

# Tax Awareness Training for Auditors

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- Caveat on CPE instructor/courses

# Tax and Auditors

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- Adequate Technical Competence Under Rule 201

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- Interpretation 201-1 requirements

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- Interpretation 201-1 requirements
  - Have necessary expertise or

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  - Have necessary expertise or
  - Consult with others or

# Tax and Auditors

- Adequate Technical Competence Under Rule 201
- Interpretation 201-1 requirements
  - Have necessary expertise or
  - Consult with others or
  - Can obtain expertise timely

# Tax and Auditors

# Tax and Auditors

- Rule 101 - Independence

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- Rule 101 - Independence
- Ethics Interpretation 101-3

# Tax and Auditors

- Rule 101 - Independence
- Ethics Interpretation 101-3
  - Taxes are a covered nonattest service

# Tax and Auditors

- Rule 101 - Independence
- Ethics Interpretation 101-3
  - Taxes are a covered nonattest service
  - Who is responsible for FIN 48 decisions?

# Tax and Auditors

- Rule 101 - Independence
- Ethics Interpretation 101-3
  - Taxes are a covered nonattest service
  - Who is responsible for FIN 48 decisions?
  - Who will client say is responsible???

# Tax and Other A&A

# Tax and Other A&A

- Reviews

# Tax and Other A&A

- Reviews
- Compilations

# Tax and Other A&A

- Reviews
- Compilations
- Inside Accountant

# Today's Course

# Today's Course

- FIN 48

# Today's Course

- FIN 48
- GAAP vs. Tax

# Today's Course

- FIN 48
- GAAP vs. Tax
- Computation of Corporate Income Tax

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- FIN 48
- GAAP vs. Tax
- Computation of Corporate Income Tax
- Adjusted Current Earnings

# Today's Course

- FIN 48
- GAAP vs. Tax
- Computation of Corporate Income Tax
- Adjusted Current Earnings
- Employees/Compensation Issues

# Today's Course

# Today's Course

- S Corporations and Tax

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- S Corporations and Tax
- Debt vs. Equity

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- S Corporations and Tax
- Debt vs. Equity
- Intangible Assets

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- S Corporations and Tax
- Debt vs. Equity
- Intangible Assets
- Reasonable Compensation

# Today's Course

- S Corporations and Tax
- Debt vs. Equity
- Intangible Assets
- Reasonable Compensation
- Current Developments

# FIN 48

## Module 10

# Private Company Ruling

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- No tabular reconciliation of uncertain tax positions

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- No tabular reconciliation of uncertain tax positions
- No summary of exposures that would change effective tax rate

# Private Company Ruling

- No tabular reconciliation of uncertain tax positions
- No summary of exposures that would change effective tax rate
- Other measurement and disclosure rules generally apply

# How We Got Here

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- Ethics Interpretation 101-3

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- Enron/Corporate Tax Shelters

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- Ethics Interpretation 101-3
- Enron/Corporate Tax Shelters
- IRS OPR: Circular 230 §10.35

# How We Got Here

- Ethics Interpretation 101-3
- Enron/Corporate Tax Shelters
- IRS OPR: Circular 230 §10.35
- FASB: FIN 48

# How We Got Here

- Ethics Interpretation 101-3
- Enron/Corporate Tax Shelters
- IRS OPR: Circular 230 §10.35
- FASB: FIN 48
- Congress: §6694(a)

# FASB and Taxes

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- Tax as a “super” contingency

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- Tax as a “super” contingency
- IRS interest in FIN 48

# FASB and Taxes

- Tax as a “super” contingency
- IRS interest in FIN 48
- Independence challenges

# Prior GAAP Guidance

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- Contingent liability: SFAS 5

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  - Probable (accrue)

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- Contingent liability: SFAS 5
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  - Reasonably possible (disclose)

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- Contingent liability: SFAS 5
  - Probable (accrue)
  - Reasonably possible (disclose)
  - Remote (no disclosure)

# Prior GAAP Guidance

- Contingent liability: SFAS 5
  - Probable (accrue)
  - Reasonably possible (disclose)
  - Remote (no disclosure)
- Can consider likelihood of claim being asserted

**FIN 48**

# FIN 48

- Concentrates on recognition of tax benefits

# FIN 48

- Concentrates on recognition of tax benefits
- “More likely than not” standard

# Presumption

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- Position will be examined

# Presumption

- Position will be examined
- Agent fully informed on all law and relevant facts

# Presumption

- Position will be examined
- Agent fully informed on all law and relevant facts
- Treat as if going to court

# Tax Positions

# Tax Positions

- Everything is a tax position

# Tax Positions

- Everything is a tax position
- Appendix from staff defines very broadly

# Example Issues

# Example Issues

- Nexus-failed to file return

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- Transfer pricing (related entities)

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- Transfer pricing (related entities)
- Income excluded from return

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- Nexus-failed to file return
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- Deductions claimed
- Classification as tax free

# Example Issues

- Nexus-failed to file return
- Transfer pricing (related entities)
- Income excluded from return
- Deductions claimed
- Classification as tax free
- Positions inherited in combination

# Unit of Account

# Unit of Account

- Not account balance

# Unit of Account

- Not account balance
- Single account may have multiple positions

# Initial Recognition

# Initial Recognition

- Fiscal year beginning after 12/15/06

# Initial Recognition

- Fiscal year beginning after 12/15/06
- No benefit recognized for position unless MLTN

# Example

## **ILLUSTRATION # 1**

A company has been in business for 20 years. It has filed tax returns in its home state for all 20 years. It also has filed state tax returns in one neighboring state for 15 years. However, the Company has not filed in another neighboring state where it technically has nexus. If the neighboring state has an administrative practice to only go 6 years on nexus audits, then that administrative practice would support a MLTN position that an additional accrual for that state could be limited to 6 years.

# Initial Measurement

# Initial Measurement

- Measured at largest benefit deemed be MLTN

# Initial Measurement

- Measured at largest benefit deemed be MLTN
- Can use cumulative probabilities

# Example

<u>Deduction Allowed</u>	<u>Probability of Tax benefit</u>	<u>Probability of Successful Outcome</u>	<u>Cumulative Probability</u>
\$100,000	\$ 30,000	30%	30%
60,000	18,000	25%	55%
30,000	9,000	20%	75%
20,000	6,000	15%	90%
10,000	3,000	5%	95%
0	0	5%	100%

# Example

# Example

- Tax return reflects \$30,000 reduction in taxes (tax partner worries about §6694(a) issues...)

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- Uncertain tax benefit liability \$12,000

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- Noncurrent if don't expect current exam

# Example

- Tax return reflects \$30,000 reduction in taxes (tax partner worries about §6694(a) issues...)
- Uncertain tax benefit liability \$12,000
- Noncurrent if don't expect current exam
- Accrue interest and penalties as well

# Interest and Penalties

# Interest and Penalties

- Continue to be accrued while position fails to meet MLTN standard

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- Continue to be accrued while position fails to meet MLTN standard
- Interest-can be either interest expense or income taxes

# Interest and Penalties

- Continue to be accrued while position fails to meet MLTN standard
- Interest-can be either interest expense or income taxes
- Penalties-can be either income taxes or administrative expense

# Other Issues

# Other Issues

- Tax planning strategies

# Other Issues

- Tax planning strategies
- Timing issues

# Subsequent Accounting

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- Reevaluate positions each year

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- New developments in courts, law, etc. can cause change (for better or worse)

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- Reevaluate positions each year
- New developments in courts, law, etc. can cause change (for better or worse)
- Also consider expiration of statute of limitations

# Later Recognition

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- MLTN threshold now decided is met

# Later Recognition

- MLTN threshold now decided is met
- Examined and settled in entity's favor

# Later Recognition

- MLTN threshold now decided is met
- Examined and settled in entity's favor
- Statute of limitations expired

# Later Recognition

- MLTN threshold now decided is met
- Examined and settled in entity's favor
- Statute of limitations expired
- Later failure possible too

# Example

Statute of limitations expires and the \$100,000 deduction is not challenged. The \$12,000 liability for unrecognized tax benefits should be reversed.

# Example

IRS completes its examination and does not question the \$100,000 deduction. The \$12,000 liability for unrecognized tax benefits should be reversed.

# Example

IRS examines the company's return and disallows \$25,000 of the deduction. With interest and penalties, the company must pay \$17,000.

Debit - Liability For Unrecognized Tax Benefits	12,000	
Debit - Income Tax Expense	5,000	
Credit - Current Tax Payable		17,000

# Effective Settlement

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- Completed examination

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- Entity has no intention to appeal

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- Entity has no intention to appeal
- Determine only remote possibility position would be reopened

# Effective Settlement

- Completed examination
- Entity has no intention to appeal
- Determine only remote possibility position would be reopened
- True even if authority never looked at the position in question

# Disclosures

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- Policy classification of interest and penalties

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- Policy classification of interest and penalties
- Tabular disclosure

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- Policy classification of interest and penalties
- Tabular disclosure
  - Increase/decrease from prior years

# Disclosures

- Policy classification of interest and penalties
- Tabular disclosure
  - Increase/decrease from prior years
  - Increase/decrease from current year

# Disclosures

- Policy classification of interest and penalties
- Tabular disclosure
  - Increase/decrease from prior years
  - Increase/decrease from current year
  - Decreases from settlements

# Disclosures

- Policy classification of interest and penalties
- Tabular disclosure
  - Increase/decrease from prior years
  - Increase/decrease from current year
  - Decreases from settlements
  - Decreases due to statute

# Disclosures

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- Unrecognized benefits that would impact tax rate

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- Interest and penalties (both balance sheet and P&L)

# Disclosures

- Unrecognized benefits that would impact tax rate
- Interest and penalties (both balance sheet and P&L)
- SOP 94-6 disclosures (change in next 12 months-like statutes expiring)

# Disclosures

- Unrecognized benefits that would impact tax rate
- Interest and penalties (both balance sheet and P&L)
- SOP 94-6 disclosures (change in next 12 months-like statutes expiring)
- Open tax years by jurisdictions

# Other

# Other

- **Effective date (including prior positions)**

# Other

- Effective date (including prior positions)
- Sample disclosures

# Ethics Interpretation

## 101-3

# Ethics Interpretation

## 101-3

- Cannot make management decision

# Ethics Interpretation

## 101-3

- Cannot make management decision
- Appoint person to take responsibility

# Ethics Interpretation

## 101-3

- Cannot make management decision
- Appoint person to take responsibility
- PEEC release indicating can comply with 101-3 and advise on tax position

# Ethics Interpretation

## 101-3

- Cannot make management decision
- Appoint person to take responsibility
- PEEC release indicating can comply with 101-3 and advise on tax position
- However...

# Section 7525

# Section 7525

- Potential internal conflict with privilege

# Section 7525

- Potential internal conflict with privilege
- IRS position likely to be waiver

# IRS Use of Information

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- IRS LMSB Memorandum on use of FIN 48 disclosures

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- IRS “reconsidering” tax accrual workpapers position

# IRS Use of Information

- IRS LMSB Memorandum on use of FIN 48 disclosures
- IRS “reconsidering” tax accrual workpapers position
- *Textron* case for general auditor privilege

# GAAP vs. Tax

## Module I

# Background

# Background

- GAAP designed to reflect financial results of entity

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- Tax is based on statutory frameworks

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- Tax is based on statutory frameworks
- Treatments often differ

# Background

- GAAP designed to reflect financial results of entity
- Tax is based on statutory frameworks
- Treatments often differ
- Potential for GAAP departures when tax basis used inappropriately

# Accounts Receivable

# Accounts Receivable

- GAAP - net realizable value

# Accounts Receivable

- GAAP - net realizable value
- Taxes - direct charge off method

# Inventories

# Inventories

- GAAP Methods

# Inventories

- GAAP Methods
- Tax Method

# Inventories

- GAAP Methods
- Tax Method
  - Can be different

# Inventories

- GAAP Methods
- Tax Method
  - Can be different
  - §263A (“Fuller” absorption method)

# Marketable Securities

# Marketable Securities

- GAAP Methods & Classifications

# Marketable Securities

- GAAP Methods & Classifications
- Tax - cost/basis under tax rules

# Fixed Assets

# Fixed Assets

- GAAP cost rules include latitude

# Fixed Assets

- GAAP cost rules include latitude
- Tax - determine basis under §1012

# Fixed Assets

- GAAP cost rules include latitude
- Tax - determine basis under §1012
- Rules may be similar, but not identical

# Depreciation

# Depreciation

- GAAP - methods recover costs down to salvage value

# Depreciation

- GAAP - methods recover costs down to salvage value
- Tax - lives and methods generally specified

# Depreciation

- GAAP - methods recover costs down to salvage value
- Tax - lives and methods generally specified
- Two are not the same

# Life Insurance

# Life Insurance

- GAAP - record cash value and offset insurance expense

# Life Insurance

- GAAP - record cash value and offset insurance expense
- Tax - prohibitions for certain covered individuals in certain cases

# Long Lived Assets

# Long Lived Assets

- **GAAP - issues on impairment of long lived assets**

# Long Lived Assets

- GAAP - issues on impairment of long lived assets
- No tax provision

# Intangibles

# Intangibles

- GAAP

# Intangibles

- GAAP
- Tax

# Intangibles

- GAAP
- Tax
  - §197 intangibles 15 years

# Intangibles

- GAAP
- Tax
  - §197 intangibles 15 years
  - Others must not be goodwill and have a determinable useful life

# Liabilities and Contingencies

# Liabilities and Contingencies

- Contingent liabilities (FASB 5)

# Liabilities and Contingencies

- Contingent liabilities (FASB 5)
- Income tax limited deduction rules

# Leases

# Leases

- GAAP

# Leases

- GAAP
- Tax

# Retirement Plans

# Retirement Plans

- Complexity everywhere

# Retirement Plans

- Complexity everywhere
- GAAP concern liability

# Retirement Plans

- Complexity everywhere
- GAAP concern liability
- Tax concern excess deductions (especially small plans)

# Debt v. Equity

# Debt v. Equity

- **GAAP** - normally follow legal form

# Debt v. Equity

- GAAP - normally follow legal form
- Tax - due to different treatments, very different concerns

# Convertible Debt

# Convertible Debt

- GAAP issues

# Convertible Debt

- GAAP issues
- Tax issues

# S Corporations

# S Corporations

- Fully tax creative (despite PPC's implications to the contrary)

# S Corporations

- Fully tax creative (despite PPC's implications to the contrary)
- Capital accounts do not equate to book amounts--AAA is not retained earnings

# Revenue

# Revenue

- GAAP - concern with premature recognition (especially post dot-com)

# Revenue

- GAAP - concern with premature recognition (especially post dot-com)
- Tax - concern with late recognition

# Compensation

# Compensation

- GAAP - match to period (compensated absences)

# Compensation

- GAAP - match to period (compensated absences)
- Tax limited rules

# Charitable Contributions

# Charitable Contributions

- GAAP - like other expenses

# Charitable Contributions

- GAAP - like other expenses
- Tax - subject to limits (10% for C corporations)

# Expenses/Related Parties

# Expenses/Related Parties

- Different definitions of related

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- Different definitions of related
- GAAP - primary concern disclosure not recording

# Expenses/Related Parties

- Different definitions of related
- GAAP - primary concern disclosure not recording
- Tax - primary concern tax “games” including timing

# Research & Development

# Research & Development

- GAAP

# Research & Development

- GAAP
- Tax

# Federal Income Taxes

# Federal Income Taxes

- GAAP (but subject to FIN 48 rules)

# Federal Income Taxes

- GAAP (but subject to FIN 48 rules)
- Tax (subject to §6694(a) rules on disclosure)

# Fines & Penalties

# Fines & Penalties

- GAAP

# Fines & Penalties

- GAAP
- Tax

# Foreign Taxes

# Foreign Taxes

- GAAP

# Foreign Taxes

- GAAP
- Tax

# Property Taxes

# Property Taxes

- GAAP

# Property Taxes

- GAAP
- Tax

# Computation of Corporate Income Tax

## Module 2

# Computation

Begin with	Income (from whatever source derived)
Minus	<u>Exclusions from gross income</u>
Equals	Gross Income
Minus	<u>Deductions</u>
Equals	Taxable Income
Multiplied by	<u>Tax Rate</u>
Equals	Regular Income Tax
Minus	<u>Credits and estimated payments</u>
Equals	<u>Tax Due</u>

# Tax Rates

If taxable income (line 30, Form 1120, or line 26, Form 1120-A) is:	But		Of the
Over	Not Over	Tax Is	Amount Over--
\$0	\$50,000	15%	\$0
50,000	75,000	\$7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	---	35%	0

# Controlled Group Limits

# Controlled Group Limits

- Level of income at each of the lower tier income tax rates,

# Controlled Group Limits

- Level of income at each of the lower tier income tax rates,
- \$250,000 accumulated earnings credit,

# Controlled Group Limits

- Level of income at each of the lower tier income tax rates,
- \$250,000 accumulated earnings credit,
- \$40,000 AMT exemption, and

# Controlled Group Limits

- Level of income at each of the lower tier income tax rates,
- \$250,000 accumulated earnings credit,
- \$40,000 AMT exemption, and
- \$2,000,000 amount for computing the environmental tax.

# Parent-Subsidiary

# Parent-Subsidiary

- Parent-subsubsidiary

# Parent-Subsidiary

- Parent-subsubsidiary
  - 80% of combined voting power owned and

# Parent-Subsidiary

- Parent-subsidiary
  - 80% of combined voting power owned and
  - 80% total value owned

# Brother-Sister

# Brother-Sister

- Five or fewer persons

# Brother-Sister

- Five or fewer persons
  - own more than 50% of voting power or

# Brother-Sister

- Five or fewer persons
  - own more than 50% of voting power or
  - 50% of total value of all shares

# Brother-Sister

- Five or fewer persons
  - own more than 50% of voting power or
  - 50% of total value of all shares
- Note law change to 50% only applies for controlled group purposes

# Personal Service Corporation

# Personal Service Corporation

- Loses lower brackets

# Personal Service Corporation

- Loses lower brackets
- Substantially all tests

# Personal Service Corporation

- Loses lower brackets
- Substantially all tests
  - Prohibited fields and

# Personal Service Corporation

- Loses lower brackets
- Substantially all tests
  - Prohibited fields and
  - Ownership by service employees

# Accumulated Earnings Tax

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- \$250,000/\$150,000 limitation on “unreasonable accumulation”

# Accumulated Earnings Tax

- \$250,000/\$150,000 limitation on “unreasonable accumulation”
- Closely held company issue

# Accumulated Earnings Tax

- \$250,000/\$150,000 limitation on “unreasonable accumulation”
- Closely held company issue
- Penalties issue (as well as FIN 48)

# Accumulations

# Accumulations

- Reg. §1.537-2

# Accumulations

- Reg. §1.537-2
- Acceptable grounds

# Accumulations

- Reg. §1.537-2
- Acceptable grounds
- Unacceptable grounds

# Bardahl Formula

# Bardahl Formula

- *Bardahl Manufacturing v. Commissioner, TC*  
Memo 1965-200

# Bardahl Formula

- *Bardahl Manufacturing v. Commissioner*, TC Memo 1965-200
- IRS outlines in Internal Revenue Manual, Chapter 600)

# Example

a.	Cost of Goods	\$ 1,000,000
b.	Average beginning-ending inventory	\$ 100,000
c.	Material turnover factor	36.5 days
d.	Sales	\$ 2,400,000
e.	Trade accounts receivable at end of year	\$ 600,000
f.	Percentage of year sales factor	91.25 days
g.	Cost of sales	\$1,000,000
h.	Expenses (including estimated federal income tax payments)	\$ 500,000
i.	Total of g. and h.	\$1,500,000
j.	Less depreciation	\$ (100,000)
k.	Annual operating expenses	\$ 1,400,000
l.	Operating cycle percentage $\frac{36.5 + 91.25}{365}$	35%
m.	Ordinary operating expense (35% $\times$ \$1,400,000)	\$ 490,000

# Personal Holding Company

# Personal Holding Company

- Meant to stop “incorporated” pocketbooks

# Personal Holding Company

- Meant to stop “incorporated” pocketbooks
- Test

# Personal Holding Company

- Meant to stop “incorporated” pocketbooks
- Test
  - 60% of adjusted gross income is PHC income

# Personal Holding Company

- Meant to stop “incorporated” pocketbooks
- Test
  - 60% of adjusted gross income is PHC income
  - More than 50% owned, directly or indirectly, by 5 or fewer individuals

# Personal Holding Company

- Meant to stop “incorporated” pocketbooks
- Test
  - 60% of adjusted gross income is PHC income
  - More than 50% owned, directly or indirectly, by 5 or fewer individuals
- Excluded corporations

# Adjusted Current Earnings

Module 3

# General ACE

# General ACE

- Under §56(g)

# General ACE

- Under §56(g)
- Used for AMT, environmental tax

# General ACE

- Under §56(g)
- Used for AMT, environmental tax
- Add back 75% of ACE adjustment for AMT

# General ACE

- Under §56(g)
- Used for AMT, environmental tax
- Add back 75% of ACE adjustment for AMT
- ACE another method of computing taxable income

# General ACE

- Under §56(g)
- Used for AMT, environmental tax
- Add back 75% of ACE adjustment for AMT
- ACE another method of computing taxable income
- E&P items not already taken into account in computing AMTI

# Deductions

# Deductions

- Generally must be deductible for both pre-adjustment AMTI and current earnings & profits

# Deductions

- Generally must be deductible for both pre-adjustment AMTI and current earnings & profits
- A few exceptions for expenses associated with exempt income

# Deductions

- Generally must be deductible for both pre-adjustment AMTI and current earnings & profits
- A few exceptions for expenses associated with exempt income
- Items you don't get to deduct

# Limit on Negative Adjustments

**Example:** AB Corp. is a calendar year taxpayer. ACE and pre-adjustment AMT is as follows:

	<u>Y1</u>	<u>Y2</u>	<u>Y3</u>	<u>Y4</u>
ACE	\$ 700	\$900	\$ 400	\$ 100
Pre-adjustment AMTI	\$ 800	\$600	\$ 500	\$ 600
	\$(100)	\$300	\$(100)	\$(500)
75%	\$ ( 75)	\$225	\$ ( 75)	\$ 375

# Calculating ACE

# Calculating ACE

- Starting point AMTI before

# Calculating ACE

- Starting point AMTI before
  - NOL

# Calculating ACE

- Starting point AMTI before
  - NOL
  - Exemption allowance

# Calculating ACE

- Starting point AMTI before
  - NOL
  - Exemption allowance
  - ACE adjustment itself

# Calculating ACE

- Starting point AMTI before
  - NOL
  - Exemption allowance
  - ACE adjustment itself
- 75% of difference will find way into calculation

# Items Includable-in E&P

# Items Includable-in E&P

- Life insurance proceeds in excess of ACE basis

# Items Includable-in E&P

- Life insurance proceeds in excess of ACE basis
- Inside policy build-up

# Items Includable-in E&P

- Life insurance proceeds in excess of ACE basis
- Inside policy build-up
- Tax exempt interest

# Items Includable-in E&P

- Life insurance proceeds in excess of ACE basis
- Inside policy build-up
- Tax exempt interest
- Received for injuries and sickness excluded under §104

# Items Includable-in E&P

# Items Includable-in E&P

- Pre 1954 lease issue

# Items Includable-in E&P

- Pre 1954 lease issue
- Tax benefit exclusions recalculated for E&P (§111 issues)

# Items Includable-in E&P

- Pre 1954 lease issue
- Tax benefit exclusions recalculated for E&P (§111 issues)
- Cost sharing arrangements under §126

# Items Includable-in E&P

- Pre 1954 lease issue
- Tax benefit exclusions recalculated for E&P (§111 issues)
- Cost sharing arrangements under §126
- Interest income from loans to ESOP

# Items Includable-in E&P

- Pre 1954 lease issue
- Tax benefit exclusions recalculated for E&P (§111 issues)
- Cost sharing arrangements under §126
- Interest income from loans to ESOP
- Trouble thrift excluded income

# Not Deductible Items

# Not Deductible Items

- Dividends received deduction (subject to limits)

# Not Deductible Items

- Dividends received deduction (subject to limits)
- Preferred stock dividends (§244)

# Not Deductible Items

- Dividends received deduction (subject to limits)
- Preferred stock dividends (§244)
- §245 foreign corporations (subject to limits)

# Not Deductible Items

- Dividends received deduction (subject to limits)
- Preferred stock dividends (§244)
- §245 foreign corporations (subject to limits)
- §247 preferred stock dividends of public utilities

# Not Deductible Items

# Not Deductible Items

- §404(k) dividends paid to employee stock ownership plan

# Not Deductible Items

- §404(k) dividends paid to employee stock ownership plan
- §1382(c) nonpatronage dividends

# Not Deductible Items

- §404(k) dividends paid to employee stock ownership plan
- §1382(c) nonpatronage dividends
- Unrecovered losses attributable to certain damages excludable under §186

# Not Deductible Items

- §404(k) dividends paid to employee stock ownership plan
- §1382(c) nonpatronage dividends
- Unrecovered losses attributable to certain damages excludable under §186
- §806 small life insurance company deduction

# Excluded from Both

# Excluded from Both

- Improvements excluded under §109

# Excluded from Both

- Improvements excluded under §109
- Nonshareholder contribution under §118

# Excluded from Both

- Improvements excluded under §109
- Nonshareholder contribution under §118
- Federal income tax refunds

# Excluded from Both

- Improvements excluded under §109
- Nonshareholder contribution under §118
- Federal income tax refunds
- Commissioner can identify additional items

# §56(g)(4)(D) Adjustments

# §56(g)(4)(D) Adjustments

- Intangible drilling costs

# §56(g)(4)(D) Adjustments

- Intangible drilling costs
- Organizational expenditures

# §56(g)(4)(D) Adjustments

- Intangible drilling costs
- Organizational expenditures
- Circulation expenditures

# §56(g)(4)(D) Adjustments

- Intangible drilling costs
- Organizational expenditures
- Circulation expenditures
- Installment sale

# Example

**Example:** AB Corp. has pre-adjustment AMTI of \$500,000. AB Corp. sold, on the installment method, an asset on which there is a \$100,000 realized gain, and \$20,000 is recognized. Because the sale was a nondealer sale of property for less than \$150,000, IRC Section 453A(a)(1) does not apply. AB Corp. must include the total realized gain in ACE

# §56(g)(4)(D) Adjustments

# §56(g)(4)(D) Adjustments

- Restate inventory on FIFO basis if use LIFO

# ACE Adjustments

# ACE Adjustments

- Loss on exchange of debt pools

# ACE Adjustments

- Loss on exchange of debt pools
- Life insurance company acquisition expense

# ACE Adjustments

- Loss on exchange of debt pools
- Life insurance company acquisition expense
- Depletion

# ACE Adjustments

- Loss on exchange of debt pools
- Life insurance company acquisition expense
- Depletion
- Revision due to ownership changes  
(recalculate built in loss rules)

# Built in Loss Example

## Examples:

- a. Beta Corporation was acquired by Alpha, Inc. Beta's assets have a fair market value of \$1,500,000, ACE basis of \$2,000,000 and tax basis of \$1,700,000. For regular tax purposes, there is no built-in loss recognition, because the loss is not greater than 15% of the fair market value of the assets. The ACE built-in loss, however, exceeds 15% of the FMV, and Beta must reduce the basis in its assets for ACE to fair market value
- b. the de minimis rule contained in section 382 applies for ACE purposes, so built-in losses less than \$10 million or 15% of the fair market value of the assets of the company (whichever is lower) will not trigger an asset write-down

# Miscellaneous Issues

# Miscellaneous Issues

- Consolidated issues

# Miscellaneous Issues

- Consolidated issues
- Partners in partnerships

# Miscellaneous Issues

- Consolidated issues
- Partners in partnerships
- OID and market discount on tax exempts

# Life Insurance Policies

# Life Insurance Policies

- Increase in cash value

# Life Insurance Policies

- Increase in cash value
- Policy cost exceeds cash buildup, there is no adjustment

# Example

## Example 1:

On January 1, Y1, corporation X, a calendar year taxpayer, purchased a flexible premium life insurance contract with a death benefit of \$100,000 and planned annual gross premiums of \$2,200 payable on January 1 of each year. The net surrender value of the contract at the end of 1987 and subsequent years, together with the cumulative premiums for the contract at the end of each year, are set forth in the following table:

<u>YEAR</u>	<u>CUMULATIVE PREMIUMS PAID</u>	<u>YEAR-END NET SURRENDER VALUE</u>
Y1	\$2,200	\$2,420
Y2	4,400	5,082
Y3	6,600	8,010
Y4	8,800	11,231
Y5	11,000	14,744
Y6	13,200	17,820
Y7	15,400	20,944
Y8	17,600	24,464
Y9	19,800	27,720

# Example

## Worksheet for calculation of ACE adjustment for inside buildup of insurance owned by a corporation

Net surrender value of contract at end of period <u>Y9</u>	\$ <u>27,720</u>
ADD: distributions that are recoveries of basis	<u>                    </u> (+)
DEDUCT: net surrender value of contract at end of preceding period <u>Y8</u>	<u>24,464</u>
DEDUCT: premiums paid during the period	<u>2,200</u>
TOTAL DEDUCTION	<u>26,664</u> (-)
ACE INCLUSION	\$ <u>1,056</u>

# Term Insurance

# Term Insurance

- Reduced by premium allocable to the taxable year

# Term Insurance

- Reduced by premium allocable to the taxable year
- Premiums paid not allocable to taxable year create basis

# Policy Basis

# Policy Basis

- Pre-1990 policies, basis based on premiums paid prior to 1990

# Policy Basis

- Pre-1990 policies, basis based on premiums paid prior to 1990
- After that add in ACE adjustments

# Example

## Example 1:

Using the same facts as in example A.1., the corporation's basis in the policy at 12/31/95 is calculated as follows:

Premiums paid through Y3		\$ 6,600
Y4 inclusion	\$1,021	
Y4 premium	2,200	3,221
Y5 inclusion	1,313	
Y5 premium	2,200	3,513
Y6 inclusion	876	
Y6 premium	2,200	3,076
Y7 inclusion	924	
Y7 premium	2,200	3,124
Y8 inclusion	1,320	
Y8 premium	2,200	3,520
Y9 inclusion	1,056	
Y9 premium	<u>2,200</u>	<u>3,256</u>
Basis at Y9		<u><u>\$26,310</u></u>

# Example

## Example 2:

In April, Y10, the insured dies, and Corporation X receives the \$100,000 death benefit. X includes proceeds in excess of basis in ACE, the taxable amount is calculated as follows:

death benefit	\$100,000
less basis Y9	(26,310)
less Y10 premium	<u>(2,200)</u>
	<u>\$ 71,490</u> x .75 = <u>\$53,617</u>

# LIFO Inventory

# LIFO Inventory

- ACE adjusted for changes in LIFO reserves

# LIFO Inventory

- ACE adjusted for changes in LIFO reserves
- Baseline LIFO recapture amount

# Example

Example: Calendar Corp. had the following inventories:

	<u>Y1</u>	<u>Y2</u>	<u>Y3</u>	<u>Y4</u>	<u>Y5</u>
FIFO	\$700	\$800	\$900	\$850	\$1,000
LIFO	\$500	\$550	\$600	\$625	\$ 650

First year after 12/31/89 is Y3 in this example

# Example

	<u>Y2</u>	<u>Y3</u>	<u>Y4</u>	<u>Y5</u>
LIFO recapture amount	\$250	\$300	\$225	\$350
LIFO recapture charge	N/A	50	(75)	125

# Simplified Election

# Simplified Election

- Can elect to use regular tax inventory for  
AMT & ACE

# Simplified Election

- Can elect to use regular tax inventory for AMT & ACE
- However, may be a problem due to depreciation issues--need to run numbers

# Simplified Election

- Can elect to use regular tax inventory for AMT & ACE
- However, may be a problem due to depreciation issues--need to run numbers
- Can only revoke with IRS consent

# Comprehensive Example

## Amount Includible/Deductible

<u>Description</u>	<u>E&amp;P</u>	<u>Tax</u>	<u>AMT</u>	<u>ACE</u>
Factory payroll	\$300,000	\$300,000	\$300,000	\$300,000
Interest income - Private Activity Bond	2,000	—	2,000	2,000
Municipal Bonds	3,000	—	—	3,000
Meal expense for salesman & customers	(10,000)	(5,000)	(5,000)	(5,000)
Payroll tax penalty	( 300)	—	—	—
Federal income tax	(17,000)	—	—	—
Capital loss in excess of gain	(15,000)	—	—	—
Proceeds of life insurance in excess of basis	87,000			87,000

# Compensation, Fringe Benefits & Reimbursed Business Expenses

## Module 4

# Executive Compensation

# Executive Compensation

- Current vs. Future

# Executive Compensation

- Current vs. Future
- §409A impact

# Executive Compensation

- Current vs. Future
- §409A impact
- Lower capital gains

# Executive Compensation

- Current vs. Future
- §409A impact
- Lower capital gains
  - ISOs not as advantageous

# Executive Compensation

- Current vs. Future
- §409A impact
- Lower capital gains
  - ISOs not as advantageous
  - §83(b) election - and related gamble

# Reasonable Compensation

# Reasonable Compensation

- C Corporation Issue

# Reasonable Compensation

- C Corporation Issue
- S Corporation Issue

# Compensation

# Compensation

- Fringe benefits

# Compensation

- Fringe benefits
- Group insurance

# Compensation

- Fringe benefits
- Group insurance
- Sick pay

# Compensation

- Fringe benefits
- Group insurance
- Sick pay
- Medical reimbursements

# Compensation

- Fringe benefits
- Group insurance
- Sick pay
- Medical reimbursements
- Related corporations

# Compensation

# Compensation

- Must be for actual services (paying the kids or nonparticipating spouse)

# Compensation

- Must be for actual services (paying the kids or nonparticipating spouse)
- Use company's method of accounting to compute

# Compensation

- Must be for actual services (paying the kids or nonparticipating spouse)
- Use company's method of accounting to compute
- Factors to consider (including where appeal would go)

# Below Market Loans

# Below Market Loans

- Must be a loan in substance

# Below Market Loans

- Must be a loan in substance
- Treatment of shareholder/employee

# Below Market Loans

- Must be a loan in substance
- Treatment of shareholder/employee
  - Demand loans

# Below Market Loans

- Must be a loan in substance
- Treatment of shareholder/employee
  - Demand loans
  - Term loans

# Below Market Loans

- Must be a loan in substance
- Treatment of shareholder/employee
  - Demand loans
  - Term loans
- Applicable federal rate

# Fringe Benefits

# Fringe Benefits

- Section 61 (all income from all sources)

# Fringe Benefits

- Section 61 (all income from all sources)
- Section 83 (property for services)

# Fringe Benefits

- Section 61 (all income from all sources)
- Section 83 (property for services)
- Section 132 (certain fringe benefits)

# Fringe Benefits

- Section 61 (all income from all sources)
- Section 83 (property for services)
- Section 132 (certain fringe benefits)
- Benefit is taxable unless specifically excluded

# Example of Fringes

# Example of Fringes

- Employer-provided automobile

# Example of Fringes

- Employer-provided automobile
- Flight on an employer-provided aircraft

# Example of Fringes

- Employer-provided automobile
- Flight on an employer-provided aircraft
- Employer-provided free or discounted commercial airline flight

# Example of Fringes

- Employer-provided automobile
- Flight on an employer-provided aircraft
- Employer-provided free or discounted commercial airline flight
- Employer-provided vacation

# Example of Fringes

- Employer-provided automobile
- Flight on an employer-provided aircraft
- Employer-provided free or discounted commercial airline flight
- Employer-provided vacation
- Employer-provided discount on property or services

# Example of Fringes

- Employer-provided automobile
- Flight on an employer-provided aircraft
- Employer-provided free or discounted commercial airline flight
- Employer-provided vacation
- Employer-provided discount on property or services
- Employer-provided membership in a country club or other social club

# Example of Fringes

- Employer-provided automobile
- Flight on an employer-provided aircraft
- Employer-provided free or discounted commercial airline flight
- Employer-provided vacation
- Employer-provided discount on property or services
- Employer-provided membership in a country club or other social club
- Employer-provided ticket to an entertainment or sporting event.

# § 132 Fringes

# § 132 Fringes

- No additional cost service

# § 132 Fringes

- No additional cost service
- Qualified employee discount

# Working Condition Fringe

# Working Condition Fringe

- Exclude property or services provided to employee if would be deductible under §162 or §167 for employee

# Working Condition Fringe

- Exclude property or services provided to employee if would be deductible under §162 or §167 for employee
- No nondiscrimination rules

# De Minimis Fringes

# De Minimis Fringes

- Too small to account for

# De Minimis Fringes

- Too small to account for
- Cash and gift certificates/cards never count

# Athletic Facilities

# Athletic Facilities

- Exclusion tightly written

# Athletic Facilities

- Exclusion tightly written
- Can't "outsource" to give memberships in local gym

# Reimbursements

# Reimbursements

- Accountable plan rules

# Reimbursements

- Accountable plan rules
- IRS has increased interest in the area

# Reimbursements

- Accountable plan rules
- IRS has increased interest in the area
- Fail to meet accountable plan rules, have to include in income (and subject to payroll taxes)

# Accountable Plans

# Accountable Plans

- Business connection

# Accountable Plans

- Business connection
- Substantiation issues

# Accountable Plans

- Business connection
- Substantiation issues
- Repayment of excess reimbursements must be required

# Accountable Plans

- Business connection
- Substantiation issues
- Repayment of excess reimbursements must be required
- Cannot use “auto allowance” (a favorite of sales staff) unless require accounting/repayment of excess payments

# Advances

# Advances

- Can pay in advance

# Advances

- Can pay in advance
- Safe harbors

# Advances

- Can pay in advance
- Safe harbors
  - Fixed date method

# Advances

- Can pay in advance
- Safe harbors
  - Fixed date method
  - Periodic statement method

# Advances

- Can pay in advance
- Safe harbors
  - Fixed date method
  - Periodic statement method
  - Won't apply if abusive

# Treatment

# Treatment

- Accountable plan excluded from income

# Treatment

- Accountable plan excluded from income
- Other plans must add to income/pick up for payroll taxes

# Treatment

- Accountable plan excluded from income
- Other plans must add to income/pick up for payroll taxes
- Employee fails to repay, include excess in wages (but if a pattern, may not have accountable plan--need to attempt to enforce)

# Automobiles

# Automobiles

- Favorite of IRS agents, especially for owners

# Automobiles

- Favorite of IRS agents, especially for owners
- Detailed documentation rules

# Automobiles

- Favorite of IRS agents, especially for owners
- Detailed documentation rules
- Even if not a “luxury auto” for depreciation purposes, likely still “listed property” for documentation requirements

# Depreciation

# Depreciation

- “Luxury auto” rules

# Depreciation

- “Luxury auto” rules
- Based on year placed in service

# Limits

REV. PROC. 2007-30 TABLE 1

**DEPRECIATION LIMITATIONS FOR PASSENGER AUTOMOBILES  
PLACED IN SERVICE BY THE TAXPAYER DURING CALENDAR YEAR 2007**

Tax Year	Amount
1st Tax Year	\$ 3,060
2nd Tax Year	\$ 4,900
3rd Tax Year	\$ 2,850
Each Succeeding Year	\$ 1,775

REV. PROC. 2007-30 TABLE 2

**DEPRECIATION LIMITATIONS FOR TRUCKS AND VANS  
PLACED IN SERVICE BY THE TAXPAYER DURING CALENDAR YEAR 2007**

Tax Year	Amount
1st Tax Year	\$ 3,260
2nd Tax Year	\$ 5,200
3rd Tax Year	\$ 3,050
Each Succeeding Year	\$ 1,875

# Other Rules

# Other Rules

- Use drops below 50% on any listed vehicle

# Other Rules

- Use drops below 50% on any listed vehicle
  - Straight line depreciation

# Other Rules

- Use drops below 50% on any listed vehicle
  - Straight line depreciation
  - No §179

# Other Rules

- Use drops below 50% on any listed vehicle
  - Straight line depreciation
  - No §179
  - Recapture of excess in prior years

# Other Rules

- Use drops below 50% on any listed vehicle
  - Straight line depreciation
  - No §179
  - Recapture of excess in prior years
- Lease inclusion amount for leased autos

# Substantiation

# Substantiation

- Amount of each expenditure

# Substantiation

- Amount of each expenditure
- Amount of each business/investment use based on mileage or other appropriate measure

# Substantiation

- Amount of each expenditure
- Amount of each business/investment use based on mileage or other appropriate measure
- Date

# Substantiation

- Amount of each expenditure
- Amount of each business/investment use based on mileage or other appropriate measure
- Date
- Business purpose

# Personal Use Portion

# Personal Use Portion

- Income imputed

# Personal Use Portion

- Income imputed
- Methods allowed

# Personal Use Portion

- Income imputed
- Methods allowed
  - Annual lease valuation method

# Personal Use Portion

- Income imputed
- Methods allowed
  - Annual lease valuation method
  - Cents per mile method

# Personal Use Portion

- Income imputed
- Methods allowed
  - Annual lease valuation method
  - Cents per mile method
  - Commuting valuation rules

# Personal Use Portion

- Income imputed
- Methods allowed
  - Annual lease valuation method
  - Cents per mile method
  - Commuting valuation rules
- Each method defined in detail

# 5% Owners

# 5% Owners

- Even with income recognized, personal use not allowed to be treated as business related for

# 5% Owners

- Even with income recognized, personal use not allowed to be treated as business related for
  - 5% owners

# 5% Owners

- Even with income recognized, personal use not allowed to be treated as business related for
  - 5% owners
  - Related individuals (tax treatment)

# 5% Owners

- Even with income recognized, personal use not allowed to be treated as business related for
  - 5% owners
  - Related individuals (tax treatment)
- Would impact tax provision (FIN 48 again)

# Example Fringes

# Example Fringes

- Business use

# Example Fringes

- Business use
- Personal use prohibited

# Example Fringes

- Business use
- Personal use prohibited
- Personal use limited to commuting

# Example Fringes

- Business use
- Personal use prohibited
- Personal use limited to commuting
- Certain vehicles exempt

# Example Fringes

- Business use
- Personal use prohibited
- Personal use limited to commuting
- Certain vehicles exempt
- Qualified demonstration use for auto salesmen

# Example Expense

# Example Expense

- Ordinary and necessary expense

# Example Expense

- Ordinary and necessary expense
- List of basic items

# Meals & Entertainment

# Meals & Entertainment

- Directly related/Associated with

# Meals & Entertainment

- Directly related/Associated with
- Conductive to business

# Meals & Entertainment

- Directly related/Associated with
- Conductive to business
- Entertainment

# Meals & Entertainment

- Directly related/Associated with
- Conductive to business
- Entertainment
  - Salesperson-shows linkage to commission

# Meals & Entertainment

- Directly related/Associated with
- Conductive to business
- Entertainment
  - Salesperson-shows linkage to commission
  - Salaried-employer must require employee to provide entertainment

# Meals & Entertainment

# Meals & Entertainment

- Meals

# Meals & Entertainment

- Meals
  - Taxpayer or representative must be present

# Meals & Entertainment

- Meals
  - Taxpayer or representative must be present
  - Can be employee or contractor

# Meals & Entertainment

- Meals
  - Taxpayer or representative must be present
  - Can be employee or contractor
- Allocation of expense issues/incidental expenses

# Meals & Entertainment

# Meals & Entertainment

- Recreational club dues

# Meals & Entertainment

- Recreational club dues
- Tickets to events

# Meals & Entertainment

- Recreational club dues
- Tickets to events
- Meals during travel (including allowed M&I per diem)

# Travel Expenses

# Travel Expenses

- Reasonable “ordinary & necessary” expenses

# Travel Expenses

- Reasonable “ordinary & necessary” expenses
- Away from home overnight requirement (sleep test)

# Travel Expenses

- Reasonable “ordinary & necessary” expenses
- Away from home overnight requirement (sleep test)
- Away from tax home requirement (entire city or general area)

# Temporary Assignment

# Temporary Assignment

- Travel expenses (even daily) deductible if away from tax home temporarily

# Temporary Assignment

- Travel expenses (even daily) deductible if away from tax home temporarily
- One year test

# Temporary Assignment

- Travel expenses (even daily) deductible if away from tax home temporarily
- One year test
- Problems

# Temporary Assignment

- Travel expenses (even daily) deductible if away from tax home temporarily
- One year test
- Problems
  - Indefinite term

# Temporary Assignment

- Travel expenses (even daily) deductible if away from tax home temporarily
- One year test
- Problems
  - Indefinite term
  - No tax home

# Less than One Year

# Less than One Year

- §162(a)

# Less than One Year

- §162(a)
- One Year Cliff Test

# Test for Tax Home

# Test for Tax Home

- Home near prior work location

# Test for Tax Home

- Home near prior work location
- Duplication of living expenses

# Test for Tax Home

- Home near prior work location
- Duplication of living expenses
- At claimed tax home

# Test for Tax Home

- Home near prior work location
- Duplication of living expenses
- At claimed tax home
  - Family members

# Test for Tax Home

- Home near prior work location
- Duplication of living expenses
- At claimed tax home
  - Family members
  - Used for taxpayer's own lodging frequently

# Manual Glitch

# Manual Glitch

- Portion at p. 4-14 (c) at top of page should be deleted

# Manual Glitch

- Portion at p. 4-14 (c) at top of page should be deleted
- Now pure 1 year test (Revenue Ruling 93-86 and §162(a)(2)) except for crime prosecution

# Business Gifts

# Business Gifts

- \$25 per year limitation (IRC §274(b)(1))

# Business Gifts

- \$25 per year limitation (IRC §274(b)(1))
- Husband/wife count as one person

# Dwelling Unit

# Dwelling Unit

- Special limitations under §280A

# Dwelling Unit

- Special limitations under §280A
- *Feldman* provision (§280A(c)(6))

# Records: Travel

# Records: Travel

- Amount of each expenditure

# Records: Travel

- Amount of each expenditure
- Date of departure and return

# Records: Travel

- Amount of each expenditure
- Date of departure and return
- Destinations

# Records: Travel

- Amount of each expenditure
- Date of departure and return
- Destinations
- Business reasons

# Records: Travel

- Amount of each expenditure
- Date of departure and return
- Destinations
- Business reasons
- Receipts for lodging

# Records: Entertainment

# Records: Entertainment

- Amount of each expenditure

# Records: Entertainment

- Amount of each expenditure
- Date

# Records: Entertainment

- Amount of each expenditure
- Date
- Name, location, type of entertainment

# Records: Entertainment

- Amount of each expenditure
- Date
- Name, location, type of entertainment
- Reason/nature of business benefit

# Records: Entertainment

- Amount of each expenditure
- Date
- Name, location, type of entertainment
- Reason/nature of business benefit
- Person entertained

# Records: Entertainment

- Amount of each expenditure
- Date
- Name, location, type of entertainment
- Reason/nature of business benefit
- Person entertained
- Receipt

# Records: Gifts

# Records: Gifts

- Cost and description

# Records: Gifts

- Cost and description
- Date

# Records: Gifts

- Cost and description
- Date
- Reason

# Records: Gifts

- Cost and description
- Date
- Reason
- Receipt

# Overview

# Overview

- Payroll tax exposure for employees in general

# Overview

- Payroll tax exposure for employees in general
- Income tax exposure for disallowed payments to owners and related parties

# When an S Corporation Pays Income Tax

Module 5

# S Corporations & Tax

# S Corporations & Tax

- Open C years

# S Corporations & Tax

- Open C years
- State income taxes

# S Corporations & Tax

- Open C years
- State income taxes
- Built in gains

# S Corporations & Tax

- Open C years
- State income taxes
- Built in gains
- Excess passive income

# Built in Gains Tax

# Built in Gains Tax

- Repeal of General Utilities doctrine

# Built in Gains Tax

- Repeal of General Utilities doctrine
- C corporations electing S status

# Built in Gains Tax

- Repeal of General Utilities doctrine
- C corporations electing S status
- Applies to all gains recognized unless show

# Built in Gains Tax

- Repeal of General Utilities doctrine
- C corporations electing S status
- Applies to all gains recognized unless show
  - Asset not owned on date of S election

# Built in Gains Tax

- Repeal of General Utilities doctrine
- C corporations electing S status
- Applies to all gains recognized unless show
  - Asset not owned on date of S election
  - Appreciation occurred after S election

# Net Built in Gain

# Net Built in Gain

- List each item

# Net Built in Gain

- List each item
- FMV for each item

# Net Built in Gain

- List each item
- FMV for each item
- Tax basis

# Net Built in Gain

- List each item
- FMV for each item
- Tax basis
- $\text{FMV} - \text{basis} = \text{built in gain}$

# Net Built in Gain

- List each item
- FMV for each item
- Tax basis
- $\text{FMV} - \text{basis} = \text{built in gain}$
- Overall recognition limited to net calculated

# Inventories

# Inventories

- Bulk sale (Reg. 1.1374-7)

# Inventories

- Bulk sale (Reg. 1.1374-7)
- LIFO recapture tax

# LIFO Example

	Dr.	Cr.
LIFO Reserve	\$100,000	
Other Income		\$100,000
To recapture LIFO reserve		
Federal Income		
Tax Expense	\$ 34,000	
Accrued FIT Current		\$ 8,500
Accrued FIT Long-term		\$ 25,500
To provide FIT on LIFO recapture.		

**No passthrough of tax deduction to shareholder, unlike  
BIG tax**

# Other Impacts

# Other Impacts

- Increase E&P (problem for other tax)

# Other Impacts

- Increase E&P (problem for other tax)
- Still on LIFO and still bound

# Calculate BIG Tax

# Calculate BIG Tax

- Highest rate

# Calculate BIG Tax

- Highest rate
- Computation - lesser of

# Calculate BIG Tax

- Highest rate
- Computation - lesser of
  - Recognized net built in gain

# Calculate BIG Tax

- Highest rate
- Computation - lesser of
  - Recognized net built in gain
  - Taxable income for year

# Calculate BIG Tax

- Highest rate
- Computation - lesser of
  - Recognized net built in gain
  - Taxable income for year
- But if use second option, carryover hits

# Calculate BIG Tax

- Highest rate
- Computation - lesser of
  - Recognized net built in gain
  - Taxable income for year
- But if use second option, carryover hits
- NOLs from C years allowed to be used

# Comprehensive Example

	<u>TAX BASIS</u>	<u>FAIR MARKET VALUE</u>	<u>NET UNREALIZED BUILT-IN GAIN</u>
Cash	\$ 100	\$ 100	\$ -0-
Accounts Receivable	1,000	1,000	-0-
Inventory (FIFO)	3,000	4,500	1,500
Investments	500	300	(200)
Fixed assets	10,000	12,000	2,000
Goodwill	-0-	10,000	10,000
	<u>          </u>	<u>          </u>	<u>          </u>
Total assets	<u>\$14,600</u>	<u>\$27,900</u>	<u>\$13,300</u>
Accrued expenses	\$ 500	\$ 1,600	\$1,100
Notes payable	5,000	5,000	-0-
Stockholder's equity	<u>9,100</u>	<u>21,300</u>	<u>12,200</u>
Total liabilities and Stockholder's equity	<u>\$14,600</u>	<u>\$27,900</u>	<u>\$13,300</u>

# Comprehensive Example

	<u>S YEAR 1</u>	<u>S YEAR 2</u>	<u>S YEAR 3</u>
Taxable income	<u>\$ 200</u>	<u>\$ 2,800</u>	<u>\$ 800</u>
Recognized built-in gain (loss)			
Inventory	\$ 1,500	\$ -0-	\$ -0-
Investments	-0-	-0-	(200)
Fixed assets	-0-	2,000	-0-
Accrued expenses	<u>(1,100)</u>	<u>-0-</u>	<u>-0-</u>
Net recognized Built-in gain	<u>\$ 400</u>	<u>\$ 2,000</u>	<u>\$ (200)</u>
Base for built-in gain tax	<u>\$ 200</u>	<u>\$ 2,200</u>	<u>\$ -0-</u>
Tax at 35%	<u>\$ 70</u>	<u>\$ 770</u>	<u>\$ -0-</u>
Built in gain carry forward	\$ 200	\$ -0-	\$ -0-

# Comprehensive Example

Corporation Name, Schedule K, Form 11 20S, Year EI#

<u>Line #</u>	<u>S Corporation Income Type</u>	<u>Amount</u>	<u>Tax on Built-in Gain</u>	<u>Income to be Reported By Shareholder(s)</u>
---------------	----------------------------------	---------------	-----------------------------	--

Using those column headings and making a few simple assumptions for each year in the illustration, here are the entries for that schedule for each year:

## S Year 1

1	ordinary	\$ 200	70	130
---	----------	--------	----	-----

## S Year 2

2	ordinary	800	70	730
5	1231	2,000	700	1,300

## S Year 3

The schedule is not required because no built-in gain tax is due in year 3

# Installment Sales

# Installment Sales

- Exception to 10 year period (Notice 90-27)

# Installment Sales

- Exception to 10 year period (Notice 90-27)
- Gain pushed outside 10 year period still subject to BIG if sale within 10 year period

# Excess Passive Income

# Excess Passive Income

- Two problems

# Excess Passive Income

- Two problems
  - Tax imposed on S corporation and

# Excess Passive Income

- Two problems
  - Tax imposed on S corporation and
  - Will not have an S corporation if have issue for 3 years-major audit problem if not noticed

# Excess Passive Income

- Two problems
  - Tax imposed on S corporation and
  - Will not have an S corporation if have issue for 3 years-major audit problem if not noticed
- Designed to block PHCs from going S route

# Passive Income

# Passive Income

- Net passive income

# Passive Income

- Net passive income
- Passive investment income (Reg. §1.1362-2(c)(5)) less

# Passive Income

- Net passive income
  - Passive investment income (Reg. §1.1362-2(c)(5)) less
  - Deductions attributable

# Passive Investment Income

# Passive Investment Income

- Royalties

# Passive Investment Income

- Royalties
- Rents (with exceptions)

# Passive Investment Income

- Royalties
- Rents (with exceptions)
- Dividends

# Passive Investment Income

- Royalties
- Rents (with exceptions)
- Dividends
- Interest

# Passive Investment Income

- Royalties
- Rents (with exceptions)
- Dividends
- Interest
- Annuities

# Passive Investment Income

- Royalties
- Rents (with exceptions)
- Dividends
- Interest
- Annuities
- Sales and exchanges of stock & securities

# Excess Net Passive Income

# Excess Net Passive Income

- Ratio exceeds 25%, have triggered

# Excess Net Passive Income

- Ratio exceeds 25%, have triggered
- Only applies if S corporation has E&P

# Example

Step 1. Determine excess of passive investment income over 25% of gross income:

Passive investment income	\$80,000
Gross income factor (\$200,000 x 25%)	<u>50,000</u>
Excess	<u>\$30,000</u>

Step 2. Determine net passive income:

Passive investment income	\$80,000
Directly connected expenses	<u>10,000</u>
Net passive income	<u>\$70,000</u>

Step 3. Determine excess net passive income:

$$\frac{\$30,000 \text{ (from Step 1)}}{\$80,000 \text{ (passive investment income)}} \times \$70,000 \text{ (from Step 2)} = \$26,250$$

Step 4. Determine limitation on excess net passive income:

Taxable income	<u>\$20,000</u>
----------------	-----------------

Step 5. Compute tax:

Excess net passive income [Lesser of Step 3 (\$26,250) or Step 4 (\$20,000)]	\$20,000
Multiply by maximum corporate tax rate	<u>35%</u>
Tax	<u>\$7,000</u>

# Waiver of Tax

# Waiver of Tax

- Good faith determined did not have E&P

# Waiver of Tax

- Good faith determined did not have E&P
- Corrective distributive

# Reduction of Tax

# Reduction of Tax

- Applied prorata to each item of income

# Reduction of Tax

- Applied prorata to each item of income
- Shareholders pay tax on net income

# Loss of S Status

# Loss of S Status

- §1375(d)(3) causes loss of election after 3rd straight year of excess passive income

# Loss of S Status

- §1375(d)(3) causes loss of election after 3rd straight year of excess passive income
- S election ends at beginning of year 4

# Loss of S Status

- §1375(d)(3) causes loss of election after 3rd straight year of excess passive income
- S election ends at beginning of year 4
- Solution to both: get rid of E&P

# Loss of S Status

- §1375(d)(3) causes loss of election after 3rd straight year of excess passive income
- S election ends at beginning of year 4
- Solution to both: get rid of E&P
  - Distribute

# Loss of S Status

- §1375(d)(3) causes loss of election after 3rd straight year of excess passive income
- S election ends at beginning of year 4
- Solution to both: get rid of E&P
  - Distribute
  - Elect to treat as distributed

# Debt vs. Equity

## Module 6

# Capitalization

# Capitalization

- Tax problem is documenting debt as debt

# Capitalization

- Tax problem is documenting debt as debt
- As well, legal issues with thin capitalization

# Debt Problems: C

# Debt Problems: C

- Section 385

# Debt Problems: C

- Section 385
- Payment of principal treated as dividend

# Debt Problems: C

- Section 385
- Payment of principal treated as dividend
- No safe harbor

# Debt Problems: S

# Debt Problems: S

- Second class of stock: no more S corporation

# Debt Problems: S

- Second class of stock: no more S corporation
- Safe harbor rules

# Debt Problems: S

- Second class of stock: no more S corporation
- Safe harbor rules
- S debt basis problems

# Safe Harbor S Debt

# Safe Harbor S Debt

- In writing

# Safe Harbor S Debt

- In writing
- Fixed sum on demand or date certain

# Safe Harbor S Debt

- In writing
- Fixed sum on demand or date certain
- Fixed rate of interest

# Safe Harbor S Debt

- In writing
- Fixed sum on demand or date certain
- Fixed rate of interest
- Not contingent

# Safe Harbor S Debt

- In writing
- Fixed sum on demand or date certain
- Fixed rate of interest
- Not contingent
- Not convertible

# Safe Harbor S Debt

- In writing
- Fixed sum on demand or date certain
- Fixed rate of interest
- Not contingent
- Not convertible
- Owed to eligible S shareholder

§ 1244

# § 1244

- Ordinary loss deduction for small business stock (\$50,000/\$100,000)

# § 1244

- Ordinary loss deduction for small business stock (\$50,000/\$100,000)
- Only applies to stock

# Loss on Debt

# Loss on Debt

- Nonbusiness - short term capital loss

# Loss on Debt

- Nonbusiness - short term capital loss
- Business - ordinary loss

# Loss on Debt

- Nonbusiness - short term capital loss
- Business - ordinary loss
- Tough to get into second category

# Section 1244

# Section 1244

- No longer required statement (strike out in manual)

# Section 1244

- No longer required statement (strike out in manual)
- \$1,000,000 limit

# Section 1244

- No longer required statement (strike out in manual)
- \$1,000,000 limit
- Original purchaser

# Section 1244

- No longer required statement (strike out in manual)
- \$1,000,000 limit
- Original purchaser
- Individual/partnership owner

# Section 1244

# Section 1244

- Stock issued for cash or property

# Section 1244

- Stock issued for cash or property
- Not received excess “passive” income

# Limit on Individual Loss

# Limit on Individual Loss

- **\$50,000/\$100,000**

# Limit on Individual Loss

- \$50,000/\$100,000
- Basis in excess of FMV on acquisition

# Limit on Individual Loss

- \$50,000/\$100,000
- Basis in excess of FMV on acquisition
- Later increases in basis

# Planning Strategies

# Planning Strategies

- All capital from owner

# Planning Strategies

- All capital from owner
- Owner has to borrow

# Planning Strategies

- All capital from owner
- Owner has to borrow
- Direct loans required

# Why C May Make Sense

	<u>S Corp.</u>	<u>C Corp.</u>
Profit	\$ 50,000	\$ 50,000
Current Tax	<u>(16,500)</u>	<u>(7,500)</u>
Cash to work with	\$ <u>33,500</u>	\$ <u>42,500</u>
Future value @ 8% for 20 years	\$ 1,532,960	\$ 1,944,800
Tax on Liquidation	n/a	<u>(641,784)</u>
Net to Owner	<u>\$ 1,532,960</u>	<u>\$ 1,303,016</u>

# Intangible Assets

## Module 7

# Intangible Assets

# Intangible Assets

- Accounting Treatment

# Intangible Assets

- Accounting Treatment
  - Amortization over life

# Intangible Assets

- Accounting Treatment
  - Amortization over life
  - Revaluation of goodwill (SFAS 142)

# Intangible Assets

- Accounting Treatment
  - Amortization over life
  - Revaluation of goodwill (SFAS 142)
- Tax treatment governed by §1060

# Allocation Under § 1060

# Allocation Under § 1060

- Residual method

# Allocation Under § 1060

- Residual method
- Problem areas

# Contract Clauses

# Contract Clauses

- Taxpayer challenges (you signed it, you live with it)

# Contract Clauses

- Taxpayer challenges (you signed it, you live with it)
- IRS challenges

# Contract Clauses

- Taxpayer challenges (you signed it, you live with it)
- IRS challenges
  - Adverse interests

# Contract Clauses

- Taxpayer challenges (you signed it, you live with it)
- IRS challenges
  - Adverse interests
  - Otherwise...

# Operating Provisions

# Operating Provisions

- Applicable acquisitions

# Operating Provisions

- Applicable acquisitions
- Binding on both buyer and seller

# Operating Provisions

- Applicable acquisitions
- Binding on both buyer and seller
- Hierarchy of allocation

# Classes

# Classes

- Class I: Cash...

# Classes

- Class I: Cash...
- Class II: CDs, ...

# Classes

- Class I: Cash...
- Class II: CDs, ...
- Class III: All other assets except goodwill and going concern value

# Classes

- Class I: Cash...
- Class II: CDs, ...
- Class III: All other assets except goodwill and going concern value
- Class IV: Intangible assets in nature of goodwill & going concern (15 year)

# Miscellaneous

# Miscellaneous

- Basis allocated can be no more than FMV of class

# Miscellaneous

- Basis allocated can be no more than FMV of class
- Conforming rules for 338 elections

# Miscellaneous

- Basis allocated can be no more than FMV of class
- Conforming rules for 338 elections
- Form 8594 filing

# Section 197

# Section 197

- **Governs intangibles acquired in business acquisition**

# Section 197

- Governs intangibles acquired in business acquisition
- 15 year period

# Section 197

- Governs intangibles acquired in business acquisition
- 15 year period
- Covenant not to compete override-- otherwise doesn't apply to items otherwise deductible

# Section 197 Definition

# Section 197 Definition

- Goodwill

# Section 197 Definition

- Goodwill
- Assembled workforce

# Section 197 Definition

- Goodwill
- Assembled workforce
- Governmental granted right

# Section 197 Definition

- Goodwill
- Assembled workforce
- Governmental granted right
- Covenant not to compete

# Section 197 Definition

- Goodwill
- Assembled workforce
- Governmental granted right
- Covenant not to compete
- Franchise, trademark, trade name

# Excluded

# Excluded

- Interest in entity

# Excluded

- Interest in entity
- Financial contracts

# Excluded

- Interest in entity
- Financial contracts
- Interest in land

# Excluded

- Interest in entity
- Financial contracts
- Interest in land
- Certain software

# Excluded

- Interest in entity
- Financial contracts
- Interest in land
- Certain software
- Certain films, sound recordings, etc.

# Excluded

# Excluded

- Certain rights to receive tangible property or services

# Excluded

- Certain rights to receive tangible property or services
- Certain interests in patents or copyrights

# Excluded

- Certain rights to receive tangible property or services
- Certain interests in patents or copyrights
- Lease of tangible property

# Excluded

- Certain rights to receive tangible property or services
- Certain interests in patents or copyrights
- Lease of tangible property
- Interest in existing indebtedness

# Excluded

- Certain rights to receive tangible property or services
- Certain interests in patents or copyrights
- Lease of tangible property
- Interest in existing indebtedness
- Professional sports franchise

# Excluded

# Excluded

- **Certain transaction costs**

# Excluded

- Certain transaction costs
- Certain purchased mortgage servicing rights

# Example

Service customer list - 5 year useful life	\$ 150,000
Vehicle customer list - 3 year useful life	\$ 150,000
Advertising - 4 year useful life	\$ 100,000
Computer software - canned	\$ 100,000
Computer software - other	\$ 100,000
Franchise (10 years)	\$ 500,000
Goodwill	\$ 50,000
	<hr/>
	\$ 1,150,000

# Example

	<u>Prior Law</u>	<u>New Law</u>	<u>Difference</u>
Customer list - 5 yr.	\$ 30,000	\$ 10,000	\$ (20,000)
Customer list - 3 yr.	50,000	10,000	40,000
Advertising - 4 yr. *	25,000	6,667	18,333
Software (canned) *	20,000	33,333	13,333
Software (other) *	20,000	6,667	(13,333)
Franchise	50,000	33,333	(16,667)
Goodwill	<u>- 0 -</u>	<u>3,333</u>	<u>3,333</u>
Total annual recovery	<u>\$195,000</u>	\$103,333	\$ <u>(91,667)</u>

**Footnote \*** Canned computer software is not a section 197 intangible and is depreciable over 36 months pursuant to code section 167(f).

Legal and accounting fees of \$25,000 are not section 197 assets and not deductible. They must be capitalized under the *INDOPCO* rule.

# Definitions

# Definitions

- Goodwill

# Definitions

- Goodwill
- Going concern value

# Definitions

- Goodwill
- Going concern value
- Workforce

# Definitions

- Goodwill
- Going concern value
- Workforce
- Information Base

# Definitions

- Goodwill
- Going concern value
- Workforce
- Information Base
- Know how

# Definitions

# Definitions

- Customer based intangibles

# Definitions

- Customer based intangibles
- Supplier based intangibles

# Definitions

- Customer based intangibles
- Supplier based intangibles
- Licenses, permits, etc.

# Definitions

- Customer based intangibles
- Supplier based intangibles
- Licenses, permits, etc.
- Covenants not to compete

# Definitions

- Customer based intangibles
- Supplier based intangibles
- Licenses, permits, etc.
- Covenants not to compete
- Franchises, trademarks, etc.

# Exceptions

# Exceptions

- Trade or business acquisition issue

# Exceptions

- Trade or business acquisition issue
- Facts and circumstances

# Enumerated Exceptions

Any interest in a corporation, partnership, trust, or estate

**EXAMPLE:** The rule does not apply to the cost of acquiring stock, partnership interests, or interests in a trust or estate whether or not such interests are regularly traded on an established market.

# Enumerated Exceptions

Any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap or other similar financial contract

NOTE: An interest in mortgage servicing contract, credit card servicing contract or other contract to service debt issued by another person, and an interest under an assumption reinsurance contract is not excluded from the definition by reason of the exclusion for interests under certain financial contracts.

# Exception Software

# Exception Software

- General public availability

# Exception Software

- General public availability
- Non-exclusive license

# Exception Software

- General public availability
- Non-exclusive license
- Not substantially modified

# Exception Software

- General public availability
- Non-exclusive license
- Not substantially modified
- *Microsoft Excel*

# Computer Software

# Computer Software

- Cause computer to perform functions

# Computer Software

- Cause computer to perform functions
- Not include database or similar item (such as tax research databases)

# Computer Software

- Cause computer to perform functions
- Not include database or similar item (such as tax research databases)
- Not §197 if depreciable under §167(f)

# Excluded

# Excluded

- **Films, sound recordings, etc., not acquired as part of a trade or business**

# Excluded

- Films, sound recordings, etc., not acquired as part of a trade or business
- Similarly for rights to receive property or services

# Example

**EXAMPLE:** A taxpayer acquired from another person a favorable contract right vested in such person to receive a specified amount of raw material each month for the next three years, which is the remaining life of the contract, and that right is not acquired as part of the acquisition of assets constituting a trade or business or a substantial portion thereof. The taxpayer should be required to amortize the cost of acquiring the contract right ratably over the remaining life of the contract.

If the favorable contract right is to receive a specified amount of raw materials during an unspecified period, the taxpayer should be required to amortize the cost of acquiring the contract right by multiplying such cost by a fraction, the numerator of which is the amount of raw materials to be received under the contract.

# Exceptions

# Exceptions

- Patents and copyrights

# Exceptions

- Patents and copyrights
- Leases

# Exceptions

- Patents and copyrights
- Leases
- Debt instruments

# Exceptions

- Patents and copyrights
- Leases
- Debt instruments
- Sports franchise

# Exceptions

- Patents and copyrights
- Leases
- Debt instruments
- Sports franchise
- Professional services

# Exceptions

# Exceptions

- Rights to service debts

# Exceptions

- Rights to service debts
- Governmental unit contracts

# Self-Created Intangibles

# Self-Created Intangibles

- Outsourced it-considered self-created

# Self-Created Intangibles

- Outsourced it-considered self-created
- Entering into or renewing contract for 197 intangible

# Self-Created Intangibles

- Outsourced it-considered self-created
- Entering into or renewing contract for 197 intangible
- Governmental license

# Self-Created Intangibles

- Outsourced it-considered self-created
- Entering into or renewing contract for 197 intangible
- Governmental license
- Agreement not to compete

# Special Rules

# Special Rules

- Adjusted basis

# Special Rules

- Adjusted basis
  - Same as under current

# Special Rules

- Adjusted basis
  - Same as under current
  - Contingent basis additions go over remaining term

# Special Rules

- Adjusted basis
  - Same as under current
  - Contingent basis additions go over remaining term
- Adjustment of basis if dispose of 197 intangible

# Tax Free Transactions

**EXAMPLE.** Assume that Mr. Brown owns an intangible that has been amortized under Section 197 for 5 full years and has a remaining unamortized but amortizable basis of \$300,000. Assume also that Mr. Brown exchanges the asset and \$100,000 in cash for a like-kind amortizable Section 197 intangible in a transaction to which Section 1031 applies. (i.e. a like kind exchange) Under these provisions, \$300,000 of the basis of the acquired amortizable Section 197 intangible is to be amortized over the 10 years remaining in the original 15 year amortization period for the transferred asset and the additional \$100,000 basis is to be amortized over 15 years.

# Partnerships

# Partnerships

- No 754 election in place, no adjustment

# Partnerships

- No 754 election in place, no adjustment
- If 754 election in place, “new” 15 year period starts for basis adjustment

# Sale of 197 Assets

# Sale of 197 Assets

- Held more than one year, §1231

# Sale of 197 Assets

- Held more than one year, §1231
- §§1245 and 1239 may apply

# Other Issues

# Other Issues

- Acquisition costs

# Other Issues

- Acquisition costs
- Relationship with §§338 and 1060

# Anti-Churning Rules

# Anti-Churning Rules

- Acquired after 8/10/93

# Anti-Churning Rules

- Acquired after 8/10/93
- Taxpayer or related party held asset in period from 7/25/91 through 8/10/93 or

# Anti-Churning Rules

- Acquired after 8/10/93
- Taxpayer or related party held asset in period from 7/25/91 through 8/10/93 or
- Acquired from person held at that period and user does not change or

# Anti-Churning Rules

- Acquired after 8/10/93
- Taxpayer or related party held asset in period from 7/25/91 through 8/10/93 or
- Acquired from person held at that period and user does not change or
- Granted to related party

# Reasonable Compensation

Module 8

# Reasonable Compensation

# Reasonable Compensation

- Salary history of recipient

# Reasonable Compensation

- Salary history of recipient
- Dividend history

# Reasonable Compensation

- Salary history of recipient
- Dividend history
- Employee salary scale

# Reasonable Compensation

- Salary history of recipient
- Dividend history
- Employee salary scale
- Industry salary scale

# Reasonable Compensation

# Reasonable Compensation

- Qualifications of employee

# Reasonable Compensation

- Qualifications of employee
- Contribution to business

# Reasonable Compensation

- Qualifications of employee
- Contribution to business
- Independent investor test

# Intent Test

# Intent Test

- Must have been intended to be compensation

# Intent Test

- Must have been intended to be compensation
- Travel and entertainment originally filed rule

# Intent Test

- Must have been intended to be compensation
- Travel and entertainment originally filed rule
- See cases

# Current Tax Developments

## Module 9