



Implementing Best Practices & Educating Lawyers: Teaching Skills and Professionalism Across the Curriculum

Workshop
2C

Integrating Tax Issues and Practical Transactional
Planning in a Law School Curriculum

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Leah Witcher Jackson graduated summa cum laude from Baylor University (B.B.A. in accounting) and cum laude from Baylor Law School where she served as an editor of the *Baylor Law Review*.

After graduation, she worked for a law firm focusing on business and tax law. She joined the Baylor Law School faculty in 1989 and was named associate dean in 1991 at the time of Dean Brad Toben's appointment as dean. For 18 years, Dean Toben and Associate Dean Jackson have worked closely together as the leadership team for Baylor Law School. In addition to her administrative duties she teaches classes in Basic Tax and Accounting for Lawyers (required for all Baylor students), Individual Taxation, Partnership Taxation and Corporate Taxation. She is an elected member of the Texas Bar Foundation and a past President of the Waco McLennan County Bar Association and Midway Education Foundation.

She is an alumnae of the Leadership Texas and Leadership America programs. She has been recognized as an Outstanding Alumnus for Leadership Waco and a Woman of Distinction by the Blue Bonnett Council of Girl Scouts. She has participated in an Oxford Round Table to discuss the status of women in our society.

She currently serves as Co-Chair for the Texas Women in Higher Education and is working on the creation of the Greater Waco Community Education Alliance. She writes and speaks on tax, business, non-profit, and leadership topics.

Integrating Tax Issues and Practical Transactional Planning in a Law School Curriculum

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I. Introduction: Why Tax Planning is Important

During Fiscal Year 2008, the United States received \$2.66 trillion into the Treasury. Of that amount, the Internal Revenue Service collected more than \$2.3 trillion in taxes, net of refunds, 45.8 percent of which was attributable to the individual income tax, 13 percent came from corporate taxes, and 37.9 percent came from employment taxes. Needless to say, taxes are the foundation of our nation's operational budget. Less obvious is the use of the tax system to influence decisions made by U.S. citizens every day. The Internal Revenue Code has targeted provisions that either encourage some desired activity or provide special aid to certain taxpayers in specific situations. Some of them make great sense. For example, the federal government seeks to encourage certain forms of investment, such as providing incentives to buy new plants and equipment. This produces more tax savings upfront, creating additional capital for business to expand. These tax-advantaged investments help create new business and jobs. Understanding this reality helps explain Former Internal Revenue Service Commissioner Donald Alexander's statement when he once said, "As a citizen, you have an obligation to the country's tax system, but you also have an obligation to yourself to know your rights under the law and possible tax deductions -- and to claim every one of them."

The purpose of this presentation is to encourage the integration of relevant tax issue into non-tax courses and to encourage the use of discussions and exercises in tax classes as an opportunity to incorporate non-tax considerations of the tax transactions being covered. This integrated approach to teaching transactions is essential to adequately prepare our students to competently and effectively represent their clients. Moreover, certain areas of law practice require the understanding and integration of tax planning into the work for which the lawyer is hired.

The next section offers tax topics that should be covered in non-tax classes at least generally or by reference to tax classes which cover the topics with more specificity. The third section suggests ways to incorporate practical concepts into tax discussions thereby helping students view transactions comprehensively as will be necessary in the practice of law. The last section offers some hypothetical situations that can be used for discussion or assignment. Additional documents and problems will be distributed during the presentation, including sample real estate documents, business and financial statements, and divorce documents. Anyone who desires the longer version of these materials (including references to Internal Revenue Code sections and regulations), please email me.

II. Integration of Tax Topics into Non-Tax Classes:

A. Business Organizations

1. Tax Issues When Starting a Business

a. Choice of Entity

- i. **Sole proprietor** – Income is taxed to owner. Operating income reported on Form 1040, Schedule C.
- ii. **Partnerships** (all kinds) – Income is taxed to partners. Partnership income and deductions divided per their agreement, subject to some limitations. Partnership files Form 1065 with a Schedule K-1 for each partner. Each individual partner report income and deductions on personal Form 1040. Corporate partners report its income and deductions on its Form 1120.
- iii. **C Corporation** – Income is taxed to the corporation. Corporate income and deductions reported on Form 1120. When previously taxed income (dividends) are distributed to shareholders, corporation files a Form 1099-DIV to report the amount of dividend income that each shareholder must report as income on shareholders' tax returns.

- iv. **S Corporation** – S Corporation does not pay tax on its normal operating income. Its income is taxed to shareholders in proportion to the shareholders' percentage of stock ownership. Corporation must qualify to be treated as an S Corporation and must file a Form 2553 to make the election to be taxed as an S Corporation. Corporation files Form 1120S with a Schedule K-1 for each shareholder. Each shareholder report income and deductions on shareholder's tax return.
 - v. **Limited Liability Companies** – No income tax code provisions apply to LLC's. Treasury Regulations create presumption that an LLC with one member will be treated as a disregarded entity (sole proprietor for individual member) unless it elects to be taxed as a C corporation (or S corporation if otherwise qualify and elect.) An LLC with two or more members will be treated as a partnership unless it elects to be taxed as a C corporation (or S if otherwise qualify and elect.)
- b. Employer Identification Number
 - i. File Form SS4 to obtain EIN before opening a bank account for the business.
 - ii. File appropriate form with state taxing agency or division.
2. *Tax Issues When Operating a Business*
- a. Structure of compensation to owners
 - i. Salary and Wages are subject to employment taxes as well as income taxes.
 - ii. Distributions of profit are generally nontaxable to owners except for shareholders of C Corporations.
 - iii. Consider tax deferred arrangements such as qualified pension or profit sharing plans for those who perform services for the business.
 - iv. The calculation of some state taxes affected by amounts treated as salary.
 - b. Structure of compensation to others who perform services for business
 - i. Wages or salary paid to employees are subject to employment taxes. The business pays half (7.65% on the first \$106,900 of salary plus self-employment income, and 1.45% on all above \$106,900). The employer withholds the other half from employee's check so the employee pays it.
 - ii. Amounts paid to non-employee independent contractors are not subject to employment taxes. Individual independent contractors must pay full amount of employment taxes (15.3% on the first \$106,900 of salary plus self-employment income, and 2.9% on all amounts above \$106,900 in 2009).
 - c. Acquisition of assets to be used by business
 - i. If assets are acquired by the business, the business reports the operating income/deductions and the gain/loss upon disposition.
 - ii. If assets are acquired by owners and leased to business, the business makes lease payments to the owners and takes rental deductions. Owners reports rental income, operating deductions and gain/loss upon disposition.
3. *Tax Issues When Disposing of Business or Interest in a Business*
- a. Sale of business assets by business
 - i. Gain potentially taxed twice if C Corporation sells assets and distributes the proceeds to shareholders. Double taxation is possible in some S Corporation scenarios. If corporation does not distribute the sale proceeds, tax problems can arise if the corporation invests the proceeds in passive investments.
 - ii. Gain taxed only once if business is taxed as a sole proprietor or partnership. Losses generally can be deducted by owners if sole proprietor or partners.
 - b. Sale of business interest by owners
 - i. Capital gain or loss if sale of stock by shareholders of C or S corporation.
 - ii. Sale of sole proprietorship or partnership interest can produce some ordinary income as well as capital gain or loss.
 - iii. Tax-deferred gain on disposition of C Corporation stock if transaction structured as a tax-exempt reorganization. Complicated rules apply.

B. Employment Relations

1. *Compensation Arrangements* –
 - a. Current compensation to those who perform services for business.
 - i. Wages or salary paid to employees are subject to employment taxes. The business pays half (7.65% on the first \$106,900 of salary plus self-employment income, and 1.45% on all above \$106,900 in 2009). Employee pays other one-half which is withheld from employee's paycheck.
 - ii. Amounts paid to non-employee independent contractors are not subject to employment taxes. Individual independent contractors must pay full amount of employment taxes (15.3% on the first \$106,900 of salary plus self-employment income, and 2.9% on all above \$106,900 in 2009).
 - b. Deferred Compensation
 - i. Qualified Retirement Plans – Ex. 401K, stock options, pensions
 - Contributions deductible by Employer
 - Contributions not taxable to Employee until distributed
 - Heavily Regulated
 - Non-discrimination provisions
 - ii. Nonqualified Deferred Compensation Plan
 - Unless certain requirements in section 409A are met, amounts deferred under a nonqualified deferred compensation plan are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.
2. *Fringe Benefits*
 - a. Must account for any benefit offered to employees. Only qualified fringe benefits can be offered without the value of the benefit becoming taxable income to employee. Examples of tax-free fringe benefits include:
 - i. Health and accident insurance coverage
 - ii. No additional cost service benefits
 - iii. Qualified Employee Discounts
 - iv. Working Condition Fringe Benefits
 - v. De minimis Fringe Benefits
 - vi. Qualified Transportation Fringe Benefits
 - vii. Qualified Moving Expense Reimbursement
 - viii. \$50,000 group term life insurance
3. *Withholding of Taxes*
 - a. OASDI (Social Security Tax). The employee's share is 6.2% of gross compensation up to \$106,800 in 2009. Employer must withhold from employee's check and deposit it into the Treasury in accordance with the rules for withholding. The employer is also liable for a separate 6.2% for Social Security, making the total Social Security tax 12.4%.
 - b. Medicare Tax. The employee's share of the Medicare portion is 1.45% of wages with no limit. The employer is also liable for separate 1.45% Medicare taxes making the total Medicare tax 2.9% of wages.
 - c. Federal Unemployment Tax (FUTA). The tax is 6.2% through 2009, and 6.0% for 2010 and later of the first \$7,000 paid each employee as wages each year.
 - d. Federal Income Taxation – Employer must withhold income tax in accordance with IRS Publication 15 (2009), (Circular E), Employer's Tax Guide.
4. *Employee v. Independent Contractor*
 - a. Business or individual who pays an amount to non-employee independent contractor does not have to pay half of the employment taxes nor withhold any taxes.
 - i. Individual independent contractors must pay full amount of employment taxes on all earnings from self-employment (15.3% on the first \$106,900 and 2.9% on all above \$106,900 in 2009).

- ii. Reporting requirement. All taxpayers must file an information return (Form 1099-Misc) for payments made to another person in the course of the taxpayer's trade or business that constitute income aggregating \$600 or more in any tax year.
- b. Factual determination if person performing services is employee or independent contractor. Factors considered:
 - Employer's right to control the details of the work (most important)
 - Whether person is engaged in a distinct occupation
 - Whether work is usually done under direction of employer or by Specialist without supervision
 - Skill required to do the job
 - Length of time the person is employed
 - Method of payment – by time or by job
 - Whether work is part of regular business of employer
 - What parties believed

C. Real Estate

1. *Tax Issues When Acquiring Real Estate*

- a. Acquisition of real estate to be used by business
 - i. If acquired by the business, business reports operating income/deductions and gain/loss upon disposition.
 - ii. If acquired by owners and leased to business, business pays owner rent and takes rental deduction. Owner reports rental income, operating deductions and gain/loss upon disposition.
- b. Acquisition of real estate to be rented to others. Choice of Entity issue: Acquired by entity or individual?
 - i. If acquired by the business, business reports operating income/deductions and gain/loss upon disposition
 - ii. If acquired by owners and leased to business, business pays owner rent and takes rental deduction. Owner reports rental income, operating deductions and gain/loss upon disposition.
 - iii. Shifting of income and value is possible.
- c. Acquisition of personal residence
 - ii. § 36 first time home buyers credit before December 1, 2009
 - iii. Deduct interest expense only if Qualified Residence Interest or Home Equity Interest

2. *Tax Issues While Holding Real Estate*

- a. Real Estate used in a business or held for investment – all ordinary expenses are deductible.
- b. Real Estate used in a rental operation – all ordinary expenses are deductible but subject to Passive Activity Loss Limitation Rules.
- c. Interest Deduction
 - i. Real estate used in a business or held for investment – interest is fully deductible as an expense of the business or investment activity.
 - ii. Real estate used for personal use – only deduct interest if:
 - iii. It is taxpayer's principle residence or one secondary residence
 - iii. Loan is qualified acquisition indebtedness (limited to \$1Million) or qualified home equity indebtedness (limited to \$100,000)
 - iv. Loan must be secured by lien against the property
- d. Real Estate Taxes
 - i. Real Estate Taxes can always be deducted. Only question is where on the tax return and what limits apply.

3. *Tax Issues When Disposing of Real Estate*

- a. § 121 Gain from sale of principal residence – exclude gain up to \$250,000 (or \$500,000 if married filing jointly) on sale of house if used as taxpayer's principal residence for at least two of the last 5 years.

- b. If disposing of entity-owned realty but proceeds need to go to owner, need to think about best structure and timing for the sale and distribution.
- c. Non-taxable structures
 - i. § 1031 Like-kind exchanges
 - ii. Corporate reorganizations when real estate is the prime asset

D. Family Law - Negotiations

1. *§ 71 Alimony or separate maintenance payment* – If payment qualifies as alimony, payor gets tax deduction and payee must report as taxable income. Can be negotiated. Requirements:
 - a. Cash payment
 - b. Received by (or on behalf of) spouse – allows for indirect alimony
 - c. In a divorce or separation instrument – temporary or final order or written agreement incident to decree
 - d. Not specifically designated as non-alimony (allows for negotiated agreement)
 - e. Divorce and legally separated, former spouses cannot live together
 - f. No liability to pay beyond death of payee spouse
 - g. Not child support
2. *§ 71(c) Child support payment* – Not income to recipient and not deductible by payor
 - a. Payment which the terms of the divorce or separation instrument fix as a sum which is payable for the support of the children of the payor spouse.
 - b. Reg. § 1.71-1T(c) – a payment or portion of a payment is child support if the payment is tied to a contingency clearly related to a child or associated with an event involving the child
3. *§1041 Transfers of Property between spouses or incident to divorce* – Property settlement have no current tax consequences.
 - a. No gain or loss recognized on a transfer of property to a spouse, or a former spouse, but only if incident to divorce.
 - b. Basis of the property is transferred with the property, i.e. spouse that gets the property takes the property with the same basis as it had in the hands of the spouse that transferred the property.

E. Litigation

1. *Damages*
 - a. § 104 (a)(2) Damages for Personal Physical Injuries or Physical Sickness – If cause of action is based upon a personal physical injury or sickness, all damages are excluded except for punitive damages.
 - i. Reimbursement of medical expenses are generally not taxable, unless already deducted as medical expenses
 - ii. Pain & suffering damages are not taxable
 - iii. Compensation for lost wages is not taxable
 - iv. Punitive damages are taxable
 - b. Non-Physical Injury or Sickness Damages – Damages are generally taxable
 - i. Damages that are for non-physical injury are taxable
 - ii. Pre-judgment and post-judgment interest is taxable
 - c. Mental anguish and emotional distress is taxable UNLESS result of physical injury.
 - d. Stress without physical injury - taxable UNLESS stress manifests in physical way so to need counseling or medical treatment
 - i. Amount recovered for medical expenses is excluded
 - ii. Excess recovery over actual expenses is taxable
2. *Attorneys' fees*
 - a. Fully deductible if litigation relates to operation of a business.
 - b. If related to collection of tax exempt damages, no deduction.
 - c. If related to non-business taxable damages, deduction may be limited.

III. Integration of Non-Tax Issues into Tax Classes

A. Business Organizations Issues

1. *Choice of Entity*- Three primary factors considered:
 - Liability of entity and owners – state law controls
 - Taxation of income and losses – federal and state
 - Formation and maintenance of records – federal and state
 - a. Options:
 - i. Sole Proprietorship
 - Owner fully liable
 - Assumed Name Certificate may be required to be filed
 - ii. Limited Liability Company
 - Owners liability limited
 - Filing requirement determined by state law
 - iii. General Partnership
 - Owners jointly and severally liable
 - Assumed Name Certificate may be required to be filed
 - iv. Limited Liability Company
 - Owners liability limited
 - Filing requirement determined by state law
 - v. Limited Partnerships (including LLP, LLLP)
 - Owners liability limited (except for general partners)
 - Filing requirement determined by state law
 - vi. C Corporation
 - Owners liability limited
 - Filing requirement determined by state law
 - vii. S Corporation
 - Owners liability limited
 - Filing requirement determined by state law
 - Form 1023 required to be filed with IRS
 - b. Separation of Owner and Business
 - i. Piercing the Entity Veil Issues
2. *Representation of entities*
 - a. Conflict of Interest Issues
 - i. Who is your client?
 - ii. Lawyer's personal involvement or ownership
 - b. Other professional responsibility issues
 - i. Duties owed by board members to corporation
 - ii. Duties owed by officers to entity
 - iii. Duties of general partners
 - iv. Permissible roles of limited partners
3. *Financial Statements*
 - a. Common records maintained
 - i. Balance Sheet
 - ii. Profit/Loss Statement
 - iii. Statement of Cash Flow
 - b. Analysis of Statements
 - i. Used ratios to compare to industry standards or ranges
 - ii. For financing and investing decisions

B. Real Estate Issues

1. *Acquiring and Selling Real Estate*
 - a. Review of documents (deeds, notes, lien documents, closing statements)
 - b. Role of lawyer, broker, title company

2. *Explanation of time value of money*
3. *Interest, Interest Rates, and Points System*
4. *Discuss Financing Opportunities*
 - a. Term of notes
 - b. Selecting assets to pledge as security & and documents needed
 - c. Types of Mortgages

C. Litigation Issues

1. *Common Fee Structures in legal profession*
 - a. Engagement letters
 - b. Timing of when they are “earned”
2. *Use of Structured Settlements*
 - a. Reason they are favored in section 104 to encourage use
 - b. When to use and how to arrange
3. *Advancing of Legal Expenses and Client Trust accounts*
 - a. How to set up
 - b. Use of Retainers
 - c. When are they expensed
4. *Tax controversies*
 - a. Administrative process with IRS
 - b. Litigation process from filing petition through final judgments and appeals is generally similar to any other federal litigation

D. Family Law Issues

1. *Negotiation of property settlements and alimony*
 - a. Key terms in temporary orders and final decrees for enforcement and security
2. *“Best interest of the child” in child custody and child support negotiations*
 - a. Professional responsibility opportunity to effect the outcome

E. Employment Relation Issues

1. *Compensation Arrangements*

See notes above
2. *Workers Compensation*
 - a. Insurance that provides compensation medical care for employees who are injured in the course of employment
 - b. Employees lose mandatory relinquishment of the employee's right to sue his or her employer for the tort of negligence.
 - c. Only applies to employees
3. *Employee versus Independent Contractor*

See notes above
4. *Consulting Agreements*
5. *Covenants Not to Compete*

IV. Helpful Websites

- A. www.irs.gov
- B. States' comptroller websites

V. Hypotheticals: Discussions & Assignments:

Hypo 1: Ted Mosbey, a fresh out of work architect, has decided to start his own architecture firm. Ted an architectural mastermind, is very unfamiliar with all the specific requirements in regards to starting a new business. He wants a business structure that allows him to manage the business on his own, with limited help from CPAs or attorneys. Ted is just starting his own firm and is basically judgment proof.

Assignment 1: What type of business entity do you advise Ted to form, and what are some of the issues (tax and otherwise) that Ted needs to address? Assume that Ted decides to create an LLC, draft the documents that will be necessary to start his firm. Can also give additional information about his assets and projected income and add discussion or drafting of business plan and projected financial statements necessary to borrow money to finance his new firm.

Hypo 2: Barney and Marshall have decided to leave Goliath National Bank, and want to start their own law firm. Marshall is an attorney and no one is exactly sure what Barney does, but he seems to know his way around a law office. Barney has promised to put up all the financing for the new business, and Marshall has promised to run the day to day activities of the law firm.

Assignment 2: What type of business entity do you advise Barney and Marshall to form, and what are some of the issues (tax and otherwise) that you need to discuss with them?

Hypo 3: Lily and Marshall want to purchase a house in a new borough of New York called DOWISETREPLA. The two are strapped for cash due to Lily's shopping habits, and want to know what their financing options are in regards to purchasing the house, and what tax savings are out there if they purchase the house. Their real estate broker has told them something about "points," but they do not understand what she means. Someone else asked if they were interested in a 15 or 30 year note. All they know is that they want the house as soon as possible.

Assignment 3: Explain how the financing process works (including points and interests), and explain what tax savings and deductions are available to the couple. What documents will be necessary to close the transaction? Also could give students additional information and have them complete the documents necessary to close.

Hypo 4: Marshall and Lily come into your office after having a huge fight about Lily returning to art school in San Francisco. The two are talking about getting a divorce, and they are both worried about what will happen to all of their belongings if the two of them separate and get a divorce.

Assignment 4: Explain the basics of property division following a divorce. Also, could give them an inventory of property with basis and fair market values and have the students negotiate the divorce and then complete the agreement to be presented to the court for approval.

Hypo 5: While trying to make it to the hospital to visit Ted, Barney was struck by a bus. He was in a full body cast for over a year, and as a result was unable to work during that time. He suffered broken legs and arms. The doctors have told him that his physical and mental abilities may be diminished as a result of the accident. Barney decided to sue the bus company for the accident, and is thinking about asking for damages in the following categories: lost wages, medical expenses, pain and suffering, and emotional distress.

Assignment 5: Figure out and determine the best course of action in determining which damages to ask for, and determine the taxability of each type of damages. Draft the petition to be filed in state district court.