductions other than the deductions for A.G.I. and the deduction for personal and dependency exemptions.<sup>31</sup> While deductions for A.G.I. are deductible without limitation, itemized deductions are deducted only if their total exceeds the taxpayer's *standard deduction*. For example, if T has total itemized deductions of \$3,900 and his standard deduction amount is \$5,450, he normally would claim the standard deduction in lieu of itemizing deductions. In contrast, if T's itemized deductions were \$6,000, he would no doubt elect to itemize in order to maximize his deductions.

The standard deduction was introduced along with the concept of adjusted gross income and deductions *for* and *from* A.G.I. as part of the overall plan to eliminate the need for every taxpayer to list or itemize certain deductions on his or her return. As suggested above, by allowing the taxpayer to claim some standard amount of deductions in lieu of itemizing each one, the administrative problem of verifying the millions of deductions that otherwise would have been claimed has been eliminated. The standard deduction also simplifies return preparation since most individuals no longer have to determine the amount of most of the deductions to which they are entitled. For this reason, the amount of the standard deduction is theoretically set at a level that equals or exceeds the average person's expenditures for those items qualifying as deductions from A.G.I. Consequently, the great majority of taxpayers claim the standard deduction in lieu of itemizing deductions.

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<sup>31</sup> § 63.

The amount of each taxpayer's standard deduction differs depending on his or her filing status.<sup>32</sup> The amounts for each filing status are adjusted annually for inflation. For 2007 and 2008, the amounts are shown below:

<i>Filing Status</i>	<i>Standard Deduction Amount</i>	
	<i>2008</i>	<i>2007</i>
Single . . . . .	\$ 5,450	\$ 5,350
Unmarried head of household . . . . .	8,000	7,850
Married persons filing a joint return (and surviving spouse) . . . . .	10,900	10,700
Married persons filing a separate return . . . . .	5,450	5,350

**Additional Standard Deduction for Elderly or Blind Taxpayers.** Congress has long extended some type of tax relief to the elderly and blind to take into account their special situations. Currently, an unmarried taxpayer who is either blind or age 65 at the close of the taxable year is allowed to increase his or her basic standard deduction by an additional \$1,350 (2008).<sup>33</sup> If an unmarried taxpayer is *both* blind and 65 or older, he or she is allowed to increase the standard deduction by \$2,700. If a taxpayer is married, he or she is allowed only \$1,050 (2008) for each status for a maximum increase on a joint return of \$4,200 (\$1,050 + \$1,050 + \$1,050 + \$1,050).

**Example 9.** In 2008, S, single, celebrated her sixty-fifth birthday. Instead of using the \$5,450 standard deduction amount allowed for single taxpayers for 2008, S will be allowed a standard deduction of \$6,800 (\$5,450 basic standard deduction + \$1,350 additional standard deduction) for 2008.

If S were married filing a joint return for 2008, the standard deduction amount allowed would be \$11,950 (\$10,900 + \$1,050). If both S and her husband were 65 or older, the standard deduction would be \$13,000 [\$10,900 standard deduction + (2 × \$1,050 additional standard deduction)].

Both age and blindness are determined at the close of the taxable year. Guidelines are provided for determining whether an individual is legally blind, and specific filing requirements must be met.<sup>34</sup> An individual is considered to have attained age 65 on the day *preceding* his or her sixty-fifth birthday.<sup>35</sup> Thus, if a taxpayer's sixty-fifth birthday is January 1, 2009, he or she is considered to be 65 on December 31, 2008.

**Limitations on Use of Standard Deductions.** Not all individuals are entitled to the full benefit of the standard deduction.<sup>36</sup> For example, a married person filing a separate return is not allowed a standard deduction if his or her spouse itemizes. This prevents a married couple from increasing their total deductions by having one spouse claim all of the itemized deductions and the other spouse claiming the standard deduction. Nonresident aliens are also denied use of the standard deduction. In addition, the standard deduction is limited for an individual who is claimed as a dependent on another taxpayer's return. This limitation is discussed in Chapter 4.

<sup>32</sup> § 63(c) contains the standard deduction amounts for 1988. The amounts for subsequent years are adjusted for inflation and announced by the IRS annually. Filing status is discussed in Chapter 4.

<sup>33</sup> § 63(f).

<sup>34</sup> §§ 151(d) and 151(d)(3). A taxpayer is legally blind if he or she cannot see better than 20/200 in the better eye with corrective lenses, or the taxpayer's field of vision is not more than 20 degrees. A statement prepared by a physician or optometrist must be attached to the return when a taxpayer is less than totally blind. Reg. § 1.151-1(d)(2).

<sup>35</sup> Reg. § 1.151-1(c)(2).

<sup>36</sup> See § 63(c)(6) for this exception and others.

**Itemized Deductions.** As explained above, itemized deductions simply are those deductions that are not deductible for A.G.I. The majority of itemized deductions are for selected personal, family and living expenses that Congress believed should be allowed for various policy reasons. These include medical expenses, state and local property, income and sales taxes, home mortgage interest, charitable contributions and casualty and theft losses. A partial list of itemized deductions is provided in Exhibit 3-6. In addition to these, a special subset of itemized deductions, so-called “miscellaneous itemized deductions” are allowed as discussed below.

*Miscellaneous Itemized Deductions.* Itemized deductions are also allowed for a group of other expenses referred to as *miscellaneous itemized deductions*. Miscellaneous itemized deductions include the deductions for unreimbursed employee business expenses (e.g., dues to professional organizations, subscriptions to professional journals, travel), tax return preparation fees and related costs, and certain investment expenses (e.g. safety deposit boxes, investment advice). The classification of an expense as a miscellaneous itemized deduction is extremely important because a limitation is imposed on their deduction. Only the portion of miscellaneous itemized deductions exceeding 2 percent of adjusted gross income is deductible. Congress imposed this limitation in hopes of simplifying the law. The 2 percent floor is intended to relieve taxpayers of the burden of recordkeeping (unless they expect to incur substantial expenditures) and relieve the IRS of the burden of auditing these expenditures.

**Example 10.** R, single, is employed as an architect for the firm of J&B Associates where he earned \$50,000. His itemized deductions for the year were interest on his home mortgage, \$5,000; charitable contributions, \$900; tax return preparation fee, \$300; and unreimbursed professional dues, \$800. R’s total itemized deductions are computed as follows:

Miscellaneous itemized deductions:	
Tax return preparation fee . . . . .	\$ 300
Professional dues . . . . .	800
	<hr/>
Total miscellaneous itemized deductions . . . . .	\$ 1,100
A.G.I. limitation (2% × \$50,000) . . . . .	(1,000)
	<hr/>
Total deductible miscellaneous itemized deductions . . . . .	\$ 100
Other itemized deductions: . . . . .	
Interest on home mortgage . . . . .	5,000
Charitable contributions . . . . .	900
	<hr/>
Total itemized deductions . . . . .	<u>\$ 6,000</u>

Because R’s itemized deductions of \$6,000 exceed the standard deduction for single persons, \$5,450 (2008), he will deduct the entire \$6,000. Note that only \$100 of R’s miscellaneous itemized deductions is deductible, whereas all of his other itemized deductions are deductible.

*Deduction Cutback Rule.* In search of more revenue, Congress imposed a limitation on the amount of itemized deductions that high-income taxpayers may deduct. Since 1990 taxpayers must reduce total itemized deductions otherwise allowable (*other than* medical expenses, casualty and theft losses, investment interest and certain gambling losses) by 1 percent (2 percent for 2006 and 2007, 3 percent for prior years) of their A.G.I. in excess

of \$159,950 (\$79,975 for married individuals filing separately).<sup>39</sup> However, this reduction cannot exceed 80 percent of the deductions. This 80 percent limit ensures that taxpayers subject to the cutback rule can deduct at least 20 percent of their so-called 1 percent deductions. As a result, a taxpayer's itemized deductions are never completely phased out.

**Example 11.** J and K are married and file a joint return for 2008. Their combined adjusted gross income is \$182,750 and they are entitled to itemized deductions of \$16,500 and exemption deductions of \$7,000. Due to the cutback rule, their deductible itemized deductions must be reduced (i.e., cut back) by \$228 [(\$182,750 - \$159,950 = \$22,800) × 1%], leaving \$16,272 (\$16,500 - \$228). J and K have taxable income calculated as follows:

Adjusted gross income .....	\$182,750
Minus: Deductible itemized deductions after cutback .....	- 16,272
Minus: Exemption deductions (\$3,500 × 2) .....	- 7,000
Equals: Taxable Income .....	<u>\$159,478</u>

The 1 percent cutback rule on itemized deductions should not be confused with the 2 percent limitation on miscellaneous itemized deductions discussed above. Miscellaneous

### EXHIBIT 3-6 Partial List of Itemized Deductions

#### **Not Subject to 1 Percent Cutback Rule**

Medical expenses (amount in excess of 7.5 percent of A.G.I.):  
 Prescription drugs and insulin  
 Medical insurance premiums  
 Fees of doctors, dentists, nurses, hospitals, etc.  
 Medical transportation  
 Hearing aids, dentures, eyeglasses, etc.  
 Investment interest (to extent of investment income)  
 Casualty and theft losses (amount in excess of 10 percent of A.G.I.)  
 Wagering losses (to the extent of wagering income)

#### **Subject to 1 Percent Cutback Rule**

Certain state, local, and foreign taxes:  
 State, local, and foreign income taxes  
 State, local, and foreign real property taxes  
 State and local personal property taxes  
 State and local sales taxes  
 Mortgage interest on personal residences (limited)  
 Mortgage insurance on personal residences  
 Charitable contributions (not to exceed 50 percent of A.G.I.)  
 Miscellaneous itemized deductions (amount in excess of 2 percent of A.G.I.):  
 Costs of preparation of tax returns  
 Fees and expenses related to tax planning and advice  
 Investment counseling and investment expenses  
 Certain unreimbursed employee business expenses (including travel and transportation, professional dues, subscriptions, continuing education, union dues, and special work clothing)

<sup>39</sup> Technically, § 68 provides a 3% cutback. However, for 2006–2007, the cutback was 2/3 of this amount or 2% and for 2008–2009 it is only 1/3 or 1%. For this reason, throughout the text this provision is referred to as the 1% cutback rule. Practitioners also refer to this rule as the phase-out or phase-down rule.

itemized deductions that exceed the 2 percent of A.G.I. threshold are still subject to the 1 percent cutback rule. The deduction cutback rule, which is scheduled to expire in 2010, is discussed in detail in Chapter 11.

**Exemptions.** Congress has always recognized the need to insulate from tax a certain amount of income required by the taxpayer to support himself and others. For this reason, every individual taxpayer is entitled to a basic deduction for himself and his dependents. This deduction is called an *exemption*. For 2008, an individual taxpayer is entitled to a deduction of \$3,500 for each *personal* and *dependency* exemption.<sup>40</sup> *Personal exemptions* are those allowed for the taxpayer. Generally, every taxpayer is entitled to claim a personal exemption for himself or herself. However, taxpayers *cannot* claim a personal exemption on their own return if they can be claimed as a dependent on another taxpayer's return.<sup>41</sup> If husband and wife file a joint return, they are treated as two taxpayers and are therefore entitled to claim two personal exemptions. *Dependency exemptions* may be claimed for qualifying individuals who are supported by the taxpayer.<sup>42</sup> In addition to the 1 percent cutback in itemized deductions, high-income taxpayers are required to reduce the amount of their total deduction for personal and dependency exemptions. All the special rules governing deductions for exemptions are discussed in detail in Chapter 4.

**Taxable Income and Tax Rates.** After all deductions have been identified, they are subtracted from gross income to arrive at taxable income. Taxable income is the tax base to which the tax rates are applied to determine the taxpayer's gross tax liability (i.e., the tax liability before any credits or prepayments).

The tax rate schedule to be used in computing the tax varies, depending on the nature of the taxable entity. For example, one set of tax rates applies to all regular corporations (see inside back cover of text). In contrast, individuals use one of four tax rate schedules (see inside front cover) depending on their filing status, of which there are four. These are:

1. Unmarried individuals (i.e., single) who are not surviving spouses or heads of household
2. Heads of household
3. Married individuals filing jointly and surviving spouses
4. Married individuals filing separately

These tax rate structures are all graduated with the rates of 10, 15, 25, 28, 33, and 35 percent. Although the rates in each schedule are identical, the degree of progressivity differs. For example, in 2008 the 28 percent marginal rate applies to single taxpayers when income exceeds \$78,850, but this rate does not apply to married individuals filing jointly until income exceeds \$131,450. The various filing statuses and rate schedules are discussed in Chapter 4.

<sup>40</sup> §151(d)(1). For 1989 the exemption was \$2,000. For years *after* 1989, the amount has been indexed for inflation.

<sup>41</sup> § 151(d)(2).

<sup>42</sup> § 152.

**Example 12.** H and W are married and file a joint return for 2008. They have adjusted gross income of \$151,000, two dependents, and itemized deductions of \$32,000. Their taxable income is \$105,000, computed as follows:

Adjusted gross income . . . . .		\$151,000
Minus: Itemized deductions . . . . .	\$32,000	
Personal exemptions (\$3,500 × 4) . . . . .	+ 14,000	- 46,000
Equals: Taxable income . . . . .		<u>\$ 105,000</u>

The tax for a married couple filing jointly on this amount computed using the rate schedules is \$18,937.50 as shown below.

Tax on \$65,100 . . . . .	\$ 8,962.50
Plus: Tax on excess at 25% [(\$105,000 – \$65,100 = \$39,900) × .25] . . . . .	9,975.00
Equals: Total tax . . . . .	<u>\$18,937.50</u>

**Credits.** Unlike a deduction, which reduces income in arriving at taxable income, a credit is a direct reduction in tax liability. Normally, when the credit exceeds a person’s total tax, the excess is not refunded—hence, these credits are referred to as *nonrefundable* credits. In some instances, however, the taxpayer is entitled to receive a payment for any excess credit. This type of credit is known as a *refundable* credit.

Credits have frequently been preferred by Congress and theoreticians because they affect all taxpayers equally. In contrast, the value of a deduction varies with the taxpayer’s marginal tax rate. However, credits often have complicated rules and limitations. A partial list of tax credits is included in Exhibit 3-7.

**EXHIBIT 3-7  
Partial List of Tax Credits**

Foreign tax credit	Credit for the elderly
Child tax credit	Credit for producing fuel from a nonconventional source
Earned income credit	Credit for increasing research activities
Child and dependent care credit	Welfare to work credit
Credit for adoption expenses	Work opportunity credit
Hope scholarship credit	Low income housing credit
Lifetime learning credit	Credit for rehabilitating certain buildings

**Prepayments.** Attempting to accelerate the collection of revenues for the war effort in 1943, Congress installed a “pay-as-you-go” system for certain taxes. Under this system, income taxes are paid in installments as the income is earned.

Prepayment, or advance payment, of the tax liability can be made in several ways. For individual taxpayers, the two most common forms of prepayment are Federal income taxes withheld from an employee’s salaries and wages and quarterly estimated tax payments made by the taxpayer. Certain corporate taxpayers must make quarterly estimated tax payments as well. Quarterly estimated tax payments are required for taxpayers who have not prepaid a specified level of their anticipated Federal income tax in any other way, and there are penalties for failure to make adequate estimated prepayments.

These prepayments serve two valuable purposes. As suggested above, prepayments allow the government to have earlier use of the tax proceeds. Secondly, prepayments reduce the uncertainty of collecting taxes since the government, by withholding at the source, gets the money before the taxpayer has a chance to put it to a different use. In effect, the government collects the tax while the taxpayer has the wherewithal (ability) to pay the tax.

**Other Taxes.** There are several types of other taxes that must be reported and paid with the regular Federal income tax. A partial list of these taxes is included in Exhibit 3-8. Two deserve special mention.

**EXHIBIT 3-8****Partial List of Other Taxes**


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Alternative minimum tax
Self-employment tax
Social security tax on tip income not reported to employer
Tax on premature withdrawal from an Individual Retirement Account
Tax from recapture of investment credit
Uncollected employee F.I.C.A. and R.R.T.A. tax on tips

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*Self-Employment Tax.* As explained in Chapter 1, self-employed individuals as well as general partners in partnerships are, like employees, required to pay FICA taxes (commonly known as self-employment taxes). Since the tax is paid on income from sole proprietorship and partnership businesses carried on by individual partners, it is convenient for the IRS to collect this tax along with the income tax on Form 1040. The individual calculates the tax on Schedule SE and claims the income tax deduction for one-half of the self-employment tax paid on page 1 of Form 1040.

*Alternative Minimum Tax.* In 1969 there was an outcry by the media and others that the rich did not pay their fair share of taxes. Indeed, the House Ways and Means Committee Report indicated that in 1964 over 1,100 returns with adjusted gross incomes over \$200,000 paid an average tax of 22 percent. Moreover, it reported that there were a significant number of cases where taxpayers with economic income of \$1 million or more paid an effective tax amounting to less than 5 percent of their income. As might be expected, faced with such facts Congress decided to take action. However, instead of risking the wrath of their constituents by simply repealing the various loopholes that enabled these taxpayers to avoid taxes, Congress elected to take a politically cautious approach: a direct tax on the loopholes. In effect, the taxpayer simply added up all of the loopholes and paid a flat tax on them. As a result, the minimum tax was born. The whole thrust of this new tax was to ensure that all individuals paid a minimum tax on their income. It currently applies to all taxpayers, individuals, corporations, and fiduciaries.

Over the years, the minimum tax evolved into a monster and was adorned with its current name, the alternative minimum tax (AMT). Despite the changes and increased complexity, it remains basically the same. The mathematical steps for computing the AMT are relatively simple:

	Regular taxable income
±	<u>Adjustments and preferences</u>
	Alternative minimum taxable income
–	<u>Exemption (subject to phase-out)</u>
	Tax base
×	<u>Rate</u>
	Tentative alternative minimum tax
–	<u>Regular tax</u>
	<u>Alternative minimum tax</u>

As the formula above illustrates, the taxpayer starts with taxable income and then adds certain income that is excluded for regular tax purposes and adds back certain deductions that are normally allowed. These modifications to regular taxable income are referred to as *preference items* and *adjustments*. In this regard, it is important to recognize that the AMT effectively functions as an entirely separate system with its own rules. For example, while most interest from state and local bonds is not taxable, such interest is taxable for AMT

purposes if the bonds are used to fund some private activity such as a downtown mall. Similarly, deductions that are usually allowed for regular tax purposes, such as exemptions, miscellaneous itemized deductions, and state and local taxes, are not allowed in computing the AMT. In effect, there are two rules for some items: one rule for regular tax purposes and another for AMT purposes. After taking into account all of the special adjustments required under this alternative system, the new result is called alternative minimum taxable income. This amount is then reduced by an allowable exemption to arrive at the tax base. In the waning moments of 2007, Congress raised the exemption amount, enabling an estimated 20 million taxpayers to avoid the tax. As of this writing, the exemptions for 2008 are not available. For 2007 the exemption amounts are \$66,250 (\$33,125 for those filing separately) for joint filers and \$44,350 for single and head-of-household taxpayers. The exemption is reduced by 25% for each dollar by which AMTI exceeds certain levels (e.g. \$150,000 for joint filers, \$112,000 for singles). A two-tier rate structure is then applied to the tax base (26 percent on the first \$175,000 and 28 percent on the excess). The product is referred to as the tentative AMT. This amount is compared to the regular tax, and the taxpayer pays the higher. Technically, the excess of the tentative AMT over the regular tax is the AMT, but the bottom line is that the taxpayer pays the higher amount.

**Example 13.** H and W are married with four children. For 2007, they filed a joint return, reporting gross income of \$400,000 and regular taxable income of \$180,000. Various adjustments required under the AMT were \$40,550. Using the 2007 exemption and 2007 regular tax rates, the couple must pay an AMT of \$5,311, computed as follows:

	Regular taxable income .....	\$180,000
±	<u>Adjustments</u> .....	<u>40,550</u>
	Alternative minimum taxable income .....	\$220,550
–	<u>Exemption [\$66,250 – \$17,637 (25% × (\$220,550 – \$150,000 = 70,550))]</u> ...	<u>(48,613)</u>
	Tax base .....	\$171,937
×	<u>Rate</u> .....	<u>× 26%</u>
	Tentative alternative minimum tax .....	\$ 44,704
–	<u>Regular tax (2007 rates)</u> .....	<u>(39,393)</u>
	Alternative minimum tax .....	<u>\$ 5,311</u>

Note that the AMT is only \$5,311, but the taxpayer must pay a total of \$44,704 (regular tax of \$39,393 + AMT of \$5,311).

There is no good rule of thumb as to when the AMT is triggered. For the vast majority of taxpayers it is simply not an issue. These individuals are not subject to the tax since they have low to moderate taxable incomes with few adjustments, causing them to fall below the exemption amounts. It is typically high-income taxpayers who have substantial adjustments, and other taxpayers who are successful in avoiding the regular tax, that fall prey to the AMT. Obviously the key lies in the nature of the adjustments. For now it is sufficient to say that beyond the few preferences and adjustments mentioned above there are several more such as those relating to depreciation, depletion, and stock options. Full coverage of the AMT is deferred until Chapter 13. Nevertheless, even at this early juncture it is important to recognize that the AMT exists and often alters what appears to be very favorable tax treatment for some items. More importantly, the net of the AMT has started catching far more taxpayers than Congress ever intended.



 **CHECK YOUR KNOWLEDGE**

**Review Question 1.** It's time for "Tax Jeopardy." Here are the answers; supply the questions.

- a. The type of expenses all taxpayers can deduct.

What are business expenses? Around tax time, there is a single question that can be heard reverberating across the land: What can I deduct? The answer is business expenses. All taxpayers are allowed to deduct the ordinary and necessary expenses incurred in carrying on a trade or business. The vast majority of all deductions fall into this category. Note also that this rule allows the deduction of employee business expenses. In addition, taxpayers are entitled to deduct expenses related to investment activities (e.g., investment advice or repairs and maintenance on rental property).

- b. The type of expenses taxpayers normally cannot deduct.

What are personal expenses? Although business expenses are deductible, personal expenses normally are not deductible. For example, the costs of food, shelter, clothing, and personal hygiene cannot be deducted. However, there are some exceptions.

- c. Five notable exceptions to the rule that personal expenses are not deductible. (Hint: they are all reported on Schedule A of Form 1040, found in Appendix B of this book.) What are the following?

1. Medical expenses (but only if they exceed 7.5 percent of A.G.I.)
2. Taxes
  - ▶ State and local income or sales taxes but not both
  - ▶ Real estate taxes
  - ▶ Personal property taxes
3. Interest
  - ▶ Home mortgage interest
  - ▶ Student loan interest (maximum of \$2,500)
  - ▶ Investment interest (but only to the extent of investment income)
4. Charitable contributions
5. Casualty and theft losses

- d. The type of business expenses that are deductible as itemized deductions.

What are unreimbursed employee business expenses? For example, if an employee pays for a business meal and his or her employer reimburses the cost of the meal, the expense is deductible in arriving at A.G.I. if the employer includes the reimbursement in the employee's gross income. However, when the expense is not reimbursed, it is allowable only as an itemized deduction. Other common examples of employee business expenses that are frequently deductible as itemized deductions are unreimbursed professional expenses (e.g., subscriptions, dues, license fees), union dues, and special clothing (when deductible).

- e. The only type of tax-exempt income reported on the return. (Hint: see page 1 of Form 1040.)

What is tax-exempt interest income (reported on line 8b of page 1 of Form 1040)?

- f. Something the individual tax formula has that the corporate tax formula does not have.

What is adjusted gross income? What is the standard deduction? What are exemptions?

- g. A benefit received by the elderly and blind.

What is the increased standard deduction for taxpayers who are age 65 or over or who are blind?

- h. Deductions that are deductible for individuals even if the taxpayer does not itemize deductions.

What are deductions for A.G.I.? In addition, deductions for exemptions are permitted regardless of whether the taxpayer itemizes. However, exemption deductions are not deductions for A.G.I.

- i. A deduction that may be claimed by virtually all individual taxpayers.

What is the exemption deduction, or the standard deduction? As explained above, however, certain persons are not entitled to a standard deduction. For example, a married person filing a separate return must itemize if his or her spouse does. In addition, as fully explained in Chapter 4, taxpayers cannot claim a personal exemption on their own return if they can be claimed as a dependent on another taxpayer's return.

- j. A loss from this activity may not be deductible.

What are losses from rental real estate and any other activity in which the taxpayer does not materially participate? Before losses from an activity can be deducted (e.g., a loss that passes through from a partnership or a loss from renting a duplex), they must run through the gauntlet of tests prescribed by the passive loss rules covered in Chapter 12.

- k. A separate tax intended to close loopholes.

What is the alternative minimum tax?

**Review Question 2.** Mabel, single, just reached the age of 65 and was somewhat relieved because she remembered hearing of the tax she would save as a 65-year-old senior. What tax savings can Mabel expect?

*Perhaps none.* The only benefit for being 65 years old is an additional standard deduction (\$1,350 for unmarried taxpayers for 2008). If Mabel itemizes her deductions rather than claiming the standard deduction, she receives no benefit. If she does not itemize, her standard deduction for 2008 is \$6,800 (the basic standard deduction of \$5,450 plus the extra \$1,350).

**Review Question 3.** Dick and Jane just learned that they are expecting their first child. What tax benefits can they expect after Junior is born?

*Many.* First are the dependency exemption deduction (\$3,500 for 2008) and the child tax credit (\$1,000 for 2008). In addition, Dick and Jane can look forward to a credit for any job-related child care expenses that they pay.

**Review Question 4.** Are deductions of a sole proprietor deductible *for* or *from* adjusted gross income? (Hint: see lines 23 through 27 on Page 1 of Form 1040 and Schedule C in Appendix B of this book.)

The trade or business expenses of a sole proprietor or someone who is self-employed are deductible for A.G.I. Note that these are not shown as one of the deductions for A.G.I. on Page 1 of Form 1040. Instead, they are netted against the sole proprietor's income on Schedule C, and this net profit is included in the taxpayer's total income reported on Page 1 of Form 1040.

**Review Question 5.** A sole proprietor's income generally is subject to self-employment tax. Is the deduction for one-half of the self-employment tax deducted for or from adjusted gross income? Is it reported on Schedule C or Form 1040?

This is a deduction for A.G.I. and is reported as a deduction for A.G.I. on page 1 of Form 1040 (and not Schedule C).

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## INTRODUCTION TO PROPERTY TRANSACTIONS

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The tax provisions governing property transactions play a very important part in our tax system. Obviously, their major purpose is to provide for the tax treatment of transactions involving a sale, exchange, or other disposition of property. However, the basic rules covering property transactions can also impact the tax liability in other indirect ways. For example, the amount of the deduction granted for a charitable contribution of property may depend on what the tax result would have been had the property been sold rather than donated. As this example suggests, a basic knowledge of the tax treatment of property transactions is helpful in understanding other facets of taxation. For this reason, an overview of property transactions is presented here. Chapters 14, 15, 16, and 17 examine this subject in detail.

The tax consequences of any property transaction may be determined by answering the following three questions:

1. What is the amount of gain or loss *realized*?
2. How much of this gain or loss is *recognized*?
3. What is the *character* of the gain or loss recognized?

Each of these questions is considered in the following sections.

### GAIN OR LOSS REALIZED

A realized gain or loss results when a taxpayer sells, exchanges, or otherwise disposes of property. In the simple case where property is purchased for cash and later sold for cash, the gain or loss realized is the difference between the purchase price and the sale price, adjusted for transaction costs. The determination of the realized gain or loss is more complicated when property other than cash is received, when liabilities are involved, or when the property was not acquired by purchase. As a result, a more formal

method for computing the gain or loss realized is used. The formulas for computing the gain or loss realized are shown in Exhibits 3-9, 3-10, and 3-11. As these exhibits illustrate, the gain or loss realized in a sale or other disposition is the difference between the *amount realized* and the *adjusted basis* in the property given up.

**EXHIBIT 3-9****Computation of Amount Realized**


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	Amount of money received (net of money paid)
<b>Add:</b>	Fair market value of any other property received
	Liabilities discharged in the transaction (net of liabilities assumed)
<b>Less:</b>	Selling costs
Equals:	<b>Amount realized</b>

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**EXHIBIT 3-10****Determination of Adjusted Basis**


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	<b>Basis at time of acquisition:</b>
	For purchased property, use cost
	Special rules apply for the following methods of acquisition:
	Gift
	Bequest or inheritance
	Nontaxable transactions
<b>Add:</b>	Capital improvements, additions
<b>Less:</b>	Depreciation and other capital recoveries
Equals:	<b>Adjusted basis in property</b>

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**EXHIBIT 3-11****Computation of Gain or Loss Realized**


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	Amount realized from sale or other disposition
<b>Less:</b>	Adjusted basis in property (other than money) given up
Equals:	<b>Gain or loss realized</b>

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**Amount Realized.** The amount realized is a measure of the economic value received for the property given up. It generally includes the amount of any money plus the fair market value of any other property received, reduced by any selling costs.<sup>43</sup> In determining the amount realized, consideration must also be given to any liabilities from which the taxpayer is relieved or which the taxpayer incurs. From an economic standpoint, when a taxpayer is relieved of debt, it is the same as if cash were received and used to pay off the debt. In contrast, when a taxpayer assumes a debt (or receives property that is subject to a debt), it is the same as if the taxpayer gave up cash. Consequently, when a sale or exchange involves the transfer of liabilities, the amount realized is increased for the net amount of any liabilities discharged or decreased for the net amount of any liabilities incurred.

**Adjusted Basis.** The adjusted basis of property is similar to the concept of “book value” used for accounting purposes. It is the taxpayer’s basis at the time of acquisition—usually cost—increased or decreased by certain required modifications.<sup>44</sup>

<sup>43</sup> § 1001(b).

<sup>44</sup> §§ 1011 through 1016.

The taxpayer's basis at the time of acquisition, or original basis, depends on how the property was acquired. For purchased property, the taxpayer's original basis is the property's cost. When property is acquired by gift, inheritance, or some form of tax-deferred exchange, special rules are applied in determining the original basis. Once the original basis is ascertained, it must be increased for any capital improvements and reduced by depreciation and other capital recoveries. The adjusted basis represents the amount of investment that can be recovered free of tax.

**Example 14.** This year, L sold 100 shares of M Corporation stock for \$41 per share for a total of \$4,100. He received a settlement check of \$4,000, net of the broker's sales commission of \$100. L had purchased the shares several years ago for \$12 per share for a total of \$1,200. In addition, he paid a sales commission of \$30. L's realized gain is \$2,770, computed as follows:

Amount realized (\$4,100 – \$100) .....	\$4,000
Less: Adjusted basis (\$1,200 + \$30) .....	<u>– 1,230</u>
Gain realized .....	<u><u>\$2,770</u></u>

**Example 15.** During the year, T sold his office building. As part of the sales agreement, T received \$20,000 cash, and the buyer assumed the mortgage on the building of \$180,000. T also paid a real estate brokerage commission of \$7,000. T originally acquired the building for \$300,000 in 1990, but since that time had deducted depreciation of \$230,000 and had made permanent improvements of \$10,000. T's gain realized is computed as follows:

Amount realized:			
Cash received .....	\$ 20,000		
Liability assumed by buyer .....	+180,000		
Selling expenses .....	<u>–7,000</u>		
			\$193,000
Less: Adjusted basis			
Original cost .....	\$300,000		
Depreciation claimed .....	–230,000		
Capital improvements .....	<u>+10,000</u>		
			<u>– 80,000</u>
Gain realized .....			<u><u>\$113,000</u></u>

### GAIN OR LOSS RECOGNIZED

The gain or loss *realized* is a measure of the economic gain or loss that results from the ownership and sale or disposition of property. However, due to special provisions in the tax law, the gain or loss reported for tax purposes may be different from the realized gain or loss. The amount of gain or loss that affects the tax liability is called the *recognized* gain or loss.

Normally, all realized gains are recognized and included as part of the taxpayer's total income. In some instances, however, the gain recognition may be deferred or postponed until a subsequent transaction occurs.

**Example 16.** M exchanged some land in Oregon costing \$10,000 for land in Florida valued at \$50,000. Although M has realized gain of \$40,000 (\$50,000 – \$10,000), assuming certain requirements are satisfied, this gain will not be recognized,

but rather postponed. This rule was adopted because the taxpayer's economic position after the transaction is essentially unchanged. Moreover, the taxpayer has not received any cash or wherewithal with which she could pay any tax that might result.

Chapter 15 contains a discussion of the more common types of property transactions in which the recognition of an individual taxpayer's realized gains are postponed.

Any loss realized must be specifically allowed as a deduction before it is recognized. Individuals generally are allowed to deduct *three* types of losses. These are:

1. Losses incurred in a trade or business (e.g., an uncollectible receivable of an accrual basis taxpayer)
2. Losses incurred in an activity engaged in for profit (e.g., sale of investment property such as stock at a loss)
3. Casualty and theft losses

Losses in the first two categories generally are deductions for adjusted gross income. Casualty and theft losses from property used in an individual's trade, business, or income-producing activity also are allowed as deductions for adjusted gross income. However, casualty and theft losses from personal use property are classified as itemized deductions and are deductible only to the extent they exceed \$100 per casualty or theft and other specific limitations. Other than casualty and theft losses, all other losses from dispositions of personal use assets are *not* deductible. For example, if a taxpayer sold his personal residence for a loss, the loss would not be deductible. The rules governing the deductibility of losses in the first three categories are covered in Chapter 10. The special rules governing the deduction of "capital" losses are introduced below and covered in greater detail in Chapter 16.

### CHARACTER OF THE GAIN OR LOSS

From 1913 through 1921, all includible income was taxed in the same manner. Since 1921, however, Congress has provided special tax treatment for "capital" gains or losses. As a result, in determining the tax consequences of a property transaction, consideration must be given to the character or nature of the gain or loss—that is, whether the gain or loss should be classified as a *capital* gain or loss or an *ordinary* gain or loss. Any *recognized* gain or loss must be characterized as either an ordinary or a capital gain or loss.

**Capital Gains and Losses.** Although capital gains and losses arise in numerous ways, they normally result from the sale or exchange of a *capital asset*. Any gain or loss due to the sale or exchange of a capital asset is considered a capital gain or loss.

Capital assets are defined in § 1221 of the Code as being anything *other* than the following:

1. Inventory, or other property held primarily for sale to customers in the ordinary course of a trade or business
2. Depreciable property or real property used in a trade or business of the taxpayer
3. Trade accounts or notes receivable
4. Certain copyrights, literary, musical, or artistic compositions, and letters or memoranda held by the person whose personal efforts created them, and certain specified other holders of these types of property
5. U.S. government publications acquired other than by purchase at the price at which they are sold to the general public

The term *capital assets*, therefore, includes most passive investments (e.g., stocks and bonds) and most personal use assets of a taxpayer. However, property used in a trade or business is not a capital asset but is subject to special tax treatment, as discussed later in this chapter.

**Treatment of Capital Gains.** Except for a short period between 1913 and 1922, the tax law consistently has taxed gains from the sale of certain “capital assets” at rates that are substantially lower than those that apply to other income. Most recently, the special advantage is justified on the grounds that it encourages greater investment and savings. Regardless of the rationale, the hard fact is that the rules necessary to carry out the objective create an incredible layer of complexity to the tax laws. To illustrate, simply consider that capital gains qualifying for special treatment could now be taxed at one of five different rates (28%, 25%, 15%, 10%, or 0%).

*Holding Period.* The exact treatment of a capital gain or loss depends primarily on how long the taxpayer held the asset or what is technically referred to as the taxpayer’s *holding period*. The holding period is a critical element in determining which of the rates will apply. As might be expected, the longer the holding period is, the lower the applicable tax rate will be. A *short-term* gain or loss is one resulting from the sale or disposition of an asset held *one year or less*. A *long-term* gain or loss occurs when an asset is held for *more than one year*. However, after this initial classification, individuals must subdivide the long-term group into additional subgroups: (1) the 28% group for long-term capital gains resulting from the sales of *collectibles* (e.g., antiques, coins, stamps) and *qualified small business stock* (note that only 50% of this gain is taxed if the holding period exceeds 60 months, making the effective tax rate 14%); (2) the 25% group for long-term capital gains (and only gains) from the sale of depreciable real estate (e.g., office buildings, warehouses, apartment buildings) held for more than one year but only to the extent of the depreciation claimed on such property; and (3) the 15% group for other (most) long-term capital gains.

The effect of the new rules is to require taxpayers to assign their capital gains and losses into one of four different groups and net the amounts to determine the net gain or loss in each group as shown below.

Holding period (months)	<i>Short-term</i>	<i>Long-term</i>		
	≤ 12 Ordinary	Collectibles > 12 & § 1202 28%	Realty > 12 25%	> 12 15%
Gains	\$xx,xxx	\$x,xxx	Gains only	\$xx,xxx
Losses	(xxx)	(x,xxx)	—	(x,xxx)
Net gain or loss	????	????	Gain only	????

As a practical matter, the capital gains of most individuals arise from the sales of stocks and bonds and mutual fund transactions. Rarely do individuals have gains from collectibles, § 1202, stock or depreciable realty. Consequently, for most individuals, the classification and netting process is much easier than it might appear.

**Applicable Capital Gains Rates.** Generalizations about the treatment of capital gains and losses are difficult because the actual treatment can be determined only after the various groups (i.e., the four groups above) are combined, or netted, to determine the overall net gain or loss during the year. The details of this netting process are quite complex and left to Chapter 16. Suffice it to say here that the treatment of the net gains of each group—*before any netting between groups*—can be summarized as follows:

1. A net short-term capital gain (NSTCG) generally receives no special treatment and is taxed as ordinary income at the taxpayer’s regular tax rate (up to 35%).
2. A net 28% capital gain (N28CG) is taxed at a maximum rate of 28%.

3. A net 25% gain (N25CG) from dispositions of realty is taxed at a maximum rate of 25% (generally only to the extent of any depreciation claimed). The balance of any gain is part of the 15% group.
4. A net 15% gain (N15CG) is taxed at a maximum rate of 15%. However, if the taxpayer's tax bracket (determined by including the net 15% gain) is 15% or less, the net gain in this group is taxed at a rate of 0%.

In applying these rules, it should be emphasized that they operate to set only the maximum rate at which the particular type of gain will be taxed. If the taxpayer's tax using the regular rates would be lower, the regular rates are used. For example, if the taxpayer is in the 15% tax bracket and has a 28% gain, the 15% rate would apply instead of the 28% rate.

**Example 17.** During the year, T, who is in the 35% tax bracket, reported the following capital gains and losses.

	<u>Short-term</u>	<u>Long-term</u>	
		<u>28%</u>	<u>15%</u>
Gains .....	\$10,000	\$4,000	\$10,000
Losses .....	(4,000)	—	(3,000)
	<u>\$ 6,000</u>	<u>\$4,000</u>	<u>\$ 7,000</u>

In this case, T has a NSTCG of \$6,000, a N28CG of \$4,000, and a N15CG of \$7,000. As explained in Chapter 16, no further netting of these transactions occurs. T's NSTCG of \$6,000 receives no special treatment and is taxed as ordinary income. T's N28CG is taxed at 28% while his N15CG is taxed at 15%.

**Dividends Taxed at Capital Gain Rates.** Beginning in 2003, most dividends received are taxed at the same rate that historically has been reserved for long-term capital gains rates.<sup>45</sup> Currently, the rate is 15% and 0% for dividends that would otherwise be taxed at an ordinary rate of 15% or lower. The qualifying dividend is not subject to the capital gain and loss netting process. As a result, the dividends are subject to capital gains treatment regardless of whether the taxpayer has other capital gains or losses. The details related to calculating the tax on these dividends are presented in Chapter 16.

**Example 18.** During 2007, S, single, sold stock he had held for several years. He sold 100 shares of L for a \$500 long-term capital loss and 200 shares of G for a \$3,200 long-term capital gain. S also received qualified dividends of \$370 for the year. S is single and has no dependents. Assume her taxable income including the above transactions is \$81,920. The following calculations demonstrate the application of the favorable 15 percent capital gains rate.

Gain on Evergreen Solar .....	\$3,200
Loss on Gateway .....	(500)
Net capital gain .....	\$2,700
Dividend income .....	370
Amount subject to 15% capital gains rate .....	\$3,070
S's taxable income is taxed as follows:	
Amount subject to 15% capital gains rate .....	\$3,070
Amount treated as ordinary income	
(\$81,920 - \$3,070) .....	\$78,850

<sup>45</sup> § 1(h)(11).



S's tax is calculated as follows:

Tax on ordinary income of \$78,850 (see inside front cover) .....	\$16,056
Tax on gains and dividends at 15% (\$3,070 × 15%) .....	461
Total tax .....	<u>\$16,517</u>

**Treatment of Capital Losses.** While capital gains receive favorable treatment, such is not the case with capital losses. As can be seen in *Example 17* above, capital losses are first netted with capital gains within the same group. A net capital loss from a particular group can then be combined with net capital gains from the other groups. As a general rule, the long-term groups are netted together before considering any short-term items. If after netting all of the groups together, the taxpayer has an overall net capital loss, the loss is deductible up to an annual limit of \$3,000. The deductible capital loss is a deduction for adjusted gross income. Any losses in excess of the annual \$3,000 limitation are carried forward to the following year where they are treated as if they occurred in such year. In effect, an unused capital loss can be carried over for an indefinite period.

**Example 19.** During the year, B reported the following capital gains and losses.

		<u>Long-term</u>	
	<u>Short-term</u>	<u>28%</u>	<u>15%</u>
Gains .....	\$10,000	\$3,000	\$5,000
Losses .....	<u>(18,000)</u>	<u>(4,000)</u>	<u>(3,000)</u>
	<u>(\$8,000)</u>	<u>(\$1,000)</u>	<u>\$2,000</u>

B's only other taxable income included his salary of \$50,000. He had no other deductions for A.G.I. After netting all of his gains and losses, B has a net capital loss of \$7,000. T may deduct only \$3,000 of the net capital loss in determining his A.G.I. Therefore, his A.G.I. is \$47,000 (\$50,000 – \$3,000). The unused capital loss of \$4,000 (\$7,000 – \$3,000) is carried forward to future years when it is treated as if it arose in the subsequent year. In such case, the loss can be used against other capital gains or ordinary income just as it was this year.

Details of capital gain and loss treatment and the capital loss carryover rules are discussed in Chapter 16.

**Corporate Taxpayers.** The taxation of capital gains for corporate taxpayers differs somewhat from that for individuals. Most important, the capital gains of a corporation receive no special treatment but are taxed as ordinary income. In addition, the capital losses of a corporation can never offset ordinary income but can be carried back three and forward five years to offset other capital gains. There are a number of other differences which are considered in a full discussion of a corporation's capital gains and losses in Chapter 19.

## TRADE OR BUSINESS PROPERTY

Depreciable property and real property used in a trade or business are not capital assets, but are subject to several special provisions. Nevertheless, gain on the sale of these assets may ultimately be treated as capital gain while losses may be treated as ordinary losses. These rules are exceedingly complex and considered in Chapter 17.

 **CHECK YOUR KNOWLEDGE**

Try the following true-false questions.

**Review Question 1.** An individual always receives preferential treatment for his or her capital gains.

*False.* An individual can receive special treatment only for long-term capital gains. Short-term capital gains are treated just like ordinary income.

**Review Question 2.** J is interested in the stock market. This year she realized a \$1,000 short-term capital gain and an \$8,000 capital loss from stock she held for two years. She will report a \$1,000 short-term capital gain and carry over the \$8,000 long-term capital loss.

*False.* She first nets the short-term gain of \$1,000 against her \$8,000 15% loss, resulting in an overall long-term capital loss of \$7,000. She may deduct \$3,000 of this loss as a deduction for A.G.I. The remaining loss is carried over to the following year, when it will be treated as if she had realized a long-term (28%) capital loss of \$4,000.

**Review Question 3.** K makes \$300,000 a year and plays the stock market. So far this year she has realized a 15% capital gain of \$3,000. It is now December 31. Should K sell stock and recognize a \$3,000 15% loss?

Who knows! If she recognizes a \$3,000 loss, the loss is offset against the gain and therefore reduces income that would have been taxed at a 15 percent rate. This would produce a tax benefit from the loss of only \$450 ( $\$3,000 \times 15\%$ ). If she waits and uses the loss against ordinary income, it will produce a tax benefit of \$1,050 ( $35\% \times \$3,000$ ), or \$600 ( $\$1,050 - \$450$ ) more. However, if she postpones the loss until some subsequent year hoping to use it to offset income taxed at a higher rate, she will lose the time value of the \$450.

**Review Question 4.** A corporation receives no special treatment for its long-term capital gains.

*True.* The capital gains of a corporation are treated in the same manner as ordinary income.

**Review Question 5.** John Doe is the typical American taxpayer. He is married, has a dog and two kids. He also owns two cars: a brand new Ford and a 1996 Chevrolet. He bought the Ford for \$17,000 and the Chevy for \$10,000. Both of the cars were used for personal purposes. This year John and his family moved to New York and decided they did not need the cars, so he sold them. He sold the Chevy for only \$3,000. The story on the Ford was different. The Ford happened to be a Mustang convertible, and because Mustangs were in demand and were on back order, a car nut was willing to give him \$19,000, a \$2,000 premium for not having to wait. How will these sales affect John's taxable income? Explain whether the taxpayer has a gain or loss, its character, and in the case of a loss whether it is deductible for or from A.G.I.

John reports a capital gain of \$2,000. The first step is to determine John's gain or loss realized. In this case, the determination is simple. On the sale of the Chevy, John realized a loss of \$7,000 ( $\$3,000 - \$10,000$ ), and on the sale of the Mustang he realized a gain of \$2,000 ( $\$19,000 - \$17,000$ ). The second step is to determine whether he recognizes the gain and loss realized. John must recognize the gain. As a general rule, all income is taxable unless the taxpayer can point to a specific provision that specifically exempts the income from tax. In this case, there is no exclusion. On the other hand, the \$7,000 loss is not deductible. Although all income is normally taxable, only those items specifically authorized are deductible. Only three types of losses are deductible: (1) losses incurred in

carrying on a trade or business; (2) losses incurred in an activity engaged in for profit (e.g., investment losses); and (3) casualty and theft losses. In this case, the loss on the sale of the Chevy is purely personal, and therefore no deduction is allowed. Thus John is not allowed to net the loss against the gain but must report only the gain of \$2,000. While this may seem like a surprising result, understand that tax is a one-way street: as a general rule, all income is taxable and only those expenses and losses specifically allowed are deductible. The final step is determining the character of the gain, that is, whether the gain is capital gain or ordinary income. In order for a taxpayer to have a capital gain, there must be a sale or exchange of a capital asset. The Code defines a capital asset as essentially everything but inventory and real or depreciable property used in a trade or business. In this case, the car is not used in business and it does not represent inventory, so it is a capital asset. As a result, John reports a capital gain of \$2,000.

**Review Question 6.** Indicate whether the following assets are capital assets.

- a. 2,000 boxes of Frosted Flakes held by a grocery store
- b. A crane used in the taxpayer's bungee-jumping business
- c. A warehouse owned by Wal-Mart
- d. IBM stock held for investment
- e. The personal residence of Jane Doe

The Code generally defines a capital asset as essentially everything but inventory, business receivables, and real or depreciable property used in a trade or business. Based on this definition, the Frosted Flakes are not a capital asset since they are held as inventory by the grocery; the crane is not a capital asset since it is depreciable property used in a business; and the warehouse is not a capital asset since it is real property used in a business. The personal residence and IBM stock are both capital assets since they are neither inventory nor property used in a trade or business.

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## TAX PLANNING CONSIDERATIONS

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### CHOICE OF BUSINESS FORM

One of the major decisions confronting a business from a tax perspective concerns selecting the form in which it conducts its operations. A taxpayer could choose to operate a business as a sole proprietorship, a partnership, a limited liability company, an S corporation, or a regular C corporation. Each of these entities has its own tax characteristics that make it more or less suitable for a particular situation. The following discussion highlights a number of the basic factors that should be considered.

Perhaps the most important consideration in choosing a business form is the outlook for the business. A business that expects losses will typically opt for a business form different from the one that expects profits. A key advantage of a conduit entity (i.e., partnership or S corporation) applies in years in which a business suffers losses. Like income, losses flow through to the owners of the entity and generally can be used to offset other income at the individual level. In contrast, losses suffered by a regular C corporation are bottled up inside the corporate entity and can benefit only the corporation. Losses of a regular corporation generally are carried back two years and carried forward 20 years to offset income that the corporation has in prior or subsequent years.

A profitable business may also benefit from choosing the proper form of organization. To illustrate, consider a business that is generating taxable income of \$1 million per year. If the taxpayer conducts the business as a sole proprietorship or through one of the conduit entities, the top tax rate applied to the income is 35 percent. Similarly, if a C corporation

is used to operate the business, the top rate is 35 percent. However, for most corporations—those with taxable incomes not exceeding \$10 million—the top rate is 34 percent. Moreover, tax savings may also be generated at lower levels of income. This possibility can be seen in the tax rate schedules for corporations and individuals. A quick comparison reveals that the first \$50,000 of income of a corporate taxpayer is taxed at a 15 percent rate, whereas married taxpayers filing jointly receive the benefits of a 15 percent (or lower) rate on a maximum of \$65,100 (for 2008). Obviously, the tax-wise individual might try to structure the activities so that the best of both worlds could be obtained. Consider a business that produces taxable income of \$90,000. If a corporation is used, the company could pay a deductible salary of \$50,000 to the owner (assuming it is a reasonable amount), leaving \$40,000 of taxable income in the corporation. By so doing, the maximum tax rate paid on the income would be 15 percent. Had the business been operated as a sole proprietorship or an S corporation, \$24,900, the amount of taxable income in excess of \$65,100, would have been taxed at a 25 percent rate (married filing jointly) or 10 percentage points higher. This may seem appealing, but it is a very simplistic analysis and leaves vital elements out of the equation. For example, this scheme completely ignores the problem of double taxation; it assumes that the taxpayer will be able to withdraw the \$34,000 (\$40,000 – \$6,000 corporate income tax) left in the corporation at a later time in a deductible fashion so as to avoid the second tax. Unfortunately, doing so is not as easy as it may appear, and this plan as well as any other requires careful analysis. Suffice it to say here, however, that careful planning at the outset of a new business can save the taxpayer substantial taxes in the future.

A major disadvantage of partnerships and S corporations concerns the treatment of certain fringe benefits. As explained in Chapter 6, the Code contains a host of fringe benefits that generally are deductible by the employer and nontaxable to the employee. For example, a corporation is entitled to deduct the costs of group-term life insurance provided to an employee, and the benefit (i.e., the payment of the premiums) is not treated as taxable compensation to the employee but is tax-free. Note that if the employee purchases the insurance directly, it is purchased with compensation that has been previously taxed. As a result, the employee acquires the benefit with after-tax dollars. The favorable tax treatment of fringe benefits is generally available only to employees of a business. Unfortunately, partners and shareholders in S corporations who work in the business are not considered employees for this purpose and consequently cannot obtain many of the tax-favored fringe benefits. In contrast, shareholders in regular C corporations who work in the business are treated as employees and are therefore able to take advantage of the various benefits. Consideration should also be given to payroll and self-employment taxes.

### ITEMIZED DEDUCTIONS VS. STANDARD DEDUCTION

A typical complaint of many taxpayers is that they have insufficient deductions to itemize and therefore cannot benefit from any deductions they have in a particular year. Nevertheless, with a little planning, not all of those deductions will be wasted. Taxpayers in this situation should attempt to bunch all their itemized deductions into one year. By so doing, they may itemize one year and claim the standard deduction the next. By alternating each year, total deductions over the two-year period are increased. This could be accomplished simply by postponing or accelerating the payment of expenses. Cash basis taxpayers have this flexibility because they are entitled to deduct expenses when paid.

**Example 20.** Last year, X, a widow age 61, made the final payment on her home mortgage. As a result, she no longer has the interest deductions that in the past enabled her to itemize. In fact, the only deductible expenses she anticipates are property taxes on the house and charitable contributions to her church. However, these expenses together do not exceed the standard deduction as her estimates below show.

	<u>2008</u>	<u>2007</u>
Property taxes .....	\$1,400	\$1,400
Charitable contributions .....	<u>3,700</u>	<u>3,700</u>
Total .....	<u>\$5,100</u>	<u>\$5,100</u>

If the pattern above continues, X will not benefit from any of the itemized deductions since they do not exceed the standard deduction for single taxpayers, \$5,450. In short, she would obtain a total of \$10,900 ( $\$5,450 \times 2$ ) of deductions over the two-year period, assuming the standard deduction does not change. Note, however, what would happen if X simply shifted the payment of the charitable contributions from one year to the other by paying it either earlier or later. In such case, total itemized deductions in one year would be \$8,800 ( $\$5,100 + \$3,700$ ) and she could itemize, while in the other year she could claim the standard deduction. As a result, she would obtain total deductions over the two-year period of \$14,250 ( $\$8,800 + \$5,450$ ), or \$3,550 more than if she merely claimed the standard deduction.

### EMPLOYEE BUSINESS EXPENSES

Most employee business expenses are typically paid by the employer, either through direct payment or reimbursement. As such, the expenses are deductible by the employer. In the case of reimbursements, the employee has equal amounts of income and deduction if the reimbursement equals the expense. The net effect on adjusted gross income is zero.

If an employer requires employees to incur some business expenses, the employee can claim them only to the extent he or she itemizes and has miscellaneous itemized deductions in excess of 2 percent of A.G.I. As a result, the employee may receive little or no tax benefit from the expenses.

In reviewing the employee's compensation package, employers might consider changing their reimbursement policies. If an employer adopts more generous reimbursement policies in lieu of compensation increases, the employees may benefit.

**Example 21.** E is an employee with gross income of \$20,000. She typically has annual employee business expenses of \$750 that are not reimbursed. Since E does not itemize, she derives no tax benefit from the expenses.

If, instead of the above arrangement, E received a salary of \$19,250 and the \$750 were reimbursed, she would be in the same economic position before tax. However, she would pay \$113 ( $\$750 \times 15\%$  marginal tax on her salary) less in Federal income taxes.

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## PROBLEM MATERIALS

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### DISCUSSION QUESTIONS

- 3-1 *Taxable Entities.* List the classes of taxable entities under the Federal income tax. Identify at least one type of entity that is not subject to the tax.
- 3-2 *Double Taxation.* It has been stated that corporate earnings are subject to double taxation by the Federal government. Elaborate.
- 3-3 *Fiduciary.* In some regards, the fiduciary is a conduit for Federal income tax purposes. Explain.

- 3-4** *Partnership and S Corporation Returns.* The partnership and S corporation tax returns are often referred to as information returns only. Explain.
- 3-5** *Income from Partnerships.* Y is a general partner in the XYZ Partnership. For the current calendar year, Y's share of profits includes his guaranteed compensation of \$55,000 and his share of remaining profits, which is \$22,000. What is the proper income tax and payroll tax (F.I.C.A. or self-employment tax) treatment of each of the following to Y for the current calendar year?
- The guaranteed compensation of \$50,000
  - The remaining income share of \$22,000
- 3-6** *Income from S Corporations.* K is the president and chief executive officer of KL, Inc., an S corporation that is owned equally by individuals K and L. K receives a salary of \$83,000, and her share of the net income, after deducting executive salaries, is \$50,000. What is the proper income tax and payroll tax (F.I.C.A. or self-employment tax) treatment of each of the following to K for the current calendar year?
- The salary, assuming it is reasonable in amount
  - The net income of \$50,000 that passes through to K
  - The \$3,600 that the company paid for group employee medical insurance for K and her family
- 3-7** *Tax Formula.* Reproduce the tax formula for individual taxpayers in good form and briefly describe each of the components of the formula. Discuss the differences between the tax formula for individuals and that for corporations.
- 3-8** *Gross Income.* How is gross income defined in the Internal Revenue Code?
- 3-9** *Deductions.* Distinguish between deductions *for* and deductions *from* adjusted gross income.
- 3-10** *Standard Deduction.* What is the standard deduction? Explain its relationship to itemized deductions. Which taxpayers are entitled to additional standard deductions?
- 3-11** *Itemized Deductions.* List seven major categories of itemized deductions. How and when are these reduced? Is the standard deduction reduced? If so, under what circumstances?
- 3-12** *Employee Business Expenses.* Expenses incurred that are directly related to one's activities as an employee are trade or business expenses. True or False?
- 3-13** *Additional Standard Deduction.* H and W are married and are 74 and 76 years of age, respectively. Assuming they have gross income of \$25,000 for 2007 and file a joint return, determine their taxable income.
- 3-14** *Exemptions.* Differentiate between personal exemptions and dependency exemptions. Which taxpayers are denied a personal exemption?
- 3-15** *Credits.* There are numerous credits that are allowed to reduce a taxpayer's Federal Income tax liability. List at least four such credits.
- 3-16** *Credits.* Credits of equal amount affect persons in different tax brackets equally, whereas deductions of equal amount are more beneficial to taxpayers in higher tax brackets. Explain.
- 3-17** *Prepayments.* What is meant by the concept of "wherewithal to pay" for tax purposes? How do prepayments of an individual's income taxes in the form of withholding and quarterly estimates represent the application of this concept?

- 3-18** *Alternative Minimum Tax.* What is the alternative minimum tax? Explain what is meant by *alternative* and *minimum* in this context.
- 3-19** *Amount Realized.* What is meant by “the amount realized in a sale or other disposition”? How is the amount realized calculated?
- 3-20** *Adjusted Basis.* Describe the concept of adjusted basis. How is the basis in purchased property determined?
- 3-21** *Gain or Loss Realized.* Reproduce the formula for determining the gain or loss realized in a sale or other disposition of property.
- 3-22** *Gain or Loss Recognized.* Differentiate between the terms “gain or loss realized” and “gain or loss recognized.”
- 3-23** *Losses.* Which losses are deductible by individual taxpayers?
- 3-24** *Capital Assets.* Define the term “capital asset.”
- 3-25** *Holding Period.* The determination of the holding period is important in determining the treatment of capital gains and losses. What is the difference between a long-term holding period and a short-term holding period?
- 3-26** *Capital Gains.* Briefly explain the favorable treatment given to capital gains and when such treatment applies.
- 3-27** *Capital Losses of Individuals.* There are “limitations” on the capital loss deduction for individuals. Identify these limitations.
- 3-28** *Capital Losses of Corporations.* What is the limitation on the deduction for capital losses of a corporate taxpayer?
- 3-29** *Carryover of Excess Capital Losses.* Excess capital losses of individuals may be offset against gains for other years. Specify the carryover and/or carryback period for such excess losses.

### **? YOU MAKE THE CALL**

- 3-30** Shortly after Murray began working in the tax department of the public accounting firm of Dewey, Cheatham and Howe, he was preparing a tax return and discovered an error in last year’s work papers. In computing the gain on the sale of the taxpayer’s duplex, the preparer had failed to increase the amount realized by the \$50,000 mortgage assumed by the buyer. Apparently, the mistake was overlooked during the review process. Upon discovering the mistake, Murray went to his immediate supervisor, Norm (who actually prepared last year’s return), and pointed out the error. Norm, knowing that the client would probably flip if he found out he had to pay more tax, told Murray “let’s just wait and see if the IRS catches it. Forget it for now.” What should Murray do?

### **PROBLEMS**

- 3-31** *To Whom Is Income Taxed?* In each of the following separate cases, determine how much income is to be taxed to each of the taxpayers involved:
- a.** Alpha Partnership is owned 60 percent by William and 40 percent by Patricia, who agree to share profits according to their ownership ratios. For the current year, Alpha earned \$12,000 in ordinary income and made no cash distributions.

- b. Beta Trust is managed by Susan for the benefit of Gregory. The trust is required to distribute all income currently. For the current year, Beta Trust had net ordinary income of \$5,500 and made cash distributions to Gregory of \$7,000.
- c. Gamma Corporation earned net ordinary income of \$24,000 during the current calendar year. The corporation is a regular U.S. corporation. Heather and Kristie each own 50 percent of the stock and received dividend distributions of \$1,350 each during the year.

**3-32** *Selecting a Form of Doing Business.* Which form of business—sole proprietorship, partnership, S corporation, limited liability company, or regular corporation—is each of the following taxpayers likely to choose? An answer may include more than one business form.

- a. Edmund and Gloria are starting a new business that they expect to operate at a net loss for about five years. Both Edmund and Gloria expect to have substantial incomes during those years from other sources.
- b. Robin would like to incorporate her growing retail business for nontax reasons. Because she needs all of the net profits to meet personal obligations, Robin would like to avoid the corporate “double tax” on dividends.

**3-33** *Income from C Corporations.* M is the president and chief executive officer of MN, Inc., a corporation that is owned solely by M. During the current calendar year, MN, Inc. paid M a salary of \$80,000, a bonus of \$22,000, and dividends of \$30,000. The corporation’s gross income is \$350,000, and its expenses excluding payments to M are \$225,000.

- a. Compute the corporation’s taxable income and determine its gross income tax.
- b. Assuming M’s only other income is interest income of \$12,500, determine M’s adjusted gross income.
- c. Does this situation represent double taxation of corporate profits? Explain.

**3-34** *Income from Partnerships.* J is a one-fourth partner in JKLM Partnership. The partnership had gross sales of \$880,000, cost of sales of \$540,000, and operating expenses excluding payments to partners of \$145,000 for the current calendar year. Partners’ compensation for services of \$90,000 (\$45,000 to J) were paid, and distributions of \$120,000 (\$30,000 to J) were made for the year.

- a. Determine the partnership’s net income for tax reporting purposes.
- b. Determine the amount of income J must report from the partnership for the year.
- c. Determine how much of the income in (b) is self-employment income.

**3-35** *Income from Fiduciaries.* G created a trust for the benefit of B to be managed by T. For the current year, the trust had gross income of \$45,000, income-producing deductions of \$1,900, and cash distributions to B of \$12,500.

- a. Determine the taxable income of the trust.
- b. Assuming B’s only other income is interest of \$22,300, determine B’s adjusted gross income.

**3-36** *Tax Treatment of Various Entities.* Office Supplies Unlimited is a small office supply outlet. The results of its operations for the most recent year are summarized as follows:

Gross profit on sales . . . . .	\$95,000
Cash operating expenses . . . . .	43,000
Depreciation expense . . . . .	16,500
Compensation to owner(s) . . . . .	20,000
Distribution of profit to owner(s) . . . . .	5,000



In each of the following situations, determine how much income is to be taxed (i.e., to be included along with any other income in calculating taxable income) to each of the taxpayers involved.

- a. The business is a sole proprietorship owned by T.
- b. The business is a partnership owned by R and S with an agreement to share all items equally. S is guaranteed a salary of \$20,000 (see above).
- c. The business is a corporation owned equally by U and K. K is employed by the business and receives a salary of \$20,000 (see above).

**3-37** *Gross Income.* The following represent some of the more important items of income for Federal tax purposes. For each, indicate whether it is fully includible in gross income, fully excludable from gross income, or partially includible and partially excludable.

- a. Alimony received from a former spouse
- b. Interest from state and local governments
- c. Money and other property inherited from a relative
- d. Social security benefits
- e. Tips and gratuities
- f. Proceeds of life insurance received upon the death of one's spouse

**3-38** *Classifying Deductions.* The following represent some of the more important deductions for Federal tax purposes. For each, indicate whether it is deductible for A.G.I. or as an itemized deduction.

- a. Alimony paid to one's former spouse
- b. Charitable contributions
- c. Trade or business expenses of a self-employed person
- d. Expenses of providing an apartment to a tenant for rent
- e. Interest incurred to finance one's principal residence
- f. Reimbursed trade or business expenses of an employee
- g. Unreimbursed trade or business expenses of an employee

**3-39** *Determining Adjusted Gross Income and Taxable Income.* Fred and Susan are married and file a joint income tax return. Neither is blind or age 65. They have two children whom they support, and the following income and deductions for 2008:

Gross income . . . . .	\$57,200
Deductions for A.G.I. . . . .	1,200
Total itemized deductions . . . . .	8,900
Credits and prepayments . . . . .	3,050

Determine Fred and Susan's adjusted gross income and taxable income for the calendar year 2008.

**3-40** *Tax Formula.* The following information is from the 2008 joint income tax return of Gregory and Stacy Jones, both of good sight and under 65 years of age.

Gross income . . . . .	\$66,600
Adjusted gross income . . . . .	57,750
Taxable income . . . . .	29,250
Number of personal exemptions . . . . .	2
Number of dependency exemptions . . . . .	2

Determine the amount of the Jones's deductions for A.G.I. and the amount of their itemized deductions.

**3-41** *Tax Formula.* Complete the following table of independent cases for a single person with good eyesight and under age 65 in 2008:

	<u>A</u>	<u>B</u>	<u>C</u>
Gross income . . . . .	\$50,000	\$ ???	\$ ???
Deductions for A.G.I. . . . .	(???)	(8,000)	(7,000)
Adjusted gross income (A.G.I.) . . . . .	\$42,000	\$78,000	???
Itemized deductions . . . . .	(7,300)	(4,650)	(7,350)
Standard deduction . . . . .	(???)	(???)	(???)
Exemptions . . . . .	2	1	1
	(???)	(???)	(???)
Taxable income . . . . .	<u>\$ ???</u>	<u>\$ ???</u>	<u>\$63,300</u>

**3-42** *Worldwide Income Subject to Tax.* T, a U.S. citizen, has income that was earned outside the United States. The income was \$20,000, and a tax of \$2,000 was paid to the foreign government. Determine the general treatment of this income and the tax paid under the following circumstances:

- a. The tax paid was on income earned on foreign investments, and the U.S. tax attributable to this income is \$2,800.
- b. Same as (a), except the U.S. tax attributable to this income is \$1,800.
- c. Same as (a), except the income is from services rendered while absent from the United States for 13 successive months.

**3-43** *Alternative Minimum Tax.* L is single, has no dependents, and uses the cash method and the calendar year for tax purposes. The following information was derived from L’s records for 2007:

Taxable income (regular income tax) . . . . .	\$74,200
AMT adjustments and preferences . . . . .	70,200

Although L has substantial gross income and deductions, she does not itemize. Calculate L’s regular income tax using the tax rates for 2007 and her alternative minimum tax, if any.

**3-44** *Asset Classification.* For each of the assets in the list below, designate the appropriate category using the symbols given:

- C - Capital asset
- T - Trade or business asset (§ 1231)
- O - Other (neither capital nor § 1231 asset)

- a. Personal residence
- b. Stock in Xerox Corporation
- c. Motor home used for vacations
- d. Groceries held for sale to customers
- e. Land held for investment
- f. Land and building held for use in auto repair business
- g. Trade accounts receivable of physician’s office
- h. Silver coins held primarily for speculation

**3-45** *Gain or Loss Realized.* During the current year, W disposed of a vacant lot which he had held for investment. W received cash of \$12,000 for his equity in the lot. The lot was subject to a \$32,000 mortgage that was assumed by the buyer. Assuming W’s basis in the lot was \$23,000, how much is his realized gain or loss?

- 3-46 *Adjusted Basis.* M owns a rental residence that she is considering selling, but she is interested in knowing her exact tax basis in the property. She originally paid \$39,000 for the property. M has spent \$8,000 on a new garage, \$2,500 for a new outdoor patio deck, and \$4,500 on repairs and maintenance. M has been allowed depreciation on the unit in the amount of \$7,500. Based on this information, calculate M's basis in the rental residence.
- 3-47 *Gain or Loss Realized, Adjusted Basis.* This year S sold her rental house. She received cash of \$6,000 and a vacant lot worth \$30,000. The buyer assumed the \$36,000 mortgage loan outstanding against S's property. S had purchased the house for \$52,000 four years earlier and had deducted depreciation of \$12,000. How much are S's amount realized, her adjusted basis in the house sold, and her gain or loss realized in this transaction?
- 3-48 *Capital Gain and Loss.* Individual D is in the 35% tax bracket. This year he executed the following transactions.

<i>Transaction</i>	<i>Sales Price</i>	<i>Adjusted Basis</i>	<i>Holding Period</i>
Sale of 100 shares of XYZ . . . . .	\$2,000	\$1,000	15 months
Sale of land held for investment. . . . .	9,000	3,000	19 months
Sale of silver held for speculation . . . . .	5,000	7,000	23 months
Sale of personal jewelry . . . . .	4,000	6,000	60 months

Determine the tax consequences (e.g., gain, loss, applicable tax rates) of these transactions.

- 3-49 *Excess Capital Loss.* This year, T, an individual taxpayer, had a short-term capital gain of \$4,000 and a capital loss of \$9,000 from stock he held for four years. How much is T's allowable capital loss deduction for the year? What is the treatment of the short-term gain?
- 3-50 *Individual's Tax Computation.* Richard Hartman, age 29, single with no dependents, received a salary of \$32,270 in 2008. During the year, he received \$1,300 interest income from a savings account and a \$1,500 gift from his grandmother. At the advice of his father, Richard sold stock he had held as an investment for five years, for a \$3,000 gain. He also sustained a loss of \$1,000 from the sale of land held as an investment and owned for four months. Richard had itemized deductions of \$5,250. For 2008 compute the following for Richard:
  - a. Gross income
  - b. Adjusted gross income
  - c. Taxable income
  - d. Income tax before credits and prepayments (use the appropriate 2008 tax rate schedule located on the inside front cover)
  - e. Income tax savings that would result if Richard made a deductible \$2,000 contribution to a qualified Individual Retirement Account
- 3-51 *Tax Treatment of Income from Entities.* The G family—Mr. G, Mrs. G, and G Jr.—owns interests in the following successful entities:
  - 1. X Corporation is a calendar year regular corporation owned 60 percent by Mr. G and 15 percent by G Jr. During the year, it paid salaries to Mr. G of \$80,000 to be its president and to G Jr. of \$24,000 to be a plant supervisor. The company earned a net taxable income of \$75,000, and paid dividends to Mr. G and G Jr. in the amounts of \$42,000 and \$10,500, respectively.

2. Mrs. G owned a 60 percent capital interest in a retail outlet, P Partnership. The partnership earned a net taxable income of \$60,000 and made distributions during the year of \$72,000. The profit and the distributions were allocated according to relative capital interests.
3. Mr. G and G Jr. each own 25 percent interest in H Corporation, an electing S Corporation. The corporation is a start-up venture and generated a net tax loss of \$28,000 for the calendar year. No dividend distributions were made by H. Both Mr. G and G Jr. have bases in their H Corporation stock of \$30,000.
4. G Jr. is the sole beneficiary of G Trust created by Mrs. G's father. The trust received dividends of \$16,000 and made distributions of \$4,500 to G Jr.

Determine the amount of income or loss from each entity that is to be reported by the following:

- a. Mr. and Mrs. G on their joint calendar year tax return
- b. G Jr. on his calendar year individual return
- c. X Corporation
- d. P Partnership
- e. H Corporation
- f. G Trust

- 3-52** *Comprehensive Taxable Income Computation.* Indy Smith, single, is an anthropology professor at State University. The tax records that he brought to you for preparation of his return revealed the following items.

<i>Income</i>	
Salary from State University . . . . .	\$67,850
Part-time consulting . . . . .	5,000
Dividend income . . . . .	1,250
Reimbursement of travel to Denver by State University . . . . .	200
<i>Expenses</i>	
Interest on personal residence . . . . .	\$ 9,800
Travel expenses related to consulting . . . . .	1,000
Tax return preparation fee . . . . .	500
Safe deposit box to hold bonds . . . . .	50
Travel and lodging to present academic paper in Denver related to his teaching position . . . . .	450

In addition, Indy claims a dependency exemption for his father for whom he provides 60 percent support (including 60 percent of housing costs). Compute Indy's final tax liability for calendar year 2008.

**TaxCut** 3-53

*Comprehensive Taxable Income Computation.* Eli and Lilly have been happily married for 30 years. Eli, 67, is a research chemist at Pharmaceuticals Inc. Lilly, 64, recently retired but stays busy managing the couple's investments, including a duplex. The majority of the couple's income is derived from Eli's employment, from which he received a salary of \$95,000 this year. Other income includes interest on corporate bonds of \$5,600 and interest on State of Illinois bonds of \$1,000. In addition, rents collected from the duplex were \$10,000 while rental expenses (e.g., maintenance, utilities, depreciation) were \$6,000. During the year, the company transferred Eli to a new division located on the north side of town. As a result, the couple decided to move so that Eli would not have such a long commute. They paid deductible moving expenses of \$2,000. The couple also paid the following expenses: unreimbursed medical expenses, \$7,400; interest on the home mortgage, \$11,700; property taxes on the home, \$3,000; charitable contributions, \$4,000; and rental of safe deposit box, \$100. Determine the couple's taxable income for 2008.

- 3-54** *Alternative Minimum Tax.* H and W are married and filed a joint return for 2007. The couple has five children between the ages of 3 and 13. Their records for the current year reveal the following:

Salary income (their only income) . . . . .	\$100,000
State and local taxes (property and income) . . . . .	12,600
Total itemized deductions . . . . .	\$18,700

Using the 2007 tax rates, compute the alternative minimum tax, if any.

- 3-55** *Losses.* This year, B and J formed a partnership to operate a bar and grill. B was the brains behind the venture and J supplied the bulk of the financing. B contributed \$30,000 to the partnership, receiving a 30 percent interest while J contributed \$70,000 for a 70 percent interest. B received 30 percent of the profits and losses and J received 70 percent. During the year, B worked his fingers to the bone, running the business. J did little, sitting back and watching his investment. For the year, the partnership reported a \$30,000 loss (revenues \$60,000, deductible expenses \$90,000). Can B and J use their share of the loss as a deduction to offset other income they might have on their own individual tax return (Form 1040) such as the salary income of their spouses? Explain.

## TAX RETURN PROBLEMS

### CONTINUOUS TAX RETURN PROBLEMS See Appendix I, Part 1

## RESEARCH PROBLEMS

- 3-56** *Using the Internal Revenue Code.* Locate a copy of the *Internal Revenue Code of 1986*. Read §§ 61 through 65, 67, 151, and 152. Read the titles of §§ 71 through 135, 161, and 162.
- Describe how Congress defined “gross income.”
  - Why is the “exemption deduction” properly called a deduction from adjusted gross income?
  - A taxpayer is self-employed and incurs an ordinary and necessary expense in his business endeavor. What is the authority for deducting the expense? Why is it considered a deduction *for* adjusted gross income?
  - A taxpayer pays alimony to her former husband. Within limits, it is deductible *for* adjusted gross income. Why?

