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Reconstructing Records for Tax Compliance

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Due Diligence

- A paid preparer should make adequate inquiries to be satisfied that the taxpayer is carrying on a business and that the income and expenses reported on the tax return are substantially correct and complete

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Reasons to Reconstruct Records

- State or federal tax audits
- Tax return preparation
- Civil or criminal investigations, including supporting claims of embezzlement, theft, elder financial abuse, insurance fraud, contract disputes, and misappropriation of assets
- Divorce–supporting or refuting claims that accounts and financial data have been altered or income and assets have been hidden
- Spousal and child support income calculations
- Partner and shareholder disputes
- Accidental destruction of records
- Disaster recovery or casualty loss
- Business growth that requires a retooling of accounting/bookkeeping systems
- Loan applications or proof of compliance with existing loan covenants
- Anticipated sale, merger, or acquisition of a business
- Business valuations
- Determining cash flow and solvency

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Reasons to Reconstruct Records

- Estate planning
- Exit and succession planning
- Probate or other court accountings
- Conservatorships
- Board of Directors changes
- Abrupt change of leadership or accounting personnel
- GAAP compliance
- Strategic tax planning
- Budgeting and forecasting analysis
- Annual reports preparation
- Vendor or major donor/investor requests for financial information
- Rebuilding trust in financial reporting
- Bankruptcy, insolvency or restructuring
- Complying with new international accounting standards

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Bottom Line

- When analyzing inadequate-record cases, the courts have set forth these general legal principles:
  - The Service's determinations are presumed to be correct
  - The taxpayer bears the burden of proving the determination erroneous
  - Deductions are a matter of legislative grace
  - Taxpayers bear the burden of proving they are entitled to any deduction claimed, including the burden to substantiate

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George M. Cohan

- In a landmark case, George M. Cohan v. Comr. [39 F.2d 540 (CA-2 1930)], Mr. Cohan could not substantiate $55,000 in entertainment and travel expenditures
- The IRS did not allow any part of the deduction because there was no substantiating documentation
- The trial court concurred
- However, the appeals court ordered the trial court to estimate a reasonable amount that could be deducted
- The appeals court held that when some amount has definitely been spent, the IRS can use an estimated amount if the taxpayer has no records
- The court gave the IRS the freedom to bias the estimate against the taxpayer "whose inexactitude is of his own making"

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- Using the Cohan rule, courts have allowed partial deductions for union dues, wages, utilities, and postage
- The deduction depends on the credibility of the taxpayer and corroborating testimony
- After 1962, the Cohan rule was no longer applicable to travel and entertainment expenses because of the explicit requirements of § 274
- However, Treasury regulations § 1.274-5T(c)(5) states that if records are lost due to circumstances beyond the control of the taxpayer, the taxpayer has the right to a deduction based on a "reasonable reconstruction of his expenditures"

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George M. Cohan

- The courts have refused to apply the Cohan rule when the taxpayer could have obtained duplicate records, but failed to do so
- The courts will not estimate deductions when there is neither a reasonable basis for an estimate nor a reasonable method to allocate an expense into deductible and nondeductible portions
- Deduction of expenses is, however, only half of the equation
- Taxpayers are also responsible for the proper inclusion of income items
- Calculation of gross income is often accomplished through the use of income reconstruction
- The IRS is not permitted to use income reconstruction in every circumstance
- Properly kept records that show actual income cannot be disregarded by the IRS

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Clients Duty to Keep Records

- In filing tax returns or other documents with the IRS, taxpayers are under a duty to keep and maintain books and records that will substantiate the accuracy of their filed documents
- Tax law includes both general and specific recordkeeping responsibilities
- A failure to adhere to these can result in the loss of favorable tax treatment, the disallowance of deductions, tax deficiencies and, often, penalties
- When records are lost, destroyed in a casualty or stolen, some relief is possible, but only after satisfying tough burden-of-proof and reconstruction requirements

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Regulation §1.6001-1

- Requires that all persons filing income tax returns must keep books of account or records (including inventories) to sufficiently establish:
  - Gross income
  - Deductions
  - Credits and other matters shown on the return
  - The regulation also requires retaining records that may be material to the administration of the tax
  - Other regulations under § 6001 list similar requirements for estate tax, gift tax, payroll taxes, excise taxes and information returns
  - The regulation also requires making them available for inspection by the IRS upon request

Regulation §1.441-1(b)(7)

- Books should consist of records that clearly and adequately reflect income on an annual basis
- To that end, § 446 specifies using the cash receipts and disbursement method of accounting, the accrual method, or some combination of methods approved by the Service, as long as it clearly reflects income
- Inventory requires use of the accrual method for purchases and sales, although there are some small business exceptions

Regulation §1.441-1(b)(7)

- A hybrid method can use elements of both methods, provided it clearly reflects income and is used consistently from year to year
- Whatever the method, it must clearly reflect income and accurately represent the taxpayer's income, expenses and credits
- While wage-earners have to keep accurate records, they do not have to keep formal accounting books, under Regulation §1.6001-1(b)
- Whether or not required to keep books, all taxpayers must be able to substantiate the accuracy of their returns

§274

- § 274 imparts strict recordkeeping requirements for specific expenditures
- When applicable, it requires taxpayers to have expense records; otherwise, they cannot take the deduction, even if otherwise eligible
- Taxpayers meet the § 274 substantiation requirement when they maintain adequate records
- The term "adequate records" has two components — a diary, log of expenses or similar record — corroborated by documentary evidence, which generally includes receipts for all items over $75 and for lodging

Let's Review §274

- Amount
  - The amount of each separate expense, such as transportation, lodging or meals
  - However, the daily cost of meals and incidentals can be compiled into general categories, such as meals, taxi fares and laundry
  - Entertainment is treated similarly; the daily cost of taxi fares and telephone calls is aggregated
  - The amount spent on gifts or listed property (including acquisition costs and capital improvements) must be documented
- Time
  - This is the exact dates the traveler is away from home; the number of days spent on business while away from home and the dates of entertainment, gifts and acquisition of listed property
- Place/Destination
  - This is the specific cities, towns or places the traveler visited while on business away from home, and includes the name, address, and/or location of entertainment or place of business discussion

Record Reconstruction

- When a taxpayer is eligible to reconstruct his or her expenses
  - Determine exactly what has been lost
  - Determine if it is the only copy of an item
  - For those items that are the only copy, rank the relative importance of the lost items, starting with those of highest importance
  - Make a list of the items that warrant the time and expense of reconstruction
  - Determine if there is a state, Federal or other agency from which to request a copy of a lost report
  - For items of public record, contact the local courthouse for a copy
  - For bank records, contact the bank
    - It can be expensive to get copies of canceled checks, but they are available

More - Description of item

- Business purpose
  - This is the business reason for traveling or the type of benefit the individual expects to result from traveling or the use of listed property
  - The nature of the business discussion, as well as the business reason or anticipated benefit for entertainment and gifts
  - The amount of business or investment use, such as miles driven for automobiles or minutes of conversation for cell phones
  - This component supports the allocation of business and nonbusiness use of an item of property
  - This is the identification of the people entertained or the recipients of gifts and their occupations, to establish a business relationship
- Business relationship
  - This is the identification of the people entertained or the recipients of gifts and their occupations, to establish a business relationship

Other Record Sources

- Tenant leases
- Any sort of legal documents- fines, inspection reports, court appearances
- Any type of permit taken out on the property
- Assets that require depreciation - such as property or improvements
- Insurance policies
- Loan documents- such as mortgages
- Property title/deed
- Advertising costs for the business or property

Tax Returns and Information Documents

- Form 4506 – actual copy of the return $50.00 per year
  - Up to 8 years can be requested on each form
  - Can take up to 60 days + for IRS to provide
  - Generally only the last 7 years are available
  - Form 709 Gift Tax return, use letter to make request- first find out what years have been filed
  - Form 4506 – T Transcripts only, up to 4 years can be requested
  - Form 4506 – EZ Transcripts only, up to 4 years can be requested

Types of Returns/Documents

- Forms 1040, 1120, 941, etc. and all attachments originally submitted to the IRS, including Form(s) W-2, schedules, or amended returns
- Enter only one return number
- If the client needs more than one type of return, complete another Form 4506

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Other Documents

- **Transcript requested.** Enter the tax form number (1040, 1065, 1120, etc.) and check the appropriate box
- **Return Transcript,** which includes most of the line items of a tax return as filed with the IRS
- A tax return transcript does not reflect changes made to the account after the return is processed
- Transcripts are only available for the following returns: Form 1040 series, Form 1065, Form 1120, Form 1120A, Form 1120H, Form 1120L, and Form 1120S
- Return transcripts are available for the current year and returns processed during the prior 3 processing years
- Most requests will be processed within 10 business days

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Other Documents

- **Account Transcript,** contains information on the financial status of the account, such as payments made on the account, penalty assessments, and adjustments made by the taxpayer or the IRS after the return was filed
- **Return information** is limited to items such as tax liability and estimated tax payments
- **Record of Account Transcript** - combines the tax return and tax account transcripts above into one complete transcript. This transcript is available for the current tax year and returns processed during the prior three years using Get Transcript Online or Form 4506-T
  - Available for current year and 3 prior tax years
- **Verification of Non-filing,** which is proof from the IRS that the client **did not** file a return for the year
- Current year requests are only available after June 15th
- There are no availability restrictions on prior year requests

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Other Documents

- **Form W-2, Form 1099 series, Form 1098 series, or Form 5498 series transcript**
  - The IRS can provide a transcript that includes data from these information returns
  - State or local information is not included with the Form W-2 information
  - The IRS may be able to provide this transcript information for up to 10 years
  - Information for the current year is generally not available until the year after it is filed with the IRS
  - For example, W-2 information for 2016, filed in 2017, will likely not be available from the IRS until 2018

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Other Documents

- If the client needs W-2 information for retirement purposes, they should contact the Social Security Administration at 1-800-772-1213
- Most requests will be processed within 10 business days
- Caution
  - If the client needs a copy of Form W-2 or Form 1099, they should first contact the payer
  - To get a copy of the Form W-2 or Form 1099 filed with the return, use Form 4506 and request a copy of the return, which includes all attachments

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State of Iowa Procedure

- Iowa individual non-filers
  - IDR does not get state withholding data from W-2
  - Will allow 3% of federal withholding if W-2 missing
  - But, only if taxpayer has same employer and filed some years, same proportion will be allowed

Those attending from other states if you have knowledge of a state procedure, concerning this issue, please let me know and I will share

Beginning in 2017, for the 2016 tax year, Iowa requires the filing of Forms W-2

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What Should You do if the Taxpayer Does Not Have the Records?

- In the event of a loss of client records or due to poor recordkeeping, a paid preparer may need to help his client reconstruct the records
- The reconstruction will demonstrate that the paid preparer exercised due diligence and it will also teach the client about recordkeeping
- The goal of record reconstruction is to use available documentation to develop a sound and reasonable estimate of the taxpayer's business income and expenses to support the Schedule C prepared
- Although the taxpayer may not have formal books and records with supporting documentation, they may have partial records that can be used as a basis for reconstruction

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Appointment Books or Calendars

- An appointment book could be used to develop:
  - Where a taxpayer traveled to provide services, and how many trips
  - A count of how many people were provided services
  - A count of how many of each type of service was rendered; for example, how many haircut appointments, how many manicure appointments
- The number of trips made and the locations traveled to could be combined with online map tools data to support total business miles driven

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On Line Map Tools

- Online map tools can be used to reconstruct mileage calculations
- IRS standard allowances
  - The IRS provides standard expense allowances including per diem expenses for truck drivers and standard mileage rates

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Standard Mileage Rate Chart (Annually In Cents Per Mile) - https://www.irs.gov/taxprofessionals/standard-mileage-rates/

Period	Rates in cents per mile			Source
	Business	Charity	Medical Moving	
2017	53.5	14	17	IR-2016-169
2016	54	14	19	IR-2015-137
2015	57.5	14	23	IR-2014-114
2014	56	14	23.5	IR-2013-95
2013	56.5	14	24	IR-2012-95
2012	55.5	14	23	IRB-2012-02
July 1 - Dec. 31, 2011	55.5	14	23.5	IR-2011-69
Jan. 1 - June 30, 2011	51	14	19	IR-2010-119
2010	50	14	16.5	IR-2009-111
2009	55	14	24	IR-2008-131
July 1 - Dec. 31, 2008	58.5	14	27	IR-2008-82
Jan. 1 - June 30, 2008	50.5	14	19	IR-2007-192
2007	48.5	14	20	IR-2006-168
2006	44.5	14	18	IR-2005-138
2005	40.5	14	15	IR-2004-139 Pub. L. 109-73 IR-2005-99
2004	37.5	14	14	IR-2003-121
2003	36	14	12	Rev. Proc. 2002-61
2002	36.5	14	13	Rev. Proc. 2001-54
2001	34.5	14	12	Rev. Proc. 2000-48 2000-2 C.B. 570
2000	32.5	14	10	Rev. Proc. 99-38 1999-2 C.B. 525
1999	31	14	10	Announcement 99-7 1999-1 C.B. 306 Rev. Proc. 98-63 1998-2 C.B. 818
1998	32.5	14	10	Rev. Proc. 97-58 1997-2 C.B. 587
1997	31.5	12	10	Rev. Proc. 96-63 1996-2 C.B. 420

Per Diem

- Per diem is the allowance for lodging (excluding taxes), meals and incidental expenses
- The General Services Administration (GSA) establishes per diem rates for destinations within the Continental United States (CONUS)
- The State Department establishes the foreign rates
- Per diem cannot be used to substantiate lodging expenses – a receipt is required

Checkbook, Cancelled Checks, Bank Statements or Credit Card Statements

- These documents can be used to gain information about expenses incurred and what types of services were performed for clients
- Reconstruction of receipts can be accomplished using the information from the checking account transcripts

Cell Phone Records and Call History or Computer Logs

- Use to develop a list of clients served during specific timeframes
- Check emails that may substantiate a client or information concerning meetings

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List of Regular Clients

- A client could reconstruct a reasonable calendar of services

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Partial Receipts or Sales Tax Records

- Can provide information regarding what expenses were incurred for services
- Obtain records from state and government agencies **IF** sales tax was paid or other fees paid

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Prior Year Returns

- Prior year returns can provide the basis for records if activities are similar from year to year
- A starting point for your client would identify regular places of business where copies of source documents may be able to be obtained

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Business Records - Reminder

- Inventories – Get copies of invoices from suppliers
- Income – Get copies of bank statements
  - The deposits should closely reflect what the sales were for any given time period
- Obtain copies of last year's federal, state and local tax returns including sales tax reports, payroll tax returns and business licenses (from city or county)
  - These will reflect gross sales for a given time period

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Business Records

- If the client purchased an existing business, go back to the broker for a copy of the purchase agreement
  - This should detail what was acquired
- If the building was constructed for the taxpayer, contact the contractor for building plans or the county/city planning commissions for copies of any plans

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Substitute for Return (SFR)

- Return filed by IRS based on information documents
- Generally filed single with 1 exemption and -0- expenses
- Reconstruction of income and expenses is required to correct the SFR
- File an original return based on the record reconstruction

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SFR

- IRS generally look at these returns as HIGH audit potential
- A bank deposit analysis should be performed and expenses that have been reconstructed must be substantiated

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IRS

- An IRS agent may use a reconstruction method to calculate income
- History of court cases have been upheld concerning reconstruction of income
- §446 - IRS agents are entitled to determine a taxpayer's income by any method that clearly reflects income

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Methods Available for IRS Use

- Source and Application of Funds
- Bank Deposits and Cash Expenditures Method
- Markup Method
- Unit and Volume Method
- Net Worth Method

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The Source and Application of Funds Method

- An analysis of a taxpayer's cash flows and comparison of all known expenditures with all known receipts for the period
- Net increases and decreases in assets and liabilities are taken into account along with nondeductible expenditures and nontaxable receipts
- The excess of expenditures over the sum of reported and nontaxable income is the adjustment to income

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Bank Deposits and Cash Expenditures Method

- In summary, income is proven through a detailed, in-depth analysis of all bank deposits, cancelled checks, currency transactions, and electronic debits, transfers, and credits to the bank accounts AND identification of the taxpayer's cash expenditures
- The Bank Deposits and Cash Expenditures Method is distinguished from the Bank Account Analysis by:
  - The depth and analysis of all the individual bank account transactions, and
  - The accounting for cash expenditures, and
  - Determination of actual personal living expenses

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Markup Method

- The Markup Method produces a reconstruction of income based on the use of percentages or ratios considered typical for the business under examination in order to make the actual determination of tax liability
- It consists of an analysis of sales and/or cost of sales and the application of an appropriate percentage of markup to arrive at the taxpayer's gross receipts
- By reference to similar businesses, percentage computations determine sales, cost of sales, gross profit, or even net profit
- By using some known base and the typical applicable percentage, individual items of income or expenses may be determined
- These percentages can be obtained from analysis of Bureau of Labor Statistics data or industry publications. If known, use of the taxpayer's actual markup is required

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Markup Method

- The Markup Method is a formal indirect method that can overcome the weaknesses of the Bank Deposits and Cash Expenditures Method, Source and Application of Funds Method, and Net Worth Method, which do not effectively reconstruct income when cash is not deposited and the total cash outlays cannot be determined unless volunteered by the taxpayer

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Unit and Volume Method

- In many instances gross receipts may be determined or verified by applying the sales price to the volume of business done by the taxpayer
- The number of units or volume of business done by the taxpayer might be determined from the taxpayer's books as the records under examination may be adequate as to cost of goods sold or expenses
- In other cases, the determination of units or volume handled may come from third party sources
- This method for determining the actual tax liability has been effectively applied in carry out pizza businesses, coin operated Laundromats, and mortuaries

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Net Worth Method

- The Net Worth Method for determining the actual tax liability is based upon the theory that increases in a taxpayer's net worth during a taxable year, adjusted for nondeductible expenditures and nontaxable income, must result from taxable income
- This method requires a complete reconstruction of the taxpayer's financial history, since the government must account for all assets, liabilities, nondeductible expenditures, and nontaxable sources of funds during the relevant period

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Net Worth Method

- The theory of the Net Worth Method is based upon the fact that for any given year, a taxpayer's income is applied or expended on items which are either deductible or nondeductible, including increases to the taxpayer's net worth through the purchase of assets and/or reduction of liabilities
- The taxpayer's net worth (total assets less total liabilities) is determined at the beginning and at the end of the taxable year
- The difference between these two amounts will be the increase or decrease in net worth
- The taxable portion of the income can be reconstructed by calculating the increase in net worth during the year, adding back the nondeductible items, and subtracting that portion of the income which is partially or wholly nontaxable

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Subtopic Information

Statutes

- Internal Revenue Code
- § 6501 (3-year audit statute)
- § 6502 (10-year debt collection statute)
- § 6503 (suspending the 10-year debt collection statute) and
- § 6511 (3-year refund statute)

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Non Filed Return

- No statute of limitations

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How Long to Keep Records

- Keep copies of filed tax returns
- They help in preparing future tax returns and making computations if it is necessary to file an amended return
- If the taxpayer owes additional tax and the situations below, do not apply to them; keep records for 3 years
  - They did not report income that they should report, and it is more than 25% of the gross income shown on the return; keep records for 6 years
  - They file a fraudulent return; keep records indefinitely
  - They do not file a return; keep records indefinitely

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How Long to Keep Records

- The taxpayer files a claim for credit or refund after they file the return; keep records for 3 years from the date they filed the original return or 2 years from the date they paid the tax, whichever is later
- The taxpayer filed a claim for a loss from worthless securities or bad debt deduction; keep records for 7 years
- Keep all employment tax records for at least 4 years after the date that the tax becomes due or is paid, whichever is later

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Are the records connected to assets?

- Keep records relating to property until the period of limitations expires for the year in which the taxpayer disposes of the property in a taxable disposition
- Taxpayers must keep these records to figure any depreciation, amortization, or depletion deduction and to figure the gain or loss when they sell or otherwise dispose of the property
- The taxpayer must keep the records on the old property, as well as on the new property, until the period of limitations expires for the year in which they dispose of the new property in a taxable disposition

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The Scoop – Upcoming Dates

- August 16
- August 30
- September 13
- October 4
- October 18
- November 1
- December 13, 2017
- Held at 8:00 am and 12:00 pm Central time

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Tour of the CALT Website

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Up Coming Webinars http://www.calt.iastate.edu/calendar-node-field-seminar-date/month

- Uber/Lyft Drivers and Business Expenses August 22
- Self-Rental August 23
- Ethics Part 1 and 2 September 1
- Ethics Part 1 and 2 October 6, 2017
- Tax Reform and New Law Update October 17
- New Partnership Audit Rules October 19
- Iowa Farm Leases (Legal Issues) October 12
- Iowa Rural Property (Legal Issues) October 13
- The New Partnership Audit Regime October 19, 2017
- Farm Expenses October 24, 2017
- Farm Income October 26, 2017
- Ethics Part 1 and 2 December 15
- Ethics Part 1 and 2 December 18

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Upcoming Seminars – Mark Your Calendar – Final Dates

- September 21, 2017 Ag Law Seminar, Live and Webinar
- September 22, 2017 Farm and Estate Tax Review, Live and Webinar
- Retirement and Social Security Issues(Webinar) = October 10-11, 2017

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The Schedule is Finalized for the 44th Annual Federal Income Tax Schools

- November 2-3, 2017 – Maquoketa, Iowa – Centerstone Inn and Suites
- November 6-7, 2017 – Le Mars, Iowa – Le Mars Convention Center
- November 8-9, 2017 – Atlantic, Iowa – Cass County Community Center
- November 9-10, 2017 – Mason City, Iowa – North Iowa Area Community College
- November 16-17, 2017 – Ottumwa, Iowa – Indian Hills Community College
- November 20-21, 2017 – Waterloo, Iowa – Hawkeye Community College
- December 11-12, 2017 – Ames, Iowa and Live Webinar – Quality Inn and Suites

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