

REGULATION 1 CLASS NOTES

The Regulation section covers primarily taxation and various business law topics. Taxation comprises approximately 60% of the Regulation exam and covers individual, corporate, subchapter S corporations, partnership and various transactional tax concepts (classes R1-R4). Ethics and professional and legal responsibilities comprise approximately 18% (covered in R4) and business law the remaining approximately 22% (covered in R5-R7).

This lecture covers the taxation of individuals with an emphasis on filing status, exemptions, gross income and capital gains and losses. According to the AICPA's Content Specification Outline these items and the items listed in lecture R2 should make up between 28% and 34% of your Regulation examination.

OVERVIEW

I. INDIVIDUAL TAXATION

- A Be very familiar with the categories and flow of this formula:

Gross Income
(Adjustments)
Adjusted Gross Income
(Standard or Itemized Deductions) - Greater
(Exemptions)
Taxable Income

x Tax Rate equals

Federal Income tax
(Tax Credits)
Other Taxes
(Payments)
Tax Due or Refund

Adjustments can also be known as **deductions to arrive at AGI**.

II. FORM 1040 AND OTHER FORMS

- A. Familiarize yourself with the form so that you can handle **simulation questions** that ask you to put the amount where it belongs on the tax form – remember to use your cues like the form itself.

III. FILING STATUS

- A. **General rule** is status **as of December 31** (except in case of spouse's death during the year)

- B. **Surviving spouse** status is only available for taxpayers who have dependent child living with them for the **entire year**.
- C. **Head of household** – examiners like to mix and match the **whole year = widow/widower** and **half year = head of household** concepts

IV. EXEMPTIONS

- A. Emphasis on whether exemption is allowed, not dollar amount.
- B. Spouse is personal exemption, not dependent.
- C. **CARES** and **SUPORT** mnemonic for dependency exemptions.
- D. **Multiple support agreements** two or more taxpayers contribute more than 50% support of a person but none more than 50%; the contributors may decide who claims the dependency exemption. Must contribute more than 10% of support to be eligible.
- E. When doing gross income test do not consider non-taxable income.

V. GROSS INCOME - VERY IMPORTANT!

- A. **Taxable = FMV** and **non-taxable = NBV**.
- B. Realized: if realized and recognized, include on tax return.
- C. Wages – watch for FMV of property received.
- D. Life insurance proceeds – note interest income element of deferred payout is taxable.
- E. Meals and lodging – not taxable if for the benefit of the employer and furnish on the employer's premises. For lodging, must be a condition of employment.
- F. Interest income – **State and local obligation are non-taxable**. Federal obligations and interest on state and federal tax refunds are taxable.
- G. Series EE bonds are tax exempt if used for **higher education**.
- H. Dividends – know sources (E&P) and character (taxable or Return of capital), dividend tax rate = 15% on **qualified dividends**, tax free distributions (watch cash option on stock dividend), life insurance dividends.
- I. State tax refunds – taxable only if itemized in prior year (**1040EZ means standard deduction** and non-taxable refund).
- J. Alimony income – know what payments qualify and difference between **alimony (taxable)** and **child support (non-taxable)**.
- K. Schedule C = sole proprietor (**self-employed**). Note there are several issues that relate to deduction in this area. **Meals & entertainment rule = 50% deductible** (also applies to unreimbursed employee expenses. Can deduct prepaid interest but must use the accrual method. **Bad debts actually written off** may be deducted but only if an accrual basis taxpayer. Non-deductible expenses = personal expenses, federal taxes and salaries paid to sole proprietor. Self employment taxes not deductible on Schedule C, they are an adjustment to AGI. (Also see Schedule SE.) **Net operating losses = 2/20**.
- L. Uniform capitalization rules – Capitalize direct materials, direct labor and O/H; expense selling and research.
- M. IRA Income – know **Traditional IRA** vs. **Roth** vs. **Non-deductible IRA**. **10% penalty tax rate** applies to early withdrawals except for **HIM DEAD**.

- N. Annuities = partially taxable and partially nontaxable except when annuitant outlives life expectancy then all taxable.
- O. Schedule E – know items included.
- P. Rental income – always passive, prepaid rent or nonrefundable deposit is taxable when received
- Q. PALs – know when and how allowed, know Mom and Pop Exception and phase-out.
- R. **Unemployment compensation - taxable**; don't confuse with Workers' Compensation (non-taxable)
- S. Social Security income – know percentage taxable (from 0% to 85%) at various levels but calculation is rarely if ever tested
- T. Gambling winnings and losses – no net losses allowed.
- U. Scholarships and fellowships – know rules of taxability.
- V. Gifts and inheritances are not taxable to the beneficiary.

VI. CAPITAL GAINS AND LOSSES

- A. Definitions – real vs. personal property, capital vs. non-capital assets. Non-capital = inventory; 1231, 1245, 1250; A/R; original works; and Treasury stock.
- B. Amount realized less Adjusted basis = gain or loss.
- C. Adjusted basis – general rule purchase price. For gift property use lower FMV at date of gift if selling at a loss. Inherited property basis rules = FMV on date of death or alternative valuation date. (Alternate valuation date also covered in later lecture.)
- D. Gains excluded or deferred (mnemonic **HIDE IT**), know the boot rules (gain recognized only to extent of boot).
- E. Nondeductible losses (mnemonic **WRAP**), wash sale (30 days before or after), related party transactions (same concept as gift rules as far as taxability).
- R. Individual capital gain and loss rules – know holding period, rates (15% for long-term), \$3,000 maximum capital loss deduction and no carryback – unlimited carryforward.
- G. Corporate capital gain and loss rules – no net capital losses, 3 carryback and 5 carryforward provision.

Simulations – quite often the examiners will ask candidates to complete a tax form other than the ones we have included in the review material. **Don't panic!** Read the form to determine what information is needed in order to complete the form. Most forms are self explanatory since they need to be used by all taxpayers. So relax, read the form, and fill in the necessary information.

We hope you find these tips helpful. Work hard and you will succeed.