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CPA REG Study Guide

Taxation & Regulation — chapter-by-chapter review

2026 CPA Exam Blueprint · tax year 2025 law (incl. One Big Beautiful Bill Act)

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How to Use This Guide and the REG Exam Format

This guide is a chapter-by-chapter review of the **Taxation and Regulation (REG)** core section of the Uniform CPA Examination. It follows the same eighteen chapters as the REG practice bank on UPractice.org, so you can read a chapter and then drill the matching multiple-choice questions and simulations right away.

REG is the only core section that mixes **law** and **tax**. About a third of the exam asks about professional ethics in tax practice, federal tax procedure and business law (agency, contracts, secured transactions, bankruptcy, employment regulation and business entities). The rest is federal income taxation of property transactions, individuals and entities. You need two different study habits: precise rule recall for the law topics, and fast, careful computation for the tax topics.

The REG section at a glance

Feature	REG (2026 Blueprints)
Testing time	4 hours
Multiple-choice questions (MCQs)	72, in two testlets of 36
Task-based simulations (TBSs)	8, in three testlets (2, 3 and 3)
Total testlets	5
Optional break	15 minutes after testlet 3 (does not count against the 4 hours)
Score weighting	MCQs 50%, TBSs 50%
Score scale / passing score	0–99 / 75
Skill levels	Remembering and understanding 25–35%; Application 35–45%; Analysis 25–35%

Compared with the TCP discipline section, REG has many more remembering-and-understanding points. Definitions, deadlines and "which rule applies" questions matter, especially in the ethics and law areas.

Content areas and weights

Blueprint area	Weight	Chapters in this guide
I. Ethics, professional responsibilities and federal tax procedures	10–20%	1–4
II. Business law	15–25%	5–10 (and the legal-duties part of 4)
III. Federal taxation of property transactions	5–15%	11–12
IV. Federal taxation of individuals	22–32%	13–15
V. Federal taxation of entities (including tax preparation)	23–33%	16–18

Exam tip: Areas IV and V together are 45–65% of the exam. Individual and entity taxation must be solid, but do not skip business law: at 15–25% it is worth as much as a full tax area, and the rules are quick to learn.

Which tax law this guide uses

The AICPA's policy is that changes to the Internal Revenue Code and federal tax regulations become eligible for testing in the calendar quarter that begins **six months after the later of the enactment date or the effective date**. For the One Big Beautiful Bill Act (OBBBA, enacted July 4, 2025), the Board of Examiners adopted a phased approach: provisions effective in 2024 and 2025 became testable on REG on **July 1, 2026**. Unless a question says otherwise, assume events happen in the current year and the most recent law applies.

This guide, like the practice bank, uses **one tax year: 2025**, including the OBBBA changes that apply to 2025. Penalty amounts that are indexed by the year a return is filed use the amounts for returns filed in **2026** (that is, 2025 returns).

2025 OBBBA changes used in this guide	2026-only changes NOT used in computations
Standard deduction $15,750 single / $31,500 MFJ / $23,625 HOH	0.5% individual and 1% corporate charitable floors
Child tax credit $2,200 per child ($1,700 refundable)	Expanded dependent care credit and $7,500 exclusion
SALT cap $40,000, reduced above $500,000 MAGI, floor $10,000	2026 inflation adjustments
Senior, tips, overtime and car-loan-interest deductions	
§179 $2,500,000 limit / $4,000,000 threshold	
100% bonus depreciation for property acquired after January 19, 2025	
Domestic research costs deductible (§174A); §163(j) uses EBITDA-style ATI	

Watch out: The REG blueprint says candidates are **not** tested on inflation-indexed amounts (such as brackets, the standard deduction or the gift exclusion); the question will give you any indexed figure it needs. Non-indexed rules (percentages, the $3,000 capital loss limit, the $250,000/$500,000 home-sale exclusion, the 21% corporate rate, the 7.5% medical floor) you must know cold.

How each chapter is organized

1. **Plain-language explanation** of each rule the bank tests.
2. **Key-number tables** with the rules, deadlines and 2025 amounts.
3. **Worked examples** with every step shown. Each figure was computed and re-checked before it was printed.
4. **Exam tips, traps and memory tricks** in colored boxes: green for exam tips, blue for worked examples, red for traps and purple for memory tricks.
5. **Key takeaways** — a short summary to reread the night before the exam.

A study plan that works

1. **Diagnose first.** Take one short MCQ set from each blueprint area to see where you stand.
2. **Study in blueprint order**: ethics and procedure (1–4), business law (5–10), property (11–12), individuals (13–15), entities (16–18). Property basis and gain rules feed every later tax chapter.
3. **Read, then drill immediately.** After each chapter, do 20–30 timed MCQs from the matching bank chapter, then its simulations.
4. **Memorize the non-indexed rules** with flash cards: FICA rates, DRD percentages, statutes of limitation, penalty rates, bankruptcy priority order.
5. **Work every calculation twice**: once untimed writing out the full schedule, once timed at about 1.5 minutes per MCQ.
6. **Take full mock exams** (72 MCQs + 8 TBSs in 4 hours) in the last two weeks and review each miss by chapter.

Test-day strategy

- **Budget your time.** About 90 minutes for the two MCQ testlets leaves roughly 2.5 hours for eight simulations.
- **Read the last sentence of a simulation first** so you know what to compute, then go to the exhibits.
- **Use the amounts given in the question**, not memorized indexed figures.
- **Answer everything.** There is no penalty for guessing, and simulations give partial credit.
- **Take the optional break** after testlet 3; the clock stops.

Memory trick: "Law: who and when. Tax: how much and what character." For law questions, identify the parties and the timing; for tax questions, compute the amount and then decide whether it is ordinary, capital or §1231.

Key takeaways

- REG: 4 hours, 72 MCQs and 8 TBSs in 5 testlets, 50/50 weighting, passing score 75.
- Areas: Ethics and procedure 10–20%, Business law 15–25%, Property 5–15%, Individuals 22–32%, Entities 23–33%.
- This guide uses 2025 tax law including OBBBA changes effective for 2025; indexed amounts are given on the exam.
- Read a chapter, then drill the matching bank chapter immediately.

1. Circular 230 and Tax Practice Ethics

Anyone who represents taxpayers before the IRS works under two layers of ethical rules. **Treasury Department Circular 230** (31 CFR Part 10) is federal law: it applies to every practitioner and is enforced by the IRS Office of Professional Responsibility. The **AICPA Statements on Standards for Tax Services (SSTS)** apply to AICPA members as professional standards. REG tests both, plus the related confidentiality rules in the Internal Revenue Code.

Who may practice before the IRS

"Practice before the IRS" means all matters connected with a presentation to the IRS about a client's rights or liabilities: preparing and filing documents, corresponding and communicating with the IRS, giving written advice with potential for avoidance or evasion, and representing a client at conferences, hearings and meetings.

Practitioner	Representation rights
Attorneys	Unlimited — any matter, any IRS office
Certified public accountants	Unlimited
Enrolled agents (EAs)	Unlimited (licensed by the IRS after an exam or IRS experience)
Enrolled actuaries and enrolled retirement plan agents	Limited to their specialty (certain retirement plan matters)
Annual Filing Season Program (AFSP) record holders	Only returns they prepared and signed, and only before revenue agents, customer service and the Taxpayer Advocate Service (not Appeals or collection)
Unenrolled preparers without AFSP	No representation; may prepare returns only

Everyone who prepares returns for compensation needs a **preparer tax identification number (PTIN)**. Representation is authorized on **Form 2848** (power of attorney). **Form 8821** only lets a person receive confidential information; it does not authorize representation.

Enrolled agents renew every three years and need **72 hours** of continuing education per cycle (at least **16 hours each year**, including **2 hours of ethics**). AFSP participants complete **18 hours** a year, including the **6-hour Annual Federal Tax Refresher (AFTR)** course with a test (some exempt groups need fewer hours).

> **Memory trick:** "ACE" — **A**ttorneys, **C**PAs and **E**nrolled agents are the three groups with unlimited practice rights.

Duties and restrictions (Subpart B)

Section	Rule in plain words
§10.20	Give the IRS records and information it properly requests, unless you believe in good faith they are privileged
§10.21	If you learn the client did not comply with the law or made an **error or omission**, promptly **advise the client** of the noncompliance and its consequences
§10.22	Exercise **due diligence** in preparing returns and in statements to the IRS and clients; you may rely on others' work if you used reasonable care
§10.23	Do not unreasonably delay the prompt disposition of a matter
§10.25	Former government employees face post-employment restrictions
§10.27	No **unconscionable** fees; **contingent fees** only in limited cases
§10.28	Return **client records** on request, even if fees are unpaid
§10.29	**Conflicts of interest** only with informed written consent
§10.30	Advertising may not be false, misleading or deceptive
§10.31	Never **endorse or negotiate** a client's refund check
§10.32	Practice of law not authorized by Circular 230
§10.33	Best practices (aspirational, not enforced alone)
§10.34	Standards for **return positions** and documents
§10.35	Competence
§10.36	Firm leaders must have procedures to ensure compliance
§10.37	Standards for **written advice**

Errors and omissions (§10.21)

When a practitioner discovers a client error on a prior return, the duty is to **advise the client** promptly of the error and the consequences of not correcting it. The practitioner has **no duty — and no right without the client's consent — to tell the IRS**. The SSTS add that a member should recommend corrective action and consider whether to continue the engagement if the client refuses to correct the error; if the member continues, the member should take reasonable steps so the error is not repeated on later returns.

Fees (§10.27)

A practitioner may not charge an unconscionable fee. A **contingent fee** (one based on the result or the amount of tax saved) is allowed **only** for:

1. Services in connection with an IRS **examination** of, or challenge to, an **original return**, or an amended return or claim for refund filed **within 120 days** after the taxpayer received written notice of the examination;
2. A claim solely for a **refund of interest or penalties** assessed by the IRS; or
3. **Judicial proceedings** under the Internal Revenue Code.

A contingent fee for **preparing an original return** is never allowed, no matter what the client signs.

> **Example:** On March 2, 2026, a client receives written notice that the IRS is examining her 2024 return. Her CPA wants to file an amended return and charge 20% of any refund. Step 1: count 120 days from March 2, 2026 — the window ends **June 30, 2026**. Step 2: if the amended return is filed by that date, the contingent fee is permitted; if it is filed later, the fee must be fixed or hourly.

Client records (§10.28)

On request, the practitioner must promptly return **client records** needed for the client to comply with federal tax obligations, **even if the fee has not been paid**. "Client records" are the client's own original documents, and documents the practitioner prepared that were already given to the client. The practitioner's own **work product** (returns, workpapers, schedules) may be withheld until the fee is paid, if state law allows — but any return or document the client needs to comply that was prepared and paid for must be provided. The practitioner may keep copies.

Conflicts of interest (§10.29)

A conflict exists when representing one client is directly adverse to another, or when a significant risk exists that representation will be materially limited by responsibilities to another client, a former client, a third person or the practitioner's own interest. The practitioner may still represent the clients if:

- the practitioner reasonably believes he or she can provide competent, diligent representation to each affected client;
- the representation is not prohibited by law; and
- **each affected client waives the conflict with informed consent confirmed in writing** (within a reasonable time, generally no later than 30 days after consent).

Written consents must be **kept for at least 36 months** after the representation ends and provided to the IRS on request.

Advertising and solicitation (§10.30)

Advertising must not be false or misleading. Practitioners may state their credentials (for example "enrolled to represent taxpayers before the IRS" for EAs), but may not use the term "certified" for IRS enrollment or imply an employment relationship with the IRS. Practitioners who publish fee schedules must honor them for at least **30 calendar days** after publication. Records of direct mail and e-commerce solicitations must be kept 36 months.

> **Memory trick:** "120 – 36 – 30": the 120-day contingent-fee window after an exam notice, 36 months to keep conflict consents, 30 days to honor a published fee schedule.

Return positions and written advice

Standards for return positions (§10.34 and SSTS)

A practitioner may not sign a return or advise a position if the position:

- **lacks a reasonable basis**;
- is an **unreasonable position** under §6694(a) — that is, it lacks **substantial authority** and is not adequately disclosed (or, for a tax shelter or reportable transaction, is not "more likely than not" to be sustained); or
- is a **willful** attempt to understate tax or a **reckless or intentional** disregard of rules.

Standard	Rough likelihood of success	Effect
More likely than not	Greater than 50%	Required for tax shelter and reportable-transaction positions
Substantial authority	Roughly 40% (objective weighing of authority)	Position may be taken without disclosure
Reasonable basis	Roughly 20% (more than merely arguable)	Position may be taken **only with disclosure** (Form 8275 or 8275-R)
Below reasonable basis	Frivolous or merely colorable	May not be taken, even with disclosure

The practitioner must inform the client of any penalties reasonably likely to apply and of ways to avoid them (such as disclosure). A practitioner may generally rely in good faith on client information without verification, but **cannot ignore** information that seems incorrect, inconsistent or incomplete and must make reasonable inquiries.

> **Watch out:** "Chance of audit" is never a factor. Under §10.37 and the SSTS, the practitioner may not consider the possibility that a return will not be audited or an issue will not be raised when deciding whether a position is supportable.

Written advice (§10.37)

Written advice on federal tax matters must be based on reasonable factual and legal assumptions, reasonably consider all relevant facts the practitioner knows or should know, use reasonable efforts to identify the facts, not rely unreasonably on representations of others, and relate the law to the facts. It may not take into account the possibility of audit or settlement.

Other SSTS points

- **Estimates**: a member may use the taxpayer's reasonable estimates when records are not available, if presented in a way that does not imply greater accuracy.
- **Departure from a prior IRS determination**: a member may recommend a position that departs from how an item was settled in an earlier exam, if the position meets the return-position standards.
- **Unanswered questions**: a member should make a reasonable effort to get answers to all applicable questions on a return before signing.

Sanctions (Subpart C and D)

The IRS may **censure**, **suspend** (for any period) or **disbar** a practitioner who is incompetent or disreputable, violates Circular 230, or willfully misleads a client. It may also impose a **monetary penalty** under §10.50(c) up to the **gross income derived (or to be derived)** from the conduct, either instead of or in addition to censure, suspension or disbarment. The penalty may also be imposed on the practitioner's firm if it knew or should have known of the conduct.

Examples of **disreputable conduct** (§10.51): conviction of a tax crime or a felony involving dishonesty; giving false information to the IRS; willfully failing to file one's own returns; misappropriating client funds meant for taxes; bribing IRS employees; and willfully signing a return the practitioner knows is false.

> **Example:** A CPA earned fees of $18,000 from a scheme in which she gave clients false written advice. Under §10.50(c), the IRS may impose a monetary penalty of up to **$18,000** (the gross income derived), and may also suspend or disbar her in the same proceeding.

Confidentiality of taxpayer information

- **§7216** makes it a **criminal misdemeanor** for a preparer to **knowingly or recklessly** disclose or use return information without consent (fine up to $1,000, up to 1 year in prison, or both).
- **§6713** is the **civil** counterpart: **$250 per** unauthorized disclosure or use, up to **$10,000 per calendar year**.
- Consent must be specific, in writing, and obtained before the disclosure. Disclosures are allowed without consent for things like a court order, peer review and quality review, and to comply with law.
- Tax preparers are financial institutions for purposes of the Gramm-Leach-Bliley Act and must safeguard customer information.

> **Example:** A preparer gives a list of client names and refund amounts to an insurance agent without consent. If the preparer did not act knowingly or recklessly, only the civil §6713 penalty applies: $250 per disclosure, capped at $10,000 for the year. Knowing disclosure adds exposure under §7216.

Common traps

- Choosing "notify the IRS" when the practitioner finds a client error. The correct response is to **advise the client**.
- Thinking unpaid fees let the practitioner hold the **client's own records**.
- Treating any contingent fee as allowed because the client consented in writing.
- Confusing Form 8821 (information only) with Form 2848 (representation).
- Believing AFSP holders may represent clients before Appeals or in collection matters.

Key takeaways

- Attorneys, CPAs and EAs have unlimited practice rights; AFSP holders are limited to returns they prepared and signed, at the examination level.
- On discovering an error: advise the client of the error and its consequences; do not tell the IRS without consent.
- Contingent fees only for exams of original returns (and amended returns within 120 days of the exam notice), interest and penalty refund claims, and judicial proceedings.
- Return client records even if fees are unpaid; conflicts need informed written consent from each client, kept 36 months.
- Positions need substantial authority, or a reasonable basis plus disclosure; never consider audit chances.
- Sanctions: censure, suspension, disbarment and a monetary penalty up to gross income derived.

2. Tax Preparer and Taxpayer Penalties

Civil penalties enforce honest preparation and timely compliance. REG asks two kinds of questions: **which penalty applies** to a set of facts, and **how much** it is. Start every penalty question by deciding who is being penalized — the preparer, the taxpayer, a responsible person in a business, or a promoter.

Who is a tax return preparer?

A **tax return preparer** is anyone who prepares for compensation, or employs others to prepare for compensation, all or a **substantial portion** of a return or refund claim. A person who gives advice on a substantial portion of a return can be a non-signing preparer. People who only type, reproduce or provide mechanical help, who prepare a return for their employer as a regular employee, or who prepare returns for free are not preparers for these penalties.

Preparer penalties

Understatement penalties — §6694

Penalty	Trigger	Amount
§6694(a)	Understatement due to an **unreasonable position** the preparer knew or should have known about	Greater of **$1,000** or **50%** of the income derived (or to be derived) from the return
§6694(b)	Understatement due to **willful** attempt to understate, or **reckless or intentional** disregard of rules	Greater of **$5,000** or **75%** of the income derived

A position is **not unreasonable** if it has **substantial authority**, or if it has a **reasonable basis and is adequately disclosed** (Form 8275/8275-R, or on the return). Tax shelter and reportable-transaction positions need a reasonable belief that the position is **more likely than not** to be sustained. The §6694(a) penalty is also excused if the preparer shows **reasonable cause and good faith**. If both penalties apply, the §6694(b) amount is reduced by the §6694(a) amount paid.

Memory trick: "1-50 / 5-75." Unreasonable: $1,000 or 50%. Willful or reckless: $5,000 or 75%. Always the **greater** of the two.

Example: Preparer A charged a $2,400 fee for a return with an undisclosed position lacking substantial authority (not willful). Penalty = greater of $1,000 or 50% × $2,400 = $1,200 → **$1,200**. Preparer B charged $8,000 for a return on which he recklessly ignored the rules. Penalty = greater of $5,000 or 75% × $8,000 = $6,000 → **$6,000**. If B's fee had been $5,000, 75% would be $3,750, so the floor of **$5,000** applies.

Per-failure penalties — §6695

These penalties apply whether or not tax is understated. The amounts are indexed; for **returns and claims filed in 2026** (Rev. Proc. 2024-40):

Subsection	Failure	Amount (filed in 2026)	Annual cap
§6695(a)	Failure to furnish a copy of the return to the taxpayer	$65 per failure	$32,500
§6695(b)	Failure to sign the return	$65 per failure	$32,500
§6695(c)	Failure to furnish an identifying number (PTIN)	$65 per failure	$32,500
§6695(d)	Failure to retain a copy or list of returns (3 years)	$65 per failure	$32,500
§6695(e)	Failure to file correct information returns	$65 per return and item	$32,500
§6695(f)	**Endorsing or negotiating** a taxpayer's refund check	$650 per check	None
§6695(g)	Failure to meet **due diligence** for the EIC, child tax credit/additional CTC/credit for other dependents, AOTC, or **head of household** status	$650 per failure	None

Due diligence under §6695(g) means completing and submitting **Form 8867**, computing the credits correctly, making reasonable inquiries when information seems wrong or incomplete (the **knowledge** requirement) and keeping records for **3 years**.

Example: During 2026 a preparer fails to sign 40 returns, fails to give clients copies of 600 returns, cashes 3 client refund checks and fails the due-diligence rules 4 times.

- Failure to sign: 40 × $65 = **$2,600** (under the cap).
- Failure to furnish copies: 600 × $65 = $39,000, capped at **$32,500**.
- Refund checks: 3 × $650 = **$1,950** (no cap).
- Due diligence: 4 × $650 = **$2,600** (no cap).
- Total = $2,600 + $32,500 + $1,950 + $2,600 = **$39,650**.

Other preparer and promoter penalties

Section	Conduct	Penalty
§6713	Unauthorized disclosure or use of return information (civil)	$250 per disclosure, max $10,000 per year
§7216	Knowing or reckless disclosure or use (criminal misdemeanor)	Up to $1,000 fine and/or 1 year in prison
§6700	Promoting abusive tax shelters	Generally 50% of gross income derived from the activity (false-statement cases)
§6701	Aiding and abetting an understatement of another person's tax	$1,000 per return ($10,000 for corporate returns)
§7407	Injunction against preparers who repeatedly engage in prohibited conduct	Court may bar the person from preparing returns
§7206(2)	Willfully aiding or assisting a false return (felony)	Fine and prison

Example: A preparer sold a list of 50 clients' names and refund amounts to a marketer without consent. Civil penalty = 50 × $250 = $12,500, capped at **$10,000** for the calendar year.

Taxpayer penalties

Failure to file and failure to pay — §6651

Penalty	Rate	Maximum
Failure to file (FTF)	**5%** of net tax due per month or part of a month	25% (5 months)
Failure to pay (FTP)	**0.5%** of unpaid tax per month or part of a month	25%
FTP after an IRS notice and demand / levy notice	1% per month after 10 days following a notice of intent to levy	—
FTP during an installment agreement (timely filed return)	0.25% per month	—
Fraudulent failure to file	15% per month	75%

Key interactions:

- For any month in which both apply, the FTF penalty is **reduced by the FTP penalty**, so the combined rate is 5% (4.5% + 0.5%) for the first five months.
- A **part of a month counts as a full month**.
- If a return is more than **60 days late**, the minimum FTF penalty is the **lesser of $525** (returns required to be filed in 2026) **or 100% of the tax due**.

- An extension of time to **file** (Form 4868, six months) is not an extension of time to **pay**. If at least 90% of the tax is paid by the original due date and the balance with the return, no FTP penalty applies during the extension.
- Both penalties are excused for **reasonable cause** and not willful neglect. The IRS also grants **first-time abatement** administratively to taxpayers with a clean three-year history.

Example: Olga's 2025 return, due April 15, 2026, showed $20,000 of tax, none paid. She filed it, with payment, 3 months and 10 days late (no extension). The partial month counts, so the period is 4 months.

- FTP: 0.5% × 4 × $20,000 = **$400**.
- FTF: (5% − 0.5%) × 4 × $20,000 = **$3,600**.
- Total = **$4,000** (the same as 5% × 4 × $20,000).

If a $10,000 balance stayed unfiled and unpaid for 9 months, FTP = 0.5% × 9 × $10,000 = $450, and FTF = 4.5% × 5 × $10,000 = $2,250 (the FTF maxes out after 5 months). Total = **$2,700**.

Accuracy-related penalty — §6662

A **20%** penalty applies to the portion of an underpayment caused by:

- **negligence** or disregard of rules or regulations;
- a **substantial understatement** of income tax;
- a **substantial valuation misstatement** (value or basis claimed is 150% or more of the correct amount); and certain other items.

A **gross valuation misstatement** (200% or more) raises the rate to **40%**. The penalties do not stack: the maximum accuracy-related penalty on any portion is 20% (or 40%).

Taxpayer	Substantial understatement threshold
Individuals	Understatement exceeds the **greater of 10% of the correct tax or $5,000**
Corporations (other than S corporations)	Understatement exceeds the **lesser of** 10% of the correct tax (or, if greater, $10,000) **or $10 million**

The understatement is reduced for items with **substantial authority** or with a **reasonable basis that were disclosed**. The **reasonable cause and good faith** exception (§6664(c)) also applies.

Example: Correct tax is $80,000; Ravi reported $66,000. Understatement = $80,000 − $66,000 = $14,000. Threshold = greater of 10% × $80,000 = $8,000 or $5,000 = $8,000. Since $14,000 > $8,000, it is substantial. Penalty = 20% × $14,000 = **$2,800**.

If correct tax were $40,000 and reported tax $34,000, the understatement would be $6,000 against a threshold of greater of $4,000 or $5,000 = $5,000 — still substantial.

Civil fraud — §6663

The civil fraud penalty is **75%** of the portion of the underpayment attributable to fraud. The **IRS** must prove fraud by **clear and convincing evidence**; once it proves part of the underpayment is fraudulent, the whole underpayment is treated as fraud except any portion the taxpayer proves was not. The accuracy-related penalty does not apply to the portion penalized as fraud. Example: a $24,000 fraudulent underpayment → penalty 75% × $24,000 = **$18,000**.

Estimated tax underpayment — §6654

Individuals owe a penalty (computed like interest) if they did not pay enough through withholding and quarterly estimates. No penalty applies if each installment (generally 25% of the required annual payment) was paid on time, where the required annual payment is the **lesser of**:

- **90%** of the current-year tax, or
- **100%** of the prior-year tax (**110%** if prior-year AGI exceeded **$150,000**, or $75,000 if married filing separately). The prior-year test is unavailable if no return was filed for a 12-month prior year.

There is no penalty if the tax shown on the return minus withholding is **less than $1,000**. Withholding is treated as paid evenly through the year unless the taxpayer elects otherwise, which makes extra withholding late in the year a useful fix. Corporations use 100% of current or prior-year tax (large corporations, $1 million+ of taxable income in a prior 3 years, may use the prior-year rule only for the first installment).

> **Example:** Lena's 2024 AGI was $180,000 and 2024 tax was $30,000. Her 2025 tax is $40,000. Required annual payment = lesser of 90% × $40,000 = $36,000 or 110% × $30,000 = $33,000 → **$33,000**, or **$8,250** per quarter.

Trust fund recovery penalty — §6672

Any **responsible person** (an officer, employee or other person with authority over which bills get paid) who **willfully** fails to collect, account for or pay over withheld taxes is personally liable for a penalty equal to **100%** of the unpaid **trust fund taxes**: withheld **income tax** and the **employee's share of FICA**. The employer's matching FICA is **not** a trust fund tax.

> **Example:** A company withheld $30,000 of income tax and $15,300 of employee FICA (7.65% × $200,000 of wages) but used the money to pay suppliers. The responsible officer's penalty = $30,000 + $15,300 = **$45,300**. The employer's own $15,300 of matching FICA is excluded.

Other taxpayer penalties and interest

- **Frivolous return** (§6702): $5,000.
- **Erroneous refund claim** (§6676): 20% of the excessive amount claimed without reasonable cause.
- **Interest** on underpayments runs from the original due date (without extensions) at the federal short-term rate plus 3 percentage points, compounded daily. Interest is never excused for reasonable cause and is not deductible by individuals.

Common traps

- Forgetting to reduce the FTF penalty by the FTP penalty in overlapping months.
- Using "greater of" for the estimated-tax safe harbor — it is the **lesser of** 90% current or 100%/110% prior.
- Including the employer's FICA in the trust fund recovery penalty.
- Applying the §6694 penalty to a person who gave only mechanical help.
- Treating a filing extension as a payment extension.

Key takeaways

- §6694(a): greater of $1,000 or 50% of fee; §6694(b): greater of $5,000 or 75%.
- §6695 for 2026 filings: $65 per failure (cap $32,500) for copy, signature, PTIN, retention and information-return failures; $650 for each refund check negotiated or due-diligence failure, no cap.
- FTF 5% per month and FTP 0.5% per month, each capped at 25%; FTF reduced by FTP; minimum FTF after 60 days is the lesser of $525 or the tax.
- Accuracy penalty 20% (40% for gross valuation misstatements); individual substantial understatement > greater of 10% or $5,000. Civil fraud 75%.
- Estimated tax: lesser of 90% current or 100% (110%) prior; under $1,000 owed → no penalty.
- Trust fund recovery penalty = 100% of withheld income tax plus employee FICA.

3. Federal Tax Procedures

Tax procedure is about **where the rules come from, how the IRS checks returns, how disputes are resolved and how long each side has to act**. Questions are mostly recall, but date computations for statutes of limitation are common in both MCQs and simulations.

Sources of tax authority

Source	Issued by	Weight
Internal Revenue Code (Title 26)	Congress	Highest statutory authority
Treaties	President with Senate	Equal to the Code; later in time generally controls
Final regulations	Treasury	Force of law unless invalid; given high deference
Temporary regulations	Treasury	Same weight as final while in effect (expire after 3 years)
Proposed regulations	Treasury	Not binding; show the IRS's view
Revenue rulings	IRS (published in the Internal Revenue Bulletin)	IRS's position on specific facts; bind the IRS, may be relied on by taxpayers with the same facts
Revenue procedures	IRS	Procedural guidance (e.g., inflation adjustments); bind the IRS
Private letter rulings (PLRs)	IRS, at a taxpayer's request	Bind the IRS **only for the requesting taxpayer**; no precedent for others (but count as authority for substantial-authority purposes)
Technical advice memoranda	IRS National Office during an exam	Binding only for that taxpayer
Court decisions	Courts	Supreme Court binds all; circuit courts bind their own circuit

Interpretive regulations explain the Code under general authority; **legislative** regulations are issued under a specific grant of authority in a Code section and carry more weight. Committee reports and the "Blue Book" (Joint Committee on Taxation) help interpret legislative intent.

> **Exam tip:** "Who is bound?" is a frequent question. A revenue ruling can be cited by any taxpayer with substantially the same facts; a private letter ruling protects only the taxpayer who asked for it.

IRS examinations

The IRS selects returns by computer scoring (the Discriminant Function System), information-matching, related examinations and other methods.

Type	Where	Typical use
Correspondence examination	By mail	Simple issues on individual returns
Office examination	IRS office	Individuals and small businesses with a few issues
Field examination	Taxpayer's place of business	Businesses and complex returns, by a revenue agent

Taxpayers may represent themselves or be represented by a practitioner with a **Form 2848**. If the taxpayer agrees with proposed changes, the taxpayer signs **Form 870** (waiver of restrictions on assessment), which lets the IRS assess immediately and stops interest from running 30 days after filing the form.

The dispute path

1. **Examination** ends with a revenue agent's report.
2. **30-day letter** — the taxpayer may agree, or request an **Appeals** conference. A **written protest** is required if the proposed deficiency in any period exceeds **$25,000**; a small-case request is enough at or below that amount.
3. **Appeals** (Independent Office of Appeals) may settle based on the hazards of litigation.
4. **90-day letter** (statutory **notice of deficiency**) — the taxpayer has **90 days** (**150 days** if addressed to a person outside the United States) to petition the **Tax Court**. The IRS cannot assess the deficiency during this period.
5. If no petition is filed, the IRS **assesses** the tax and begins collection.

The trial courts

Court	Pay tax first?	Jury?	Appeal goes to	Notes
U.S. Tax Court	**No**	No	U.S. Court of Appeals for the taxpayer's circuit	Petition within 90 days of the notice of deficiency; judges are tax specialists
Tax Court **small case** procedure	No	No	**No appeal**	Deficiency (including penalties) of **$50,000 or less** per year; informal
U.S. District Court	**Yes** (refund suit)	**Yes — the only one**	U.S. Court of Appeals for the circuit	General-jurisdiction judges
U.S. Court of Federal Claims	**Yes** (refund suit)	No	U.S. Court of Appeals for the **Federal Circuit**	Sits in Washington, D.C.

Appeals from any circuit court go to the **U.S. Supreme Court** only if it grants **certiorari**.

For a refund suit, the taxpayer must first pay the tax and file an **administrative refund claim**; suit may be filed **six months** after the claim was filed (or sooner if the IRS denies it) and within **two years** after a notice of disallowance.

> **Memory trick:** "Tax Court = Tell them later, pay later." It is the only trial forum that does not require payment first. "District = Decide by jury." "Claims = Capital (D.C.) and the Federal Circuit."

Burden of proof

The taxpayer generally bears the burden of proof. The burden shifts to the IRS on a factual issue if the taxpayer introduces **credible evidence**, has complied with substantiation and record-keeping requirements, cooperated with reasonable IRS requests, and (for entities) meets net-worth limits. The IRS always bears the burden for **fraud** (clear and convincing evidence) and for producing evidence that penalties apply to individuals.

Statutes of limitation

Assessment

Situation	Period to assess
General rule	**3 years** after the **later** of the date the return was filed or its **due date** (without extensions)
Omission of more than **25% of gross income** stated on the return	**6 years**
Fraudulent return, **no return** filed, or willful attempt to evade	**Unlimited**
Unreported foreign financial assets income over $5,000 (certain cases)	6 years
Taxpayer and IRS sign **Form 872**	Extended by agreement

A return filed **early** is treated as filed on the due date. A return filed late (including on extension) starts the clock on the actual filing date.

> **Example:** Kofi's 2025 return was due April 15, 2026.
>
> - He filed on March 1, 2026 → treated as filed April 15, 2026 → assessment period ends **April 15, 2029**.
> - Had he filed on extension on October 10, 2026, it would end **October 10, 2029**.
> - He reported gross income of $200,000 but omitted $60,000. $60,000 ÷ $200,000 = 30%, which exceeds 25%, so the period is **6 years**.

Collection

After a timely assessment, the IRS has **10 years** to collect by levy or court proceeding. Tools include federal tax liens (which attach to all property), levies after notice, and installment agreements or offers in compromise (based on doubt as to liability, doubt as to collectibility or effective tax administration). A taxpayer can request a **collection due process** hearing within 30 days of a notice of lien filing or intent to levy.

Refund claims

A claim for refund (Form 1040-X for individuals, Form 1120-X for corporations) must be filed by the **later** of:

- **3 years** from the date the return was filed, or
- **2 years** from the date the tax was paid.

The refund is limited to tax paid within the **lookback period** — the 3 years (plus any extension) before the claim if filed within the 3-year window, or the 2 years before the claim otherwise. Withholding and estimated payments are treated as paid on the return's original due date.

Special refund periods	**Period**
Bad debts and **worthless securities**	**7 years**
Net operating loss or capital loss carrybacks	3 years after the due date (with extensions) of the loss year's return
Foreign tax credit	10 years

> **Example:** Mira's employer withheld $8,000 for 2025 (treated as paid April 15, 2026). She filed her return on time on April 15, 2026. She can claim a refund of any of it until **April 15, 2029** (3 years after filing). After an audit she paid an additional $3,000 on May 1, 2027. If she files a refund claim on June 1, 2029, it is too late under the 3-year rule but within 2 years of the $3,000 payment, so the claim is timely — and the refund is limited to the **$3,000** paid in the 2 years before the claim. The $8,000 of withholding is outside that window.

Disclosure and information forms

Form	Purpose
8275	Disclose a position to avoid substantial-understatement penalties
8275-R	Disclose a position **contrary to a regulation**
8886	Report participation in a **reportable transaction** (listed, confidential, contractual protection, loss and transaction-of-interest categories)
2848	Power of attorney — authorizes representation
8821	Tax information authorization — receive information only
872	Consent to extend the assessment period
870	Waiver of restrictions on assessment (agreeing to a deficiency)
4868 / 7004	Automatic extension of time to file (individuals 6 months / businesses)
1040-X / 1120-X	Amended return or refund claim

Recordkeeping and substantiation

Taxpayers must keep records that support items on a return as long as they may be material — generally until the assessment period expires; employment tax records at least 4 years. Travel, gifts and listed property need contemporaneous substantiation (amount, time, place and business purpose). Charitable gifts of $250 or more need a contemporaneous written acknowledgment; noncash gifts over $500 need Form 8283, and over $5,000 generally a qualified appraisal.

Common traps

- Counting the 3-year period from an **early** filing date instead of the due date.
- Choosing District Court for a taxpayer who does not want to pay the tax first — that is the **Tax Court**.
- Treating a PLR as precedent for other taxpayers.
- Forgetting that only District Court offers a **jury**.
- Assuming small-case Tax Court decisions can be appealed — they cannot.

Key takeaways

- Authority: Code → final/temporary regulations → proposed regulations; revenue rulings and procedures bind the IRS; PLRs bind only for the requester.
- Path: exam → 30-day letter → Appeals → 90-day letter → Tax Court (no prepayment) or pay and sue in District Court (jury) or Court of Federal Claims.
- Assessment: 3 years from the later of filing or due date; 6 years for >25% gross income omission; unlimited for fraud or no return. Collection: 10 years.
- Refunds: later of 3 years from filing or 2 years from payment; 7 years for bad debts and worthless securities.
- Disclosure: Form 8275 (8275-R against regulations); Form 8886 for reportable transactions.

4. Accountants' Legal Duties and Liability

This chapter covers an accountant's legal exposure to **clients** and **third parties** under common law, and the rules on **privilege and confidentiality**. Questions usually describe a CPA's mistake and ask whether a particular plaintiff can recover, under which theory, and which defense works.

Liability to clients

A CPA's duties to a client arise from two sources:

- **Contract**: the engagement letter defines the services. Failing to perform them (for example, missing a filing deadline the CPA agreed to meet) is a **breach of contract**. Privity exists by definition.
- **Tort**: the CPA must perform with the care of a **reasonably competent CPA** in the same circumstances. Professional standards (GAAP, GAAS, SSTS, Circular 230) are evidence of what that care requires, but compliance does not automatically prove due care.

Negligence

Element	Meaning
Duty	The CPA owed the plaintiff a duty of care (always owed to the client; to third parties depends on the jurisdiction's rule)
Breach	The CPA failed to act as a reasonably competent CPA would
Proximate cause	The breach caused the loss, and the loss was a foreseeable result
Damages	The plaintiff suffered an actual loss

Ordinary negligence is carelessness; it requires **no intent**. **Gross negligence** (also called **constructive fraud**) is a reckless disregard for the truth or extreme lack of care, which courts treat like fraud for purposes of third-party liability and punitive damages.

Fraud

Element	Meaning
Misrepresentation or omission of a **material fact**	Not mere opinion
Scienter	Knowledge of falsity or reckless disregard for the truth
Intent to induce reliance	The CPA meant for others to act on it
Justifiable reliance	The plaintiff actually and reasonably relied
Damages	Loss caused by the reliance

Fraud may also support **punitive damages**.

Memory trick: Negligence is "**D-B-C-D**" (Duty, Breach, Causation, Damages). Fraud adds the **S** — **S**cienter. If the question says the CPA "knew" or acted "recklessly," think fraud or constructive fraud; if it says "failed to follow standards," think negligence.

Damages in tax engagements

The client recovers losses **caused by** the CPA's error — typically **penalties and interest** the client would not otherwise have paid, plus costs to correct the problem. The client generally **cannot** recover the tax itself, because the client owed that tax anyway. Some courts allow interest when the error deprived the client of an opportunity to avoid it.

Example: A CPA forgot to file a client's extension and the return was filed 3 months late. The client paid $12,000 of tax, a $1,620 late-filing penalty and $310 of interest. The CPA's negligence caused the penalty and the interest, so damages are $1,620 + $310 = **$1,930**. The $12,000 tax is not recoverable because the client owed it regardless.

Liability to third parties

Third parties (lenders, investors, buyers) are not in privity with the CPA. Whether they can sue for **negligence** depends on the state's approach. For **fraud** and **gross negligence**, every approach lets **all reasonably foreseeable** users recover.

Approach	Who may sue the CPA for ordinary negligence
Ultramares (privity or near-privity)	Clients and third parties so closely connected that the relationship approaches privity — the CPA knew the specific party and purpose, and some conduct linked the CPA to that party (*Credit Alliance* test)
Restatement (Second) of Torts §552 (majority)	Persons or a **limited class** of persons the CPA **knew** would rely on the work, for the transaction (or a substantially similar one) the CPA knew of — **actually foreseen** users
Foreseeability (minority)	**All reasonably foreseeable** users of the CPA's work

Example: A CPA prepared financial statements for Delta Co. knowing they would be given to First Bank for a specific loan. Delta instead used them to get a loan from Second Bank, which the CPA never heard of. If the CPA was negligent:

- *Ultramares* state: First Bank may recover only if near-privity is shown; Second Bank cannot.
- Restatement state: First Bank is a known user and can recover; Second Bank probably cannot, because it was not a known or limited class of user — unless the CPA knew the statements would go to some bank for a loan of this type.
- Foreseeability state: both banks may recover if their reliance was reasonably foreseeable.
- If the CPA was **fraudulent**, both banks may recover in any state.

Defenses

Defense	Effect
Due care	No breach — the CPA met professional standards
Lack of causation	The loss came from something else (e.g., the business failed for unrelated reasons)
No reliance	The plaintiff did not read or rely on the work
Contributory negligence	In a few states, any negligence by the plaintiff **bars** recovery entirely
Comparative negligence	In most states, damages are **reduced** by the plaintiff's percentage of fault
Lack of privity / known user	Third party falls outside the state's rule (negligence only)
Statute of limitations	Claim filed too late

Client negligence is usually a defense only if it **contributed to the CPA's failure** (for example, the client's employees hid documents the CPA requested).

> **Example:** A jury finds a client's damages are $100,000 and the client was 30% at fault. In a comparative-negligence state, the CPA pays $100,000 × (1 − 30%) = **$70,000**. In a contributory-negligence state, the client recovers **nothing**.

Statutory liability in brief

Accountants can also face liability under federal statutes. The securities laws are mostly tested elsewhere, but the core contrast is worth knowing: under **Section 11 of the Securities Act of 1933**, purchasers in a registered offering can sue for material misstatements in a registration statement **without proving reliance or negligence**, and the CPA must prove **due diligence**; under **Rule 10b-5 of the Securities Exchange Act of 1934**, the plaintiff must prove **scienter** and reliance. Criminal liability arises for willful violations and for tax crimes such as willfully aiding a false return.

Privilege and confidentiality

Accountant-client privilege

There is **no general federal accountant-client privilege**. Some states recognize one by statute for state-law matters. Communications with a CPA can generally be obtained by subpoena in federal proceedings.

The federally authorized tax practitioner privilege — §7525

Section 7525 extends the attorney-client privilege to communications between a taxpayer and a **federally authorized tax practitioner** (CPA, enrolled agent, attorney, enrolled actuary) about **tax advice**, but only:

- in **noncriminal** tax matters **before the IRS** and in noncriminal federal tax proceedings in federal court;

- not for **criminal** tax matters;
- not for written communications promoting participation in a **tax shelter**;
- not for return-preparation information (which is meant to be disclosed to the IRS).

> **Watch out:** If the IRS refers a case for criminal investigation, the §7525 privilege does not protect the CPA's communications. State-law matters are also outside §7525.

Confidentiality

The AICPA Code of Professional Conduct requires members not to disclose **confidential client information** without the client's consent. Disclosure without consent **is** permitted to:

- comply with a validly issued and enforceable **subpoena or summons**, or with laws and regulations;
- respond to a **peer review** or quality review;
- respond to or initiate an inquiry by a recognized **ethics** investigative or disciplinary body; and
- defend the member in litigation or disputes with the client.

The Code of Federal Regulations under §7216 and the civil §6713 penalty (Chapter 1) add tax-specific restrictions. Under the Gramm-Leach-Bliley Act, CPAs who prepare tax returns must give privacy notices and protect nonpublic personal information.

Working papers

Working papers belong to the **accountant**, not the client. The accountant must keep them confidential and may not transfer them to another firm (for example, when selling a practice) without client consent. The client is entitled to its own records and to certain information not otherwise available to it (see Circular 230 §10.28 and the AICPA records rules).

Common traps

- Requiring scienter to prove negligence — negligence needs no intent.
- Applying the *Ultramares* rule when the question names a Restatement state.
- Thinking §7525 protects communications in a criminal investigation.
- Awarding the client the tax it owed as damages instead of only the penalties and interest caused by the error.
- Assuming working papers belong to the client.

Key takeaways

- Negligence: duty, breach, proximate cause, damages; standard of the reasonably competent CPA.
- Fraud adds scienter and justifiable reliance; gross negligence (constructive fraud) is treated like fraud.
- Third-party negligence: *Ultramares* (near-privity), Restatement (known users or limited class), foreseeability (all foreseeable users). Fraud reaches all foreseeable users.

- Defenses: due care, no causation, no reliance, contributory (bars) or comparative (reduces) negligence.
- §7525 privilege: tax advice by federally authorized practitioners in noncriminal federal tax matters only.
- No general federal accountant-client privilege; working papers belong to the CPA; disclose without consent only for subpoenas, law, peer review and ethics inquiries.

5. Agency

An **agency** relationship exists when one person (the **principal**) authorizes another (the **agent**) to act on the principal's behalf and subject to the principal's control, and the agent agrees. Agency law answers three exam questions: **Is the principal bound by the agent's contract? Who is liable to the third party? Is the principal liable for the agent's torts?**

Creating an agency

- An agency is **consensual**; it may be created by express agreement (oral or written), by implication from conduct, by estoppel, or by ratification.
- **No consideration** is required (a gratuitous agent still owes duties).
- Only the **principal needs contractual capacity**. A minor can serve as an agent; a contract made by a minor agent binds the principal.
- **Equal dignity rule**: if the agent will sign a contract that must be in writing under the statute of frauds (for example, a land sale), the agent's authority must also be in writing in most states.
- A **power of attorney** is a written grant of authority. A **durable** power of attorney survives the principal's incapacity.

Agents versus employees and independent contractors

Relationship	Key feature	Principal liable for torts?
Employee (servant)	Employer controls the **manner and means** of the work	**Yes**, if within the **scope of employment** (*respondeat superior*)
Independent contractor	Hirer controls only the **result**	Generally **no**, except for inherently dangerous activities, non-delegable duties, or the hirer's own negligence in selecting the contractor

Authority — when is the principal bound?

Type	Source	Example
Express actual authority	Principal's words (oral or written) to the **agent**	"Buy up to 500 units at $10 each"
Implied actual authority	Reasonably necessary to carry out express authority, or customary for the position	A store manager may hire a cashier
Apparent authority	Principal's words or **conduct toward the third party** that lead the third party reasonably to believe the agent has authority	Principal lets a former agent keep using company order forms; supplier is not told the agency ended
Ratification	Principal's later approval of an unauthorized act	Principal accepts the benefits of the contract knowing the facts

Apparent authority can **never** come only from the agent's own statements or conduct; it must be traceable to the **principal**. A principal with actual authority is bound even if the third party did not know about it; apparent authority requires the third party to rely reasonably.

Ratification requirements

1. The principal had **knowledge of all material facts**.
2. The principal ratified the **entire** transaction (not just the favorable parts).
3. The agent acted **on behalf of** the principal (so an **undisclosed principal cannot ratify**).
4. The principal **existed and had capacity** when the agent acted and when ratifying.
5. Ratification occurred before the third party withdrew.

Ratification may be express or implied (accepting benefits), and it relates back to the date of the original act.

> **Example:** Without authority, Lin signs a one-year supply contract "for Atlas Corp." When Atlas's president learns all the terms, she says Atlas will honor the price terms but not the delivery terms. Atlas has not ratified, because a principal must ratify the **whole** contract. If Atlas instead accepted the first delivery knowing all the terms, that conduct would ratify the entire contract.

Promoters and pre-incorporation contracts

A corporation cannot ratify a contract made before it existed, because it did not exist at the time of the act. Instead, the corporation may **adopt** the contract (expressly or by accepting its benefits). The **promoter remains personally liable** until a **novation** — an agreement among the promoter, the corporation and the third party that substitutes the corporation and releases the promoter.

Liability to third parties on contracts

Principal's status when the contract was made	Who is liable to the third party?
Disclosed — third party knows there is a principal and who it is	**Principal** only (if the agent had authority)
Partially disclosed — third party knows there is a principal but not who	**Both** principal and agent
Undisclosed — third party thinks the agent is acting for itself	**Agent**; once the principal is discovered, the third party may **elect** to hold either the agent or the principal (not both)

An agent who acts **without authority** is personally liable to the third party for **breach of the implied warranty of authority**, unless the principal ratifies. An agent is also liable if it signs in its own name or expressly agrees to be liable.

Exam tip: An undisclosed principal is generally bound by its agent's authorized contracts and may enforce them, except when the contract is personal or the third party would not have dealt with the principal.

Liability for torts and crimes

- The principal (employer) is **vicariously liable** for an employee's torts committed **within the scope of employment**, even if the employer forbade the act. Factors: the kind of conduct the employee was hired for, within authorized time and space limits, and at least partly to serve the employer.
- A **frolic** (a substantial departure for the employee's own purposes) is outside the scope; a minor **detour** usually is not.
- **Intentional torts** are within scope if they are foreseeable or serve the employer's purpose (a bouncer using excessive force).
- The **agent remains personally liable** for his or her own torts. If the principal pays, it may seek **indemnification** from a negligent agent.
- A principal is generally **not** criminally liable for an agent's crimes unless it authorized or participated in them (corporations may be liable for crimes of officers acting within their duties).

Example: Delivery driver Sam, on his route, stops at a store to pick up supplies for his employer and negligently backs into a parked car. This is within the scope of employment, so the employer is liable to the car owner; Sam is also liable. If Sam had driven 50 miles off-route on a personal weekend trip in the company truck, that is a frolic and the employer generally is not liable.

Duties of agents and principals

Agent owes the principal	Principal owes the agent
Loyalty (no self-dealing, no undisclosed competing interests, no secret profits)	**Compensation** (reasonable value if not agreed, unless gratuitous)
Obedience to reasonable instructions	**Reimbursement** of authorized expenses
Reasonable care and skill	**Indemnification** for losses suffered while acting within authority
Accounting for money and property; no commingling	**Cooperation** — not interfering with the agent's performance
Notification of material information	Safe working conditions (for employees)

Notice to an agent about matters within the scope of the agency is **imputed to the principal**.

Watch out: If an agent breaches the duty of loyalty — for example, secretly buying the property the principal wanted and reselling it to the principal at a profit — the principal can recover the **secret profit** and the agent may lose compensation for that transaction.

Termination of the agency

By the parties

- Fulfillment of purpose, expiration of an agreed term, mutual agreement.
- **Revocation** by the principal or **renunciation** by the agent. Either party has the **power** to end the agency at any time, but may lack the **right** to — a party who ends an agency for a fixed term early may owe damages for breach.
- An **agency coupled with an interest** (the agent has an interest in the subject matter, such as a lender authorized to sell collateral) **cannot be revoked** by the principal and is not ended by the principal's death.

By operation of law

- **Death or insanity** of either party, **bankruptcy** of the principal (in most cases), impossibility, illegality, destruction of the subject matter, or war.
- No notice is needed; the agent's **actual and apparent authority end immediately**.

Notice to third parties when the parties end the agency

If the parties end the agency, apparent authority may continue until third parties are told:

Third party	Notice required
Those who **dealt with the agent before**	**Actual notice** (direct communication)
Those who knew of the agency but had not dealt with the agent	**Constructive notice** (for example, a newspaper notice)

Example: Ivy was a purchasing agent for Maple Co. and regularly bought from Supplier X. Maple fires Ivy but tells no one. Ivy then orders goods from X in Maple's name. Maple is bound because Ivy still has **apparent authority** as to X, which had dealt with her and received no actual notice. Maple can then seek recovery from Ivy. Had Maple's owner died before the order, the agency would have ended by operation of law and Maple's estate would not be bound.

Common traps

- Basing apparent authority on what the **agent** said.
- Letting an **undisclosed principal** ratify.
- Assuming a corporation's **adoption** releases the promoter — only a **novation** does.
- Forgetting that termination by operation of law needs **no notice**.
- Holding an employer liable for an independent contractor's ordinary negligence.

Key takeaways

- Agency is consensual, needs no consideration, and only the principal needs capacity; the equal dignity rule may require written authority.
- Authority: express, implied, apparent (from the principal's conduct toward the third party) and ratification (full knowledge, whole contract, disclosed principal, existing principal).
- Disclosed principal → principal liable; partially disclosed → both; undisclosed → agent, then the third party elects once the principal is known.
- Employers are vicariously liable for employee torts within the scope of employment, not for independent contractors (with exceptions).
- Agents owe loyalty, obedience, care, accounting and notification; principals owe compensation, reimbursement, indemnification and cooperation.
- Termination by law needs no notice; termination by the parties needs actual notice to prior dealers and constructive notice to others.

6. Contracts

A **contract** is an agreement the law will enforce. REG tests formation, defenses, the statute of frauds, performance and discharge, and remedies, always with an eye on **which body of law applies**: the **common law** (services, real estate, employment, insurance, intangibles) or **UCC Article 2** (sales of **goods** — movable, tangible personal property). For mixed contracts, the **predominant purpose** decides.

Formation

A valid contract needs: **agreement** (offer and acceptance), **consideration**, **capacity**, **legality**, and in some cases a **writing**. Contracts are **void** (no contract), **voidable** (one party may cancel), or **unenforceable** (valid, but a defense such as the statute of frauds prevents enforcement).

Offer

An offer shows a present intent to be bound, has definite terms and is communicated to the offeree. Advertisements and catalogs are generally **invitations** to make offers. Under the UCC, a contract can be formed even if terms such as price or delivery are open, as long as the parties intended a contract and there is a basis for a remedy; the **quantity** term is needed (requirements and output contracts are allowed).

An offer ends by: revocation, rejection, counteroffer, lapse of time (stated or reasonable), death or incapacity of either party (unless an option exists), destruction of the subject matter, or supervening illegality.

Irrevocable offers	Rule
Option contract (common law)	Offeree pays consideration to keep the offer open
Firm offer (UCC §2-205)	A **merchant's signed written** promise to keep an offer open is irrevocable **without consideration** for the stated time, or a reasonable time if none, but **no more than 3 months**
Detrimental reliance / part performance of a unilateral contract	Offer becomes irrevocable while the offeree performs

Acceptance

Issue	Common law	UCC Article 2
Terms of acceptance	**Mirror-image rule**: any change is a **counteroffer** (rejection)	**§2-207**: an acceptance with additional or different terms is still an acceptance unless expressly conditional
Additional terms	Not part of the contract	Non-merchant deal: proposals only. **Between merchants**: become part of the contract **unless** the offer limits acceptance to its terms, they **materially alter** it, or the offeror **objects** within a reasonable time
Method	Any reasonable method unless the offer specifies	Same; a seller may accept by prompt shipment (shipping nonconforming goods is both acceptance and breach unless offered as an accommodation)

Timing — the mailbox rule

Communication	Effective when
Offer, revocation, rejection, counteroffer	**Received**
Acceptance by an authorized (or reasonable) means	**Dispatched** (mailbox rule)
Acceptance sent **after** a rejection was sent	Effective only if it arrives first (first to arrive wins)
Acceptance by an unauthorized means	Effective on receipt
Offer states acceptance effective only on receipt	Received

> **Example:** On May 1, Alpha mails an offer to Beta. On May 3, Beta mails an acceptance. On May 4, before Beta's letter arrives, Alpha emails a revocation, which Beta receives that day. A contract was formed **May 3**, because acceptance was effective on dispatch and the revocation was effective only on receipt on May 4 — too late.

Consideration

Consideration is a **bargained-for exchange** of legal value (a promise, act or forbearance). Not consideration: **past consideration**, a **preexisting legal duty**, illusory promises and moral obligations. Courts do not ask whether the bargain was fair.

- **Common law**: a modification needs **new consideration**.
- **UCC**: a modification made in **good faith** needs **no consideration** (but may need a writing if the contract as modified is within the statute of frauds).
- Settling a **disputed** debt for less is binding (accord and satisfaction); paying less on an **undisputed, liquidated** debt does not discharge the rest.
- **Promissory estoppel** enforces a promise without consideration when the promisor should expect reliance, the promisee reasonably relies to its detriment, and injustice can be avoided only by enforcement.

Capacity, legality and defenses

Defense	Effect
Minors	Contract **voidable** by the minor until a reasonable time after reaching majority; minor liable for the **reasonable value of necessaries**
Persons **adjudicated** incompetent	**Void**
Mental incapacity not adjudicated, or intoxication	Voidable if the person could not understand the transaction
Illegal subject matter	Void; courts leave the parties where they are
Fraud in the inducement (lie about a material fact, with scienter, justifiable reliance, injury)	Voidable
Fraud in the execution (deceived about the nature of the document itself)	**Void**
Innocent misrepresentation	Voidable (rescission, not damages)
Duress — physical	Void
Duress — economic or threat	Voidable
Undue influence (confidential relationship abused)	Voidable
Mutual mistake of a material fact	Voidable by either party
Unilateral mistake	Generally not a defense, unless the other party knew or should have known (e.g., obvious math error)
Unconscionability	Court may refuse to enforce the clause or the contract

Statute of frauds

These contracts must be evidenced by a **writing signed by the party to be charged** (the party being sued):

Contract type	Memory trick "MY LEGS"
In consideration of **M**arriage	M
Cannot be performed within one **Y**ear of making	Y
Interest in **L**and (sales, leases over one year, mortgages, easements)	L
Executor's promise to pay estate debts personally	E
Guaranty — promise to pay another's debt (unless the main purpose is the guarantor's own benefit)	G
Sale of goods for **$500 or more** (UCC)	S

A contract for an indefinite term that **could** be performed within a year is not covered. Under the UCC, the writing need only show a contract and state the **quantity**; it is enforceable only up to the quantity shown.

UCC exceptions (no writing needed):

- **Specially manufactured** goods, once the seller has substantially started;
- **Admission** in court pleadings or testimony (up to the quantity admitted);
- **Part performance** — goods received and accepted, or paid for;
- **Merchant's confirmation** — between merchants, a written confirmation binds the recipient unless it objects in writing within **10 days**.

The **parol evidence rule** bars prior or contemporaneous oral evidence that contradicts a fully integrated written contract, but allows evidence of fraud, duress, mistake, later modifications, conditions precedent, and evidence to clarify ambiguity.

Third-party rights

- **Assignment** transfers rights; most rights are assignable unless personal, prohibited by law, or materially increasing the obligor's risk. The assignee steps into the assignor's shoes, so the obligor keeps any defenses it had against the assignor. The assignor impliedly warrants that the right exists and is not subject to undisclosed defenses, but does not guarantee that the obligor will pay.
- **Delegation** transfers duties; the delegating party **remains liable** unless there is a novation. Personal services cannot be delegated.
- **Third-party beneficiaries**: **intended** beneficiaries (creditor or donee) may sue once their rights vest; **incidental** beneficiaries may not.

Performance and discharge

Doctrine	Common law	UCC
Standard of performance	**Substantial performance** (good-faith, minor deviation) — party gets the contract price minus damages	**Perfect tender** — buyer may reject goods that fail to conform in any respect
Cure	Not a general right	Seller may **cure** within the original time, or later if it had reasonable grounds to believe the tender would be acceptable
Installment contracts	—	Buyer may reject an installment only if the defect substantially impairs its value

A contract is also discharged by: full performance, mutual rescission, **novation**, accord and satisfaction, **impossibility** (death of a personal-service party, destruction of the specific subject matter, supervening illegality) or **commercial impracticability** (UCC), and **anticipatory repudiation** (the other party may sue immediately, or wait and demand assurances). A **material breach** excuses the other party's performance; a minor breach only gives a right to damages.

Remedies

Remedy	When
Compensatory (expectation) damages	Put the injured party where it would have been if the contract had been performed
Consequential damages	Losses from special circumstances that were **foreseeable** when the contract was made
Incidental damages	Reasonable costs from the breach (inspection, storage, transportation)
Liquidated damages	Enforceable if damages were hard to estimate and the amount is a **reasonable forecast**; an unreasonable amount is an unenforceable **penalty**
Punitive damages	Generally **not** for breach of contract (tort cases only)
Specific performance	Only when money is inadequate: **land** and **unique goods**; never for personal services
Rescission and restitution	Undo the contract and return benefits

The injured party has a **duty to mitigate** (reduce) its damages.

> **Example:** A contractor agreed to build a garage for $120,000, then walked off the job before starting. The owner hired a replacement for $135,000. Expectation damages = $135,000 − $120,000 = **$15,000**. If the contract had a clause for $500 per day of delay, and the job finished 12 days late, liquidated damages would be 12 × $500 = **$6,000** if $500 a day was a reasonable forecast.

UCC buyer and seller remedies

- **Buyer's cover**: buy substitute goods in good faith and recover (cover price − contract price) + incidental + consequential damages − expenses saved.
- **Buyer without cover**: (market price at the time the buyer learned of the breach − contract price) + incidentals.
- **Seller's resale**: (contract price − resale price) + incidental damages − expenses saved.
- **Seller's market damages**: contract price − market price at the time and place of tender, plus incidentals.
- Seller may also **withhold** or **stop delivery** and recover the **price** if the buyer accepted the goods or they cannot be resold.

Example: A buyer contracted for goods at $50,000. The seller failed to deliver, and the buyer covered at $56,000, spending $1,000 on inspection and freight. Damages = ($56,000 − $50,000) + $1,000 = **$7,000**.

In another case, a buyer wrongfully rejected goods priced at $40,000. The seller resold them for $33,000, paid $500 of resale costs and saved $200 of delivery costs. Damages = ($40,000 − $33,000) + $500 − $200 = **$7,300**.

Sales: risk of loss and title (UCC)

Situation	Risk of loss passes to the buyer
Shipment contract (FOB seller's place)	When the goods are **delivered to the carrier**
Destination contract (FOB buyer's place)	When the goods are **tendered at the destination**
No carrier — **merchant seller**	When the buyer **receives** the goods
No carrier — **non-merchant seller**	On **tender** of delivery
Goods held by a bailee (warehouse)	When the buyer receives a negotiable document, or the bailee acknowledges the buyer's right
Seller ships **nonconforming** goods (breach)	Stays with the **seller** until cure or acceptance
Buyer breaches before risk passed	Buyer bears risk for a commercially reasonable time, to the extent of the seller's uninsured loss

Sale or return (goods mainly for resale): risk with the buyer, and the buyer's creditors can reach the goods. **Sale on approval** (goods mainly for use): risk and title stay with the seller until the buyer accepts.

Warranties: express warranties (affirmations of fact, descriptions, samples); the **implied warranty of merchantability** (only merchant sellers; disclaimed by "as is" or a conspicuous writing mentioning merchantability); the **implied warranty of fitness for a particular purpose** (any seller who knows the buyer's purpose and that the buyer is relying on the seller; disclaimed only in a conspicuous writing); and the warranty of title.

Common traps

- Applying the mailbox rule to revocations or rejections — those are effective on **receipt**.
- Forgetting that UCC modifications need **no consideration**.
- Awarding specific performance for standard goods or personal services.
- Requiring a merchant's firm offer to be supported by consideration.
- Treating additional terms between merchants as automatically excluded.

Key takeaways

- Common law governs services and land; UCC Article 2 governs goods (predominant purpose test for mixed deals).
- Acceptance effective on dispatch; offers, revocations, rejections effective on receipt.
- Firm offers: merchant, signed writing, up to 3 months. UCC §2-207 replaces the mirror-image rule.
- Statute of frauds: marriage, over one year, land, executor, guaranty, goods $500+; UCC exceptions for specially manufactured goods, admissions, part performance and the 10-day merchant confirmation.
- Common law: substantial performance; UCC: perfect tender with a right to cure.
- Remedies: expectation, consequential (foreseeable), liquidated (reasonable forecast), specific performance (land, unique goods); duty to mitigate.
- Risk of loss: shipment → carrier; destination → tender; no carrier → merchant on receipt, non-merchant on tender; breaching seller keeps the risk.

7. Debtor-Creditor Relationships

Creditors protect themselves in two main ways: by getting a **third person's promise** to pay (suretyship and guaranty) and by getting an interest in the **debtor's property** (a security interest under UCC Article 9). REG also tests other creditor remedies such as liens and attachment.

Suretyship and guaranty

A **surety** promises the creditor to pay the debtor's obligation if the debtor does not. Three parties are involved: the **creditor**, the **principal debtor**, and the **surety**.

Party	Liability
Surety	**Primarily** liable — the creditor may demand payment from the surety as soon as the debt is due and unpaid, without first suing the debtor or using collateral
Guarantor of payment	Same as a surety for practical purposes
Guarantor of collection	**Secondarily** liable — only after the creditor obtains a judgment against the debtor that cannot be collected (or the debtor is insolvent or cannot be found)

A promise to answer for another's debt must be **in writing** (statute of frauds), unless its **main purpose** is to benefit the promisor. Consideration given to the debtor at the same time also supports the surety's promise; a guarantee of an **existing** debt needs new consideration.

Rights of the surety

Right	Meaning
Exoneration	Before paying, the surety may ask a court to compel the debtor to pay when the debt is due
Reimbursement	After paying, the surety may recover the amount paid from the debtor
Subrogation	After paying in full, the surety steps into the creditor's shoes, including rights to collateral and priority
Contribution	A co-surety who pays more than its share may recover the excess from the other co-sureties

Defenses of the surety

The surety is released (fully or partly) by	The surety is not released by
Debtor's defenses that go to the contract itself (creditor's fraud or duress on the debtor, failure of consideration, illegality)	Debtor's **bankruptcy** or discharge
Creditor's fraud on the surety (e.g., hiding known material facts about the debtor's risk)	Debtor's **incapacity** (minority, insanity)
Material modification of the debt without the surety's consent — an **uncompensated** surety is fully released; a **compensated** surety only to the extent it was **prejudiced**	Debtor's **death**
Release of the debtor without reserving rights against the surety	Creditor's failure to notify the surety of the default
Release or impairment of collateral — released to the extent of the collateral's value	Creditor's failure to sue the debtor first (for a surety)
Creditor's **refusal of a tender** of payment by the debtor or surety (surety released)	
Statute of limitations, payment, or the surety's own incapacity	

Memory trick: The surety's personal-to-the-debtor defenses don't work: "**B-I-D**" — **B**ankruptcy, **I**ncapacity, **D**eath of the debtor never release the surety. Those are exactly the risks a surety agrees to cover.

Co-sureties

Co-sureties guarantee the same debt. Unless they agree otherwise, each bears a share **in proportion to the amount it guaranteed**. A creditor's release of one co-surety reduces the others' liability by the released surety's share.

Example: Ana and Ben are co-sureties on a $100,000 loan: Ana for up to $60,000, Ben for up to $40,000. The debtor defaults owing $50,000 and Ana pays all of it.

- Ana's share = $60,000 ÷ $100,000 × $50,000 = $30,000.
- Ben's share = $40,000 ÷ $100,000 × $50,000 = $20,000.
- Ana may recover **$20,000** from Ben by contribution, and both may seek reimbursement from the debtor.

Secured transactions — UCC Article 9

Article 9 governs **security interests in personal property** and fixtures. Key vocabulary:

Term	Meaning
Security interest	An interest in personal property that secures payment or performance
Collateral	The property subject to the security interest
Security agreement	The agreement creating the interest
Financing statement (UCC-1)	The public notice filed to perfect
Purchase money security interest (PMSI)	Interest held by the seller who financed the purchase, or by a lender whose loan was used to buy the collateral

Types of collateral

Consumer goods (personal, family or household use), **equipment** (business use), **inventory** (held for sale or lease, including raw materials), **farm products**, and intangibles such as **accounts**, **instruments**, **chattel paper**, **investment property** and **deposit accounts**. The **use** the debtor makes of the goods — not the nature of the goods — decides the category: a laptop is inventory for a computer store, equipment for an accounting firm and a consumer good for a student.

Attachment — enforceable against the debtor

A security interest **attaches** when all three occur (in any order):

1. The secured party gives **value** (a loan, credit or a binding commitment).
2. The debtor has **rights in the collateral**.
3. There is an **authenticated (signed) security agreement** describing the collateral, **or** the secured party has **possession** or **control** of the collateral under an agreement.

Perfection — priority against third parties

Method	Used for
Filing a financing statement	Most collateral; effective **5 years**, renewable by a continuation statement filed within 6 months before lapse
Possession	Goods, instruments, negotiable documents, money (money can be perfected **only** by possession)
Control	**Deposit accounts** (only by control), investment property, letter-of-credit rights, electronic chattel paper
Automatic (attachment alone)	**PMSI in consumer goods** (except vehicles and other goods under certificate-of-title laws)

A financing statement need only give the debtor's name, the secured party's name, and an indication of the collateral; it may be filed before the security interest attaches.

Priority rules

Contest	Winner
Two **perfected** interests	The first to **file or perfect**, whichever is earlier
Perfected vs. unperfected	**Perfected**
Two **unperfected** interests	The first to **attach**
Secured party vs. **lien creditor** (including a bankruptcy trustee)	Lien creditor beats an **unperfected** interest; a perfected interest beats a later lien creditor
PMSI in equipment (and other non-inventory goods)	Beats earlier-filed interests if perfected **within 20 days** after the debtor receives the collateral
PMSI in inventory	Beats earlier-filed interests only if perfected **before** the debtor receives the inventory **and** the PMSI holder gives **authenticated notice** to prior filed secured parties
Buyer in the ordinary course of business (buying from a merchant's inventory)	Takes **free** of security interests created by the seller, even perfected and known ones
Consumer buying from a consumer (**garage sale**) a good subject to an automatically perfected PMSI	Buyer takes free if buying for value, without knowledge, for personal use, **before a financing statement is filed**

Example: On March 1, First Bank lends to Delta Co. and files a financing statement covering "all equipment, now owned or later acquired." On April 10, Delta buys a machine on credit from Seller S, which takes a PMSI. Delta receives the machine April 10, and S files on April 25 (15 days later). S wins priority in the machine over First Bank because S perfected its PMSI in equipment within 20 days of delivery. If S had waited until May 5 (25 days), First Bank's earlier filing would win.

Example: Corner Appliance sells a refrigerator to Nina, a consumer, keeping a PMSI and filing nothing. The PMSI is perfected automatically. Nina's creditors cannot defeat it. But if Nina sells the refrigerator at a yard sale to her neighbor for home use, the neighbor takes free of Corner's interest because no financing statement was filed.

Default and remedies

On default, the secured party may:

- **Take possession** of the collateral, by self-help if it can do so **without a breach of the peace**, or through judicial process;
- **Dispose** of it by public or private sale in a **commercially reasonable** manner, after reasonable **notice** to the debtor and secondary obligors (and, for non-consumer goods, other secured parties who filed);
- Propose **strict foreclosure** (keep the collateral in full or partial satisfaction of the debt), unless the debtor or other secured parties object; for consumer goods, strict foreclosure is not

allowed once the debtor has paid **60%** of the cash price (the creditor must sell within 90 days); or
- Sue on the debt.

The debtor may **redeem** the collateral any time before disposition by paying the entire debt plus expenses.

Distribution of sale proceeds

1. **Reasonable expenses** of repossessing, holding and selling (including attorney fees if agreed);
2. The **debt owed to the foreclosing secured party**;
3. **Subordinate** secured parties who made an authenticated **demand** before distribution;
4. **Surplus** to the **debtor**.

If the proceeds fall short, the debtor is liable for the **deficiency** (unless otherwise agreed).

> **Example:** Senior lender S1 (owed $60,000) repossesses and sells equipment for $90,000, paying $5,000 of sale expenses. Junior lender S2, owed $40,000, sent a timely written demand.
>
> - Net after expenses: $90,000 − $5,000 = $85,000.
> - S1 receives $60,000; $25,000 remains.
> - S2 receives **$25,000**; its remaining **$15,000** is an unsecured deficiency claim against the debtor. The debtor receives no surplus.
>
> Had the sale produced $120,000 with $4,000 of expenses, S1 owed $70,000 and S2 owed $30,000: $120,000 − $4,000 − $70,000 − $30,000 = **$16,000** surplus to the debtor.

Other creditor rights and remedies

Remedy	Description
Mechanic's (construction) lien	Unpaid contractors and suppliers may file a lien on the real property improved; foreclosed by sale
Artisan's lien	A possessory lien for someone who repaired personal property (lost if possession is voluntarily surrendered)
Attachment (prejudgment)	Court-ordered seizure of property before judgment, when authorized by statute
Writ of execution	After judgment, the sheriff seizes and sells the debtor's nonexempt property
Garnishment	Collecting from a third party who owes the debtor (wages, bank accounts), subject to federal and state limits
Composition agreement	Creditors agree to accept less in full satisfaction; binding only on creditors who join
Assignment for the benefit of creditors	Debtor transfers assets to a trustee to sell and pay creditors; creditors may still file an involuntary bankruptcy
Fraudulent conveyance	Creditors may set aside transfers made to hinder, delay or defraud them
Homestead exemption	State law protects some of the equity in the debtor's home from unsecured creditors

Common traps

- Treating the debtor's **bankruptcy, death or incapacity** as a surety defense.
- Forgetting that **expenses** come off the top of foreclosure-sale proceeds.
- Using **filing** to perfect an interest in a **deposit account** — only control works.
- Giving a PMSI in **inventory** the 20-day grace period — that is only for non-inventory collateral.
- Letting a secured party beat a **buyer in the ordinary course**.

Key takeaways

- A surety is primarily liable; a guarantor of collection is liable only after the creditor tries to collect from the debtor.
- Surety rights: exoneration, reimbursement, subrogation, contribution (pro rata by amounts guaranteed).
- Attachment: value + debtor's rights + authenticated security agreement (or possession/control).
- Perfection: filing (5 years), possession, control (deposit accounts), automatic (PMSI in consumer goods).
- Priority: first to file or perfect; PMSI equipment within 20 days; PMSI inventory perfect plus notice before delivery; buyers in the ordinary course take free.
- Sale proceeds: expenses → senior debt → juniors who demanded → surplus to debtor; debtor owes any deficiency.

8. Bankruptcy

The federal Bankruptcy Code (Title 11) gives honest debtors a fresh start and gives creditors an orderly, fair distribution. REG tests the chapters available, how a case begins, the trustee's powers, the order in which claims are paid, and which debts survive the discharge.

The main chapters

Chapter	Purpose	Who may use it
Chapter 7 — liquidation	Trustee collects and sells nonexempt assets and distributes proceeds; individuals usually receive a discharge	Individuals, partnerships and corporations (not banks, insurance companies or railroads); individuals with primarily consumer debts must pass the **means test**
Chapter 11 — reorganization	Debtor (usually as **debtor in possession**) proposes a plan to restructure and keep operating	Businesses and individuals; Subchapter V for small businesses
Chapter 13 — adjustment of debts of an individual with regular income	Debtor keeps property and pays creditors from future income over **3 to 5 years**	Individuals with regular income within statutory debt limits; **voluntary only**

Starting a case

Voluntary petition

The debtor files a petition with schedules of assets, liabilities, income and expenses. **Insolvency is not required.** Individuals must receive credit counseling within 180 days before filing.

Involuntary petition (Chapters 7 and 11 only)

Number of creditors	Petitioners needed	Claim requirement (cases filed on or after April 1, 2025)
12 or more	**At least 3** creditors	Aggregate **unsecured**, undisputed, noncontingent claims of at least **$21,050**
Fewer than 12	**1 or more** creditors	Same $21,050 aggregate

- An involuntary petition **cannot** be filed against **farmers** or **nonprofit (charitable) corporations**, and an involuntary Chapter 13 does not exist.
- If the debtor contests, the court grants relief only if the debtor is **generally not paying its debts as they become due** (an **equity** insolvency test) or a custodian took charge of most of the debtor's property within **120 days** before filing. **Balance-sheet insolvency is not required.**

- If the petition is dismissed, the court may award the debtor costs and attorney fees, and damages (including punitive damages) against petitioners who filed in **bad faith**.

> **Example:** Kestrel Co. has 15 creditors and is not paying its bills as they come due, though its assets exceed its liabilities. Two creditors with unsecured claims totaling $30,000 file an involuntary petition. The petition fails: with 12 or more creditors, **three** petitioners are required. If a third creditor joins, the petition succeeds — Kestrel's balance-sheet solvency does not matter.

Effects of filing

- **Automatic stay**: filing immediately stops most collection actions, lawsuits, foreclosures and repossessions. Exceptions include criminal proceedings, collection of **domestic support** obligations from non-estate property, and certain tax audits. A secured creditor may ask the court to **lift the stay** if its interest is not adequately protected.
- **Bankruptcy estate**: all the debtor's legal and equitable interests in property at filing, plus property acquired within **180 days** after filing by inheritance, a property settlement or life insurance. Wages earned after filing in Chapter 7 are **not** part of the estate. An individual may claim **exemptions** (federal or state) such as part of the home equity, a vehicle, tools of the trade and retirement accounts.
- **Order for relief** and a **trustee** (interim, then possibly elected at the creditors' meeting) in Chapter 7.

The trustee's avoiding powers

Power	Rule
Strong-arm power	The trustee has the rights of a hypothetical **lien creditor** at filing, so it defeats **unperfected** security interests
Preferences (§547)	Avoid a transfer (1) to or for a creditor, (2) for an **antecedent** debt, (3) while the debtor was **insolvent** (presumed during the 90 days before filing), (4) within **90 days** before filing (**1 year** for **insiders**), (5) that lets the creditor receive more than it would in a Chapter 7 liquidation
Fraudulent transfers (§548)	Avoid transfers within **2 years** before filing made with **actual intent** to hinder, delay or defraud creditors, or for less than **reasonably equivalent value** while insolvent (constructive fraud); state law may reach back further
Setoff and post-petition transfers	Certain setoffs within 90 days and unauthorized post-petition transfers may be avoided

Insiders include relatives, partners, directors, officers and controlling persons of the debtor. The creditor's knowledge of insolvency is **not** an element of a preference.

Exceptions — transfers that are not avoidable preferences

- **Contemporaneous exchange for new value** (e.g., a cash purchase).
- Payments in the **ordinary course of business** under ordinary terms.

- **PMSI** perfected within **30 days** after the debtor received the property (the enabling loan).
- Later new value given to the debtor (to that extent).
- Consumer debtors: total transfers under **$600**; non-consumer debtors: total transfers under **$8,575** (cases filed on or after April 1, 2025).
- Payments of **domestic support** obligations.

> **Example:** Seventy-five days before filing, insolvent Quill Corp. paid $12,000 to a supplier on a bill that was 4 months overdue and outside its normal terms. This is a preference: transfer to a creditor, on an antecedent debt, while insolvent, within 90 days, and better than liquidation. Another payment of $9,000 made **8 months** before filing to the CEO's brother (an insider) on an old loan is also a preference because the look-back for insiders is **1 year**.

Claims and distribution in Chapter 7

1. **Secured creditors** are paid from their **collateral**. If the collateral is worth less than the debt (an **undersecured** creditor), the shortfall is a **general unsecured** claim.
2. **Priority unsecured claims** are paid in order; each class is paid **in full** before the next class gets anything, and within a class, pro rata.
3. **General unsecured** creditors share what remains **pro rata**.
4. Any remainder goes to the debtor.

Priority	Claim (selected)
1st	**Domestic support obligations** (child support, alimony)
2nd	**Administrative expenses** of the estate (trustee and attorney fees, post-petition costs)
3rd	Involuntary-gap creditors (debts arising in the ordinary course between an involuntary filing and the order for relief)
4th	**Wages**, salaries and commissions earned within **180 days** before filing (or cessation of business), up to **$17,150** per person
5th	Contributions to employee benefit plans within 180 days (shared cap with wages)
6th	Grain farmers and fishermen (limited)
7th	**Consumer deposits** for goods or services not delivered, up to **$3,800** per person
8th	**Taxes** (generally income taxes for years whose returns were due within 3 years before filing, and trust fund taxes)
10th	Death or injury claims from drunk or drugged driving

Wage or deposit claims above the cap are general unsecured claims. (Dollar caps shown are those for cases filed on or after April 1, 2025; they are adjusted every three years.)

Example: In a Chapter 7 case, Bank holds a $200,000 claim secured by equipment that sells for $150,000. Other nonexempt assets produce $210,000. Claims: administrative expenses $30,000; employee wages earned within 180 days $20,000 (all within the per-person cap); taxes $40,000; other general unsecured claims $140,000.

- Bank receives the $150,000 collateral proceeds; its $50,000 shortfall is a general unsecured claim.
- Priority claims from the $210,000: $30,000 + $20,000 + $40,000 = $90,000, all paid in full, leaving $120,000.
- General unsecured claims = $140,000 + $50,000 = $190,000. Payout rate = $120,000 ÷ $190,000 = 63.16%.
- Bank's unsecured recovery = $50,000 × 63.16% = $31,579, so Bank receives **$181,579** in total. Other general creditors receive $140,000 × 63.16% = **$88,421**.

Discharge

A discharge releases the debtor from personal liability for most pre-petition debts. Corporations and partnerships **do not** receive a discharge in Chapter 7 (they simply dissolve).

Debts that are not discharged

- **Domestic support** obligations and most property settlements in divorce;
- **Taxes** for returns due within **3 years** before filing, unfiled or fraudulent returns, and trust fund taxes;
- **Student loans**, unless repayment would cause **undue hardship**;
- Debts obtained by **fraud**, false financial statements, or embezzlement or breach of fiduciary duty;
- Claims for **willful and malicious injury**, and death or injury from driving while intoxicated;
- **Fines and penalties** owed to governments;
- Debts not listed in the schedules (unless the creditor knew of the case);
- Certain recent luxury purchases and cash advances.

Denial of the entire discharge (Chapter 7)

The court denies **any** discharge if the debtor: received a Chapter 7 (or 11) discharge in a case filed within **8 years** before; **concealed** or destroyed property or records with intent to defraud; made a **false oath** or claim; failed to explain a loss of assets; refused to obey court orders; or failed to complete a required personal financial management course.

A discharge may be **revoked** within one year if it was obtained by fraud. A debtor may **reaffirm** a debt (agree to keep paying it) before discharge if the agreement is filed with the court; the debtor may rescind it within **60 days** after filing or before discharge, whichever is later.

Chapter 11 and Chapter 13 in brief

- **Chapter 11**: the debtor in possession runs the business and usually has 120 days of exclusivity to propose a plan. Creditors are grouped into classes and vote; a class accepts if more than **half in number** and at least **two-thirds in amount** of those voting accept. The court may confirm over a class's objection (**cram-down**) if the plan is fair and equitable and does not discriminate unfairly. Confirmation discharges most debts.
- **Chapter 13**: the plan lasts 3 years (5 if income is above the state median). Unsecured creditors must receive at least what they would get in Chapter 7. A co-debtor stay protects individuals who co-signed consumer debts. After completing the plan, the debtor receives a discharge that is broader than Chapter 7's in a few respects.

Common traps

- Treating an **undersecured** creditor's whole claim as secured.
- Requiring the creditor to **know** of the debtor's insolvency for a preference.
- Assuming an involuntary petition requires **balance-sheet** insolvency.
- Forgetting the **1-year** look-back for insiders.
- Listing taxes ahead of wages — domestic support, administrative expenses and wages come first.

Key takeaways

- Chapter 7 liquidates, Chapter 11 reorganizes, Chapter 13 adjusts an individual's debts from income (voluntary only).
- Involuntary petitions: 12+ creditors need 3 petitioners, fewer need 1; $21,050 aggregate unsecured claims; not against farmers or charities; test is not paying debts as they come due.
- Filing triggers the automatic stay and creates the estate.
- Trustee avoids unperfected interests, preferences (90 days / 1 year for insiders) and fraudulent transfers (2 years).
- Distribution: secured creditors from collateral → priority claims in order (support, administration, wages, ..., taxes) → general unsecured pro rata.
- Nondischargeable: support, recent taxes, student loans (absent undue hardship), fraud, willful injury, DUI claims, fines. Total denial for a prior Chapter 7 discharge within 8 years, concealment or false oaths.

9. Federal Regulation of Employers

This chapter covers the federal rules an employer must follow beyond income tax on its own profits: **employment taxes**, **worker classification**, the **Affordable Care Act (ACA)** employer rules, and the **Foreign Corrupt Practices Act (FCPA)**. Most questions ask who pays a tax, at what rate, on how much wage, or whether a worker is an employee.

Employment taxes

FICA (Social Security and Medicare)

Component	Employee rate	Employer rate	Wage base (2025)
Social Security (OASDI)	6.2%	6.2%	First **$176,100** of wages
Medicare (HI)	1.45%	1.45%	All wages
Additional Medicare Tax	**0.9%**	**None**	Wages over **$200,000** (employer must withhold above $200,000 regardless of filing status)

The 0.9% tax is the employee's liability. The employee's actual threshold depends on filing status ($200,000 single, $250,000 married filing jointly, $125,000 married filing separately); any difference is settled on the employee's return. The employer must **withhold** income tax and the employee's FICA, **match** the regular FICA, and deposit both.

Example: Priya earns $210,000 of wages from one employer in 2025.

- Social Security: 6.2% × $176,100 = $10,918.20.
- Medicare: 1.45% × $210,000 = $3,045.00.
- Additional Medicare: 0.9% × ($210,000 − $200,000) = $90.00.
- Employee total withheld = **$14,053.20**.
- Employer total = $10,918.20 + $3,045.00 = **$13,963.20** (no 0.9% match).

If an employee works for two employers, each employer withholds Social Security up to the full wage base; the employee claims the excess as a credit on Form 1040. The employers do not get a refund of their matching share.

FUTA (federal unemployment tax)

- Paid **only by the employer**; nothing is withheld from employees.
- Rate **6.0%** on the first **$7,000** of each employee's wages.
- Credit of up to **5.4%** for timely state unemployment contributions, so the usual net rate is **0.6%** — at most **$42** per employee per year. (Employers in "credit reduction" states get a smaller credit.)

- Reported annually on **Form 940**. FICA and income tax withholding are reported quarterly on **Form 941** (Form 944 for very small employers).

> **Example:** A dental office paid three employees $30,000, $6,000 and $12,000 in 2025 and paid its state unemployment tax on time. FUTA wages = $7,000 + $6,000 + $7,000 = $20,000. FUTA = 0.6% × $20,000 = **$120**.

What counts as wages

Wages include salaries, bonuses, commissions, vacation pay, the fair value of noncash pay and **taxable** fringe benefits (such as group-term life insurance over $50,000 for FICA purposes, or personal use of a company car). Most excludable fringe benefits (health coverage, qualified transportation within limits) are not FICA wages. **Tips** of $20 or more a month reported to the employer are wages. Qualified **overtime** pay remains fully subject to FICA and withholding even though OBBBA allows an income tax deduction for the premium portion.

Trust fund recovery penalty

Withheld income tax and the **employee's** share of FICA are held "in trust" for the government. A **responsible person** who **willfully** fails to pay them over is personally liable for **100%** of the unpaid trust fund amount (§6672). The employer's matching FICA and FUTA are not trust fund taxes. See Chapter 2.

Worker classification

Whether a worker is an **employee** or an **independent contractor** decides who owes employment taxes. The test is the employer's **right to control** — not what the contract calls the worker. The IRS groups the evidence into three categories:

Category	Points toward employee status
Behavioral control	Business instructs when, where and how to work; provides training
Financial control	Business reimburses expenses, provides tools; worker paid by the hour, has no investment and no opportunity for profit or loss; does not offer services to the public
Relationship of the parties	Employee-type benefits, indefinite relationship, services are a key part of the regular business; written contract is considered but not controlling

- Either party may ask the IRS for a determination on **Form SS-8**.
- An employer that misclassified workers may qualify for **Section 530 relief** (no federal employment tax liability) if it had a **reasonable basis** for the treatment, filed all required **Forms 1099** consistently, and treated all similar workers the same way.
- The **Voluntary Classification Settlement Program** lets employers reclassify workers prospectively and pay a reduced amount for past years.
- **Statutory employees** (certain drivers, full-time life insurance agents, home workers, traveling salespeople) are subject to FICA, and **statutory nonemployees** (qualified real estate agents and direct sellers paid on output) are treated as self-employed.

Independent contractors pay their own **self-employment tax** (Chapter 15). Businesses report payments to contractors on **Form 1099-NEC**.

> **Exam tip:** "The contract says she is an independent contractor" is never enough. Look for who controls how the work is done.

The Affordable Care Act — employer rules

Employer shared responsibility (§4980H)

An **applicable large employer (ALE)** had on average **50 or more full-time employees, including full-time equivalents**, during the prior calendar year.

- **Full-time employee**: averages **30 or more hours per week**, or **130 hours per month**.
- **Full-time equivalents (FTEs)**: add the monthly hours of part-time employees (no more than 120 per employee) and divide by **120**.

An ALE owes a payment (assessable) if it does not offer **affordable, minimum-value** coverage to at least 95% of its full-time employees and their dependents, **and** at least one full-time employee buys exchange coverage and receives a **premium tax credit**. Part-time employees are counted to decide ALE status, but the payment is triggered only by full-time employees. ALEs file Forms **1094-C and 1095-C**.

> **Example:** Harbor Lane Co. has 40 full-time employees and 20 part-time employees who each work 90 hours a month. FTEs = (20 × 90) ÷ 120 = 15. Total = 40 + 15 = **55**, so Harbor Lane is an ALE. It owes a §4980H payment only if a **full-time** employee gets a premium tax credit.

Small business health care tax credit (§45R)

Requirement	Rule
Size	Fewer than **25 FTEs**
Wages	Average annual wages below an indexed limit (the credit phases out as average wages rise; the 2025 figure used in the limit is $33,300)
Contribution	Employer pays at least **50%** of the premium for employee-only coverage under a uniform policy
Coverage	Purchased through the **SHOP** Marketplace
Credit	Up to **50%** of premiums paid (**35%** for tax-exempt employers, as a refundable credit against payroll taxes)
Duration	Available for **2 consecutive** tax years

The full credit goes to employers with 10 or fewer FTEs and average wages at or below the lower limit; it is reduced for larger or higher-paying employers. Premiums used for the credit are not also deducted.

The Foreign Corrupt Practices Act

Anti-bribery provisions

The FCPA makes it illegal for **issuers** (companies registered with the SEC), **domestic concerns** (U.S. businesses and persons) and others acting in the United States to **corruptly** offer or pay **anything of value** to a **foreign official**, foreign political party or candidate, to obtain or keep business. Payments through intermediaries the payer **knows** will pass them on are covered.

Exception or defense	Meaning
Facilitating ("grease") payments	Small payments to speed up **routine, nondiscretionary** government actions (processing visas, providing utilities, scheduling inspections) — an exception
Lawful under the written laws of the foreign country	Affirmative defense (local custom is not enough)
Reasonable and bona fide expenditures	Travel and lodging directly related to promoting products or performing a contract — affirmative defense

Accounting provisions (issuers only)

Issuers must **keep books and records** that accurately and fairly reflect transactions in reasonable detail, and maintain a system of **internal accounting controls** that provides reasonable assurance transactions are authorized and recorded properly.

Penalties

Both civil and criminal penalties apply to companies and individuals; individuals can be imprisoned. **Fines imposed on individuals may not be paid by their employer.**

> **Example:** A U.S. company's sales manager pays $50 to a foreign customs clerk to process routine paperwork that the clerk must process anyway — a facilitating payment, not a violation. Paying $50,000 to a foreign defense minister to win a contract is a violation even if the payment is common in that country, unless the country's **written** law permits it.

Common traps

- Counting the employer's FICA match in the trust fund recovery penalty.
- Applying the 0.9% Additional Medicare Tax to the employer.
- Thinking a written contractor agreement settles worker status.
- Treating FUTA as a tax withheld from employees.
- Counting part-time employees as triggering the §4980H payment — only full-time employees who get premium credits do.
- Assuming the FCPA accounting rules apply to private companies — they apply to issuers.

Key takeaways

- FICA: 6.2% Social Security on the first $176,100 (2025) + 1.45% Medicare, both employer and employee; 0.9% Additional Medicare withheld over $200,000, no employer match.
- FUTA: 6.0% on $7,000 less up to 5.4% state credit = 0.6% ($42 per employee); employer only.
- Worker status depends on the right to control (behavioral, financial, relationship); Form SS-8; Section 530 relief.
- ACA: ALE = 50+ full-time including FTEs (hours ÷ 120); full-time = 30 hours a week; payment triggered by a full-time employee's premium tax credit.
- Small employer health credit: fewer than 25 FTEs, 50% employer contribution, SHOP, up to 50% (35% exempt), 2 consecutive years.
- FCPA: no corrupt payments to foreign officials; facilitating payments excepted; issuers must keep accurate books and internal controls.

10. Business Structures

REG compares the legal features of the major business forms: how each is **formed**, who **manages** it, who is **liable** for its debts, how ownership **transfers**, and how it **ends**. Tax treatment of these entities is covered in Chapters 16–18; this chapter is the state-law side.

Comparison of business forms

Feature	Sole proprietorship	General partnership	Limited partnership (LP)	LLP	LLC	Corporation
State filing to form	No (maybe a trade-name filing)	**No**	Certificate of limited partnership	Statement of qualification	Articles of organization	**Articles of incorporation**
Owner liability	Unlimited	**Unlimited, joint and several**	GPs unlimited; LPs limited to investment	Limited (no liability for other partners' torts or, in most states, debts)	Limited	Limited
Management	Owner	All partners equally	General partner(s)	All partners	Members, or managers if manager-managed	Board of directors and officers
Transfer of interest	—	Only financial rights without consent	Same	Same	Same (by default)	Shares freely transferable
Continuity	Ends with owner	Dissociation may trigger dissolution	Continues if a GP remains	Similar to partnership	Perpetual	Perpetual

General partnerships

A general partnership is an association of two or more persons to carry on as **co-owners** a business **for profit**. It can be formed by conduct, with no writing and no filing. **Sharing profits** creates a presumption of partnership, but not if the profits are received as wages, rent, interest on a loan, or payment for goodwill. Most states follow the **Revised Uniform Partnership Act (RUPA)**, under which a partnership is an **entity** separate from its partners.

Default rules (when the agreement is silent)

Matter	Default
Profits	Shared **equally** (per capita), regardless of capital contributed
Losses	Shared in the **same proportion as profits**
Management	Each partner has an **equal** vote
Ordinary business decisions	**Majority** vote
Extraordinary matters, amending the agreement, **admitting a new partner**	**Unanimous** consent
Compensation for services	None (except for winding up)
Interest on capital	None

> **Example:** Ayo, Beth and Cruz form a partnership. Ayo contributes $100,000, Beth $50,000 and Cruz $10,000; they have no agreement on profits. Profit for the year is $90,000. Each partner receives **$30,000**, because profits are shared equally by default regardless of capital.

Partners as agents

Each partner is an **agent** of the partnership for carrying on its business in the usual way. The partnership is bound by a partner's act within actual or apparent authority. Acts outside the usual course of business (such as selling all the assets or confessing a judgment) require unanimous authorization.

Liability

- Partners are **jointly and severally** liable for all partnership obligations, including torts committed by other partners within the scope of the business.
- Under RUPA, a judgment creditor must generally first **exhaust partnership assets** before levying on a partner's personal assets.
- An **incoming partner** is liable for debts that arose **before** admission only to the extent of his or her **capital contribution** (not personally); for later debts, fully.
- A **dissociated partner** remains liable for debts incurred before dissociation, and for up to **2 years** afterward to third parties who reasonably believed the person was still a partner, unless a statement of dissociation is filed (effective 90 days after filing) or notice is given.

Partners' rights and duties

Partners owe each other **fiduciary duties of loyalty and care** (care = avoid gross negligence, recklessness, intentional misconduct, knowing violations of law) and an obligation of **good faith and fair dealing**. Each partner has a right to information and access to the books, a right to an accounting, and a right to share in management.

A partner's **transferable interest** (the right to receive distributions) may be assigned without consent, but the assignee **does not become a partner** and has no management rights. A

judgment creditor of a partner may obtain a **charging order** against that interest. Specific partnership property belongs to the partnership, not the individual partner.

Dissociation, dissolution and winding up

Dissociation (withdrawal, death, expulsion, bankruptcy) ends a partner's participation. In a partnership at will, a partner's express will to withdraw causes **dissolution**. Otherwise the business may continue and buy out the dissociated partner. On dissolution, the partnership **winds up**: completes pending business, sells assets and pays debts.

Order of distribution under RUPA:

1. **Creditors**, including partners who are creditors (partner loans) — they rank equally with outside creditors.
2. **Partners**, according to their **capital account** balances after allocating gains and losses from liquidation.

A partner with a **negative** capital account must **contribute** that amount to the partnership.

> **Example:** A partnership of A, B and C (sharing profits and losses equally) is winding up. It has $150,000 of cash after selling all assets. It owes outside creditors $100,000 and owes partner A $20,000 on a loan. After the sale, capital accounts are A $30,000, B $20,000, C $10,000 before allocating a $30,000 loss on the sale.
>
> - Loss allocation: $30,000 ÷ 3 = $10,000 each → A $20,000, B $10,000, C $0.
> - Pay creditors (including A's loan): $150,000 − $100,000 − $20,000 = $30,000 left.
> - Distribute to partners by capital: A **$20,000**, B **$10,000**, C **$0**.
>
> If the cash were only $135,000, the loss would be $45,000 ($15,000 each): A $15,000, B $5,000, C **−$5,000**. C must contribute $5,000. Cash for partners = $135,000 − $120,000 + $5,000 = $20,000 → A $15,000, B $5,000.

Limited partnerships, LLPs and LLCs

Limited partnership

- Formed by filing a **certificate of limited partnership**; must have **at least one general partner** (unlimited liability) and at least one limited partner.
- **Limited partners** risk only their investment. Under the modern Uniform Limited Partnership Act (2001), a limited partner does not lose limited liability merely by participating in management; under older acts, a limited partner who took part in control could become liable to third parties who reasonably believed he or she was a general partner.
- Limited partners have no right to manage, but have rights to information and to sue derivatively.

Limited liability partnership (LLP)

A general partnership that files a statement of qualification. Partners are **not personally liable** for partnership obligations arising from other partners' **malpractice** or (in most states) any

partnership obligations, but remain liable for their **own** negligence and for those they supervise. Popular for professional firms such as CPA firms.

Limited liability company (LLC)

- Formed by filing **articles of organization**; the **operating agreement** governs internal affairs.
- **Members** have limited liability, even if they manage.
- **Member-managed** (default; each member is an agent) or **manager-managed** (only managers are agents).
- Members owe fiduciary duties in member-managed LLCs; managers do in manager-managed LLCs.
- Default tax treatment: partnership (multi-member) or disregarded entity (single member), with the option to be taxed as a corporation (Chapter 18).

Corporations

Formation

- Created by filing **articles of incorporation** with the state; corporate existence begins on **filing** under the Revised Model Business Corporation Act (RMBCA).
- Articles must include the corporate name, number of authorized shares, the registered agent and office, and each incorporator's name and address.
- **Promoters** are personally liable on pre-incorporation contracts until a **novation** (Chapter 5). The corporation is bound only if it **adopts** the contract.
- **Bylaws** (internal rules) are adopted by the incorporators or board and may be amended by the board unless reserved to shareholders.
- **Piercing the corporate veil**: courts may hold shareholders personally liable when the corporation is a mere alter ego — commingled funds, ignored formalities, inadequate capitalization, or use to commit fraud.

Directors and officers

- The **board of directors** manages the corporation, declares dividends, appoints officers and approves fundamental changes. Directors act as a body at meetings with a **quorum** (majority unless otherwise set); written unanimous consent is allowed.
- Officers are agents appointed by the board and can be removed by it at any time.
- **Duty of care**: act in good faith with the care an ordinarily prudent person would use. The **business judgment rule** protects informed, good-faith decisions with a rational basis, even if they turn out badly.
- **Duty of loyalty**: no self-dealing without disclosure and approval, and no taking of **corporate opportunities** without first offering them to the corporation.
- Directors may rely in good faith on reports by officers, employees and professionals such as CPAs. Corporations may indemnify directors and buy liability insurance.

Shareholders

- Elect and remove directors, approve **fundamental changes**, amend the articles, and inspect books and records for a proper purpose (on 5 business days' written notice).
- **Preemptive rights** (the right to buy new shares to keep a proportional interest) exist **only if the articles provide them** under the RMBCA.
- **Cumulative voting** (multiply shares by the number of directors to be elected) applies only if the articles provide it.
- May bring a **derivative suit** on behalf of the corporation after making a written demand on the board (unless futile).
- Shareholders are generally not liable for corporate debts, except for unpaid subscription amounts, receipt of illegal dividends knowing they were illegal, or veil piercing.

Dividends

The board has discretion to declare dividends. Distributions are **illegal** if, afterward, the corporation could not pay its debts as they come due or its assets would be less than its liabilities plus liquidation preferences. **Directors** who vote for an illegal dividend are personally liable to the corporation; shareholders who knew it was illegal must return it. Once declared, a cash dividend is a debt of the corporation. Preferred stock may be **cumulative** (unpaid dividends accumulate as arrearages).

Fundamental changes

Mergers, consolidations, share exchanges, sale of substantially all assets outside the ordinary course, amendment of the articles and voluntary dissolution need **board approval and shareholder approval**. Shareholders who dissent from a merger or asset sale have **appraisal rights**: they may demand payment of the **fair value** of their shares.

A **short-form merger** of a subsidiary at least **90%** owned by the parent needs **no shareholder vote** of either corporation (and no vote of the subsidiary's board). The subsidiary's minority shareholders keep appraisal rights.

Dissolution may also be **administrative** (failure to file reports or pay fees) or **judicial** (deadlock, fraud, waste, or at the request of creditors or the state).

Common traps

- Sharing profits by capital when the partnership agreement is silent — the default is **equally**.
- Assuming shareholders automatically have **preemptive rights** or cumulative voting.
- Paying partners before **partner-creditors** under RUPA — partner loans rank with outside creditors.
- Making an incoming partner personally liable for pre-admission debts.
- Requiring a shareholder vote in a 90% short-form merger.

Key takeaways

- General partnerships form without filing; partners have unlimited joint and several liability (exhaust partnership assets first); incoming partners risk only capital for old debts.

- Defaults: profits equal, losses like profits, majority for ordinary matters, unanimity to admit partners or amend.
- RUPA winding up: creditors (including partner-creditors) → partners by capital account; negative balances must be contributed.
- LPs need a general partner; LLPs shield partners from others' malpractice; LLC members have limited liability.
- Corporations exist on filing articles; promoters liable until novation; business judgment rule protects informed good-faith decisions; duty of loyalty bars taking corporate opportunities.
- Preemptive rights and cumulative voting only if the articles say so; fundamental changes need board and shareholder approval with appraisal rights; 90% short-form merger needs no shareholder vote.

11. Basis of Assets and Cost Recovery

Basis is the taxpayer's investment in property for tax purposes. It determines gain or loss on a sale (Chapter 12) and the amount that can be recovered through depreciation, amortization or expensing. This chapter covers how basis is set when property is **bought, received as a gift, inherited or converted**, and how cost is recovered under **MACRS, §179, bonus depreciation and amortization**.

Initial basis

Purchased property

Basis = **cost**: cash paid, plus the FMV of property given, plus **liabilities assumed** or taken subject to, plus acquisition costs such as sales tax, freight, installation, testing, legal fees and title costs. Real estate taxes the buyer pays on the seller's behalf are added to basis; taxes allocable to the buyer's own ownership period are deducted, not capitalized.

When several assets are bought together (a lump-sum purchase), cost is allocated by **relative FMV**. In a business acquisition, cost is allocated under the residual method, with any excess going to **goodwill** (amortized under §197).

Adjusted basis

Adjusted basis = initial basis **+** capital improvements, additions, and assessments for local improvements **−** depreciation (allowed or allowable, whichever is greater), §179 and bonus deductions, casualty losses deducted, insurance reimbursements, and nontaxable return-of-capital distributions.

> **Watch out:** Basis is reduced by depreciation **allowable** even if the taxpayer failed to claim it.

Gifts — carryover basis with a loss limit

Situation at the date of the gift	Basis for gain	Basis for loss
FMV ≥ donor's adjusted basis	Donor's basis (plus gift tax adjustment)	Donor's basis
FMV < donor's adjusted basis	Donor's basis	**FMV at the date of gift**

When FMV at the gift was below the donor's basis (the **dual-basis rule**), a later sale price **between** the two bases produces **no gain and no loss**. The donee's holding period includes the donor's if the donor's basis is used; if FMV is used (loss basis), the holding period starts on the gift date.

Gift tax adjustment: if gift tax was paid on appreciated property, basis increases by the gift tax attributable to the **net appreciation**: gift tax paid × (FMV − donor's basis) ÷ amount of the gift (FMV after the annual exclusion).

Example: Mom gives Jae stock with a basis of $10,000 and an FMV of $7,000 (no gift tax). Jae's sale results:

- Sells for $12,000: use the gain basis of $10,000 → **$2,000 gain**.
- Sells for $5,000: use the loss basis of $7,000 → **$2,000 loss**.
- Sells for $8,000: gain basis gives a $2,000 loss, loss basis gives a $1,000 gain → **no gain or loss**.

Example: Dad gives land with a basis of $40,000 and FMV of $100,000 and pays $18,000 of gift tax. Amount of the gift after the $19,000 annual exclusion = $81,000. Net appreciation = $60,000. Adjustment = $18,000 × $60,000 ÷ $81,000 = $13,333. Donee's basis = $40,000 + $13,333 = **$53,333**.

Inherited property

Basis = **FMV at the date of death** (or the **alternate valuation date**, 6 months later, if the executor elects it to reduce both the gross estate and estate tax). This "step-up" (or step-down) eliminates the decedent's unrealized gain or loss. Inherited property always has a **long-term** holding period. Income in respect of a decedent (such as unpaid salary or IRA balances) does not get a step-up. Appreciated property given to a decedent within 1 year before death and inherited back by the donor keeps the decedent's basis.

Converted personal-use property

When personal-use property (such as a home) is converted to business or rental use, the basis for **depreciation and loss** is the **lesser of** adjusted basis or FMV at conversion. The basis for gain is the regular adjusted basis.

Example: Lee converts her home to a rental. Her basis in the building (excluding land) is $240,000; its FMV at conversion is $200,000. Depreciable basis is **$200,000**. If it were nonresidential, annual depreciation would be $200,000 ÷ 39 = $5,128; as residential rental it uses 27.5 years.

Other basis rules

Acquisition	Basis
Property received as **compensation**	FMV (amount included in income)
Like-kind exchange	FMV of property received − deferred gain (Chapter 12)
Property received in a §351 or §721 contribution	Carryover (Chapters 16 and 18)
Stock dividends (nontaxable)	Allocate original basis over old and new shares
Wash sale replacement shares	Cost + disallowed loss; holding period tacks
Bargain purchase from an employer	Price paid + amount included in income

Depreciation under MACRS

The **Modified Accelerated Cost Recovery System** applies to most tangible property placed in service after 1986. **Land is never depreciable.** Depreciation begins when property is **placed in service**.

Class	Typical property	Method	Convention
3-year	Certain tractor units, racehorses	200% declining balance	Half-year / mid-quarter
5-year	**Cars, light trucks, computers**, office machinery	200% DB	Half-year / mid-quarter
7-year	**Office furniture, fixtures, most machinery and equipment**	200% DB	Half-year / mid-quarter
15-year	Land improvements (fences, roads); **qualified improvement property**	150% DB	Half-year / mid-quarter
27.5-year	**Residential rental** buildings	Straight-line	**Mid-month**
39-year	**Nonresidential real property**	Straight-line	**Mid-month**

Conventions

- **Half-year**: personal property is treated as placed in service (and disposed of) at the middle of the year.
- **Mid-quarter**: required for all personal property placed in service in the year if **more than 40%** of the year's depreciable basis (excluding real property and amounts expensed under §179) was placed in service in the **last quarter**.
- **Mid-month**: real property is treated as placed in service in the middle of the month.

First-year MACRS rates	5-year	7-year
Half-year convention	20.00%	14.29%
Second year (half-year)	32.00%	24.49%
Mid-quarter, placed in service in Q1	35.00%	25.00%
Mid-quarter, Q4	5.00%	3.57%

Example: A company (electing out of bonus depreciation and not using §179) buys 7-year equipment for $70,000. Year 1: $70,000 × 14.29% = **$10,003**. Year 2: $70,000 × 24.49% = **$17,143**.

Example: In 2025 a business places 5-year property in service: $200,000 in February and $300,000 in November, electing out of bonus and §179. Q4 property = $300,000 ÷ $500,000 = 60%, more than 40%, so the **mid-quarter** convention applies. Depreciation = $200,000 × 35% + $300,000 × 5% = $70,000 + $15,000 = **$85,000**. Under the half-year convention it would have been $500,000 × 20% = $100,000, so the mid-quarter rule cost $15,000 of first-year depreciation.

Example: A residential rental building (excluding land) costing $330,000 is placed in service in **July**. Under mid-month, it is in service for 5.5 months in year 1: $330,000 ÷ 27.5 × 5.5 ÷ 12 = **$5,500**. An office building costing $390,000 placed in service in March: $390,000 ÷ 39 × 9.5 ÷ 12 = **$7,917**.

In the year of disposition, personal property gets a half-year (or mid-quarter) of depreciation, and real property gets depreciation through the middle of the month of sale.

Listed property and luxury autos

Listed property (passenger autos and other property used for transportation, and certain entertainment property) must be used **more than 50%** for business to use MACRS accelerated methods, §179 and bonus; otherwise the alternative depreciation system (straight-line) applies, and if business use later drops to 50% or less, excess depreciation is recaptured. Passenger autos are subject to annual dollar caps on depreciation (indexed). Employees cannot deduct unreimbursed business expenses, so these rules matter for self-employed people and businesses.

Section 179 expensing

A taxpayer may elect to **expense** the cost of qualifying property (tangible personal property, off-the-shelf software and qualified real property improvements such as roofs, HVAC, fire protection and security systems) in the year placed in service.

2025 (OBBBA)	Amount
Maximum deduction	**$2,500,000**
Phase-out threshold	Reduced dollar for dollar when qualifying property placed in service exceeds **$4,000,000**
Business income limit	Deduction cannot exceed taxable income from the active conduct of **any trade or business** (including wages); the excess **carries forward**
SUV cap	Indexed limit for heavy SUVs

Property must be used more than 50% in business and acquired by purchase from an unrelated party.

Bonus depreciation (§168(k))

Property	2025 bonus rate
Acquired **after January 19, 2025** (OBBBA, permanent)	**100%**
Acquired before January 20, 2025, placed in service in 2025	**40%**

Bonus applies to new or used property with a recovery period of **20 years or less** (and qualified improvement property), unless the taxpayer **elects out** by class. Unlike §179, bonus depreciation has **no dollar limit** and **no business-income limit** — it can create a net operating loss.

Order of deductions

1. **§179** (elected amount reduces basis),
2. **Bonus depreciation** on the remaining basis,
3. **Regular MACRS** on whatever is left.

Example: In 2025 Cedarline Co. places in service $4,300,000 of equipment acquired after January 19, 2025. Its business income before §179 is $1,500,000.

- §179 limit = $2,500,000 − ($4,300,000 − $4,000,000) = **$2,200,000** (elected).
- Business income limit: deduct **$1,500,000** now; **$700,000** carries forward.
- Remaining basis = $4,300,000 − $2,200,000 = $2,100,000 → 100% bonus = **$2,100,000**.
- Total 2025 deduction = $1,500,000 + $2,100,000 = **$3,600,000**; no MACRS basis remains.

Example: A business placed in service on January 10, 2025, 5-year property costing $100,000 that it had acquired in 2024. Bonus at 40% = $40,000. MACRS on the remaining $60,000 × 20% = $12,000. Total year-1 deduction = **$52,000**.

Amortization and intangibles

Item	Rule
§197 intangibles acquired in a business purchase (goodwill, going-concern value, customer lists, covenants not to compete, franchises, trademarks)	Straight-line over **15 years**, starting the month of acquisition
Self-created goodwill	Not amortizable
Start-up costs and **organizational costs** (separately)	Deduct up to **$5,000** each in the year business begins, reduced dollar for dollar by costs over **$50,000**; remainder amortized over **180 months** starting the month business begins
Domestic research and experimental expenditures (§174A, OBBBA)	**Deductible** in tax years beginning after 2024 (or may elect to amortize over at least 60 months); foreign research is amortized over 15 years
Natural resources	Cost or percentage depletion (the greater); percentage depletion can exceed basis

Example: A new business began operating on October 1, 2025, after incurring $53,000 of start-up costs. Immediate deduction = $5,000 − ($53,000 − $50,000) = $2,000. Remaining $51,000 ÷ 180 × 3 months = $850. Total 2025 deduction = **$2,850**.

Example: On April 1, 2025, a company buys a business and allocates $450,000 to goodwill. 2025 amortization = $450,000 ÷ 15 × 9 ÷ 12 = **$22,500**.

Common traps

- Depreciating **land** or including land in a building's depreciable basis.
- Using FMV at the gift date for **gain** on gifted property.
- Applying the **business-income limit** to bonus depreciation (it applies only to §179).
- Forgetting to test the **mid-quarter** 40% rule.
- Using 27.5 years for a commercial building (39 years) or half-year for real property (mid-month).

Key takeaways

- Purchased property: cost plus acquisition costs and assumed debt. Inherited property: FMV at death, always long-term.
- Gift: donor's basis for gain; lesser of donor's basis or FMV for loss when FMV is lower; between the two → no gain or loss. Add the gift tax on net appreciation.
- Converted personal-use property: depreciable basis is the lesser of adjusted basis or FMV.
- MACRS: 5/7-year 200% DB with half-year (mid-quarter if > 40% in Q4); 27.5- and 39-year straight-line mid-month.

- 2025 §179: $2,500,000, phase-out over $4,000,000, limited to business income. Bonus: 100% if acquired after January 19, 2025; 40% for earlier-acquired property placed in service in 2025. Order: §179 → bonus → MACRS.
- §197 intangibles over 15 years; start-up and organizational costs $5,000 each (phased out over $50,000), rest over 180 months; domestic research expensed.

12. Property Transactions and Gift Tax

When property is sold or exchanged, three questions follow: **How much gain or loss is realized? How much is recognized now? What is its character?** This chapter walks through each step, the main nonrecognition rules, related-party and installment rules, and the federal gift tax.

Realized gain or loss

Realized gain (loss) = amount realized − adjusted basis

Amount realized = cash received + FMV of property or services received + **liabilities of the seller assumed** (or taken subject to) by the buyer − selling expenses (commissions, legal fees).

> **Example:** Omar sells a building for $200,000 cash plus land worth $50,000, and the buyer assumes Omar's $150,000 mortgage. Omar pays a $24,000 commission. His adjusted basis is $290,000.
>
> - Amount realized = $200,000 + $50,000 + $150,000 − $24,000 = **$376,000**.
> - Realized gain = $376,000 − $290,000 = **$86,000**.

All realized gains are **recognized** unless a Code section says otherwise. Losses are deductible only if the property was used in a **trade or business** or held for **investment** (or from a casualty in limited cases) — **losses on personal-use property** (a personal car or home) are **not deductible**.

Character: capital assets

A **capital asset** is any property **except**: inventory and property held primarily for sale to customers; **depreciable property and real property used in a trade or business** (these are §1231 assets); accounts and notes receivable from the business; copyrights and creative works held by the creator; certain government publications; and supplies. Personal-use assets and investments (stocks, bonds, land held for investment) **are** capital assets.

Holding period: more than **1 year** = long-term. Gifts and like-kind exchanges usually **tack** the prior holding period; inherited property is always long-term.

Netting for individuals

1. Net short-term gains and losses; net long-term gains and losses.
2. If the results have opposite signs, net them against each other.
3. **Net capital loss**: deduct up to **$3,000** a year ($1,500 married filing separately) against ordinary income; carry the rest forward **indefinitely**, keeping its short- or long-term character. Short-term losses are used first.
4. **Net capital gain** (net LTCG over net STCL) is taxed at **0/15/20%**, except 28% for collectibles and the §1202 taxable portion, and up to 25% for **unrecaptured §1250 gain**.

Example: Mei has STCG $4,000, STCL $10,000, LTCG $6,000 and LTCL $9,000. Net short-term = −$6,000; net long-term = −$3,000; total = −$9,000. She deducts **$3,000** (taken from the short-term loss first) and carries forward **$3,000 short-term** and **$3,000 long-term**.

Corporations

Corporations get **no deduction** for a net capital loss against ordinary income. They carry it **back 3 years and forward 5 years**, always as a **short-term** loss, offsetting only capital gains. Corporate capital gains are taxed at the regular 21% rate.

Special losses

- **Worthless securities**: treated as sold on the **last day of the tax year** they become worthless.
- **§1244 small business stock**: individuals may treat up to **$50,000** ($100,000 MFJ) of loss each year as **ordinary**.
- **Wash sales**: a loss is disallowed if substantially identical stock is bought within **30 days before or after** the sale; the disallowed loss is added to the basis of the new shares.
- **Nonbusiness bad debts**: short-term capital loss when totally worthless.

Section 1231 and depreciation recapture

Section 1231 property is depreciable property and real property used in a trade or business and held **more than 1 year** (plus involuntary conversions of such property and of long-term capital assets held for business or investment).

Step 1 — Recapture

Rule	Property	Ordinary income
§1245	Depreciable **personal** property (equipment, vehicles, furniture) and amortizable intangibles	Gain up to **all depreciation** (and §179/bonus) taken
§1250	Depreciable **real** property	Only excess of accelerated over straight-line depreciation — **none** for property depreciated straight-line under MACRS
Unrecaptured §1250 gain (individuals)	Real property	Gain up to straight-line depreciation is a §1231 gain but taxed at up to **25%** when it ends up as capital gain
§291 (C corporations)	Real property	**20%** of the lesser of the depreciation taken or the recognized gain is ordinary

Step 2 — §1231 netting

- Net §1231 **gain** → treated as **long-term capital gain**, except that it is ordinary to the extent of **nonrecaptured net §1231 losses** from the prior **5 years** (the lookback rule).
- Net §1231 **loss** → **ordinary loss** (fully deductible).

Memory trick: Section 1231 is "the best of both worlds": gains are capital, losses are ordinary — but the 5-year lookback takes back the advantage if you recently took ordinary losses.

Example: Equipment cost $100,000; accumulated depreciation is $60,000 (adjusted basis $40,000).

- Sold for $70,000: gain $30,000, all **§1245 ordinary** (less than the $60,000 depreciation).
- Sold for $120,000: gain $80,000 → **$60,000 ordinary** (§1245) and **$20,000 §1231** gain.
- Sold for $35,000: **$5,000 §1231 loss** (ordinary if it is the net §1231 result).

Example: A building cost $500,000 and has $120,000 of straight-line depreciation (adjusted basis $380,000). It sells for $600,000: gain $220,000.

- Individual owner: no §1250 ordinary recapture. $120,000 is **unrecaptured §1250 gain** (max 25%); $100,000 is §1231 gain.
- C corporation owner: §291 ordinary = 20% × $120,000 = **$24,000**; the other $196,000 is §1231 gain.

Example: In 2025 Ivan has a net §1231 gain of $50,000. He had net §1231 losses of $18,000 in 2022 that have not been recaptured. Result: **$18,000 ordinary** income and **$32,000 long-term capital gain**.

Nonrecognition: like-kind exchanges (§1031)

Gain or loss is **not recognized** when **real property** held for business or investment is exchanged for like-kind real property also held for business or investment. Since 2018, **only real property** qualifies (any U.S. real estate for any U.S. real estate — land for a building, rental house for a warehouse). Personal residences, inventory, stocks and personal property do not qualify; U.S. and foreign real property are not like-kind.

- **Deferred exchange**: the replacement property must be **identified within 45 days** and **received within 180 days** (or by the return due date, if earlier) after transferring the old property.
- **Boot** (cash, non-like-kind property and **net liability relief**) causes gain to be recognized: **recognized gain = lesser of realized gain or boot received**. Liabilities the other party assumes are boot received. Liabilities the taxpayer assumes, and cash the taxpayer pays, **offset** liabilities relieved (only the **net** relief is boot). But liabilities the taxpayer assumes **do not** offset **cash** the taxpayer receives.
- **Losses are never recognized** in a like-kind exchange, even with boot.
- **Basis of new property** = FMV of new property − deferred gain (or + deferred loss). Equivalent: old basis + gain recognized + boot paid (including liabilities assumed) − boot received (including liabilities relieved).

- Exchanges between **related parties** are disqualified if either party disposes of the property within **2 years**.

> **Example:** Ruth trades a warehouse (FMV $800,000, adjusted basis $500,000, mortgage $200,000 assumed by the other party) for an apartment building (FMV $750,000) subject to a $170,000 mortgage that she assumes, plus $20,000 cash.
>
> - Amount realized = $750,000 + $20,000 + $200,000 − $170,000 = $800,000; realized gain = $800,000 − $500,000 = **$300,000**.
> - Boot = $20,000 cash + net liability relief ($200,000 − $170,000 = $30,000) = **$50,000**.
> - Recognized gain = lesser of $300,000 or $50,000 = **$50,000**; deferred gain = $250,000.
> - Basis of new building = $750,000 − $250,000 = **$500,000**. Check: $500,000 + $50,000 + $170,000 − $200,000 − $20,000 = $500,000.

Involuntary conversions (§1033)

When property is destroyed, stolen or condemned and the owner receives insurance or condemnation proceeds, the owner may **elect to defer gain** by reinvesting in qualified replacement property. Gain recognized = **lesser of realized gain or proceeds not reinvested**. Replacement must be made within **2 years** after the end of the year the gain is realized (**3 years** for condemned business or investment **real** property). The replacement test is **similar or related in use** (like-kind for condemned real property). Losses are recognized normally (if otherwise deductible). New basis = cost of replacement − deferred gain.

Sale of a principal residence (§121)

Requirement	Rule
Exclusion	Up to **$250,000** of gain (**$500,000** MFJ)
Ownership and use	Owned **and** used as a principal residence for at least **2 of the 5 years** before the sale (MFJ: either spouse owns, **both** use)
Frequency	Once every **2 years**
Reduced exclusion	If the tests are not met because of a change in **employment, health or unforeseen circumstances**: maximum × months of qualifying use (or ownership, if shorter) ÷ 24
Nonqualified use	Gain allocated to periods after 2008 when the home was not the principal residence (e.g., a rental before moving in) is not excludable; depreciation after May 6, 1997 is taxable

Losses on a personal residence are never deductible.

Example: A married couple sells their home of 10 years for $1,100,000, paying $60,000 of selling costs. Basis is $400,000. Gain = $1,100,000 − $60,000 − $400,000 = $640,000. Excluded = $500,000; taxable long-term gain = **$140,000**.

A single taxpayer who owned and lived in a home for 15 months and moved for a new job far away qualifies for a reduced exclusion of $250,000 × 15 ÷ 24 = **$156,250**.

Related parties and installment sales

Related-party losses (§267)

Losses on sales or exchanges between **related parties** are **disallowed**. Related parties include family (spouse, ancestors, lineal descendants, **brothers and sisters**; not in-laws, aunts, uncles or cousins), and an individual and a corporation or partnership in which the individual owns **more than 50%** (directly or by attribution). The buyer may use the disallowed loss to **reduce a later gain** on resale, but not to create or increase a loss.

Example: Kevin sells stock with a basis of $50,000 to his sister for $35,000. His $15,000 loss is disallowed. If she later sells for $45,000, her $10,000 gain is reduced by the $15,000 → **$0** gain (no loss). If she sells for $60,000, gain = $25,000 − $15,000 = **$10,000**.

Installment sales (§453)

When at least one payment is received after the year of sale, gain is reported as payments are received: **gain recognized = payments received × gross profit percentage** (gross profit ÷ contract price). **Depreciation recapture** is recognized **in full in the year of sale** regardless of payments, and the recapture is added to basis for the gross profit computation. The installment method is not available for inventory, dealer sales, publicly traded stock, or losses.

Example: Sale of equipment for $200,000 (payable $40,000 now and the rest in later years). Adjusted basis is $60,000 (cost $150,000, depreciation $90,000). Total gain = $140,000.

- Year of sale: §1245 recapture of **$90,000** ordinary income, all recognized now.
- Remaining gross profit = $200,000 − ($60,000 + $90,000) = $50,000; gross profit % = $50,000 ÷ $200,000 = 25%.
- Year-1 §1231 gain = $40,000 × 25% = **$10,000**.

Federal gift tax

A **gift** is a transfer for less than full consideration. The **donor** pays the tax. The gift tax and estate tax share a unified rate schedule (top rate 40%) and a **unified credit** that covers transfers up to the basic exclusion amount ($13,990,000 for 2025).

Gift tax rules (2025)	Amount
Annual exclusion	**$19,000** per donee (present-interest gifts only)
Gift splitting	Married donors may elect to treat each gift as made half by each spouse — doubling the exclusion to $38,000 per donee; both must consent and both file Form 709
Tuition and medical payments	**Unlimited** exclusion if paid **directly** to the school or medical provider
Marital deduction	**Unlimited** for gifts to a **U.S. citizen** spouse; annual exclusion of $190,000 for a non-citizen spouse
Charitable deduction	Unlimited
Political contributions	Not taxable gifts
Return	**Form 709**, due **April 15** of the following year (extended with the income tax return)

Gifts of **future interests** (for example, a remainder interest, or most transfers to a trust without withdrawal rights) do not qualify for the annual exclusion. Opening a joint bank account is not a gift until the other party withdraws funds. A loan forgiven is a gift when forgiven.

Example: In 2025 Tom (married; his wife consents to gift splitting) gives his daughter $100,000 and his son $30,000, and pays his grandson's college $40,000 directly.

- Tuition paid directly: fully excluded.
- Split gifts: each spouse is treated as giving $50,000 to the daughter and $15,000 to the son.
- Each spouse's taxable gifts = ($50,000 − $19,000) + $0 = **$31,000**. Each files Form 709; the unified credit covers the tax, so no gift tax is actually paid.

Common traps

- Leaving liabilities assumed by the buyer out of the amount realized.
- Recognizing a **loss** in a like-kind exchange, or treating personal property as like-kind after 2017.
- Forgetting the **5-year lookback** on net §1231 gains.
- Deducting a loss on a sale to a sibling, or treating in-laws as related.
- Deferring depreciation recapture under the installment method.
- Applying the annual exclusion to a future-interest gift.

Key takeaways

- Amount realized = cash + FMV of property + liabilities relieved − selling costs; gain = amount realized − adjusted basis.

- Individuals deduct $3,000 of net capital loss and carry the rest forward indefinitely; corporations carry back 3, forward 5, against capital gains only.
- §1245 recaptures all depreciation as ordinary; individuals have unrecaptured §1250 gain at up to 25%; corporations have §291 20% recapture; net §1231 gain is capital (after the 5-year lookback), net loss is ordinary.
- §1031: real property only; recognized gain = lesser of realized gain or boot; 45/180-day rules; new basis = FMV − deferred gain.
- §121: $250,000/$500,000 with 2-of-5-year ownership and use; reduced exclusion for job, health or unforeseen moves.
- §267 disallows related-party losses; installment gain = payments × gross profit %, recapture in the year of sale.
- Gift tax: $19,000 annual exclusion per donee, gift splitting, unlimited direct tuition and medical, unlimited citizen-spouse and charitable gifts; Form 709 due April 15.

13. Gross Income and Pass-Through Items

Gross income is "all income from whatever source derived" unless a specific provision excludes it. The exam tests whether an item is **included or excluded**, **how much** is taxable (Social Security, scholarships, fringe benefits, distributions), and **when** it is reported. This chapter also covers income that flows through from partnerships, S corporations, estates and trusts.

Basic principles

- **Realization**: income is taxed when realized in a transaction, not when property merely rises in value.
- **Constructive receipt** (cash-method taxpayers): income credited to an account or made available without substantial restriction is taxable even if not physically taken (interest credited to a savings account, a paycheck available on December 31).
- **Claim of right**: amounts received without restriction are income even if they might have to be repaid later.
- **Assignment of income**: income from services is taxed to the person who earns it; income from property is taxed to the owner of the property.
- **Prepaid income**: generally taxable when received (accrual taxpayers may defer advance payments for goods and services one year in limited cases); **security deposits** are not income unless kept.

Common inclusions

Item	Treatment
Wages, salaries, bonuses, commissions, **tips**	Included (OBBBA's tips and overtime provisions are **deductions**, not exclusions — Chapter 14)
Interest — banks, corporate bonds, **U.S. Treasury** obligations, federal tax refunds	Included (Treasury interest is exempt from **state** tax, not federal)
Dividends	Included; qualified dividends get 0/15/20% rates
Business income (Schedule C), rents and royalties (Schedule E)	Net income included
Prizes, awards, gambling winnings	Included at FMV; gambling losses deductible only as an itemized deduction up to winnings
Unemployment compensation	Included
Alimony under divorce instruments executed **before 2019**	Included by the recipient (deductible by the payer)
Canceled debt	Included unless an exclusion applies
Treasure trove, found property	Included when reduced to undisputed possession
Illegal income	Included
Jury duty pay, election worker pay	Included
Punitive damages	Included (even in physical-injury cases)
Embezzled funds	Included

Common exclusions

Item	Rule
State and local (municipal) bond interest	Excluded (private activity bond interest is an AMT preference)
Gifts and inheritances	Excluded (but income later earned on them is taxable)
Life insurance death benefits	Excluded (interest on installment payouts is taxable; a policy bought from another owner is taxable above cost unless an exception applies)
Damages for physical injury or physical sickness	Excluded, including lost wages; emotional distress damages excluded only if tied to a physical injury or up to medical costs
Workers' compensation	Excluded
Employer-provided **health insurance** and reimbursed medical expenses	Excluded
Disability benefits from a policy the **employee paid for** with after-tax dollars	Excluded (employer-paid plans are taxable)
Child support	Never income and never deductible
Alimony under instruments executed **after 2018**	**Not** income to the recipient and **not** deductible by the payer
Property settlements in divorce	Not taxable; carryover basis
Qualified scholarships (degree candidates)	Excluded for tuition, fees, books, supplies and required equipment; **room, board, travel** and amounts for **services** (teaching, research) are taxable
U.S. savings bond interest used for higher education	Excluded subject to income limits
Foreign earned income	Up to **$130,000** (2025) excluded by election for qualifying individuals abroad
Return of capital	Not income

Social Security benefits

Up to **50%** or **85%** of benefits may be taxable, depending on **provisional income**:

Provisional income = AGI (excluding Social Security) + tax-exempt interest + 50% of benefits

Filing status	Base amount (50% tier)	Adjusted base (85% tier)
Single, HOH	$25,000	$34,000
Married filing jointly	$32,000	$44,000
MFS living together	$0	$0

Taxable benefits = the **lesser** of:

- 85% of benefits, or
- 85% × (provisional income − adjusted base) + the lesser of (a) 50% of benefits or (b) 50% × (adjusted base − base amount). (If provisional income is between the two bases, use 50% × (provisional income − base) instead, capped at 50% of benefits.)

These thresholds are **not** indexed for inflation.

Example: Single taxpayer: benefits $24,000, other income $30,000, municipal interest $2,000.

- Provisional income = $30,000 + $2,000 + 50% × $24,000 = $44,000 (above $34,000).
- 85% × ($44,000 − $34,000) = $8,500.
- Plus the lesser of 50% × $24,000 = $12,000 or 50% × ($34,000 − $25,000) = $4,500 → $4,500.
- $8,500 + $4,500 = $13,000; cap = 85% × $24,000 = $20,400.
- Taxable benefits = **$13,000**.

Married couple filing jointly: benefits $30,000, other income $50,000. Provisional income = $50,000 + $15,000 = $65,000. 85% × ($65,000 − $44,000) = $17,850, plus the lesser of $15,000 or 50% × $12,000 = $6,000 → $23,850; cap $25,500. Taxable = **$23,850**.

Employee fringe benefits

Benefit	2025 exclusion
Group-term life insurance	Cost of the first **$50,000** of coverage; cost above $50,000 (IRS Table I rates) is taxable wages
Qualified transportation (transit pass, vanpool, parking)	**$325 per month** each for transit and parking
Educational assistance (including student loan payments through 2025 and, under OBBBA, permanently)	**$5,250** per year
Dependent care assistance	**$5,000** per year ($2,500 MFS) for 2025
No-additional-cost services (empty airline seats)	Fully excluded
Qualified employee discounts	Services: **20%** of the price to customers; goods: up to the employer's **gross profit percentage**
Working condition fringes	Excluded to the extent the employee could deduct the cost if paid personally
De minimis fringes	Small, infrequent items (holiday turkey, occasional snacks) excluded; **cash** and gift cards are taxable
Meals and lodging on the employer's premises for the employer's convenience	Excluded (lodging must be a condition of employment)
Employer contributions to health plans, HSAs (within limits) and accident plans	Excluded
Adoption assistance	Excluded up to an indexed limit

Many of these exclusions require plans that do not discriminate in favor of highly compensated employees; otherwise the HCEs are taxed.

> **Example:** Ana, age 52, has $150,000 of employer-paid group-term life coverage. Using the given Table I rate of $0.23 per $1,000 per month for ages 50–54: taxable coverage = $150,000 − $50,000 = $100,000. Taxable income = 100 × $0.23 × 12 = **$276**.

> **Example:** A graduate student receives a $30,500 scholarship covering tuition $20,000, required books $1,500 and room and board $9,000, plus $4,000 for working as a teaching assistant. Excluded: $20,000 + $1,500 = $21,500. Taxable: $9,000 (room and board) + $4,000 (services) = **$13,000**.

Discharge of indebtedness

Canceled debt is income unless an exclusion applies:

Exclusion	Limit
Debt discharged in a **Title 11 bankruptcy**	Fully excluded
Taxpayer **insolvent** immediately before the discharge	Excluded **to the extent of insolvency** (liabilities − FMV of assets)
Qualified farm debt, qualified real property business debt	Limited exclusions
Qualified principal residence debt	Discharges before 2026 (and under written arrangements entered before 2026)
Certain student loans (death or disability discharges, certain public-service programs)	Excluded
Gift (debt forgiven out of affection)	Gift, not income

Excluded amounts reduce **tax attributes** (NOLs, credits, basis, etc.).

> **Example:** A lender cancels $40,000 of Luis's debt. Just before, his liabilities were $150,000 and his assets were worth $125,000, so he was insolvent by $25,000. He excludes **$25,000** and includes **$15,000** in gross income.

Corporate distributions to shareholders

A distribution from a C corporation is:

1. A **dividend** to the extent of the corporation's **earnings and profits (E&P)** — current E&P first, then accumulated E&P;
2. Then a nontaxable **return of capital** reducing stock basis to zero;
3. Then **capital gain**.

Stock dividends are generally nontaxable (basis is reallocated), unless the shareholder could choose cash or the distribution is disproportionate.

> **Example:** Riverton Corp. has current E&P of $30,000 and no accumulated E&P. It distributes $50,000 to its sole shareholder, whose stock basis is $12,000. Dividend = **$30,000**; return of capital = **$12,000** (basis now $0); capital gain = $50,000 − $30,000 − $12,000 = **$8,000**.

Pass-through items

Partnerships and S corporations

Partners and S corporation shareholders report their **distributive share** of the entity's income, deductions, gains, losses and credits for the entity's tax year that **ends within or with** the owner's tax year — **whether or not any cash is distributed**. Each item keeps its **character** (ordinary business income, interest, dividends, capital gain, §1231 gain, charitable contributions, tax-exempt income) and is reported on **Schedule K-1**.

- **Ordinary business income** from a partnership is generally subject to **self-employment tax** for general partners; S corporation pass-through income is not.
- **Guaranteed payments** to partners are ordinary income (and SE income) to the partner.
- **Distributions** themselves are generally tax-free reductions of basis (taxed only if cash exceeds basis — Chapters 17 and 18).

> **Example:** Fatima owns 30% of a partnership with $200,000 of ordinary business income in 2025. The partnership distributes only $20,000 to her. She reports **$60,000** of ordinary income (30% × $200,000). The $20,000 distribution reduces her basis and is not separately taxed.

Estates and trusts

Beneficiaries include their share of **distributable net income (DNI)** distributed (or required to be distributed) to them, keeping its character, on a Schedule K-1 from Form 1041. Income kept by the trust is taxed to the trust.

Other income items to know

- **Annuities**: each payment is part taxable, part return of investment; the **exclusion ratio** = investment in the contract ÷ expected return.
- **Below-market loans**: the lender may have imputed interest income (gift loans of $10,000 or less are generally ignored).
- **Kiddie tax**: a child's net unearned income above a threshold is taxed at the parents' rate (the 2025 unearned income threshold is $2,700, being twice the $1,350 base amount).
- **Hobby income** is fully taxable, and hobby expenses are not deductible.
- **Barter**: FMV of goods or services received is income.
- **Rental of a home for fewer than 15 days** a year: income excluded and expenses not deducted.

Common traps

- Excluding **Treasury** interest — it is federally taxable.
- Treating all scholarship money as tax-free, including room, board and teaching pay.
- Taxing partnership **distributions** instead of distributive **shares**.
- Treating post-2018 alimony as income or child support as deductible.
- Treating tips and overtime pay as excluded — they are included, then partly deducted.

Key takeaways

- All income is included unless excluded: municipal interest, gifts, inheritances, life insurance proceeds, physical-injury damages, qualified scholarships (tuition and books only) and many fringe benefits are excluded.
- Social Security: provisional income vs $25,000/$34,000 (single) or $32,000/$44,000 (MFJ); taxable portion never exceeds 85% of benefits.

- 2025 fringe limits: group-term life $50,000; transit and parking $325 a month; educational assistance $5,250; dependent care $5,000; service discounts 20%, goods up to gross profit %.
- Canceled debt is income unless bankruptcy, insolvency (to the extent of insolvency) or another exclusion applies.
- Distributions: dividend to E&P, then return of capital, then capital gain.
- Owners of pass-through entities report their distributive shares, with character preserved, whether or not distributed.

14. Adjustments, Deductions and Loss Limits

Deductions reduce income in a fixed order. First come **adjustments** ("above the line") to reach **adjusted gross income (AGI)**. Then the taxpayer subtracts the **greater of the standard deduction or itemized deductions**, plus deductions available to everyone — the **qualified business income (QBI)** deduction and, for 2025, OBBBA's **senior, tips, overtime and car-loan-interest** deductions — to reach **taxable income**. Separately, **loss limitation** rules decide whether a business or investment loss can be used at all this year.

The individual tax formula

Step	Item
	Gross income
−	**Adjustments** (for AGI)
=	**Adjusted gross income**
−	Greater of **standard deduction** or **itemized deductions**
−	QBI deduction; senior, tips, overtime and car-loan-interest deductions (2025–2028)
=	**Taxable income**

AGI matters beyond the formula: it sets floors (medical 7.5%), percentage limits (charity) and many phase-outs.

Adjustments to arrive at AGI

Adjustment	Key rule
One-half of self-employment tax	Deductible portion of SE tax
Self-employed health insurance	Premiums for the self-employed person and family, up to net SE earnings; not if eligible for an employer-subsidized plan
Self-employed retirement (SEP, SIMPLE, solo 401(k))	Contributions for the owner
Traditional IRA contributions	Up to $7,000 (+$1,000 catch-up at 50+) for 2025; phased out if the taxpayer (or spouse) is an active plan participant above income limits
HSA contributions (not through payroll)	2025 limits $4,300 self-only / $8,550 family (+$1,000 at 55+)
Student loan interest	Up to **$2,500**; 2025 phase-out MAGI $85,000–$100,000 single, $170,000–$200,000 MFJ; not for MFS
Educator expenses	Up to $300 per eligible educator
Alimony paid	Only under divorce instruments executed **before 2019**
Penalty on early withdrawal of savings	Fully deductible
Moving expenses	Only for active-duty military moving under orders
Business expenses of reservists, performing artists and fee-based officials	Limited categories

Trade or business expenses and rental expenses are also deducted "above the line" because they reduce Schedule C and Schedule E income.

Standard deduction (2025, OBBBA)

Filing status	Basic amount	Additional for age 65+ or blind (each)
Single	**$15,750**	$2,000
Married filing jointly / qualifying surviving spouse	**$31,500**	$1,600 per spouse per condition
Head of household	**$23,625**	$2,000
Married filing separately	$15,750	$1,600

A **dependent's** standard deduction is limited to the greater of **$1,350** or **earned income + $450** (not above the regular amount). A married person filing separately whose spouse itemizes must also itemize. Nonresident aliens get no standard deduction.

Itemized deductions (Schedule A)

Medical expenses

Deductible to the extent they exceed **7.5% of AGI**. Includes doctors, dentists, hospitals, prescription drugs, insulin, health and long-term-care insurance premiums (LTC within age-based limits), medical transportation (21 cents per mile for 2025) and medically required capital improvements to the extent they do not increase home value. Not deductible: cosmetic surgery, over-the-counter drugs (other than insulin), general health items, and amounts reimbursed by insurance. Expenses for a dependent count, even if the dependent's gross income is too high to claim him or her.

State and local taxes (SALT)

Deduct state and local **income** (or **sales**) taxes, **real property** taxes and **personal property** taxes based on value — together capped:

2025 SALT cap (OBBBA)	Rule
Cap	**$40,000** ($20,000 MFS)
Phase-down	Cap reduced by **30%** of MAGI over **$500,000** ($250,000 MFS)
Floor	Cap never falls below **$10,000** ($5,000 MFS)

Foreign real property taxes and federal taxes are not deductible. Taxes paid in a trade or business or on rental property are deducted on Schedule C or E, outside the cap.

> **Example:** A single taxpayer has MAGI of $560,000 and pays $45,000 of state income and property taxes. Cap = $40,000 − 30% × ($560,000 − $500,000) = $40,000 − $18,000 = **$22,000**. At MAGI of $650,000, $40,000 − $45,000 would be negative, so the **$10,000** floor applies.

Interest

- **Qualified residence interest** on **acquisition indebtedness** (to buy, build or substantially improve a main or second home) of up to **$750,000** ($375,000 MFS), or $1,000,000 for debt incurred before December 16, 2017. Interest on home equity debt not used to improve the home is not deductible. Points paid to buy a main home are generally deductible when paid.
- **Investment interest** is deductible up to **net investment income**; the excess carries forward indefinitely. Qualified dividends and net capital gain count as investment income only if the taxpayer elects to give up the preferential rates on them.
- **Personal interest** (credit cards, most car loans) is not itemizable (but see OBBBA's car-loan interest deduction below).

Charitable contributions

Contribution to a public charity	AGI limit
Cash	**60%**
Long-term capital gain property — deduct **FMV**	**30%** (or elect to deduct **basis** under the 50% limit)
Ordinary income property (inventory, property held one year or less)	Deduct **basis** (lesser of FMV or basis), 50% limit
Tangible personal property not used for the charity's exempt purpose	Deduct basis
Gifts to most **private nonoperating foundations**	30% cash / 20% capital gain property

Excess contributions carry forward **5 years**. Services are never deductible, but out-of-pocket costs (and 14 cents per mile for 2025) are. Gifts of **$250 or more** require a **contemporaneous written acknowledgment**; noncash gifts over $500 require Form 8283; over $5,000, a qualified appraisal (except publicly traded securities). If a donor receives a benefit (a dinner), only the excess over the benefit's value is deductible.

> **Example:** Rosa (AGI $100,000) donates publicly traded stock held 3 years, FMV $40,000, basis $10,000, to a public charity. She may deduct FMV limited to 30% × $100,000 = **$30,000**, carrying **$10,000** forward 5 years. Alternatively she may elect to deduct only the $10,000 basis under the 50% limit, with no carryover.

Casualty and theft losses; other itemized deductions

Personal casualty and theft losses are deductible only if caused by a **federally declared disaster**: each loss is reduced by **$100**, and the total by **10% of AGI**. **Gambling losses** (up to winnings) are deductible. **Miscellaneous itemized deductions subject to the 2% floor** (unreimbursed employee expenses, tax preparation fees, investment fees) are **not deductible** — OBBBA made their elimination permanent.

> **Example:** Single taxpayer, AGI $120,000. Medical expenses $14,000 → $14,000 − 7.5% × $120,000 = $5,000. State income and property taxes $12,000 (below the cap). Mortgage interest on $400,000 of acquisition debt $9,500. Cash to church $4,000. Itemized total = $5,000 + $12,000 + $9,500 + $4,000 = **$30,500**, more than the $15,750 standard deduction, so she itemizes.

OBBBA deductions for 2025–2028

These are taken whether or not the taxpayer itemizes (they reduce taxable income, not AGI).

Deduction	Maximum	Phase-out
Senior deduction (age 65+ by year-end; SSN required; MFJ must file jointly)	**$6,000** per eligible person ($12,000 if both spouses qualify)	Reduced by **6%** of MAGI over **$75,000** ($150,000 MFJ)
Qualified tips (occupations customarily receiving tips; reported on W-2/1099)	**$25,000** per return	Reduced by $100 per $1,000 of MAGI over **$150,000** ($300,000 MFJ)
Qualified overtime — only the **premium** portion (the "half" in time-and-a-half) required by the Fair Labor Standards Act	**$12,500** ($25,000 MFJ)	Reduced by $100 per $1,000 of MAGI over **$150,000** ($300,000 MFJ)
Car loan interest on a new, personal-use vehicle with final assembly in the U.S., loan originated after 2024	**$10,000**	Phases out above MAGI of **$100,000** ($200,000 MFJ)

Married taxpayers must file jointly to claim the tips and overtime deductions. These amounts remain in gross income and remain subject to FICA.

Example: Single taxpayer age 67 with MAGI of $95,000: senior deduction = $6,000 − 6% × ($95,000 − $75,000) = $6,000 − $1,200 = **$4,800** (in addition to the $2,000 extra standard deduction for age).

A single factory worker received $18,000 of overtime pay at time-and-a-half. The premium portion is one-third: $18,000 ÷ 3 = **$6,000** deductible (below the $12,500 cap).

A single server with $30,000 of qualified tips and MAGI of $160,000: maximum = $25,000 − $100 × ($160,000 − $150,000) ÷ $1,000 = **$24,000**.

Qualified business income (QBI) deduction (§199A)

Owners of sole proprietorships, partnerships, S corporations and many rental activities may deduct up to **20% of qualified business income**. QBI excludes wages earned as an employee, guaranteed payments, reasonable compensation from an S corporation and investment income.

Below the threshold (2025 taxable income before QBI of **$197,300** single / **$394,600** MFJ), the deduction is the **lesser of**:

- 20% of QBI, or
- 20% × (taxable income before the QBI deduction − net capital gain, including qualified dividends).

Above the threshold, the deduction for each business is limited to the greater of 50% of W-2 wages or 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified property, phased in over the next $50,000 ($100,000 MFJ), and **specified service trades or businesses** (health, law, accounting, consulting, financial services and similar) lose the deduction entirely above the range.

Example: A single sole proprietor has QBI of $80,000 and taxable income before QBI of $90,000, including $5,000 of net capital gain. Deduction = lesser of 20% × $80,000 = $16,000 or 20% × ($90,000 − $5,000) = $17,000 → **$16,000**.

Business deduction rules to know

Item	Rule
Ordinary and necessary business expenses	Deductible (§162); capital expenditures are depreciated
Business **meals**	**50%** deductible (taxpayer or employee present, not lavish)
Entertainment	**Not** deductible
Business **gifts**	**$25** per recipient per year
Fines, penalties, bribes, lobbying, political contributions	Not deductible
Business mileage (2025)	70 cents per mile
Home office — regular and exclusive use as the principal place of business	Actual expenses, or the **simplified method of $5 per square foot up to 300 square feet** ($1,500); limited to business income
Business bad debts	Ordinary deduction (partial worthlessness allowed); accrual taxpayers only for amounts previously included in income
Domestic research costs	Deductible (§174A)
Hobby expenses	Not deductible; hobby income fully taxable

Example: A self-employed consultant uses 250 square feet of her home exclusively and regularly as her office. Simplified method: 250 × $5 = **$1,250**.

Loss limitations — apply in order

1. **Basis** (tax basis in the activity, partnership or S corporation),
2. **At-risk** (§465),
3. **Passive activity** (§469),
4. **Excess business loss** (§461(l)).

A loss disallowed at one step is suspended and never reaches the next step that year.

At-risk rules

A taxpayer is at risk for cash and the adjusted basis of property contributed, plus debt for which he or she is **personally liable** (recourse), plus **qualified nonrecourse financing** secured by real property from a commercial lender. Most other **nonrecourse** debt is **not** at risk. Disallowed losses carry forward.

Example: An investor contributes $20,000 cash to an equipment-leasing venture, is personally liable on $30,000 of debt, and the venture has $50,000 of nonrecourse seller financing allocable to him. Amount at risk = $20,000 + $30,000 = **$50,000**.

Passive activity rules

A **passive activity** is a trade or business in which the taxpayer does not **materially participate**, and (generally) any **rental activity**. Passive losses offset only passive income; excess losses are suspended and carried forward, and are released in full when the taxpayer disposes of the entire activity in a taxable transaction. Portfolio income (interest, dividends, capital gains) is **not** passive income.

Special rule	Detail
Active participation in rental real estate (owns at least 10%, participates in management decisions)	Up to **$25,000** of rental losses may offset nonpassive income
Phase-out	Allowance reduced by **50%** of MAGI over **$100,000**; gone at **$150,000**
Real estate professionals (more than 750 hours and more than half of personal services in real property businesses, with material participation)	Rentals are not automatically passive

Example: Kim actively participates in a rental house that produces a $22,000 loss; her MAGI is $130,000 and she has no passive income. Allowance = $25,000 − 50% × ($130,000 − $100,000) = **$10,000**. She deducts $10,000 and suspends $12,000.

Excess business loss

Noncorporate taxpayers may not deduct aggregate net business losses above **$313,000** (single) or **$626,000** (MFJ) for 2025. The disallowed excess becomes part of a **net operating loss carryforward** (individual NOLs carry forward indefinitely, usable up to 80% of taxable income).

Example: A single taxpayer has a $400,000 net loss from her business (with sufficient basis, at-risk amount and material participation). Excess business loss = $400,000 − $313,000 = **$87,000**, carried forward as an NOL.

Common traps

- Forgetting the **SALT phase-down** above $500,000 of MAGI.
- Deducting 2% miscellaneous items (unreimbursed employee expenses, tax prep fees).
- Treating the **full** overtime pay, rather than the premium, as deductible.
- Applying the 60% limit to appreciated stock — it is 30% when deducting FMV.
- Letting passive losses offset portfolio income.
- Forgetting the $25,000 rental allowance is gone at $150,000 MAGI.

Key takeaways

- Adjustments: half of SE tax, SE health insurance, retirement contributions, IRA, HSA, student loan interest ($2,500), educator ($300), pre-2019 alimony.
- 2025 standard deduction: $15,750 / $31,500 / $23,625; +$2,000 unmarried or +$1,600 married for 65+ or blind.
- Itemized: medical over 7.5% of AGI; SALT $40,000 cap reduced by 30% over $500,000 MAGI, floor $10,000; mortgage interest on up to $750,000; charity 60% cash / 30% capital gain property, 5-year carryover.
- OBBBA 2025: senior $6,000 (6% phase-out over $75,000/$150,000); tips $25,000; overtime premium $12,500/$25,000; car loan interest $10,000.
- QBI below threshold: lesser of 20% of QBI or 20% of (taxable income − net capital gain).
- Loss limits in order: basis → at-risk → passive ($25,000 rental allowance phased out from $100,000 to $150,000) → excess business loss ($313,000/$626,000).

15. Filing Status, Tax Computation and Credits

Once taxable income is known, the tax is computed from the rate schedule for the taxpayer's **filing status**, with lower rates for **qualified dividends and net long-term capital gains**. Then **other taxes** are added (self-employment tax, Additional Medicare Tax, net investment income tax, AMT) and **credits** are subtracted. This chapter covers each step.

Filing status

Filing status is determined on the **last day of the tax year** (December 31). A taxpayer whose spouse died during the year is treated as married for that year.

Status	Requirements
Married filing jointly	Married on December 31 (or spouse died during the year); both agree; joint and several liability
Married filing separately	Married taxpayers who file separately; loses many credits (EIC, education credits, most dependent care)
Head of household	**Unmarried** (or "considered unmarried" — lived apart from the spouse for the last 6 months), paid **more than half the cost** of keeping up a home that was the main home of a **qualifying person** for more than half the year. Exception: a **dependent parent** may live in a **separate** home the taxpayer maintains
Qualifying surviving spouse	For the **2 years after** the year of the spouse's death, if the taxpayer has not remarried and maintains a home for a **dependent child**; uses joint rates and standard deduction
Single	Unmarried or legally separated under a decree, not qualifying for another status

Example: Mark's wife died in March 2024. He has a 10-year-old son who lives with him and he has not remarried. 2024: married filing jointly. 2025 and 2026: **qualifying surviving spouse**. 2027: head of household (if he still qualifies).

Dependents

A dependent must be a **qualifying child** or a **qualifying relative**, and must be a U.S. citizen, national or resident (or resident of Canada or Mexico). A dependent who files a joint return (other than only to claim a refund) generally cannot be claimed.

Test	Qualifying child	Qualifying relative
Relationship	Child, stepchild, foster child, sibling, step-sibling or a descendant of any of them	Listed relatives (parents, grandparents, siblings, in-laws, aunts, uncles, nieces, nephews, children) **or** any person who lived with the taxpayer all year as a household member
Age	Under **19** at year-end, or under **24** and a full-time student for 5 months, or permanently disabled; and younger than the taxpayer	None
Residency	Lived with the taxpayer **more than half the year** (temporary absences count as time at home)	Household member only if not a listed relative
Support	Child did **not** provide more than half of his or her own support	Taxpayer provided **more than half** of the support (or a multiple support agreement for someone contributing more than 10%)
Gross income	None	Less than **$5,200** (2025)

Tie-breaker rules apply when more than one person could claim a qualifying child (parent first; then the parent with whom the child lived longer; then higher AGI). A **custodial parent** may release the dependency claim to the noncustodial parent on **Form 8332**.

> **Memory trick:** Qualifying child — "**RARS**": **R**elationship, **A**ge, **R**esidency, **S**upport (child's own). Qualifying relative — "**R-I-S**": **R**elationship or household member, **I**ncome under $5,200, **S**upport over half from the taxpayer.

Computing the regular tax

2025 ordinary rate schedule (selected)

Rate	Single — taxable income up to	MFJ — taxable income up to
10%	$11,925	$23,850
12%	$48,475	$96,950
22%	$103,350	$206,700
24%	$197,300	$394,600
32%	$250,525	$501,050
35%	$626,350	$751,600
37%	above $626,350	above $751,600

Example: Single, taxable income $85,000, all ordinary.

- 10% × $11,925 = $1,192.50
- 12% × ($48,475 − $11,925) = $4,386.00
- 22% × ($85,000 − $48,475) = $8,035.50
- Tax = **$13,614**. Marginal rate 22%; average rate about 16%.

Qualified dividends and net capital gain

Qualified dividends and net long-term capital gain are taxed at **0%, 15% or 20%**, stacked **on top of** ordinary income. For 2025 the 0% rate applies to taxable income up to **$48,350** single / **$96,700** MFJ / $64,750 HOH; the 15% rate up to **$533,400** / **$600,050** / $566,700; 20% above. Unrecaptured §1250 gain is taxed at up to 25%; collectibles at up to 28%.

Example: A married couple has taxable income of $180,000, including $20,000 of long-term capital gain. Ordinary income = $160,000; tax on it = $2,385 + 12% × $73,100 + 22% × $63,050 = $25,028. All of the $20,000 gain falls above $96,700, so it is taxed at 15% = $3,000. Total tax = **$28,028** (versus $29,428 if all income were ordinary).

Kiddie tax

A child's **net unearned income** above **$2,700** (2025) is taxed at the **parents'** rate. It applies to children under 19, full-time students under 24 (if earned income does not exceed half of support), and children under 18 regardless of support.

Other taxes

Self-employment tax

Self-employed individuals with net earnings of **$400 or more** pay both halves of FICA:

1. Net earnings from self-employment = net profit × **92.35%**.
2. Social Security portion = **12.4%** × net earnings up to the wage base ($176,100 for 2025, reduced by any W-2 Social Security wages).
3. Medicare portion = **2.9%** × all net earnings.
4. **One-half** of SE tax is an adjustment to AGI.

Example: Net Schedule C profit of $80,000. Net earnings = $80,000 × 92.35% = $73,880. SE tax = $73,880 × 15.3% = **$11,303.64** (Social Security $9,161.12 + Medicare $2,142.52). Deduction for AGI = **$5,651.82**.

Additional Medicare Tax and net investment income tax

Tax	Rate	Base	Threshold (not indexed)
Additional Medicare Tax	0.9%	Wages and SE income above the threshold	$200,000 single/HOH; $250,000 MFJ; $125,000 MFS
Net investment income tax (NIIT)	3.8%	**Lesser of** net investment income or MAGI over the threshold	Same thresholds

Net investment income includes interest, dividends, rents, royalties, annuities, passive business income and net gains on investment property; it excludes wages, SE income, active business income, tax-exempt interest, distributions from retirement plans and excluded home-sale gain.

> **Example:** A single taxpayer has MAGI of $260,000, including $40,000 of net investment income. NIIT = 3.8% × lesser of $40,000 or ($260,000 − $200,000 = $60,000) = 3.8% × $40,000 = **$1,520**. If the same person had $230,000 of wages, Additional Medicare Tax = 0.9% × $30,000 = **$270**.

Alternative minimum tax (AMT)

1. Start with **taxable income**.
2. Add **adjustments** and **preferences**: SALT deducted as an itemized deduction, the standard deduction (if taken), the spread on exercise of **incentive stock options**, **private activity bond** interest, excess depreciation, and others = **AMTI**.
3. Subtract the **exemption** — 2025: **$88,100** single / **$137,000** MFJ, reduced by **25%** of AMTI over **$626,350** / **$1,252,700**.
4. Apply **26%** to the first **$239,100** and **28%** above (capital gains keep their preferential rates) = tentative minimum tax.
5. AMT = tentative minimum tax − regular tax (if positive).

> **Example:** A single taxpayer has taxable income of $250,000 (regular tax $57,063). Add-backs: SALT $30,000 and ISO bargain element $120,000. AMTI = $400,000 (below the phase-out). AMT base = $400,000 − $88,100 = $311,900. Tentative minimum tax = 26% × $239,100 + 28% × $72,800 = $62,166 + $20,384 = $82,550. AMT = $82,550 − $57,063 = **$25,487**.

Credits

Credits reduce tax dollar for dollar. **Refundable** credits can produce a refund beyond tax liability; **nonrefundable** credits can only reduce tax to zero.

Child tax credit and credit for other dependents (2025)

Item	Rule
Child tax credit	**$2,200** per qualifying child **under 17** with a valid SSN
Refundable portion (additional child tax credit)	Up to **$1,700** per child, equal to 15% of earned income over $2,500
Credit for other dependents	**$500** per other dependent (nonrefundable), e.g., a 17-year-old or a dependent parent
Phase-out	Combined credit reduced **$50 per $1,000** (or part) of MAGI over **$200,000** ($400,000 MFJ)

Example: A married couple with two children ages 8 and 12 has MAGI of $430,000. Credit before phase-out = 2 × $2,200 = $4,400. Reduction = $50 × ($30,000 ÷ $1,000) = $1,500. Credit = **$2,900**.

Child and dependent care credit (2025 rules)

- For care of a qualifying child **under 13** or a disabled spouse or dependent so the taxpayer (and spouse) can **work or look for work**.
- Expense limit: **$3,000** for one qualifying person, **$6,000** for two or more, reduced by excluded employer dependent-care benefits and limited to the lower-earning spouse's earned income.
- Rate: **35%**, reduced by 1 percentage point for each $2,000 (or part) of AGI over **$15,000**, but not below **20%** (reached at AGI over $43,000).
- Nonrefundable. (OBBBA raises the rates starting in **2026**; do not use them for 2025.)

Example: AGI $40,000, two children in day care, expenses $7,000. Limit $6,000. Excess AGI = $25,000 → 12.5, rounded up to 13 → rate = 35% − 13% = 22%. Credit = 22% × $6,000 = **$1,320**.

Education credits

Feature	American opportunity tax credit (AOTC)	Lifetime learning credit (LLC)
Amount	100% of first $2,000 + 25% of next $2,000 = up to **$2,500 per student**	20% of up to $10,000 = up to **$2,000 per return**
Years	First **4 years** of postsecondary education; at least half-time; no felony drug conviction	Unlimited years, any course to improve job skills
Refundable	**40%** (up to $1,000)	No
Expenses	Tuition, fees and **course materials** (books)	Tuition and fees required for enrollment
Phase-out (MAGI)	**$80,000–$90,000** single; **$160,000–$180,000** MFJ (both credits)	Same

Both credits are unavailable to married taxpayers filing separately. Only one credit may be taken per student per year.

Example: A couple (MAGI $170,000) pays $4,000 of qualified tuition for their freshman daughter. Tentative AOTC = $2,000 + 25% × $2,000 = $2,500. Phase-out: ($180,000 − $170,000) ÷ $20,000 = 50% allowed → **$1,250**. Refundable portion = 40% × $1,250 = **$500**.

Other credits to recognize

Credit	Key points
Earned income credit	Refundable; low-to-moderate earned income; amount depends on number of qualifying children; investment income limit; not for MFS (with limited exceptions)
Premium tax credit	Refundable; for Marketplace health coverage; reconciled on Form 8962
Adoption credit	Qualified adoption expenses up to an indexed limit per child; OBBBA makes up to $5,000 refundable starting 2025
Saver's credit	Nonrefundable; low-income taxpayers contributing to retirement plans
Foreign tax credit	Nonrefundable; or deduct foreign taxes instead
Residential clean energy credit	30% of qualifying solar and similar costs (OBBBA ends it for expenditures after 2025)
Credit for the elderly or disabled	Small nonrefundable credit
Excess Social Security withheld	Refundable, when two or more employers withheld over the wage base

Common traps

- Multiplying all taxable income by the **top marginal** rate instead of using the brackets.
- Using OBBBA's **2026** dependent care rules for 2025.
- Forgetting the **92.35%** factor in SE tax.
- Applying the HOH "same home" rule to a dependent parent — a parent may live elsewhere.
- Allowing the child tax credit for a 17-year-old (use the $500 other-dependent credit).
- Computing NIIT on all investment income instead of the lesser of NII or excess MAGI.

Key takeaways

- Filing status is fixed on December 31; qualifying surviving spouse for 2 years after the death year with a dependent child; HOH needs an unmarried taxpayer maintaining a home for a qualifying person.
- Qualifying child: relationship, age (<19, <24 student), residency over half the year, child not self-supporting. Qualifying relative: relationship or household member, gross income under $5,200 (2025), over half support.
- Qualified dividends and net LTCG: 0/15/20% stacked on top of ordinary income.
- SE tax: net profit × 92.35% × 15.3% (12.4% portion capped at $176,100); deduct half.

- NIIT 3.8% on the lesser of NII or MAGI over $200,000/$250,000; Additional Medicare 0.9% over the same thresholds.
- AMT 2025: exemption $88,100/$137,000 phased out 25% over $626,350/$1,252,700; 26%/28% split at $239,100.
- CTC $2,200 per child under 17 (up to $1,700 refundable), phased out $50 per $1,000 over $200,000/$400,000; child care credit 20–35% of $3,000/$6,000; AOTC up to $2,500 (40% refundable), LLC up to $2,000.

16. C Corporations

A **C corporation** is a separate taxpayer. It pays a **flat 21%** tax on its taxable income, and its shareholders pay tax again on dividends — the "double tax." REG tests corporate taxable income (including the dividends-received deduction, charitable limit, capital losses and NOLs), the **book-to-tax reconciliation**, and corporate transactions: **formation, distributions, redemptions and liquidations**, plus state nexus basics.

Filing and payment basics

Item	Rule
Tax rate	**21%** flat
Return	**Form 1120**, due the **15th day of the 4th month** after year-end (April 15 for calendar years); automatic **6-month** extension (Form 7004)
Estimated tax	Quarterly; safe harbor 100% of current-year tax or 100% of prior-year tax (prior-year not allowed if no tax last year; "large" corporations may use it only for the first installment)
Accounting method	Cash method allowed if average annual gross receipts for the prior 3 years are **$31 million** or less (2025)
Tax year	Any year-end (calendar or fiscal)
Corporate AMT	Applies only to very large corporations (average annual adjusted financial statement income over $1 billion)

Computing taxable income

Corporations use most individual business deduction rules, with these special features:

Dividends-received deduction (DRD)

Ownership of the paying domestic corporation	DRD
Less than **20%**	**50%**
20% to less than **80%**	**65%**
80% or more (affiliated group)	**100%**

The 50% and 65% DRDs are limited to that percentage of **taxable income before the DRD** (and before NOL and capital loss carrybacks) — **unless** the full DRD would **create or increase a net operating loss**, in which case the full DRD is allowed. Stock must be held more than 45 days around the ex-dividend date; debt-financed stock gets a reduced DRD.

Charitable contributions

Deduction limited to **10% of taxable income** computed **before** the charitable deduction, the DRD, NOL carrybacks and capital loss carrybacks. Excess carries forward **5 years**. An accrual-

basis corporation may deduct a contribution authorized by the board during the year and paid within 3½ months after year-end. (OBBBA adds a 1% floor starting in **2026** — not for 2025.)

Capital gains and losses

Taxed at 21%. Net capital losses are **not deductible** against ordinary income; they carry **back 3 years and forward 5 years** as short-term losses.

Net operating losses

NOLs arising after 2017 carry **forward indefinitely** (no carryback, except farming and certain insurance losses) and may offset only **80%** of taxable income (computed before the NOL deduction).

> **Example:** Northgate Corp. has a $300,000 NOL carryforward from 2023 and 2025 taxable income of $250,000 before the NOL. NOL deduction = lesser of $300,000 or 80% × $250,000 = **$200,000**. Taxable income = **$50,000**; carryforward remaining = **$100,000**.

Business interest limit (§163(j))

Business interest expense is deductible up to business interest income + **30% of adjusted taxable income** (+ floor plan interest). For tax years beginning after 2024, ATI is computed **before** depreciation, amortization and depletion (an EBITDA-style measure, restored by OBBBA). Disallowed interest carries forward indefinitely. Small businesses with average gross receipts of **$31 million** or less are exempt.

> **Example:** Ironwood Inc. has ATI of $1,000,000, business interest income of $20,000 and business interest expense of $400,000. Limit = $20,000 + 30% × $1,000,000 = **$320,000**. Disallowed = **$80,000**, carried forward.

Other corporate deduction points

- **Organizational costs** (legal fees for the charter, state fees): $5,000 immediate deduction, phased out over $50,000, remainder over 180 months. Costs of issuing stock are **not** deductible or amortizable.
- **Compensation** over $1 million to covered employees of public companies is not deductible (§162(m)).
- No deduction for federal income tax, fines and penalties, or premiums on key-person life insurance where the corporation is the beneficiary.

Example: Sunfield Corp. has taxable income of $500,000 before charitable contributions and the DRD, including $100,000 of dividends from a 30%-owned domestic corporation. It contributed $60,000 to charity.

- Charitable limit = 10% × $500,000 = $50,000 (carry forward **$10,000**).
- Taxable income before DRD = $500,000 − $50,000 = $450,000.
- DRD = 65% × $100,000 = $65,000 (limit 65% × $450,000 = $292,500 is not binding).
- Taxable income = $450,000 − $65,000 = **$385,000**; tax = 21% × $385,000 = **$80,850**.

Example: Two corporations each receive $100,000 of dividends from 10%-owned corporations (50% DRD, full DRD $50,000).

- Corp A has a $10,000 operating loss: taxable income before DRD = $90,000. Full DRD would leave $40,000 (no NOL), so the limit applies: 50% × $90,000 = **$45,000**. Taxable income = $45,000.
- Corp B has a $60,000 operating loss: taxable income before DRD = $40,000. The full $50,000 DRD would **create an NOL** of $10,000, so the full DRD is allowed: taxable income = **−$10,000** (NOL).

Book-to-tax reconciliation (Schedule M-1 / M-3)

Schedule M-1 starts with **net income per books** and reconciles to **taxable income**. Corporations with total assets of $10 million or more file the more detailed Schedule M-3. **Schedule M-2** reconciles unappropriated retained earnings.

Add to book income	Subtract from book income
Federal income tax expense	**Tax-exempt interest** income
Excess of capital losses over capital gains	**Life insurance proceeds** on key persons
Income taxable but not on the books (prepaid rent received)	**Excess of tax depreciation** over book depreciation
Fines and penalties, political contributions	Book income not taxable this year
Nondeductible 50% of meals, entertainment	DRD and NOL (on the return itself, not M-1)
Key-person **life insurance premiums**	Charitable carryover used this year
Charitable contributions over the 10% limit	
Book depreciation over tax depreciation	

Example: Maplecrest Corp. reports net income per books of $300,000. Book expenses include federal income tax $70,000, fines $5,000, meals of $8,000 (50% nondeductible = $4,000), and premiums of $3,000 on key-person life insurance. It had a $6,000 net capital loss. Book income includes $8,000 of municipal bond interest. Tax depreciation exceeds book depreciation by $20,000.

Taxable income = $300,000 + $70,000 + $5,000 + $4,000 + $3,000 + $6,000 − $8,000 − $20,000 = **$360,000**.

Permanent differences (tax-exempt interest, fines, the nondeductible half of meals, life insurance) never reverse; **temporary differences** (depreciation, prepaid income, bad-debt allowances) reverse in later years and create deferred taxes for financial reporting.

Forming a corporation — §351

No gain or loss is recognized when persons transfer **property** (not services) to a corporation solely for its **stock**, and the transferors together **control** the corporation immediately after — at least **80%** of the voting power and 80% of each class of nonvoting stock.

- **Boot** (cash or other property received): gain recognized = **lesser of realized gain or boot**. Losses are never recognized.
- **Services**: stock received for services is ordinary income at FMV, and the service provider's stock does not count toward control unless he or she also transfers property of more than nominal value.
- **Liabilities** assumed by the corporation are not boot, unless there is a tax-avoidance purpose (then all are boot). Under **§357(c)**, gain is recognized to the extent liabilities assumed **exceed** the total basis of property transferred.
- **Shareholder's stock basis** = basis of property transferred + gain recognized − boot received − liabilities assumed by the corporation.
- **Corporation's basis in property** = transferor's basis + gain recognized by the transferor (limited if built-in losses are imported). Holding periods tack.
- The corporation recognizes no gain on issuing its stock (§1032).

Example: Haddad transfers land (basis $60,000, FMV $100,000) for stock worth $90,000 plus $10,000 cash, and transferors have 80% control. Realized gain = $40,000; recognized = lesser of $40,000 or $10,000 boot = **$10,000**. Stock basis = $60,000 + $10,000 − $10,000 = **$60,000**. Corporation's land basis = $60,000 + $10,000 = **$70,000**.

If instead he transferred property with a $50,000 basis subject to a $70,000 mortgage, §357(c) gain = $70,000 − $50,000 = **$20,000**, and stock basis = $50,000 + $20,000 − $70,000 = **$0**.

Distributions and earnings and profits

E&P measures the corporation's economic ability to pay dividends. Start with taxable income and adjust: add tax-exempt income, the DRD and NOL deductions; subtract federal income taxes, nondeductible expenses (fines, 50% of meals) and excess capital losses; use straight-line (ADS) depreciation and reverse §179 over five years; recognize installment-sale gains in full.

Order of distributions

1. Dividend to the extent of **current E&P** (allocated pro rata to all distributions during the year);
2. Then **accumulated E&P** (in date order);
3. Then **return of capital** to the extent of stock basis;
4. Then **capital gain**.

If current E&P is **negative**, it is prorated to the date of distribution and netted against accumulated E&P at that date. If current E&P is positive, distributions are dividends to that extent even if accumulated E&P is a deficit.

> **Example:** Bluepeak Corp. has current E&P of $40,000 and accumulated E&P of $30,000. It distributes $100,000 to its sole shareholder (stock basis $20,000). Dividend = $40,000 + $30,000 = **$70,000**; return of capital = **$20,000**; capital gain = **$10,000**.
>
> Another corporation has accumulated E&P of $50,000 at January 1 and a current-year deficit of $20,000 (spread evenly). It distributes $60,000 on July 1. E&P at July 1 = $50,000 − $10,000 = $40,000 → dividend **$40,000**; the other $20,000 reduces basis.

Property distributions

- The corporation recognizes **gain** (but **not loss**) as if it sold appreciated property at FMV. The gain increases E&P.
- The shareholder's distribution amount = **FMV** − liabilities assumed by the shareholder; the shareholder's **basis** in the property = **FMV**.
- E&P is reduced by the greater of FMV or adjusted basis (net of liabilities).

> **Example:** A corporation with ample E&P distributes land (FMV $90,000, basis $30,000) subject to a $20,000 mortgage. Corporation's recognized gain = **$60,000**. Shareholder's dividend = $90,000 − $20,000 = **$70,000**; basis in land = **$90,000**.

Constructive dividends include bargain sales to shareholders, excessive compensation to shareholder-employees, personal use of corporate property and loans with no intent to repay.

Redemptions

A redemption is a corporation's purchase of its own stock. It is treated as a **sale or exchange** (capital gain or loss) if it meets one of these tests; otherwise it is a **distribution** taxed under the E&P rules:

Test	Requirement
Substantially disproportionate (§302(b)(2))	After the redemption the shareholder owns **less than 50%** of voting power **and less than 80%** of his or her percentage before
Complete termination (§302(b)(3))	All of the shareholder's stock is redeemed (family attribution may be waived)
Not essentially equivalent to a dividend	A meaningful reduction in interest (facts and circumstances)
Partial liquidation (noncorporate shareholders)	Corporation contracts its business
Redemption to pay death taxes (§303)	Stock included in a decedent's estate

Constructive ownership (**§318 attribution** from family members, entities and options) applies in measuring ownership.

> **Example:** Jamal owns 400 of 1,000 shares (40%); no attribution applies. The corporation redeems 150 of his shares. After: 250 ÷ 850 = 29.4%. Tests: below 50% and below 80% × 40% = 32%. Both met → **sale or exchange** treatment.

Liquidations

- **Complete liquidation (§331/§336)**: shareholders treat amounts received as full payment for their stock — **capital gain or loss** (FMV received − stock basis), and take an FMV basis in property received. The corporation recognizes **gain and loss** as if it sold its assets at FMV (some losses are disallowed for distributions to related parties).
- **Parent-subsidiary liquidation (§332/§337)**: if a parent owns at least **80%** of the subsidiary's stock (vote and value), neither the parent nor the subsidiary recognizes gain or loss on distributions to the parent; the parent takes **carryover basis** and inherits tax attributes (NOLs, E&P). Distributions to minority shareholders are taxable to them and gain (not loss) is recognized by the subsidiary.

State and local taxation

- A state may tax a corporation only if it has **nexus** with the state. **P.L. 86-272** prohibits a state income tax on a company whose only activity in the state is **solicitation of orders for tangible personal property**, with orders approved and shipped from outside the state. It does not protect services, intangibles or activities beyond solicitation.
- For **sales and use tax**, *South Dakota v. Wayfair* (2018) allows **economic nexus** based on sales volume or transactions, without physical presence.
- Multistate income is **apportioned** using factors (most states now use a single **sales** factor); nonbusiness income is **allocated** to a single state.

Common traps

- Deducting a corporate capital loss against ordinary income.
- Forgetting the **NOL exception** to the DRD taxable-income limit.
- Recognizing a **loss** on a nonliquidating property distribution.
- Counting stock received for **services** toward the 80% control test.
- Using book depreciation for E&P instead of straight-line.

Key takeaways

- 21% flat rate; Form 1120 due the 15th day of the 4th month; net capital losses back 3, forward 5; NOLs forward indefinitely, limited to 80% of taxable income.
- Charitable limit 10% of taxable income before charity, DRD and carrybacks; 5-year carryover.
- DRD 50% / 65% / 100%; taxable-income limit unless the full DRD creates or increases an NOL.
- M-1: add federal tax, fines, nondeductible meals, key-person premiums, excess capital loss; subtract tax-exempt interest, life insurance proceeds, excess tax depreciation.
- §351: 80% control; gain = lesser of realized gain or boot; §357(c) gain when liabilities exceed basis; stock basis = property basis + gain − boot − liabilities.
- Distributions: current E&P, then accumulated E&P, then basis, then gain; corporation recognizes gain but not loss on property distributions; shareholder basis = FMV.
- Redemptions: substantially disproportionate (< 50% and < 80% of before) or complete termination → exchange; liquidations → capital gain or loss; 80% parent-subsidiary liquidations tax-free with carryover basis.
- §163(j): 30% of EBITDA-style ATI, $31 million small-business exemption. P.L. 86-272 protects only solicitation of tangible goods; *Wayfair* allows economic nexus for sales tax.

17. S Corporations

An **S corporation** is a state-law corporation that elects under Subchapter S to be taxed as a **pass-through entity**. It generally pays no federal income tax; its income, deductions, losses and credits flow to the shareholders on **Schedule K-1**. REG tests eligibility, the election and its termination, allocation of income, **shareholder basis**, distributions, and the few taxes an S corporation can still owe.

Eligibility

Requirement	Rule
Entity	**Domestic** corporation (or an LLC that elects corporate status), not an ineligible corporation (certain banks, insurance companies)
Shareholders	No more than **100**; members of a **family** (a common ancestor, lineal descendants within six generations, and their spouses) may be treated as **one** shareholder; a married couple counts as one
Eligible shareholders	**U.S. citizens and resident aliens**, **estates**, certain **trusts** (grantor trusts, QSSTs, ESBTs, testamentary trusts for 2 years), and **§501(c)(3) organizations** and qualified retirement plan trusts
Ineligible shareholders	**Nonresident aliens**, **partnerships**, **C corporations** (an S corporation may own a qualified subchapter S subsidiary) and multi-member LLCs
Stock	**One class of stock** — identical rights to distributions and liquidation proceeds; **differences in voting rights are allowed**

Straight debt meeting safe-harbor rules is not a second class of stock.

Election and termination

- File **Form 2553**, signed by **all** shareholders on the date of the election (and anyone who held stock earlier in the year, for a current-year election).
- To be effective for the **current** year, file by the **15th day of the 3rd month** (March 15 for a calendar year) — and the corporation must have been eligible all year before the election. A late election applies the following year unless the IRS grants late-election relief.
- The corporation generally must use a **calendar year** unless it has a business purpose or makes a §444 election.

Termination event	Effective
Voluntary revocation by shareholders holding **more than 50%** of all shares (voting and nonvoting)	First day of the year if made by the 15th day of the 3rd month; otherwise the next year (or a chosen later date)
Ceasing to qualify (101st shareholder, ineligible shareholder, second class of stock)	The **day** the event occurs
Excess passive investment income: accumulated C corporation E&P at year-end and passive investment income over **25%** of gross receipts for **3 consecutive** years	First day of the **4th** year

After a termination, the corporation must generally wait **5 years** to re-elect, unless the IRS consents. In a termination year, income is allocated between the S short year and the C short year pro rata by days, or by an election to close the books.

Pass-through and allocation

The S corporation files **Form 1120-S**, due **March 15** (15th day of the 3rd month), with a 6-month extension available. It computes **ordinary business income (loss)** and lists **separately stated items** — those that could affect shareholders differently:

- Capital gains and losses, §1231 gains and losses;
- Interest, dividends and royalties (portfolio income);
- Rental real estate and other rental income or loss;
- Charitable contributions;
- §179 deduction;
- Tax-exempt income and nondeductible expenses;
- Investment interest, foreign taxes and credits.

Items are allocated **per share, per day**. Special allocations are **not allowed** (unlike partnerships). When a shareholder's entire interest ends, all affected shareholders may agree to **close the books** instead.

> **Example:** Lark Inc. has 2025 ordinary income of $365,000 (365-day year). Ann owns 50% all year. Bo owns the other 50% for 146 days, then sells to Cy, who holds those shares for 219 days.
>
> - Ann: 50% × $365,000 = **$182,500**.
> - Bo: $365,000 × 50% × 146 ÷ 365 = **$73,000**.
> - Cy: $365,000 × 50% × 219 ÷ 365 = **$109,500**.

Treatment of shareholders

- Pass-through income is **not** subject to self-employment tax. Shareholder-employees must receive **reasonable compensation** as W-2 wages subject to FICA.

- **More-than-2% shareholders** are treated like partners for fringe benefits: health insurance paid for them is included in W-2 wages, and they deduct it as self-employed health insurance.
- Losses are subject to the basis, at-risk, passive activity and excess business loss limits (Chapter 14).

Shareholder basis

Stock basis — annual order of adjustments

Order	Adjustment
Start	Beginning stock basis (initial basis = cash + adjusted basis of property contributed, or purchase price)
1	**Increase** for all income items, including **tax-exempt** income, and capital contributions
2	**Decrease** for **distributions** (not below zero)
3	**Decrease** for **nondeductible, noncapital expenses** (fines, the nondeductible half of meals)
4	**Decrease** for **losses and deductions** (not below zero)

Because distributions are subtracted before losses, a loss year may suspend losses but leave distributions tax-free.

Debt basis

- A shareholder gets **debt basis** only for loans the shareholder **personally makes** to the corporation (the corporation owes the shareholder directly).
- **Guaranteeing** a bank loan to the corporation does **not** create basis (unlike a partner's share of partnership debt). If the shareholder later pays on the guarantee, basis arises then.
- Losses in excess of stock basis reduce debt basis. **Distributions never reduce debt basis.**
- Later net income **restores debt basis first** (up to its original amount), then increases stock basis.

Losses beyond stock and debt basis are **suspended** indefinitely and can be used only by that shareholder when basis is restored; they are lost if the stock is transferred (except to a spouse or in a divorce). After the S election terminates, a **post-termination transition period** (generally 1 year) allows suspended losses to be used to the extent of stock basis.

Example: Mensah is the sole shareholder. Beginning stock basis is $30,000, and he has loaned the corporation $10,000. For 2025: tax-exempt interest $2,000, long-term capital gain $4,000, ordinary loss $50,000, nondeductible expenses $1,000, and a cash distribution of $8,000.

- Increases: $30,000 + $2,000 + $4,000 = $36,000.
- Distribution: $36,000 − $8,000 = $28,000 (tax-free).
- Nondeductible expenses: $28,000 − $1,000 = $27,000.
- Loss: $27,000 absorbed by stock basis (now $0); the remaining $23,000 reduces debt basis by $10,000 (now $0).
- Deductible loss = **$37,000**; suspended loss = **$13,000**.

In 2026 the corporation earns $15,000 of ordinary income: debt basis is restored first to **$10,000**, then stock basis increases to **$5,000**. The suspended $13,000 loss can be used against that basis (subject to the other limits).

Distributions

S corporation with no accumulated E&P

Distributions are **tax-free** to the extent of **stock basis**; any excess is **capital gain**.

Example: A shareholder with stock basis of $25,000 (after the year's income adjustments) receives a $40,000 distribution from an S corporation that was never a C corporation. Tax-free = **$25,000**; capital gain = **$15,000**.

S corporation with accumulated E&P (a former C corporation)

The corporation tracks an **accumulated adjustments account (AAA)** — the cumulative undistributed S-period income. Distributions come out in this order:

1. **AAA** — tax-free (reduces stock basis);
2. **Accumulated E&P** from C years — **taxable dividend** (does not reduce basis);
3. Remaining amount — tax-free return of **stock basis**;
4. Excess — **capital gain**.

Shareholders may elect, with all affected shareholders' consent, to distribute E&P first (useful to avoid the passive-income tax or termination).

Example: A former C corporation has AAA of $30,000 and accumulated E&P of $10,000. It distributes $50,000 to its sole shareholder, whose stock basis is $60,000. AAA portion: **$30,000** tax-free (basis to $30,000). E&P portion: **$10,000** dividend. Remaining $10,000: tax-free return of basis (basis to $20,000). No capital gain.

Property distributions: the S corporation recognizes **gain** (not loss) as if it sold the property at FMV; the gain passes through to shareholders and increases their basis. The shareholder's basis in the property is FMV.

Taxes at the S corporation level

Tax	Applies when	Rate and base
Built-in gains tax (§1374)	A former C corporation (or one that received C corporation assets in a carryover-basis transaction) sells or disposes of assets that had built-in gain on the conversion date, within the **5-year recognition period**	**21%** of the net recognized built-in gain, limited to the remaining **net unrealized built-in gain (NUBIG)** and to the corporation's **taxable income** for the year (as if a C corporation); gain blocked by the income limit carries forward within the period
Excess net passive income tax (§1375)	Accumulated C corporation E&P at year-end and passive investment income over **25%** of gross receipts	**21%** of excess net passive income
LIFO recapture	C corporation using LIFO converts to S	Spread over 4 years

Built-in gains tax paid **reduces** the gain passed through to shareholders (treated as a loss of the same character).

> **Example:** Cedarline Inc. converted from C to S status in 2022 with NUBIG of $200,000. In 2025 (within 5 years) it sells an asset with a $90,000 built-in gain. Its 2025 taxable income computed as if it were a C corporation is $70,000. Recognized built-in gain = lesser of $90,000 or $70,000 = $70,000. Tax = 21% × $70,000 = **$14,700**. The other **$20,000** carries forward to 2026 (still within the period).

Common traps

- Giving S shareholders basis for **corporate bank debt** they guaranteed.
- Allowing **special allocations** — S items are always per share, per day.
- Applying **SE tax** to S corporation pass-through income.
- Subtracting losses before distributions in the basis computation.
- Thinking a difference in **voting rights** creates a second class of stock.
- Filing an election after March 15 and treating it as effective for the current year.

Key takeaways

- Eligibility: domestic corporation, up to 100 shareholders (family = 1), individuals, estates, certain trusts and exempt organizations; no nonresident aliens, partnerships or C corporations; one class of stock (voting differences OK).
- Election by March 15 for the current year with all shareholders' consent; revocation by more than 50% of shares; 5-year wait after termination; passive income over 25% for 3 years with C-year E&P terminates.
- Items allocated per share per day; Form 1120-S due March 15.

- Basis order: + income (including tax-exempt), − distributions, − nondeductible expenses, − losses. Losses limited to stock plus debt basis (shareholder loans only); income restores debt basis first.
- No E&P: distributions tax-free to basis, then capital gain. With E&P: AAA → dividend from E&P → basis → gain.
- Built-in gains tax: 21%, within 5 years of conversion, limited to NUBIG and taxable income.

18. Partnerships, LLCs and Exempt Organizations

A **partnership** — including a multi-member **LLC** that does not elect corporate treatment — is a pass-through entity. It files an information return and allocates its items to partners, who pay the tax. Partnerships are more flexible than S corporations: any type of owner may be a partner, allocations can be special, and partners get basis for partnership debt. This chapter also covers **tax-exempt organizations** and the **unrelated business income tax**.

Entity classification

Under the **check-the-box** regulations, an eligible unincorporated entity is classified by default as:

Entity	Default	May elect (Form 8832)
Multi-member LLC or partnership	**Partnership**	Corporation (and then S status with Form 2553)
Single-member LLC	**Disregarded entity** (Schedule C / owner's return)	Corporation
State-law corporation	Corporation (cannot check the box)	S election only

A new classification election generally cannot be changed again for **60 months**.

Formation — §721

No gain or loss is recognized by a partner or the partnership when **property** is contributed in exchange for a partnership interest. There is **no control requirement** (unlike §351).

- **Partner's outside basis** = cash + adjusted basis of property contributed + partner's share of **partnership liabilities** − liabilities of the partner **assumed by the partnership**.
- **Net liability relief** (the decrease in the partner's individual liabilities) is treated as a **cash distribution**. If it exceeds the partner's basis, the excess is **gain** (and basis goes to zero).
- The partnership takes a **carryover basis** in contributed property (inside basis) and a **tacked holding period**.
- **§704(c)**: built-in gain or loss on contributed property must be allocated to the **contributing partner** when recognized.
- A partner who receives a **capital interest** for **services** has ordinary income equal to the FMV of the interest; a profits interest generally is not taxed on receipt.

Example: Alvarez contributes land (basis $40,000, FMV $100,000) subject to a $60,000 mortgage for a 25% interest; the partnership assumes the mortgage. Okafor contributes $75,000 cash for another 25%.

- Alvarez: $40,000 − $60,000 + 25% × $60,000 = **−$5,000** → he recognizes **$5,000 gain** and his basis is **$0**.
- Okafor: $75,000 + 25% × $60,000 = **$90,000**.
- Partnership's basis in the land = **$40,000** (carryover).

Operations — Form 1065

Item	Rule
Return	**Form 1065**, due **March 15** (15th day of the 3rd month) for calendar-year partnerships; 6-month extension
Late-filing penalty	Per partner per month (up to 12 months); $255 for returns required to be filed in 2026
Tax year	**Majority interest** partners' year → **principal partners'** year → **least aggregate deferral**
Audits	Centralized partnership audit regime: adjustments generally assessed at the partnership level, with a **partnership representative**

The partnership computes **ordinary business income (OBI)** and lists **separately stated items** (capital gains and losses, §1231 items, portfolio income, charitable contributions, §179 deduction, tax-exempt income, investment interest, foreign taxes, credits). Partners report their distributive shares for the partnership year ending within or with their own year, whether or not distributed.

Guaranteed payments

Guaranteed payments are payments to a partner for services or the use of capital determined **without regard to partnership income**. They are **deducted** in computing OBI and are **ordinary income** (and **self-employment income** for services) to the recipient partner, in addition to the partner's distributive share.

Example: The Alma–Ben partnership (50/50) has income of $200,000 before a $50,000 guaranteed payment to Alma for managing the business. OBI = $200,000 − $50,000 = $150,000.

- Alma: $50,000 guaranteed payment + 50% × $150,000 = **$125,000** ordinary income (all SE income for a general partner).
- Ben: 50% × $150,000 = **$75,000**.

Allocations

Partners may agree to **special allocations** of particular items if they have **substantial economic effect** (they are reflected in capital accounts that govern liquidation). Otherwise items follow the partners' interests in the partnership. When interests change during the year, items are allocated using an interim closing of the books or proration.

Self-employment tax

A general partner's share of OBI from a trade or business and guaranteed payments for services are **SE income**. A limited partner's distributive share generally is not (guaranteed payments for services still are).

Outside basis and loss limits

Increases	Decreases (not below zero)
Contributions (cash and property basis)	**Distributions** (cash at amount, property at basis)
Share of OBI and **all** income items, including **tax-exempt** income	Share of losses and deductions
Increase in share of partnership **liabilities** (treated as a cash contribution)	**Decrease** in share of liabilities (treated as a cash distribution)
	Nondeductible, noncapital expenses

Unlike an S shareholder, a partner gets basis for his or her share of partnership **liabilities**, including bank loans. Losses are limited to **outside basis**, then the **at-risk** and **passive** rules and the excess business loss rule. Losses beyond basis are suspended and carried forward indefinitely.

> **Example:** Chen's beginning outside basis is $50,000. His shares for 2025: OBI $30,000, tax-exempt interest $2,000, LTCG $4,000, §179 deduction $6,000, charitable contributions $1,000, and a $10,000 increase in his share of partnership liabilities. He received a $20,000 cash distribution.
>
> Ending basis = $50,000 + $30,000 + $2,000 + $4,000 + $10,000 − $20,000 − $6,000 − $1,000 = **$69,000**.

> **Example:** Novak's basis is $10,000 and her share of partnership loss is $18,000. She may deduct **$10,000** (subject to the at-risk and passive rules); **$8,000** is suspended until she has more basis.

Distributions

Nonliquidating (current) distributions

- **Cash** (including a decrease in liabilities) reduces basis; **gain** is recognized only if **cash exceeds outside basis**. Marketable securities generally count as cash.

- **Property** generally causes no gain. The partner's basis in distributed property = **lesser of** the partnership's inside basis or the partner's remaining outside basis (after cash).
- No loss is recognized on a current distribution.

> **Example:** Kim has outside basis of $30,000. She receives $10,000 cash and land with an inside basis of $25,000 (FMV $40,000).
>
> - Cash first: $30,000 − $10,000 = $20,000 left; no gain.
> - Land basis = lesser of $25,000 or $20,000 = **$20,000**; Kim's outside basis becomes **$0**. No gain or loss.
> - If she had received $35,000 cash instead, she would recognize **$5,000** of gain.

Liquidating distributions

- Gain only if **cash** exceeds outside basis.
- **Loss** is recognized **only** if the partner receives **nothing but cash, unrealized receivables and inventory**, and their bases total less than outside basis.
- Otherwise, any remaining outside basis is assigned to **other property** received, so the partner's full basis carries over.

> **Example:** Reyes's outside basis is $50,000. In liquidation he receives $10,000 cash and inventory with a partnership basis of $15,000. Inventory takes $15,000; loss = $50,000 − $10,000 − $15,000 = **$25,000** (capital loss). If he had also received land with an inside basis of $5,000, no loss is recognized; the land takes the remaining **$25,000** of basis.

Sale of a partnership interest

- **Amount realized** includes cash + the selling partner's share of **partnership liabilities** relieved.
- Gain or loss is generally **capital**, except the portion attributable to **§751 "hot assets"** — **unrealized receivables** (including depreciation recapture) and **inventory** — which is **ordinary**.
- The partnership's year closes for the selling partner on the sale date.

> **Example:** Patel sells his one-third interest for $90,000 cash. His share of partnership liabilities is $30,000, and his outside basis (including that liability share) is $70,000. Amount realized = $90,000 + $30,000 = $120,000; total gain = $120,000 − $70,000 = **$50,000**. His share of the appreciation in hot assets is $12,000, so **$12,000** is ordinary income and **$38,000** is capital gain.

Tax-exempt organizations

Recognition and types

Type	Purpose / notes
§501(c)(3)	Charitable, religious, educational, scientific, literary; contributions deductible; **public charities** or **private foundations**
§501(c)(4)	Social welfare organizations (may lobby)
§501(c)(6)	Business leagues, chambers of commerce, trade associations
§501(c)(7)	Social clubs

- A §501(c)(3) applies on **Form 1023** (or the streamlined **Form 1023-EZ** for small organizations). Exemption is retroactive to the formation date if the application is filed within **27 months** after the end of the month of formation.
- Churches (and gross receipts normally $5,000 or less) are not required to apply.
- A §501(c)(3) may **not** participate in **political campaigns** for or against a candidate (absolute ban), and lobbying may not be a substantial part of its activities (public charities can elect a spending-based test under §501(h)). Private inurement to insiders is prohibited; excess benefit transactions trigger excise taxes on the insider and managers.
- **Private foundations** pay an excise tax of 1.39% on net investment income and face rules against self-dealing, excess business holdings, jeopardizing investments and failure to distribute income.

Annual returns

Form	Who files
Form 990-N (e-Postcard)	Gross receipts normally **$50,000 or less**
Form 990-EZ	Gross receipts under $200,000 **and** total assets under $500,000
Form 990	Larger organizations
Form 990-PF	All private foundations
Form 990-T	Organizations with **$1,000 or more** of gross unrelated business income

Returns are due the **15th day of the 5th month** after year-end. Failing to file for **3 consecutive years** automatically revokes exemption. Churches and certain government units are excepted from Form 990 filing.

Unrelated business income tax (UBIT)

Income is **unrelated business taxable income (UBTI)** if it comes from a **trade or business** that is **regularly carried on** and **not substantially related** to the exempt purpose (other than by providing funds).

Excluded from UBTI	Included
Dividends, interest, annuities, royalties	Income from a regularly operated unrelated business (e.g., a museum's commercial parking garage open to the public)
Rents from real property (and incidental personal property)	**Debt-financed** property income (proportion financed by debt)
Gains on sale of property (other than inventory)	Advertising income in a periodical (generally)
Businesses run by **volunteers**	Rents based on the tenant's net profits
Sales of **donated merchandise** (thrift shop)	
Businesses for the **convenience** of members, students, patients or employees	
Certain bingo games, trade shows, qualified sponsorship payments	

UBTI is reduced by a **$1,000 specific deduction** and taxed at the corporate rate of **21%** (trust rates for exempt trusts). Losses from one unrelated business cannot offset income from another.

> **Example:** A charity runs a commercial catering business open to the public with net income of $80,000 and also receives $20,000 of dividends. UBTI = $80,000 − $1,000 = **$79,000** (dividends excluded). UBIT = 21% × $79,000 = **$16,590**, reported on Form 990-T.

Common traps

- Forgetting a partner's share of **liabilities** in outside basis.
- Recognizing **gain** on a property distribution — only cash in excess of basis triggers gain.
- Recognizing a **loss** on a liquidating distribution that includes other property.
- Treating guaranteed payments as part of the distributive share instead of a deduction in OBI.
- Including dividends, interest, rents or donated-goods sales in UBTI.
- Thinking a §501(c)(3) may endorse a candidate if it is nonpartisan otherwise.

Key takeaways

- Multi-member LLCs default to partnership status; single-member LLCs are disregarded; check-the-box on Form 8832.
- §721: no gain on contributions (no control test); basis = cash + property basis + share of liabilities − liabilities relieved; gain if net liability relief exceeds basis; carryover inside basis; §704(c) allocates built-in gain to the contributor.
- OBI excludes separately stated items; guaranteed payments are deductible to the partnership and ordinary (SE) income to the partner; Form 1065 due March 15.
- Losses limited to outside basis, then at-risk and passive rules.

- Current distributions: gain only if cash > basis; property basis = lesser of inside basis or remaining outside basis. Liquidating: loss only with just cash, receivables and inventory.
- Sale of an interest: amount realized includes liability relief; §751 hot assets produce ordinary income.
- Exempt organizations: Form 1023 within 27 months; Form 990-N if receipts ≤ $50,000; UBTI from a regularly carried-on unrelated business, less $1,000, taxed at 21%; no political campaign activity.

Final Review Checklist

Use this checklist in the last week before your exam. For each line, ask whether you could explain the rule and, where it applies, work a numeric example without notes. Anything you cannot do quickly, reread in its chapter and drill in the matching bank chapter.

Key numbers sheet

Item	Amount
Preparer penalties §6694(a) / (b)	Greater of $1,000 or 50% of fee / greater of $5,000 or 75%
§6695 (returns filed in 2026)	$65 per failure, max $32,500; refund checks and due diligence $650 each, no cap
Failure to file / failure to pay	5% / 0.5% per month, max 25% each; minimum FTF $525 or 100% of tax if over 60 days late
Accuracy / fraud penalties	20% (40% gross valuation) / 75%
Statutes of limitation	Assess 3 years (6 for > 25% omission; unlimited for fraud); collect 10; refund later of 3 from filing or 2 from payment; 7 for bad debts
Involuntary bankruptcy	3 petitioners if 12+ creditors; $21,050 unsecured claims
FICA / FUTA	6.2% to $176,100 + 1.45%; 0.9% over $200,000 (employee only); FUTA 0.6% of $7,000
Standard deduction 2025	$15,750 single / $31,500 MFJ / $23,625 HOH
SALT cap 2025	$40,000 less 30% of MAGI over $500,000, floor $10,000
Senior / tips / overtime / car interest	$6,000 / $25,000 / $12,500 ($25,000 MFJ) / $10,000
Child tax credit	$2,200 ($1,700 refundable); phase-out over $200,000 / $400,000
AMT 2025	Exemption $88,100 / $137,000; 28% above $239,100
§179 / bonus	$2,500,000 phased out over $4,000,000 / 100% if acquired after January 19, 2025
Gift tax	$19,000 annual exclusion; basic exclusion $13,990,000
Corporate rate / DRD	21% / 50%, 65%, 100%

Ethics, procedures and liability (Chapters 1–4)

☐ I can name who has unlimited practice rights (attorneys, CPAs, EAs) and what AFSP holders may do.

☐ I know a practitioner who finds a client error must advise the client, not the IRS.

☐ I can list the three situations where contingent fees are allowed and apply the 120-day rule.

☐ I know client records must be returned even if fees are unpaid.

☐ I can state the conflict-of-interest consent rules and the 36-month retention period.

☐ I can rank more likely than not, substantial authority and reasonable basis, and know when disclosure is needed.

☐ I can compute the §6694(a) and (b) penalties and the §6695 per-failure penalties with caps.

☐ I can compute combined failure-to-file and failure-to-pay penalties, including partial months.

☐ I can test a substantial understatement and compute the 20% penalty.

☐ I can compute the required annual estimated payment using the lesser-of rule (110% above $150,000 AGI).

☐ I know the trust fund recovery penalty includes only withheld income tax and employee FICA.

☐ I can rank tax authorities and say who is bound by a revenue ruling versus a PLR.

☐ I can trace the dispute path from examination to the 90-day letter and choose the right court.

☐ I can compute assessment and refund deadlines, including early-filed returns.

☐ I can list the elements of negligence and fraud and the three third-party liability approaches.

☐ I know the limits of the §7525 privilege and who owns working papers.

Business law (Chapters 5–10)

☐ I can distinguish express, implied and apparent authority and the requirements for ratification.

☐ I know who is liable to the third party for disclosed, partially disclosed and undisclosed principals.

☐ I can apply respondeat superior and the frolic-versus-detour distinction.

☐ I know which terminations require notice and what kind.

☐ I can decide whether the common law or the UCC governs a contract.

☐ I can apply the mailbox rule and the effective times of revocations and rejections.

☐ I know the merchant firm offer rule and UCC §2-207 for additional terms.

☐ I can list the statute of frauds categories and the UCC exceptions.

☐ I can compute expectation, cover and resale damages and judge a liquidated damages clause.

☐ I can decide when risk of loss passes under shipment, destination and no-carrier contracts.

☐ I know which defenses release a surety and which do not, and can compute co-surety contribution.

☐ I can state the requirements for attachment and each method of perfection.

☐ I can resolve priority disputes, including PMSI equipment (20 days) and PMSI inventory (notice).

☐ I can distribute foreclosure-sale proceeds in the correct order.

☐ I know the involuntary bankruptcy petition requirements and the test for relief.

☐ I can identify a voidable preference and its exceptions, including the insider 1-year rule.

☐ I can distribute a Chapter 7 estate, including undersecured claims and priority classes.

☐ I can list the nondischargeable debts and grounds for denial of discharge.

☐ I can compute employee and employer FICA, Additional Medicare Tax and FUTA.

☐ I can classify a worker using behavioral, financial and relationship factors.

☐ I can test ALE status using full-time equivalents and know what triggers the §4980H payment.
☐ I know the FCPA's anti-bribery exception and defenses and its accounting rules for issuers.
☐ I know partnership default rules for profits, losses, management and admission of partners.
☐ I can wind up a partnership under RUPA, including partner loans and negative capital accounts.
☐ I know the liability features of LPs, LLPs, LLCs and corporations.
☐ I can apply the business judgment rule and the duty of loyalty, and the rules on preemptive rights.
☐ I know which corporate changes need shareholder approval and when appraisal rights apply.

Property transactions (Chapters 11–12)

☐ I can determine basis for purchased, gifted (including the dual-basis rule), inherited and converted property.
☐ I can compute the gift tax basis adjustment for net appreciation.
☐ I can compute MACRS depreciation with half-year, mid-quarter and mid-month conventions.
☐ I can apply §179 (dollar limit, phase-out, business income limit), then bonus, then MACRS.
☐ I can compute start-up cost and §197 amortization.
☐ I can compute amount realized, including liabilities assumed by the buyer.
☐ I can net capital gains and losses for individuals and corporations and handle carryovers.
☐ I can split gain into §1245 ordinary, unrecaptured §1250, §291 and §1231 portions.
☐ I can apply the §1231 netting and 5-year lookback rule.
☐ I can compute recognized gain, deferred gain and new basis in a like-kind exchange with boot and liabilities.
☐ I can apply the §121 exclusion, including the reduced exclusion.
☐ I can apply §267 to related-party losses and compute installment-sale gain with recapture.
☐ I can compute taxable gifts using the annual exclusion, gift splitting and the tuition/medical exclusion.

Individuals (Chapters 13–15)

☐ I can classify common items as included or excluded from gross income.
☐ I can compute taxable Social Security benefits using provisional income.
☐ I can apply the 2025 fringe benefit exclusions and compute group-term life imputed income.
☐ I can compute the taxable part of a scholarship and the insolvency exclusion for canceled debt.
☐ I can classify a corporate distribution as dividend, return of capital or gain.
☐ I know pass-through owners are taxed on distributive shares, not distributions.
☐ I can list the adjustments to AGI and the 2025 standard deduction amounts.
☐ I can compute itemized deductions, including the 7.5% medical floor and the SALT phase-down.
☐ I can apply the charitable contribution limits and carryover.
☐ I can compute the senior, tips, overtime and car-loan interest deductions with their phase-outs.
☐ I can compute the QBI deduction below the threshold.

☐ I can apply the loss limits in order: basis, at-risk, passive (including the $25,000 allowance) and excess business loss.

☐ I can determine filing status, including qualifying surviving spouse and head of household.

☐ I can test qualifying child and qualifying relative status.

☐ I can compute regular tax from the brackets, including preferential rates on capital gains.

☐ I can compute SE tax, NIIT, Additional Medicare Tax and a basic AMT.

☐ I can compute the child tax credit, child care credit and education credits with phase-outs.

Entities (Chapters 16–18)

☐ I can compute corporate taxable income with the charitable limit and DRD, including the NOL exception.

☐ I can apply the corporate NOL 80% limit and capital loss carryback/forward rules.

☐ I can compute the §163(j) interest limitation.

☐ I can reconcile book income to taxable income on Schedule M-1.

☐ I can compute gain and basis in a §351 transfer, including boot and §357(c).

☐ I can allocate distributions to current and accumulated E&P and handle property distributions.

☐ I can test a redemption for substantially disproportionate treatment.

☐ I can contrast a regular liquidation with a §332 parent-subsidiary liquidation.

☐ I know the nexus protections of P.L. 86-272 and the effect of *Wayfair*.

☐ I can list the S corporation eligibility requirements and election and termination rules.

☐ I can allocate S corporation income per share per day.

☐ I can compute S shareholder stock and debt basis in the correct order and identify suspended losses.

☐ I can apply the AAA / E&P distribution ordering and the built-in gains tax.

☐ I can compute a partner's basis on formation, including liability shifts and gain from net liability relief.

☐ I can compute OBI and treat guaranteed payments correctly.

☐ I can roll forward a partner's outside basis.

☐ I can compute the results of current and liquidating partnership distributions.

☐ I can compute gain on the sale of a partnership interest, including hot assets.

☐ I know exempt-organization filing rules and can compute UBTI and the tax on it.

The day before the exam

☐ I reviewed every "Key takeaways" section once.

☐ I know my testing center location, ID requirements and start time.

☐ I plan to spend about 90 minutes on the two MCQ testlets and use the optional break after testlet 3.

☐ I will read each simulation's requirement first and answer every item.

Now practice it

Every chapter in this guide has matching practice tests, simulations and mock exams at **UPractice.org**.