# NINJA NOTES

Financial Accounting & Reporting 2026

## Business Consolidation & Combinations

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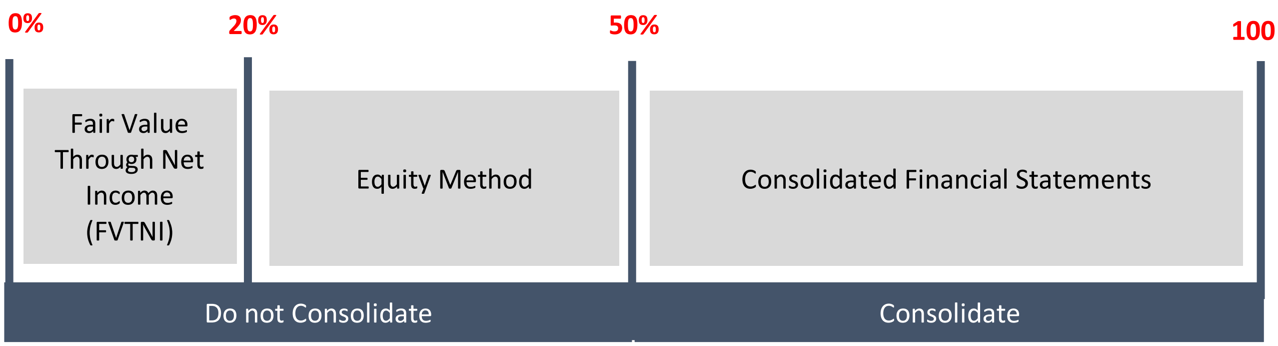
# Business Consolidation & Combinations

## Business Consolidation: Basics

- Accounting for Investment in Equity Securities

| | | | |
|---|---|---|---|
| 0%-20% | No Control or Significant Influence | Indicates that no influence over the investee company exists. | Fair Value through Net Income |
| 20%-50% | Significant Influence | Indicates that the investor has significant influence over the investee. | Equity Method |
| > 50% | Control | Indicates that investors have control over the investee. | Consolidated Financial Statements |



- Consolidation Criteria
  - All Subsidiaries must be consolidated unless
    - Significant doubt regarding the parent's ability to control the subsidiary
    - Subsidiary is in bankruptcy, legal reorganization, or under severe foreign restrictions
  - If the Parent's Year end is not equal to the Subsidiary's End
    - Year-end difference is more than three months
      - The subsidiary must prepare special financial statements that correspond to the parent company's year-end.
    - Year-end difference is less than three months
      - Can use the subsidiary's regular financial statements.
      - Must make material adjustments for any significant transactions or events that occurred during the gap period.
  - If Parents own more than 50% of a subsidiary and the subsidiary owns more than 50% of another company.
    - The first subsidiary will consolidate with the second company. The parent will consolidate with the subsidiary.

# Business Consolidation: Accounting

- Accounting for Subsidiary: Acquisition Date
    - Acquisition of Subsidiary

| | | | |
|---|---|---|---|
| Investment in Subsidiary | | XXX | |
| | Cash | | XXX |

| | | | |
|---|---|---|---|
| Investment in Subsidiary | | XXX | |
| | Common Stock | | XXX |
| | Additional Paid-in-Capital | | XXX |

- Cost incurred During Acquisition
    - Direct, Indirect or General Costs

| | | | |
|---|---|---|---|
| Expense | | XXX | |
| | Cash | | XXX |

- Cost of Issuing Securities for Financing an Acquisition

| | | | |
|---|---|---|---|
| Additional-Paid-in-Capital | | XXX | |
| | Cash | | XXX |

- Accounting for Subsidiary: End of the Year
    - Balance Sheet Consolidation
    - Income Statement Consolidation

## Balance Sheet Consolidation

- Steps in Balance Sheet Consolidation
  - Step 1: Calculate Goodwill / Bargain Purchase
  - Step 2: Elimination of Inter-Company Transactions
  - Step 3: Calculate the Increase in Fair Value
  - Step 4: Calculate Parents Retained Earnings
  - Step 5: Calculate Non-Controlling Interest (NCI)
  - Step 6: Calculate Investment in Subsidiary
  - Step 7: Consolidate the Subsidiary's Assets and Liabilities
  - Step 8: Prepare Consolidated Balance Sheet

- Calculate Goodwill / Bargain Purchase
  - Step 1: Determine the Fair Value of the Company at the Acquisition
    - Market Capitalization Method

FV of the Company at Acquisition = No. of Shares of Subsidiary x Market Price of Subsidiary's Share at acquisition Date

    - Purchase Price Method

FV of the Company at Acquisition = Purchase Price of Investment in Subsidiary / Ownership %

  - Step 2: Determine the Fair Value of the Company's Net Assets at the Acquisition

FV of Company's Net Assets at Acquisition = FV of Assets – FV of Liabilities

FV of Company's Net Assets at Acquisition = Common Stock + Additional Paid-in Capital + Retained Earnings

  - Step 3: Determine Goodwill / Bargain Purchase

| | |
|---|---|
| Fair Value of the Company at Acquisition | XXX |
| Less: Fair Value of Company's Identifiable Net Assets at Acquisition | (XXX) |
| Goodwill | XXX |

| | |
|---|---|
| Fair Value of Company's Identifiable Net Assets at Acquisition | XXX |
| Less: Fair Value of the Company at Acquisition | (XXX) |
| Bargain Purchase | XXX |

- Elimination of Inter-Company Transaction
    - Elimination of Inter-Company Accounts Receivable and Accounts Payable

| | | | |
|---|---|---|---|
| Parent (AP) | | XXX | |
| | Subsidiary (AR) | | XXXX |

    - Elimination of Inter-Company Sales/Purchases with all the Inventory Sold

| | | | |
|---|---|---|---|
| Sales | | XXX | |
| | Cost of Sales | | XXX |

    - Elimination of Inter-Company Sales/Purchase with some Inventory unsold and Unrealized Profit

| | | | |
|---|---|---|---|
| Sales | | XXX | |
| | Cost of Sales | | XXX |
| | Inventory | | XXX |

The impact of this elimination on Balance Sheet consolidation is as follows:

| | | | |
|---|---|---|---|
| Retained Earnings | | XXX | |
| | Inventory | | XXX |

    - Elimination of Inter-Company Sales of PPE (Property, Plant & Equipment)

| | | | |
|---|---|---|---|
| Asset | | XXX | |
| Gain on Disposal (RE) | | XXX | |
| | Accumulated Depreciation | | XXX |

| | | | |
|---|---|---|---|
| Accumulated Depreciation | | XXX | |
| | Depreciation Expense (RE) | | XXX |

    - Elimination of Inter-Company Sales of Bonds

| | | | |
|---|---|---|---|
| Bonds Payable | | XXX | |
| | Investment in Bonds | | XXX |

| | | | |
|---|---|---|---|
| Interest Income | | XXX | |
| | Interest Expense | | XXX |

| | | | |
|---|---|---|---|
| Interest Payable | | XXX | |
| | Interest Receivable | | XXX |

- Elimination of Inter-Company Dividends Receivable and Dividends Payable
  - Dividend Paid by Subsidiary to Parent

| | | | |
|---|---|---|---|
| Dividends Payable | | XXX | |
| | Dividends Receivable | | XXX |

  - Dividend Paid by Parent to Subsidiary
    - The dividend paid by the Parent is not eliminated.

- Calculate the Increase in Fair Value
  - Step 1: Determine the fair value of the subsidiary's net assets at the date of acquisition.

| | |
|---|---|
| Common Stock (At Acquisition) | XXX |
| Additional Paid-in-Capital (At Acquisition) | XXX |
| Retained Earnings (At Acquisition) | XXX |
| FV of Net Assets (At Acquisition) | XXX |

  - Step 2: Determine the fair value of the subsidiary's net assets at the date of consolidation.

| | |
|---|---|
| Common Stock (At Consolidation) | XXX |
| Additional Paid-in-Capital (At Consolidation) | XXX |
| Retained Earnings (At Consolidation) | XXX |
| FV of Net Assets (At Consolidation) | XXX |

  - Step 3: Calculate the increase in Fair Value

| | |
|---|---|
| FV of Net Assets (At Consolidation) | XXX |
| Less: FV of Net Assets (At Acquisition) | (XXX) |
| Increase in Fair Value | XXX |

  - Step 4: Adjust for any unrealized profits and dividends.

| | |
|---|---|
| Increase in Fair Value | XXX |
| Less: Unrealized Profit in Inventory | (XXX) |
| Add: Dividend Paid by Subsidiary | XXX |
| **Post-Acquisition Profit** | **XXX** |

- Calculate Parents Retained Earnings

| | |
|---|---|
| Parent’s Retained Earnings | XXX |
| Less: Dividend's Paid by Parent | (XXX) |
| Add: Parent's Share of Subsidiary's Post-Acquisition Profit | XXX |
| Parent’s Retained Earnings (At Consolidation) | XXX |

- Calculate Non-Controlling Interest (NCI)
  - Step 1: Determine the Fair Value of Non-Controlling Interest (NCI) at the Acquisition
    - Market Capitalization Method

      FV of NCI at Acquisition = No. of Shares of NCI at Subsidiary x Market Price of Subsidiary's Share at acquisition date.

    - Purchase Price Method

      FV of NCI at Acquisition = Purchase Price of Investment in Subsidiary / Ownership % x NCI %

  - Step 2: Determine the Fair Value of Non-Controlling Interest (NCI) at Consolidation

| | |
|---|---|
| Non-Controlling Interest (NCI) at Acquisition | XXX |
| Add: NCI's Share of Subsidiary's Post-Acquisition Net Income | XXX |
| Less: NCI's Share of Subsidiary's Post-Acquisition Dividend | (XXX) |
| Non-Controlling Interest (NCI) (At Consolidation) | XXX |

- Calculate Investment in the Subsidiary

| | |
|---|---|
| Investment in Subsidiary | XXX |
| Add: Parent's Share of Subsidiary's Post-Acquisition Profit | XXX |
| Less: Parent's Share of Subsidiary's Dividend | XXX |
| Investment in Subsidiary | **XXX** |

- Consolidation Journal Entry

| | | | |
|---|---|---|---|
| Common Stock (Subsidiary) | | Book Value | |
| Additional Paid-in-Capital (Subsidiary) | | Book Value | |
| Retained Earnings (Subsidiary) | | Book Value – Unrealized Profit | |
| Goodwill | | Calculated above | |
| | Non-Controlling Interest | | Calculated above |
| | Investment in Subsidiary | | Book Value |

- Prepare a Consolidated Balance Sheet

| Consolidated Balance Sheet | | | |
|---|---|---|---|
| Assets | | Liability | |
| Current Assets | | Current Liabilities | |
| Cash | Parent 100% + Subsidiary 100% | Accounts Payable | Parent 100% + Subsidiary 100% - Elimination |
| Accounts Receivable | Parent 100% + Subsidiary 100% - Elimination | Accrued Liabilities | Parent 100% + Subsidiary 100% - Elimination |
| Inventory | Parent 100% + Subsidiary 100% - Elimination | | |
| Non-Current Assets | | Non-Current Liabilities | |
| PP&E | Parent 100% + Subsidiary 100% - Elimination | Bonds Payable | Parent 100% + Subsidiary 100% - Elimination |
| Investment | Parent 100% + Subsidiary 100% - Elimination | | |
| Goodwill | Calculated Above | Equity | |
| | | | |
| | | Common Stock | Parent 100% |
| | | Additional-Paid-in-Capital | Parent 100% |
| | | Retained Earnings | Calculated Above |
| | | Non-Controlling Interest | Calculated Above |

## Income Statement Consolidation

- Consolidated Income Statement = 100% Parent + 100% Subsidiary - Intercompany Transactions.

| Consolidated Income Statement | | | | |
|---|---|---|---|---|
| | Parent (100%) | Subsidiary (100%) | Inter-Company | Consolidated |
| Sales | XXX | XXX | (XXX) | XXX |
| Less: Cost of Sales | (XXX) | (XXX) | XXX | (XXX) |
| Gross Profit | XXX | XXX | | XXX |
| Less: Selling, General & Administrative Expenses | (XXX) | (XXX) | | (XXX) |
| Operating Profit | XXX | XXX | | XXX |
| Less: Interest | (XXX) | (XXX) | | (XXX) |
| Less: Taxes | (XXX) | (XXX) | | (XXX) |
| Net Income | XXX | XXX | | XXX |

- Consolidated Net Income would be allocated to Parent and Non-Controlling Interest (NCI) based on their percentage of ownership as follows:
    - Subsidiary's Net Income attributable to Parent = Subsidiary's Net Income x Parent's Ownership %
    - Subsidiary's Net Income attributable to NCI = Subsidiary's Net Income x NCI Ownership %

# NINJA NOTES

## Auditing & Attestation 2026

# Internal Control

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# Internal Control

## Audit Stages

- Pre-Engagement Acceptance Activities → Engagement Letter → Audit Strategy & Planning → **Internal Control Evaluation** → Substantive Procedures → Audit Completion → Report Preparation and Communication → Post-Audit Responsibilities & Audit Quality Management

## COSO Internal Control Framework

- COSO was formed in 1985.

- Its primary goal was to provide guidance and frameworks for enterprise risk management, internal control, and fraud deterrence.

- COSO Members
  - American Institute of Certified Public Accountants (AICPA)
  - American Accounting Association (AAA)
  - Financial Executives International (FEI)
  - Institute of Internal Auditors (IIA)
  - Institute of Management Accountants (IMA)
- Internal Controls - Objectives
  - Ensure Effective and Efficient Operations
  - Accurate and Reliable Financial Reporting
  - Compliance with Laws and Regulations.
- Internal Controls - Components
  - Control Environment
  - Risk Assessment
  - Information and Communication
  - Monitoring
  - Control Activities

- Internal Controls – Components and Principles

**Control Environment**

- Demonstrate Commitment to Integrity and Ethics
- Board of Directors exercise Oversight Responsibility
- Establish Structure, Authority & Responsibility
- Demonstrates commitment to competence
- Enforce Accountability

**Risk Assessment**

- Specifies suitable objectives
- Identifies and analyzes risk
- Assesses fraud risk
- Identifies and analyzes significant change

**Information and Communication Systems**

- Uses relevant information
- Communicates internally
- Communicates externally

**Monitoring**

- Conducts ongoing and/or separate evaluations
- Evaluates and communicates deficiencies

**Control Activities**

- Selects and develops control activities
- Selects and develops general controls over technology
- Deploys control activities through policies and procedures

- Segregation of Duties in Internal Control
    - Custody
    - Authorization
    - Recording
    - Reconciliation
- Internal Controls - Limitations
    - Competence
    - Collusion

    - Override by management
    - Obsolescence
    - Cost constraints

- Internal Control - Deficiencies
    - Control Deficiencies
        - A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
    - Significant Deficiencies
        - Deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention of TCWG and Management.
    - Material Weaknesses
        - Deficiency, or a combination of deficiencies, in internal control involving financial reporting, such that there is a reasonable possibility that a material misstatement.

- Internal Control - Types
    - Preventive Controls
    - Detective Controls
    - Corrective Controls
    - Directive Controls
    - Compensating Controls

## Auditor’s Consideration of Internal Control

- Test of Controls: Non-Issuers vs. Issuers
  - Non-Issuers
    - Financial Statements
      - Opinion on Client's Financial Statements
      - Mandatory to perform Substantive Procedures (Test of Details & Analytical Procedures)
    - Internal Controls
      - No Opinion on Client’s Internal Control
      - Optional to perform Test of Controls
  - Issuers
    - Financial Statements
      - Opinion on Client's Financial Statements
      - Mandatory to perform Substantive Procedures (Test of Details & Analytical Procedures)
    - Internal Controls
      - Opinion on Client’s Internal Control
      - Mandatory to perform Test of Controls
- Assess Inherent Risk (Obtain an Understanding of the Entity & its Environment)
  - Obtain an Understanding of the Entity & its Environment
    - Objectives & Strategies
    - Financial Performance
    - External Environment
    - Nature of Operations
    - Ownership and Governance
    - Investments

    - Financing Structure
    - Accounting Policies
  - Procedures to Assess Inherent Risk
    - Analytical Procedures
    - Inquiries
    - Inspection
  - Document Understanding of Entity
- Assess Control Risk (Obtain an Understanding of the Entity's Internal Control)
  - Obtain an Understanding of the Entity's Internal Control
    - Evaluate Design of Internal Controls
    - Assess Implementation of Internal Controls
  - Procedures for Understanding Internal Control
    - Inquiries
    - Walkthroughs
    - Inspection
    - Observation
  - Top Down Approach
    - Step 1: Assess Risk at Financial Statement Level / Entity Level
    - Step 2: Evaluate Risk at Account Balances, Transactions & Disclosures Level
    - Step 3: Evaluate Risk at Assertion Level
  - Document Understanding of Internal Controls
    - Key Elements to Document
      - Each of the Internal Control Components
      - Any Significant Risks Identified and Related Internal Controls

- Types of Documentation Forms
  - Flowcharts
  - Internal Control Questionnaire (ICQ)
  - Narratives
  - Decision Tree

- Assess Risk of Material Misstatement (IR and CR)

Obtain an Understanding of Entity and its Environment → Inherent Risk

Obtain an Understanding of Entity's Internal Control → Control Risk

Risk of Material Misstatement (RMM) = Inherent Risk (IR) x Control Risk (CR)

  - Steps to Assess RMM
    - Identify Risks
    - Consider the Likelihood of Identified Risks
    - Consider the Magnitude of the Impact on Financial Statements
    - Determine if Identified Risks are Significant

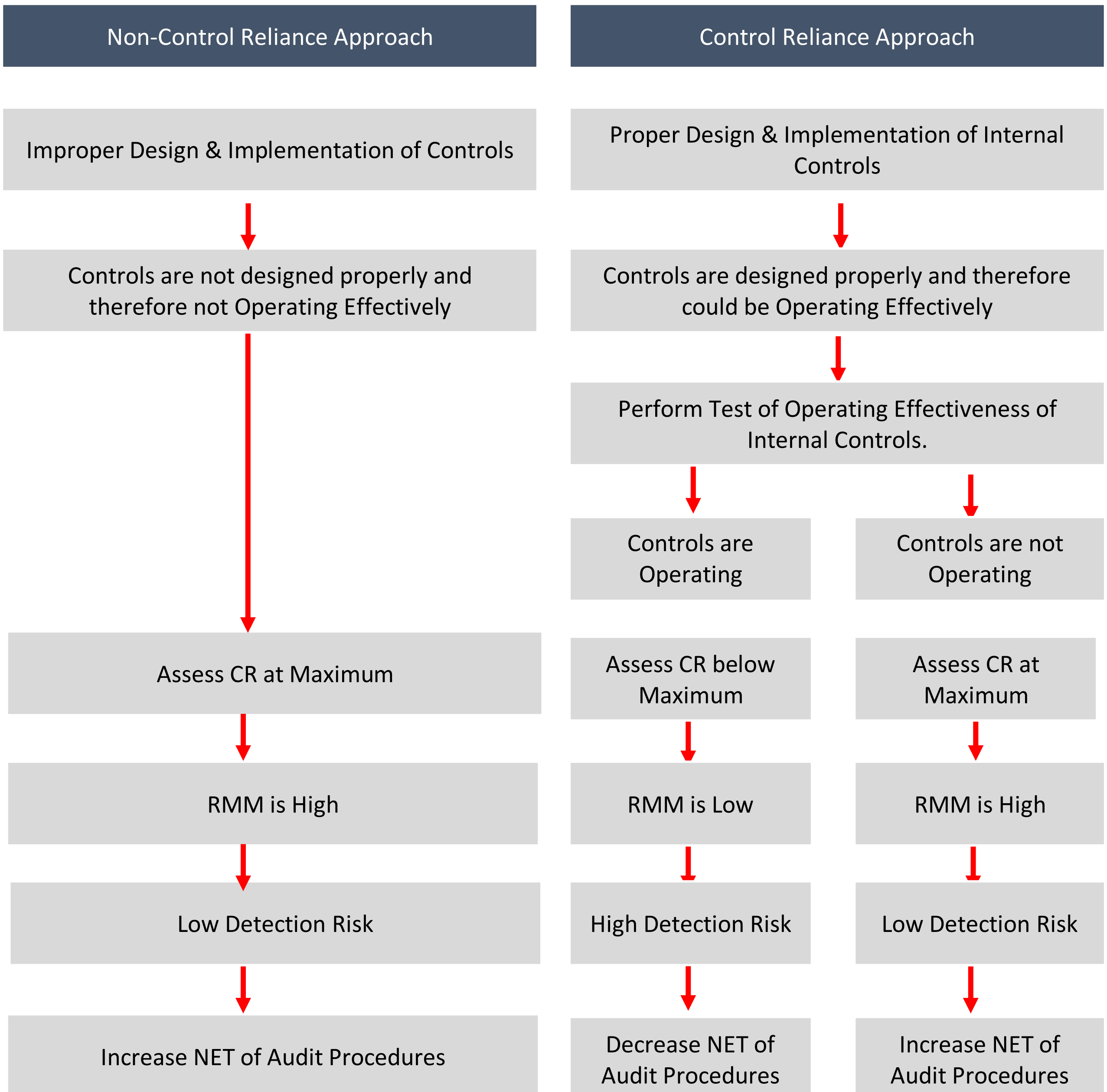
- Determine Audit Approach

| Non-Control Reliance Approach | Control Reliance Approach |
| --- | --- |
| Improper Design & Implementation of Controls | Proper Design & Implementation of Internal Controls |
| Controls are not designed properly and therefore not Operating Effectively | Controls are designed properly and therefore could be Operating Effectively |
| Do not Perform Test of Operating Effectiveness of Internal Controls | Perform Test of Operating Effectiveness of Internal Controls |

- Perform Test of Controls
  - Nature, Extent, and Timing of the Tests of Controls
    - Nature of Test of Controls
      - ➢ Performing Tests to see how the controls were applied at relevant times during the period under audit.
      - ➢ Performing Tests to see the consistency with which the controls were applied.
      - ➢ Performing Tests to see by whom or by what means they were applied.
    - Extent of Test of Controls
      - ➢ Automated Controls
        - ⇒ Smaller sample size or less frequent testing, assuming there have been no changes to the system.
      - ➢ Manual Controls
        - ⇒ Larger sample size and more frequent testing due to higher susceptibility to inconsistency and errors.

        - Timing of Test of Controls
            - Controls Tested during Interim
                - ⇒ Significant Changes in Control: Additional Testing
                - ⇒ No Significant Changes in Control: No Additional Testing
            - Controls Tested During Previous Year Audit
                - ⇒ Non-Issuers
                    - □ Changes in Controls: If there have been changes in the control, the controls should be tested again in the current year.
                    - □ No Changes in Controls: If no significant changes have occurred, the controls should be tested at least once every third year.
                    - □ Significant Risks: Controls address significant risks should be tested in the current period.
                - ⇒ Issuers
                    - □ Auditors are required to test controls each year for issuers.
    - Procedures for Test of Controls to determine Operating Effectiveness
        - Reperformance
        - Inquiry
        - Inspection
        - Observation

- Decide NET of Audit Procedures



## Transaction Cycles

- Revenue Cycle

**Customer**

**Documents Prepared and Sent:**

Purchase Order → Vendor

**Process**

- Customer sends a Purchase Order to prospective Sellers.

**Sales Department (Authorization)**

**Documents Received:** Purchase Order

**Documents Prepared and Sent:**

Sales Order → Credit Department

**Process**

- Receive a Purchase Order from Customer
- Sales Clerk will prepare a Sales Order from the Purchase Order and forward it Credit Department for Approval

**Credit Department (Authorization)**

**Documents Received:** Sales Order

**Documents Prepared and Sent:**

Approved Sales Order → Shipping Department

**Process**

- Credit Department will receive Sales Order from Sales Department.
- Credit team will do a credit check on the customer and approve or disapprove a sale
  - If the Sales Order is disapproved, sale is rejected nothing else happens
  - If the Sales Order is approved, approved Sales Order is
    prepared in triplicate and sent to Shipping, Billing and Accounting

**Shipping Department (Custody)**

**Documents Received:** Approved Sales Order

**Documents Prepared and Sent:**

- Inventory → Client
- Bill of Lading → Client & Billing Department

**Process**

- Shipping Team receives the Approved Sales Order and will ship Inventory to the Client
- Bill of Lading prepared by Shipping team and is sent to Client & Billing Department.

**Billing Department (Recordkeeping)**

**Documents Received:** Approved Sales Order & Bill of Lading

**Documents Prepared and Sent:**

- Invoice → Client
- Update Sales Journal, Sales Summary and Accounts Receivable Master File

**Process**

- Billing Team receives Approved Sales Order & Bill of Lading and will prepare Invoice and send it to the Client.
- Billing Team will Prepare Sales Journal, Sales Summary and Update Accounts Receivable Master File

**Accounting Department**

**Documents Received:** Approved Sales Order, Inventory Report and Approved Write-Off

**Documents Prepared and Sent:**

Records sales in General Ledger

**Process**

- Accounting Team records sales in General Ledger.

- Cash Receipts Cycle

**Customer**

**Documents Prepared and Sent:**

Checks & Remittance Advice → Vendor

**Process**

- Customer sends checks and remittance advice.

↓

**Mailroom (Custody)**

**Documents Received:** Checks & Remittance Advice

**Documents Prepared and Sent:**

- Check Listing Summary → Cashier, Accounts Receivable and Accounting
- Remittance Advice → Accounts Receivable

**Process**

- Receive Checks and Remittance Advice
- Separate Checks and Remittance Advice
- Prepare Check Listing Summary for Checks and send it to Cashier, Accounts Receivable and Accounting
- Send Remittance Advice to Accounts Receivable.

↓

**Cashier (Custody)**

**Documents Received:** Check Listing Summary

**Documents Prepared and Sent:**

Check Deposit Summary → Accounts Receivable and Accounting

**Process**

- Receive Checks and Check Listing Summary from Mailroom.
- Deposit Checks and Prepare a Check Deposit Summary and send it to Accounts Receivable and Accounting.

↓

Accounts Receivable Department (Recordkeeping)

**Documents Prepared and Sent:**

- Prepare a Cash Deposit Summary.
- Update Accounts Receivable Master File

**Documents Received:** Remittance Advice, Check Listing Summary and Check Deposit Summary

**Process:**

- Receive Remittance Advice, Check Listing Summary, Check Deposit Summary and Prepare a Cash Deposit Summary.
- Update Accounts Receivable Master File

Accounting Department (Recordkeeping)

**Documents Prepared and Sent:**

Update General Ledger

**Documents Received:** Check Listing Summary, Check Deposit Summary and Cash Deposit Summary

**Process**

- Accounting Team updates General Ledger.

- Expenditure Cycle

**Requisition Department**

**Documents Prepared and Sent:**

Approved Requisition → Procurement Department & Accounts Payable Department

**Process**

- Prepare a requisition.
- Department Head or any other approving authority will approve the requisition.
- Approved Requisition would be sent across to the Procurement Department

↓

**Procurement Department (Authorization)**

**Documents Received:** Approved Requisition

**Documents Prepared and Sent:**

Purchase Order → Vendor, Receiving Department (Blind Copy), Accounts Payable Department

**Process**

- Receives Approved Requisition.
- Prepares Purchase Order and sends it to Vendors, Accounts Payable and Receiving.
- Based on Purchase order, Procurement Department would invite various quotations from different vendors.
- Select the best vendor and negotiate terms and conditions of the purchase and authorize the purchase

↓

**Receiving Department (Custody)**

**Documents Received:** Purchase Order Blind Copy

**Documents Prepared and Sent:**

Receiving Report → Accounts Payable Department

**Process**

- Receives Blind Copy of Purchase Order. Purchase Order copy sent to receiving dept. excludes quantity of goods ordered (called 'blind copy') to avoid any possibility of receiving clerk knowing or relying on the P.O. quantity. Therefore, the receiving clerk is forced to independently count the goods received from the vendor to prepare the receiving report
- Receive and Count the inventory
- Prepare Receiving Report and send it to Accounts Payable Department.

**Accounts Payable Department (Recordkeeping)**

**Documents Received:** Approved Requisition, Purchase Order, Receiving Report,& Invoice

**Documents Prepared and Sent:**

- Update Purchase Journal, Purchase Summary and Accounts Payable Master.
- Voucher Package → Treasury

**Process**

- Receive Voucher Package which comprises of
  - Approved Requisition (What was requested)
  - Purchase Order (What was ordered)
  - Receiving Report (What was received)
  - Invoice (What was billed).
- Perform the 3-Way Match; Approve the voucher for payment and send approved voucher to Treasury Team.
- Update Purchase Journal, Purchase Summary and Accounts Payable Master.

**Treasury Department (Custody)**

**Documents Received:** Voucher Package

**Documents Prepared and Sent:**

Checks or Remittance Advice → Vendor

**Process**

- Receive Approved Voucher Package, Pay the Voucher Package and Stamp it paid to avoid double payment.
- Send Checks or Remittance Advice to Vendor Payable Master.

**Accounting Department (Recordkeeping)**

**Documents Prepared and Sent:**

Update General Ledger

**Process**

- Accounting Team updates General Ledger.

- Inventory Cycle

**Procurement Department (Authorization)**

- Receives Approved Requisition.
- Prepares Purchase Order and sends it to Vendors,
- Based on Purchase order, Procurement Department would invite various quotations from different vendors.
- Select the best vendor and negotiate terms and conditions of the purchase and authorize the purchase

**Receiving Department (Custody)**

- Receive and Count the inventory
- Prepare Receiving Report and send it to Accounts Payable Department.

Discussed in Expenditure Cycle

**Warehousing Department (Custody)**

- Holds custody of the verified quantity of the Inventory

**Shipping Department (Custody)**

- Responsible for shipping Finished Goods Inventory to the Customer

Discussed in Revenue Cycle

- Personnel & Payroll Cycle

**Payroll Department (Recordkeeping)**

**Documents Received:** Pay Rate Authorization & Approved Time Record

**Documents Prepared and Sent:**

- Update Employee records & Payroll Journal
- Prepare Payroll Summary
- Unsigned Checks → Treasury

**Process**

- Receive Pay rate authorization from HR Department
- Receive Approved Time Record from Production Department
- Prepare Check and send it to Treasury
- Update Employee records & Payroll Journal
- Prepare Payroll Summary

**Treasury Department (Custody)**

**Documents Received:** Unsigned Checks

**Documents Prepared and Sent:**

Signed Checks → Employees

**Process**

- Sign Checks and hand, it to Employees

**Accounting Department (Recordkeeping)**

**Documents Prepared and Sent:**

Update General Ledger

**Process**

- Accounting Team updates General Ledger.

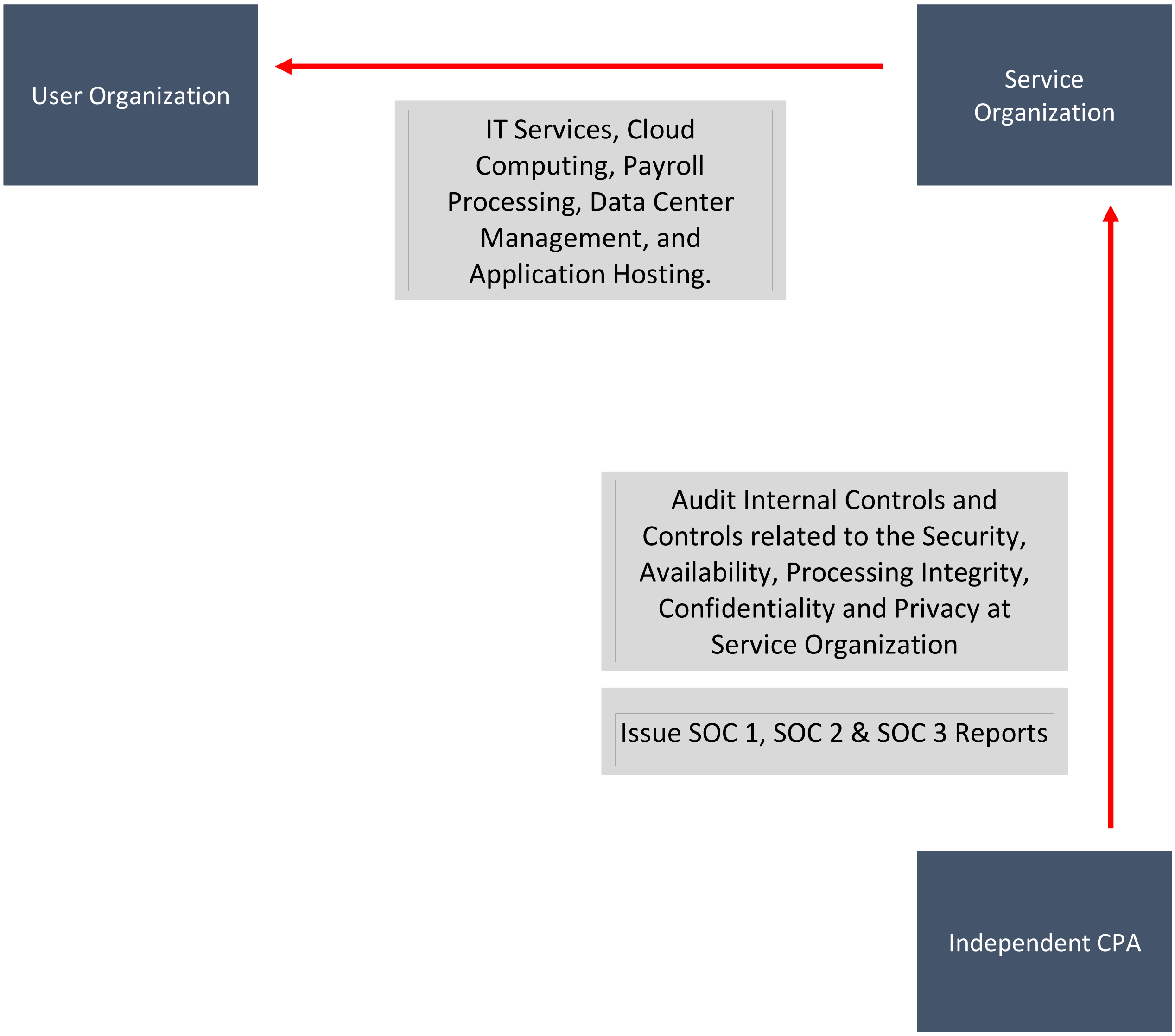
# Internal Control Deficiencies and Communication

- Internal Control Deficiencies
  - Types of Deficiencies
    - Design Deficiency (Not Designed Properly)
    - Operating Deficiency (Designed Properly but Doesn't Work)
  - Levels of Deficiency
    - Control Deficiency (Low)
    - Significant Deficiency (Medium)
    - Material Weakness (High)
- Internal Control Communications

| | Audit of Financial Statements: Non-Issuers | Audit of Financial Statements & Internal Control: Non-Issuers | Audit of Financial Statements & Internal Control: Issuers |
|---|---|---|---|
| Communication: Control Deficiencies | Management: No Communication Required.<br><br>TCWG: No Communication Required | Management: Within 60 days of Audit Report Release Date in Oral/Writing.<br><br>TCWG: No Communication Required | Management: By Audit Report Release Date in Oral/Writing.<br><br>TCWG: No Communication Required |
| Communication: Significant Deficiency | Management: Within 60 days of Audit Report Release Date in Writing.<br><br>TCWG: Within 60 days of Audit Report Release Date in Writing. | Management: By Audit Report Release Date in Writing.<br><br>TCWG: By Audit Report Release Date in Writing | Management: By Audit Report Release Date in Writing.<br><br>TCWG: By Audit Report Release Date in Writing |
| Communication: Material Weakness | Management: Within 60 days of Audit Report Release Date in Writing.<br><br>TCWG: Within 60 days of Audit Report Release Date in Writing. | Management: By Audit Report Release Date in Writing.<br><br>TCWG: By Audit Report Release Date in Writing | Management: By Audit Report Release Date in Writing.<br><br>TCWG: By Audit Report Release Date in Writing |

## Internal Controls at Service Organization

- Service Organization and User Organization




- Standards for SOC Engagements

| | |
|---|---|
| SOC 1 | Statement on Standards for Attestation Engagements (SSAE) No. 18 |
| SOC 2 | AICPA's Trust Services Criteria (TSC) & SSAE No. 18 |
| SOC 3 | AICPA's Trust Services Criteria (TSC) & SSAE No. 18 |

- Types of System and Organization Controls (SOC) Engagements

SOC 1

- Report on Controls Related to Financial Reporting at Service Organization.

SOC 2

- Restricted Use Report on Controls related to the AICPA'S 5 Trust Service Categories (Security, Availability, Processing Integrity, Confidentiality and Privacy) at Service Organization.

SOC 3

- General Use Report on Controls related to the AICPA'S 5 Trust Service Categories(Security, Availability, Processing Integrity, Confidentiality and Privacy) at Service Organization.

- SOC 1 Reports

| Report Type | Focus | Assessment | Timeframe |
|---|---|---|---|
| Type 1 | Design of Internal Controls. | Assesses the suitability and effectiveness of the controls in place at the service organization. | Specific Point in Time. |
| Type 2 | Design and Operating Effectiveness of Internal Controls. | Assesses the suitability and effectiveness of the controls, and how they are operating in practice. | Over a Period of time. |

- SOC 2 Reports

| Report Type | Focus | Assessment | Timeframe |
|---|---|---|---|
| Type 1 | Design of Internal Controls related to security, availability, confidentiality, privacy, and integrity of systems. | Assesses the suitability and effectiveness of the controls in place at the service organization | Specific Point in Time. |
| Type 2 | Design and Operating Effectiveness of Internal Controls related to security, availability, confidentiality, privacy, and integrity of systems. | Assesses the suitability and effectiveness of the controls, and how they are operating in practice | Over a Period of time. |

# NINJA NOTES

## Regulation 2026

# Individual Taxation

(July 1, 2026 – June 30, 2027 Exams)

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# Individual Taxation

## Overview of Individual Taxation

- Filing Requirements of Form 1040
    - Who must file Form 1040?
        - Income is greater than the standard deduction
        - Net self-employment income of $400 or more
    - When to file Form 1040?
        - Form 1040 must be filed by April 15
- Overview of Form 1040

| |
|---|
| Gross Income |
| <Adjustments> |
| **Adjusted Gross Income (AGI)** |
| <Standard Deduction> or <Itemized Deductions> |
| <Charitable Contributions Deduction> (For Non-Itemizers) |
| <Qualified Business Income Deduction> |
| <Additional Deductions> |
| **Taxable Income** |
| x Tax Rate |
| **Federal Income Tax** |
| < Tax Credits > |
| Alternative Minimum Tax |
| Self-Employment Tax |
| < Estimated Payments / Withholdings > |
| **Tax Due** |

| | |
|---|---|
| Gross Income | • Wages and Salaries (Salary Income)<br>• Interest & Dividend (Portfolio Income)<br>• Business Income or Loss (Business Income)<br>• Capital Gains & Losses<br>• Passive Income (Income from Pass-thru entities)<br>• Farming Income<br>• Other Miscellaneous Income |
| <Adjustments> | • Contributions to HSA: Health Savings Account<br>• Contributions Individual Retirement Account (IRA)<br>• Alimony Paid<br>• Withdrawal of Savings Penalty<br>• Educator Expenses<br>• Student Loan Interest Deduction<br>• Moving Expenses for Members of the Armed Forces and U.S. Intelligence Community<br>• Legal Fees for Discrimination Suit<br>• Jury Duty Fees Paid to Your Employer<br>• Deductions for Self-Employed |
| **Adjusted Gross Income (AGI)** | |
| <Standard Deduction><br>or<br><Itemized Deductions> | Standard Deduction and Additional Standard Deduction<br>Or<br>Itemized Deductions:<br>• Medical Expenses (In Excess of 7.5% of AGI)<br>• State/Local/Foreign Taxes (SALT) paid (up to $40,400)<br>• Interest Expense<br>• Charitable Contributions<br>• Casualty Losses<br>• Gambling Losses<br>• Federal Estate Tax on Income in Respect of a Decedent (IRD)<br>• Educator Expenses |
| <Charitable Contributions Deduction><br>(For Non-Itemizers) | |
| <Qualified Business Income Deduction> | |
| <Additional Deductions> | • Tips Deduction<br>• Qualified Overtime Compensation<br>• Car Loan Interest Deduction<br>• Enhanced Senior Deduction |
| **Taxable Income** | |
| x Tax Rate | |
| **Federal Income Tax** | |

| | |
|---|---|
| < Tax Credits > | • Child Tax Credit<br>• American Opportunity Tax Credit<br>• Earned Income Credit<br>• Premium Tax Credit<br>• Adoption Credit<br>• Lifetime Learning Credit<br>• Dependent and Child Care Credit<br>• Elderly and Disabled Credit<br>• Credit for Other Dependents<br>• Retirement Savings Contribution Credit<br>• Foreign Tax Credit<br>• General Business Credits |
| Alternative Minimum Tax | |
| Self-Employment Tax | |
| <Estimated Payments / Withholdings> | |
| **Tax Due** | |

- Tax Accounting Basis: Cash & Accrual
    - Cash Basis: Cash Basis is allowed for small businesses that have average annual gross receipts of $32 Million or less (for 2026) during the preceding 3 Years.
    - Accrual Basis: Accrual Basis is mandatory for businesses that have average annual gross receipts of more than $32 Million (for 2026) during the preceding 3 Years.

# Qualifying Child and Qualifying Relative

- Qualifying Child and a Qualifying Relative are terms used by the IRS to determine if a person can be claimed as a dependent on your federal income tax return.

- Claiming a dependent can provide certain tax benefits, such as advantageous filing status, deductions, or credits.

- Qualifying Child

  - Son, daughter, stepchild, foster child, brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of these (e.g., grandchild, niece, or nephew).

  - The child must be under age 19 at the end of the tax year or under age 24 if they are a full-time student.

  - The child must not have provided more than half of their own support during the tax year

  - The child must have lived with you for more than half of the tax year.

  - Citizen of United States or Resident of United States, Mexico or Canada

  - No income limit for the dependent to be claimed as a qualifying child

  - The child must not be filing a joint return for the tax year.

- Qualifying Relative

  - Not a Qualifying Child.

  - The person must either live with you all year as a member of your household or be related to you as a child, sibling, parent, grandparent, niece, nephew, aunt, uncle, or in-law

  - There is no age limit for a dependent to be claimed as a qualifying relative

  - Taxpayer must provide more than half of the person's total support for the tax year

  - Citizen of United States or Resident of United States, Mexico or Canada

  - The person's gross income for the tax year must be less than the annual exemption amount ($5,300 for tax year 2026; this amount may change in subsequent years)

  - The relative must not be filing a joint return for the tax year.

## Filing Status

- Single
  - Unmarried
  - Married but legally separated as of year-end
- Married Filing Jointly (MFJ)
  - Married and not divorced or legally separated as of year-end
  - Both spouses file one single joint return (Form 1040)
  - Neither spouse is a non-resident alien
  - Tax year is the same for both spouses
- Married Filing Separately (MFS)
  - Married couples who file separate tax returns, reporting their individual income, deductions, and credits.
- Head of Household
  - Unmarried or Considered Unmarried
  - Maintaining a Household
    - The taxpayer must have paid more than half the cost of maintaining a home for the tax year.
  - Must have a qualifying person, such as a dependent child, parent, or relative:
    - Qualifying Child
      - Meets the criteria of a Qualifying Child
    - Qualifying Relative other than Parent
      - Meets the criteria of a Qualifying Relative
      - Actually Related
      - Lives with the taxpayer for more than half the year (not the whole year)
    - Qualifying Relative who is a Parent
      - Meets the criteria of a Qualifying Relative

    - Actually Related
    - Need not live with the taxpayer
- Surviving Spouse (SS) / Qualifying Widow(er)
    - Spouse passed away in the last two years
    - Not Remarried
    - Qualifying Child
    - Principle Residence for the Qualifying Child for the whole year

## Gross Income

- Various types of gross income should be reported on U.S. tax forms:

| Type of Income | Relevant Form(s) |
|---|---|
| Wages and Salaries (Salary Income) | Form W-2 |
| Interest & Dividend (Portfolio Income) | Schedule B |
| Business Income or Loss (Business Income) | Schedule C |
| Capital Gains & Losses | Schedule D |
| Passive Income (Income from Pass-thru entities) | Schedule E |
| Farming Income | Schedule F |
| Other Miscellaneous Income | Schedule 1 |

- Wages and Salaries (Form W-2)

| Taxable | Non-Taxable |
|---|---|
| **Cash & Property**<br>• Include receipts in cash and FMV of property<br><br>**Tips**<br>• Tips > $20: Report to employer by 10th of next month: Included in month reported<br>• Tips < $20: No need to report to the employer: Included in the month received<br><br>For 2025–2028, eligible workers may claim an Additional Deduction of up to $25,000 of Qualified Tips<br><br>**Overtime Compensation**<br>• Overtime Compensation paid to an employee is included in gross income as wages. However, for tax years 2025 through 2028, a portion of Qualified Overtime Compensation may be deductible as an Additional Deduction<br><br>**Cancellation of Debt**<br>• Debt cancellation by employer should be included in gross income.<br><br>**Bargain Purchase**<br>• Include the difference between FMV and Purchase Price | **Insurance Premiums**<br>• Group-term life insurance premiums for the first $50,000 of coverage are excluded from taxable income<br><br>**Proceeds on Life Insurance**<br>• Proceeds from a life insurance policy are generally excluded from beneficiaries' gross income<br><br>**Medical/Health/Accident Insurance Premiums**<br>• Employer-paid medical, health, dental, vision, or accident insurance premiums are not part of the employee's taxable income<br><br>**Qualified Medical Expenses Reimbursement**<br>• Reimbursements for qualified medical expenses are generally not taxable<br><br>**HSA Contributions**<br>• Employer contributions to HSA accounts are not part of the employee's taxable income |

**Guaranteed Payments**

- Guaranteed payments received by a partner without regard to the partnership income are included in gross income and are subject to self-employment tax.

**Taxable Fringe Benefits**

- Include FMV of fringe benefits in gross income (e.g., personal use of company car, moving expense reimbursements, non-qualified bicycle commuting)

**Insurance Premiums**

- Include premiums paid for coverage above $50,000

**Stock Options**

Stock Options have Readily Determinable Fair Market Value:

- **Granted:** Ordinary Income = FMV of Options on Grant Date – Cost
- **Exercised:** No Tax on Exercise.
  Basis of Stock = Exercise Price + Income Recognized on Options on Grant Date
- **Sold:** Capital Gain or Loss = Sales Price – Basis of Stock
- **Lapsed:** Capital Loss = Income Recognized on Options on Grant Date.

Stock Options that do not have Readily Determinable Fair Market Value:

- **Granted:** No Tax on Grant
- **Exercised:** Ordinary Income = FMV of Stock at Exercise Date – Exercise Price
- **Sold:** Capital Gain or Loss = Sales Price - FMV of Stock at Exercise Date.
- **Lapsed:** No Deduction on Lapse.

**Contributions to Flexible Spending Arrangements (FSAs)**

- Healthcare FSA
  - Individuals: $3,400 (For 2026)
- Dependent Care FSA
  - Single & MFJ: $7,500 (For 2026)
  - MFS: $3,750 (For 2026)

**Dependent Care Benefits**

- Employer-provided Dependent Care Benefits are not taxable up to a certain limit ($7,500 per year for most taxpayers)

**Qualified Adoption Expenses**

- Employer-provided financial assistance for adoption-related expenses is not taxable up to $17,670 (for 2026)

**Workers' Compensation**

- Workers' compensation in the form of wage replacement and medical benefits to employees who are injured or become ill as a direct result of their job is not taxable income for the employee.

**Employee Achievement Award**

- Employee Achievement Award is not taxable if the value does not exceed $400 and is not cash or cash equivalent

**De Minimis Fringe Benefits**

- Low-value benefits are not considered taxable income

**Meals in Employer-Operated Facilities**

- Meals provided on the employer's premises are generally not taxable

**Lodging (Required for the Job)**

- Lodging provided on the employer's premises as a job requirement is generally not taxable

**Transit Passes & Parking Benefits**

- Employer-provided transit passes up to $340/month (for 2026) and parking benefits up to $340/month (for 2026) are not taxable, helping offset commuting costs

**Qualified Employee Discounts**

- Discounts on merchandise or services are not taxable:
    - Merchandise discounts: If the discount is less than the employer's gross profit percentage (Discount % < Gross Profit %; Not Taxable)
    - Service Discounts If Discount is less than 20% of FMV of service (Discount % < 20%; Not Taxable)

**Educational Expenses**

- Employer-provided educational assistance up to $5,250 per year (for 2026) for undergraduate or graduate-level education is not taxable; covers tuition, books, supplies, and required equipment
- The $5,250 cap is a combined limit that also covers employer payments toward an employee's qualified student loan principal or interest

**Contributions to the Pension Plan**

- Employer contributions to SEP or SIMPLE plans are not taxable

**Qualified Tuition Reductions**

- Qualified tuition reductions for educational institution employees are not taxable. If for a graduate degree, should be engaged in teaching (even if in a different institution) and should receive pay for that.

- Interest & Dividend (Schedule B)
  - Interest Income (Part I of Schedule B)

| Taxable | Non-Taxable |
|---|---|
| Interest on U.S. Federal bonds, U.S. Treasury bills, and other U.S. obligations. | Interest earned on State, Municipal, and U.S. Possession Bonds are not taxable. |
| Interest in Industrial Development Bonds and Corporate Bonds. | Series EE & Series I Savings Bonds: Interest earned is not taxed upon redemption if used for qualified higher education expenses (tuition and fees, not room and board) for the taxpayer, their spouse, or their dependents. |
| Interest paid by Federal or State Government on late payment of tax refund. | |
| The Interest portion of the Installment Sale proceeds. | |

  - Dividend Income (Part II of Schedule B)

| Taxable | Non-Taxable |
|---|---|
| **Qualified Dividends**<br>• Taxed at lower rates as they meet specific criteria set by the IRS<br><br>**Ordinary Dividends**<br>• Dividends that do not meet the criteria to be considered qualified dividends. Taxed at the taxpayer's ordinary income tax rate | **Return of Capital**<br>• Non-taxable distribution representing a return on the shareholder's initial investment.<br><br>**Stock Splits**<br>• A corporate action dividing existing shares into multiple shares.<br><br>**Stock Dividends**<br>• Stock dividends to common stockholders allocate the original basis to the increased number of stocks held. Non-taxable when there is no option to receive cash dividends.<br><br>**Mutual Funds Invested in Tax-Free Bonds**<br>• Dividends from mutual funds invested in tax-free bonds are not taxable.<br><br>**Life Insurance**<br>• Non-taxable return of premium/capital from life insurance.<br><br>**S-Corp Dividend**<br>• S-Corp Income flows through to Schedule E of S-Corp shareholders and is not taxable as dividends. |

- Business Income (Schedule C)
    - Applicability
        - Self-Employed Individuals
        - Sole Proprietors
        - Single-Member LLCs
        - Income from a Hobby
        - Husband and Wife Joint Venture
        - Statutory Employees
    - Overview of Schedule C

<table>
<tr><td>Gross Receipts</td><td>Total amount received from sales and services provided during the tax year.</td></tr>
<tr><td>Sales Returns</td><td>Sales Returns represent the value of Sales returned by the customer.</td></tr>
<tr><td>Net Receipts</td><td>Net Receipts = Gross Receipts – Sales Return.<br>(If cash basis, net receipts equal cash received.)</td></tr>
<tr><td>Cost of Goods Sold or Cost of Services</td><td>Cost of Goods Sold (COGS) = Opening Inventory + Cost of Goods Manufactured - Ending Inventory<br><br>Inventory<ul><li>Small Businesses with average annual gross receipts of $32 Million (for 2026) or less during the preceding three Years:<ul><li><u>If Using Accrual Basis of Accounting:</u><ul><li>Inventory is valued at a Lower Cost or Market Value</li><li>May use, specific identification, FIFO or LIFO Rule. (Must follow LIFO Conformity Rule)</li></ul></li><li><u>If Using Cash Basis of Accounting:</u><ul><li>Treat Inventory as non-incidental material and supplies</li><li>Conform to taxpayer’s financial accounting treatment of inventories.</li></ul></li></ul></li><li>Businesses with average annual gross receipts of $32 Million (for 2026) or more during the preceding three Years:<ul><li>Must use UNICAP Rules for Inventory</li></ul></li></ul></td></tr>
<tr><td>Gross Profit</td><td>Gross Profit = Net Receipts – COGS</td></tr>
<tr><td>Other income</td><td>Other Income may include:</td></tr>
</table>

| | |
|---|---|
| | • Federal and State Gasoline Tax Credit<br>• Royalties<br>• Rental Income (if part of business operations)<br>• Interest on business accounts<br>• Gains from the sale of business assets |
| **Gross Income** | Gross Income = Gross Profit + Other Income |
| <Total Expenses> | |
| **Net Profit/Loss** | Gross Income – Total Expenses – Expenses for Business Use of Home |

- Deductible Business Expenses
  - Salaries
  - State and Local Taxes and Federal Payroll Taxes
  - Office Expenses
  - Transportation Expenses
  - Business Meals up to 50%
  - Business Travel
  - Interest on Business Loan
  - Fringe Benefits Paid to Employee
  - Legal & Professional Services and Fees
  - Business Bad Debts
  - Depreciation and Amortization
  - Business Start-Up Cost
    - Businesses can deduct up to $5,000 in start-up costs during the first year of operation. However, this $5,000 limit is reduced dollar-for-dollar for start-up expenses exceeding $50,000. If your start-up costs exceed the deductible limit the remaining balance will be amortized over 180 months (15 years), beginning with the month your business starts operating.

- Non-Deductible Expenses
  - Salaries to Owner
  - Entertainment Expense
  - Federal Income Taxes
  - Fines & Penalties
  - Personal Expense
  - Expenses for Illegal Business
  - Transportation Benefits Provided to an Employee for Travel Between Home Location and Office
- Uniform Capitalization (UNICAP) Rules
  - Applies to
    - Produced for Use: Example, Building constructed for own use
    - Produced for Sale: Example, Manufacturer's Inventory
    - Acquired for Resale: Example, Retailer's Inventory
  - Capitalized Costs
    - Pre-Production Costs
    - Production Costs
      - Direct Materials
      - Direct Labor
      - Direct & Indirect Production Costs (Factory Overheads)
    - Pre-Sale Costs
  - Non-Capitalized Costs
    - Advertising, Selling, and Distribution Expenses
    - Income Taxes
    - Strike Expenses

- Warranty Expenses
- General and Administrative (G&A) Expenses

- Applicability
  - Businesses with average annual gross receipts of more than $32 million (for 2026) during each of the preceding three tax years.

- Self-Employment (SE) Tax on Net Business Income
  - Net Business Income is subject to both Income Tax and Self-Employment (SE) Tax.
  - Because self-employed individuals do not have an employer to withhold and match these payroll taxes, they pay both the employer and employee portions themselves. SE Tax is reported on Schedule SE.
  - A taxpayer is subject to SE Tax if Net Earnings from Self-Employment are $400 or more during the tax year. SE Tax consists of two components:
    - Social Security Portion: 12.4% on self-employment earnings up to $184,500 (for 2026). Earnings above this threshold are not subject to the Social Security portion.
    - Medicare Portion: 2.9% on all self-employment earnings with no upper limit.
  - A taxpayer may deduct 50% of the SE Tax paid as an Above-the-Line Adjustment in arriving at AGI.

- Net Operating Loss (NOL)
    - Sources of NOL
        - Business Loss from a Sole Proprietorship reported on Schedule C
        - Share of Business Loss from a Partnership or S-Corporation reported on Schedule E
        - Farming Business Loss reported on Schedule F
    - NOL Calculation

| Component | Amount $ |
|---|---|
| Loss Sources: | |
| Schedule C Business Loss | (XXX) |
| Schedule F Farming Business Loss | (XXX) |
| Schedule E Partnership/S-Corp Loss | (XXX) |
| Income Sources: | |
| Wages & Salaries Income (Form W-2) | XXX |
| Business Income (Schedule C) | XXX |
| Passive Income (Schedule E) | XXX |
| Farming Income (Schedule F) | XXX |
| **Net Operating Loss (NOL)** | **(XXX)** |

        - Excess Business Losses (Business Losses in excess of Business Income) can be deducted against other sources of income unto $512,000 for MFJ and $256,000 for other taxpayers (for 2026) and the balance is carried forward as NOL.
    - NOL Treatment
        - Businesses can now carry forward Net Operating Losses (NOLs) indefinitely but can only use NOL carryforwards to offset up to 80% of their taxable income in a given year, with any remaining NOLs continuing to be carried forward indefinitely.

- Capital Gains & Losses (Schedule D)
  - Calculation of Capital Gains and Losses

| | |
|---|---|
| Proceeds | Cash received<br>Property received (FMV)<br>Services received (FMV)<br>Cancellation of Debt<br>Selling Expenses |
| <Adjusted Basis of Assets Sold> | |
| **Capital Gain or Loss Realized** | Holding Period > 1 Year (Long-Term Capital Gain or Loss)<br>Holding Period < 1 Year (Short-Term Capital Gain or Loss) |

  - Netting Process for Capital Gains and Losses
    - Step 1: Net Short-Term Gains and Losses together, and Long-Term Gains and Losses together

| |
|---|
| Short-Term Capital Gain |
| (Short-Term Capital Loss) |
| Net Short-Term Capital Gain / (Net Short-Term Capital Loss) |

| |
|---|
| Long-Term Capital Gain |
| (Long-Term Capital Loss) |
| Net Long-Term Capital Gain / (Net Long-Term Capital Loss) |

    - Step 2: Net Short-Term Gains and Losses with Long-Term Gains and Losses if opposite signs or else no netting.
      - If one is a net gain and the other is a net loss, net them together. This will result in either a single net Short-Term Capital Gain/Loss or a Single Net Long-Term Capital Gain/Loss.

| |
|---|
| Net Short-Term Capital Gain |
| (Net Long-Term Capital Loss) |
| Net Short-Term Capital Gain |

| |
|---|
| (Net Short-Term Capital Loss) |
| Net Long-Term Capital Gain |
| Net Short-Term Capital Loss |

| |
|---|
| Net Long-Term Capital Gain |
| (Net Short-Term Capital Loss) |
| Net Long-Term Capital Gain |

| |
|---|
| (Net Long-Term Capital Loss) |
| Net Short-Term Capital Gain |
| Net Long-Term Capital Loss |

- If both are gains or both are losses, do not net them together. In this case, you will have either:
  - ⇒ Net Short-Term Capital Gain and Net Long-Term Capital Gain.
  - ⇒ Net Short-Term Capital Loss and Net Long-Term Capital Loss.

- Tax Treatment of Capital Gains and Losses

| Type | Tax Treatment |
|---|---|
| Net Short-Term Capital Gain | • Short-Term Capital Gains are taxed at Ordinary Income Tax Rates. |
| Net Short-Term Capital Loss | • Set off Net Short-Term Capital Loss from other sources of income up to \$3,000 (MFJ & Single) & \$1,500 (MFS) every year.<br>• Excess carried forward indefinitely. Capital Losses retain their character (Short-Term or Long-Term) when carried forward to future years. |
| Net Long-Term Capital Gain | • Long-Term Capital Gains are taxed at Capital Gain Tax Rates (0%, 15%, 20%). |
| Net Long-Term Capital Loss | • Set off Net Long-Term Capital Loss from other sources of income up to \$3,000 (MFJ & Single) & \$1,500 (MFS) every year.<br>• Excess carried forward indefinitely. Capital Losses retain their character (Short-Term or Long-Term) when carried forward to future years. |

- Passive Income (Schedule E)
  - Passive Activities include the following:
    - Income from Rental Real Estate Activities
    - Income from Royalties
    - Income from Closely Held C-Corporations and Personal Service Corporations
    - Income from Schedule K-1 (Pass-through Income)
      - Partnerships and Limited Liability Companies (LLCs)
      - S-Corporations
      - Estates and Trusts

- Passive Activity Loss Offset Rules

  - Passive Activity Losses (PAL) can generally be offset against passive income only.

  - Excess Passive Activity Losses (PAL) are carried forward indefinitely or until the activity is disposed of.

  - Exceptions: Material Participation: A Taxpayer Materially participates in an activity if they meet any one of the following seven tests:

    - Participates more than 500 hours in the activity during the year.

    - Participation constitutes substantially all of the participation in the activity by all individuals.

    - Participates more than 100 hours and no other individual participates more.

    - Activity is a "significant participation activity" (more than 100 hours) and total significant participation activity hours exceed 500 hours.

    - Materially participated in the activity for any 5 of the preceding 10 tax years.

    - Activity is a personal service activity and the taxpayer materially participated for any 3 prior tax years.

    - Based on all facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis.

  - The effect of meeting a Material Participation test depends on the type of activity:

    - Rental Real Estate Activities

      - ⇒ If the taxpayer qualifies as a Real Estate Professional and Materially Participates in the Rental Activity, Income from the rental Activity is treated as Active Income and losses are fully deductible against all types of income with no PAL limitations.

    - Other Passive Activities

      - ⇒ If the taxpayer Materially Participates, Income from the activity is treated as Active Income and Losses are fully deductible against all types of income with no PAL limitations.

- Income from Rental Real Estate Activities
    - Rental Income: Calculation

| | |
|---|---|
| Gross Rental Income | • Gross Rental Income includes<br>  ○ Rent Payments taxpayers receive from tenants during the tax year.<br>  ○ Other payments from tenants, such as:<br>    ▪ Reimbursement for utilities<br>    ▪ Other property-related expenses<br>• Cash Basis: Rent Received & Accrual Basis: Rent Earned |
| Prepaid Rental Income | • Prepaid Rental Income is always included, even on an accrual basis.<br>• Rental income is taxed earlier than received or earned. |
| Lease Cancellation Payment | • Payments received for lease cancellation are included in the calculation of Net Rental Income. |
| Lease Improvement In-lieu-of Rent | • Payments received for lease improvements in place of rent are included in the calculation of Net Rental Income. |
| <Rental Expenses> | • Rental Expenses include:<br>  ○ Mortgage interest<br>  ○ Property taxes<br>  ○ Insurance<br>  ○ Depreciation<br>  ○ Repairs and Maintenance<br>  ○ Utilities<br>  ○ Property Management Fees<br>  ○ Advertising Costs<br>  ○ Legal and Professional Fees |
| **Net Rental Income or Loss** | |

- Home Is Rented Out and used as a Personal Residence

| | Rental Income | Rental Expenses |
|---|---|---|
| Treated as Personal Residence:<br><br>• Used as a Home: Higher of 14 Days or 10% of Rented Days.<br>and<br>• Rented for less than 15 days during the year. [This is sometimes called the "Augusta Rule" (after Augusta, Georgia, where homeowners frequently rent during the Masters Golf Tournament)] | Not Included | Not Deducted on Schedule E.<br><br>**Mortgage Interest & Property Taxes:**<br>• Allowed as an Itemized Deduction on Schedule A.<br><br>**Property Expenses:**<br>• Property expenses such as utilities, insurance, and depreciation are not deductible. |
| Treated as Personal and Rental Residence:<br><br>• Used as a Home: Higher of 14 Days or 10% of Rented Days.<br>and<br>• Rented for 15 or more days during the year. | Included | Proportionate Reductions for Rental Expenses are allowed on Schedule E.<br><br>**Mortgage Interest & Property Taxes:**<br>• Mortgage Interest & Property Taxes allocated between Personal and Rental Use<br>    ○ Deductible for the Period Rented on Schedule E (Months Rented / 12)<br>    ○ Allowed as an Itemized Deduction on Schedule A for the period used as a personal residence. (Months used as a Personal Residence / 12)<br><br>**Property Expenses:**<br>• Property Expenses such as utilities, insurance, and depreciation are allocated proportionately between Personal and Rental Use.<br>    ○ Deductible for the Period Rented on Schedule E.<br>    ○ Not Deductible for Period used as a personal residence. |

- Income from Rental Activities (Loss Limitations)

| | Income Type | Impact |
|---|---|---|
| Materially Participating & Real Estate Professional | Active | Losses are fully deductible against all types of income (Active, Portfolio, and Passive) with no PAL limitations. |
| Actively Participating (10%+ Ownership + Management Decisions) | Passive (with Special Allowance) | Up to $25,000 of rental losses may be deducted against Active and Portfolio Income, subject to AGI phase-out (fully phased out at $150,000 AGI). |
| No Material Participation & No Active Participation | Passive | Losses are limited to Passive Income only. Excess losses are suspended and carried forward. |

- Income from Royalties

| | |
|---|---|
| Gross Royalty Income | • Gross Royalty Income includes<br>○ Upfront Payments<br>○ Ongoing Royalties based on Sales or Usage,<br>○ Other Relevant Payments |
| <Royalty Expenses> | • Royalty Expenses include:<br>○ Legal Fees.<br>○ Agent Fees.<br>○ Other Costs directly associated with generating the Royalty Income. |
| **Net Royalty Income or Loss** | |

- Income from Closely Held C-Corporations and Personal Service Corporations

  - This has been discussed along with C-Corporation Taxation.

- Income from Schedule K-1 (Pass-through Income): Partnerships, Limited Liability Companies (LLCs), S-Corporations, Estates, and Trusts.

  - This has been discussed along with Entities Taxation.

- Farming Income (Schedule F)
  - Accounting Methods Used to Report Farming Income

| Accounting Method | Description |
|---|---|
| Cash Basis | Income is reported in the year it is received, and expenses are deducted in the year they are paid. |
| Accrual Basis | Income is reported in the year it is earned, and expenses are deducted in the year they are incurred, regardless of when cash is received or paid. |
| Crop Basis | Expenses for producing the crop are deducted in the year income is realized from the sale of the crop. |

  - Farming Income: Calculation

| | |
|---|---|
| Farming Income | Farming Income includes:<br>• Sales of livestock, produce, grains, etc.<br>• Agricultural program payments.<br>• Crop insurance proceeds and disaster payments.<br>• Cooperative distributions.<br>• Custom hire (machine work) income.<br>• Other farming-related income. |
| <Farming Expenses> | Farming Expenses include:<br>• Vehicle expenses.<br>• Chemicals, conservation, and depreciation.<br>• Employee benefits and feed for livestock.<br>• Fertilizers, freight, and fuel expenses.<br>• Insurance, interest, and labor costs.<br>• Rent or lease, repairs, and seeds/plants.<br>• Taxes, utilities, and veterinary expenses.<br>• Other farming-related expenses. |
| **Net Farming Profit or Loss** | |

  - Net Operating Loss Related to Farming
    - Net Operating Losses (NOL) related to farming can still be carried back for two years and carried forward for 20 years.

- Other Items of Inclusions in Gross Income
  - Alimony Received

| | |
|---|---|
| Divorces finalized prior to January 1, 2019 | • **Alimony Received:** Taxable<br>• **Alimony Paid:** Deductible |
| Divorces finalized on or after January 1, 2019 | • **Alimony Received:** Not Taxable<br>• **Alimony Paid:** Not Deductible |

  - Social Security Benefits
    - Taxation of Social Security benefits depends on the beneficiary's provisional income.
    - 0% - 85% of Social Security Benefits are taxable based on the provisional income level.
  - Distributions from Individual Retirement Account (IRA)

| | Traditional IRA | Roth IRA | Coverdell IRA |
|---|---|---|---|
| Contribution | Deductible | Non-Deductible | Non-Deductible |
| Distributions: Principal | Taxable (For Deductible Contributions) & Non-Taxable (For Non-Deductible Contributions) | Not Taxable | Not Taxable |
| Distributions: Interest | Taxable | Not Taxable | Not Taxable |
| Distribution Age Limits | Distributions can occur after age 59 ½. | Must occur at least five years after the first contribution to the Roth IRA and Distribution occurs after you've reached age 59 ½. | No Age limit on Distribution. However, Funds should be used by the beneficiary before age 30. |
| Penalty on Early Withdrawal | 10% Penalty + Income Tax on the amount withdrawn in case of early withdrawal | 10% Penalty + Income Tax on the Earnings Portion in case of early withdrawal | 10% Penalty + Income Tax on the Earnings Portion of Leftover Funds |
| Required Minimum Distributions (RMDs) | RMDs must begin by April 1 of the year following the year that you turn 73 (if born between 1951 and 1959) or age 75 (if born in 1960 or later) | No RMDs. | No RMDs. |

- Distributions from Qualified Tuition Programs (529 Plans)
  - A Qualified Tuition Program (QTP), also known as a 529 plan, is a tax-advantaged savings plan designed to encourage saving for future education expenses.
  - Contribution
    - Non-Deductible Contributions
  - Distribution
    - Principal: Non-Taxable
    - Interest: Non-Taxable (when used for Qualified Education Expenses)
- Distributions from Trump Accounts
  - Trump Accounts are a new tax-advantaged savings vehicle created under OBBBA for U.S. citizen children. Available for U.S. Citizen Children under age 18 with a valid Social Security Number.
  - The federal government provides a one-time $1,000 contribution for each U.S. citizen child born between January 1, 2025, and December 31, 2028.
  - Total Contributions to a Trump Account during the year cannot exceed $5,000 per child (for 2026), combined across all contributors (parents, family, other individuals, and employers).
  - Employers may contribute up to $2,500 per employee per year (For 2026).
  - Contributions
    - Individual Contributions: Non-Deductible
    - Federal Seed Contribution: Non-Taxable
    - Employer Contributions: Non-Taxable.
  - Distribution
    - Principal
      - ⇒ Distributions out of Individual Contributions: Non-Taxable
      - ⇒ Distributions out of Federal Seed Contribution: Taxable
      - ⇒ Distributions out of Employer Contributions: Taxable
    - Interest: Taxable

- Income from Pensions and Annuities

| | Qualified Pension and Retirement Plans | Non-Qualified Pension and Retirement Plans |
|---|---|---|
| Contributions | Deductible | Non-Deductible |
| Distributions: Principal | Taxable | Non-Taxable |
| Distributions: Interest | Taxable | Taxable |

- State and Local Tax Refunds

| Situation | Taxability of State and Local Tax Refunds |
|---|---|
| Itemized Deductions | Taxable up to the benefit received from the deduction |
| Standard Deduction | Not Taxable |

- Unemployment Compensation
- Debt Cancellation
- Gambling Winnings
- Jury Duty Fees
- Prizes and Awards
    - Prizes and awards are taxable
    - Exceptions:
        - Selection without any action on the recipient's part.
        - Services not required of the recipient.
        - Charity or government gets the payment as assigned by the recipient.
- Punitive Damages
- Scholarships and Grants
    - Non-Degree Students: Taxable
    - Degree Students: Non-Taxable to the extent used for tuition and fees, books, supplies, and equipment.
- Income Earned by Decedent

- Exclusions from Gross Income
    - Foreign Earned Income Exclusion
    - Alimony Received for divorce or separation agreements executed or modified on or after January 1, 2019.
    - Inheritance and Gifts
    - Life Insurance Policy
    - Medical Benefits

# Adjustments (Above the Line Deductions)

- Contributions to HSA: Health Savings Account

| | HSA: Health Savings Account / MSA: Medical Savings Account Deduction |
|---|---|
| Contribution | • Deductible<br>• $4,400 (Individual) & $8,750 (Family) (for 2026)<br>• Additional $1,000 Contribution allowed for Individuals aged 55 and above |
| Distributions | • Non-Taxable if used for Qualified Medical Expenses |
| Penalty on Non-Qualified Use | • 20% Penalty + Income Tax if the distribution is not used for medical expenses. |

- Contributions Individual Retirement Account (IRA)

| Retirement Account | Deductibility | Contribution Limit | Additional Contribution | Retirement Savings Contribution Credit |
|---|---|---|---|---|
| Traditional IRA | Deductible.<br><br>Contributions to a Traditional Individual Retirement Account (IRA) may be Fully, Partially, or Non-Deductible depending on the Taxpayer's Income Level and participation in an Employer-Sponsored Retirement Plan. | Lesser of<br>• $7,500 (Single) & $15,000 (MFJ) (for 2026)<br>• Earned Income (Wage, Business & Alimony).<br><br>This annual limit applies to the combined total of the taxpayer's contributions to all Traditional and Roth IRAs and it is not a separate limit for each. | An additional $1,100 (for 2026) is allowed for Individuals aged 50 and above | Allows Retirement Savings Contribution Credit for up to 50% on $2,000 Contributions for Low-Income Groups |
| Roth IRA | Non-Deductible | Lesser of<br>• $7,500 (Single) & $15,000 (MFJ) (for 2026)<br>• Earned Income (Wage, Business & Alimony).<br><br>This annual limit applies to the combined total of the taxpayer's contributions to all Traditional and Roth IRAs and it is not a separate limit for each. | An additional $1,100 (for 2026) is allowed for Individuals aged 50 and above | Allows Retirement Savings Contribution Credit for up to 50% on $2,000 Contributions for Low-Income Groups |
| Coverdell IRA (ESA) | Non-Deductible | $2,000 | N/A | N/A |

- Alimony Paid

| | |
|---|---|
| Divorces finalized prior to January 1, 2019 | • **Alimony Received:** Taxable<br>• **Alimony Paid:** Deductible |
| Divorces finalized on or after January 1, 2019 | • **Alimony Received:** Not Taxable<br>• **Alimony Paid:** Not Deductible |

- Withdrawal of Savings Penalty

- Educator Expenses

  - Educators in primary and secondary schools can deduct up to $350 (for 2026) of unreimbursed qualified teaching expenses

- Student Loan Interest Deduction

  - Individuals can deduct the lesser of $2,500 or the amount of interest paid on a student loan for the tax year for themselves, spouse, or dependents.

- Moving Expenses for Members of the Armed Forces and U.S. Intelligence Community

- Legal Fees for Discrimination Suit

- Jury Duty Fees Paid to Your Employer

- Deductions for Self-Employed

  - Self-Employment Taxes

    - Self-employed individuals are allowed to deduct the employer's portion of self-employment taxes (7.65%) paid by them which is 50% of total Self-Employment Taxes paid.

  - Self-Employment Health Insurance Deduction

  - Self-Employed Retirement Plans

| | Qualified Pension and Retirement Plans | Non-Qualified Pension and Retirement Plans |
|---|---|---|
| Contributions | Deductible | Non-Deductible |
| Distributions: Principal | Taxable | Non-Taxable |
| Distributions: Interest | Taxable | Taxable |

## Standard Deduction

- Standard Deduction Limits (for 2026)

| Filing Status | Standard Deduction |
|---|---|
| Single/Married Filing Separately | $16,100 |
| Married Filing Jointly/Qualifying Widow(er) | $32,200 |
| Head of Household | $24,150 |

- Additional Standard Deduction (for 2026)

| | Single | Married Filing Jointly |
|---|---|---|
| Single / Only 1 Spouse Qualify | | |
| 65 or Blind | $2,050 | $1,650 |
| 65 and Blind | $4,100 | $3,300 |
| Both Spouses Qualify | | |
| Each 65 or Blind | - | $3,300 |
| Both 65 and Blind | - | $6,600 |

- Standard Deduction – Individuals Claimed as Dependents
    - For dependents of others, the Standard Deduction is the greater of $1,350 or earned income + $450 for 2026 but must not exceed the regular Standard Deduction.

- Charitable Contribution Deduction for Non-Itemizers
    - Above-the-Line Deduction available only to taxpayers who claim the Standard Deduction.
    - Fixed Amounts: $1,000 (Single) / $2,000 (MFJ).
    - Eligible Contributions: Cash gifts to Qualifying Public Charities only.
    - Mutually Exclusive with Itemizing: Taxpayers who itemize must claim Charitable Contributions on Schedule A and cannot claim this Above-the-Line Deduction.

# Itemized Deductions

- Medical Expenses (In Excess of 7.5% of AGI)
  - Qualified Medical Expenses for Self, Spouse and Dependents
    - To claim someone as a dependent for Medical Expenses, they must meet the following criteria:
      - Taxpayer must provide more than half of the person's total support for the tax year
      - The person must either live with the taxpayer all year as a member of taxpayer's household or be related to taxpayer as a child, sibling, parent, grandparent, niece, nephew, aunt, uncle, or in-law
      - Citizen of United States or Resident of United States, Mexico or Canada
    - However, they are not required to meet the Gross Income (Gross Income less than $5,300 for 2026) or Joint Return (No Joint Return) criteria which is required to meet the definition of Qualifying Relative.
  - Qualified and Non-Qualified Medical Expenses

| Qualified Medical Expenses | Non-Qualified Medical Expenses |
|---|---|
| • Prescribed drugs and medicines. | • Over-the-counter drugs not prescribed by a physician |
| • Fees paid to medical practitioners, including doctors, dentists, and surgeons. | • General health costs, like Gym Memberships and Health Club Membership, that aren't prescribed by a physician for a specific health condition |
| • Travel Costs for Medical Care (Actual Costs or Standard Mileage Rate of $0.205/mile for 2026) | • Personal hygiene items and ordinary personal care expenses. |
| • Meals and Lodging provided by a hospital or similar institution during medical treatment. | • Household help. |
| • Stop-Smoking Programs | • Illegal operations or treatments. |
| • Weight-Loss Programs (only if the purpose is to treat obesity or other disease) | • Cosmetic surgery purely for aesthetic reasons. |
| • Surgery including plastic/cosmetic surgery done to cure the disfiguring injury, illness, or birth defects.<br>• LASIK surgery | • The Medicare portion of Social Security and Self-Employment Taxes. |
| • Insurance Premiums for Medical, Dental, Hospital care, and Qualifying Long-Term Care Policies | • Insurance premiums for Accident, Disability, and Life Insurance. |
| • Medical Equipment and devices like eyeglasses, hearing aids, false teeth, etc. | • Funeral and Burial Expenses. |
| • Costs to install medically prescribed facilities or remove structural barriers at home for | |

| | |
|---|---|
| physically handicapped such as swimming pool, elevator, etc.<br>⇒ Deduction = Cost of Home Improvement – Increase in FMV | |

- Calculation of Deductible Medical Expenses

| Qualified Medical Expense | XXX |
|---|---|
| <Insurance/Employer Reimbursement> | (XXX) |
| **Medical Expense Paid** | **XXX** |
| <7.5% of AGI> | (XXX) |
| **Deductible Medical Expenses** | **XXX** |

- State/Local/Foreign Taxes (SALT) (up to $40,400) (for 2026)

| Deductible Taxes | Non-Deductible Taxes |
|---|---|
| • State and Local Income Taxes or State and Local Sales Tax | • Federal Income Tax |
| • State and Local Personal and Real Property Tax | • Federal, State, and Local Estate or Gift Taxes |
| • Foreign Income Tax | • Social Security and Self-Employment Taxes |
| | • Business Taxes. |
| | • Foreign Sales Tax, Real Property Tax, and Personal Property Tax |

  - The increased SALT limit is subject to a phase-out for high-income taxpayers. For 2026, the deduction is reduced by 30% of the amount by which Modified Adjusted Gross Income (MAGI) exceeds:
    - $505,000 for Joint Filers, Surviving Spouses, and Single Filers
    - $252,500 for Married Filing Separately

- Interest Expense

| Deductible Interest | Non-Deductible Interest |
|---|---|
| • Home Mortgage Interest | • Personal Consumer Interest |
| • Investment Interest Expense | • Education Loan Interest |
| • Home Equity Loans | • Prepaid Interest |
| • Mortgage Insurance Premiums | |

- Charitable Contributions
  - Charitable Contributions made to Qualified Charitable Organizations by cash, check, credit card, or property are allowed as an Itemized Deduction on Schedule A, subject to AGI ceiling limitations that depend on the type of property contributed, with only the amount remaining above the 0.5% of AGI floor ultimately deductible.
  - Charitable Contribution Ceilings

| Contribution Type | Deduction | Deduction Limit |
|---|---|---|
| Cash | Amount Contributed | Up To 60% of Adjusted Gross Income (AGI) |
| Ordinary Income Property | Lower of Basis or FMV of Property | Up To 50% of Adjusted Gross Income (AGI) |
| Long-Term Property | FMV of Property | Up To 30% of Adjusted Gross Income (AGI) |

  - Charitable Contribution Floor
    - Only Charitable Contributions more than 0.5% of AGI are deductible. The 0.5% floor is applied to Total Aggregate Contributions after the AGI ceilings are applied.
  - Carryover of Excess (5 Years)
    - Contributions more than the AGI ceilings may be carried forward for up to 5 years on a First-In, First-Out Basis.
    - If the taxpayer's Total Contributions exceed the AGI ceiling, both the ceiling-excess amount and the amount disallowed by the 0.5% floor carry forward 5 years.
    - If the taxpayer's Total Contributions do not exceed the AGI ceiling, the amount disallowed by the 0.5% floor is permanently lost (no carryforward).
  - Charitable Contribution Deduction Calculation

| | |
|---|---|
| Charitable Contribution | XXX |
| <Benefits Received> | (XXX) |
| Qualified Contribution | XXX |
| <AGI Ceiling Limitation> | (XXX) |
| Deductible Contribution before Floor | XXX |
| <0.5% of AGI> | (XXX) |
| Charitable Contribution Deduction | **XXX** |

- Deductible and Non-Deductible Charitable Contribution

| Deductible Charitable Contribution | Non-Deductible Charitable Contribution |
|---|---|
| • Charitable Contributions to Qualified Domestic Organizations for religious, charitable, scientific, literary, or educational purposes. | • Contributions to individuals or non-qualified organizations civic leagues, social clubs, foreign organizations, political organizations, communist organizations, chambers of commerce, and labor unions. |
| • Out-of-pocket costs incurred while doing work for a charitable organization. | • Cannot deduct the value of taxpayer’s time or services that taxpayer donates to a charitable organization. |
| • $50 per student per month for every completed month of an unrelated student staying in a taxpayer's home on agreement with a qualified organization. | • Cannot deduct the value of the use of a property that the taxpayer allows to a charitable organization. |
| | • Cannot deduct the value of Blood Donation |

- Timing of Deduction
  - Cash or Check: Deductible when actually paid.
  - Credit Card: Deductible when charged, even if payment to the bank occurs in the following year.
- Substantiation Requirements
  - Regardless of the amount, taxpayers must keep records (bank record or written acknowledgement from the charity) to substantiate cash contributions.
- Multiple Types of Property Contribution
  - **Step 1: Cash -** Cash Contributions are deductible up to 60% of AGI.
  - **Step 2: Ordinary Income Property -** Ordinary Income Property is deductible up to 50% of AGI, minus the cash already deducted in Step 1. Even though cash has a higher 60% ceiling, the first 50% of AGI is shared between Cash and Ordinary Income Property. Cash takes its share first, and Ordinary Income Property gets whatever room remains under the 50% line.
  - **Step 3: LTCG Property -** LTCG property is deductible up to the lesser of:
    - 30% of AGI, OR
    - 50% of AGI minus the Cash and Ordinary Income Property already deducted in Steps 1 and 2.

    LTCG has its own absolute cap at 30% of AGI, but it also competes for the same 50% bucket. The taxpayer receives the smaller of the two.

- Casualty Losses (In Excess of 10% of AGI)
  - Personal Casualty Losses are deductible as an itemized deduction on Schedule A only if the loss is attributable to a Federally Declared Disaster or a State-Declared Disaster, and only to the extent the total losses exceed 10% of AGI.
  - Deductible and Non-Deductible Casualty Losses

| Deductible Casualty Losses | Non-Deductible Casualty Losses |
|---|---|
| • Personal Property Losses that occurred due to a Federally Declared Disaster or a State-Declared Disaster | • Personal Property Losses that occurred due to a Federally Declared Disaster or a State-Declared Disaster (Note: Business Property Casualty Losses are deductible, but as a business loss rather than as an itemized deduction.) |
| | • Progressive Damage that happens over time, such as wear and tear or deterioration. |
| | • Casualty Insurance Premiums for insurance coverage |
| | • Incidental Expenses such as temporary housing, meals, and transportation costs incurred due to a casualty or disaster, but not directly related to the damage or destruction of property, are not deductible as a casualty loss. |

  - Casualty Loss Deduction Calculation

| | |
|---|---|
| Drop in FMV (Limited to Tax Basis of the Asset) | XXX |
| <Insurance/Government Reimbursement> | (XXX) |
| <$100 per event> | ($100) |
| **Loss Eligible for Deduction** | **XXX** |
| <10% of AGI> | (XXX) |
| **Deductible Casualty Loss** | **XXX** |

- Gambling Losses
  - Gambling Losses are allowed as an Itemized Deduction on Schedule A.
  - For tax years beginning in 2026, the deduction is limited to the lesser of:
    - 90% of the taxpayer's Gambling Losses for the year, or
    - The taxpayer's Gambling Winnings for the year (included in Gross Income).
  - Net Gambling Losses cannot offset other types of income.

- Federal Estate Tax on Income in Respect of a Decedent (IRD)
  - Income in Respect of a Decedent (IRD) refers to income that a decedent was entitled to receive but had not received before death.
  - IRD is subject to potential double taxation because it is included in both:
    - The decedent's gross estate (subject to federal estate tax), and
    - The recipient's gross income when received (subject to federal income tax).
  - To mitigate this double taxation, the recipient of the IRD is allowed an itemized deduction on Schedule A for the portion of the federal estate tax that is attributable to the IRD being included in the decedent's gross estate.
  - This deduction is not subject to the 2% AGI floor.
- Educator Expenses
  - Eligible Educators may claim an Itemized Deduction on Schedule A for any Qualified Teaching Expenses exceeding the $350 (for 2026) Above-the-Line limit.
  - There is no dollar limit on this Itemized Deduction.
- Limitation on Itemized Deductions for High-Income Taxpayers
  - Total amount of Itemized Deductions allowed for taxpayers in the Top (37%) Federal Income Tax Bracket is reduced.
  - This limitation effectively caps the tax benefit of Itemized Deductions at 35 cents per dollar for these taxpayers, rather than the full 37 cents.

# Qualified Business Income (QBI) Deduction

- Step 1: Calculate Tentative QBI Deduction
  - Tentative QBI Deduction = QBI x 20%
- Step 2: Apply Phase-Out (Wage and Property Limitation)
  - Phase-out of QBI Deduction is based on 2 factors:
    - Taxable Income of the Taxpayer.
    - Whether the business is Qualified Trade or Business (QTB) or Specified Service Trade or Business (SSTB).
  - Phase-Outs will be based on Wage and Property Limitation. Wage and property limitation is greater of:
    - 50% of the W-2 wages relating to the qualified trade or business
    - (25% of the W-2 wages relating to the business) + (2.5% percent of the unadjusted basis immediately after acquisition of all qualified property)
  - Therefore, QBI Deduction after phase-outs for 2026 will be calculated based on the following formula:

| | Taxable Income | | QTB | SSTB |
|---|---|---|---|---|
| | Single | MFJ | | |
| **Below Threshold** | $201,750 | $403,500 | Full 20% Deduction | Full 20% Deduction |
| **Between Threshold** | $201,750 – $276,750 | $403,500 – $553,500 | QBI Deduction - [(QBI Deduction - W-2 Wage & Property Limitation) x Phase-in Percentage] | [(1 - Phase-in %) x QBI Deduction] - {[(1- Phase-in %) x QBI Deduction)] - [(1- Phase-in %) x W-2 Wage & Property Limitation]} x Phase-in Percentage Used up |
| **Above Threshold** | $276,750 | $553,500 | QBI Deduction Limited to W-2 Wage & Property Limitation | No QBI Deduction |

  - Phase-in % calculation (For 2026):
    - Single: (Taxable Income – $201,750) / $75,000
    - MFJ: (Taxable Income – $403,500) / $150,000

- Step 3: Apply Overall Limitation
    - The final QBI deduction would be limited to an overall limitation calculated as 20% of (Taxable Income – Capital Gain) of the taxpayer.
- Step 4: Apply Minimum Deduction
    - Taxpayers with at least $1,000 of QBI from an active trade or business in which they materially participate are entitled to a minimum QBI deduction of $400 (For 2026). If the deduction calculated under Steps 1–3 is less than $400 (or zero), the taxpayer claims the $400 minimum instead.
    - Exception: The $400 minimum does not apply to SSTB owners whose taxable income exceeds the SSTB phase-out threshold, because those taxpayers are not eligible for any QBI deduction.

## Additional Deductions (2025 – 2028)

- Tips Deduction
    - Deduction available whether taxpayer Itemizes or takes the Standard Deduction.
    - Up to $25,000 of Qualified Tips per year.
- Qualified Overtime Compensation Deduction
    - Deduction available whether taxpayer Itemizes or takes the Standard Deduction.
    - Up to $12,500 (Single) / $25,000 (MFJ) per year.
    - Only the premium portion qualifies (the half-time amount above the regular hourly rate). The regular-rate portion does not qualify.
- Car Loan Interest Deduction
    - Deduction available whether taxpayer Itemizes or takes the Standard Deduction.
    - Up to $10,000 of Qualified Car Loan Interest per year.
- Enhanced Senior Deduction
    - Deduction available whether taxpayer Itemizes or takes the Standard Deduction.
    - In addition to the existing Additional Standard Deduction for age 65 or older
    - Deduction Limit: $6,000 per qualifying spouse. Up to $6,000 (Single) / $12,000 (MFJ if both spouses age 65+).

## Tax Rates (2026)

| Tax Rate | Single | Head of Household | Married MFJ / QW | MFS |
|---|---|---|---|---|
| 10% | Up to $12,400 | Up to $17,700 | Up to $24,800 | Up to $12,400 |
| 12% | $12,401 to $50,400 | $17,701 to $67,450 | $24,801 to $100,800 | $12,401 to $50,400 |
| 22% | $50,401 to $105,700 | $67,451 to $105,700 | $100,801 to $211,400 | $50,401 to $105,700 |
| 24% | $105,701 to $201,775 | $105,701 to $201,775 | $211,401 to $403,550 | $105,701 to $201,775 |
| 32% | $201,776 to $256,225 | $201,776 to $256,200 | $403,551 to $512,450 | $201,776 to $256,225 |
| 35% | $256,226 to $640,600 | $256,201 to $640,600 | $512,451 to $768,700 | $256,226 to $384,350 |
| 37% | $640,601 or more | $640,601 or more | $768,701 or more | $384,351 or more |

## Tax Credits

| Tax Credit | Description | Credit Amount |
|---|---|---|
| Refundable Credit | | |
| Child Tax Credit | Aids taxpayers with qualifying dependent children | Up to $2,200 per qualifying child (for 2026) |
| American Opportunity Tax Credit | Education credit for qualified expenses in the first 4 years of college | Up to $2,500 per eligible student |
| Earned Income Credit | Assistance for low-to-moderate-income individuals and families with earned income | Maximum credit amounts based on the number of qualifying children |
| Premium Tax Credit | Helps low-income individuals and families afford health insurance coverage. | Depending upon the taxpayer’s income, the cost of coverage in the taxpayer’s area, and the size of the taxpayer’s household, |
| Adoption Credit | Helps with expenses incurred for adopting a child under 18 years of age | Limited to $17,670 per child (for 2026) |
| Non-Refundable Credit | | |
| Lifetime Learning Credit | Education credit for qualified expenses beyond the first 4 years of college | Up to $2,000 per taxpayer |
| Dependent and Child Care Credit | Provides assistance for child and dependent care expenses | Percentage of qualifying expenses, up to $3,000 for one dependent or $6,000 for multiple dependents |
| Elderly and Disabled Credit | Credit for individuals over 65 years or permanently disabled | 15% of Eligible Income |
| Credit for Other Dependents | Credit for eligible dependents that do not qualify for the Child Tax Credit | Up to $500 per eligible dependent |
| Retirement Savings Contribution Credit | Credit for contributions to retirement savings accounts | Percentage of eligible contributions, up to $2,000 |
| Foreign Tax Credit | Credit for foreign income taxes paid to a foreign government | Actual foreign taxes paid, subject to foreign tax credit limitation |
| General Business Credits | Various credits available to businesses for qualifying activities | Varies depending on the type of credit |

# Other Taxes

- Federal Insurance Contributions Act (FICA) Tax & Self-Employment Tax
  - Employee

| | Employer's FICA Contribution | Employee's FICA Contribution | Total |
|---|---|---|---|
| FICA Social Security | 6.2% | 6.2% | 12.4% |
| FICA Medicare | 1.45% | 1.45% | 2.9% |
| Total Contribution | 7.65% | 7.65% | 15.3% |

    - Withhold employees' shares from Wages
    - Employer's FICA Share is Deductible as a business expense.
  - Self Employed Individuals
    - Self-Employed Individuals are required to pay both Employee's and Employers' share of FICA which is equal to 15.3%.
    - Allowed to deduct the employer's portion of self-employment taxes (7.65%) paid by them which is 50% of total Self-Employment Taxes paid.
- Kiddie Tax
  - The Kiddie Tax is a tax that applies to the unearned income of children
  - Applies to children under the age of 18 and certain full-time students under the age of 24.
  - A child is subject to kiddie tax if the following conditions are met:
    - Have net unearned income above $2,700 (threshold amount for 2026).
    - Is under age 18, or is age 18 to under 24, a full-time student, and does not provide more than one-half of their own support.
  - Kiddie Tax Calculation

| | |
|---|---|
| Child's Unearned Income | |
| ($2,700) | |
| **Net Unearned Minor Income** → | Taxed at Parent's Marginal Tax Rates |

- Net Investment Income Tax
    - The Net Investment Income Tax (NIIT) is a 3.8% tax that applies to certain net investment income of individuals, estates, and trusts with income above the statutory threshold amounts.
    - Net Investment Income Tax Calculation
        - Net Investment Income Tax (NIIT) applies to the lesser of:
            - ➢ Net Investment Income
            - ➢ Amount by which Modified Adjusted Gross Income exceeds the thresholds:
              Modified Adjusted Gross Income - \$200,000 (Single) / \$250,000 (MFJ) / \$125,000 (MFS)

## Estimated Payments & Withholdings

- Estimated Payments
    - Estimated tax payments are typically due in four equal installments as follows:
        - 1st payment: April 15.
        - 2nd payment: June 15.
        - 3rd payment: September 15.
        - 4th payment: January 15 of the following year.
    - Penalty for Failure to Make Estimated Tax Payments
        - Penalty for underpayment of Estimated Taxes will not apply in the following circumstances:
            - ➢ Taxpayer owes less than \$1,000 on the tax return due date (April 15).
            - ➢ Estimated Tax Payments are equal to the lesser of:
                - ⇒ Withholding and Estimated Tax Payments is at least 90% of the Current Year Tax Liability.
                - ⇒ Withholding and Estimated Tax Payments are at least 100% of the Prior Year's Tax Liability (Withholding and Estimated Tax Payments are at least 110% of the Prior Year's Tax Liability if the Prior Year AGI was more than \$150,000)
            - ➢ Zero tax liability in the Prior Year.
- Withholdings
    - Income taxes that are withheld and paid directly by an individual's employer on their behalf.

# NINJA NOTES

## Tax Compliance & Planning 2026

# C-Corporation Taxation

**(July 1, 2026 – June 30, 2027 Exams)**

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# C-Corporation Taxation

## Formation

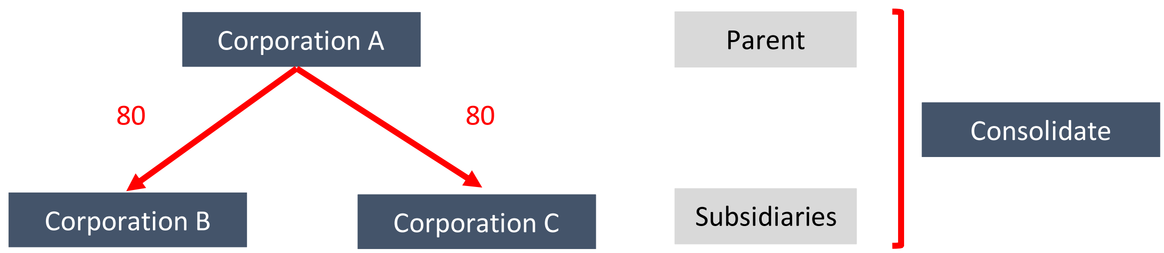
| Transactions | Gain / Loss for Shareholder | Shareholder's Basis in C-Corporation Stock | Gain / Loss for Corporation | Corporations Basis in Property |
|---|---|---|---|---|
| Issuance of Stock in Exchange for Cash | | | | |
| Issuance of Stock in Exchange for Cash | • No Gain or Loss | • Value of Cash Contributed | • No Gain or Loss | • Value of Cash Contributed |
| Issuance of Stock in Exchange for Property | | | | |
| Contributors of Cash and Property > 80% or More control | • Gain Realized = FMV – Basis<br>• Gain Recognized = $0 | • Basis of Property Contributed - Mortgage Debt Given Up | • No Gain or Loss | • Shareholder's Carryover Basis |
| Contributors of Cash and Property < 80% or More control | • Gain Realized & Recognized = FMV – Basis | • Basis of Property Contributed - Mortgage Debt Given Up + Gain Recognized | • No Gain or Loss | • Shareholder's Carryover Basis + Gain Recognized by the Shareholder |
| Boot is received by the shareholder along with stock | • Gain Realized = FMV – Basis<br>• Gain Recognized = Lesser of Gain Realized or Boot Received | • Basis of Property Contributed - Mortgage Debt Given Up + Gain Recognized - Boot Received | • No Gain or Loss | • Shareholder's Carryover Basis + Gain Recognized by the Shareholder |
| Mortgage Debt Exceeds the Basis of Property | • Gain Realized = FMV – Basis<br>• Gain Recognized = Mortgage Debt – Basis | • Basis of Property Contributed - Mortgage Debt Given Up + Gain Recognized ($0) | • No Gain or Loss | • Shareholder's Carryover Basis + Gain Recognized by the Shareholder |
| Shareholder's Basis of Property > FMV of Property | • Loss Realized = Basis – FMV<br>• Loss Recognized = $0 | • Basis of Property Contributed - Mortgage Debt Given Up | • No Gain or Loss | • FMV of Property (Shareholder's Carryover Basis - Loss Realized by the Shareholder) |
| Issuance of Stock in Exchange for Services | | | | |
| Issuance of Stock in Exchange for Services | • Ordinary Income = FMV of Stock Received | • FMV of Stock Received | • Value of Stock Issued for Services will be taken as Expense Deduction | • Corporation will have no basis in service since it was an expense |

# C-Corporation Filing Requirements

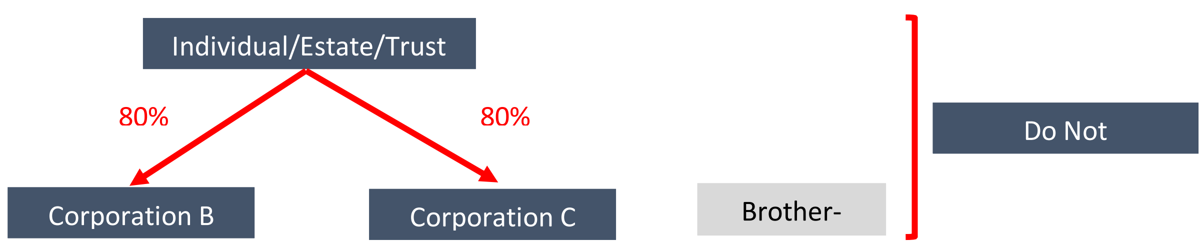
- Filing Requirements of Form 1120
    - Who must file Form 1120?
        - All C-Corporations must file Form 1120 even if they have no taxable income.
    - When to file Form 1120?
        - A C-Corporation must file Form 1120 with the IRS on or before 3.5 months after the close of its tax year.
        - For a calendar year (January to December) corporation, the return is due April 15.
- Tax Accounting Basis: Cash & Accrual
    - Cash Basis
        - C-Corporations that have average annual gross receipts of $32 Million or less (for 2026) during the preceding 3 Years.
        - Qualified Personal Service Corporations where at least 95% of shares are held by qualified shareholders including employees.
    - Accrual Basis
        - C-Corporations that have average annual gross receipts of more than $32 Million (for 2026) during the preceding 3 Years.
        - Tax Shelters
- Amended Returns
    - Amended Return or Claim of Refunds may be filed up to the later of:
        - 3 Years after the Date of filing the return
        - 2 Years after Tax Payment Date
- IRS Statute of Limitations

| | |
|---|---|
| Error or Simple Negligence | 3 years after later of Due Date or Filing Date |
| Gross Negligence | 6 years after later of Due Date or Filing Date |
| Fraud or Failure to File | No Time Limit |

- Consolidated Tax Returns
  - C-Corporations owning more than 80% of voting power and stock of other C-corporations can elect to file a consolidated return.
  - Who Can Consolidate?
    - Parent-Subsidiary Entities




  - Who Cannot Consolidate?
    - C-Corps and S-Corps
    - Brother-Sister Entities




  - Consolidated Taxable Income Calculation
    - Step 1: Calculate Each Member's Stand-Alone Taxable Income
    - Step 2: Adjust for Intercompany Transactions: Remove the effects of transactions between members of the Consolidated Group:
      - Intercompany Dividends
      - Intercompany Inventory Sales
      - Intercompany Sales of Other Assets
    - Step 3: Remove Items Determined at the Consolidated Level
      - Capital Gains and Losses

  - Section 1231 Gains and Losses
  - Net Operating Loss (NOL)
  - Charitable Contribution Deduction (subject to OBBBA's 1% of ATI floor and 10% of ATI ceiling for C-corporations)
  - Dividends Received Deduction (DRD) on dividends from Non-Group Corporations
- Step 4: Combine the Adjusted Member Amounts
- Step 5: Apply Consolidated-Level Adjustments: Recalculate at the Consolidated Level the items removed in Step 3:
  - Capital Gains and Losses
  - Section 1231 Gains and Losses
  - NOL
  - Charitable Contribution Deduction
  - DRD.

## Overview of Form 1120

| |
|---|
| Gross Income |
| <Ordinary Deductions> |
| <Charitable Contributions Deductions> |
| **Income Before NOL Deduction & Special Deduction (DRD)** |
| <Net Operating Loss Deduction> |
| **Income Before Special Deduction** |
| <Dividend Received Deduction> |
| **Taxable Income** |
| x Tax Rate (21%) |
| **Gross Tax Liability** |
| <Tax Credits> |
| <Estimated Tax Payments> |
| Underpayment Penalties & Interest |
| Accumulated Earnings Tax or Personal Holding Company Tax |
| Base Erosion Anti-Abuse Tax (BEAT) |
| **Total Tax Liability** |

# Net Operating Loss Deduction

| | |
|---|---|
| Carryback | Not Allowed |
| Carryforward | Carry Forward Indefinitely but can offset up to 80% of Taxable Income |

- Limitations on Net Operating Loss (NOL) Deduction in Case of Ownership Changes
  - A Corporation could acquire another Corporation with NOL and immediately utilize the acquired company's NOL to offset its own taxable income. This could result in significant tax savings for the acquiring corporation, as it could substantially reduce its tax liability by using the NOLs of the Loss-Making Corporation.
  - This could incentivize acquiring corporations to engage in transactions primarily for the purpose of using the NOLs, rather than for legitimate business reasons.
  - Section 382 exists to prevent these abusive tax planning strategies that aim to inappropriately exploit NOLs.
  - To prevent abuse, when a corporation acquires a loss-making corporation, no NOL carryover should be allowed. However, there can be legitimate business transactions that happen to involve a Loss-Making Corporation.
  - As such, Acquiring Corporations should be allowed to deduct the portion of NOL that the Loss-Making Corporation could have used had it not been acquired.
  - Section 382 Annual Limitation: Calculation
    - The Annual Limitation under Section 382 restricts the amount of NOLs that can be utilized in a given year after an ownership change, which is calculated as follows:

| | |
|---|---|
| Value of Corporation's Stock before the Ownership Change | |
| x Applicable Federal Long-Term, Tax-Exempt Interest Rate | Adjusted Federal Long-Term Tax-Exempt Rate is higher of rate for the month of the ownership change and the prior two months |
| **Section 382 Limitation** | |

    - This 382 Annual Limitation would apply in addition to the 80% limitation.

## Tax Treatment of Capital Gains and Losses: Corporations

| Type | Tax Treatment |
|---|---|
| Net Short-Term Capital Gain | • Short-Term Capital Gains are taxed at Ordinary Corporate Income Tax Rates |
| Net Short-Term Capital Loss | • Short-Term Capital Loss may be deducted only to the extent of the Capital Gain during the year.<br>• Net Short-Term Capital Losses not allowed as a deduction can be carried back 3 years and carried forward 5-years. Short-Term Capital Losses retain their character when carried back or forward. |
| Net Long-Term Capital Gain | • Long-Term Capital Gains are taxed at Ordinary Corporate Income Tax Rates |
| Net Long-Term Capital Loss | • Long-Term Capital Loss may be deducted only to the extent of the Capital Gain during the year.<br>• Net Long-Term Capital Losses not allowed as a deduction can be carried back 3 years and carried forward 5-years. Long-Term Capital Losses are converted to Short-Term when carried back or forward. |

## Foreign Tax Credit

- Foreign Tax credit is available to U.S. corporations for income taxes paid to foreign countries on income that is also reported on the U.S. tax return.

- Foreign tax credit is calculated as actual foreign taxes paid, subject to the following limitation:

    - $$\text{Foreign Tax Credit Limitation} = \text{US Tax Liability} \times \frac{\text{Foreign Income}}{\text{Worldwide Income}}$$

- Foreign Tax Credit in excess of limitation may be carried back 1 year and carried forward 10 years.

## Estimated Tax Payments

- C-Corporations are generally required to make estimated tax payments if they expect their estimated tax to be $500 or more.
- The due dates for estimated tax payments are as follows:
  - 1st Quarter Payment: Due by the 15th day of the 4th month (April 15)
  - 2nd Quarter Payment: Due by the 15th day of the 6th month (June 15)
  - 3rd Quarter Payment: Due by the 15th day of the 9th month (September 15)
  - 4th Quarter Payment: Due by the 15th day of the 12th month (December 15).
- Each Payment is equal to 25 percent of the Corporation's Annual Required Payment. The Minimum Annual Required Payment is the Lowest of three options:
  - Option 1: 100% of the Corporation's Tax Liability in the Current Year.
  - Option 2: 100% of the Corporation's Tax Liability on the Prior Year's Tax Return. Subject to two restrictions discussed below:
    - Large Corporations: Large Corporations are Corporations with taxable income of more than $1,000,000 in any of the preceding 3 Years. Large Corporations may use the 100% Prior Year Safe Harbor only for the first Quarter Payment. For the Second, Third, and fourth Quarter Payments, Large Corporations must use Option 1 (Current Year Actual) or Option 3 (Annualization).
    - All Corporations: Option 2 is unavailable if the Corporation had No Tax Liability on the Prior Year Tax Return, or if the Prior Tax Year was less than 12 months.
  - Option 3: 100% of the Corporation's Estimated Tax Liability for the Current Year using the Annualized Quarterly Taxable Income Method. The annualization factor and required cumulative payment percentage for each quarter are:

| Quarter | Months of Income Considered | Annualization Factor | Cumulative Required Payment |
|---|---|---|---|
| 1st Quarter | Months 1 to 3 | 12/3 | 25% of Annualized Tax |
| 2nd Quarter | Months 1 to 3 | 12/3 | 50% of Annualized Tax |
| 3rd Quarter | Months 1 to 6 | 12/6 | 75% of Annualized Tax |
| 4th Quarter | Months 1 to 9 | 12/9 | 100% of Annualized Tax |

## Underpayment Penalties & Interest

IRS will impose penalties and interest if a corporation fails to pay enough tax throughout the year, either through withholding or estimated tax payments.

# Earnings and Profit: Current Earnings and Profits & Accumulated Earnings and Profits

- Current Earnings and Profits (CEP)

| | |
|---|---|
| **Taxable Income** | **XXX** |
| Add: Tax-Exempt Income | XXX |
| Add: Life insurance Proceeds on the Death of a Key Employee | XXX |
| Add: Refunds of Federal Income Tax Paid | XXX |
| Add: Dividend Received Deduction | XXX |
| Add: Excess Depreciation Under Tax & Section 179 | XXX |
| Add: Organizational Expense Amortization | XXX |
| Add: NOL Deductions that have reduced the Current Year's Taxable Income | XXX |
| Add: Capital Loss Carryovers that have reduced the Current Year's Taxable Income | XXX |
| Add: Charitable Contribution Carryovers that have reduced the Current Year's Taxable Income | XXX |
| Less: Expenses to earn the Tax-Exempt Income | (XXX) |
| Less: Federal Income Taxes Paid | (XXX) |
| Less: Non-Deductible Fines, Penalties, Political Contributions, etc. | (XXX) |
| Less: Non-Deductible Meals and Entertainment | (XXX) |
| Less: Life Insurance Premiums for Key Employees | (XXX) |
| Less: Current Year Non-Deductible Capital Loss | (XXX) |
| Less: Current Year Non-Deductible Charitable Contribution | (XXX) |
| **Current Earnings & Profit** | **XXX** |

- Accumulated Earnings & Profits (AEP)

| | |
|---|---|
| **Opening Accumulated Earnings and Profit** | **XXX** |
| Add/Less: Current Earnings and Profits | XXX / (XXX) |
| Less: Distributions<br>• Cash Distributions: Amount Distributed<br>• Property Distributions: (Higher of FMV or Basis) - Liability | (XXX) |
| **Closing Accumulated Earnings and Profit** | **XXX** |

# Non-Liquidating Distributions

- Shareholder
  - Distribution Amount

| Type | Distribution Amount |
| --- | --- |
| Cash | Amount of Cash Received |
| Property | FMV of Property - Liability |
| Stock | FMV of Stock |

  - Tax Treatment

| Stock, Property or Cash Distribution | |
| --- | --- |
| Up to Higher of (CEP) or (CEP + AEP) | • Taxable Dividend (Taxed at Ordinary Income Tax Rates).<br>• Impact on CEP & AEP: Reduces CEP & AEP<br>• No Impact on Basis |
| Beyond CEP and AEP but up to Basis | • Non-Taxable Return of Capital.<br>• Reduces Shareholder's Basis in C-Corporation Stock |
| Beyond Basis | • Taxable Capital Gain (Taxed at Capital Gain Tax Rates). |

- Corporation

| | |
| --- | --- |
| Cash | No Gain or Loss is recognized |
| Property | Gain is recognized but Losses are not recognized |
| Stock | No Gain or Loss is recognized |

# Liquidating Distributions

| Transactions | Gain / Loss for Shareholder | Shareholder's Basis in Property | Gain / Loss for Corporation |
|---|---|---|---|
| C-Corp Distributes Cash | | | |
| C-Corp Distributes Cash | • Gain or Loss = Cash Received – Basis in Stock | • Basis in Cash = Amount of Cash Received (FMV) | • No Gain or Loss |
| C-Corp Sells Property and Distributes Cash | | | |
| C-Corp Sells Property and Distributes Cash | • Gain or Loss = Cash Received – Basis in Stock | • Basis in Cash = Amount of Cash Received (FMV) | • Gain or Loss = Cash Received – Basis in Property |
| C-Corp Distributes Property | | | |
| Property is not Subject to Liability | • Gain or Loss = FMV of Property – Basis in Stock | • Basis in Property = Basis in C-Corporation Stock +/- Gain or Loss Recognized (FMV) | • Gain or Loss = FMV of Property – Basis in Property |
| Property is Subject to Liability and Liability < FMV | • Gain or Loss = (FMV of Property – Liability Assumed) – Basis in Stock | • Basis in Property = Basis in C-Corporation Stock +/- Gain or Loss Recognized + Liability Assumed (FMV) | • Gain or Loss = FMV of Property – Basis in Property |
| Property is Subject to Liability and Liability > FMV | • Loss = Basis in Stock | • Basis in Property = Basis in C-Corporation Stock +/- Gain or Loss Recognized + Liability Assumed (Liability) | • Gain = Liability – Basis in Property |

## Loans Between C-Corporation and Shareholders

- When the interest rate on a loan between a C-Corporation and a Shareholder is below the Applicable Federal Rate (AFR), the IRS recharacterizes the transaction using imputed interest rules.
- Applicable Federal Rate (AFR)
    - The AFR is the minimum interest rate the IRS deems acceptable for loans between related parties. The IRS publishes short-term, mid-term, and long-term AFRs each month based on the loan's term. A loan made at or above the applicable AFR avoids imputed interest treatment.
- Imputed Interest Calculation
    - Imputed Interest Income = Principal Amount x (AFR – Interest Rate)
- Loans from C-Corporation to Shareholder (Below Market)
    - Imputed Interest Income to the Corporation
    - Imputed Income to the Shareholder-Borrower
        - The shareholder is treated as having received a Deemed Payment from the Corporation equal to the Imputed Interest, which is then treated as if paid back as Interest. The character of the Deemed Payment depends on the shareholder's relationship to the corporation:
            - Shareholder Only: Dividend Income
            - Shareholder who is also an Employee
                - ⇒ More than De Minimis Stock: Dividend Income
                - ⇒ De Minimis Stock: Compensation
- Loans from Shareholder to C-Corporation (Below Market)
    - Imputed Interest Expense to the Corporation
    - Imputed Interest Income to the Shareholder and Capital Contribution by Shareholder
- Documentation and Bona Fide Loan Status
    - To avoid recharacterization of a shareholder loan as a constructive dividend or capital contribution, the loan must be well-documented and have the characteristics of a bona fide loan

# Stock Redemptions and Corporate Reorganization

- Stock Redemption
  - Stock Redemption is when a corporation buys back its own shares from the marketplace, reducing the number of outstanding shares.
  - Tax Consequences of Stock Redemption

| | |
|---|---|
| Proportionate Redemption | • In a proportional redemption, the corporation repurchases shares from shareholders in a way that their percentage ownership in the corporation remains the same.<br><br>• In case of proportionate redemption, proceeds received is treated as a dividend distribution and taxed as dividend income as follows:<br>○ **Up to Earnings and Profits:** Dividend Income (Reduces E&P)<br>○ **Up to Basis:** Non-Taxable Return of Capital (Reduces Basis)<br>○ **Beyond Basis:** Capital Gain |
| Disproportionate Redemption | • In a Disproportionate Redemption, the corporation repurchases shares in a way that the shareholder's percentage ownership in the corporation is meaningfully reduced. A redemption qualifies as Substantially Disproportionate only if both of the following tests are met:<br>○ The shareholder's Ownership Percentage after the redemption is less than 50% of the Corporation's Outstanding Voting Stock, and<br>○ The shareholder's ownership percentage after the redemption is less than 80% of the shareholder's percentage before the redemption.<br><br>• For purposes of these tests, family attribution rules treat the shareholder as owning stock held by their spouse, children, grandchildren, and parents. Siblings are not attributed.<br><br>• In case of Disproportionate Redemption, the redemption is treated as a sale of the stock by the shareholder and capital gain or loss is recognized as follows:<br>Capital Gain or Loss = Proceeds − Basis in Stock |

  - Excise Tax on Stock Redemption
    - The Inflation Reduction Act of 2022 included a new 1% excise tax on repurchases of corporate stock. The tax is effective for repurchases of stock beginning after December 31, 2022.

- Corporate Reorganization
  - Corporate reorganization refers to a significant restructuring of a company's business operations, legal structure, or ownership.
  - Types of Reorganizations
    - Type “A” (Statutory Merger or Consolidation)
    - Type “B” (Stock for Stock)
    - Type “C” (Stock for Assets)
    - Type “D” (Divisive)
    - Type “E” (Recapitalization)
    - Type “F” (Change in Identity, Form, or Place)
    - Type “G” (Bankruptcy)
  - Tax Consequences of Reorganization

| | Gain or Loss | Basis in Stock and Basis in Property |
|---|---|---|
| Shareholders | No gain or loss is recognized to the shareholders of the corporations involved in a tax-free reorganization.<br><br>However, if they receive other property in addition to stock, it is treated as boot and gain is recognized equal to the lower of:<br>• Boot received, or<br>• Realized gain. | Shareholder’s Basis in Stock Received = Basis in Stock Surrendered + Gain Recognized – Boot Received |
| Corporation | Gain or loss generally is not recognized to the corporations involved in the reorganization. | Acquiring Corporations Basis in Property = Transferor’s Basis in Property |

# International Taxation Issues

- U.S. Taxation System
  - Worldwide Tax System
    - U.S. Citizens and Residents are taxed on worldwide income, regardless of where it's earned.
    - The 2017 Tax Cuts and Jobs Act allows U.S. corporations to claim a 100% dividends-received deduction on foreign-sourced dividends, effectively moving toward a territorial system for certain income types.
  - Territorial Tax System
    - Under a Territorial System, only income earned within the country is taxed. Foreign-Sourced Income is generally exempt.
    - Many OECD countries use this system, taxing only domestic income.
  - Taxation of Noncitizens and Nonresidents
    - Noncitizens and Nonresidents may be taxed as U.S. residents if they meet the Substantial Presence Test, based on days spent in the U.S.
    - Income connected to a U.S. trade or business is taxable in the U.S., even for foreign persons.
- Permanent Establishment
  - Permanent Establishment (PE) is used to determine the right of a country to tax a foreign company.
  - A PE usually arises when a foreign corporation has a sufficient level of activity or presence in another country that it becomes subject to tax in that country on its business profits.
  - Activities that could create a Permanent Establishment (PE) typically include:
    - Physical Presence
    - Duration
    - Dependent Agents: Having a dependent agent in a foreign country who has the authority to conclude contracts.

- Sourcing of Income
  - Interest
    - Interest Income is sourced to the residence of the payer.
  - Dividends
    - Dividend income is sourced to the country in which the payer corporation is created or organized.
  - Rents
    - Rental income is sourced to the location of the property being rented.
  - Royalties
    - Royalty is sourced to the location where the property is used.
  - Gain on Sale of Real Property
    - The source of income from the sale or exchange of real property is generally the location of the property.
  - Gain on Sale of Inventory
    - Sourcing of income from the sale of inventory depends on where the title to the inventory passes.
  - Services
    - The source of income for services is the location where the services are performed.
  - Special Exception for Short-Term Services by Nonresident Aliens
  - Underwriting Income
    - Amounts received as Underwriting Income derived from the issuing or reinsuring of any insurance or annuity contract are sourced based on where the underwriting activity occurs.
  - Social Security Benefits
    - Social Security Benefits paid by the U.S. government are sourced to the United States and are treated as U.S. Source Income.
  - Guarantees
    - From a Noncorporate U.S. Resident or Domestic Corporation: U.S. Source Income.
    - From a Foreign Person, if the amount is connected with income that is effectively connected with the conduct of a U.S. trade or business: U.S. Source Income.

- Taxability of Income from Foreign Operations of US Person
  - Foreign Branch
    - Foreign Branch is not a separate legal entity from the U.S. corporation. Instead, it is an extension of the U.S. corporation itself.
  - Foreign Subsidiaries
    - A Foreign Subsidiary, on the other hand, is a separate legal entity from a U.S. corporation.
    - Controlled Foreign Corporation (CFC) or a Special Foreign Corporation (SFC)
      - Controlled Foreign Corporation (CFC)
        - A CFC is defined as a foreign corporation where U.S. shareholders, each owning at least 10% of the corporation, collectively own more than 50% of the total value or voting power of the corporation's stock.
      - Special Foreign Corporation (SFC)
        - SFCs are foreign corporations that meet either of the following conditions:
          - The Corporation is a CFC
          - A Foreign Corporation where at least one U.S. corporation owns 10% or more of the foreign corporation's stock
    - Subpart F Income or Non-Subpart F Income
      - Subpart F Income
        - Foreign Personal Holding Company Income
          - Dividends, Interest, Rents, Royalties, Annuities and Income from the sale of property that produces passive income.
        - Foreign Base Company Sales Income
          - This is income earned from related party sales of personal property where the CFC's country is neither the origin nor the destination of the goods.
        - Foreign Base Company Services Income
          - This is income earned from related party services where the services are performed outside the CFC's country.
        - Foreign Base Company Oil-Related Income

- ☐ Income derived from the processing, transportation, distribution, or sale of oil, gas, or primary petroleum products outside the CFC's country of incorporation.

➢ Non-Subpart F Income

⇒ Non-Subpart F income refers to earned Income.

- Taxability of Income from Foreign Branch and Foreign Subsidiaries

| | Taxation | Exceptions |
|---|---|---|
| Foreign Branch | Taxed when earned at 21%. | |
| Foreign Subsidiary | Taxed only when repatriated subject to 100% Dividend Received Deduction | Section 965 Inclusion (CFC and SFC)<br>GILTI Inclusion (CFC) |

- Section 965 Inclusion

  - Background

➢ The Tax Reforms Act of 1986 made Dividend from Non-Subpart F Income Taxable only when repatriated to the U.S. as Dividend Income.

➢ U.S. corporations would keep profits earned by their foreign subsidiaries overseas to avoid the additional U.S. tax upon repatriation, leading to a buildup of undistributed foreign earnings.

➢ To counter this, the TCJA which is applicable from 1st Jan 2018, allowed 100% DRD.

➢ The Accumulated Untaxed Earnings made between 1986-2017 would be subject to a one-time transition tax, i.e., Section 965 Inclusion Tax, irrespective of repatriation.

➢ Section 965 Inclusion applies to both SFCs and CFCs.

  - Calculation

➢ At 15.5% of U.S. Shareholder's Portion of Cash Position

⇒ Tax Rate of 15.5% instead of 21% implies that only 73.81% (15.5%/21%) of the income is taxed, which is a deduction of 26.19%.

➢ At 8% of Remainder

⇒ A Tax Rate of 8% instead of 21% implies that only 38.19% (8%/21%) of the income is taxed which is a deduction of 61.90%

- U.S. Taxation of Foreign Persons
    - Definition of Foreign Person
        - Nonresident Alien Individuals
        - Foreign Corporations
        - Foreign Partnerships
        - Foreign Trusts and Estates
        - Any other non-U.S. persons
    - Categories of U.S. Source Income
        - Business Income
            - Taxed on a Net Basis (Gross Income minus Deductions) at graduated U.S. rates.
            - Reporting
                - U.S. Branches: Must file Form 1120-F.
                - U.S. Subsidiaries: Taxed as U.S. corporations, filing Form 1120.
        - Non-Business Income
            - Taxed on a Gross Basis at a 30% withholding rate. No deductions allowed.
            - Withholding rate may be reduced by tax treaties.
    - U.S. Withholding Tax Regimes for Nonbusiness Income
        - FDAP (Fixed, Determinable, Annual, or Periodic Income)
            - Passive income, such as interest, dividends, rents, and royalties, taxed at 30%.
            - Withholding is mandatory on the gross amount with no deductions.
        - FATCA (Foreign Account Tax Compliance Act of 2010)
            - Aims to prevent U.S. Tax Evasion via Foreign Financial Institutions (FFIs).
            - Imposes a 30% withholding tax on non-compliant FFIs and NFFEs.
            - FFIs must report U.S. Persons' accounts on Form 8966 FATCA Report.

- Foreign Persons Treated as U.S. Residents
  - Foreign Persons generally taxed only on U.S. Source income but may be taxed on Worldwide Income if treated as U.S. Residents.
    - Green Card Test: Foreign individuals with lawful, permanent U.S. residency are taxed as U.S. Residents.
    - Substantial Presence Test: Foreign Individuals are U.S. residents if:
      - ⇒ Present at least 31 days in the current year.
      - ⇒ Present for at least 183 days over a three-year period, using a weighted formula.
    - First-Year Election: A Foreign Individual can elect U.S. residency for tax purposes if:
      - ⇒ Present for 31 consecutive days in the current year.
      - ⇒ Present for 75% of the days in the current year.
      - ⇒ Meets the substantial presence test the following year.
- Expatriation Rules for Individuals and the Mark-to-Market Regime
  - Mark-to-Market Regime: Applies to U.S. Citizens and Long-Term Residents who Expatriate.
  - Covered Expatriates: Subject to mark-to-market tax if they meet any of the following:
    - Tax Liability Test: Annual tax liability exceeds $211,000 (2026).
    - Net Worth Test: Net worth is $2 million or more.
    - Compliance Test: Non-compliance with U.S. tax obligations in the previous five years.
  - Tax Calculation: All property is treated as sold the day before expatriation.
    - An exclusion of $910,000 (2026) is allowed.
    - Taxpayers may defer payment of the tax.

- Expatriated Entity Rules for Corporations
  - Incentives to Expatriate: U.S. corporations may expatriate under a foreign parent to reduce tax obligations.
  - Categories:
    - 80% or More: Former U.S. shareholders own 80%+ of the new foreign parent.
    - 60% to 80%: Former U.S. shareholders own 60-80% of the new foreign parent.
  - TCJA Impact: The Tax Cuts and Jobs Act (TCJA) limits benefits for expatriated entities, including denying lower rates on dividends from surrogate foreign corporations.

- Tax Treaties and Their Impact on U.S. Taxation
  - Tax Treaties prevent double taxation and tax evasion by modifying U.S. tax rules for international income and investments.
  - Legal Status
    - Tax Treaties carry the same legal weight as domestic U.S. tax laws and can override standard tax rules.
  - Withholding Rates
    - Treaties often lower the withholding tax on investment income (e.g., dividends, interest) below the standard 30%, sometimes to 15% or lower.
  - Other Modifications
    - Business Income: Defines "Permanent Establishment" to determine when foreign profits are taxable in the U.S.
    - Residency: Sets rules to decide which country taxes an individual, based on residency criteria.
    - Source of Income: Alters rules for determining whether income is U.S. Source or Foreign-Source.
  - U.S. Tax Treaty Network
    - The U.S. has Treaties with about 60 countries, ensuring cooperation and reducing double taxation in cross-border activities.

## Transfer Pricing

- Transfer Pricing sets prices for transactions between related entities in multinational enterprises. The IRS ensures these transactions follow the arm's length principle to prevent income shifting.
- Affiliated Groups
    - Affiliated Group
        - Businesses in multiple countries with intercompany transactions may structure prices to understate income, risking tax disputes.
    - Controlled and Uncontrolled Taxpayer
        - Control: Influence over another entity, leading to control. Assumed when income or deductions shift arbitrarily.
        - Controlled Taxpayer: Part of a group controlled by the same interests.
        - Uncontrolled Taxpayer: Operates independently, used as a benchmark for arm's length transactions.
    - Controlled and Uncontrolled Transactions
        - Controlled Transaction: Between entities in the same group, scrutinized by the IRS.
        - Uncontrolled Transaction: Between independent entities, used as Comparables.
- IRS Authority in Distribution, Apportionment, and Allocation
    - IRS Authority: Adjusts income, deductions, and credits among controlled entities to reflect true economic activity.
    - Scope: Applies to any entity, U.S. or foreign, affiliated or not.
    - Arm's-Length Standard
        - Ensures related transactions are treated as independent, preventing income distortion.
        - Comparable Transactions: Used by the IRS to verify arm's length pricing.

- Comparable Transactions and Standards of Comparability
  - To determine if a controlled transaction meets the arm's-length standard, the IRS relies on comparable transactions.
  - Pricing Methods
    - Comparable Uncontrolled Price (CUP)
      - ⇒ Usage: Compares prices from similar transactions between uncontrolled parties.
      - ⇒ Applicable to: Tangible Property (e.g., sales, purchases, leases).
    - Comparable Uncontrolled Transaction (CUT)
      - ⇒ Usage: Compares terms of controlled transactions involving intangible property with those of uncontrolled transactions.
      - ⇒ Applicable to: Intangible Property (e.g., royalty payments).
    - Resale Price Method
      - ⇒ Usage: Adjusts resale prices for gross margins to determine the arm's-length price.
      - ⇒ Applicable to: Tangible Property.
    - Cost Plus Method
      - ⇒ Usage: Adds a gross profit mark-up to production costs to determine the transfer price.
      - ⇒ Applicable to: Tangible Property.
    - Comparable Profits Method (CPM)
      - ⇒ Usage: Compares the profitability of controlled transactions with similar uncontrolled transactions using financial ratios.
      - ⇒ Based on: Operating margin, gross margin, return on assets, or return on capital.

- Transfer Pricing Issues and IRS Authority
    - Transfer Pricing Issues occur when U.S. taxpayers' transactions with affiliates do not follow the arm's-length standard.
    - The IRS scrutinizes these, especially when the affiliate isn't subject to U.S. tax or doesn't file a consolidated return.
    - Circumstances Leading to Transfer Pricing Issues
        - Property Transfers: Issues arise when property (tangible or intangible) is transferred, sold, purchased, or leased to/from an affiliate not subject to U.S. tax or without a consolidated return.
        - Loan Agreements/Service Contracts: Problems occur when such agreements are with affiliates not subject to U.S. tax or not filing a consolidated return.
        - Cost Sharing: Issues arise when a U.S. taxpayer shares costs with an affiliate not subject to U.S. tax or without a consolidated return.
    - IRS Options for Adjustments
        - Modify Basis of Assets: Adjust asset values to reflect true economic value.
        - Recognition of Income: Require income recognition in otherwise tax-free transactions, like exchanges or incorporations.
    - Authority of the IRS to Make Adjustments
        - The IRS can adjust taxable income if it differs from what would be reported in arm's-length transactions.
        - Courts may reverse IRS adjustments if the taxpayer shows the transactions fall within an arm's-length range, using two or more uncontrolled Comparables.

- Avoidance of Penalties
    - Penalties from IRS adjustments can be avoided by meeting specific criteria.
        - Section 482 Study
            - Standard Methods: Ensure prices follow regulations and complete documentation before filing.
            - Alternative Methods: Justify and document alternatives if standard methods don't apply.
        - Foreign Transactions:
            - Avoid penalties if U.S. Income isn't impacted.
    - Competent Authority
        - Resolution: Request IRS and foreign authorities to resolve double taxation.
        - Timing: Request after IRS action leads to inconsistent taxation.
- Advance Pricing Agreement (APA) Program
    - The APA Program helps resolve transfer pricing disputes before they lead to audits, ensuring pricing aligns with the arm's-length standard.
    - Key Components
        - Choosing a Transfer Pricing Method (TPM)
        - Selecting Comparables
        - Deciding on Analysis Years
        - Adjusting Comparables' Results
        - Constructing a Range of Results
        - Testing During APA Period
        - Agreeing on Critical Assumptions

# Tax Planning for Corporations

- Tax Planning Strategies Overview
    - Effective Tax Planning maximizes after-tax Cash Inflows (Income) and minimizes after-tax Cash Outflows (Deductions).
    - Each tax strategy works by reducing the Present Value of Tax Costs (associated with Income) or maximizing the Present Value of Tax Savings (associated with Deductions). The framework is:
        - Tax Cost (Savings) = Pretax Income (Deduction) x Marginal Tax Rate
        - Present Value of Tax Cost (Savings) = Tax Cost (Savings) x Discount Factor
    - Because a dollar today is worth more than a dollar in the future, the timing of income, deductions, and tax payments materially affects the after-tax result. The goal is to:
        - Defer Tax Costs (associated with Income) by Deferring Income Recognition into later years (Lower PV of Tax Cost).
        - Accelerate Tax Savings (associated with Deductions) by Accelerating Deduction Recognition into earlier years (higher PV of Tax Savings).
- Timing Strategies (When)
    - Tax Rates to Decrease in the Future
        - Deferring Income
            - Delay Billing
            - Defer Bonuses
        - Accelerating Expenses
            - Prepay Deductible Expenses
            - Accelerate Purchases
            - Charitable Donations
    - Tax Rates to Increase in the Future
        - Accelerating Income
            - Offer Early Payment Incentives

- Close Deals Before Year-End

- Delaying Expenses

  - Deferring Purchases

  - Deferring Charitable Donations

- Utilization of NOL and Capital Loss Carryovers

  - Capital Loss Carryforwards

    - Corporate Capital Losses expire after 5 years. A Corporation with an expiring Capital Loss Carryforward should consider recognizing capital Gains (even gains it would otherwise prefer to defer) to absorb the carryforward before it expires.

  - NOL Carryforwards

    - NOLs generated after 2017 carry forward indefinitely but offset only 80% of post-2020 taxable income. NOLs generated before 2018 retain their 20-year carryforward but can offset 100% of taxable income, so a corporation should use older NOLs first.

- Impact of Changes in Tax Legislation

  - Future Legislation Increases Deductibility of Expenses

    - Defer Expenses

  - Future Legislation Decreases Deductibility of Expenses

    - Accelerating Expenses

  - Future Legislation Increases Tax on Income

    - Accelerating Income

  - Future Legislation Decreases Tax on Income

    - Deferring Income

- Income-Shifting Strategies (Who/Where)
    - Transactions Between Jurisdictions (Where)
        - Although Federal Corporate Income Tax is a flat 21% in all states, State Corporate Income Tax Rates vary widely.
        - Some states have no corporate income tax (e.g., South Dakota), while others have rates exceeding 9%.
        - This creates Income-Shifting Opportunities for corporations operating in multiple states.
    - Transactions Between Corporations and Their Owners (Who)
        - When Corporations and their Shareholder-Owners have different marginal tax rates, transactions between them can shift income to whoever faces the lower rate.

# NINJA NOTES

## Business Analysis & Reporting 2026

# Cost Accounting

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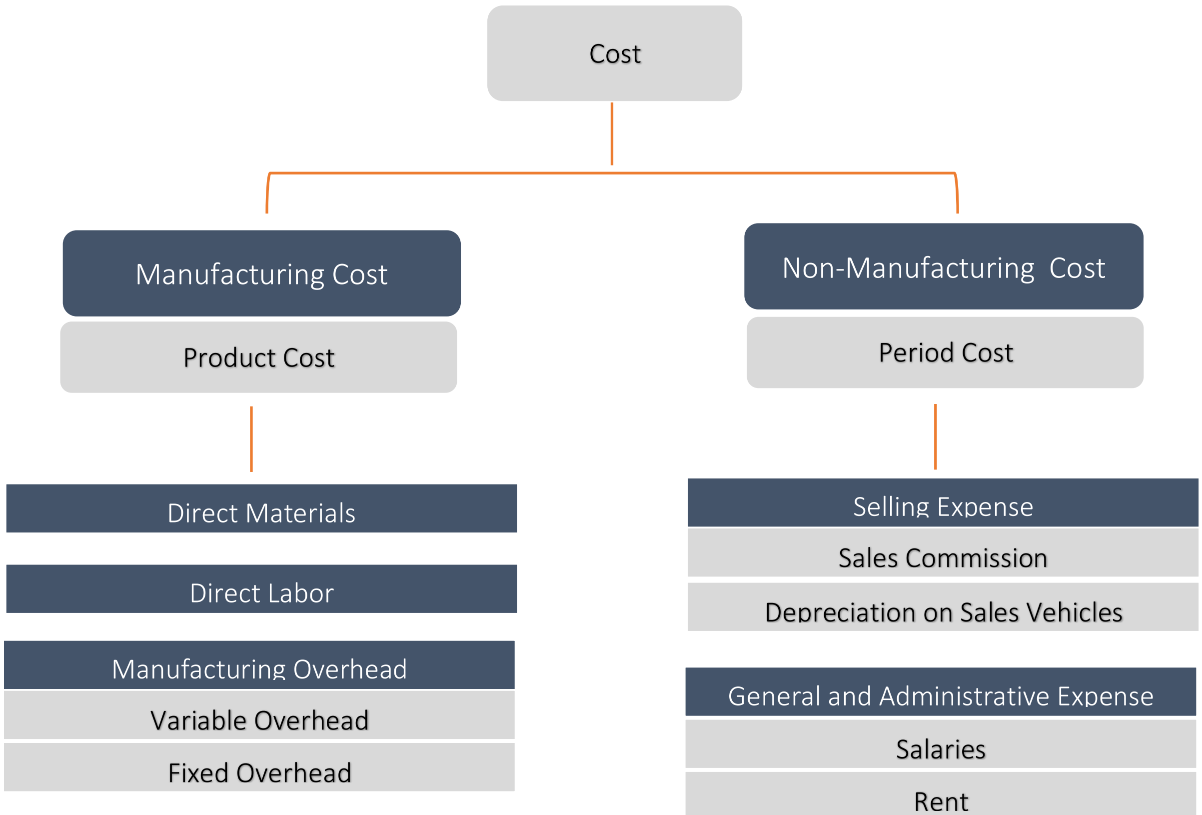
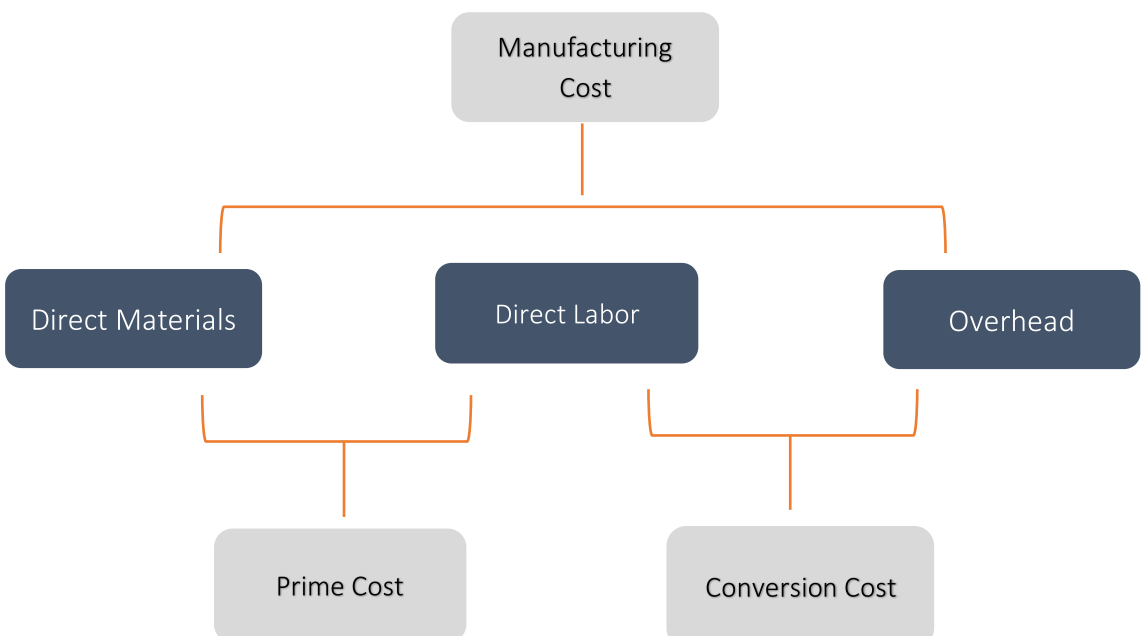
# Cost Accounting

## Cost Behavior and Cost Objects

- Cost Behavior
    - Cost Behavior indicates the movement of a cost in relation to the production volume.
    - Fixed Costs
        - Total Fixed Costs remain constant within relevant range
        - Fixed Costs per unit change in relation to production volume
        - Fixed Costs are incurred even if there is no activity
    - Variable Costs
        - Variable Costs remain constant on a per unit basis
        - Total Variable Costs Vary in relation to production volume
        - Variable Costs are zero if there is no activity
    - Mixed Costs
        - Displays characteristics of both fixed & variable costs
        - Costs vary with level of activity but not proportionally

- Cost Object


Cost
Manufacturing Cost
Product Cost
Non-Manufacturing Cost
Period Cost
Direct Materials
Direct Labor
Manufacturing Overhead
Variable Overhead
Fixed Overhead
Selling Expense
Sales Commission
Depreciation on Sales Vehicles
General and Administrative Expense
Salaries
Rent


Manufacturing Cost
Direct Materials
Direct Labor
Overhead
Prime Cost
Conversion Cost

# Overhead Application and Cost Driver

- Overheads
  - Indirect Costs that cannot be traced directly to a product/job and are therefore applied.
- Overhead Application
  - Overhead is applied at a pre-determined overhead rate.
    - Predetermined Overhead Application Rate = $\frac{\text{Budgeted Overhead Costs}}{\text{Budgeted Direct Labor Hours}}$
  - Applied Overhead = Predetermined Overhead Rate x Actual Labor Hours
- Variances in Actual and Applied Overheads
  - Overapplied Overhead
    - Overapplied Overhead implies that Applied Overhead is more than Actual Overhead (Applied Overhead > Actual Overhead).
  - Underapplied Overhead
    - Underapplied Overhead implies that Applied Overhead is less than Actual Overhead (Applied Overhead < Actual Overhead).
- Reasons for Overapplied / Underapplied Overhead
  - Budgeted Overhead are Overestimated/Underestimated
  - Difference in Activity Level
    - Actual Activity > Budgeted Activity = Overhead Applied > Actual Overhead = Overapplied Overhead
    - Actual Activity < Budgeted Activity = Overhead Applied < Actual Overhead = Underapplied Overhead
- Journal Entry
  - Applied Overhead

| | | |
|---|---|---|
| WIP | XXX | |
| Overhead Applied | | XXX |

- Actual Overhead

| | | |
|---|---|---|
| Overhead Control | XXX | |
| Cash | | XXX |

- Adjustment for Overapplied / Underapplied Overhead

| | | |
|---|---|---|
| Overhead Applied | XXX | |
| Cost of Goods Sold (Underapplied) | XXX | |
| Overhead Control | | XXX |
| Cost of Goods Sold (Overapplied) | | XXX |

- Underapplied or Overapplied is Immaterial
  - If Underapplied or Overapplied Overhead is Immaterial, it is adjusted only to the Cost of Goods Sold.
- Underapplied or Overapplied is Material
  - If Underapplied or Overapplied Overhead is Material it is adjusted for in the Work-in-Process Inventory, Finished Goods Inventory, and Cost of Goods Sold in proportion to their relative size.

## Types of Overhead Rates

- Normal Rate
  - Normal Overhead Rate = Actual Overhead Costs / Actual Direct Labor Hours
- Pre-Determined Overhead Rate
  - Pre-determined Overhead Rate = Budgeted Overhead Costs / Budgeted Direct Labor Hours
- Blanket Overhead Rate (Factory-Wide Overhead Rate)
  - Blanket Overhead Rate = Total Overheads for the Factory / Total Number of Hours for the Factory
- Departmental Overhead Rate
  - Departmental Overhead Rate = Total Overheads of the Department / Total Number of Hours for the Department

## Inventory Flow

- Trading Organizations

| |
|---|
| Opening Finished Goods Inventory |
| Add: Purchases |
| Less: Closing Finished Goods Inventory |
| Cost of Goods Sold |

- Manufacturing Organizations

| |
|---|
| Opening Raw Materials |
| Add: Purchases |
| Less: Ending Raw Materials |
| Direct Materials Consumed |

| |
|---|
| Opening Work-In-Process Inventory |
| Add: Direct Materials Consumed |
| Add: Freight-In |
| Add: Direct Labor |
| Add: Overheads Applied |
| Less: Ending Work-In-Process Inventory |
| Cost of Goods Manufactured |

| |
|---|
| Opening Finished Goods Inventory |
| Add: Cost of Goods Manufactured |
| Less: Ending Finished Goods Inventory |
| Cost of Goods Sold (Tentative) |

| |
|---|
| Cost of Goods Sold (Tentative) |
| Add: Underapplied Overhead |
| Less: Overapplied Overhead |
| Cost of Goods Sold |

## Costing Systems

- Job Order Costing
  - Costs are allocated to specific jobs and orders
  - Suitability of Job Order Costing
    - Used for unique, expensive, and heterogeneous products
    - Production is carried out solely because of a customer's order, not as a part of the entity's planned inventory
    - Management wants to account for each job as a separate cost unit
  - Costing Calculation
    - Direct Material: Costs are traced & added to the job
    - Direct Labor: All costs incurred are traced to be added to the job
    - Overheads: Applied to products based on direct labor hours incurred on the job
    - Total Cost = Direct Materials + Direct Labor + Overheads
  - Spoilage
    - Refers to rejected units that cannot be rectified
    - Normal Spoilage
      - Losses or expenses inevitable in nature
      - Treated as Product Costs & charged to COGS
      - Per Unit Cost = $\frac{\text{Total Costs}}{\text{Total Units} - \text{Normal Spoilage Units}}$
    - Abnormal Spoilage
      - Loss or Spoilage of inventory caused due to unforeseeable & abnormal conditions
      - Treated as period costs & charged to a separate expense account
      - Abnormal Spoilage = $\frac{\text{Total Cost}}{(\text{Total Units} - \text{Normal Spoilage Units})} \times \text{Abnormal Spoilage Units}$

- Benefits
    - Useful in analyzing the job-wise profitability.
    - Enhances decision making
    - Easier identification & treatment of spoilages arising during the production
- Limitations
    - Excessive and Expensive Process

- Process Costing
    - Process Costing is a costing method that aggregates production costs by departments or by production phases.
    - Unit Cost is determined by dividing the Total Costs charged to a cost center in a particular period by the Output of that cost center.
    - Suitability of Process Costing
        - Manufacturing activity is carried on continuously.
        - The finished goods produced are homogeneous, and every unit is not distinguishable from other units.
        - The factory is divided into several cost centers or departments and each department is a stage of production.
    - Definitions
        - Equivalent Unit
            - Expression of units produced in terms of complete units
        - Percentage Complete
            - Degree, point/phase in the manufacturing process at which a product currently stands

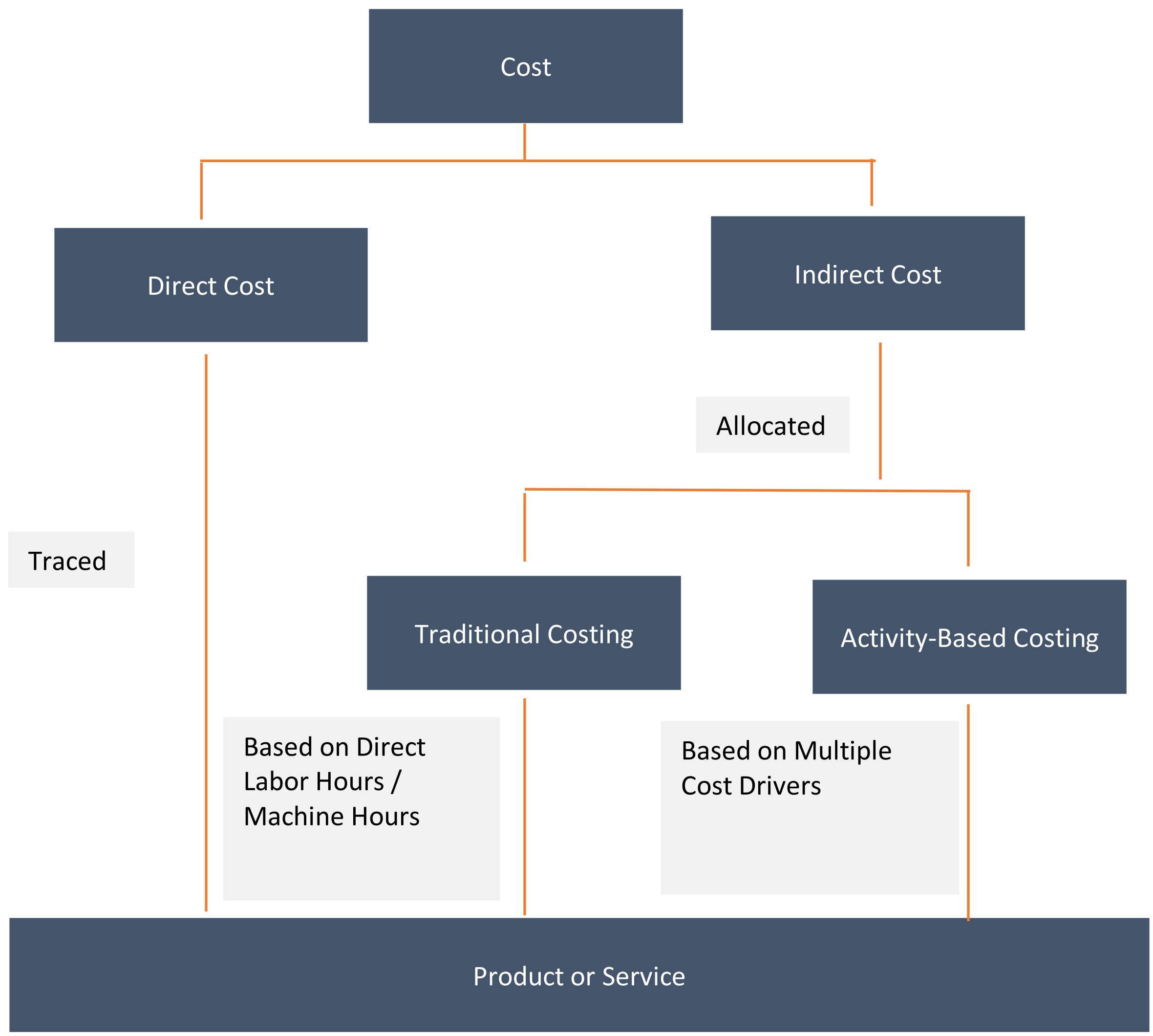
- Process Costing Methods
  - FIFO Method
    - Per Unit Cost = $\dfrac{\text{Manufacturing Cost incurred in the Current Period}}{\text{Equivalent units manufactured in the Current Period}}$
  - Weighted Average Method
    - Per Unit Cost = $\dfrac{\text{Manufacturing Cost of the Current Period + Beginning Inventory}}{\text{Equivalent units manufactured in the Current Period + Beginning Inventory}}$
- Process Costing Steps (Template)

| | | |
|---|---|---|
| Step 1 | **Inventory Balances** | |
| | Opening WIP Inventory | XXX |
| | Units Started | XXX |
| | Units to Account for | XXX |
| | Units Completed | XXX |
| | Ending WIP | XXX |
| | Units Accounted for | XXX |
| Step 2 | **Calculate Equivalent Units** | |
| | **FIFO** | |
| | Units Completed | |
| | Equivalent Units Completed from Opening Inventory | Units x % Completed |
| | Equivalent Units Started and Completed | Units x 100% |
| | Ending Inventory | |
| | Units in Ending Inventory | Units x % Completed |
| | **Weighted Average** | |
| | Units Completed | |
| | Equivalent Units Completed from Opening Inventory | Units x 100% |
| | Equivalent Units Started and Completed | Units x 100% |
| | Ending Inventory | |
| | Units in Ending Inventory | Units x % Completed |

| | |
|---|---|
| | |
| Step 3 | **Calculate Cost**<br><br>**FIFO**<br><br>Direct Material (Current Period) XXX<br>Direct Labor (Current Period) XXX<br>Overhead (Current Period) XXX<br>Total Cost XXX<br><br>**Weighted Average**<br><br>Direct Material (Current Period + Beginning Inventory) XXX<br>Direct Labor (Current Period + Beginning Inventory) XXX<br>Overhead (Current Period + Beginning Inventory) XXX<br>Total Cost XXX |
| Step 4 | **Calculate Cost per Unit**<br><br>Cost per Unit = Total Cost / Equivalent Units |
| Step 5 | **Calculate Ending Inventory Value**<br><br>Ending Inventory = Equivalent Units in Ending Inventory x Cost per Unit |

- Spoilage
  - Refers to rejected units that cannot be rectified
  - Normal Spoilage
    - Losses or expenses inevitable in nature
    - Treated as Product Costs & charged to COGS
    - Normal Loss units are not included in computation of Equivalent Units
  - Abnormal Spoilage
    - Loss or Spoilage of inventory caused due to unforeseeable & abnormal conditions
    - Treated as period costs & charged to a separate expense account
    - Normal Loss units are included in computation of Equivalent Units

- Activity-Based Costing
  - Under Traditional Costing Methods, Overhead Costs are allocated to products and services based on Volume-Based Drivers such as Direct Labor Hours or Machine Hours.
  - Activity-Based Costing (ABC) is an improvement over traditional methods of allocating overhead expenses as it assigns costs based on activities consumed by products and services.



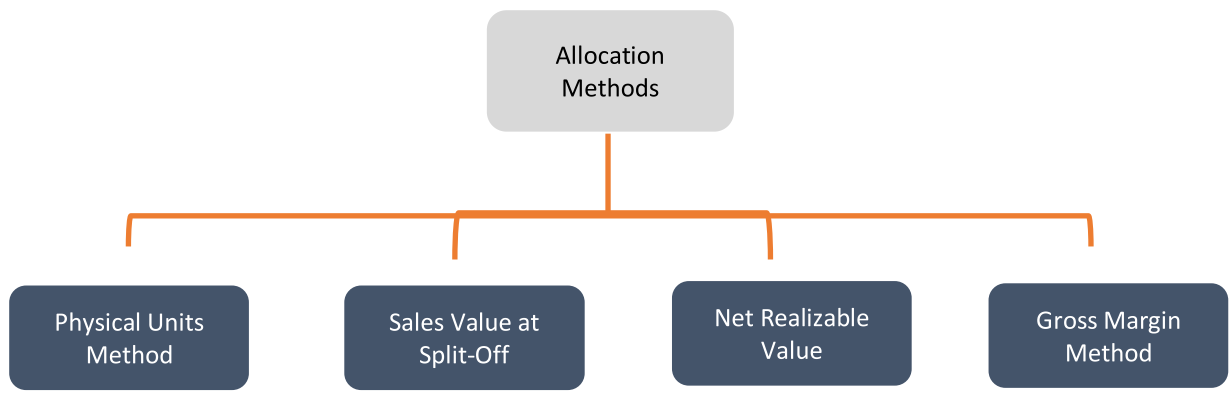

  - Definitions
    - Activities: Work done that incurs costs
    - Cost Drivers: Reflect consumption of costs by activities & products
  - Allocation
    - Costs are allocated to activities based on relative consumption of that drivers.

- Advantages
    - Identification of Cost Behavior
    - Accurate Cost Allocation
    - Streamlining of Activities
- Limitations
    - Expensive
    - Difficult Implementation
    - Not Useful for Small-Sized Firms

- Service Department Cost
  - In-house Support Departments
  - Mostly Cost Centers
  - Costs allocated to production department/other service departments
    - Direct Method
    - Step-Down Method
    - Reciprocal Method
  - Direct Method
    - Costs are directly allocated to production departments based on the ratio of production departments consumption of that service department's activity.
  - Step-Down Method
    - Costs are sequentially allocated to service as well as production departments.
    - Costs of departments providing the most services are allocated first to other service and production departments and then the cost of other service departments are allocated using the same logic.
  - Reciprocal Method
    - Recognizes interdependent nature of service departments
    - Cost Allocation is based on creation of simultaneous equations based on consumption

- Joint Products and By-Products Costing
  - Definition
    - Joint-Product
      - Two or more Products of equal importance produced simultaneously from the same Joint Manufacturing Process.
    - By-Product
      - By-Products are products that emerge as a result of the processing operation of another product.
      - Minor sales value as compared with the sales value of the main (Joint) Products.
    - Split-Off Point
      - Split-Off Point represents the point of production where the various Joint and By-Products become identifiable as separate individual products.
    - Joint Costs
      - Joint Costs represent the cost of the input factors incurred before the split-off and must be allocated to the joint products.
    - Net Realizable Value
      - Net Realizable Value represents sales value less estimated cost to complete and sell.
    - Separable Costs
      - Separable Costs are additional processing costs incurred after the split-off point.

- Joint Product Costing




- Physical Units Method
  - Allocated to products based on the units manufactured for each product
  - Cost Allocation per product = $\dfrac{\text{No. of Units Produced}}{\text{Total No. of Units Produced}} \times \text{Total Overhead Costs}$
- Sales Value at Split-Off Method
  - Allocated to products based on their relative sales value at the split-off point
  - Cost Allocation per product = $\dfrac{\text{Sales Value at Split Off}}{\text{Total Sales Value at Split-Off}} \times \text{Total Overhead Costs}$
- Net Realizable Value Method
  - Used when Joint Costs have no Sales Value at Split-Off Point
  - NRV = Sales Value – Additional Processing Cost
  - Cost Allocation per product = $\dfrac{\text{NRV}}{\text{Total NRV}} \times \text{Total Overhead Costs}$
- Gross Margin Method
  - Aims at maintaining the same gross margin percentage across all products
  - Gross Margin = Gross Profit / Sales
  - Cost Allocation per product = (Gross Margin % x Sales Value) – Additional Processing Cost

- By-Product Costing
  - By-Products are not allocated joint costs rather NRV from by-products are subtracted from total joint costs.
  - Joint costs that are then allocated to the joint products using one of the methods discussed above.

- Absorption Costing & Variable Costing
  - Difference between Absorption Costing and Variable Costing

| | Absorption Costing | Variable Costing |
|---|---|---|
| Purpose | External Reporting Purposes | Internal Decision Making |
| Product Cost | Direct Material, Direct Labor, Variable Manufacturing Overhead & Fixed Manufacturing Overhead | Direct Material, Direct Labor, Variable Manufacturing Overhead |
| Period Cost | Variable & Fixed Selling, General and Administrative Overhead | Fixed Manufacturing Overhead, Variable & Fixed Selling, General and Administrative Overhead |
| Format | Sales XXX<br><br>Variable Manufacturing Costs. (XXX)<br>Fixed Manufacturing Costs (XXX)<br><br>**Gross Margin XXX**<br><br>Variable SG&A (XXX)<br>Fixed SG&A (XXX)<br><br>**Net Operating Income XXX** | Sales XXX<br><br>Variable Manufacturing Costs. (XXX)<br>Variable SG&A (XXX)<br><br>**Contribution Margin XXX**<br><br>Fixed Manufacturing Costs (XXX)<br>Fixed SG&A (XXX)<br><br>**Net Operating Income XXX** |

- Effect of Difference
  - Sales Exceed Production
    - If Sales > Production
    - Then, Opening Inventory > Closing Inventory
    - Fixed Manufacturing Overhead Expensed
      - ⇒ Absorption Costing
        - All of Fixed Manufacturing Overhead for the current period, plus Fixed Manufacturing Overhead of the Beginning Inventory Sold
      - ⇒ Variable Costing
        - All of Fixed Manufacturing Overhead for the Current Period
    - Therefore, Variable Costing Income > Absorption Costing Income
    - Difference Income = (Opening Inventory - Ending Inventory) x Per Unit Fixed Manufacturing Overhead
  - Production Exceeds Sales
    - If Sales < Production
    - Then, Opening Inventory < Closing Inventory
    - Fixed Manufacturing Overhead Expensed
      - ⇒ Absorption Costing
        - Some of Fixed Manufacturing Overhead for the Current Period
      - ⇒ Variable Costing
        - All of Fixed Manufacturing Overhead for the Current Period
    - Therefore, Variable Costing Income < Absorption Costing Income
    - Difference Income = (Ending Inventory - Opening Inventory) x Per Unit Fixed Manufacturing Overhead

            - Production Equals Sales
                - If Sales = Production
                - Then, Opening Inventory = Closing Inventory
                - Fixed manufacturing overhead expensed:
                    - ⇒ Absorption Costing
                        - □ All of Fixed Manufacturing Overhead for the Current Period
                    - ⇒ Variable Costing
                        - □ All of Fixed Manufacturing Overhead for the Current Period
                - Therefore, Variable Costing Income = Absorption Costing Income

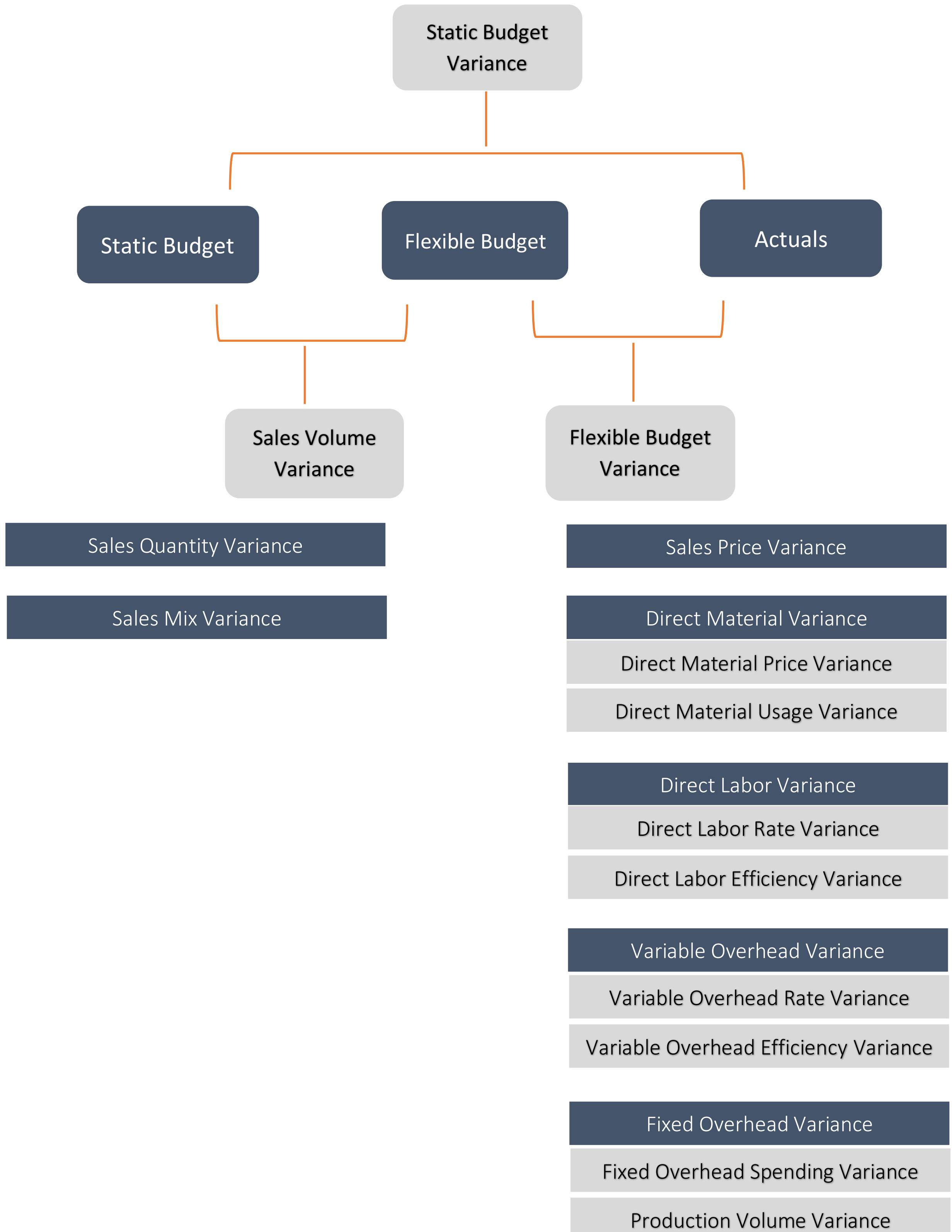
## Variance Analysis

- Definition and Types
    - The monitoring of budgets is done by comparing the Budgeted Figures with the Actual Figures.
    - Variances may be of two types:
        - Unfavorable Variance
            - An Unfavorable Variance is a variance that causes a lower revenue or higher expense than what was budgeted.
        - Favorable Variance
            - A Favorable Variance is a variance that causes a higher revenue or a lower expense than what was budgeted.
- Management by Exception
    - Management intervenes only in Exceptional & Significant Situations
    - Allows management to prioritize their time according to the intensity of situations
    - Situations Warranting Management's Attention
        - Quantitative Factors
        - Qualitative Factors

- Advantages
  - Better Use of Management's Time
  - Boosts Employee Morale
- Disadvantages
  - Possibility of Lapses in Reporting
  - Reactive, not Proactive
- Using Management by Exception for analyzing variances
  - Variance is an indication of deviation from the set standards of performance, management intervention might be required if variances are deemed exceptional.
  - Favorable Variance
    - Management must Evaluate the Reason Behind Increased Favorable Variance
      - ⇒ Efficient Performance
      - ⇒ Faulty Standards-Setting
  - Unfavorable Variance
    - Corrective measures should be promptly implemented to deal with unfavorable variance

- Use of Standard Costing System
    - Standard Costs
        - Predetermined target costs, attainable under efficient & optimum conditions
        - Allows employees to establish their target & work towards attaining it
    - Components
        - Direct Materials
            - Standard Price
            - Standard Quantity
        - Direct Labor
            - Standard Rate
            - Standard Hours
        - Variable Overhead
            - Standard Rate
            - Standard Hours
        - Fixed Overhead
            - Budgeted Overhead
            - Pre-determined overhead rate

- Analysis of Variance from Standard Cost Expectations

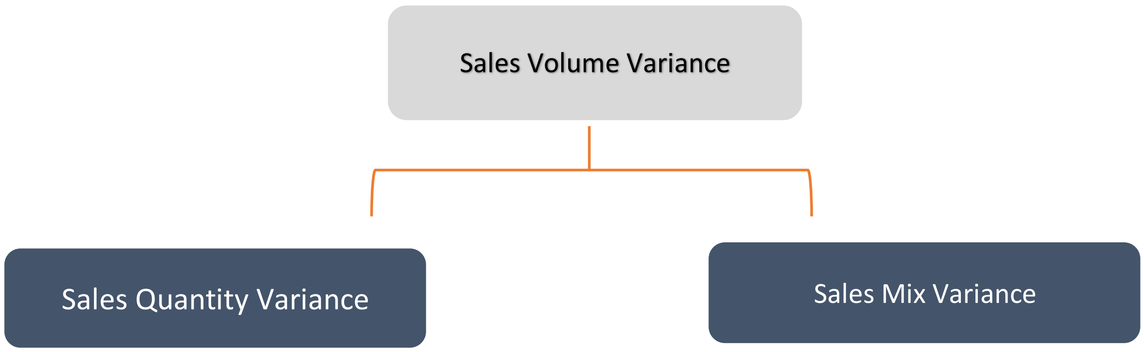


- Flexible Budget Variance

| Variance | Formulae | Responsibility Center |
| --- | --- | --- |
| **Sales Price Variance** | Actual Quantity x (Actual Price - Standard Price) | Sales Department |
| Direct Material Variance | | |
| **Direct Material Price Variance** | Actual Quantity Purchased x (Standard Price - Actual Price) | Purchase Department |
| **Direct Material Usage Variance** | Standard Price x (Standard Quantity - Actual Quantity Used) | Production Department |
| Direct Labor Variance | | |
| **Direct Labor Rate Variance** | Actual Hours x (Standard Rate - Actual Rate) | Human Resource Department |
| **Direct Labor Efficiency Variance** | Standard Rate x (Standard Hours - Actual Hours) | Production Department |
| Variable Overhead Variance | | |
| **Variable Overhead Rate Variance** | Actual Hours x (Standard Rate - Actual Rate) | Production Department |
| **Variable Overhead Efficiency Variance** | Standard Rate x (Standard Hours - Actual Hours) | Production Department |
| Fixed Overhead Variance | | |
| **Overhead Spending Variance** | Budgeted Fixed Overhead - Actual Fixed Overhead | Production Department |
| **Production Volume Variance** | Applied Fixed Overhead - Budgeted Fixed Overhead | Production Department |

- Overhead Variance Approach
  - 4-Variance Approach
    - Variable Overhead Spending Variance
    - Variable Overhead Efficiency Variance
    - Fixed Overhead Spending (Budget) Variance
    - Production Volume Variance
  - 3-Variance Approach
    - Spending Variance: Variable Overhead Spending Variance + Fixed Overhead Spending (Budget) Variance
    - Efficiency Variance
    - Production Volume Variance
  - 2-Variance Approach
    - Controllable Variance: Variable Overhead Spending Variance + Fixed Overhead Spending (Budget) Variance + Efficiency Variance
    - Non-Controllable Variance: Production Volume Variance

- Sales Volume Variance




| Variance | Formulae | Responsibility Center |
|---|---|---|
| Sales Volume Variance | | |
| **Sales Quantity Variance** | Standard Contribution x Standard Mix x (Actual Quantity - Standard Quantity) | Sales Department |
| **Sales Mix Variance** | Standard Contribution x Actual Quantity x (Actual Mix - Standard Mix) | Sales Department |

# NINJA NOTES

Information Systems & Control
2026

## System and Organization Controls (SOC)

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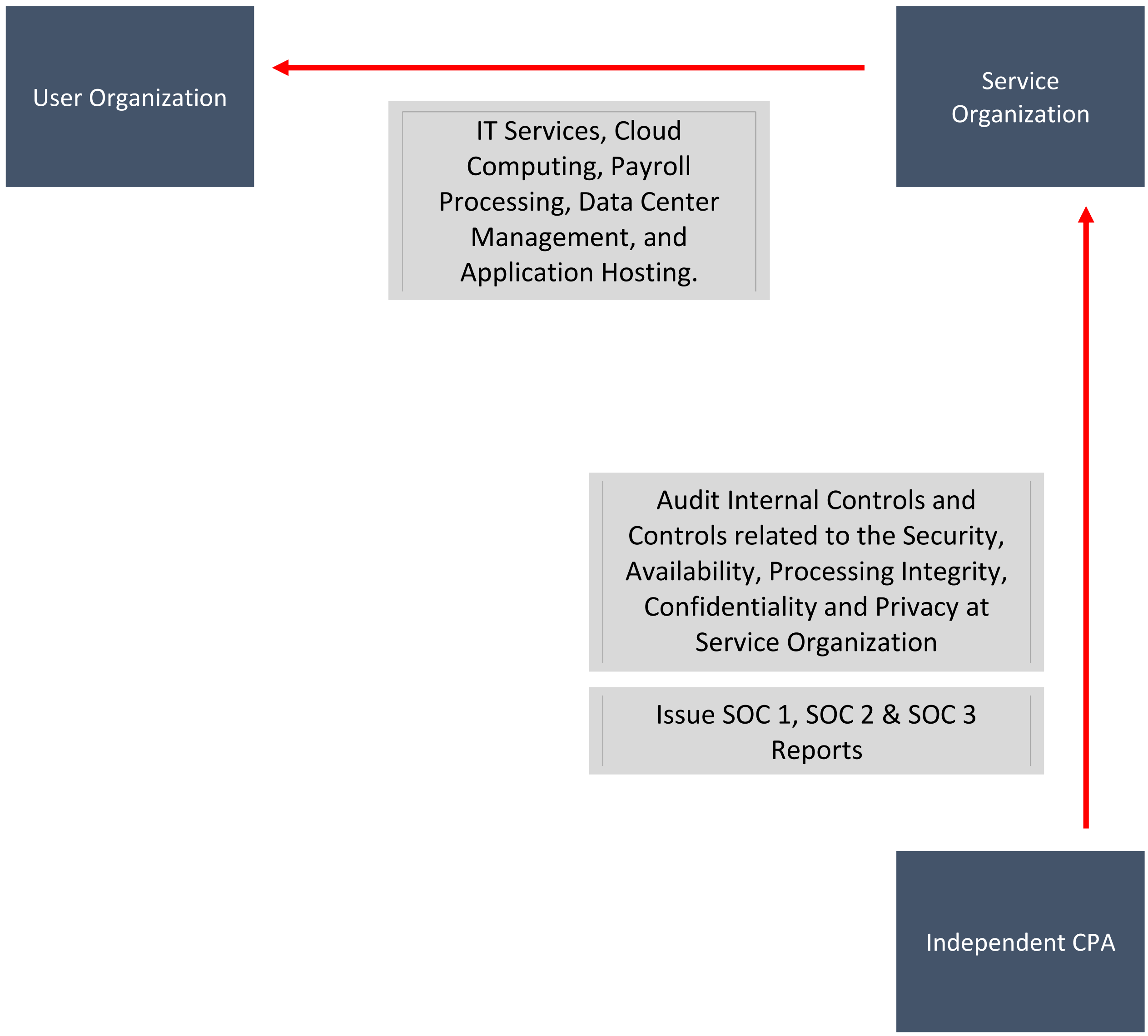
# System and Organization Controls (SOC)

## System and Organization Controls (SOC) Standards and Engagements

- Types of Services Provided by Service Organizations
    - Outsourced Payroll Processors
    - Cloud Service Providers
    - Credit Card Processing Organizations
    - Enterprise IT Outsourcing Services
    - Financial Technology (FinTech) Services
    - Customer Support Services
- SOC (System and Organization Controls) Engagements are assessments performed by independent auditors to evaluate and report on the design and effectiveness of a service organization's controls, processes, and security measures.

- Service Organization and User Organization



- Standards for SOC Engagements
  - SOC 1
    - AICPA Attestation Standards
  - SOC 2
    - AICPA's Trust Services Criteria (TSC) & AICPA Attestation Standards
  - SOC 3
    - AICPA's Trust Services Criteria (TSC) & AICPA Attestation Standards
- Trust Services Criteria (TSC)
  - Purpose
    - The Trust Services Criteria (TSC) are a set of principles and criteria established by the American Institute of Certified Public Accountants (AICPA) to evaluate the design and effectiveness of a service organization's controls relevant to the security, availability, processing integrity, confidentiality, and privacy of a system.
  - Trust Services Categories
    - The Trust Services Criteria (TSC) are organized into five Trust Services Categories, which represent different aspects of an organization's system controls.
    - In the Trust Services Criteria (TSC), categories represent different aspects of an organization's system controls, such as Security, Availability, Processing Integrity, Confidentiality, and Privacy.
      - ➢ Security
        - ⇒ Security is essential for safeguarding an organization's data and assets from unauthorized access, disclosure, damage.
      - ➢ Availability
        - ⇒ Availability refers to the ability of an entity to ensure that its data, systems, and services are accessible and operational when needed to meet its objectives.
      - ➢ Processing Integrity

⇒ Processing Integrity is a crucial aspect of information and systems that ensures the accurate and reliable processing of data in order to achieve an organization's objectives.

- Confidentiality

⇒ Confidentiality pertains to an entity's ability to protect designated confidential information throughout its lifecycle, in line with management's objectives.

- Privacy

⇒ The Privacy category deals with the collection, use, retention, disclosure, and disposal of personal information in compliance with the organization's privacy notice and the Generally Accepted Privacy Principles (GAPP).

- Trust Services Criteria
    - Criteria are the specific guidelines or requirements within each category that help organizations evaluate the effectiveness of their controls.
    - Trust Services Criteria are organized as follows:
        - Common Criteria apply to all categories, ensuring a consistent approach when evaluating controls across different areas
        - Additional Specific Criteria apply only to categories of availability, processing integrity, confidentiality, and privacy, are included

Common Criteria

COSO Criteria

- CC1 Series - Control Environment
- CC2 Series - Communication and Information
- CC3 Series - Risk Assessment
- CC4 Series - Monitoring of Controls
- CC5 Series - Control Activities related to the Design and Implementation of Controls

Supplementary Criteria

- Logical and Physical Access Controls
- System Operations
- Change Management
- Risk Mitigation

Additional Specific Criteria

- A Series – Availability
- PI Series - Processing Integrity
- C Series – Confidentiality
- P Series - Privacy

- Types of System and Organization Controls (SOC) Engagements

**SOC 1**

- Report on Controls Related to Financial Reporting at Service Organization

**SOC 2**

- Restricted Use Report on Controls related to the AICPA'S 5 Trust Service Categories (Security, Availability, Processing Integrity, Confidentiality and Privacy) at Service Organization

**SOC 3**

- General Use Report on Controls related to the AICPA'S 5 Trust Service Categories(Security, Availability, Processing Integrity, Confidentiality and Privacy) at Service Organization

**SOC 2 Plus**

- Report on Controls related to the AICPA's trust service criteria plus additional security frameworks at Service Organizartion

**SOC for Cybersecurity**

- Report on Controls related to an organization's cybersecurity risk management program

**SOC for Supply Chain**

- Report on Controls related to an organization's supply chain risk management efforts

- SOC 1 Reports
    - A SOC 1 report is an examination report that focuses on a service organization's internal controls relevant to a user entity's financial reporting.
    - There are two types of SOC 1® reports: Type 1 and Type 2.

| Report Type | Focus | Assessment | Timeframe |
|---|---|---|---|
| Type 1 | Design of Internal Controls | Assesses the suitability and effectiveness of the controls in place at the service organization | Specific Point in Time |
| Type 2 | Design and Operating Effectiveness of Internal Controls | Assesses the suitability and effectiveness of the controls, and how they are operating in practice | Over a Period of time |

- SOC 2 Reports
    - A SOC 2 report is an examination report that focuses on a service organization's non-financial reporting controls as they relate to the security, availability, processing integrity, confidentiality, and privacy of a system.
    - There are two types of SOC 2® reports: Type 1 and Type 2

| Report Type | Focus | Assessment | Timeframe |
|---|---|---|---|
| Type 1 | Design of Internal Controls related to security, availability, confidentiality, privacy, and integrity of systems | Assesses the suitability and effectiveness of the controls in place at the service organization | Specific Point in Time |
| Type 2 | Design and Operating Effectiveness of Internal Controls related to security, availability, confidentiality, privacy, and integrity of systems | Assesses the suitability and effectiveness of the controls, and how they are operating in practice | Over a Period of time |

- SOC 3 Reports
    - SOC 3® reports are similar to SOC 2® reports but are intended for general use and are available to the public.

- They provide assurance about the Security, Availability, Processing Integrity, Confidentiality, and Privacy of the systems and services provided by a service organization.

- SOC 2+ Reports
  - A SOC 2 Plus report includes the same Trust Services Criteria as a regular SOC 2 report (Security, Availability, Processing Integrity, Confidentiality, and Privacy) while also addressing additional, industry-specific, or regulatory requirements.
  - There are two types of SOC 2 + reports: Type 1 and Type 2

| Report Type | Focus | Assessment | Timeframe |
|---|---|---|---|
| Type 1 | Design of Internal Controls related to security, availability, confidentiality, privacy, and integrity of systems while also addressing additional, industry-specific or regulatory requirements. | Assesses the suitability and effectiveness of the controls in place at the service organization | Specific Point in Time |
| Type 2 | Design and Operating Effectiveness of Internal Controls related to security, availability, confidentiality, privacy, and integrity of systems while also addressing additional, industry-specific, or regulatory requirements. | Assesses the suitability and effectiveness of the controls, and how they are operating in practice | Over a Period of time |

- SOC Reports for Cybersecurity
  - A SOC (System and Organization Controls) for Cybersecurity report is a standardized examination and assessment provided by independent auditors to evaluate and attest to an organization's cybersecurity risk management program.
- SOC Reports for Supply Chain
  - SOC (System and Organization Controls) reports for Supply Chain Management are standardized audit reports provided by independent auditors to assess and attest to the effectiveness of a company's internal controls related to its supply chain processes.

## Subservice Organization and Complementary User Entity Controls (CUECs)

- Subservice Organization
    - A Sub-Service organization, also known as a Subservice Organization, is a third-party vendor that provides services to a primary service organization.
    - Criteria for a Vendor to be Considered a Subservice Organization
        - Nature of Services
            - The vendor's services should be directly related to the primary service organization's operations and have a significant impact on the services provided to user entities (customers).
        - Dependence
            - The primary service organization should have a significant reliance on the vendor's services to fulfill its service commitments to user entities.
        - Control Impact
            - The vendor's controls and processes should have a direct or indirect impact on the primary service organization's Control Environment.
        - Outsourced Services
            - The vendor should be providing services that were previously performed by the primary service organization or could be reasonably expected to be performed in-house.
        - Contractual Relationship
            - There should be a formal contractual relationship between the primary service organization and the Sub-Service Organization, Outlining the Responsibilities, Expectations, and Service Level Agreements (SLAs) for both parties.
    - Controls at Subservice Organization
        - Two common methods for addressing a Sub-Service Organization's Controls within a Primary Service Organization's SOC Report are the Inclusive Method and The Carve-Out Method.

        - Inclusive Method

            - In the Inclusive Method, the Sub-Service Organization's Controls are included within the scope of the Primary Service Organization's SOC Report.

        - Carve-Out Method

            - In the Carve-Out Method, the Primary Service Organization's SOC Report excludes the specific controls of the Sub-Service Organization.

- Complementary User Entity Controls (CUECs) in SOC 1® and SOC 2® Engagements

    - Complementary User Entity Controls (CUECs) are controls that should be implemented by the User Entities (Customers) of a Service Organization to help ensure that the Service Organization's Controls achieve their intended objectives.

    - CUECs serve several purposes:

        - Clarify Responsibilities
        - Enhance Control Effectiveness
        - Improve Risk Management
        - Support Informed Decision-Making
        - Facilitate Compliance and Audit Activities
        - Inform user entities about potential gaps in controls
        - Strengthen the overall assurance provided by the SOC report

    - Examples of CUECs

        - Security Monitoring
        - Managed Service Provider (MSP) Environment Changes
        - Encrypted Financial Data
        - Physical Access Controls
        - Authorization Policies

    - Disclosure Requirements for CUECs in SOC Reports

- SOC 1® Engagements
  - ➢ CUECs that are necessary to ensure control objectives are met should be clearly described in the system description.

- SOC 2® Engagements
  - ➢ In SOC 2® reports, the system description must include a description of the relevant CUECs and a statement that user entities are responsible for implementing these controls.

- Impact of CUECs and CSOCs on SOC Reports
  - If the application of CUECs or CSOCs is necessary to achieve the related control objectives, the service auditor's report must include a statement to this effect.

## Acceptance and Planning for SOC Engagements

- Intended Users of SOC 1®, SOC 2® and SOC 3® Reports

| Report Type | Intended Users |
|---|---|
| SOC 1 Reports | SOC 1 (System and Organization Controls 1) reports are intended for the management of a service organization, the user entities that rely on the service organization's controls, and the auditors of those user entities |
| SOC 2 Reports | SOC 2 (System and Organization Controls 2) reports are intended for the management of a service organization, user entities that rely on the service organization's services, and other stakeholders who need information on the service organization's controls related to security, availability, processing integrity, confidentiality, and privacy |
| SOC 3 Reports | SOC 3 (System and Organization Controls 3) reports are intended for a broader audience, including the general public, customers, and business partners |

- Independence Requirements for SOC Engagements
  - Service Auditor and Service Organization
    - Financial Independence
    - Employment and Management Independence
    - Independence in Familiarity and Personal Relationships
    - No Undue Influence
    - Independence from Subservice Organizations: Service Organization must maintain Independence from Subservice Organizations.

- Service Auditor and Subservice Organizations
  - Independence from Subservice Organizations: Inclusive Method = Required.
  - Independence from Subservice Organizations: Carve-Out Method = Not Required.
- Service Auditor’s Lack of Independence
  - Disclaimer of Opinion
  - No Explanation for Lack of Independence

- Agreeing to Engagement Terms
  - Objectives and Scope of the Engagement
  - Responsibilities of the Service Auditor and Management
  - Criteria Used to Measure or Evaluate the Subject Matter
  - Acknowledgment of Attestation Standards and Engagement Limitations
  - Written Assertion from Management
- Objectives of the Service Auditor
  - Obtain Reasonable Assurance
  - Reporting the Service Auditor's Findings
- Steps in SOC Engagements
  - SOC 1 Engagements
    - Pre-Engagement Activities
      - Determine Scope, System, and Relevant Controls for Financial Reporting
      - Obtain a Signed Engagement Letter
    - Planning
      - Obtain an Understanding of the Service Organization's System and Processes
      - Assess the Risk Associated with Control Objectives

- Determine the Nature, Timing, and Extent of Procedures
- Plan coordination with management and other auditors, if applicable

- Understanding and Evaluating System Description
  - Evaluate Management's System Description
  - Compare System Description to suitable criteria
  - Identify control Objectives, Controls, and Complementary User Entity Controls (CUECs)
- Testing Controls (Type 2 Report)
  - Test Design and Operating Effectiveness of Controls
  - Document testing procedures, sample sizes, and results
  - Identify Exceptions or Deviations
- Evaluating the Results
  - Assess the Overall Effectiveness of Controls
  - Determine implications of identified exceptions or deficiencies
  - Evaluate the need for modifications to the Service Auditor's Report
- Reporting
  - Prepare the independent service auditor's report
  - Include management's assertion, System Description, Control Objectives, CUECs, and Other Information
  - Review the report for Completeness and Accuracy, Obtain Required Approvals
- Post-Engagement Activities
  - Communicate results to management and stakeholders
  - Discuss identified deficiencies and recommendations for improvement
  - Provide the final SOC 1 Report

- SOC 2 Engagements
  - Pre-Engagement Activities
    - Determine scope, system, and Trust Services Criteria (security, availability, processing integrity, confidentiality, and privacy)
    - Obtain a Signed Engagement Letter
  - Planning
    - Obtain an Understanding of the Service Organization's System and Processes
    - Assess the risk associated with Trust Services Criteria
    - Determine the Nature, Timing, and Extent of Procedures
    - Plan coordination with management and other auditors, if applicable
  - Understanding and Evaluating System Description
    - Evaluate Management's System Description
    - Compare System Description to description criteria
    - Identify Controls and Complementary User Entity Controls (CUECs)
  - Testing Controls (Type 2 Report)
    - Test Design and Operating Effectiveness of Controls
    - Document Testing Procedures, Sample Sizes, and Results
    - Identify Exceptions or Deviations
  - Evaluating the Results
    - Assess the Overall Effectiveness of Controls

        - Determine implications of identified exceptions or deficiencies
        - Evaluate the need for modifications to the Service Auditor's Report
    - Reporting
        - Prepare the Independent Service Auditor's Report
        - Include Management's Assertion, System Description, Trust Services Criteria, CUECs, and Other Information
        - Review the report for Completeness and Accuracy, Obtain Required Approvals
    - Post-Engagement Activities
        - Communicate results to Management and Stakeholders
        - Discuss Identified Deficiencies and Recommendations for Improvement
        - Provide the final SOC 2 Report

- Understanding Service Organization Management's Responsibilities
    - SOC 1® Engagements: Management's Responsibilities
        - Defining the Scope of the Engagement
        - Selecting the Report Type: Type 1 vs. Type 2
        - Subservice Organizations
            - Identification of Subservice Organizations
            - Carve-Out vs. Inclusive Method
        - Preparing the System Description
        - Control Design and Implementation
        - Preparing a Written Assertion
        - Providing Relevant Information
        - Disclosing Key Issues
            - Noncompliance and Fraud
            - Control Deficiencies

    - Subsequent Events
  - SOC 2® Engagements: Management's Responsibilities
    - Defining the Scope of the Engagement
    - Selecting the Report Type: Type 1 vs. Type 2
    - Risk Identification and Control Design
    - Preparing the System Description and Assertion
    - Providing Information and Access
    - Disclosing Key Issues
      - Incidents of Noncompliance or Fraud
      - Control Deficiencies
      - Subsequent Events
  - SOC 3® Engagements: Management's Responsibilities
    - Defining the Scope
    - Preparing the Assertion
    - Risk Management and Control Design
    - Providing Information and Access
- Understanding System, Boundaries of the System, System Requirements, and Service Commitments in a SOC 2 Engagement
  - System
    - Infrastructure
    - Software
    - People
    - Data
    - Procedures

- Boundaries of the System
  - Clearly define the boundaries of the system to ensure that report users understand which components are included in the SOC engagement.

- Service Commitments and System Requirements
  - Service Commitments
    - Service commitments are the promises and declarations made by the service organization to its user entities (customers) regarding the delivery of services.
  - System Requirements
    - System requirements refer to the necessary specifications, functionalities, and performance characteristics required for the service organization's system to effectively deliver its services in line with its service commitments.
- Understanding of the System in a SOC 2 Engagement
  - Review the System Description
  - Understand the Services provided
  - Identify the System Boundaries
  - Assess the Control Objectives and Trust Services Criteria
  - Consider Relevant Risks and Threats
  - Review Complementary User Entity Controls (CUECs) and Complementary Subservice Organization Controls (CSOCs)

- Understanding Incident Reporting Procedures in a SOC 2 Engagement
  - Review policies and procedures
  - Interview management and personnel
  - Assess communication channels
  - Review training materials
  - Test incident reporting process
  - Review monitoring and follow-up activities

- Management Assertions specific to SOC Engagements
  - SOC 1 Reports
    - Type 1 Report
      - The description of the system is fairly presented
      - The internal controls are suitably designed to achieve the control objectives
    - Type 2 Report
      - The description of the system is fairly presented
      - The internal controls are suitably designed to achieve the control objectives
      - The internal controls were operating effectively during the specified period
  - SOC 2 Reports
    - Type 1 Report
      - The description of the system is fairly presented
      - The internal controls relevant to the security, availability, processing integrity, confidentiality, and privacy of a system are suitably designed
      - These controls are implemented as of a specified date
    - Type 2 Report
      - The description of the system is fairly presented
      - The internal controls relevant to the security, availability, processing integrity, confidentiality, and privacy of a system are suitably designed
      - These controls are implemented as of a specified date
      - These controls were operating effectively during the specified period to meet the relevant Trust Services Criteria
  - SOC 3 Reports

- The description of the system is fairly presented
- The internal controls relevant to the security, availability, processing integrity, confidentiality, and privacy of a system are suitably designed
- These controls were operating effectively during the specified period to meet the relevant Trust Services Criteria

- Materiality for SOC Engagements
  - Materiality is determined by the Service Auditor at the planning stage of the SOC engagement, considering both Qualitative and Quantitative Factors.
    - Quantitative Factors
      - Monetary value of transactions processed by the service organization
      - Volume of data processed, stored, or transmitted
      - Number of users affected by the service organization's services
      - Percentage of total assets, revenue, or expenses of the user entities
    - Qualitative Factors
      - Nature and complexity of the service organization's services
      - Regulatory environment, including industry-specific requirements and compliance obligations
      - Potential impact of control failures on user entities, such as reputational damage or operational disruptions
      - The service organization's risk profile and its effect on the control environment
      - Expectations of the intended users of the SOC report, such as the user entities' management, regulators, or other stakeholders
  - Use of Materiality in SOC Engagements
    - Risk Assessment
    - Control Testing
    - Evaluation of Control Deficiencies
    - Reporting

- Risk Assessment for SOC Engagements
  - Types of Risks to Consider
    - Internal and External Threats
    - System Vulnerabilities
    - Use of Subservice Organizations
    - Personnel Risks
  - Inherent Risk Factors
    - Changes in the Operating Environment
    - New Personnel
    - New or Revamped Information Systems
    - Corporate Restructurings
    - Expanded Operations
  - Performing Risk Assessment Procedures
    - Obtain an understanding of the system
    - Identify control objectives
    - Assess control suitability and effectiveness
    - Additional steps in the risk assessment process include:
      - Inquiries
      - Observations
      - Inspection
      - Reperformance

        - Fraud Risk and Noncompliance Considerations
            - Management override of controls.
            - Misappropriation of assets.
            - Creation of false or misleading documentation
    - Factors Impacting Risk Assessment
        - Materiality Considerations
        - Control Environment
        - Internal Control Components

- Responding to the Assessed Level of Risk in a SOC Engagement
    - Key Requirements for the Service Auditor
        - Design Overall Responses
        - Perform Additional Procedures
    - Responding to Assessed Risks
        - Maintaining Professional Skepticism
        - Assigning More Experienced Staff or Specialists
        - Providing Additional Supervision
        - Incorporating Unpredictability
        - Modifying the Nature, Extent, or Timing of Procedures:
    - Impact of Control Environment and Internal Control Components
        - Weak Control Environment: Increase NET
        - Ineffective Controls: Increase NET

## Performing and Reporting on SOC Engagements

- Performing Tests of Controls and Other Procedures in a SOC Engagement
  - Procedures to Obtain Evidence About the Suitability of the Design of Controls
    - Procedures to Obtain Evidence
      - Inquiry of Personnel
      - Inspection of Documents
      - Walk-throughs
      - Reading Supporting System Documentation
      - Evaluating Responses to Risks and Threats
    - Factors in Evaluating Control Design
      - Frequency
      - Competence and Authority
      - Precision and Sensitivity
      - Contradictory Evidence
  - Procedures to Obtain Evidence About the Operating Effectiveness of Controls (Type 2 Engagement)
    - Key Considerations for Operating Effectiveness
      - Suitably Designed Controls
      - Application of Controls
      - Testing Controls in the Inclusive Method: Test Subservice Organization Controls
    - Nature of Tests of Controls
      - Inquiries

- Observation
- Inspection
- Reperformance

- Extent of Tests of Controls: Factors Influencing Extent:
  - Tolerable Rate of Deviation
  - Expected Rate of Deviation
  - Control Frequency
  - Length of the Testing Period
- Timing of Tests of Controls: Factors Affecting Timing:
  - Availability of Information
  - Control Periodicity
  - Evidence Left by Controls
  - Significance of Controls

- Reporting Failures, System Incidents, and Concerns
  - Sources of Information for Incident Reporting
    - Board Meeting Minutes
    - Whistleblower Hotlines
    - Security Policies and Procedures

- Evaluating the Results of Procedures in a SOC Engagement
  - Misstatements in a SOC Engagement
    - Description Misstatement
    - Deviation or Exception
    - Deficiency in Control Design
    - Deficiency in Operating Effectiveness

- Determining the Impact of Deviations and Deficiencies
    - Pervasiveness of the Deficiency
    - Fraud or Noncompliance
    - Testing of Additional Controls

- Obtaining Written Representations from Management in a SOC Engagement
  - Content of Written Representations
    - Acknowledgment of Responsibility
    - Fair Presentation of the System Description
    - Suitability of Control Design
    - Operating Effectiveness of Controls (Type 2 Reports)
    - Disclosures to the Auditor
    - Provision of Access and Information
    - Compliance with Laws and Regulations
    - Significant Changes to Controls
    - Subsequent Events
    - Materiality of Uncorrected Misstatements
    - Disclosure of Internal Control Deficiencies
    - System Incidents and Failures
    - Significant Assumptions (SOC 1®)
  - Consequences of Not Providing Written Representations
    - Modify the opinion
    - Withdraw from the engagement

- Forming the Opinion in a SOC Engagement
  - The auditor’s evaluation is based on two key aspects
    - Sufficiency and Appropriateness of Evidence Obtained
    - Materiality of Uncorrected Misstatements
  - Specifically, the opinion focuses on the following areas
    - Fair Presentation of Management's Description
    - Suitability of Design of Controls
    - Effectiveness of Control Operations (Type 2 Engagements)
- Types of Opinions in SOC Engagements
  - Unmodified (Unqualified) Opinion
  - Qualified Opinion
    - Qualified Opinion due to Misstatements
      - Material but not pervasive misstatements in the system description or controls.
    - Qualified Opinion due to Scope Limitation
      - Service auditor is unable to obtain sufficient appropriate evidence, and the issue is material but not pervasive.
  - Adverse Opinion
    - Material and pervasive misstatements exist
  - Disclaimer of Opinion
    - Auditor is unable to obtain sufficient appropriate evidence due to a Material and Pervasive Scope limitation.

- Components of SOC Reports
  - Components of SOC 1 Reports (Type 1 & Type 2)
    - Independent Service Auditor's Report
    - Management's Assertion Letter
    - System Description
    - Control Objectives and Controls
    - Tests of Controls and Results (Type 2 only)
  - Components of SOC 2 Reports (Type 1 & Type 2)
    - Independent Service Auditor's Report
    - Management's Assertion Letter
    - System Description
    - Trust Services Criteria and Controls
    - Tests of Controls and Results (Type 2 only)
- Subsequent Events
  - Subsequent Events refer to transactions or developments that take place after the period covered by the SOC engagement but prior to the service auditor’s report date.
  - The effect of Subsequent Events in a SOC 1® or SOC 2® engagement can include:
    - Identification of Control Deficiencies
    - Changes in the Control Environment
    - Disclosure of Subsequent Events
    - Impact on the Service Auditor's Opinion

        - Consideration for Future SOC Engagements

- Subsequently Discovered Facts After the Issuance of a SOC Report
    - Subsequently discovered facts refer to information that was not known or available to the service auditor at the time of their SOC engagement (SOC 1®, SOC 2®) but would have had a significant impact on the report if they had been known.
    - The impact of subsequently discovered facts on SOC engagement can include:
        - Revision of the Service Auditor's Opinion
        - Notifying Report Users
        - Assessment of the Service Organization's Remediation Efforts
        - Impact on Future SOC Engagements
- SOC for Cybersecurity
    - SOC for Cybersecurity is a reporting framework developed by the AICPA (American Institute of Certified Public Accountants) that provides an independent assurance report on an organization's cybersecurity risk management program.
    - The SOC for Cybersecurity report has three main components:
        - Management's Description of the Entity's Cybersecurity Risk Management Program
        - Management's Assertion
        - Practitioner's Opinion