ENROLLED AGENT
SPECIAL ENROLLMENT EXAM (SEE)
STUDY GUIDE

PART 2 - BUSINESSES

IRS Provider Number: RP5CH

IRSTAXTRAINING.COM, INC.

Email: Support@IRSTaxTraining.com
Voice: 800-214-4307
Fax: 877-674-3472

www.IRSTaxTraining.com

EXCLUSIVE PUBLISHERS OF THIS LIMITED EDITION

This material is for educational purposes only and specific to the subject matter contained in the Table of Contents, and in no way does it cover all aspects of the tax code. Rather, it is constructed to offer an accurate representation of the subject matter being covered. Purchase of this course or any other course offered by IRSTaxTraining.com, Inc. comes with the provision that they are not for the purposes of offering legal or other professional services. Additionally, the course contains the current tax law as to date of publication.

ARTICLES AND COMMENTARY INCLUDED HEREIN DO NOT CONSTITUTE AN OPINION AND ARE NOT INTENDED OR WRITTEN TO BE USED, AND THEY CANNOT BE USED, BY ANY TAXPAYER FOR THE PURPOSE OF AVOIDING PENALTIES THAT MAY BE IMPOSED ON THE TAXPAYER.

Table of Contents

IRSTaxTraining.com, Inc. is pleased to provide our Enrolled Agent (EA) Exam Study Guide. This material is designed to prepare tax professionals for *Part 2 - Businesses* of the IRS Special Enrollment Exam (SEE) and provides an overview of the subject areas that are outlined for the examination period between May 1, 2021 – February 28, 2022. The study guide includes information about the administration of the examination and complete coverage of the categories that are on the exam. In addition, we have developed multiple practice tests for you to take that are simulations of the actual exam. They are timed just like the SEE and you will see your results upon completion, including the questions you missed and the correct answers. Before you sign up to take the SEE, the IRS asks you to read and follow the instructions in the Candidate Information Bulletin.

Course Description

This course, intended for exams taken between **May 1, 2021 – February 28, 2022**, is based on the **2020 tax year** and highlights major tax laws that are of significant importance to a tax practitioner. This section focuses on key Federal tax law provisions recently enacted or indexed for inflation. Among other topics, this part includes information about the Tax Cuts and Jobs Act (TCJA), taxable income, exclusions, the most common tax credits and deductions, capital gains and losses, and noteworthy tax filing documents and dates.

For exams taken between **May 1, 2021 – February 28, 2022,** all references on the examination are to the Internal Revenue Code, forms and publications, as amended through December 31, 2020. Also, unless otherwise stated, all questions relate to the calendar year 2020. Questions that contain the term ‘current tax year’ refer to the calendar year 2020. In answering questions, candidates should not take into account any legislation or court decisions after December 31, 2020.

The course includes a table of contents and comprehensive index to help guide your search for specific topics. Additionally, if you are using the electronic version of the course, you can use the word search function by pressing “CTRL + F” on your keyboard and entering the word(s) you would like to look up. Along with the extensive course content, you will also find a bibliography you can use to find additional reference material when searching for particular topics or answers to examination questions. The numbers in parentheses at the end of a sentence correspond to the numbers in the bibliography.

IRS Special Enrollment Exam (SEE)

The examination contains three parts. Each part contains 100 multiple-choice questions. There are 85 questions that are scored and 15 questions that are experimental and not scored. The length of each part is 3½ hours (not including the pre-examination tutorial and post-examination survey). An on-screen timer is provided, showing the time remaining. The parts of the examination are:

- Part 1 - Individuals
    - Preliminary Work with Taxpayer Data – 14 questions
    - Income and Assets – 17 questions
    - Deductions and Credits – 17 questions
    - Taxation – 15 questions
    - Advising the Individual Taxpayer – 11 questions
    - Specialized Returns for Individuals – 11 questions
- Part 2 - Businesses
    - Business Entities and Considerations – 30 questions
    - Business Tax Preparation – 37 questions
    - Specialized Returns and Taxpayers – 18 questions
- Part 3 - Representation, Practice and Procedures
    - Practices and Procedures – 26 questions
    - Representation before the IRS – 25 questions
    - Specific Types of Representation – 20 questions
    - Completion of the Filing Process – 14 questions

Each part of the exam is 3½ hours long. The actual seat time is 4 hours to allow for a tutorial and survey. The examination parts can be taken in any order. Each exam part may be taken 4 times per testing window, which runs from May 1 to February 28. The test is not offered during the annual blackout period in March and April. During this time the test is updated for the most recent tax law. You have a total of two years from the time you pass your first exam to pass all three parts and become an Enrolled Agent.

The examinations are closed book, so no reference materials, papers or study materials are allowed at the test center. You will not be able to leave the testing room with a copy of any notes taken during the examination. Some examination questions may contain excerpts from the Internal Revenue Code or Income Tax Regulations.

You can schedule an examination appointment at any time online at www.prometric.com/test-takers/search/irs or by calling 800-306-3926 between 8 a.m. and 9 p.m. (ET), Monday through Friday. You will receive a number confirming your appointment. Keep this confirmation number for your records - you will need it to reschedule, cancel, or change your appointment.

You may take each part of the examination at your convenience and in any order. Parts do not have to be taken on the same day or on consecutive days. You may take examination parts up to four times each during each test window. The current test window is May 1, 2021 – February 28, 2022. Testing is not available in the months of March and April each year while the examination is updated.

A confirmation email is sent containing the date time and location of the exam. If any information on the confirmation notice is incorrect, if you have not received your confirmation notice before your exam date, or if you lose your confirmation email, you can log back into your dashboard and request a duplicate confirmation.

Keep in mind that you are not allowed to take anything into the room, including jewelry, purse, wallet or watch. A locked locker is available for your personal effects, and you must turn all of your pockets inside out for security. The test center provides you with scratch paper, 2 pencils and a handheld calculator. You will also be able to use an onscreen calculator during the examination.

After completing the exam, you press the "End" button. You will be asked about 5-10 evaluation questions. When you press "End" the second time, the results come up on your screen. If you pass, the score report will show a passing designation. It will not show a score. All score values above passing indicate that a candidate is qualified. You will also receive diagnostic information which will indicate areas where you may wish to consider professional development. When you pass all three parts of the examination, you may apply for enrollment with the IRS.

If you fail, your score report will show a scaled score between 40 and 104. You will also receive diagnostic information to assist you with future examination preparation. Diagnostic information will show an indicator of 1, 2, or 3 meaning:

1. Area of weakness - Additional study is necessary. It is important for you to focus on this area as you prepare to take the test again. You may want to consider taking a course or participating actively in a study group on this topic.
2. Marginal - You may need additional study in this area.
3. Strong - You clearly demonstrated an understanding of this subject area.

This information is designed to help you prepare for retaking the examination.

You may take each part of the examination at your convenience and in any order. Examination parts do not have to be taken on the same day or on consecutive days. You may take examination parts up to four times each during each test window. If you fail any part of the examination, you must allow a 24-hour waiting period before scheduling a retest. You must re-schedule with Prometric online at www.prometric.com/test-takers/search/irs or by calling 800-306-3926.

If you do not pass a part of the examination after four attempts during the May 1 to February 28 test window, you must wait until the next test window before attempting to retake any failed part of the examination again. The average passing rate for Part 1 of the exam in 2020 was about 80%. For Part 2 the average passing rate was about 60% and for Part 3 the average passing rate was about 85%. For this reason, we recommend that candidates attempt Part 1 first followed by Part 3 and then Part 2. We also strongly recommend extra time in your preparation for Part 2. When you pass all three parts of the examination you need to file Form 23 - Application for Enrollment to Practice Before the Internal Revenue Service. As part of the evaluation of your enrollment application, the Internal Revenue Service will conduct a suitability check that will include a review of your personal tax compliance.

FAQs

What is an enrolled agent?
An enrolled agent is a person who has earned the privilege of representing taxpayers before the Internal Revenue Service. Enrolled agents, like attorneys and certified public accountants (CPAs), are unrestricted as to which taxpayers they can represent, what types of tax matters they can handle, and which IRS offices they can represent clients before.

How do you become an enrolled agent?
Review the Candidate Information Bulletin to get started and follow these steps to become an EA:

1. Obtain a Preparer Tax Identification Number (PTIN).
2. Apply to take the Special Enrollment Examination (SEE).
3. Achieve passing scores on all 3 parts of the SEE.*
4. Apply for enrollment.
5. Pass a tax compliance check to ensure that you have filed all necessary tax returns and there are no outstanding tax liabilities.

*Certain IRS employees, by virtue of past technical experience, are exempt from the exam requirement.

How much does it cost to take the Special Enrollment Examination?
There is a $185 fee for each part of the examination paid at the time of appointment scheduling. The test fee is non-refundable and non-transferable. This fee is paid at the time you schedule your examination. Accepted forms of payment include MasterCard, Visa, American Express and Electronic checks. Money orders, paper checks and cash are not accepted. Please refer to the Candidate Information Bulletin to read the policy on rescheduling appointments.

What types of tax issues could negatively impact consideration of an application for enrollment?
In general, any overdue tax return that has not been filed or any unpaid taxes unless acceptable payment arrangements have been established. Refer to Circular 230, Sections 10.5(d)(1) and 10.51, for a complete explanation of the suitability requirements.

What types of criminal convictions would negatively impact consideration of an application for enrollment?
In general, any criminal offense resulting in a felony conviction under Federal tax laws or a felony conviction related to dishonesty or a breach of trust, that is less than ten years old. Refer to Circular 230, Sections 10.5(d)(1) and 10.51, for a complete explanation of the suitability requirements.

Do enrolled agents have any continuing education requirements?
Enrolled agents must obtain a minimum of 72 hours per enrollment cycle (every three years). Additionally, they must also obtain a minimum of 16 hours of continuing education (including 2 hours of ethics or professional conduct) each enrollment year.

If I live outside the U.S., am I required to obtain a PTIN prior to becoming an enrolled agent?
Yes, all applicants must have a Preparer Tax Identification Number (PTIN) issued by the Internal Revenue Service (IRS) in order to register to take the examination. Obtain a PTIN at www.irs.gov/ptin.

After I register to take the Special Enrollment Exam, how long do I have to schedule an appointment to test?
Your examination appointment must be scheduled within one year of the date of registration. If space permits, you may register and schedule up to 2 days prior to your test date. There is no fee if you reschedule at least 30 calendar days prior to your appointment date. There is a $35 fee if you reschedule 5 to 29 calendar days before your appointment date. Another full examination fee if you reschedule less than five calendar days before your appointment date. Rescheduling an examination must be done online at http://www.prometric.com/test-takers/search/irs or by calling 800-306-3926.

I previously passed parts of the exam, how long can I carryover those scores?

Generally, candidates who pass a part of the examination can carry over a passing score up to two years from the date they passed that part of the examination. To provide candidates flexibility in testing during this period of global emergency, the two-year period has been extended to three years. This applies to any examination parts that had not expired as of February 29, 2020 and any examination parts passed on June 1, 2020 and later. For example, assume a candidate passed Part 1 on November 15, 2019. Subsequently the candidate passed Part 2 on February 15, 2020. That candidate has until November 15, 2022 to pass the remaining part. Otherwise, the candidate loses credit for Part 1. The candidate has until February 15, 2023 to pass all other parts of the examination or will lose credit for Part 2.

In another example, assume a candidate passed Part 1 on June 1, 2020. Subsequently the candidate passed Part 2 on September 1, 2020. That candidate has until June 1, 2023 to pass the remaining part. Otherwise, the candidate loses credit for Part 1. The candidate has until September 1, 2023 to pass all other parts of the examination or will lose credit for Part 2.

How do I obtain my SEE results?

Candidates taking an examination between May 1, 2021 and approximately August 1, 2021 will not receive a test score immediately upon completion of the examination. During this period data will be collected and analyzed to establish the passing score. For tests taken during this period a score report will be e-mailed to the test candidate beginning August 5, 2021. Beginning August 2, 2021, upon completion of the examination, a pass/fail message will appear on your computer screen. In addition, you will receive an email from Prometric containing your score report.

Do I have to send my test results to the IRS?

No. The test center (Prometric) will automatically share the test results with the IRS and the IRS records will be updated accordingly.

How does the IRS determine if a person passes or fails? What is the passing score?

The scoring methodology was determined by the IRS following a scoring study. A panel of subject matter experts composed of Enrolled Agents and IRS representatives established a passing score for a candidate who meets the minimum qualifications to be an Enrolled Agent. The scaled passing score is 105.

What is a scaled score system? How can I determine my score?

Scaled scores are determined by calculating the number of questions answered correctly and converting it to a scale that ranges from 40 to 130. The IRS has set the scaled passing score at 105. Failing candidates are provided a scaled score value so that they may see how close they are to being successful. Candidates that receive a scaled score of 104 are very close to passing. Candidates with a scaled score of 45 are far from being successful. You will also receive diagnostic information to assist you with future examination preparation. If you pass, the score report will show a passing designation. It will not show a score. All score values above passing indicate that a candidate *is* qualified — not *how* qualified. You will also receive diagnostic information which may indicate areas of weakness in your performance where you may need continuing education.

Once I have passed all three parts of the SEE, how do I officially become an Enrolled Agent?

You must apply for enrollment within one year of the date you passed the third examination part. You may electronically apply for enrollment and make secure payment of the $67 enrollment fee at www.pay.gov. Click Find an Agency, select Treasury (UST): Internal Revenue Service (IRS), then click Application for Enrolled Agents. You will be given the option to pay online from your bank account (ACH) or with a debit or credit card.

You may also apply for enrollment by mail by submitting a completed Form 23 - Application for Enrollment to Practice before the IRS, along with a check for $67 to the address listed on the Form. Please allow 60 days for processing (90-120 days if you are a former IRS employee). As part of the evaluation of your enrollment application, the IRS will conduct a suitability check that will include a review of your personal tax compliance.

IRS Special Enrollment Exam (SEE) Outline

The following is a list of topics for each part of the examination and the percentage of questions that will appear on the exam covering these areas. Not every topic on the list will necessarily appear on the examination and the list should not be viewed as all-inclusive. Some topics may appear in more than one examination part. However, this list is based on the results of a survey sent to over 10,000 enrolled agents and it represents the knowledge needed for the tasks performed by enrolled agents.

The *Part 2 - Businesses* exam contains 100 multiple-choice questions. There are 85 questions that are scored and 15 questions that are experimental and not scored.

Part 2 - Businesses

Section 1: Businesses Entities (30 Questions)

1.1. Business entities and considerations

- Sole proprietorships
- Partnerships and qualified joint ventures (QJV)
- Corporations
- S corporations
- Farmers
- LLCs
- Tax-exempt entities and associations
- Entity type default classifications and elections
- Employer identification number
- Accounting periods (tax year)
- Accounting methods
- Reporting requirements (e.g., Forms W-2, W-4, Form 1099)
- Hobby versus business determination and loss limitations

1.2. Partnerships

- Partnership income, expenses, distributions, and flow-through (e.g., self-employment income)
- Family partnerships
- Partner's dealings with partnership (e.g., exchange of property, guaranteed payments)
- Contribution of property and/or services to partnership (e.g., partnership's basis, property subject to indebtedness)
- Basis of partner's interest
- Disposition of partner's interest
- Partnership formation (e.g., partnership agreement, general vs. limited partners, capital contributions)
- Dissolution of partnership (e.g., sale, death of partner)
- Filing requirements, due dates, penalties, and audit notice requirements
- Partnership cancellation of debt
- Partnership level audit and opt-out

1.3. Corporations in general

- Filing requirements, due dates and penalties
- Earnings and profits
- Shareholder dividends, distributions, and recognition requirements
- Special deductions and credits (e.g., dividends received deductions, charitable deduction).
- Liquidations and stock redemptions
- Accumulated earnings tax
- Estimated tax payments
- Corporate minimum tax credit

1.4. Forming a corporation

- Services rendered to a corporation in return for stock
- IRC Section 351 exchange
- Transfer and/or receipt of money or property in addition to corporate stock
- Transfer of property subject to indebtedness
- Controlled groups
- Closely held corporations

1.5. S corporations

- Requirements to qualify (e.g., qualifying shareholders)
- Election procedure

- Income, expenses, and separately stated items
- Treatment of distributions (e.g., reasonable compensation)
- Shareholder's basis (e.g., loan basis, distributions, losses in excess of basis, services for stock)
- Revocation, termination, and reinstatement
- Debt discharge

Section 2: Business Tax Preparation (37 Questions)

2.1. Business income

- Gross receipts and other income
- Cost of goods sold (e.g., inventory practices, expenditures included, uniform capitalization rules)
- Net income/loss and at-risk limitations
- Cancellation of business debt

2.2. Business expenses, deductions and credits

- Officers and Employees' compensation (e.g., deductibility of compensation, fringe benefits, rules of family employment, statutory employee, necessary and reasonable)
- Business rental deduction, including self-rentals
- Depreciation, amortization (start-up and organizational cost), IRC Section 179, depletion, bonus depreciation, and correcting errors
- Business bad debts
- Business travel, entertainment, and gift expenses
- Vehicle use and expenses
- Interest expense
- Insurance expense
- Taxes (e.g., deductibility of taxes, assessments, and penalties; proper treatment of sales taxes paid, excise)
- Employment taxes
- Casualties, thefts, and condemnations
- Qualified business income (QBI) (e.g., SSTB, calculations, phase out, UBIA)
- Eligibility and deductibility of general business credits (e.g., disabled access credit, R&D credit, small business healthcare tax credit, foreign tax credit)
- Net operating loss deduction
- Home office

2.3. Business assets

- Basis of assets
- Disposition of property or assets
- Like-kind exchange
- Converted property
- Capitalization and repair regulations (e.g., elections)

2.4. Analysis of financial records

- Proper business type, the use of classification codes, and year to year comparison
- Income statement
- Balance sheet (e.g., proofing beginning and ending balances, relationship to income statement and depreciation)
- Method of accounting (e.g., accrual, cash, hybrid, Form 3115)
- Depreciation, depletion and amortization (e.g., start-up and organizational cost)
- Depreciation recovery (e.g., recapture, IRC Section 280F)
- Pass-through activity (e.g., K-1, separately stated items, non-deductible expenses)
- Reconciliation of tax versus books (e.g., M-1, M-2, M-3)
- Related party activity
- Loans to and from owners

2.5. Advising the business taxpayer

- Reporting and filing obligations (e.g., extended returns and potential penalties, international information returns, Form 1099 series, Form 8300)
- Payments and deposit obligations (e.g., employment tax, excise tax)
- Recordkeeping requirements (e.g., mileage log, accountable plans)
- Selection of business entity (e.g., benefits and detriments)

- Comingling (e.g., personal usage of business accounts, separation of business and personal accounts)
- Advice on accounting methods and procedures (e.g., explanation of requirements)
- Transfer of property in or out of the business
- Life cycle of the business (e.g., formation, dissolution)
- Type of industry (e.g., specified service business owners)
- Worker classification (i.e., independent contractor versus employee, outside sales, full-time versus part-time)
- Deductions and credits for tax planning (e.g., timing of income and expenses, NOL, depreciation versus IRC Section 179 versus bonus depreciation)
- ACA compliance

Section 3: Specialized Returns and Taxpayers (18 Questions)

3.1. Trust and estate income tax

- Trust types (e.g., simple/complex, grantor, irrevocable, tax shelters)
- Distributable net income and accounting income
- Exclusions, exemptions, and deductions
- Fraudulent trusts
- Income (e.g., allocations, corpus versus income)
- Separately stated items (e.g., items reported on the K-1)
- Filing requirements, tax years and penalties

3.2. Exempt organizations

- Qualifying for and maintaining tax-exempt status (e.g., IRC Section 501(c))
- Applying for IRS tax-exempt status (e.g., Form 1023, Form 1024)
- Filing requirements (e.g., Form 990 series)
- Unrelated business taxable income (UBTI)

3.3. Retirement plans

- Employer and employee contributions
- Reporting requirements
- Plans for self-employed persons (e.g., SEP and SIMPLE)
- Prohibited transactions
- Qualified and non-qualified plans
- Non-discrimination rules

3.4. Farmers

- Farm income (e.g., self-raised livestock, crop insurance proceeds, subsidies, patronage dividends, conservation payments)
- Depreciation for farmers
- Disaster-area provisions (e.g., drought, flood, other weather-related conditions)
- Farm rental (e.g., Form 4835)
- Farm tax computation (e.g., Schedule J, Schedule SE, estimated tax)

3.5 Rental Property

- Real estate professional qualifications
- Commercial rentals versus residential rentals
- Mixed used property/vacation home
- Passive loss limitation (e.g., special $25,000 allowance, MAGI limits)
- Rental income (e.g., deposits, pre-paid rent, not rented for profit)
- Rental expenses (e.g., allocation between personal and rental, repair versus capitalized)

Contact Information

Prometric

Main: 1-800-306-3926
Prometric Test Center: www.prometric.com/test-takers/search/irs

IRSTaxTraining.com

Phone: 1-800-214-4307
Web: www.irstaxtraining.com
Email: Support@irstaxtraining.com

Understanding the Icons Used in this Book

Important: Update or Change

Tip

Tip: Significant information

Note: Additional information

IRSTaxTraining.com, Inc. is an approved education provider for the California Tax Education Council (CTEC), the Internal Revenue Service (IRS) and the National Association of State Boards of Accountancy (NASBA). Our CTEC provider number is 6224 and can be confirmed at www.CTEC.org. Our IRS provider number is RP5CH and can be verified on the IRS list of Approved Continuing Education Providers under 101 Educations Services, Inc. dba IRSTaxTraining.com. Our NASBA National Registry Number is 125385 and can be verified by visiting the NASBA Confirm Registry CPE Sponsor Status website.

Businesses

Coronavirus Aid, Relief, and Economic Security Act (CARES)

The Coronavirus Aid, Relief, and Economic Security (CARES) Act is a package of measures introduced in the U.S. Senate in March of 2020 in response to the COVID-19 pandemic.

The legislation, in part, provides for: (1)

- Loans and assistance to companies and state and local governments.
- Low-interest and small business loans that can be partially forgiven.
- Individual Stimulus Payments.
- Additional unemployment benefits.
- Suspension of certain federal student loan payments.
- Financial hardship forbearance on federally backed mortgage loans.
- Assistance to hospitals and veteran's care.
- Funding for national stockpile of pharmaceutical and medical supplies.
- Tax relief provisions.

Employee Retention Credit

The CARES Act provides a refundable payroll tax credit for 50% of "qualified wages" paid or incurred by eligible employers to employees after March 12, 2020 and before January 1, 2021. The credit is available to employers carrying on a trade or business during calendar year 2020 and whose (i) operations are fully or partially suspended due to a COVID-19 related shutdown order or (ii) gross receipts decline more than 50% as compared to the same calendar quarter in the prior year.

The credit can be claimed on a quarterly basis but the amount of wages, including health benefits, for which the credit can be claimed is limited to $10,000 in aggregate per employee for all quarters. Tax-exempt organizations are eligible where their operations are fully or partially suspended due to COVID-19.

Payroll Tax Deferral

Employers and self-employed individuals are allowed to defer payment of Social Security (Old Age, Survivors, and Disability Insurance (OASID)) taxes for the period from the date of enactment of the CARES Act through December 31, 2020. The 6.2% AOSID portion of payroll taxes incurred by employers and 50% of the equivalent payroll taxes incurred by self-employed taxpayers qualify for the deferral. Half of the deferred payroll taxes are due on December 31, 2021, with the remainder due on December 31, 2022.

Net Operating Loss (NOL)

Prior to 2018, net operating losses of a business or individual could be carried back two years and forward 20, and when carried forward, they could offset 100% of taxable income. The TCJA altered these rules, disallowing all carrybacks related to post-2017 losses, providing for an indefinite carryforward period, and limiting the use of post-2017 losses when carried forward to 80% of taxable income.

The CARES Act retroactively suspends the 80% income limitation on use of NOL carryovers for taxable years beginning before January 1, 2021 and allows 100% of any such taxable income of offset the amount of such NOL carryforward. This 80% income limitation is reinstated (with slight modifications) for tax years beginning after December 31, 2021. Also, losses from 2018, 2019 and 2020, will be permitted to be carried back for up to five years. As was previously the case, a taxpayer will be permitted to forgo the carryback, and instead carry the loss forward. The bill also eliminates loss limitation rules applicable to sole proprietors and pass-through entities to allow them to take advantage of the NOL carryback.

Minimum Tax Credits

As part of TCJA, the corporate alternative minimum tax (AMT) was eliminated, effective for tax years beginning after December 31, 2017. Taxpayers that had AMT credit carryforwards were able to use them against their regular tax liability and also able to claim a refundable credit equal to 50% of the remaining AMT carryforward in years beginning in 2018 through 2020 and 100% for years beginning in 2021.

Business Interest Deduction

The business interest expense limitation of Section 163(j) increased from 30% to 50% of adjustable taxable income for tax year 2020, and retroactively for 2019. Every taxpayer who deducts business interest is required to file Form 8990 - Limitation on Business Interest Expense Under Section 163(j) unless an exception for filing is met.

Excess Business Loss Limitation

The excess business loss limitation of noncorporate taxpayers (Form 461) has been repealed for 2020, and retroactively for 2018 and 2019. If the taxpayer filed a 2018 or 2019 return with the limitation, he or she can file an amended Form 1041.

Charitable Contributions

The CARES Act changes the limitations on deductions for certain cash contributions during 2020. For corporations, the 10% limitation is increased to 25%. The Act also increases the limitation on deductions for contributions of food inventory from 15% to 25%.

Tax Cuts and Jobs Act (TCJA)

Most of the provisions in the Tax Cuts and Jobs Act (TCJA) took effect on January 1, 2018 and are operative for income tax returns filed in 2020. Since this course covers the 2020 tax year for income tax returns filed in 2021 the new tax laws are included in the material.

In general, the bill provides new tax brackets, larger standard deduction amounts and adjusted credit amounts. It scales back a popular deduction for state and local taxes, repeals a key tenet of the Affordable Care Act and cuts the corporate tax rate from 35% to 21%.

With respect to businesses, among other items the TCJA contains: (2)

- A flat 21% corporate tax rate.
- Elimination of the corporate alternative minimum tax.
- New deductions for qualified businesses (Section 199A).
- Limits on deduction for meals and entertainment expenses.
- New limits on deduction for business interest expenses.
- Changes to rules for like-kind exchanges.
- Repeals the overall limitation on certain itemized deductions.
- Changes to rules for expensing depreciable business assets (Section 179 property).

Business Entities

When beginning a business, a taxpayer must decide what form of business entity to establish. The form of business determines which income tax return form he or she must file. The most common forms of business are the sole proprietorship, partnership, corporation, and S corporation. A Limited Liability Company (LLC) is a relatively new business structure allowed by state statute. Legal and tax considerations enter into selecting a business structure.

Employer Identification Numbers (EIN)

An Employer Identification Number (EIN) is also known as a Federal Tax Identification Number and is used to identify a business entity. Generally, businesses need an EIN. The taxpayer may apply for an EIN in various ways including online. This is a free service offered by the Internal Revenue Service. The taxpayer must check with his or her state to see if he or she needs a state number or charter in addition to the EIN.

An Employer Identification Number (EIN) is a nine-digit number that the IRS assigns in the following format: XX-XXXXXXX. It is used to identify the tax accounts of employers and certain others who have no employees. However, for employee plans, an alpha (for example, P) or the plan number (e.g., 003) may follow the EIN. The IRS uses the number to identify taxpayers that are required to file various business tax returns. EINs are used by employers, sole proprietors, corporations, partnerships, non-profit associations, trusts, estates of decedents, government agencies, certain individuals, and other business entities. The taxpayer uses his or her EIN on all of the items that he or she sends to the IRS and the Social Security Administration (SSA).

Note

An EIN is for use in connection with the taxpayer's business activities only. He or she should not use his or her EIN in place of his or her Social Security number (SSN).

Partnership

A partnership must conform its tax year to its partners' tax years unless any of the following apply: (3)

- The partnership makes an election under Section 444 of the Internal Revenue Code to have a tax year other than a required tax year by filing Form 8716.
- The partnership elects to use a 52-53-week tax year that ends with reference to either its required tax year or a tax year elected under Section 444.
- The partnership can establish a business purpose for a different tax year.

The rules for the required tax year for partnerships are as follows.

- If one or more partners having the same tax year own a majority interest (more than 50%) in partnership profits and capital, the partnership must use the tax year of those partners.
- If there is no majority interest tax year, the partnership must use the tax year of all its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.
- If there is no majority interest tax year and the principal partners do not have the same tax year, the partnership generally must use a tax year that results in the least aggregate deferral of income to the partners.

If a partnership changes to a required tax year because of these rules, it can get automatic approval by filing Form 1128 - Application To Adopt, Change, or Retain a Tax Year.

S Corporation

All S corporations, regardless of when they became an S corporation, must use a permitted tax year. A permitted tax year is any of the following:

- The calendar year.
- A tax year elected under Section 444 of the Internal Revenue Code.
- A 52-53-week tax year ending with reference to the calendar year or a tax year elected under Section 444.
- Any other tax year for which the corporation establishes a business purpose.

If an electing S corporation wishes to adopt a tax year other than a calendar year, it must request IRS approval using Form 2553 - Election by a Small Business Corporation, instead of filing Form 1128 - Application To Adopt, Change, or Retain a Tax Year. For information about changing an S corporation's tax year and information about ruling requests, see the Instructions for Form 1128.

Tip

Once the election is made, it stays in effect until it is terminated or revoked. IRS consent generally is required for another election by the corporation (or successor corporation) on Form 2553 for any tax year before the 5th tax year after the first tax year in which the termination or revocation took effect. (4)

Personal Service Corporation (PSC)

A PSC must use a calendar tax year unless any of the following apply.

- The corporation makes an election under Section 444 of the Internal Revenue Code. See Section 444 Election, below for details.
- The corporation elects to use a 52-53-week tax year ending with reference to the calendar year or a tax year elected under Section 444.
- The corporation establishes a business purpose for a fiscal year.

See the Instructions for Form 1120 for general information about PSCs. For information on adopting or changing tax years for PSCs and information about ruling requests, see the Instructions for Form 1128.

Section 444 Election

A partnership, S corporation, electing S corporation, or PSC can elect under Section 444 of the Internal Revenue Code to use a tax year other than its required tax year. Certain restrictions apply to the election. A partnership or an S corporation that makes a Section 444 election must make certain required payments and a PSC must make certain distributions. The Section 444 election does not apply to any partnership, S corporation, or PSC that establishes a business purpose for a different period.

A partnership, S corporation, or PSC can make a Section 444 election if it meets all the following requirements: (3)

- It is not a member of a tiered structure (defined in Section 1.444-2T of the regulations).
- It has not previously had a Section 444 election in effect.
- It elects a year that meets the deferral period requirement.

Corporations

A new corporation (other than S corporations and PSCs) establishes its tax year when it files its first tax return. A newly reactivated corporation that has been inactive for a number of years is treated as a new taxpayer for the purpose of adopting a tax year. An S corporation or a PSC must use the required tax year rules to establish a tax year. Generally, a corporation that wants to change its tax year must obtain approval from the IRS under either the automatic approval procedures or ruling request procedures. Generally, corporations must file Form 1128 - Application To Adopt, Change, or Retain a Tax Year to adopt, change, or retain a tax year.

However, a corporation does not file Form 1128 in the following circumstances: (5)

- A corporation adopting its first tax year.
- A corporation required to change its tax year to file a consolidated return with its new common parent (see Regulations Sections 1.442-1(c) and 1.1502-76(a)).
- A foreign sales corporation (FSC) or an interest charge domestic international sales corporation (IC-DISC) changing to the tax year of the U.S. shareholder with the highest percentage of voting power (see Section 441(h)). Also see Temporary Regulations Section 1.921-1T(b)(4). However, an FSC or IC-DISC must file Form 1128 to change its tax year concurrently, if a tax year change has been made by the U.S. shareholder.

Part II of Form 1128 is used for an automatic approval request to change a tax year under Revenue Procedure 2006-45. If the applicant does not qualify for automatic approval, Part III is used for a ruling request.

Accounting Periods

The taxpayer must use a tax year to figure his or her taxable income. A tax year is an annual accounting period for keeping records and reporting income and expenses. An annual accounting period does not include a short tax year.

The taxpayer can use one of the following tax years:

- A calendar year.
- A fiscal year (including a 52-53-week tax year).

Unless the taxpayer has a required tax year, he or she adopts a tax year by filing his or her first income tax return using that tax year. A required tax year is a tax year required under the Internal Revenue Code or the Income Tax Regulations. The taxpayer cannot adopt a tax year by merely:

- Filing an application for an extension of time to file an income tax return.
- Filing an application for an employer identification number (Form SS-4).
- Paying estimated taxes.

Calendar Year

A calendar year is 12 consecutive months beginning on January 1st and ending on December 31st. If the taxpayer adopts the calendar year, he or she must maintain his or her books and records and report his or her income and expenses from January 1st through December 31st of each year.

If the taxpayer files his or her first tax return using the calendar tax year and he or she later begins business as a sole proprietor, becomes a partner in a partnership, or becomes a shareholder in an S corporation, he or she must continue to use the calendar year unless he or she obtains approval from the IRS to change it, or is otherwise allowed to change it without IRS approval. Generally, anyone can adopt the calendar year.

However, the taxpayer must adopt the calendar year if:

- He or she keeps no books or records.
- He or she has no annual accounting period.
- His or her present tax year does not qualify as a fiscal year.
- He or she is required to use a calendar year by a provision in the Internal Revenue Code or the Income Tax Regulations.

Fiscal Year

A fiscal year is 12 consecutive months ending on the last day of any month except December 31st. If the taxpayer is allowed to adopt a fiscal year, he or she must consistently maintain his or her books and records and report his or her income and expenses using the time period adopted.

52-53-Week Tax Year

The taxpayer can elect to use a 52-53-week tax year if he or she keeps his or her books and records and report his or her income and expenses on that basis. If the taxpayer makes this election, the 52-53-week tax year must always end on the same day of the week. The 52-53-week tax year must always end on: (3)

- Whatever date this same day of the week last occurs in a calendar month.
- Whatever date this same day of the week falls that is nearest to the last day of the calendar month.

For example, if the taxpayer elects a tax year that always ends on the last Monday in March, the 2020 tax year will end on March 30, 2021.

To make the election for the 52-53-week tax year, attach a statement with the following information to the tax return:

1. The month in which the new 52-53-week tax year ends.
2. The day of the week on which the tax year always ends.
3. The date the tax year ends. It can be either of the following dates on which the chosen day:
    a. Last occurs in the month in (1), above, or
    b. Occurs nearest to the last day of the month in (1), above.

When the taxpayer figures depreciation or amortization, a 52-53-week tax year is generally considered a year of 12 calendar months. (3)

To determine an effective date (or apply provisions of any law) expressed in terms of tax years beginning, including, or ending on the first or last day of a specified calendar month, a 52-53-week tax year is considered to: (3)

1. Begin on the first day of the calendar month beginning nearest to the first day of the 52-53-week tax year, and
2. End on the last day of the calendar month ending nearest to the last day of the 52-53-week tax year.

Short Tax Year

A short tax year is a tax year of less than 12 months. A short period tax return may be required when the taxpayer (as a taxable entity): (3)

- Are not in existence for an entire tax year.
- Change his or her accounting period.

Tax on a short period tax return is figured differently for each situation.

Even if a taxable entity was not in existence for the entire year, a tax return is required for the time it was in existence. Requirements for filing the return and figuring the tax are generally the same as the requirements for a return for a full tax year (12 months) ending on the last day of the short tax year.

Also, when an individual dies, a tax return must be filed for the decedent by the 15th day of the 4th month after the close of the individual's regular tax year. The decedent's final return will be a short period tax return that begins on January 1st and ends on the date of death. In the case of a decedent who dies on December 31st, the last day of the regular tax year, a full calendar year tax return is required.

Accounting Methods

An accounting method is a set of rules used to determine when income and expenses are reported on the taxpayer's tax return. His or her accounting method includes not only the overall method of accounting, but also the accounting treatment he or she uses for any material item.

The taxpayer can choose an accounting method when he or she files his or her first tax return. If the taxpayer later wants to change his or her accounting method, he or she must get IRS approval.

No single accounting method is required of all taxpayers. The taxpayer must use a system that clearly reflects his or her income and expenses and he or she must maintain records that will enable him or her to file a correct return. In addition to the taxpayer's permanent accounting books, he or she must keep any other records necessary to support the entries on his or her books and tax returns. The taxpayer must use the same accounting method from year to year. An accounting method clearly reflects income only if all items of gross income and expenses are treated the same from year to year.

If the taxpayer does not regularly use an accounting method that clearly reflects his or her income, the taxpayer's income will be refigured under the method that, in the opinion of the IRS, does clearly reflect income.

In general, a taxpayer can compute his or her taxable income under any of the following accounting methods: (3)

- Cash method.
- Accrual method.
- Special methods of accounting for certain items of income and expenses.
- A hybrid method which combines elements of two or more of the above accounting methods.

Cash Method

Most individuals and many small businesses use the cash method of accounting. Under the cash method, the taxpayer includes in his or her gross income all items of income he or she actually or constructively receives during the tax year. If the taxpayer receives property and services, he or she must include their fair market value (FMV) in income.

Under the cash method, generally, a taxpayer deducts expenses in the tax year in which he or she actually pays them. This includes business expenses for which he or she contests liability. However, the taxpayer may not be able to deduct an expense paid in advance. Instead, he or she may be required to capitalize certain costs.

Generally, if the taxpayer produces, purchases, or sells merchandise, he or she must keep an inventory and use an accrual method for sales and purchases of merchandise.

An expense a taxpayer pays in advance is deductible only in the year to which it applies, unless the expense qualifies for the 12-month rule. Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain rights or benefits for the taxpayer that do not extend beyond the earlier of the following: (3)

- 12 months after the right or benefit begins.
- The end of the tax year after the tax year in which payment is made.

If the taxpayer has not been applying the general rule (an expense paid in advance is deductible only in the year to which it applies) and/or the 12-month rule to the expenses he or she paid in advance, the taxpayer must obtain approval from the IRS before using the general rule and/or the 12-month rule.

Excluded Entities

The following entities cannot use the cash method, including any combination of methods that includes the cash method: (3)

- A corporation (other than an S corporation) with average annual gross receipts exceeding $5 million.
- A partnership with a corporation (other than an S corporation) as a partner, and with the partnership having average annual gross receipts exceeding $5 million.
- A tax shelter.

Generally, a taxpayer engaged in the trade or business of farming is allowed to use the cash method for its farming business. However, certain corporations (other than S corporations) and partnerships that have a partner that is a corporation must use an accrual method for their farming business. For this purpose, farming does not include the operation of a nursery or sod farm or the raising or harvesting of trees (other than fruit and nut trees).

There is an exception to the requirement to use an accrual method for corporations with gross receipts of $1 million or less for each prior tax year after 1975. For family corporations engaged in farming, the exception applies if gross receipts were $25 million or less for each prior tax year after 1985.

Accrual Method

Under the accrual method of accounting, generally the taxpayer reports income in the year it is earned and deducts or capitalizes expenses in the year incurred. The purpose of an accrual method of accounting is to match income and expenses in the correct year.

Generally, the taxpayer includes an amount in gross income for the tax year in which all events that fix his or her right to receive the income has occurred and he or she can determine the amount with reasonable accuracy. Under this rule, the taxpayer reports an amount in his or her gross income on the earliest of the following dates: (3)

- When he or she receives payment.
- When the income amount is due to him or her.
- When he or she earns the income.
- When title has passed.

Advance Payment for Services

Generally, the taxpayer reports an advance payment for services to be performed in a later tax year as income in the year he or she receives the payment. However, if the taxpayer receives an advance payment for services he or she agrees to perform by the end of the next tax year, the taxpayer can elect to postpone including the advance payment in income until the next tax year. However, he or she cannot postpone including any payment beyond that tax year.

The taxpayer can postpone reporting income from an advance payment he or she receives for a service agreement on property he or she sells, leases, builds, installs, or constructs. This includes an agreement providing for incidental replacement of parts or materials. However, this applies only if the taxpayer offers the property without a service agreement in the normal course of business. Generally, a taxpayer cannot postpone including an advance payment in income for services if either of the following applies: (3)

- He or she is to perform any part of the service after the end of the tax year immediately following the year he or she receives the advance payment.
- He or she is to perform any part of the service at any unspecified future date that may be after the end of the tax year immediately following the year he or she receives the advance payment.

Advance Payment for Sales

Special rules apply to including income from advance payments on agreements for future sales or other dispositions of goods held primarily for sale to customers in the ordinary course of a taxpayer's trade or business. However, the rules do not apply to a payment (or part of a payment) for services that are not an integral part of the main activities covered under the agreement. An agreement includes a gift certificate that can be redeemed for goods. Amounts due and payable are considered received.

Generally, include an advance payment in income in the year in which the taxpayer receives it. However, the taxpayer can use the alternative method. Under the alternative method, generally include an advance payment in income in the earlier tax year in which the taxpayer:

- Includes advance payments in gross receipts under the method of accounting he or she uses for tax purposes.
- Includes any part of advance payments in income for financial reports under the method of accounting used for those reports. Financial reports include reports to shareholders, partners, beneficiaries, and other proprietors for credit purposes and consolidated financial statements.

Economic Performance

Generally, a taxpayer cannot deduct or capitalize a business expense until economic performance occurs. If the taxpayer's expense is for property or services provided to him or her, or for his or her use of property, economic performance occurs as the property or services are provided or the property is used. If the taxpayer's expense is for property or services he or she provides to others, economic performance occurs as he or she provides the property or services.

Expenses Paid in Advance

An expense the taxpayer pays in advance is deductible only in the year to which it applies, unless the expense qualifies for the 12-month rule. Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain rights or benefits for the taxpayer that do not extend beyond the earlier of the following: (3)

- 12 months after the right or benefit begins.
- The end of the tax year after the tax year in which payment is made.

If the taxpayer has not been applying the general rule (an expense paid in advance is deductible only in the year to which it applies) and/or the 12-month rule to the expenses he or she paid in advance, he or she must get IRS approval before using the general rule and/or the 12-month rule. See Change in Accounting Method, next, for information on how to get IRS approval.

Changing Accounting Methods

If a taxpayer is a qualifying taxpayer or qualifying small business taxpayer and wants to change to the cash method or to account for inventoriable items as non-incidental materials and supplies, he or she must file Form 3115 - Application for Change in Accounting Method. Both changes can be requested under the automatic change procedures of Revenue Procedures 2001-10 and 2002-28, as modified, amplified, and clarified by Revenue Procedure 2011-14 (or any successor). The taxpayer can file one Form 3115 if he or she chooses to request to change to the cash method and to account for inventoriable items as non-incidental materials and supplies.

Related Persons

Business expenses and interest owed to a related person who uses the cash method of accounting are not deductible until the taxpayer makes the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship for this rule as of the end of the tax year for which the expense or interest would otherwise be deductible. See Section 267 of the Internal Revenue Code and Publication 542 - Corporations, for the definition of related person.

Inventories

An inventory is necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If the taxpayer must account for an inventory in his or her business, he or she must use an accrual method of accounting for his or her purchases and sales. To figure taxable income, the taxpayer must value his or her inventory at the beginning and end of each tax year. To determine the value, the taxpayer needs a method for identifying the items in his or her inventory and a method for valuing these items.

The rules for valuing inventory are not the same for all businesses. The method the taxpayer uses must conform to generally accepted accounting principles for similar businesses and must clearly reflect income. The taxpayer's inventory practices must be consistent from year to year.

Filing Dates

As of December 31, 2015:

- Partnership tax returns are due March 15, not April 15 as in the past. If the taxpayer's partnership is not on a calendar year, the return is due on the 15th day of the third month following the close of his or her tax year.
- C corporation tax returns are due April 15, not March 15. For non-calendar year taxpayers, it is due on the 15th day of the fourth month following the close of the tax year.
- S corporation tax returns remain unchanged. The returns are still due March 15, or the third month following the close of the taxable year.
- C corporations with tax years ending on June 30 will continue to have a due date of September 15 until 2025. For years beginning after 2025, the due date for these returns will be October 15.
- FBAR (FINCEN Form 114) will be due on April 15th, not June 30th. An extension for six months will be available (until October 15th).

Common Business Credits and Deductions

Disabled Access Credit

The Disabled Access Credit provides a nonrefundable credit for small businesses that incur expenditures for the purpose of providing access to persons with disabilities. An eligible small business is one that that earned $1 million or less or had no more than 30 full time employees in the previous year; they may take the credit each and every year they incur access expenditures.

For purposes of the credit, these expenditures are amounts paid or incurred by the eligible small business to comply with applicable requirements under the Americans With Disabilities Act of 1990 (Public Law 101-336) as in effect on November 5, 1990.

Eligible access expenditures include amounts paid or incurred: [6]

1. To remove barriers that prevent a business from being accessible to or usable by individuals with disabilities.
2. To provide qualified interpreters or other methods of making audio materials available to hearing-impaired individuals.
3. To provide qualified readers, taped texts, and other methods of making visual materials available to individuals with visual impairments.
4. To acquire or modify equipment or devices for individuals with disabilities.

The expenditures must be reasonable and necessary to accomplish the above purposes. Eligible expenditures do not include expenditures in 1 above that are paid or incurred in connection with any facility first placed in service after November 5, 1990. Also, eligible access expenditures must meet those standards issued by the Secretary of the Treasury as agreed to by the Architectural and Transportation Barriers Compliance Board and set forth in regulations.

Investment Credit

In general, the Investment Credit is available to property owners who engage in specific types of projects on their property.

Taxpayers can claim the following investment tax using Form 3468 - Investment Credit: [7]

- Qualifying Advanced Coal Project Credit.
- Qualifying Gasification Project Credit.
- Qualifying Advanced Energy Project Credit.
- Rehabilitation Credit.
- Energy Credit.

If the taxpayer leases property from someone rather than owns it and uses it in a way that qualifies for one of these credits, he or she may also be able to claim the credit by filling out Part I of Form 3468.

Investment credit property is any depreciable or amortizable property that qualifies for the rehabilitation credit, energy credit, qualifying advanced coal project credit, qualifying gasification project credit, or qualifying advanced energy project credit.

The taxpayer cannot claim a credit for property that is:

- Used mainly outside the United States (except for property described in Section 168(g)(4)).
- Used by a governmental unit or foreign person or entity (except for a qualified rehabilitated building leased to that unit, person, or entity; and property used under a lease with a term of less than 6 months).
- Used by a tax-exempt organization (other than a Section 521 farmers' cooperative) unless the property is used mainly in an unrelated trade or business or is a qualified rehabilitated building leased by the organization.
- Used for lodging or in the furnishing of lodging (see Section 50(b)(2) for exceptions).
- Certain MACRS business property to the extent it has been expensed under Section 179 of the Internal Revenue Code.

Generally, for purposes of eligibility for and figuring the amount of the investment credit, a lessor of property may elect to treat the lessee as having acquired the property. Once the election is made, the lessee will be entitled to an investment credit for that property for the tax year in which the property is placed in service and the lessor will generally not be entitled to such a credit.

If the leased property is disposed of, or otherwise ceases to be investment credit property, the property will generally be subject to the recapture rules for early dispositions.

Small Business Health Care Tax Credit

The Small Business Health Care Tax Credit helps small businesses and small tax-exempt organizations afford the cost of covering their employees and is specifically targeted for those with low- and moderate-income workers. The credit is designed to encourage small employers to provide health insurance coverage for the first time or maintain coverage they already have. In general, the credit is available to small employers that pay at least half the cost of single coverage for their employees.

In 2020, the Small Business Health Care Tax Credit benefits employers that: [8]

- Have fewer than 25 full-time equivalent employees.
- Pay average annual wages of less than $56,000 a year.
- Pay at least half of employee health insurance premiums.

To be eligible for this credit, the taxpayer must have purchased coverage through the Small Business Health Options Program, also known as the SHOP marketplace.

For tax years beginning in 2014 or later, there are changes to the credit: (8)

- The maximum credit increases to 50% of premiums paid for small business employers and 35% of premiums paid for small tax-exempt employers.
- To be eligible for the credit, a small employer must pay premiums on behalf of employees enrolled in a qualified health plan offered through a Small Business Health Options Program (SHOP) Marketplace or qualify for an exception to this requirement.
- The credit is available to eligible employers for two consecutive taxable years.

Even if the taxpayer is a small business employer who did not owe tax during the year, he or she can carry the credit back or forward to other tax years. Also, since the amount of the health insurance premium payments is more than the total credit, eligible small businesses can still claim a business expense deduction for the premiums in excess of the credit.

The credit is refundable, so even if the taxpayer has no taxable income, he or she may be eligible to receive the credit as a refund so long as it does not exceed his or her income tax withholding and Medicare tax liability. Refund payments issued to small tax-exempt employers claiming the refundable portion of credit are subject to sequestration. The taxpayer must use Form 8941 - Credit for Small Employer Health Insurance Premiums to calculate the credit.

In 2020, under the Small Business Health Care Tax Credit, if the taxpayer had more than 10 full-time equivalent employees (FTE) and average annual wages of more than $27,000, the FTE and average annual wage limitations will separately reduce the taxpayer's credit. This may reduce the taxpayer's credit to zero even if they had fewer than 25 FTEs and average annual wages of less than $56,000.

Net Operating Loss Deduction

If a business's deductions for the year are more than its income for the year, it may have a net operating loss (NOL). An NOL year is the year in which an NOL occurs. The business can use an NOL by deducting it from its income in another year or years. There are rules that limit what the business can deduct when figuring an NOL. In general, the following items are not allowed when figuring an NOL: (9)

- Capital losses in excess of capital gains.
- The Section 1202 exclusion of the gain from the sale or exchange of qualified small business stock.
- Nonbusiness deductions in excess of nonbusiness income.
- The NOL deduction.
- The Section 199A deduction for qualified business income.
- The Section 199 deduction for income attributable to domestic production activities.

The following tax entities can claim a net operating loss:

- Individuals (the taxpayer does not have to be in business to claim a net operating loss).
- Owners of sole proprietorships.
- Owners of pass through entities:
  - Partners of a partnership.
  - Members of a limited liability company.
  - Shareholders of an S corporation.
- C corporations:
  - For a regular C corporation an NOL generally the amount by which total corporate expenses exceed gross corporate income.
  - If a C corporation converts to an S corporation, any NOL carryovers it had at the time of conversion cannot be used. They can only be use if the S corporation goes back to being a C corporation.

Under the Coronavirus Aid, Relief, and Economic Security Act (CARES), a net operating loss (NOL) arising in a tax year beginning in 2018, 2019 or 2020 can be carried back for five years. The provision also allows for NOLs arising before January 1, 2021 to fully offset income.

Accordingly, the CARES Act temporarily removes limitations put in place by the 2017 Tax Cuts and Jobs Act (TCJA) where, for taxable years beginning after December 31, 2017, NOLs were limited to 80% of taxable income and could not be carried back to reduce income in a prior tax year. Under the CARES Act, losses must be carried back to the earliest year available for offset. As losses will be carried back to pre-2018 tax years, corporate taxpayers may benefit from a tax refund at favorable rates of up to 35%.

The TCJA also contained a provision (IRC Section 461(l)) for tax years beginning after December 31, 2017 that limited the deductibility of current year business losses for pass-through businesses and sole proprietorships. The limitation was $500,000 on a joint tax return and $250,000 for all other filers. A business loss in excess of these amounts was disallowed in the year in which it was incurred and was converted into an NOL that could be utilized in a future tax year. The CARES Act suspends the implementation of IRC Section 461(l) until tax years beginning after December 31, 2020, thus allowing non-corporate taxpayers to deduct excess business losses arising in 2018, 2019 and 2020.

Farming Loss

A farming loss is the smaller of:

1. The amount that would be the NOL for the tax year if only income and deductions from farming businesses were taken into account, or
2. The NOL for the tax year.

The taxpayer can choose not to carry back his or her farming loss. If he or she makes this choice, then he or she can carry his or her NOL (including the part that is attributable to farming) forward indefinitely until it is fully absorbed. To make this choice, the taxpayer attaches a statement to his or her original return filed by the due date (including extensions) for the NOL year. This statement must show that he or she is choosing to waive the carryback period under Section 172(b).

If the taxpayer filed his or her original return on time but did not file the statement with it, he or she can make this choice on an amended return filed within 6 months of the due date of the return (excluding extensions). The taxpayer attaches a statement to his or her amended return and write “Filed pursuant to Section 301.9100-2” at the top of the statement.

Once the taxpayer chooses to waive the carryback period, it generally is irrevocable. If he or she chooses to waive the carryback period for more than one NOL, he or she must make a separate choice and attach a separate statement for each NOL year. If the taxpayer does not file this statement on time, he or she cannot waive the carryback period.

Home Office Deduction

If a taxpayer uses part of his or her home for business, he or she may be able to deduct expenses for the business use of his or her home. The home office deduction is available for homeowners and renters and applies to all types of homes.

Simplified Option

For taxable years starting on, or after, January 1, 2013 (filed beginning in 2014), a taxpayer now has a simpler option for computing the business use of his or her home. The standard method has some calculation, allocation, and substantiation requirements that are complex and burdensome for small business owners. This new simplified option can significantly reduce recordkeeping burden by allowing a qualified taxpayer to multiply a prescribed rate by the allowable square footage of the office in lieu of determining actual expenses.

Highlights of the simplified option:

- Standard deduction of $5 per square foot of home used for business (maximum 300 square feet).
- Allowable home-related itemized deductions claimed in full on Schedule A. (For example: Mortgage interest, real estate taxes).
- No home depreciation deduction or later recapture of depreciation for the years the simplified option is used.

This simplified option does not change the criteria for who may claim a home office deduction. It merely simplifies the calculation and recordkeeping requirements of the allowable deduction.

Regular Method

Taxpayers using the regular method (required for tax years 2012 and prior), instead of the optional method, must determine the actual expenses of their home office. These expenses may include mortgage interest, insurance, utilities, repairs, and depreciation. Generally, when using the regular method, deductions for a home office are based on the percentage of the taxpayer's home devoted to business use. So, if the taxpayer uses a whole room or part of a room for conducting his or her business, he or she needs to figure out the percentage of his or her home devoted to his or her business activities.

Affordable Care Act Compliance

Some of the provisions of the Affordable Care Act, or health care law, apply only to applicable large employers, generally those with 50 or more full-time employees, including full-time equivalent employees. For example, applicable large employers have annual reporting responsibilities concerning whether and what health insurance they offered to their full-time employees (and their dependents).

Applicable large employers (ALE) must report to the IRS information about the health care coverage, if any, they offered to full-time employees. The IRS will use this information to administer the employer shared responsibility provisions and the Premium Tax Credit. ALEs also must furnish to employees a statement that includes the same information provided to the IRS. Employees may use this information to determine whether, for each month of the calendar year, they may claim the Premium Tax Credit on their individual income tax returns. Some ALEs may be eligible to use an alternative reporting method designed to simplify and reduce the cost of reporting.

ALEs that file 250 or more information returns during the calendar year must file the returns electronically. For information on the communication procedures, transmission formats, business rules and validation procedures for returns transmitted electronically through the ACA Information Reports (AIR) system, review Publication 5165 - Guide for Electronically Filing Affordable Care Act (ACA) Information Returns.

This information reporting is integral to the administration of the employer shared responsibility provisions because it provides information to the IRS about the health coverage, if any, an employer offers to its full-time employees. Information reporting also is integral to the administration of the Premium Tax Credit. The IRS and any employee who does not enroll in an employer plan (but instead enrolls in coverage at the Health Insurance Marketplace) need information on the employer's offer of coverage, including the cost of coverage, to determine whether that individual is eligible for the Premium Tax Credit.

This information reporting provision requires an ALE to report information about health insurance coverage offered to its full-time employees (and their dependents). ALEs are required to report to the IRS, as well as to their full-time employees, regardless of whether the ALE actually offers health insurance coverage.

If an employer has 100 or fewer employees, he or she may be able to purchase affordable insurance through the Small Business Health Options Program (SHOP) Marketplace.

Additional Large Employer requirements include: [10]

- The ALE must withhold and report an additional 0.9% on employee wages or compensation that exceeds $200,000. The ALE may be required to report the value of the health insurance coverage provided to each employee on his or her Form W-2.
- The ALE must file an annual return reporting whether and what health insurance was offered to employees.
- If the ALE provides self-insured health coverage to employees, it must file an annual return reporting certain information for each employee covered.
- The ALE must either offer affordable minimum essential coverage that provides minimum value to full-time employees (and offer coverage to the full-time employees' dependents), or potentially owe an employer shared responsibility payment.

Each ALE member must file a Form 1095-C - Employer-Provided Health Insurance Offer and Coverage and Form 1094-C - Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns with the IRS for its full-time employees. The ALE member must also furnish a similar statement to each of its full-time employees. Similar to the separate Form W-2 - Wage and Tax Statement, filed by an employer for each employee, and the Form W-3, Transmittal of Wage and Tax Statements, filed as a transmittal form for the Forms W-2, a separate information return is required for each full-time employee. Forms 1095-C are filed accompanied by the transmittal form, Form 1094-C.

An ALE member can provide the required statement to the employer's full-time employees by furnishing a copy of the Form 1095-C filed with the IRS. Alternatively, these returns and employee statements may be provided by using substitute forms. A substitute form must include all of the information required to be reported on Forms 1094-C and 1095-C and must comply with applicable revenue procedures or other published guidance relating to substitute returns.

An ALE member that fails to comply with the information reporting requirements may be subject to the general reporting penalty provisions under IRC Section 6721 (failure to file correct information returns) and IRC Section 6722 (failure to furnish correct payee statement): (11)

- The penalty for failure to file an information return generally is $100 for each return for which such failure occurs. The total penalty imposed for all failures during a calendar year cannot exceed $1,500,000.
- For returns required to be filed after December 31, 2015, the penalty for failure to file an information return generally is increased from $100 to $250 for each return for which such failure occurs. The total penalty imposed for all failures during a calendar year after December 15, 2015 cannot exceed $3,000,000.
- The penalty for failure to provide a correct payee statement is $100 for each statement with respect to which such failure occurs, with the total penalty for a calendar year not to exceed $1,500,000.
- The penalty for failure to provide a correct payee statement is increased from $100 to $250 for each statement for which the failure occurs, with the total penalty for a calendar year not to exceed $3,000,000. The increased penalty amount applies to statements required to be provided after December 31, 2015.
- Special rules apply that increase the per-statement and total penalties if there is intentional disregard of the requirement to furnish a payee statement.

The waiver of penalty and special rules under Section 6724 and the applicable regulations, including abatement of information return penalties for reasonable cause, may apply to certain failures under Section 6721 or 6722.

Sole Proprietors

A sole proprietor is someone who owns an unincorporated business by himself or herself. However, if the taxpayer is the sole member of a domestic limited liability company (LLC), he or she is not a sole proprietor if he or she elects to treat the LLC as a corporation.

By definition, a Sole Proprietor is someone who owns an unincorporated business by himself or herself. A small business and a sole proprietorship (also known as the sole trader or simply a proprietorship), are types of business entities that are owned and operated by one individual and in which there is no legal distinction between the owner and the business. The owner thus receives all the profits (subject to taxation) and has responsibility for the losses. All assets as well as debts are owned by the proprietor.

In contrast to a partnership, it is a sole proprietorship meaning the business is owned and controlled by one person even though there may be many employees working for him or her. A sole proprietor may use a business or trade name other than their legal name. They have the ability to raise capital either publicly or privately, to limit the personal liability of the officers and managers, and to limit risk to investors.

Sole proprietorships also have the least government rules and regulations affecting them. Owners have complete control over all the aspects of his or her business and can take any managerial decisions that he or she wants to take. Raising capital for a proprietorship is more difficult because an unrelated investor has less peace of mind concerning the use and security of his or her investment and the investment is more difficult to formalize as other types of business entities have more documentation. The enterprise may be crippled or terminated if the owner becomes ill. Since the business is the same legal entity as the proprietor, it ceases to exist upon the proprietor's death. Because the enterprise rests exclusively on one person, it often has difficulty raising long-term capital.

Unlimited Liability

The biggest potential downside of operating as a sole proprietorship is the lack of protection from personal liability. Most businesses operate under alternate forms, such as standard Corporations or Limited Liability Corporations (LLC's) because they provide considerable protection of personal assets in the event of litigation. They also help protect individuals if creditors are seeking to collect business debts, in that they can ordinarily only reach the assets of the business entity. Since a sole proprietorship is not legally distinct from its owner, personal assets may be subject to those claims. If the taxpayer is engaged in a business which has a significant chance of being the subject of litigation, he or she will want to make sure that they carry adequate insurance and will likely wish to choose a business form which shields the taxpayer from personal liability in the event of a lawsuit. By way of example, if the taxpayer is giving piano lessons, he or she probably has a low risk of liability; but if he or she is giving swimming lessons or horseback riding lessons, a small mistake by the taxpayer or a student can result in a significant liability to the business.

Taxation

Another potential downside of a sole proprietorship is that any income to the business is treated as income to the business owner. It is reported on their individual tax return (using Schedule C) and is taxed in the year it is received. With other corporate forms, it may be possible for the business to have its own income (and to file its own income tax return), and it may be possible to defer income to a different tax year. With a sole proprietorship, even the money the taxpayer left in the business bank account is taxed in the year it is earned, even if the business was saving it to pay for business expenses in the coming year. It is important to consider tax consequences when selecting the form of the business. The income earned from a sole proprietorship remains subject to income and self-employment (SE) tax (Medicare and Social Security contributions), and the taxpayer will be responsible to pay those taxes at the end of the year. In most cases, they will also be required to make quarterly payments of estimated tax liability, to both the state and to the Federal government. The sole proprietor may deduct legitimate business expenses when he or she calculates the taxes, as well as report losses from a sole proprietorship on the income tax return.

Husband and Wife Businesses

One of the advantages of a taxpayer operating his or her own business is hiring family members. However, the employment tax requirements for family employees may vary from those that apply to other employees. Generally speaking, when two or more people engage in a business to share profits, it is considered a partnership rather than a sole proprietorship. However, the Small Business and Work Opportunity Tax Act of 2007 changes the treatment of qualified businesses of married couples not treated as partnerships. A qualified business, or dual sole proprietorship, is one involving the conduct of a trade or business that meets the following conditions:

- The only members of the joint venture are a husband and wife.
- Both spouses materially participate in the trade or business.
- They file a joint return for the year.
- Both spouses elect to have the provision apply.

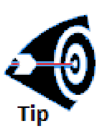
All items of income, gain, loss, deduction and credit are divided between the spouses in accordance with their respective interests in the business. Each spouse takes into account his or her respective share of these items as a sole proprietor. Thus, it is anticipated that each spouse would account for his or her respective share on the appropriate form, such as Schedule C. For purposes of determining net earnings from self-employment, each spouse's share of income or loss from a qualified joint venture is taken into account just as it is for Federal income tax purposes under the provision (i.e., in accordance with their respective interests in the venture). This generally does not increase the total tax on the return, but it does give each spouse credit for Social Security earnings on which retirement benefits are based. However, this may not be true if either spouse exceeds the Social Security tax limitation. For more information on qualified businesses, refer to Election for Husband and Wife Unincorporated Businesses.

Qualified Joint Ventures

If the taxpayer and his or her spouse both participate as the only active members of a jointly owned and operated business and they file a joint return for the tax year, they can make an election to be taxed as a Qualified Joint Venture rather than a Partnership.

Requirements for a qualified joint venture:

1. The only members in the joint venture are a husband and wife who file a joint tax return.
2. The trade or business is owned and operated by the spouses as co-owners (and not in the name of a state law entity such as an LLC or LLP).
3. The husband and wife must each materially participate in the trade or business.
4. Both spouses must elect qualified joint venture status on Form 1040 by dividing the items of income, gain, loss, deduction, credit and expenses in accordance with their respective interests in such venture and each spouse filing with the Form 1040 a separate Schedule C (Form 1040) or Form 4835 accordingly, and, if required, a separate Schedule SE (Form 1040) to pay self-employment tax.



There may be tax benefits for choosing this option. In order to make this election all the income, credit, deduction, gain or loss must be divided according to the percentage of equity in the business each spouse owns. For example, a spouse that owns 60% of the venture must account for 60% of the income while the other spouse need only account for 40% of the income. Each spouse must file a separate Schedule C or F and enter their share on each line with respect to income, deduction, loss, etc. They must also file separate Schedule SE's to pay SE tax when applicable.

Statutory Employees

If someone who works for the taxpayer is not an employee under the common law rules, the taxpayer does not withhold Federal income tax from his or her pay, unless backup withholding applies. Although the following persons may not be common law employees, they are considered employees by statute for Social Security, Medicare, and FUTA tax purposes under certain conditions:

- An agent (or commission) driver who delivers food, beverages (other than milk), laundry, or dry cleaning for someone else.
- A full-time life insurance salesperson who sells primarily for one company.

- A homeworker who works by guidelines of the person for whom the work is done, with materials furnished by and returned to that person or to someone that person designates.
- A traveling or city salesperson (other than an agent-driver or commission-driver) who works full time (except for sideline sales activities) for one firm or person getting orders from customers. The orders must be for merchandise for resale or supplies for use in the customer's business. The customers must be retailers, wholesalers, contractors, or operators of hotels, restaurants, or other businesses dealing with food or lodging.

Direct sellers, qualified real estate agents, and certain companion sitters are, by law, considered nonemployees. They are generally treated as self-employed for all Federal tax purposes, including income and employment taxes.

Independent Contractor versus Employee

Even though a sole proprietorship is not technically a business entity, owners can hire employees. There is no limit on the number of employees that a sole proprietor can employ. As the employer, a sole proprietor is responsible for filing taxes and proper administration for these hires. Some sole proprietors choose to use independent contractors. There are many reasons for this including less liability for the owner and greater flexibility in scheduling. With an independent contractor, the owner simply pays the agreed upon rate, and there is less bookkeeping involved. At the end of the year, however, the use of independent contractors is reported on tax returns and some insurance documents.

People such as doctors, dentists, veterinarians, lawyers, accountants, contractors, subcontractors, public stenographers, or auctioneers who are in an independent trade, business, or profession in which they provide their services to the general public are generally independent contractors. However, whether they are independent contractors or employees depends on the facts in each case.

It is critical that business owners correctly determine whether the individuals providing services are employees or independent contractors. Generally, the business owner must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. The business owner does not generally have to withhold or pay any taxes on payments to independent contractors. If the taxpayer is a business owner hiring or contracting with other individuals to provide services, he or she must determine whether the individuals providing services are employees or independent contractors. In determining whether the person providing service is an employee or an independent contractor, all information that provides evidence of the degree of control and independence must be considered.

The determination can be complex and depends on the facts and circumstances of each case. The determination is based on whether the person for whom the services are performed has the right to control how the worker performs the services. It is not based merely on how the worker is paid, how often the worker is paid, or whether the work is part-time or full-time.

Facts that provide evidence of the degree of control and independence fall into three categories:

1. *Behavioral*: Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. *Financia*l: Are the business aspects of the worker's job controlled by the payer (these include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)?
3. *Type of Relationship*: Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no magic or set number of factors that makes the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors which are relevant in one situation may not be relevant in another. The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination.

To file his or her annual tax return, the taxpayer will need to use Schedule C to report his or her income or loss from a business he or she operated or a profession he or she practiced as a sole proprietor.

If, after reviewing the three categories of evidence, it is still unclear whether a worker is an employee or an independent contractor, Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding can be filed with the IRS. The form may be filed by either the business or the worker. The IRS will review the facts and circumstances and officially determine the worker's status. If the taxpayer classifies an employee as an independent contractor and he or she has no reasonable basis for doing so, the taxpayer may be held liable for employment taxes for that worker. See Internal Revenue Code Section 3509 for more information.

Hobby Income versus Business Income

In order to use Schedule C, the taxpayer must be engaged in a for-profit business. A hobby is defined as an activity done regularly in one's leisure time for pleasure and not principally done with the goal of making a profit. A hobby may, in many instances, result in a profit but what is important is intent. Conversely, a for-profit business may end with a loss but that is not the intent. In order to determine if the activity qualifies as a business, taxpayers should consider the following factors:

- Does the time and effort put into the activity indicate an intention to make a profit?
- Does the taxpayer depend on income from the activity?
- If there are losses, are they due to circumstances beyond the taxpayer's control or did they occur in the start-up phase of the business?
- Has the taxpayer changed methods of operation to improve profitability?
- Does the taxpayer or his or her advisors have the knowledge needed to carry on the activity as a successful business?
- Has the taxpayer made a profit in similar activities in the past?
- Does the activity make a profit in some years?
- Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?

Tip

The IRS presumes that an activity is carried on for profit if it makes a profit during at least three of the last five tax years, including the current year or at least two of the last seven years for activities that consist primarily of breeding, showing, training or racing horses. The following table summarizes how income and expenses are treated for hobby and for-profit business.

	Sole Proprietor	Hobby
Report Expenses	Schedule C	Not Deductible
Report Income	Schedule C	Line 8, Schedule 1 (Form 1040)
Income subject to SE Tax	Yes	No

Table 2-1 – For-Profit vs. Hobby (2020)

The Tax Cuts and Jobs Act (TCJA) suspended the itemized deduction for hobby expenses, along with all other miscellaneous itemized deductions. The prohibition on deducting these expenses went into effect for 2018 and continues through 2025. This means that the taxpayer will not be able to deduct any expenses he or she earns from hobbies during these years, but he or she still have to report and pay tax on any income he or she earns from a hobby. The deduction is scheduled to return in 2026.

Recordkeeping

Good records will help the taxpayer monitor the progress of his or her business, prepare his or her financial statements, identify source of receipts, keep track of deductible expenses, prepare his or her tax returns, and support items reported on tax returns.

The taxpayer may choose any recordkeeping system suited to his or her business that clearly shows income and expenses. Except in a few cases, the law does not require any special kind of records. However, the business the taxpayer is in affects the type of records he or she needs to keep for Federal tax purposes.

The length of time a taxpayer should keep a document depends on the action, the expense, or the event that the document records. Generally, he or she must keep records that support an item of income or deductions on a tax return until the period of limitations for that return runs out.

The period of limitations is the period of time in which a taxpayer can amend a tax return to claim a credit or refund, or that the IRS can assess additional tax. The following information contains the periods of limitations that apply to income tax returns. Unless otherwise stated, the years refer to the period after the return was filed. Returns filed before the due date are treated as filed on the due date:

1. The taxpayer owes additional tax and situations (2), (3), and (4), below, do not apply to him or her; keep records for 3 years.
2. The taxpayer does not report income that he or she should report, and it is more than 25% of the gross income shown on the return; keep records for 6 years.
3. The taxpayer files a fraudulent return; keep records indefinitely.
4. The taxpayer does not file a return; keep records indefinitely.
5. The taxpayer files a claim for credit or refund after he or she files a return; keep records for 3 years from the date the taxpayer filed the original return or 2 years from the date the taxpayer paid the tax, whichever is later.
6. The taxpayer files a claim for a loss from worthless securities or bad debt deduction; keep records for 7 years.
7. Keep all employment tax records for at least 4 years after the date that the tax becomes due or is paid, whichever is later.

Keep copies of filed tax returns. They help in preparing future tax returns and making computations if the taxpayer files an amended return. Purchases, sales, payroll, and other transactions the taxpayer has in his or her business generate supporting documents. These documents contain information he or she needs to record in his or her books. A good recordkeeping system includes a summary of business transactions. Business transactions are ordinarily summarized in books called journals and ledgers. The taxpayer can buy them at a local stationery or office supply store.

A journal is a book where the taxpayer records each business transaction shown on a supporting document. He or she may have to keep separate journals for transactions that occur frequently. A ledger is a book that contains the totals from all of the journals. It is organized into different accounts. Whether the taxpayer keeps journals and ledgers and how he or she keeps them depends on the type of business. For example, a recordkeeping system for a small business might include the following items:

- Business checkbook.
- Daily summary of cash receipts.
- Monthly summary of cash receipts.
- Check disbursements journal.
- Depreciation worksheet.
- Employee compensation record.

Keep in mind, the responsibility to prove entries, deductions, and statements made on a tax return is known as the burden of proof. The taxpayer must be able to prove (substantiate) certain elements of expenses to deduct them.

Forms and Associated Taxes for Independent Contractors

Form W-9

If the taxpayer has made the determination that the person he or she is paying is an independent contractor, the first step is to have the contractor complete Form W-9 - Request for Taxpayer Identification Number and Certification. This form can be used to request the correct name and Taxpayer Identification Number (TIN), of the worker. A TIN may be either a Social Security Number (SSN), or an Employer Identification Number (EIN). The W-9 should be kept in the taxpayer's files for four years for future reference in case of any questions from the worker or the IRS.

Form 1099-MISC

Form 1099-MISC - Miscellaneous Income is most commonly used by payers to report payments made in the course of a trade or business to others for services. If the taxpayer paid someone who is not his or her employee, such as a subcontractor, attorney or accountant, $600 or more for services provided during the year, a Form 1099-MISC needs to be completed, and a copy of 1099-MISC must be provided to the independent contractor by January 31 of the year following payment. The taxpayer must also send a copy of this form to the IRS by February 28 (although the form does not have to be sent to the IRS until March 31 if the business files the 1099s electronically, using the FIRE system).

Also note that independent contractors may have their own employees or may hire other independent contractors (subcontractors). In either case, they should be aware of their tax responsibilities, including filing and reporting requirements, for these workers.

Reporting Employment Taxes

Generally, employers must report wages, tips and other compensation paid to an employee by filing the required form(s) to the IRS. Employers must also report taxes he or she deposits by filing Forms 940, 941 and 944 on paper or through e-file.

Backup Withholding

A payor generally must withhold 24% of certain taxable payments if the payee fails to furnish it with his or her correct taxpayer identification number (TIN). This withholding is referred to as "backup withholding." Payments subject to backup withholding include interest, dividends, patronage dividends, rents, royalties, commissions, nonemployee compensation, and certain other payments the payor makes in the course of a trade or business. In addition, transactions by brokers and barter exchanges and certain payments made by fishing boat operators are subject to backup withholding.

Tip

Backup withholding does not apply to wages, pensions, annuities, IRAs (including simplified employee pension (SEP) and SIMPLE retirement plans), Section 404(k) distributions from an employee stock ownership plan (ESOP), medical savings accounts, health savings accounts, long-term-care benefits, or real estate transactions.

Federal Income Tax and Social Security and Medicare Tax

In general, employers who withhold Federal income tax or Social Security and Medicare taxes must file Form 941 - Employer's Quarterly Federal Tax Return each quarter. This includes withholding on sick pay and supplemental unemployment benefits.

Federal Unemployment Tax Act (FUTA)

Only the employer pays FUTA tax; it is not withheld from the employee's wages. Report the FUTA taxes by filing Form 940 - Employer's Annual Federal Unemployment (FUTA) Tax Return.

Preparing and Filing Form W-2

At the end of the year, the employer must complete Form W-2 - Wage and Tax Statement to report wages, tips and other compensation paid to an employee. File Copy A of all paper Forms W-2 with Form W-3 - Transmittal of Wage and Tax Statements, to the Social Security Administration (SSA). File Copy 1 to an employee's state or local tax department. Even if the employer requests an extension of time to file Form W-2, he or she still must furnish Form W-2 to his or her employees by January 31.

Self-Employment

When an individual is self-employed, it typically means he or she works for him or herself, as an independent contractor, or owns his or her own business. Here are six key points the IRS would like the taxpayer to know about self-employment and self-employment taxes: (12)

1. Self-employment income can include pay received for part-time work done out of the home. This could include income earned in addition to a regular job.
2. Self-employed individuals file a Schedule C - Profit or Loss From Business with their Form 1040.
3. If the taxpayer is self-employed, he or she generally has to pay self-employment tax as well as income tax. Self-employment tax includes Social Security and Medicare taxes. The taxpayer can figure this tax using Schedule SE - Self-Employment Tax.
4. If the taxpayer is self-employed, he or she may have to make estimated tax payments. People typically make estimated tax payments to pay taxes on income that is not subject to withholding. If the taxpayer does not make estimated tax payments, he or she may have to pay a penalty when filing the income tax return. The underpayment of estimated tax penalty applies if a taxpayer does not pay enough taxes during the year.

5. When the taxpayer files the tax return, he or she can deduct some business expenses for the costs paid to run the trade or business. The taxpayer can deduct most business expenses in full, but some costs must be 'capitalized.' This means he or she can deduct a portion of the expense each year over a period of years.
6. The taxpayer may deduct only the costs that are both ordinary and necessary. An ordinary expense is one that is common and accepted in the industry. A necessary expense is one that is helpful and appropriate for the trade or business.

There are three IRS publications that will also help a self-employed individual. See Publication 334 - Tax Guide for Small Business; Publication 535 - Business Expenses and Publication 505 - Tax Withholding and Estimated Tax.

Schedule C - Profit or Loss From Business

Schedule C - Profit or Loss From Business, is designed to report the profit (or loss) from a trade or business of a sole proprietor. Nevertheless, a sole proprietor is no different from any other individual. Such an individual may have non-business income (interest, dividends), gains and losses from property transactions, rent income, or even farm income to report. Likewise, this taxpayer must either elect to itemize deductions or use the standard deduction. Small business owners can deduct all ordinary and necessary business expenses incurred in operating the business. This includes such expenses as advertising, depreciation, wages, car and truck expenses, utilities, etc., which are detailed on Schedule C. In short, Schedule C is only the place to start for the sole proprietor. The taxpayer may be subject to state and local taxes and other requirements such as business licenses and fees. Check with state and local governments for more information.

Note

For tax year 2019 and later, the taxpayer will no longer use Schedule C-EZ, but instead will use the Schedule C.

If the taxpayer's sole proprietorship business has no profit or loss during the full year, it is not necessary to file a Schedule C for that year. However, if the taxpayer's business is inactive, but he or she receives payments such as insurance that relate to the business, he or she must report those payments on a Schedule C.

The taxpayer should use Schedule C (Form 1040) to report income or loss from a business he or she operated or a profession he or she practiced as a sole proprietor. An activity qualifies as a business if:

- The taxpayer's primary purpose for engaging in the activity is for income or profit.
- The taxpayer is involved in the activity with continuity and regularity.

Here are the key parts of Schedule C discussed in detail.

Line 1: Gross receipts or sales
Except as otherwise provided in the Internal Revenue Code, gross income includes income from whatever source derived. Enter gross receipts from a trade or business on line 1. Include amounts the taxpayer received in a trade or business that were properly shown on Forms 1099-MISC. If the total amounts that were reported in box 7 of Forms 1099-MISC are more than the total the taxpayer is reporting on line 1, attach a statement explaining the difference. Do not include any amount received for the sale of property used in a business or profession on line 1. [(13)]

Line 2: Returns and Allowances
This line is only to be used by accrual-based taxpayers who previously included an amount as income when earned but were never paid. Cash basis taxpayers should never have an amount reported on line 2.

Line 4: Cost of Goods Sold
If the taxpayer makes or buys goods to sell, he or she can deduct the cost of goods sold from the gross receipts on line 4 of Schedule C. However, to determine these costs, he or she must value the inventory at the beginning and end of each tax year. This applies if the taxpayer is a manufacturer, wholesaler, or retailer or if are engaged in any business that makes, buys, or sells goods to produce income. This does not apply to a personal service business, such as the business of a doctor, lawyer, carpenter, or painter. However, if the taxpayer works in a personal service business and also sells or charges for the materials and supplies normally used in business, this also applies to them. The cost of goods sold is determined in Lines 35-42 on Schedule C. If the taxpayer must account for an inventory in their business, then he or she must generally use an accrual method of accounting for purchases and sales. [(14)]

Figuring Cost of Goods Sold on Schedule C

Line 35 - Inventory at beginning of year. If different from last year's closing inventory, attach explanation.
Line 36 - Purchases less cost of items withdrawn for personal use.
Line 37 - Cost of labor. Do not include any amounts paid by the taxpayer to him or herself.
Line 38 - Materials and supplies.
Line 39 - Other costs.
Line 40 - Add lines 35 through 39.
Line 41 - Inventory at end of year.
Line 42 - Cost of goods sold. Subtract line 41 from line 40.

Part III of Schedule C is for businesses to determine their cost of goods sold which is reported on line 4. The following is a summary of Schedule C Part III that explains how this determination is made.

Line 35: Inventory at the Beginning of the Year
Beginning inventory is the cost of merchandise on hand at the beginning of the year that will be available to sell to customers. If the taxpayer is a manufacturer or producer, it includes the total cost of raw materials, work in process, finished goods, and materials and supplies used in manufacturing the goods. Opening inventory usually will be identical to the closing inventory of the year before. Any difference between these numbers must be explained by the taxpayer in a schedule attached to the return.

Line 36: Purchases Less Cost of Items Withdrawn for Personal Use
If the taxpayer is a merchant, use the cost of all merchandise bought for sale. If the taxpayer is a manufacturer or producer, include the cost of all raw materials or parts purchased for manufacture into a finished product.

Line 37: Cost of Labor
Labor costs are usually an element of cost of goods sold only in a manufacturing or mining business. Small merchandisers (wholesalers, retailers, etc.) usually do not have labor costs that can properly be charged to cost of goods sold and are taken as a business expense deduction. In a manufacturing business, labor costs properly allocable to the cost of goods sold include both the direct and indirect labor used in fabricating the raw material into a finished, saleable product.

Line 38: Materials and Supplies
Materials and supplies, such as hardware and chemicals, used in manufacturing goods are charged to cost of goods sold. Those that are not used in the manufacturing process are treated as deferred charges and deducted as a business expense.

Line 39: Other Costs
Examples of other costs incurred in a manufacturing or mining process that can be charged to the cost of goods sold are as follows:

- *Freight* - Freight-in, express-in, and cartage-in on raw materials, supplies used in production, and merchandise purchased for sale are all part of cost of goods sold.
- *Containers* - Containers and packages that are an integral part of the product manufactured are a part of the cost of goods sold. If they are not an integral part of the manufactured product, their costs are shipping or selling expenses.
- *Overhead expenses* - Overhead expenses include expenses such as rent, heat, light, power, insurance, depreciation, taxes, maintenance, labor, and supervision. Overhead expenses that are direct and necessary expenses of the manufacturing operation are included in the cost of goods sold.

Subtract the value of taxpayer's closing inventory (including, as appropriate, the allocable parts of the cost of raw materials and supplies, direct labor, and overhead expenses) from line 40. Inventory at the end of the year is also known as closing or ending inventory. Ending inventory will usually become the beginning inventory of the next tax year. When the closing inventory (inventory at the end of the year) is subtracted from the cost of goods available for sale, the remainder is the cost of goods sold during the tax year. Report this on line 4 of Schedule C.

Other Income

Line 6: Other Income
The taxpayer reports on line 6 amounts from finance reserve income, scrap sales, bad debts he or she recovered, interest (such as on notes and accounts receivable), state gasoline or fuel tax refunds he or she received in 2020, any amount of credit for biofuel claimed on line 2 of Form 6478, any amount of credit for biodiesel and renewable diesel fuels claimed on line 8 of Form 8864, credit for Federal tax paid on fuels claimed on his or her 2019 Form 1040 or 1040-SR, prizes and awards related to his or her trade or business, amounts the taxpayer received in his or her trade or business as shown on Form 1099-PATR, any amount of credit for qualified sick, and family leave wages and other kinds of miscellaneous business income.

If the business use percentage of any listed property dropped to 50% or less in 2020, the taxpayer reports on this line any recapture of excess depreciation, including any Section 179 expense deduction. He or she uses Part IV of Form 4797 to figure the recapture. Also, if the business use percentage drops to 50% or less on leased listed property (other than a vehicle), include on this line any inclusion amount.

Expenses

This section provides an overview of business expenses that can be deducted on Schedule C. A sole proprietor can deduct the costs of operating the business and these costs are known as business expenses. These are costs that do not have to be capitalized or included in the cost of goods sold but can deducted in the current year. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the particular field of business. A necessary expense is one that is helpful and appropriate for the business. An expense does not have to be indispensable to be considered necessary. [14]

If the taxpayer has an expense that is partly for business and partly personal, separate the personal part from the business part. The personal part is not deductible.

Line 8: Advertising
Promoting a business through paid advertisements in newspapers, trade magazines, television, radio, or on the internet are all deductible. Include the normal and necessary expenses associated with these promotions. In addition, the cost of business cards, promotional items, flyers and the cost of distributing them, etc. can also be deducted as business expense. Advertising with the intention of influencing political legislation is not deductible.

Line 9: Car and Truck Expenses
A sole proprietor can deduct the actual expenses of operating a car or truck or take the standard mileage rate. This is true even if the vehicle was used for hire (such as a taxicab). Actual expenses must be used if there were five or more vehicles simultaneously in active use for the business (such as in fleet operations). Actual expenses cannot be used for a leased vehicle if the taxpayer previously used the standard mileage rate for that vehicle. A taxpayer can take the standard mileage rate of 57.5 cents for 2020 only if he or she: [13]

- Owned the vehicle and used the standard mileage rate for the first year it was placed in service.
- Leased the vehicle and are using the standard mileage rate for the entire lease period (except the period, if any, before 1998).

If the taxpayer takes the standard mileage rate, multiply the number of business miles driven by 57.5 cents for 2020 and add to this amount of parking fees and tolls, and enter the total on line 9. Taxpayer should keep a log of business miles driven as well as tolls and parking fees paid. Do not deduct depreciation, rent or lease payments, or the actual operating expenses.

If the taxpayer deducts actual expenses, include on line 9 the business portion of expenses for gasoline, oil, repairs, insurance, tires, license plates, etc., and show depreciation on line 13 and rent or lease payments on line 20a. If the taxpayer owns or leases five or more cars that are used for business at the same time, he or she must use the actual expense method. The taxpayer may also be required to provide additional information by completion of Part IV of Schedule C.

Tip

Placing the company logo, displays, or advertisements on a vehicle does not change the use from personal to business use.

Expenses incurred for use of a vehicle to get from the taxpayer's home to the place of business are treated as personal commuting expenses and are not deductible. If the taxpayer does not have a regular office, mileage driven between home and the first stop is considered to be commuting to work and is not deductible. In addition, mileage driven between the last business stop and their home is also treated as commuting mileage and is not deductible. If the taxpayer qualifies for an office within the home, however, all of their business mileage driven outside of the home is deductible.

Additional information that should be maintained and logged in order to deduct expenses for business use of a vehicle includes:

- Basis of vehicle.
- Date vehicle was placed into service.
- Total number of business miles driven for the year.
- Total number of commuting miles driven for the year.
- Total overall miles driven for the year.

To determine the business use percentage, divide the total number of business miles driven for the year by the total overall miles driven for the year.

Line 10: Commissions and Fees
Use line 10 to enter the total commissions and fees for the tax year. The taxpayer does not include commissions or fees that are capitalized or deducted elsewhere on his or her return.

Line 11: Contract Labor
Use line 11 to report the total of all payments made to independent contractors for services rendered. If the business paid $600 or more to any one individual, Form 1099-MISC must be filed and the independent contractor must receive a copy by January 31.

Examples of entities that do not need to receive Form 1099-MISC include the following:

- Payments made to employees as compensation.
- Payment made for products as opposed to services.
- Payments made to other corporations.
- Payments made that are not related to business.

Do not include any payments made to employees for wages, salaries, and commissions on line 11.

Line 12: Depletion
Enter the deduction for depletion on this line. Depletion is a measure of the cost recovery of a natural resource as it is extracted and sold. Since the resource will not be replaced the taxpayer can take a deduction to account for this. Natural resources include but are not limited to mines, oil and gas wells, timber and any exhaustible natural deposit. For more detailed information, see IRS Publication 535 - Business Expenses.

Line 13: Depreciation and Section 179 Expense
Depreciation is the annual deduction allowed to recover the cost or other basis of business or investment property having a useful life substantially beyond the tax year. It is also permissible to depreciate improvements made to business property that is being leased. Depreciation starts upon first use of the property in the business or for the production of income. It ends when the property is taken out of service, all the depreciable cost or other basis have been taken, or the property is no longer used in the business or for the production of income. See the Instructions for Form 4562 - Depreciation and Amortization and Publication 946 - How To Depreciate Property to figure the amount to enter on line 13.

Line 14: Employee Benefit Programs
Deduct contributions to employee benefit programs that are not an incidental part of a pension or profit-sharing plan included on line 19. Examples are accident and health plans, group-term life insurance, and dependent care assistance programs. The sole proprietor cannot deduct contributions made on his or her behalf as a self-employed person to any benefit plan. However, he or she may be able to deduct on Schedule 1 (Form 1040), line 16, or Form 1040NR, line 29, the amount paid for health insurance on behalf of the taxpayer, his or her spouse, and dependents,

even if the taxpayer does not itemize deductions. See the instructions for Schedule 1 (Form 1040), line 16, or Form 1040NR, line 29, for details.

The taxpayer can usually deduct insurance premiums in the tax year to which they apply. If he or she uses the cash method of accounting, he or she generally deducts insurance premiums in the tax year he or she actually paid them, even if he or she incurred them in an earlier year. If the taxpayer uses an accrual method of accounting, he or she cannot deduct insurance premiums before the tax year in which he or she incurs a liability for them. In addition, the taxpayer cannot deduct insurance premiums before the tax year in which he or she actually pays them (unless the exception for recurring items applies). Also, the taxpayer cannot deduct expenses in advance, even if he or she pays them in advance. This rule applies to any expense paid far enough in advance to, in effect, create an asset with a useful life extending substantially beyond the end of the current tax year. Expenses such as insurance are generally allocable to a period of time. The taxpayer can deduct insurance expenses for the year to which they are allocable.

Line 15: Insurance (other than health)

Deduct premiums paid for business insurance on line 15. Not all forms of business insurance are deductible. Refer to the table for some examples of business insurance can be deducted on line 15.

Deductible Premiums	Non-Deductible Premiums
Liability insurance	Insurance for loss of earnings
Workers' compensation insurance	Insurance to secure a loan
Malpractice insurance	Self-insurance reserve funds
Fire, storm, theft, accident, or similar losses	
Credit insurance that covers losses from business bad debts	

Table 2-2 - Publication 535 – Chapter 6 - Insurance (2020)

Line 16a and 16b: Interest

Under TCJA, for taxable years beginning after December 31, 2017, the deduction for business interest was limited to the sum of business income, floor plan financing interest, and 30% of the "adjusted taxable income" of the taxpayer for the taxable year, with the amount of disallowed interest generally carried forward indefinitely. The Coronavirus Aid, Relief, and Economic Security Act (CARES) increases that limit to 50% of adjusted taxable income for taxable years beginning in 2019 and 2020, thus allowing taxpayers to deduct more of their business interest. In addition, a business can elect to use its 2019 adjusted taxable income in computing its 2020 limitation if that would produce a greater interest deduction. In the case of a partnership, that election is made by the partnership.

Disallowed interest above the limit may be carried forward indefinitely, with special rules for partnerships. The taxpayer must file Form 8990 - Limitation on Business Interest Expense Under Section 163(j) to deduct any interest expenses of this trade or business unless he or she is a small business taxpayer or meets one of the other filing exceptions listed in the Instructions for Form 8990. If the taxpayer must file Form 8990, he or she figures the limit on his or her business interest expenses on Form 8990 before completing lines 16a and 16b. The interest the taxpayer cannot deduct this year will carry forward to next year on Form 8990.

The tax treatment of interest expense differs depending on its type. For example, home mortgage interest and investment interest are treated differently. Interest allocation rules require the taxpayer to allocate (classify) interest expense so it is deducted (or capitalized) on the correct line of the return and receives the right tax treatment. These rules could affect how much interest the taxpayer is allowed to deduct on Schedule C. If the taxpayer has a mortgage on real property used in the business, enter on line 16a the interest paid for 2020. The exception to this is if the taxpayer used the main home as the primary place of business. Interest paid on a home office in a principal residence is deducted of Form 8829. Report all other business interest paid on line 16b.

Line 17: Legal and Professional Services

Include on this line fees charged by accountants and attorneys that are ordinary and necessary expenses directly related to operating a business. Include fees for tax advice related to the business and for preparation of the tax forms related to the business. Also include expenses incurred in resolving asserted tax deficiencies relating to the business.

Line 18: Office Expense
The cost of running and operating an office are deductible. Examples include postage such as stamps, certified mail expenses, priority and/or express mail services. Office expenses also include consumable office supplies such as pads of paper, post it notes, file folders, pens, pencils, and receipt books. The supplies needed to operate office equipment such as printing paper, toner, cash register tape, etc. are also deductible office expenses. Line 18 should also be used to deduct office expenses that are not allowable of Form 8829 - Expenses for Business Use of Your Home. Taxpayers not eligible for in home deductions can still deduct expenses such as cleaning, additional insurance for a home office, telephone and internet usage.

Line 19: Pension and Profit-Sharing Plans
Enter the deduction for contributions to a pension, profit-sharing, or annuity plan, or plan for the benefit of the employees. If the plan included the taxpayer as a self-employed person, enter contributions made as an employer on his or her behalf on Form 1040, line 4c, or Form 1040NR, line 17a, not on Schedule C. In most cases, the sole proprietor must file the applicable form listed below if the business maintains a pension, profit-sharing, or other funded-deferred compensation plan. The filing requirement is not affected by whether or not the plan qualified under the Internal Revenue Code, or whether or not the business claims a deduction for the current tax year.

There is a penalty for failure to timely file these forms: [13]

- Form 5500-EZ - Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan. File this form if the taxpayer has a one-participant retirement plan that meets certain requirements. A one-participant plan is a plan that covers only the taxpayer (or taxpayer and their spouse).
- Form 5500-SF - Short Form Annual Return/Report of Small Employee Benefit Plan. File this form if the taxpayer has a small plan (fewer than 100 participants in most cases) that meets certain requirements.
- Form 5500 - Annual Return/Report of Employee Benefit Plan. File this form for a plan that does not meet the requirements for filing Form 5500-EZ or Form 5500-SF.

For plan years beginning on or after January 1, 2009, the Form 5500 and its schedules and the Form 5500-SF must be filed electronically under the computerized ERISA Filing Acceptance System (EFAST2). Check the DOL website at www.efast.dol.gov for additional information about the forms and schedules concerning the EFAST2 processing system, electronic filing, and software. For more details see IRS Publication 560 - Retirement Plans for Small Business.

Line 20a and 20b: Rent or Lease
If the business rented or leased vehicles, machinery, or equipment, the taxpayer should enter on line 20a the business portion of a rental cost. But if the business leased a vehicle for a term of 30 days or more, it may have to reduce the deduction by an amount called the inclusion amount. See IRS Publication 463 - Travel, Entertainment, Gift and Car Expenses for more information about leasing a car. Enter on line 20b amounts paid to rent or lease other property, such as office space in a building.

Line 21: Repairs and Maintenance
Deduct the cost of incidental repairs and maintenance that do not add to the property's value or appreciably prolong its life. Permissible expenses that can be deducted include labor, supplies and any item that do not add value to the asset, prolong the life of the asset, or adapt the asset for use in another capacity. Do not deduct the value of the sole proprietor’s own labor. Do not deduct amounts spent to restore or replace property; they must be capitalized.

Line 22: Supplies
In most cases, the taxpayer can deduct the cost of materials and supplies only to the extent they were actually consumed and used in the business during the tax year (provided they were not deducted in a prior tax year). However, if a business had incidental materials and supplies on hand for which no inventories or records of use were kept, it can deduct the cost of those actually purchased during the tax year, provided that method clearly reflects income. Acceptable deductions include the cost of books, professional instruments, equipment, etc., if they are normally used within a year. However, if their usefulness extends substantially beyond a year, the taxpayer must generally recover their costs through depreciation.

Line 23: Taxes and Licenses
Taxes that are directly attributable to a trade or business are deductible. Licenses and fees that are paid to regulatory agencies or government bodies are also deductible.

Examples of acceptable deductions that can be taken on line 23 include:

- Real estate and personal property taxes on business assets.
- State and local sales taxes imposed on the taxpayer as the seller of goods or services. If the taxpayer collected this tax from the buyer, he or she must also include the amount collected in gross receipts or sales on line 1.
- Licenses and regulatory fees for a trade or business paid each year to state or local governments. But some licenses, such as liquor licenses, may have to be amortized.
- Social Security and Medicare taxes paid to match required withholding from the employees' wages. Reduce the deduction by the amount shown on Form 8846, line 4.
- Federal unemployment tax paid.
- Federal highway use tax.
- Contributions to state unemployment insurance fund or disability benefit fund if the contributions are considered taxes under state law.

Do not deduct the following on line 23:

- Federal income taxes, including taxpayer's self-employment tax. However, he or she can deduct a portion of the self-employment tax on line 14 of Schedule 1 (Form 1040).
- Estate and gift taxes.
- Taxes assessed to pay for improvements, such as paving and sewers.
- Taxes on the taxpayer's home or personal use property.
- State and local sales taxes on property purchased for use in the business. Instead, treat these taxes as part of the cost of the property.
- State and local sales taxes imposed on the buyer that the taxpayer was required to collect and pay over to state or local governments. These taxes are not included in gross receipts or sales nor are they a deductible expense. However, if the state or local government allowed the business to retain any part of the sales tax collected, these need to be included as income on line 6.
- Other taxes and license fees not related to the business.

Line 24a and 24b: Travel, meals and entertainment
Enter expenses for lodging and transportation connected with overnight travel for business while away from the tax home on line 24a. In most cases, the tax home is the main place of business, regardless of where the taxpayer maintains the family home. The taxpayer cannot deduct expenses paid or incurred in connection with employment away from home if that period of employment exceeds 1 year. Also, the taxpayer cannot deduct travel expenses for his or her spouse, dependent, or any other individual unless that person is an employee, the travel is for a bona fide business purpose, and the expenses would otherwise be deductible by that person.

Under the Tax Cuts and Jobs Act (TCJA), the taxpayer can no longer deduct entertainment expenses. In 2020, he or she may still deduct 50% of his or her business meal expenses that are not entertainment expenses. Enter the total deductible business meals on line 24b. This includes expenses for meals while traveling away from home for business. Do not include entertainment expenses on line 24b.

Business meal expenses are deductible only if they:

- Are directly related to or associated with the active conduct of the trade or business.
- Not lavish or extravagant.
- Incurred while the sole proprietor or an employee is present at the meal.

The taxpayer cannot deduct any expense paid or incurred for a facility (such as a yacht or hunting lodge) used for any activity usually considered entertainment, amusement, or recreation. Also, they cannot deduct membership dues for any club organized for business, pleasure, recreation, or other social purpose. This includes country clubs, golf and athletic clubs, airline and hotel clubs, and clubs operated to provide meals under conditions favorable to business discussion. But it does not include civic or public service organizations, professional organizations (such as bar and medical associations), business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards.

Line 25: Utilities
Include on line 25 charges for business use electric, gas, telephone, water, sewer and other ordinary and necessary

utility charges. If the taxpayer qualifies to take an office-in-home deduction, the amounts paid for utilities for the home are included on Form 8829. If the taxpayer uses his or her home telephone for business use, the base cost of the first line into the home is not deductible. However, any long-distance charges are includible on this line.

Line 26: Wages
Enter the total salaries and wages for the tax year on line 26. Do not include salaries and wages deducted elsewhere on the return or amounts paid to the sole proprietor as these payments are treated as nondeductible owner's draw.

Wages that are attributable to the cost of goods sold should be included in the Cost of Goods Sold section (Part III Schedule C discussed earlier).

Tip

If a sole proprietor provided taxable fringe benefits to employees, such as personal use of a car, do not deduct as wages the amount applicable to depreciation and other expenses claimed elsewhere.

Line 27a: Other expenses
Line 27a includes all ordinary and necessary business expenses not deducted elsewhere on Schedule C. The type and amount of each expense are listed separately on the lines provided.

Line 30: Business use of the Home
To determine the deductible amount of business use of a taxpayer's home, complete and attach Form 8829 - Expenses for Business Use of Your Home.

Business Use of the Home

Form 8829 - Expenses For Business Use of Your Home is used when a taxpayer can claim deductions for the business use of a portion of his or her home. The general rule is that taxpayers who use a part of the home for legitimate business purposes can deduct expenses allocable to that portion of the home used for those business purposes. This is the so-called home office deduction rule.

Generally, the taxpayer can deduct business expenses that apply to a part of the home only if that part is exclusively used on a regular basis: [15]

- As the principal place of business for any of the trades or businesses.
- As a place of business used by patients, clients or customers to meet or deal with the taxpayer in the normal course of the trade or business.
- In connection with the trade or business if it is a separate structure that is not attached to the home.

Exceptions to this rule apply to space used on a regular basis for:

- Storage of inventory or product samples.
- Certain Daycare facilities.

A home office qualifies as a principal place of business if the taxpayer meets the following requirements:

- The taxpayer uses it exclusively and regularly for administrative or management activities of the trade or business.
- The taxpayer has no other fixed location where he or she conducts substantial administrative or management activities of the trade or business.

Tip

If the part of the property being used for a home office is not attached to the living area of the home, that is, it is a separate building, then the taxpayer must show that the separate building is used in connection with his trade or business. But it does **not** have to be the principal place of business.

The key is to be sure that the part of the home being claimed as the home office is used exclusively for the business activity. Thus, if the room in the house doubles as a home office and family room used by the rest of the family for entertainment, it does not qualify as being exclusively used for business. There are two exceptions to the exclusive use rule. The first is where part of the home is used for storing inventory.

Then, the taxpayer can deduct the expenses related to using that room if:

- The inventory is kept for use in the taxpayer's trade or business.
- The trade or business in question is the wholesale or retail of selling of goods.
- The home is the only fixed location of the taxpayer's trade or business.
- The storage space is used on a regular basis.
- The space being used is a separately identifiable space suitable for storage.

The second exception to the exclusive use rule is for homes that are used for providing daycare services. Then the rooms can be used for both business and personal use, but the taxpayer has to allocate out the personal use portion, which is nondeductible.

If the taxpayer qualifies for a home office deduction, the taxpayer can deduct both direct and indirect expenses for that office. Direct expenses are those that only benefit the particular room in the house used for business purposes, such as painting or repairing the room. Indirect expenses are those that benefit the entire home, including those parts of the home not being used for business.

Utilities

Business expenses for heat, lights, power, telephone service, and water and sewerage are deductible. However, any part due to personal use is not deductible. Deductions for internet-related expenses include domain registrations fees and webmaster consulting costs. When starting a business, the taxpayer may have to amortize these expenses as start-up costs.

A taxpayer is denied a business deduction for basic local telephone service charges on the first line in the residence. Additional charges for long-distance telephone calls, equipment, optional services (such as call waiting or message-taking) or additional telephone lines may be deductible. (16)

Part of the Home Used for Business

Tip

To determine what percentage of expenses can be deducted, we must discuss the business-use percentage of the home**.** Do this by dividing the area used for business by the total area of the home, in square feet. If the rooms in the home are about the same in size, simply divide the number of rooms used for business by the total number of rooms in the home.

Daycare Services

Taxpayers who use their personal residences on a regular basis in the business of providing qualifying day care services do not have to meet the exclusive use test in order to deduct business-related expenses. But, the daycare business expenses are available only if the taxpayer has applied for and has been granted a license, or certification, or approval as a daycare center under the provisions of applicable state law.

Depreciation - Business Use of the Home

If the taxpayer owns his or her home and qualifies to deduct expenses for its business use, he or she can claim a deduction for depreciation. Depreciation is an allowance for the wear and tear on the part of the taxpayer's home used for business. The taxpayer cannot depreciate the cost or value of the land. He or she recovers its cost when he or she sells or otherwise dispose of the property. Before the taxpayer figures his or her depreciation deduction, he or she needs to know the following information: (17)

- The month and year he or she started using his or her home for business.
- The adjusted basis and fair market value of his or her home (excluding land) at the time he or she began using it for business.
- The cost of any improvements before and after he or she began using the property for business.
- The percentage of his or her home used for business.

The adjusted basis of the taxpayer's home is generally its cost, plus the cost of any permanent improvements he or she made to it, minus any casualty losses or depreciation deducted in earlier tax years. A permanent improvement increases the value of property, adds to its life, or gives it a new or different use. Examples of improvements are replacing electric wiring or plumbing, adding a new roof or addition, paneling, or remodeling.

The fair market value of the taxpayer's home is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property, on or about the date the taxpayer begin using his or her home for business, may be helpful in determining the property's fair market value.

If the taxpayer first used his or her home for business before 2011 but after 1986, see IRS Publication 946 - How To Depreciate Property. If first used prior to 1987, see IRS Publication 534 - Depreciating Property Placed in Service Before 1987. Additional help can be found in Publication 587 - Business Use of Your Home.

Carryover of Non-allowed Expenses to Next Year

There is a limit on the amount of otherwise nondeductible expenses, such as utilities, insurance, and depreciation that the taxpayer can take as a home office deduction. The total amount of deductions, with depreciation taken last, cannot be more than the gross income earned from the business use of the home. The gross income limit is determined by deducting the following from gross income:

- The business percentage of expenses that would be deductible by any taxpayer regardless of whether or not he is using the home in a trade or business, such as deductible mortgage interest, real estate taxes and casualty losses.
- All other business deductions such as wages and supplies that are not directly related to the use of the home office.

The home office deduction cannot be used to create or increase a loss from the taxpayer's business. The amount of the deduction available is limited to the net income for the year from the business. Any excess loss can only be carried forward and used next year, using the same limitations. Form 8829 is completed to determine the allowable expenses for business use of the home. This figure is entered on the appropriate line on Schedule C.

Simplified Option for Home Office Deduction

Taxpayers may use a simplified option when figuring the deduction for business use of their home. This simplified option does not change the criteria for who may claim a home office deduction. It merely simplifies the calculation and recordkeeping requirements of the allowable deduction. Some key points of the simplified option are: [18]

- Standard deduction of $5 per square foot of home used for business (maximum 300 square feet or $1,500).
- Allowable home-related itemized deductions claimed in full on Schedule A. (For example: Mortgage interest, real estate taxes).
- No home depreciation deduction or later recapture of depreciation for the years the simplified option is used.

Tip

The taxpayer may choose to use either the simplified method or the regular method for any taxable year. He or she chooses a method by using that method on his or her timely filed, original Federal income tax return for the taxable year. Once the taxpayer has chosen a method for a taxable year, he or she cannot later change to the other method for that same year. If the taxpayer uses the simplified method for one year and uses the regular method for any subsequent year, he or she must calculate the depreciation deduction for the subsequent year using the appropriate optional depreciation table. This is true regardless of whether the taxpayer used an optional depreciation table for the first year the property was used in business.

Deduction for Qualified Business Income

For tax years beginning after 2017, the taxpayer may be entitled to a deduction of up to 20% of his or her qualified business income from his or her qualified trade or businesses plus 20% of the aggregate amount of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income. The deduction is subject to various limitations, such as limitations based on the type of the taxpayer's trade or business, his or her taxable income, the amount of W-2 wages paid with respect to the qualified trade or business, and the unadjusted basis of qualified property held by his or her trade or business. The taxpayer will claim this deduction on Form 1040, not on Schedule C. Unlike other deductions, this deduction can be taken in addition to the standard or itemized deductions.

Self-Employment Tax

All individuals engaged in a trade or business in any capacity, other than as employees, are subject to the self-employment tax. Generally, this includes a sole proprietor, a member of a partnership, and one who renders service as an independent contractor. For 2020, the SE tax rate on net earnings is 15.3% (12.4% Social Security tax plus 2.9% Medicare tax).

Tip

Self-employment (SE) tax is a Social Security and Medicare tax primarily for individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners and is usually calculated on the net profit from Schedule C. If a husband and wife both have separate Schedule C, each spouse must figure their SE tax separately on individual Schedule SE. If a taxpayer has more than one business and therefore more than one Schedule C, all business income or loss is determined before calculating SE tax. If any of the income from a trade or business, other than a partnership, is community property income under state law, it is included in the earnings subject to SE tax of the spouse carrying on the trade or business.

A taxpayer must pay SE tax and file Schedule SE if either of the following applies:

- Their net earnings from self-employment (excluding church employee income) were $400 or more.
- They had church employee income of $108.28 or more except for ministers and members of religious orders.

For a sole proprietor, net income (as reported on Schedule C) must be counted as self-employment income. If net income is less than $400, the self-employment tax does not apply. (19)

The Federal Insurance Contributions Act (FICA) tax includes two separate taxes. One is Social Security tax and the other is Medicare tax. Different rates apply for each of these programs. For 2020, the tax rate for Social Security is 6.2% for employees, 6.2% for employers and 12.4% for self-employed people. The Social Security tax applies only to the first $137,700 of wages, for a maximum of $8,537.40 for employees and for employers, and $17,074.80 for self-employed people. The current rate for Medicare is 1.45% for the employer, 1.45% for the employee and 2.9% for self-employed individuals. There is not a wage base limit for Medicare tax. All covered wages are subject to Medicare tax.

Federal income tax is a pay-as-you-go tax. The taxpayer must pay it as he or she earns or receives income during the year. An employee usually has income tax withheld from his or her pay. If the taxpayer does not pay his or her tax through withholding, or does not pay enough tax that way, they might have to pay estimated tax. All taxpayers generally have to make estimated tax payments if they expect to owe taxes, including self-employment tax, of $1,000 or more when they file their return.

Note

The self-employment tax is determined by completing Schedule SE Self-Employment. Business Net Profit on Schedule C is transferred to Form 1040 and to Schedule SE. If the taxpayer has to pay SE tax, he or she must file Form 1040 (with Schedule SE attached) even if the taxpayer does not otherwise have to file a Federal income tax return.

The taxpayer should read the flowchart on page 1 of Schedule SE to see if he or she can use Section A, Short Schedule SE, or if he or she must use Section B, Long Schedule SE. Generally, the taxpayer will be required to complete Section B, Long Schedule SE, if he or she: (20)

- Received tips subject to Social Security or Medicare tax that he or she did not report to his or her employer.
- Was minister, member of a religious order, or Christian Science practitioner who received IRS approval not to be taxed on earnings from these sources, but he or she owed self-employment tax on other earnings.
- Was using one of the optional methods to figure his or her net earnings.
- Received church employee income reported on Form W-2 of $108.28 or more.

Additional Medicare Tax

The taxpayer must file Form 8959 - Additional Medicare Tax if his or her total Medicare wages and tips plus his or her self-employment income (including the Medicare wages and tips and self-employment income of his or her spouse, if married filing jointly) are greater than the threshold amount for the taxpayer's filing status. Self-employment income includes amounts from Schedule SE – Section A, line 4, or Section B, line 6. Negative amounts should not be considered for the purposes of Form 8959.

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separate	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$200,000
Note: The Additional Medicare Tax of 0.9% only applies to the wages above the Threshold Amount.	

Table 2-3 - Questions and Answers for the Additional Medicare Tax (2020)

If the taxpayer has both wages and self-employment income, the threshold amount for applying Additional Medicare Tax on the self-employment income is reduced (but not below zero) by the amount of wages subject to Additional Medicare Tax.

Compensation subject to RRTA taxes and wages subject to FICA tax are not combined to determine Additional Medicare Tax liability. The threshold applicable to an individual's filing status is applied separately to each of these categories of income.

Special Rules and Exceptions

Fishing Crew Member

If the taxpayer is a member of the crew on a boat that catches fish or other water life, the earnings are subject to SE tax if all the following conditions apply: (21)

1. The taxpayer does not get any pay for the work except his or her share of the catch or a share of the proceeds from the sale of the catch, unless the pay meets all the following conditions:
   a. The pay is not more than $100 per trip.
   b. The pay is received only if there is a minimum catch.
   c. The pay is solely for additional duties (such as mate, engineer, or cook) for which additional cash pay is traditional in the fishing industry.
2. The taxpayer gets a share of the catch or a share of the proceeds from the sale of the catch.
3. The taxpayer's share depends on the amount of the catch.
4. The boat's operating crew normally numbers fewer than 10 individuals. (An operating crew is considered as normally made up of fewer than 10 if the average size of the crew on trips made during the last four calendar quarters is fewer than 10).

Notary Public

Fees the taxpayer receives for services he or she performs as a notary public are reported on Schedule C but are not subject to self-employment tax (see the Instructions for Schedule SE (Form 1040)).

State or Local Government Employee

The taxpayer is subject to SE tax if he or she is an employee of a state or local government, is paid solely on a fee basis, and the services are not covered under a Federal-state Social Security agreement.

U.S. Citizens Employed by Foreign Governments or International Organizations

If the taxpayer was a U.S. citizen employed by a foreign government for services performed in the United States, Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, or the U.S. Virgin Islands, they must pay SE tax on income earned. Income from this employment is reported on either Short or Long Schedule SE, line 2. If they performed services elsewhere as an employee of a foreign government or an international organization, those earnings are exempt from SE tax.

U.S. Citizens or Resident Aliens Living Outside the United States

A self-employed U.S. citizen or resident alien living outside the United States must pay SE tax in most cases. Also, they are not allowed to reduce foreign earnings from self-employment through the foreign earned income exclusion. However, the United States has Social Security agreements with many countries to eliminate dual taxes under two Social Security systems. Under these agreements, the taxpayer must generally pay Social Security and Medicare taxes to only the country they live in. To see which countries have agreements or to learn more, visit the Social Security Administration's International Programs website at www.socialsecurity.gov/international.

Chapter 11 Bankruptcy Cases

While a debtor in a chapter 11 bankruptcy case, the net profit or loss from self-employment (for example, from Schedule C or Schedule F) will not be included in Form 1040 income. Instead, it will be included on the income tax return (Form 1041) of the bankruptcy estate. However, the taxpayer (not the bankruptcy estate) is responsible for paying SE tax on net earnings from self-employment. Enter on the dotted line to the left of Schedule SE, line 3, Chapter 11 bankruptcy income and the amount of net profit or (loss). Combine that amount with the total of lines 1a, 1b, and 2 (if any) and enter the result on line 3. (22)

Community Income

If any of the income from a business or trade (including farming) is community income, then the income and deductions are reported based on the following: (13)

- If only one spouse participates in the business, all of the income from that business is the self-employment earnings of the spouse who carried on the business.
- If both spouses participate, the income and deductions are allocated to the spouses based on their distributive shares.
- If either or both taxpayer and spouse are partners in a partnership, they should file a partnership return.
- If the taxpayer and his or her spouse had community income and file separate returns, attach Schedule SE to the return of the spouse with the self-employment income. Also, attach Schedule(s) C or F (showing the spouse's share of community income and expenses) to the return of each spouse.

More Than One Business

If the taxpayer had two or more businesses, the net earnings from self-employment are the combined net earnings or loss from all of the businesses. If the taxpayer had a loss in one business, it reduces the income from another. Even though a separate Schedule C is required for each business or trade, figure the combined SE tax on one Schedule SE.

Income from Farming

Taxpayers who have derived income from farming should use Schedule F, Profit or Loss from Farming, rather than Schedule C to determine net profit from farming activities. Schedule F is similar to Schedule C but contains deduction and income items that are specific to farming that are not found on Schedule C.

Income from Partnerships, Trusts, Estates, & S-Corporations

Taxpayers who are members of and receive income from partnerships, trusts, estates, and/or S-corporations will receive a Schedule K-1- Beneficiary's Share of Income, Deductions, Credits from each individual entity they are a member of. They will need to complete Schedule E - Supplemental Income and Loss, Part II, to report their income from these activities.

Self-Employment Tax Deduction

Self-employed individuals who pay Self-employment (SE) tax may take an adjustment to income for a portion of the Social Security tax paid on line 14 of Schedule 1 (Form 1040). The taxpayer can deduct the employer-equivalent portion of the self-employment tax in figuring adjusted gross income. This deduction only affects income tax and not the net earnings from self-employment or self-employment tax.

Income/Loss Included in Net Earnings from Self-Employment

Additional income/loss that should be included in determining the net earnings from self-employment include the following: (22)

1. Fees and other payments received by the taxpayer for services as a director of a corporation.
2. Interest received in the course of any trade or business, such as interest on notes or accounts receivable.
3. Payments for the use of rooms or other space when taxpayer also provided substantial services for the convenience of tenants. Examples are hotel rooms, boarding houses, tourist camps or homes, trailer parks, parking lots, warehouses, and storage garages.
4. Income from the retail sale of newspapers and magazines if age 18 or older.
5. Income received as a direct seller. Newspaper carriers or distributors of any age are direct sellers if certain conditions apply.
6. Rental income from a farm if, as landlord, taxpayer materially participated in the production or management of the production of farm products on this land. This income is farm earnings. To determine whether the taxpayer materially participated in farm management or production, do not consider the activities of any agent who acted for the taxpayer.
7. Income of certain crew members of fishing vessels with crews of normally fewer than 10 people.
8. Fees as a state or local government employee if paid only on a fee basis and the job was not covered under a Federal-state Social Security coverage agreement.
9. Cash or a payment-in-kind from the Department of Agriculture for participating in a land diversion program.

Income/Loss NOT Included in Net Earnings from Self-Employment

Additional income/loss that should NOT be included in determining the net earnings from self-employment include the following: (22)

1. Salaries, fees, etc., subject to Social Security or Medicare tax that the taxpayer received for performing services as an employee, including services performed as an employee under the railroad retirement system.
2. Fees received for services performed as a notary public. If the taxpayer had no other income subject to SE tax, enter “Exempt - Notary” on Schedule 2 (Form 1040), line 4. Do not file Schedule SE. However, if the taxpayer had other earnings of $400 or more subject to SE tax, enter “Exempt - Notary” and the amount of the net profit as a notary public from Schedule C on the dotted line to the left of Schedule SE, line 3. Subtract that amount from the total of lines 1a, 1b, and 2, and enter the result on line 3.
3. Income received as a retired partner under a written partnership plan that provides for lifelong periodic retirement payments if the taxpayer had no other interest in the partnership and did not perform services for it during the year.
4. Income from real estate rentals if the taxpayer did not receive the income in the course of a trade or business as a real estate dealer. Report this income on Schedule E.
5. Income from farm rentals (including rentals paid in crop shares) if, as landlord, taxpayer did not materially participate in the production or management of the production of farm products on the land.
6. Dividends on shares of stock and interest on bonds, notes, etc., if the taxpayer did not receive the income in the course of the trade or business as a dealer in stocks or securities.
7. Payments received from the Conservation Reserve Program if the taxpayer is receiving Social Security benefits for retirement or disability. Deduct these payments on line 1b of Schedule SE.
8. Gain or loss from the sale of a capital asset.
9. Net operating losses from other years.

Figuring Earnings Subject to SE Tax

The methods for figuring earnings subject to self-employment tax are found in Publication 334 - Tax Guide for Small Business. Utilize the flowchart on page 1 of Schedule SE to determine whether the taxpayer can use Section A - Short Schedule SE, or if they must use Section B - Long Schedule SE. For either section, the taxpayer will need to know what their net earnings from self-employment are. Generally, net earnings are simply the net profit from a farm or nonfarm business.

There are three methods used to calculate the taxpayer's net earnings from self-employment:

1. *The regular method* - To figure net earnings using the regular method, multiply the taxpayer's self-employment earnings by 92.35% (0.9235).
2. *The nonfarm optional method* - Use the nonfarm optional method only for earnings that do not come from farming. The taxpayer may use this method if he or she meets all the following tests:
    a. He or she is self-employed on a regular basis. This means that his or her actual net earnings from self-employment were $400 or more in at least 2 of the 3 tax years before the one for which he or she uses this method. The net earnings can be from either farm or nonfarm earnings or both.
    b. He or she has used this method less than 5 years. (There is a 5-year lifetime limit.) The years do not have to be one after another.
    c. In 2020, his or her net nonfarm profits within annual limits:
        i. Less than $6,107, and
        ii. Less than 72.189% of his or her gross nonfarm income.
3. *The farm optional method* - Use the farm optional method only for self-employment earnings from a farming business.

The taxpayer may want to use the optional methods when he or she has a loss or a small net profit and any one of the following applies:

- ➢ He or she wants to receive credit for Social Security benefit coverage.
- ➢ He or she incurred child or dependent care expenses for which he or she could claim a credit. (An optional method may increase his or her earned income, which could increase his or her credit.)
- ➢ He or she is entitled to the Earned Income Tax Credit. (An optional method may increase his or her earned income, which could increase his or her credit.)

He or she entitled to the Additional Child Tax Credit. (An optional method may increase his or her earned income, which could increase his or her credit.)

If the taxpayer uses both optional methods, he or she must add the net earnings figured under each method to arrive at his or her total net earnings from self-employment. The taxpayer can report less than his or her total actual farm and nonfarm net earnings but not less than actual nonfarm net earnings. If he or she uses both optional methods, he or she can report no more than $5,640 as his or her combined net earnings from self-employment in 2020. The taxpayer must use the regular method unless they are eligible to use one or both of the optional methods. Use Publication 334 - Tax Guide for Small Business for general information about the Federal tax laws that apply to small business owners who are sole proprietors and to statutory employees. Publication 334 also has information on business income, expenses, and tax credits.

Regular Method

The regular method is quite simple to use. Multiply total earnings subject to SE tax by 92.35% (0.9235) to determine net earnings. This is reported on Schedule SE, line 4. Net earnings, calculated using the regular method, are also referred to as actual net earnings.

Optional Methods

The taxpayer may want to use one of the optional methods whether they have a small net profit or loss and anyone of the following conditions applies: (23)

- ➢ Taxpayer wants to receive a credit for Social Security benefit coverage.
- ➢ They can claim a Credit for Dependent or Child Care Expenses.
- ➢ They are eligible to receive the Earned Income Tax Credit (EITC).
- ➢ They are eligible to receive the Additional Child Tax Credit.

In the last three conditions, an optional method may increase earned income which could also increase the credit.

Using an optional method might increase the SE tax. However, paying more SE tax could result in the taxpayer getting higher benefits when he or she retires. If the taxpayer uses either or both optional methods, he or she must figure and pay the SE tax due under these methods even if he or she would have had a smaller tax or no tax using the regular method. The optional methods may be used only to figure the SE tax. To figure the income tax, include the actual earnings in gross income, regardless of which method the taxpayer uses to determine SE tax.

Nonfarm Optional Method

The taxpayer may use the nonfarm optional method only for earnings that do not come from farming activities. It may be used in 2020 provided all of the following conditions are met: [23]

1. Taxpayer is self-employed on a regular basis. This means that the actual net earnings from self-employment were $400 or more in at least 2 of the 3 tax years before the one for which he or she uses this method. The net earnings can be from either farm or nonfarm earnings or both.
2. Taxpayer has used this method less than 5 years. (There is a 5-year lifetime limit.) The years do not have to be consecutive.
3. Taxpayer net nonfarm profits were less than $6,107, and also less than 72.189% of gross nonfarm income.

Net Nonfarm Profits

Net nonfarm profit generally is the total of the amounts from:

- Line 31, Schedule C (Form 1040).
- Box 14, code A, Schedule K-1 (Form 1065) (from non-farm partnerships).
- Box 9, code J1, Schedule K-1 (Form 1065-B).

However, the taxpayer may need to adjust the amount reported on Schedule K-1 if he or she is a general partner or if it is a loss.

Gross Nonfarm Income

Gross nonfarm income generally is the total of the amounts from:

- Line 7, Schedule C (Form 1040).
- Box 14, code C, Schedule K-1 (Form 1065) (from non-farm partnerships).
- Box 9, code J2, Schedule K-1 (Form 1065-B).

Figuring Nonfarm Net Earnings

If the taxpayer meets the three tests explained earlier, use the following table to figure the net earnings from self-employment under the nonfarm optional method.

IF gross nonfarm income is...	THEN net earnings are equal to...
$8,460 or less	Two-thirds of gross nonfarm income
More than $8,460	$5,640

Table 2-4 – Publication 334 - Table 10-1 - Figuring Nonfarm Net Earnings (2020)

Actual Net Earnings

Taxpayer actual net earnings are 92.35% of the total earnings subject to SE tax (that is, multiply total earnings subject to SE tax by 92.35% (.9235) to get actual net earnings). Actual net earnings are equivalent to net earnings figured using the regular method.

Optional Net Earnings Less than Actual Net Earnings

The taxpayer cannot use this method to report an amount less than his or her actual net earnings from self-employment.

Gross Nonfarm Income of $8,460 or Less

The following examples illustrate how to figure net earnings when gross nonfarm income is $8,460 or less. [24]

Example 1: Net nonfarm profit less than $6,107 and less than 72.189% of gross nonfarm income.
Ann Green runs a craft business. Her actual net earnings from self-employment were $800 in 2018 and $900 in 2019. She meets the test for being self-employed on a regular basis. She has used the nonfarm optional method less than 5 years.

Her gross income and net profit in 2020 are as follows:

- Gross nonfarm income: $5,400
- Net nonfarm profit: $1,200

Ann's actual net earnings for 2020 are $1,108 ($1,200 × .9235). Because her net profit is less than $6,107 and less than 72.189% of her gross income, she can use the nonfarm optional method to figure net earnings of $3,600 ($^2/_3$ × $5,400). Because these net earnings are higher than her actual net earnings, she can report net earnings of $3,600 for 2020.

Example 2: Net nonfarm profit less than $6,107 but not less than 72.189% of gross nonfarm income.
Assume that in Example 1 Ann's gross income is $1,000 and her net profit is $800. She must use the regular method to figure her net earnings. She cannot use the nonfarm optional method because her net profit is not less than 72.189% of her gross income.

Example 3: Net loss from a nonfarm business.
Assume that in Example 1 Ann has a net loss of $700. She can use the nonfarm optional method and report $3,600 ($^2/_3$ × $5,400) as her net earnings.

Example 4: Nonfarm net earnings less than $400.
Assume that in Example 1 Ann has gross income of $525 and a net profit of $175. In this situation, she would not pay any SE tax under either the regular method or the nonfarm optional method because her net earnings under both methods are less than $400.

Gross Nonfarm Income of more than $8,460

The following examples illustrate how to figure net earnings when gross nonfarm income is more than $8,460. [24]

Example 1: Net nonfarm profit less than $6,107 and less than 72.189% of gross nonfarm income.
John White runs an appliance repair shop. His actual net earnings from self-employment were $10,500 in 2018 and $9,500 in 2019. He meets the test for being self-employed on a regular basis. He has used the nonfarm optional method less than 5 years.

His gross income and net profit in 2020 are as follows:

- Gross nonfarm income: $12,000
- Net nonfarm profit: $1,200

John's actual net earnings for 2020 are $1,108 ($1,200 × .9235). Because his net profit is less than $6,107 and less than 72.189% of his gross income, he can use the nonfarm optional method to figure net earnings of $5,640. Because these net earnings are higher than his actual net earnings, he can report net earnings of $5,640 for 2020.

Example 2: Net nonfarm profit not less than $6,107.
Assume that in Example 1 John's net profit is $6,200. He must use the regular method. He cannot use the nonfarm optional method because his net nonfarm profit is not less than $6,107.

Example 3: Net loss from a nonfarm business.
Assume that in Example 1 John has a net loss of $700. He can use the nonfarm optional method and report $5,640 as his net earnings from self-employment.

Farm Optional Method

Use the farm optional method only for earnings from a farming business. See IRS Publication 225 - Farmer's Tax Guide for additional information about this method.

Using Both Optional Methods

If the taxpayer has both farm and nonfarm earnings, they may be able to use both optional methods to determine net earnings from self-employment. To figure net earnings using both optional methods, perform the following:

1. Figure the farm and nonfarm net earnings separately under each method. Do not combine farm earnings with nonfarm earnings to figure net earnings under either method.
2. Add the net earnings figured under each method to arrive at total net earnings from self-employment.

The taxpayer can report less than his or her total actual farm and nonfarm net earnings but not less than actual nonfarm net earnings. If the taxpayer uses both optional methods, he or she can report no more than $5,640 as his or her combined net earnings from self-employment. For example, the taxpayer is a self-employed farmer but also operates a gas station. The table below summarizes the revenue or gross income, actual net earnings, and optional net earnings for both farm and nonfarm income for this example. (24)

Income & Earnings	Farm	Non-Farm
Gross Income	$3,000	$6,000
Actual Net Earnings	$900	$500
Optional Net Earnings*	$2,000	$4,000
*66% of gross income		

Table 2-5 - Publication 334 - Table 10-2 - Example - Farm and Non-Farm Earnings (2020)

There are four methods or combinations of methods that can be used to calculate the net earnings from self-employment using the farm and nonfarm gross income in this example.

1. *Method 1:* Using the regular method for both farm and nonfarm income.
2. *Method 2:* Using the optional method for farm income and the regular method for nonfarm income.
3. *Method 3:* Using the regular method for farm income and the optional method for nonfarm income.
4. *Method 4*: Using the optional method for both farm and nonfarm income.

Actual net earnings is the same as net earnings figured using the regular method.

Net Earnings	Method 1	Method 2	Method 3	Method 4
Actual Farm	$900		$900	
Optional Farm		$2,000		$2,000
Actual nonfarm	$500	$500		
Optional nonfarm			$4,000	$4,000
Amount reported:	**$1,400**	**$2,500**	**$4,900**	**$5,640***
* Limited to $5,640 because taxpayer used both optional methods				

Table 2-6 - Publication 334 - Chapter 10 - Table 10-3 - Example - Net Earnings (2020)

Form 1099-K Payment Card and Third-Party Network Transactions

A payment settlement entity (PSE), such a PayPal, must file Form 1099-K - Payment Card and Third Party Network Transactions for payments made in settlement of reportable payment transactions for each calendar year. A PSE makes a payment in settlement of a reportable payment transaction, that is, any payment card or third-party network transaction, if the PSE submits the instruction to transfer funds to the account of the participating payee to settle the reportable payment transaction.

The IRS uses third-party information reporting on forms in the 1099 series to increase voluntary compliance and improve collections. As of January 2012, payment settlement entities (PSEs) are required by the Housing Assistance Tax Act of 2008 to report on Form 1099-K the following transactions:

- All payments made in settlement of payment card transactions (e.g., credit card);
- Payments in settlement of third-party network transactions IF:
    - Gross payments to a participating payee exceed $20,000; AND
    - There are more than 200 transactions with the participating payee.

If the taxpayer does end up getting the 1099-K, verify the amount is correct with his or her own calculations then include the information on the tax forms.

Other Income

The following discussion explains how to treat other types of business income a taxpayer may receive.

Restricted Property

Restricted property is property that has certain restrictions that affect its value. If the taxpayer receives restricted stock or other property for services performed, the fair market value of the property in excess of his or her cost is included in income on Schedule C when the restriction is lifted. However, the taxpayer can choose to be taxed in the year he or she receives the property.

Gains and Losses

Do not report on Schedule C a gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers. Instead, the taxpayer must report these gains and losses on other forms.

Promissory Notes

Report promissory notes and other evidences of debt issued to the taxpayer in a sale or exchange of property that is stock in trade or held primarily for sale to customers on Schedule C. In general, the taxpayer reports them at their stated principal amount (minus any unstated interest) when he or she receives them.

Lost Income Payments

If the taxpayer reduces or stops his or her business activities, report on Schedule C any payment he or she receives for the lost income of the business from insurance or other sources. Report it on Schedule C even if the business is inactive when the taxpayer receives the payment.

Damages

The taxpayer must include in gross income compensation he or she receives during the tax year as a result of any of the following injuries connected with his or her business:

- Patent infringement.
- Breach of contract or fiduciary duty.
- Antitrust injury.

Economic Injury

The taxpayer may be entitled to a deduction against the income if it compensates him or her for actual economic injury. The deduction is the smaller of the following amounts:

- The amount the taxpayer receives or accrues for damages in the tax year reduced by the amount he or she pays or incurs in the tax year to recover that amount.
- The taxpayer's loss from the injury that he or she has not yet deducted.

Punitive Damages

The taxpayer must also include punitive damages in income.

Kickbacks

If the taxpayer receives any kickbacks, he or she should include them in income on Schedule C. However, do not include them if the taxpayer properly treats them as a reduction of a related expense item, a capital expenditure, or cost of goods sold.

Recovery of Items Previously Deducted

If the taxpayer recovers a bad debt or any other item deducted in a previous year, include the recovery in income on Schedule C. However, if all or part of the deduction in earlier years did not reduce his or her tax, the taxpayer can exclude the part that did not reduce the tax. If the taxpayer excludes part of the recovery from income, he or she must include with the return a computation showing how the exclusion was figured.

Bartering for Property or Services

Bartering is an exchange of property or services. The taxpayer must include in his or her gross receipts, at the time received, the fair market value of property or services he or she receives in exchange for something else. If the taxpayer exchanges services with another person and both the taxpayer and the other person have agreed ahead of time on the value of the services, that value will be accepted as the fair market value unless the value can be shown to be otherwise.

Partnerships

A partnership is the relationship existing between two or more persons who join to carry on a trade or business. Each person contributes money, property, labor or skill, and expects to share in the profits and losses of the business.

A partnership must file an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, it "passes through" any profits or losses to its partners. Each partner includes his or her share of the partnership's income or loss on his or her tax return. Partners are not employees and should not be issued a Form W-2. The partnership must furnish copies of Schedule K-1 (Form 1065) to the partners by the date Form 1065 - U.S. Return of Partnership Income is required to be filed, including extensions.

The main disadvantage to a partnership is that the owners can be held liable for partnership debts if there are not enough assets to cover the partnership liabilities. This type of partnership is commonly referred to as a general partnership. [25]

Forming a Partnership

An unincorporated organization with two or more members is generally classified as a partnership for Federal tax purposes if its members carry on a trade, business, financial operation, or venture and divide its profits. However, a joint undertaking merely to share expenses is not a partnership. For example, co-ownership of property maintained and rented or leased is not a partnership unless the co-owners provide services to the tenants.

The rules a taxpayer must use to determine whether an organization is classified as a partnership changed for organizations formed after 1996. An organization formed after 1996 is classified as a partnership for Federal tax purposes if it has two or more members and it is none of the following: [26]

- An organization formed under a Federal or state law that refers to it as incorporated or as a corporation, body corporate, or body politic.
- An organization formed under a state law that refers to it as a joint-stock company or joint-stock association.
- An insurance company.
- Certain banks.
- An organization wholly owned by a state or local government.
- An organization specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships).
- Certain foreign organizations identified in Section 301.7701-2(b)(8) of the regulations.
- A tax-exempt organization.
- A real estate investment trust.
- An organization classified as a trust under Section 301.7701-4 of the regulations or otherwise subject to special treatment under the Internal Revenue Code.
- Any other organization that elects to be classified as a corporation by filing Form 8832.

An organization formed before 1997 and classified as a partnership under the old rules will generally continue to be classified as a partnership as long as the organization has at least two members and does not elect to be classified as a corporation by filing Form 8832.

Family Partnership

Members of a family can be partners. However, family members (or any other person) will be recognized as partners only if one of the following requirements are met: [26]

- If capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction (even if by gift or purchase from another family member), actually own the partnership interest, and actually control the interest.

- If capital is not a material income-producing factor, they joined together in good faith to conduct a business. They agreed that contributions of each entitle them to a share in the profits, and some capital or service has been (or is) provided by each partner.

Capital is a material income-producing factor if a substantial part of the gross income of the business comes from the use of capital. Capital is ordinarily an income-producing factor if the operation of the business requires substantial inventories or investments in plants, machinery, or equipment. In general, capital is not a material income-producing factor if the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership.

A capital interest in a partnership is an interest in its assets that is distributable to the owner of the interest in either of the following situations: (26)

- The owner withdraws from the partnership.
- The partnership liquidates.

The mere right to share in earnings and profits is not a capital interest in the partnership.

If a family member (or any other person) receives a gift of a capital interest in a partnership in which capital is a material income-producing factor, the donee's distributive share of partnership income is subject to both of the following restrictions: (26)

- It must be figured by reducing the partnership income by reasonable compensation for services the donor renders to the partnership.
- The donee's distributive share of partnership income attributable to donated capital must not be proportionately greater than the donor's distributive share attributable to the donor's capital.

For purposes of determining a partner's distributive share, an interest purchased by one family member from another family member is considered a gift from the seller. The fair market value of the purchased interest is considered donated capital. For this purpose, members of a family include only spouses, ancestors, and lineal descendants (or a trust for the primary benefit of those persons).

If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a formal partnership agreement. If so, they should report income or loss from the business on Form 1065. They should not report the income on a Schedule C (Form 1040) in the name of one spouse as a sole proprietor. However, the husband and wife can elect not to treat the joint venture as a partnership by making a Qualified Joint Venture Election.

Qualified Joint Venture

A "qualified joint venture," whose only members are a husband and a wife filing a joint return, can elect not to be treated as a partnership for Federal tax purposes. A qualified joint venture conducts a trade or business where: the only members of the joint venture are husband and wife; the filing status of the husband and wife is married filing jointly; both spouses elect not to be treated as a partnership; both spouses materially participate in the trade or business (see Passive Activity Limitations in the Instructions for Form 1065 for a definition of material participation); and the business is co-owned by both spouses and is not held in the name of a state law entity such as a partnership or LLC.

Under this election, a qualified joint venture conducted by a husband and wife who file a joint return is not treated as a partnership for Federal tax purposes and therefore does not have a Form 1065 filing requirement. All items of income, gain, deduction, loss, and credit are divided between the spouses based on their respective interests in the venture. Each spouse takes into account his or her respective share of these items as a sole proprietor. Each spouse would account for his or her respective share on the appropriate form, such as Schedule C (Form 1040). For purposes of determining net earnings from self-employment, each spouse's share of income or loss from a qualified joint venture is taken into account just as it is for Federal income tax purposes (i.e., based on their respective interests in the venture).

Foreign Partnership

A foreign partnership is a partnership that is not created or organized in the United States or under the law of the United States or of any state. See Notice 2010-41 for information on when a domestic partnership will be classified as foreign.

General Partner

A general partner is a partner who is personally liable for partnership debts.

General Partnership

A general partnership is composed only of general partners.

Limited Partner

A limited partner is a partner in a partnership formed under a state limited partnership law, whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership. Some members of other entities, such as domestic or foreign business trusts or limited liability companies that are classified as partnerships, may be treated as limited partners for certain purposes.

Limited Partnership

A limited partnership is formed under a state limited partnership law and composed of at least one general partner and one or more limited partners.

Limited Liability Partnership

A limited liability partnership (LLP) is formed under a state limited liability partnership law. Generally, a partner in an LLP is not personally liable for the debts of the LLP or any other partner, nor is a partner liable for the acts or omissions of any other partner, solely by reason of being a partner.

Limited Liability Company

A limited liability company (LLC) is an entity formed under state law by filing articles of organization as an LLC. Unlike a partnership, none of the members of an LLC are personally liable for its debts. An LLC may be classified for Federal income tax purposes as a partnership, a corporation, or an entity disregarded as an entity separate from its owner by applying the rules in Regulations Section 301.7701-3. See Form 8832 - Entity Classification Election, for more details.

Tip

A domestic LLC with at least two members that does not file Form 8832 is classified as a partnership for Federal income tax purposes.

Nonrecourse Loans

Nonrecourse loans are those liabilities of the partnership for which no partner or related person bears the economic risk of loss.

Transactions Between Partnership and Partners

For certain transactions between a partner and his or her partnership, the partner is treated as not being a member of the partnership. These transactions include the following: [26]

1. Performing services for, or transferring property to, a partnership if:
    a. There is a related allocation and distribution to a partner, and
    b. The entire transaction, when viewed together, is properly characterized as occurring between the partnership and a partner not acting in the capacity of a partner.
2. Transferring money or other property to a partnership if:
    a. There is a related transfer of money or other property by the partnership to the contributing partner or another partner, and
    b. The transfers together are properly characterized as a sale or exchange of property.

A partnership that uses an accrual method of accounting cannot deduct any business expense owed to a cash basis partner until the amount is paid. However, this rule does not apply to guaranteed payments made to a partner, which are generally deductible when accrued.

Guaranteed Payments

Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership's income. A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income. Guaranteed payments are not subject to income tax withholding. [26]

The partnership generally deducts guaranteed payments on line 10 of Form 1065 - U.S. Return of Partnership Income as a business expense. They are also listed on Schedules K and K-1 of the partnership return. The individual partner reports guaranteed payments on Schedule E (Form 1040) as ordinary income, along with his or her distributive share of the partnership's other ordinary income.

Guaranteed payments made to partners for organizing the partnership or syndicating interests in the partnership are capital expenses. Generally, organizational and syndication expenses are not deductible by the partnership. However, a partnership can elect to deduct a portion of its organizational expenses and amortize the remaining expenses (see Business start-up and organizational costs in the instructions for Form 1065). Organizational expenses (if the election is not made) and syndication expenses paid to partners must be reported on the partners' Schedule K-1 as guaranteed payments.

If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's distributive share of the partnership income before taking into account the guaranteed payment.

Premiums for health insurance paid by a partnership on behalf of a partner, for services as a partner, are treated as guaranteed payments. The partnership can deduct the payments as a business expense, and the partner must include them in gross income. However, if the partnership accounts for insurance paid for a partner as a reduction in distributions to the partner, the partnership cannot deduct the premiums.

A partner who qualifies can deduct 100% of the health insurance premiums paid by the partnership on his or her behalf as an adjustment to income. The partner cannot deduct the premiums for any calendar month, or part of a month, in which the partner is eligible to participate in any subsidized health plan maintained by any employer of the partner, the partner's spouse, the partner's dependents, or any children under age 27 who are not dependents. For more information on the self-employed health insurance deduction, see chapter 6 in Publication 535.

Guaranteed payments are included in income in the partner's tax year in which the partnership's tax year ends.

If guaranteed payments to a partner result in a partnership loss in which the partner shares, the partner must report the full amount of the guaranteed payments as ordinary income. The partner separately takes into account his or her distributive share of the partnership loss, to the extent of the adjusted basis of the partner's partnership interest.

Cost of Going Into Business

When a taxpayer goes into business, treat all costs he or she incurs to get the business started as capital expenses. However, a corporation can elect to deduct a limited amount of start-up or organizational costs. Any costs not deducted can be amortized.

Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Organizational costs are the direct costs of creating the corporation. Business start-up and organizational costs are generally capital expenditures. However, the taxpayer can elect to deduct up to $5,000 of business start-up and $5,000 of organizational costs paid or incurred after October 22, 2004. The $5,000 deduction is reduced by the amount his or her total start-up or organizational costs exceed $50,000. Any remaining costs must be amortized.

Cost of Organizing a Partnership

The costs to organize a partnership are the direct costs of creating the partnership. A partnership can amortize an organizational cost only if it meets all the following tests: (27)

- It is for the creation of the partnership and not for starting or operating the partnership trade or business.
- It is chargeable to a capital account.
- It could be amortized over the life of the partnership if the partnership had a fixed life.
- It is incurred by the due date of the partnership return (excluding extensions) for the first tax year in which the partnership is in business.
- It is for a type of item normally expected to benefit the partnership throughout its entire life.

Organizational costs include the following fees: (27)

- Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of the partnership agreement.
- Accounting fees for services incident to the organization of the partnership.
- Filing fees.

The following non-qualifying costs cannot be amortized: (27)

- The cost of acquiring assets for the partnership or transferring assets to the partnership.
- The cost of admitting or removing partners, other than at the time the partnership is first organized.
- The cost of making a contract concerning the operation of the partnership trade or business including a contract between a partner and the partnership.
- The costs for issuing and marketing interests in the partnership such as brokerage, registration, and legal fees and printing costs. These “syndication fees” are capital expenses that cannot be depreciated or amortized.

Tip

If a partnership is liquidated before the end of the amortization period, the unamortized amount of qualifying organizational costs can be deducted in the partnership's final tax year. However, these costs can be deducted only to the extent they qualify as a loss from a business.

Credit for Small Employer Pension Plan Startup Costs

Eligible small employers use Form 8881 - Credit for Small Employer Pension Plan Startup Costs to claim the credit for qualified startup costs incurred in establishing or administering an eligible employer pension plan. The credit is allowed under Section 45E and is part of the general business credit. The taxpayer may elect, however, to have Section 45E not apply for the tax year the credit is available by not claiming it on his or her tax return for that year.

For an eligible small employer, the credit is 50% of the qualified startup costs paid or incurred during the tax year. The credit is limited to $500 per year for the first credit year and each of the following 2 tax years. No credit is allowed for any other tax year.

Credit for Employer-Provided Childcare Facilities and Services

Employers use Form 8882 - Credit for Employer-Provided Childcare Facilities and Services to claim the credit for qualified childcare facility and resource and referral expenditures. The credit is part of the general business credit. The employer may claim the credit any time within 3 years from the due date of his or her return on either an original or amended return. The credit is 25% of the qualified childcare facility expenditures plus 10% of the qualified childcare resource and referral expenditures paid or incurred during the tax year. The credit is limited to $150,000 per tax year.

Sale or Exchange of Property

Special rules apply to a sale or exchange of property between a partnership and certain persons. Losses will not be allowed from a sale or exchange of property (other than an interest in the partnership) directly or indirectly between a partnership and a person whose direct or indirect interest in the capital or profits of the partnership is more than 50%.

If the sale or exchange is between two partnerships in which the same persons directly or indirectly own more than 50% of the capital or profits interests in each partnership, no deduction of a loss is allowed.

The basis of each partner's interest in the partnership is decreased (but not below zero) by the partner's share of the disallowed loss.

If the purchaser later sells the property, only the gain realized that is greater than the loss not allowed will be taxable. If any gain from the sale of the property is not recognized because of this rule, the basis of each partner's interest in the partnership is increased by the partner's share of that gain.

Gains are treated as ordinary income in a sale or exchange of property directly or indirectly between a person and a partnership, or between two partnerships, if both of the following tests are met: (26)

- More than 50% of the capital or profits interest in the partnership(s) is directly or indirectly owned by the same person(s).
- The property in the hands of the transferee immediately after the transfer is not a capital asset. Property that is not a capital asset includes accounts receivable, inventory, stock-in-trade, and depreciable or real property used in a trade or business.

To determine if there is more than 50% ownership in partnership capital or profits, the following rules apply: (26)

1. An interest directly or indirectly owned by, or for, a corporation, partnership, estate, or trust is considered to be owned proportionately by, or for, its shareholders, partners, or beneficiaries.
2. An individual is considered to own the interest directly or indirectly owned by, or for, the individual's family. For this rule, "family" includes only brothers, sisters, half-brothers, half-sisters, spouses, ancestors, and lineal descendants.
3. If a person is considered to own an interest using rule (1), that person (the "constructive owner") is treated as if actually owning that interest when rules (1) and (2) are applied. However, if a person is considered to own an interest using rule (2), that person is not treated as actually owning that interest in reapplying rule (2) to make another person the constructive owner.

The following rules determine the character of the partnership's gain or loss on a disposition of certain types of contributed property: (26)

1. **Unrealized receivables.** If the property was an unrealized receivable in the hands of the contributing partner, any gain or loss on its disposition by the partnership is ordinary income or loss.
2. **Inventory items.** If the property was an inventory item in the hands of the contributing partner, any gain or loss on its disposition by the partnership within 5 years after the contribution is ordinary income or loss.
3. **Capital loss property.** If the property was a capital asset in the contributing partner's hands, any loss on its disposition by the partnership within 5 years after the contribution is a capital loss. The capital loss is limited to the amount by which the partner's adjusted basis for the property exceeded the property's fair market value immediately before the contribution.
4. **Substituted basis property.** If the disposition of any of the property listed in (1), (2), or (3) is a nonrecognition transaction, these rules apply when the recipient of the property disposes of any substituted basis property (other than certain corporate stock) resulting from the transaction.

Contribution of Services

A partner can acquire an interest in partnership capital or profits as compensation for services performed or to be performed. The value of a capital interest in a partnership that is transferred to a partner in exchange for services is taxable as ordinary income. The income recognized is added to the basis of the partnership interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest. The fair market value of such an interest received by a partner as compensation for services must generally be included in the partner's gross income in the first tax year in which the partner can transfer the interest or the interest is not subject to a substantial risk of forfeiture. The capital interest transferred as compensation for services is subject to the rules for restricted property discussed in Publication 525 under Employee Compensation.

The fair market value of an interest in partnership capital transferred to a partner as payment for services to the partnership is a guaranteed payment.

A profits interest is a partnership interest other than a capital interest. If a person receives a profits interest for providing services to, or for the benefit of, a partnership in a partner capacity or in anticipation of being a partner, the receipt of such an interest is not a taxable event for the partner or the partnership. However, this does not apply in the following situations: (26)

- The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease.
- Within 2 years of receipt, the partner disposes of the profits interest.
- The profits interest is a limited partnership interest in a publicly traded partnership.

A profits interest transferred as compensation for services is not subject to the rules for restricted property that apply to capital interests.

Contribution of Property

Usually, neither the partner nor the partnership recognizes a gain or loss when property is contributed to the partnership in exchange for a partnership interest. This applies whether a partnership is being formed or is already operating. The partnership's holding period for the property includes the partner's holding period.

The contribution of limited partnership interests in one partnership for limited partnership interests in another partnership qualifies as a tax-free contribution of property to the second partnership if the transaction is made for business purposes.

A contribution of money or other property to the partnership followed by a distribution of different property from the partnership to the partner is treated not as a contribution and distribution, but as a sale of property, if both of the following tests are met: (26)

- The distribution would not have been made but for the contribution.
- The partner's right to the distribution does not depend on the success of partnership operations.

All facts and circumstances are considered in determining if the contribution and distribution are more properly characterized as a sale. However, if the contribution and distribution occur within 2 years of each other, the transfers are presumed to be a sale unless the facts clearly indicate that the transfers are not a sale. If the contribution and distribution occur more than 2 years apart, the transfers are presumed not to be a sale unless the facts clearly indicate that the transfers are a sale.

A partner must attach Form 8275 - Disclosure Statement, (or other statement) to his or her return if the partner contributes property to a partnership and, within 2 years (before or after the contribution), the partnership transfers money or other consideration to the partner. For exceptions to this requirement, see Section 1.707-3(c)(2) of the regulations.

A partnership must attach Form 8275 (or other statement) to its return if it distributes property to a partner, and, within 2 years (before or after the distribution), the partner transfers money or other consideration to the partnership.

Form 8275 must include the following information: (26)

- A caption identifying the statement as a disclosure under Section 707 of the Internal Revenue Code.
- A description of the transferred property or money, including its value.
- A description of any relevant facts in determining if the transfers are properly viewed as a disguised sale. See Section 1.707-3(b)(2) of the regulations for a description of the facts and circumstances considered in determining if the transfers are a disguised sale.

Gain is recognized when property is contributed (in exchange for an interest in the partnership) to a partnership that would be treated as an investment company if it were incorporated.

A partnership is generally treated as an investment company if over 80% of the value of its assets is held for investment and consists of certain readily marketable items. These items include money, stocks and other equity interests in a corporation, and interests in regulated investment companies and real estate investment trusts. For more information, see Section 351(e)(1) of the Internal Revenue Code and the related regulations. Whether a partnership is treated as an investment company under this test is ordinarily determined immediately after the transfer of property. This rule applies to limited partnerships and general partnerships, regardless of whether they are privately formed or publicly syndicated.

A domestic partnership that contributed property after August 5, 1997, to a foreign partnership in exchange for a partnership interest may have to file Form 8865 - Return of U.S. Persons With Respect to Certain Foreign Partnerships if either of the following apply:

1. Immediately after the contribution, the partnership owned, directly or indirectly, at least a 10% interest in the foreign partnership.
2. The fair market value of the property contributed to the foreign partnership, when added to other contributions of property made to the partnership during the preceding 12-month period, is greater than $100,000.

The partnership may also have to file Form 8865, even if no contributions are made during the tax year, if it owns a 10% or more interest in a foreign partnership at any time during the year. See the form instructions for more information.

If a partner contributes property to a partnership, the partnership's basis for determining depreciation, depletion, gain, or loss for the property is the same as the partner's adjusted basis for the property when it was contributed, increased by any gain recognized by the partner at the time of contribution.

The fair market value of property at the time it is contributed may be different from the partner's adjusted basis. The partnership must allocate among the partners any income, deduction, gain, or loss on the property in a manner that will account for the difference. This rule also applies to contributions of accounts payable and other accrued but unpaid items of a cash basis partner.

The partnership can use different allocation methods for different items of contributed property. A single reasonable method must be consistently applied to each item, and the overall method or combination of methods must be reasonable. See Section 1.704-3 of the regulations for allocation methods generally considered reasonable.

If the partnership sells contributed property and recognizes gain or loss, built-in gain or loss is allocated to the contributing partner. If contributed property is subject to depreciation or other cost recovery, the allocation of deductions for these items takes into account built-in gain or loss on the property. However, the total depreciation, depletion, gain, or loss allocated to partners cannot be more than the depreciation or depletion allowable to the partnership or the gain or loss realized by the partnership.

Partnership Distributions

Partnership distributions include the following:

- A withdrawal by a partner in anticipation of the current year's earnings.
- A distribution of the current year's or prior years' earnings not needed for working capital.
- A complete or partial liquidation of a partner's interest.
- A distribution to all partners in a complete liquidation of the partnership.

A partnership distribution is not taken into account in determining the partner's distributive share of partnership income or loss. If any gain or loss from the distribution is recognized by the partner, it must be reported on his or her return for the tax year in which the distribution is received. Money or property withdrawn by a partner in anticipation of the current year's earnings is treated as a distribution received on the last day of the partnership's tax year.

A partner's adjusted basis in his or her partnership interest is decreased (but not below zero) by the money and adjusted basis of property distributed to the partner. A partnership generally does not recognize any gain or loss because of distributions it makes to partners. The partnership may be able to elect to adjust the basis of its undistributed property.

When a partnership distributes the following items, the distribution may be treated as a sale or exchange of property rather than a distribution:

- Unrealized receivables or substantially appreciated inventory items distributed in exchange for any part of the partner's interest in other partnership property, including money.
- Other property (including money) distributed in exchange for any part of a partner's interest in unrealized receivables or substantially appreciated inventory items.

The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in Section 702 (a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in Section 707 (c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

This treatment does not apply to the following distributions:

- A distribution of property to the partner who contributed the property to the partnership.
- Payments made to a retiring partner or successor in interest of a deceased partner that are the partner's distributive share of partnership income or guaranteed payments.

Inventory items of the partnership are considered to have appreciated substantially in value if, at the time of the distribution, their total fair market value is more than 120% of the partnership's adjusted basis for the property. However, if a principal purpose for acquiring inventory property is to avoid ordinary income treatment by reducing the appreciation to less than 120%, that property is excluded.

Partner's Gain or Loss

A partner generally recognizes gain on a partnership distribution only to the extent any money (and marketable securities treated as money) included in the distribution exceeds the adjusted basis of the partner's interest in the partnership. Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, he or she generally does not recognize any gain until the sale or other disposition of the property.

Generally, a marketable security distributed to a partner is treated as money in determining whether gain is recognized on the distribution. This treatment, however, does not generally apply if that partner contributed the security to the partnership or an investment partnership made the distribution to an eligible partner:

The amount treated as money is the security's fair market value when distributed, reduced (but not below zero) by the excess (if any) of: [26]

1. The partner's distributive share of the gain that would be recognized had the partnership sold all its marketable securities at their fair market value immediately before the transaction resulting in the distribution, over
2. The partner's distributive share of the gain that would be recognized had the partnership sold all such securities it still held after the distribution at the fair market value in 1.

A partner does not recognize loss on a partnership distribution unless all the following requirements are met: [26]

- The adjusted basis of the partner's interest in the partnership exceeds the distribution.
- The partner's entire interest in the partnership is liquidated.
- The distribution is in money, unrealized receivables, or inventory items.

If a partnership acquires a partner's debt and extinguishes the debt by distributing it to the partner, the partner will recognize capital gain or loss to the extent the fair market value of the debt differs from the basis of the debt.

The partner is treated as having satisfied the debt for its fair market value. If the issue price (adjusted for any premium or discount) of the debt exceeds its fair market value when distributed, the partner may have to include the excess amount in income as canceled debt. Similarly, a deduction may be available to a corporate partner if the fair market value of the debt at the time of distribution exceeds its adjusted issue price.

A partner generally must recognize gain on the distribution of property (other than money) if the partner contributed appreciated property to the partnership during the 7-year period before the distribution.

The gain recognized is the lesser of the following amounts: (26)

1. The excess of:
    a. The fair market value of the property received in the distribution, over
    b. The adjusted basis of the partner's interest in the partnership immediately before the distribution, reduced (but not below zero) by any money received in the distribution.
2. The "net pre-contribution gain" of the partner. This is the net gain the partner would recognize if all the property contributed by the partner within 7 years of the distribution, and held by the partnership immediately before the distribution, were distributed to another partner, other than a partner who owns more than 50% of the partnership.

The character of the gain is determined by reference to the character of the net pre-contribution gain. This gain is in addition to any gain the partner must recognize if the money distributed is more than his or her basis in the partnership. For these rules, the term "money" includes marketable securities treated as money.

The adjusted basis of the partner's interest in the partnership is increased by any net pre-contribution gain recognized by the partner. Other than for purposes of determining the gain, the increase is treated as occurring immediately before the distribution. The partnership must adjust its basis in any property the partner contributed within 7 years of the distribution to reflect any gain that partner recognizes under this rule.

Any part of a distribution that is property the partner previously contributed to the partnership is not taken into account in determining the amount of the excess distribution or the partner's net pre-contribution gain. For this purpose, the partner's previously contributed property does not include a contributed interest in an entity to the extent its value is due to property contributed to the entity after the interest was contributed to the partnership. Recognition of gain under this rule also does not apply to a distribution of unrealized receivables or substantially appreciated inventory items if the distribution is treated as a sale or exchange.

Basis of Partner's Interest

The basis of a partnership interest is the money plus the adjusted basis of any property the partner contributed. If the partner must recognize gain as a result of the contribution, this gain is included in the basis of his or her interest. Any increase in a partner's individual liabilities because of an assumption of partnership liabilities is considered a contribution of money to the partnership by the partner.

If a partner acquires an interest in a partnership by gift, inheritance, or under any circumstance other than by a contribution of money or property to the partnership, the partner's basis must be determined using the basis rules described in Publication 551.

Adjusted Basis

The basis of an interest in a partnership is increased or decreased by certain items.

A partner's basis is increased by the following items:

- The partner's additional contributions to the partnership, including an increased share of, or assumption of, partnership liabilities.
- The partner's distributive share of taxable and nontaxable partnership income.
- The partner's distributive share of the excess of the deductions for depletion over the basis of the depletable property, unless the property is oil or gas wells whose basis has been allocated to partners.

The partner's basis is decreased (but never below zero) by the following items:

- The money (including a decreased share of partnership liabilities or an assumption of the partner's individual liabilities by the partnership) and adjusted basis of property distributed to the partner by the partnership.
- The partner's distributive share of the partnership losses (including capital losses).
- The partner's distributive share of nondeductible partnership expenses that are not capital expenditures. This includes the partner's share of any Section 179 expenses, even if the partner cannot deduct the entire amount on his or her individual income tax return.
- The partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the adjusted basis of the wells allocated to the partner.

If contributed property is subject to a debt or if a partner's liabilities are assumed by the partnership, the basis of that partner's interest is reduced (but not below zero) by the liability assumed by the other partners. This partner must reduce his or her basis because the assumption of the liability is treated as a distribution of money to that partner. The other partners' assumption of the liability is treated as a contribution by them of money to the partnership.

Tip

The adjusted basis of a partner's interest is determined without considering any amount shown in the partnership books as a capital, equity, or similar account.

Partner's Basis for Distributed Property

Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.

The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership reduced by any money distributed to the partner in the same transaction. A partner's holding period for property distributed to the partner includes the period the property was held by the partnership. If the property was contributed to the partnership by a partner, then the period it was held by that partner is also included.

If the basis of property received is the adjusted basis of the partner's interest in the partnership (reduced by money received in the same transaction), it must be divided among the properties distributed to the partner.

For property distributed after August 5, 1997, allocate the basis using the following rules:

1. Allocate the basis first to unrealized receivables and inventory items included in the distribution by assigning a basis to each item equal to the partnership's adjusted basis in the item immediately before the distribution. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.
2. Allocate any remaining basis to properties other than unrealized receivables and inventory items by assigning a basis to each property equal to the partnership's adjusted basis in the property immediately before the distribution. If the allocable basis exceeds the total of these assigned bases, increase the assigned bases by the amount of the excess. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.

Allocate any basis increase required in rule (2), above, first to properties with unrealized appreciation to the extent of the unrealized appreciation. If the basis increase is less than the total unrealized appreciation, allocate it among those properties in proportion to their respective amounts of unrealized appreciation. Allocate any remaining basis increase among all the properties in proportion to their respective fair market values.

Use the following rules to allocate any basis decrease required in rule (1) or rule (2), earlier.

1. Allocate the basis decrease first to items with unrealized depreciation to the extent of the unrealized depreciation. If the basis decrease is less than the total unrealized depreciation, allocate it among those items in proportion to their respective amounts of unrealized depreciation.
2. Allocate any remaining basis decrease among all the items in proportion to their respective assigned basis amounts (as decreased in (1)).

If the basis of a partner's interest to be divided in a complete liquidation of the partner's interest is more than the partnership's adjusted basis for the unrealized receivables and inventory items distributed, and if no other property is distributed to which the partner can apply the remaining basis, the partner has a capital loss to the extent of the remaining basis of the partnership interest.

Who Must File

Domestic Partnerships

Except as provided below, every domestic partnership must file Form 1065 - U.S. Return of Partnership Income unless it neither receives income nor incurs any expenditures treated as deductions or credits for Federal income tax purposes. Entities formed as LLCs that are classified as partnerships for Federal income tax purposes have the same filing requirements as domestic partnerships.

Foreign Partnerships

Generally, a foreign partnership that has gross income effectively connected with the conduct of a trade or business within the United States or has gross income derived from sources in the United States must file Form 1065, even if its principal place of business is outside the United States or all its members are foreign persons. A foreign partnership required to file a return generally must report all of its foreign and U.S. source income.

When To File

Generally, a domestic partnership must file Form 1065 by the 15th day of the 3rd month following the date its tax year ended as shown at the top of Form 1065. For partnerships that keep their records and books of account outside the United States and Puerto Rico, an extension of time to file and pay is granted to the 15th day of the 6th month following the close of the tax year. The taxpayer should not file Form 7004 - Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns, if the partnership is taking this 2-month extension of time to file and pay. The taxpayer should attach a statement to the partnership's tax return stating that the partnership qualifies for the extension of time to file and pay. If the partnership is unable to file its return within the 2-month period, use Form 7004 to request an additional 3-month extension.

Note

If the due date falls on a Saturday, Sunday, or legal holiday, file by the next day that is not a Saturday, Sunday, or legal holiday.

Penalties

Late Filing of Return

A penalty is assessed against the partnership if it is required to file a partnership return and it:

- Fails to file the return by the due date, including extensions, or
- Files a return that fails to show all the information required, unless such failure is due to reasonable cause.

In 2020, the penalty is $210 for each month or part of a month (for a maximum of 12 months) the failure continues, multiplied by the total number of persons who were partners in the partnership during any part of the partnership's tax year for which the return is due. If the partnership receives a notice about a penalty after it files the return, the partnership may send the IRS an explanation and the Service will determine if the explanation meets reasonable-cause criteria.

Failure To Furnish Information Timely

For each failure to furnish Schedule K-1 to a partner when due and each failure to include on Schedule K-1 all the information required to be shown (or the inclusion of incorrect information), a $280 penalty may be imposed for each Schedule K-1 for which a failure occurs. The maximum penalty in 2020 is $3,392,000 for all such failures during a calendar year. If the requirement to report correct information is intentionally disregarded, each $280 penalty is increased to $560 or, if greater, 10% of the aggregate amount of items required to be reported, and the $3,392,000 maximum does not apply.

Trust Fund Recovery Penalty

This penalty may apply if certain excise, income, Social Security, and Medicare taxes that must be collected or withheld are not collected or withheld, or these taxes are not paid. The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to have been responsible for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so. The penalty is equal to the unpaid trust fund tax.

Effect of Partnership Liabilities

A partner's basis in a partnership interest includes the partner's share of a partnership liability only if, and to the extent that, the liability: (26)

1. Creates or increases the partnership's basis in any of its assets.
2. Gives rise to a current deduction to the partnership.
3. Is a nondeductible, noncapital expense of the partnership.

The term “assets” in (1) includes capitalized items allocable to future periods, such as organization expenses. A partner's share of accrued but unpaid expenses or accounts payable of a cash basis partnership are not included in the adjusted basis of the partner's interest in the partnership.

If a partner's share of partnership liabilities increases, or a partner's individual liabilities increase because he or she assumes partnership liabilities, this increase is treated as a contribution of money by the partner to the partnership.

If a partner's share of partnership liabilities decreases, or a partner's individual liabilities decrease because the partnership assumes his or her individual liabilities, this decrease is treated as a distribution of money to the partner by the partnership.

Generally, a partner or related person is considered to assume a partnership liability only to the extent that:

1. He or she is personally liable for it.
2. The creditor knows that the liability was assumed by the partner or related person.
3. The creditor can demand payment from the partner or related person.
4. No other partner or person related to another partner will bear the economic risk of loss on that liability immediately after the assumption.

If property contributed to a partnership by a partner or distributed by the partnership to a partner is subject to a liability, the transferee is treated as having assumed the liability to the extent it does not exceed the fair market value of the property.

A partnership liability is a recourse liability to the extent that any partner or a related person, defined earlier, has an economic risk of loss for that liability. A partner's share of a recourse liability equals his or her economic risk of loss for that liability. A partner has an economic risk of loss if that partner or a related person would be obligated (whether by agreement or law) to make a net payment to the creditor or a contribution to the partnership with respect to the liability if the partnership were constructively liquidated. A partner who is the creditor for a liability that would otherwise be a nonrecourse liability of the partnership has an economic risk of loss in that liability.

Generally, in a constructive liquidation, the following events are treated as occurring at the same time: (26)

- All partnership liabilities become payable in full.
- All of the partnership's assets have a value of zero, except for property contributed to secure a liability.
- All property is disposed of by the partnership in a fully taxable transaction for no consideration except relief from liabilities for which the creditor's right to reimbursement is limited solely to one or more assets of the partnership.
- All items of income, gain, loss, or deduction are allocated to the partners.
- The partnership liquidates.

A limited partner generally has no obligation to contribute additional capital to the partnership and therefore does not have an economic risk of loss in partnership recourse liabilities. Thus, absent some other factor, such as the guarantee of a partnership liability by the limited partner or the limited partner making the loan to the partnership, a limited partner generally does not have a share of partnership recourse liabilities.

A partnership liability is a nonrecourse liability if no partner or related person has an economic risk of loss for that liability. A partner's share of nonrecourse liabilities is generally proportionate to his or her share of partnership profits. However, this rule may not apply if the partnership has taken deductions attributable to nonrecourse liabilities or the partnership holds property that was contributed by a partner.

Disposition of Partner's Interest

The following discussions explain the treatment of gain or loss from the disposition of an interest in a partnership.

A loss incurred from the abandonment or worthlessness of a partnership interest is an ordinary loss only if both of the following tests are met: (26)

- The transaction is not a sale or exchange.
- The partner has not received an actual or deemed distribution from the partnership.

If the partner receives even a de minimis actual or deemed distribution, the entire loss generally is a capital loss.

Generally, a partnership's basis in its assets is not affected by a transfer of an interest in the partnership, whether by sale or exchange or because of the death of a partner. However, the partnership can elect to make an optional adjustment to basis in the year of transfer.

The sale or exchange of a partner's interest in a partnership usually results in capital gain or loss. However, there are certain exceptions. Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership. If the selling partner is relieved of any partnership liabilities, that partner must include the liability relief as part of the amount realized for his or her interest.

An exchange of partnership interests generally does not qualify as a nontaxable exchange of like-kind property. This applies regardless of whether they are general or limited partnership interests or interests in the same or different partnerships. However, under certain circumstances, such an exchange may be treated as a tax-free contribution of property to a partnership.

Tip

An interest in a partnership that has a valid election in effect under Section 761(a) of the Internal Revenue Code to be excluded from the partnership rules of the Code is treated as an interest in each of the partnership assets and not as a partnership interest.

If a partner receives money or property in exchange for any part of a partnership interest, the amount due to his or her share of the partnership's unrealized receivables or inventory items results in ordinary income or loss. This amount is treated as if it were received for the sale or exchange of property that is not a capital asset.

This treatment applies to the unrealized receivables part of payments to a retiring partner or successor in interest of a deceased partner only if that part is not treated as paid in exchange for partnership property.

Unrealized receivables include any rights to payment not already included in income for the following items: (26)

- Goods delivered or to be delivered to the extent the payment would be treated as received for property other than a capital asset.
- Services rendered or to be rendered.

These rights must have arisen under a contract or agreement that existed at the time of the sale or distribution, even though the partnership may not be able to enforce payment until a later date. For example, unrealized receivables include accounts receivable of a cash method partnership and rights to payment for work or goods begun but incomplete at the time of the sale or distribution of the partner's share.

The basis for any unrealized receivables includes all costs or expenses for the receivables that were paid or accrued but not previously taken into account under the partnership's method of accounting. Unrealized receivables include potential gain that would be ordinary income if the following partnership property were sold at its fair market value on the date of the payment: [(26)]

- Mining property for which exploration expenses were deducted.
- Stock in a Domestic International Sales Corporation (DISC).
- Certain farmland for which expenses for soil and water conservation or land clearing were deducted.
- Franchises, trademarks, or trade names.
- Oil, gas, or geothermal property for which intangible drilling and development costs were deducted.
- Stock of certain controlled foreign corporations.
- Market discount bonds and short-term obligations.
- Property subject to recapture of depreciation under Sections 1245 and 1250 of the Internal Revenue Code.

The income or loss realized by a partner upon the sale or exchange of its interest in unrealized receivables and inventory items is the amount that would have been allocated to the partner if the partnership had sold all of its property for cash at fair market value, in a fully taxable transaction, immediately prior to the partner's transfer of interest in the partnership. Any gain or loss recognized that is attributable to the unrealized receivables and inventory items will be ordinary gain or loss.

Liquidation at Partner's Retirement or Death

Payments made by the partnership to a retiring partner or successor in interest of a deceased partner in return for the partner's entire interest in the partnership may have to be allocated between payments in liquidation of the partner's interest in partnership property and other payments. The partnership's payments include an assumption of the partner's share of partnership liabilities treated as a distribution of money.

For income tax purposes, a retiring partner or successor in interest of a deceased partner is treated as a partner until his or her interest in the partnership has been completely liquidated. Payments made in liquidation of the interest of a retiring or deceased partner in exchange for his or her interest in partnership property are considered a distribution, not a distributive share or guaranteed payment that could give rise to a deduction (or its equivalent) for the partnership.

Payments made for the retiring or deceased partner's share of the partnership's unrealized receivables or goodwill are not treated as made in exchange for partnership property if both of the following tests are met:

- Capital is not a material income-producing factor for the partnership.
- The retiring or deceased partner was a general partner in the partnership.

However, this rule does not apply to payments for goodwill to the extent that the partnership agreement provides for a reasonable payment to a retiring partner for goodwill.

Unrealized receivables include, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or services rendered, or to be rendered.

Generally, the partners' valuation of a partner's interest in partnership property in an arm's-length agreement will be treated as correct. If the valuation reflects only the partner's net interest in the property (total assets less liabilities), it must be adjusted so that both the value of, and the basis for, the partner's interest includes the partner's share of partnership liabilities.

Upon the receipt of the distribution, the retiring partner or successor in interest of a deceased partner will recognize gain only to the extent that any money (and marketable securities treated as money) distributed is more than the partner's adjusted basis in the partnership. The partner will recognize a loss only if the distribution is in money, unrealized receivables, and inventory items. No loss is recognized if any other property is received. Payments made by the partnership to a retiring partner or successor in interest of a deceased partner that are not made in exchange for an interest in partnership property are treated as distributive shares of partnership income or guaranteed payments. This rule applies regardless of the time over which the payments are to be made. It applies to payments made for the partner's share of unrealized receivables and goodwill not treated as a distribution.

If the amount is based on partnership income, the payment is taxable as a distributive share of partnership income. The payment retains the same character when reported by the recipient that it would have had if reported by the partnership.

Tip

If the amount is not based on partnership income, it is treated as a guaranteed payment. The recipient reports guaranteed payments as ordinary income.

These payments are included in income by the recipient for his or her tax year that includes the end of the partnership tax year for which the payments are a distributive share or in which the partnership is entitled to deduct them as guaranteed payments.

Former partners who continue to make guaranteed periodic payments to satisfy the partnership's liability to a retired partner after the partnership is terminated can deduct the payments as a business expense in the year paid.

Terminating a Partnership

A partnership terminates when one of the following events takes place:

1. All its operations are discontinued and no part of any business, financial operation, or venture is continued by any of its partners in a partnership.
2. At least 50% of the total interest in partnership capital and profits is sold or exchanged within a 12-month period, including a sale or exchange to another partner.

Unlike other partnerships, an electing large partnership does not terminate on the sale or exchange of 50% or more of the partnership interests within a 12-month period. See Section 1.708-1(b) of the regulations for more information on the termination of a partnership. For special rules that apply to a merger, consolidation, or division of a partnership, see Sections 1.708-1(c) and 1.708-1(d) of the regulations.

The conversion of a partnership into an LLC classified as a partnership for Federal tax purposes does not terminate the partnership. The conversion is not a sale, exchange, or liquidation of any partnership interest; the partnership's tax year does not close; and the LLC can continue to use the partnership's taxpayer identification number.

Note

However, the conversion may change some of the partners' bases in their partnership interests if the partnership has recourse liabilities that become nonrecourse liabilities. Because the partners share recourse and nonrecourse liabilities differently, their bases must be adjusted to reflect the new sharing ratios. If a decrease in a partner's share of liabilities exceeds the partner's basis, he or she must recognize gain on the excess. The same rules apply if an LLC classified as a partnership is converted into a partnership.

Corporations

In forming a corporation prospective shareholders exchange money, property, or both, for the corporation's capital stock. A corporation generally takes the same deductions as a sole proprietorship to figure its taxable income. A corporation can also take special deductions. A C corporation, under United States Federal income tax law, refers to any corporation that is taxed separately from its owners. A C corporation is distinguished from an S corporation, which generally is not taxed separately. For Federal income tax purposes, a C corporation is recognized as a separate taxpaying entity. A corporation conducts business, realizes net income or loss, pays taxes and distributes profits to shareholders.

The profit of a corporation is taxed to the corporation when earned, and then is taxed to the shareholders when distributed as dividends. This creates a double tax. The corporation does not get a tax deduction when it distributes dividends to shareholders. Shareholders cannot deduct any loss of the corporation.

Tip

Corporations that have assets of $10 million or more and file at least 250 returns annually are required to electronically file their Forms 1120 and 1120S for tax years ending on or after December 31, 2007.

The rules a taxpayer must use to determine whether a business is taxed as a corporation changed for businesses formed after 1996. A business formed before 1997 and taxed as a corporation under the old rules will generally continue to be taxed as a corporation. The following businesses formed after 1996 are taxed as corporations: (28)

- A business formed under a Federal or state law that refers to it as a corporation, body corporate, or body politic.
- A business formed under a state law that refers to it as a joint-stock company or joint-stock association.
- An insurance company.
- Certain banks.
- A business wholly owned by a state or local government.
- A business specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships).
- Certain foreign businesses.
- Any other business that elects to be taxed as a corporation. For example, a limited liability company (LLC) can elect to be treated as an association taxable as a corporation by filing Form 8832 - Entity Classification Election.

Parent-Subsidiary Group

A parent-subsidiary controlled group exists when all of the following are true:

1. One or more chains of corporations are connected through stock ownership with a common parent corporation.
2. 80% of the stock of each corporation, (except the common parent) is owned by one or more corporations in the group.
3. The Parent Corporation must own 80% of at least one other corporation.

Personal Service Corporations

A corporation is a personal service corporation if it meets all of the following requirements:

1. Its principal activity during the "testing period" is performing personal services. Generally, the testing period for any tax year is the prior tax year. If the corporation has just been formed, the testing period begins on the first day of its tax year and ends on the earlier of:
   a. The last day of its tax year.
   b. The last day of the calendar year in which its tax year begins.

2. Its employee-owners substantially perform the services in (1), above. This requirement is met if more than 20% of the corporation's compensation cost for its activities of performing personal services during the testing period is for personal services performed by employee-owners.
3. Its employee-owners own more than 10% of the fair market value of its outstanding stock on the last day of the testing period.

Personal services include any activity performed in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and the performing arts.

A person is an employee-owner of a personal service corporation if both of the following apply:

1. He or she is an employee of the corporation or performs personal services for, or on behalf of, the corporation (even if he or she is an independent contractor for other purposes) on any day of the testing period.
2. He or she owns any stock in the corporation at any time during the testing period.

A corporation is closely held if all of the following apply:

1. It is not a personal service corporation.
2. At any time during the last half of the tax year, more than 50% of the value of its outstanding stock is, directly or indirectly, owned by or for five or fewer individuals. "Individual" includes certain trusts and private foundations.

A qualified personal service corporation is taxed at a flat rate of 21% on taxable income. A corporation is a qualified personal service corporation if it meets both of the following tests: (28)

1. Substantially all the corporation's activities involve the performance of personal services.
2. At least 95% of the corporation's stock, by value, is owned, directly or indirectly, by any of the following:
    a. Employees performing the personal services.
    b. Retired employees who had performed the personal services.
    c. An estate of the employee or retiree described above.
    d. Any person who acquired the stock of the corporation as a result of the death of an employee or retiree (but only for the 2-year period beginning on the date of the employee's or retiree's death).

Property Exchanged for Stock

If the taxpayer transfers property (or money and property) to a corporation in exchange for stock in that corporation, and immediately afterward he or she is in control of the corporation, the exchange is usually not taxable. This rule applies both to individuals and to groups who transfer property to a corporation. It also applies whether the corporation is being formed or is already operating.

It does not apply in the following situations: (28)

- The corporation is an investment company.
- The taxpayer transfers the property in a bankruptcy or similar proceeding in exchange for stock used to pay creditors.
- The stock is received in exchange for the corporation's debt (other than a security) or for interest on the corporation's debt (including a security) that accrued while the taxpayer held the debt.

Both the corporation and any person involved in a nontaxable exchange of property for stock must attach to their income tax returns a complete statement of all facts pertinent to the exchange.

To be in control of a corporation, the taxpayer or his or her group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock.

The term property does not include services rendered or to be rendered to the issuing corporation. The value of stock received for services is income to the recipient.

Whether the taxpayer is setting up a new corporation with just him or herself or other people, such as partners in a partnership, or getting involved in an existing corporation, under IRC Section 351(a) the taxpayer can defer (put off) any resulting tax consequence.

Under Section 351(a) no gain or loss is recognized (reported) provided both of the following are true:

1. The taxpayer receives only stock in exchange for his or her property.
2. The taxpayer is in control of the corporation immediately after the exchange.

In a Section 351 transaction, if the adjusted basis of the property transferred exceeds the property's fair market value, the transferor and transferee may make an irrevocable election to treat the basis of the stock received by the transferor as having a basis equal to the fair market value of the property transferred. The transferor and transferee make this election by attaching a statement to their tax returns filed by the due date (including extensions) for the tax year in which the transaction occurred. However, if the transferor makes the election by including the certification provided in Notice 2005-70, 2005-41, I.R.B. 694, on or with its tax return filed by the due date (including extensions), then no election need be made by the transferee. If the corporation assumes the taxpayer's liabilities, the exchange generally is not treated as if it received money or other property.

There are two exceptions to this treatment: [28]

1. If the liabilities the corporation assumes are more than the taxpayer's adjusted basis in the property he or she transfers, gain is recognized up to the difference. However, if the liabilities assumed give rise to a deduction when paid, such as a trade account payable or interest, no gain is recognized.
2. If there is no good business reason for the corporation to assume the taxpayer's liabilities, or if his or her main purpose in the exchange is to avoid Federal income tax, the assumption is treated as if the taxpayer received money in the amount of the liabilities.

Capital Contributions

Contributions to the capital of a corporation, whether or not by shareholders, are paid-in capital. These contributions are not taxable to the corporation. The corporation's basis of property contributed to capital by a shareholder is the same as the basis the shareholder had in the property, increased by any gain the shareholder recognized on the exchange. However, the increase for the gain recognized may be limited. Also, the basis of property contributed to capital by a person other than a shareholder is zero.

If a corporation receives a cash contribution from a person other than a shareholder, the corporation must reduce the basis of any property acquired with the contribution during the 12-month period beginning on the day it received the contribution by the amount of the contribution. If the amount contributed is more than the cost of the property acquired, then reduce, but not below zero, the basis of the other properties held by the corporation on the last day of the 12-month period in the following order:

1. Depreciable property.
2. Amortizable property.
3. Property subject to cost depletion but not to percentage depletion.
4. All other remaining properties.

Reduce the basis of property in each category to zero before going on to the next category.

There may be more than one piece of property in each category. Base the reduction of the basis of each property on the following ratio:

- Basis of each piece of property.
- Bases of all properties (within that category).

If the corporation wishes to make this adjustment in some other way, it must get IRS approval. The corporation files a request for approval with its income tax return for the tax year in which it receives the contribution.

Filing

The corporation uses Form 1120 - U.S. Corporation Income Tax Return, to report the income, gains, losses, deductions, credits, and to figure the income tax liability of a corporation. Unless exempt under Section 501, all domestic corporations (including corporations in bankruptcy) must file an income tax return whether or not they have taxable income. Domestic corporations must file Form 1120, unless they are required, or elect to file a special return. Any domestic corporation or group of corporations required to file Form 1120 that reports on Form 1120, Schedule L - Balance Sheets per Books, total assets at the end of the corporation's tax year that equal or exceed $10 million must complete and file Schedule M-3 - Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More instead of Schedule M-1 - Reconciliation of Income (Loss) per Books With Income per Return.

A corporation filing a non-consolidated Form 1120 that reports on Schedule L - Balance Sheets per Books total assets that equal or exceed $10 million must complete and file Schedule M-3 instead of Schedule M-1 and must check box (1) Non-consolidated return, at the top of page 1 of Schedule M-3.

Any U.S. consolidated tax group consisting of a U.S. parent corporation and additional includible corporations listed on Form 851, Affiliations Schedule, required to file Form 1120, that reports on Schedule L total consolidated assets at the end of the tax year that equal or exceed $10 million must complete and file Schedule M-3 instead of Schedule M-1, and must check box (2) Consolidated return (Form 1120 only), or box (3) Mixed 1120/L/PC group, as applicable, at the top of page 1 of Schedule M-3.

A U.S. corporation filing Form 1120 that is not required to file Schedule M-3 may voluntarily file Schedule M-3 instead of Schedule M-1. A corporation filing Schedule M-3 must check Item A, box 4, on Form 1120, page 1, indicating that Schedule M-3 is attached, whether required or voluntary. A corporation filing Schedule M-3 must not file Schedule M-1.

Generally, a corporation must file its income tax return by the 15th day of the 4th month after the end of its tax year. A new corporation filing a short-period return must generally file by the 15th day of the 4th month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 4th month after the date it dissolved.

However, a corporation with a fiscal tax year ending June 30 must file by the 15th day of the 3rd month after the end of its tax year until 2025. A corporation with a short tax year ending anytime in June will be treated as if the short year ended on June 30 and must file by the 15th day of the 3rd month after the end of its tax year.

If the due date falls on a Saturday, Sunday, or legal holiday, the corporation can file on the next business day.

Corporations generally must use EFTPS to make deposits of all tax liabilities (including Social Security, Medicare, withheld income, excise, and corporate income taxes).

File Form 7004 - Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns, to request a 6-month extension of time to file. Generally, the corporation must file Form 7004 by the regular due date of the return. See the Instructions for Form 7004. (29)

Who Must Sign

The return must be signed and dated by: (29)

- The president, vice president, treasurer, assistant treasurer, chief accounting officer.
- Any other corporate officer (such as tax officer) authorized to sign.

If a return is filed on behalf of a corporation by a receiver, trustee, or assignee, the fiduciary must sign the return, instead of the corporate officer. Returns and forms signed by a receiver or trustee in bankruptcy on behalf of a corporation must be accompanied by a copy of the order or instructions of the court authorizing signing of the return or form.

If an employee of the corporation completes Form 1120, the paid preparer space should remain blank. Anyone who prepares Form 1120 but does not charge the corporation should not complete that section. Generally, anyone who is paid to prepare the return must sign it and fill in the “Paid Preparer Use Only” area.

The paid preparer must complete the required preparer information and:

- Sign the return in the space provided for the preparer's signature.
- Give a copy of the return to the taxpayer.

A paid preparer may sign original or amended returns by rubber stamp, mechanical device, or computer software program.

Penalties

A corporation that does not file its tax return by the due date, including extensions, may be penalized 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. If the corporation is charged a penalty for late payment of tax for the same period of time, the penalty for late filing is reduced by the amount of the penalty for late payment. The minimum penalty for a return that is over 60 days late is the smaller of the tax due or $435. The penalty will not be imposed if the corporation can show the failure to file on time was due to a reasonable cause.

A corporation that does not pay the tax when due may be penalized ½ of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if the corporation can show that the failure to pay on time was due to a reasonable cause.

If income, Social Security, and Medicare taxes that a corporation must withhold from employee wages are not withheld or are not deposited or paid to the United States Treasury, the trust fund recovery penalty may apply. The penalty is the full amount of the unpaid trust fund tax. This penalty may apply to the taxpayer if these unpaid taxes cannot be immediately collected from the business.

The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, and paying these taxes, and who acted willfully in not doing so.

A responsible person can be an officer or employee of a corporation, an accountant, or a volunteer director/trustee. A responsible person also may include one who signs checks for the corporation or otherwise has authority to cause the spending of business funds.

Willfully means voluntarily, consciously, and intentionally. A responsible person acts willfully if the person knows the required actions are not taking place.

Estimated Tax

Generally, a corporation must make installment payments if it expects its estimated tax for the year to be $500 or more. If the corporation does not pay the installments when they are due, it could be subject to an underpayment penalty. Installment payments are due by the 15th day of the 4th, 6th, 9th, and 12th months of the corporation's tax year.

A corporation should use Form 1120-W - Estimated Tax for Corporations, as a worksheet to figure each required installment of estimated tax. They will generally use one of the following two methods to figure each required installment. The corporation should use the method that yields the smallest installment payments.

Accumulated Earnings Tax

A corporation can accumulate its earnings for a possible expansion or other bona fide business reasons. However, if a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax of 20%. If the accumulated earnings tax applies, interest applies to the tax from the date the corporate return was originally due, without extensions.

To determine if the corporation is subject to this tax, first treat an accumulation of $250,000 or less generally as within the reasonable needs of most businesses. Treat an accumulation of $150,000 or less as within the reasonable needs of a business whose principal function is performing services in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and the performing arts.

The term "earnings and profits" (e and p) is a common term in tax law. In general, it describes the maximum amount of corporate funds that can be distributed to the corporation's shareholders without reducing the level of its capital. E and p can either be for the current taxable year or, alternatively, accumulated since the corporation was formed.

In determining if the corporation has accumulated earnings and profits beyond its reasonable needs, value the listed and readily marketable securities owned by the corporation and purchased with its earnings and profits at net liquidation value, not at cost.

Reasonable needs of the business include the following: (28)

- Specific, definite, and feasible plans for use of the earnings accumulation in the business.
- The amount necessary to redeem the corporation's stock included in a deceased shareholder's gross estate, if the amount does not exceed the reasonably anticipated total estate and inheritance taxes and funeral and administration expenses incurred by the shareholder's estate.

The absence of a bona fide business reason for a corporation's accumulated earnings may be indicated by many different circumstances, such as a lack of regular distributions to its shareholders or withdrawals by the shareholders classified as personal loans. However, actual moves to expand the business generally qualify as a bona fide use of the accumulations. The fact that a corporation has an unreasonable accumulation of earnings is sufficient to establish liability for the accumulated earnings tax unless the corporation can show the earnings were not accumulated to allow its individual shareholders to avoid income tax.

Money or Property Distributions

Most distributions are in money, but they may also be in stock or other property. For this purpose, “property” means money, securities, and any other property; it does not include stock in the corporation making the distribution (or rights to acquire such stock). The amount of a distribution is generally the amount of any money paid to the shareholder plus the fair market value (FMV) of any property transferred to the shareholder.

However, this amount is reduced (but not below zero) by the following liabilities: (28)

- Any liability of the corporation the shareholder assumes in connection with the distribution.
- Any liability to which the property is subject immediately before, and immediately after, the distribution.

The FMV of any property distributed to a shareholder becomes the shareholder's basis in that property.

The corporation will recognize a gain on the distribution of property to a shareholder if the FMV of the property is more than its adjusted basis. This is generally the same treatment the corporation would receive if the property were sold. However, for this purpose, the FMV of the property is the greater of the following amounts:

- The actual FMV.
- The amount of any liabilities the shareholder assumed in connection with the distribution of the property.

If the property was depreciable or amortizable, the corporation may have to treat all or part of the gain as ordinary income from depreciation recapture. For more information on depreciation recapture and the sale of business property, see Publication 544.

Distributions of Stock or Stock Rights

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as “stock options”) are distributions by a corporation of rights to acquire its stock. Distributions of stock dividends and stock rights are generally tax-free to shareholders.

However, if any of the following apply to their distribution, stock and stock rights are treated as property: (28)

1. Any shareholder has the choice to receive cash or other property instead of stock or stock rights.
2. The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders.

3. The distribution is in convertible preferred stock and has the same result as in (2).
4. The distribution gives preferred stock to some common stock shareholders and gives common stock to other common stock shareholders.
5. The distribution is on preferred stock. (An increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right is not a distribution on preferred stock).

The term “stock” includes rights to acquire stock and the term “shareholder” includes a holder of rights or convertible securities.

Tip

Most distributions are in money, but they may also be in stock or other property. For this purpose, “property” generally does not include stock in the corporation or rights to acquire this stock.

Reporting Dividends and Other Distributions

A corporate distribution to a shareholder is generally treated as a distribution of earnings and profits. Any part of a distribution from either current or accumulated earnings and profits is reported to the shareholder as a dividend. Any part of a distribution that is not from earnings and profits is applied against and reduces the adjusted basis of the stock in the hands of the shareholder. To the extent the balance is more than the adjusted basis of the stock, the shareholder has a gain (usually a capital gain) from the sale or exchange of property.

A corporation must file Form 1099-DIV - Dividends and Distributions, with the IRS for each shareholder to whom they have paid dividends and other distributions on stock of $10 or more during a calendar year. The corporation must generally send Forms 1099-DIV to the IRS with Form 1096 - Annual Summary and Transmittal of U.S. Information Returns, by February 28 (March 31 if filing electronically) of the year following the year of the distribution.

A corporation should file Form 1099-DIV - Dividends and Distributions, for each person: (30)

- To whom it has paid dividends (including capital gain dividends and exempt-interest dividends) and other distributions on stock of $10 or more.
- For whom it has withheld and paid any foreign tax on dividends and other distributions on stock.
- For whom it has withheld any Federal income tax on dividends under the backup withholding rules.
- To whom it has paid $600 or more as part of a liquidation.

Generally, the corporation must furnish Forms 1099-DIV to shareholders by January 31 of the year following the close of the calendar year during which the corporation made the distributions. However, they may furnish the Form 1099-DIV to shareholders after November 30 of the year of the distributions if the corporation has made its final distributions for the year. The corporation may furnish the Form 1099-DIV to shareholders any time after April 30 of the year of the distributions if they give the Form 1099-DIV with the final distributions for the calendar year.

A calendar tax year corporation must file Form 5452 - Corporate Report of Nondividend Distributions with its income tax return for the tax year in which the nondividend distributions were made. A fiscal tax year corporation must file Form 5452 with its income tax return due for the first fiscal year ending after the calendar year in which the nondividend distributions were made.

If a corporation's earnings and profits for the year (figured as of the close of the year without reduction for any distributions made during the year) are more than the total amount of distributions made during the year, all distributions made during the year are treated as distributions of current year earnings and profits.

Income, Deductions, and Special Provisions

Rules on income and deductions that apply to individuals also apply, for the most part, to corporations. However, there are a number of special provisions that apply only to corporations.

Cost of Going Into Business

When a taxpayer goes into business, treat all costs he or she incurs to get the business started as capital expenses. However, a corporation can elect to deduct a limited amount of start-up or organizational costs. Any costs not deducted can be amortized.

Start-up costs are amounts paid or incurred for creating an active trade or business; or investigating the creation or acquisition of an active trade or business. Start-up costs include amounts paid or incurred in connection with an existing activity engaged in for profit; and for the production of income in anticipation of the activity becoming an active trade or business. Organizational costs are the direct costs of creating the corporation.

A start-up cost is amortizable if it meets both of the following tests:

1. It is a cost that could be deducted if paid or incurred to operate an existing active trade or business (in the same field as the one the new corporation entered into).
2. It is a cost paid or incurred before the day the corporation's active trade or business begins.

Start-up costs include amounts paid for the following:

- An analysis or survey of potential markets, products, labor supply, transportation facilities, etc.
- Advertisements for the opening of the business.
- Salaries and wages for employees who are being trained and their instructors.
- Travel and other necessary costs for securing prospective distributors, suppliers, or customers.
- Salaries and fees for executives and consultants, or for similar professional services.

Start-up costs do not include deductible interest, taxes, or research and experimental costs.

Business start-up and organizational costs are generally capital expenditures. However, the taxpayer can elect to deduct up to $5,000 of business start-up and $5,000 of organizational costs paid or incurred after October 22, 2004. The $5,000 deduction is reduced by the amount his or her total start-up or organizational costs exceed $50,000. Any remaining costs must be amortized.

Cost of Organizing a Corporation

Amounts paid to organize a corporation are the direct costs of creating the corporation. To qualify as an organizational cost, it must be all of the following: [31]

- For the creation of the corporation.
- Chargeable to a capital account.
- Amortized over the life of the corporation if the corporation had a fixed life.
- Incurred before the end of the first tax year in which the corporation is in business.

A corporation using the cash method of accounting can amortize organizational costs incurred within the first tax year, even if it does not pay them in that year. Examples of organizational costs include:

- The cost of temporary directors.
- The cost of organizational meetings.
- State incorporation fees.
- The cost of legal services.

The following non-qualifying costs are capital expenses that cannot be amortized:

- Costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs.
- Costs associated with the transfer of assets to the corporation.

Related Persons

A corporation that uses an accrual method of accounting cannot deduct business expenses and interest owed to a related person who uses the cash method of accounting until the corporation makes the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship, for this rule, as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied, the rule will continue to apply even if the corporation's relationship with the person ends before the expense or interest is includible in the gross income of that person. These rules also deny the deduction of losses on the sale or exchange of property between related persons.

For purposes of this rule, the following persons are related to a corporation:

1. Another corporation, that is a member of the same controlled group (as defined in Section 267(f) of the Internal Revenue Code).
2. An individual who owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation.
3. A trust fiduciary, when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
4. An S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
5. A partnership, if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.
6. Any employee-owner, if the corporation is a personal service corporation, regardless of the amount of stock owned by the employee-owner.

Controlled group of corporations means any group of:

1. **Parent-subsidiary controlled group** - One or more chains of corporations connected through stock ownership with a common parent corporation if:
    a. Stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned (within the meaning of subsection (d)(1)) by one or more of the other corporations; and
    b. The common parent corporation owns (within the meaning of subsection (d)(1)) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.
2. **Brother-sister controlled group** - Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.
3. **Combined group** - Three or more corporations each of which is a member of a group of corporations described in paragraph (1) or (2), and one of which:
    a. Is a common parent corporation included in a group of corporations described in paragraph (1), and
    b. Is included in a group of corporations described in paragraph (2).
4. **Certain insurance companies** - Two or more insurance companies subject to taxation under Section 801 which are members of a controlled group of corporations described in paragraph (1), (2), or (3). Such insurance companies shall be treated as a controlled group of corporations separate from any other corporations which are members of the controlled group of corporations described in paragraph (1), (2), or (3).

To determine whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following apply:

1. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries.
2. An individual is treated as owning the stock owned, directly or indirectly, by or for the individual's family. Family includes only brothers and sisters (including half-brothers and half-sisters), a spouse, ancestors, and lineal descendants.
3. Any individual owning (other than by applying (2), above) stock in a corporation, is treated as also owning the stock owned directly or indirectly by that individual's partner.
4. To apply (1), (2), or (3), above, stock constructively owned by a person under (1) is treated as actually owned by that person. But stock constructively owned by an individual under (2) or (3) is not treated as actually owned by the individual for applying either (2) or (3) to make another person the constructive owner of that stock.

Where it is necessary to clearly show income or prevent tax evasion, the IRS can reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly, or indirectly, by the same interests.

Tip

The disallowance of losses from the sale or exchange of property between related persons does not apply to liquidating distributions.

Income From Qualifying Shipping Activities

A corporation may make an election to be taxed on its notional shipping income at the highest corporate tax rate. If a corporation makes this election it may exclude income from qualifying shipping activities from gross income. Also, if the election is made, the corporation generally may not claim any loss, deduction, or credit with respect to qualifying shipping activities. A corporation making this election may also elect to defer gain on the disposition of a qualifying vessel. A corporation uses Form 8902 - Alternative Tax on Qualifying Shipping Activities, to make the election and figure the alternative tax.

Energy-Efficient Commercial Building Property Deduction

A corporation can claim a deduction for costs associated with energy-efficient commercial building property, placed in service before January 1, 2014. In order to qualify for the deduction: (28)

- The costs must be associated with depreciable or amortizable property in a Standard 90.1-2001 domestic building;
- The property must be either a part of the interior lighting system, the heating, cooling, ventilation and hot water system, or the building envelope (defined in Section 179D(c)(1)(C) of the Internal Revenue Code); and
- The property must be installed as part of a plan to reduce the total annual energy and power costs of the building by 50% or more.

The deduction is limited to $1.80 per square foot of the building less the total amount of deductions taken for this property in prior tax years. Other rules and limitations apply. The corporation must reduce the basis of any property by any deduction taken. The deduction is subject to recapture if the corporation fails to fully implement an energy savings plan.

The Further Consolidated Appropriations Act has extended Sections 179D retroactively for qualifying building systems placed in service from January 1, 2018, through December 31, 2020.

Dividends-Received Deduction

A corporation can deduct a percentage of certain dividends received during its tax year. This section discusses the general rules that apply. The deduction is figured on Form 1120, Schedule C, or the applicable schedule of the income tax return.

Dividends from Foreign Corporations

Generally, 100% of the foreign-source portion of dividends (and items treated as dividends) from 10%-owned foreign corporations received after December 31, 2017, may be deducted. The stock with respect to which such dividends are received must meet a special 365-day holding period and does not include certain “hybrid” dividend payments. See the instructions for Form 1120, Schedule C (or the applicable schedule of the taxpayer’s income tax return) for details regarding this deduction. Also note that this deduction is not subject to the limit on deduction for dividends related to dividends from domestic corporations, discussed below.

Dividends from Domestic Corporations

A corporation can deduct, within certain limits, 50% of the dividends received if the corporation receiving the dividend owns less than 20% of the corporation distributing the dividend. If the corporation owns 20% or more of the distributing corporation's stock, it can, subject to certain limits, deduct 65% of the dividends received.

Ownership

Determine ownership, for these rules, by the amount of voting power and value of the paying corporation's stock (other than certain preferred stock) the receiving corporation owns.

Small Business Investment Companies

Small business investment companies can deduct 100% of the dividends received from taxable domestic corporations.

Dividends from Regulated Investment Companies

Regulated investment company dividends received are subject to certain limits. Capital gain dividends received from a regulated investment company do not qualify for the deduction. For more information, see Section 854 of the Internal Revenue Code.

No Deduction Allowed for Certain Dividends

Corporations cannot take a deduction for dividends received from the following entities: (28)

- A real estate investment trust (REIT).
- A corporation exempt from tax under Section 501 or 521 of the Internal Revenue Code either for the tax year of the distribution or the preceding tax year.
- A corporation whose stock was held less than 46 days during the 91-day period beginning 45 days before the stock became ex-dividend with respect to the dividend. Ex-dividend means the holder has no rights to the dividend.
- A corporation whose preferred stock was held less than 91 days during the 181-day period beginning 90 days before the stock became ex-dividend with respect to the dividend if the dividends received are for a period or periods totaling more than 366 days.
- Any corporation, if the taxpayer's corporation is under an obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Dividends on Deposits

Dividends on deposits or withdrawable accounts in domestic building and loan associations, mutual savings banks, cooperative banks, and similar organizations are interest, not dividends. They do not qualify for this deduction.

Limit on Deduction for Dividends

The total deduction for dividends received or accrued is generally limited (in the following order) to: (28)

1. 65% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from 20%-owned corporations, then
2. 80% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from less-than-20%-owned corporations (reducing taxable income by the total dividends received from 20%-owned corporations).

Figuring the Limit

In figuring the limit, determine taxable income without the following items: (28)

- The net operating loss deduction.
- The domestic production activities deduction.
- The deduction for dividends received.
- Any adjustment due to the nontaxable part of an extraordinary dividend.
- Any capital loss carryback to the tax year.

If a corporation has a net operating loss (NOL) for a tax year, the limit of 65% (or 50%) of taxable income does not apply. To determine whether a corporation has an NOL, figure the dividends-received deduction without the 65% (or 50%) of taxable income limit.

Extraordinary Dividends

If a corporation receives an extraordinary dividend on stock held 2 years or less before the dividend announcement date, it generally must reduce its basis in the stock by the nontaxed part of the dividend. The nontaxed part is any dividends-received deduction allowable for the dividends.

An extraordinary dividend is any dividend on stock that equals or exceeds a certain percentage of the corporation's adjusted basis in the stock. The percentages are: (28)

1. 5% for stock preferred as to dividends.
2. 10% for other stock.

Treat all dividends received that have ex-dividend dates within an 85-consecutive-day period as one dividend. Treat all dividends received that have ex-dividend dates within a 365-consecutive-day period as extraordinary dividends if the total of the dividends exceeds 20% of the corporation's adjusted basis in the stock.

Any dividend on disqualified preferred stock is treated as an extraordinary dividend regardless of the period of time the corporation held the stock.

Disqualified preferred stock is any stock preferred as to dividends if any of the following apply: (28)

1. The stock when issued has a dividend rate that declines (or can reasonably be expected to decline) in the future.
2. The issue price of the stock exceeds its liquidation rights or stated redemption price.
3. The stock is otherwise structured to avoid the rules for extraordinary dividends and to enable corporate shareholders to reduce tax through a combination of dividends-received deductions and loss on the disposition of the stock.

These rules apply to stock issued after July 10, 1989, unless it was issued under a written binding contract in effect on that date, and thereafter, before the issuance of the stock.

Below-Market Loans

If a corporation receives a below-market loan and uses the proceeds for its trade or business, it may be able to deduct the forgone interest.

A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the long-term applicable Federal rate. A below-market loan generally is treated as an arm's-length transaction in which the borrower is considered as having received both the following: (28)

- A loan in exchange for a note that requires payment of interest at the long-term applicable Federal rate.
- An additional payment in an amount equal to the forgone interest.

Treat the additional payment as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction. For any period, forgone interest is equal to: (28)

1. The interest that would be payable for that period if interest accrued on the loan at the long-term applicable Federal rate and was payable annually on December 31, minus
2. Any interest actually payable on the loan for the period.

Charitable Contributions

A corporation can claim a limited deduction for charitable contributions made in cash or other property. The contribution is deductible if made to, or for the use of, a qualified organization. The taxpayer cannot take a deduction if any of the net earnings of an organization receiving contributions benefit any private shareholder or individual.

A corporation using the cash method of accounting deducts contributions in the tax year paid. A corporation using an accrual method of accounting can choose to deduct unpaid contributions for the tax year the board of directors authorizes them if it pays them by the due date for filing the corporation's tax return (not including extensions). Make the choice by reporting the contribution on the corporation's return for the tax year. Attach a declaration stating that the board of directors adopted the resolution during the tax year must accompany the return. The declaration must include the date the resolution was adopted.

Under the Coronavirus Aid, Relief, and Economic Security Act (CARES), a corporation cannot deduct charitable contributions that exceed 25% of its taxable income for the tax year. The Act also increases the limitation on deductions for contributions of food inventory from 15% to 25%.

Figure taxable income for this purpose without the following: [28]

1. The deduction for charitable contributions.
2. The dividends-received deduction.
3. The deduction allowed under Section 249 of the Internal Revenue Code.
4. The domestic production activities deduction.
5. Any net operating loss carryback to the tax year.
6. Any capital loss carryback to the tax year.

Charitable contributions of a corporation in excess of 25% of its taxable income are disallowed and may be carried forward for five years. However, only the lesser of the following two amounts can be carried over:

- The excess of the maximum amount deductible for such succeeding tax year under the 25% limitation over the sum of the contributions made in the year plus all of the excess contributions that were made in tax years before the contribution year (that is, the tax year in which a contribution was made) and that are deductible for the succeeding tax year; or
- In the case of the first succeeding tax year, the amount of the excess contribution, and in the case of the second through fifth succeeding tax years, the portion of the excess contribution not deductible between the contribution year and each succeeding tax year.

Notwithstanding any carryover to either the first, second, third, fourth, or fifth year succeeding the tax year, the total deduction for any succeeding tax year, including any carryover, may not exceed the 25% limitation on contributions and gifts.

A corporation must maintain a record of any contribution of cash, check, or other monetary contribution, regardless of the amount. The record can be a bank record, receipt, letter, or other written communication from the donee indicating the name of the organization, the date of the contribution, and the amount of the contribution. Keep the record of the contribution with the other corporate records. Do not attach the records to the corporation's return.

Generally, no deduction is allowed for any contribution of $250 or more unless the corporation gets a written acknowledgement from the donee organization. The acknowledgement should show the amount of cash contributed, a description of the property contributed, and either gives a description and a good faith estimate of the value of any goods or services provided in return for the contribution or states that no goods or services were provided in return for the contribution. The acknowledgement should be received by the due date (including extensions) of the return, or, if earlier, the date the return was filed. Keep the acknowledgement with other corporate records. Do not attach the acknowledgement to the return.

If a corporation (other than a closely held or a personal service corporation) claims a deduction of more than $500 for contributions of property other than cash, a schedule describing the property and the method used to determine its fair market value must be attached to the corporation's return.

In addition, the corporation should keep a record of:

- The approximate date and manner of acquisition of the donated property.
- The cost or other basis of the donated property held by the donor for less than 12 months prior to contribution.

Closely held and personal service corporations must complete and attach Form 8283 - Noncash Charitable Contributions, to their returns if they claim a deduction of more than $500 for non-cash contributions. For all other corporations, if the deduction claimed for donated property exceeds $5,000, complete Form 8283 and attach it to the corporation's return.

A corporation must obtain a qualified appraisal for all deductions of property claimed in excess of $5,000. A qualified appraisal is not required for the donation of cash, publicly traded securities, inventory, and any qualified vehicles sold by a donee organization without any significant intervening use or material improvement. The appraisal should be maintained with other corporate records and only attached to the corporation's return when the deduction claimed exceeds $500,000; $20,000 for donated artwork.

For a charitable contribution of property, the corporation must reduce the contribution by the sum of:

- The ordinary income and short-term capital gain that would have resulted if the property were sold at its FMV.
- For certain contributions, the long-term capital gain that would have resulted if the property were sold at its FMV.

The reduction for the long-term capital gain applies to all of the following:

- Contributions of tangible personal property for use by an exempt organization for a purpose or function unrelated to the basis for its exemption.
- Contributions of any property to or for the use of certain private foundations except for stock for which market quotations are readily available.
- Contributions of any patent, certain copyrights, trademark, trade name, trade secret, know-how, software (that is a Section 197 intangible), or similar property, or applications or registrations of such property.

The Coronavirus Aid, Relief, and Economic Security Act (CARES) changes the limitations on deductions for certain cash contributions during 2020. For corporations, the 10% limitation is increased to 25%. The Act also increases the limitation on deductions for contributions of food inventory from 15% to 25%.

Distributions in Redemption of Stock

A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock. Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if: [32]

- The redemption is not essentially equivalent to a dividend.
- There is a substantially disproportionate redemption of stock.
- There is a complete redemption of all the stock of the corporation owned by the shareholder.
- The redemption is a distribution in partial liquidation of a corporation.

A surrender of stock by a dominant shareholder who retains ownership of more than half of the corporation's voting shares is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

The transfer of investment property to a corporation, trust, fund, foundation, or other organization, in exchange for a fixed annuity contract that will make guaranteed annual payments to the taxpayer for life, is a taxable trade. If the present value of the annuity is more than his or her basis in the property traded, he or she has a taxable gain in the year of the trade. Figure the present value of the annuity according to factors used by commercial insurance companies issuing annuities.

Base Erosion and Anti-Abuse Tax (BEAT)

Under the Tax Cuts and Jobs Act, U.S. corporate shareholders of a foreign business can now deduct any dividends received when computing corporate taxable income. Because this deduction can reduce U.S. tax on foreign profits, Congress created a mechanism to deter U.S. corporations from eroding the U.S. tax base by paying tax-deductible expenses to foreign affiliates then distributing profits tax-free. The deterrent is essentially a new form of an alternative minimum tax that applies to large multinational corporations and was quickly given the acronym BEAT" The BEAT is effective for tax years beginning after December 31, 2017.

BEAT will apply to corporations that meet two requirements:

1. Average annual gross receipts of $500,000,000 for the prior three-year period; and
2. A base erosion percentage of at least 3% (2% in the case of banks and securities dealers).

BEAT does not apply to RICs, REITs or S Corporations.

To determine if a corporation exceeds the average annual gross receipts threshold for the preceding three-year period, gross receipts are determined on an affiliated group level, including all businesses with common 50% ownership with the taxpayer. Foreign corporations are included in the affiliated group if they meet the 50% ownership test. Although affiliated group rules also apply to other tax concepts, a key distinction for the BEAT is that in applying the affiliated group rules in the case of a foreign taxpayer or affiliate, only the gross sales that generate U.S. effectively connected income are taken into account. Because non-U.S. sales are removed from the computation, large multinational corporations with smaller U.S. businesses will likely be exempt from the tax.

A "base erosion payment" is any amount paid or accrued by a taxpayer to a foreign related party for which a deduction is allowable. This includes a purchase from a foreign related party of depreciable property.

Global Intangible Low-Taxed Income (GILTI)

The Tax Cuts and Jobs Act (TCJA), passed in December 2017, made major changes to the tax law, including adding new rules requiring the inclusion of global intangible low-taxed income (GILTI) generated by controlled foreign corporations (CFCs). Under the TCJA, a U.S. person that owns at least 10% of the value or voting rights in one or more CFCs will be required to include its global intangible low-taxed income as currently taxable income, regardless of whether any amount is distributed to the shareholder. A U.S. person includes U.S. individuals, domestic corporations, partnerships, trusts and estates.

New reporting rules requiring the filing of Form 8992 - U.S. Shareholder Calculation of Global Intangible Low-Taxed Income are also described in the proposed regulations. The new law applies to the first tax year of a CFC beginning after December 31, 2017, and the U.S. shareholder's year with or within which that year ends, and all subsequent tax years.

Section 965 Transition Tax

Section 965 requires United States shareholders (as defined under Section 951(b)) to pay a transition tax on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the United States. Very generally, a specified foreign corporation means either a controlled foreign corporation, as defined under Section 957 (CFC), or a foreign corporation (other than a passive foreign investment company, as defined under Section 1297, that is not also a CFC) that has a United States shareholder that is a domestic corporation. Section 965 allows U.S. shareholders to reduce the amount of the income inclusion based on deficits in earnings and profits with respect to other specified foreign corporations. The effective tax rates applicable to income inclusions are adjusted by way of a participation deduction set out in Section 965(c). A reduced foreign tax credit applies to the inclusion under Section 965(g). Taxpayers may elect to pay the transition tax in installments over an eight-year period.

The new tax applies to the last taxable year of specified foreign corporations beginning before January 1, 2018, and the tax is includible in the U.S. shareholder's tax year in which or with which the specified foreign corporation's year ends.

If the taxpayer was a U.S. shareholder of one or more CFCs or other specified foreign corporations, Section 965 requires him or her to take the following actions:

1. The taxpayer must determine if he or she held an interest in one or more specified foreign corporations whose tax year ends with or within his or her 2020 taxable year.
2. The taxpayer must determine the amount, if any, of previously untaxed earnings and profits to be included in income on his or her 2020 tax return.

3. A U.S. shareholder that is required to pay the tax with respect to a 2020 inclusion must do so either in one lump sum, or, pursuant to an election, in eight annual installments. See IRC Section 965(h).
4. Failure to properly comply with the reporting and payment obligations could result in the imposition of interest and/or the assertion of tax penalties.

Taxpayers must keep adequate records to support the calculation of tax pursuant to Section 965. Additional information and worksheets, including reporting for 2020, will be made available on irs.gov to aid taxpayers in complying with Section 965. Note that reporting Section 965 net tax liability for 2021 may differ from reporting for 2020.

Credit for Prior Year Minimum Tax

As part of TCJA, the corporate alternative minimum tax (AMT) was eliminated, effective for tax years beginning after December 31, 2017. Taxpayers that had AMT credit carryforwards were able to use them against their regular tax liability and also able to claim a refundable credit equal to 50% of the remaining AMT carryforward in years beginning in 2018 through 2020 and 100% for years beginning in 2021.

Corporate Liquidations/Dissolutions

A corporate liquidation should be considered at two levels, the shareholder level and the corporate level. On the shareholder level, a complete liquidation can be thought of as a sale of all outstanding corporate stock held by the shareholders in exchange for all of the assets in that corporation. Like any sale of stock, the shareholder receives capital gain treatment on the difference between the amount received by the shareholder in the distribution and the cost or other basis of the stock.

At the corporate level, the corporation recognizes gain or loss on the liquidation in an amount equal to the difference between the fair market value and the adjusted basis of the assets distributed. Section 336(b) requires that the fair market value used should not be less than any liability accepted by the distributee.

Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock. Each shareholder recognizes gain or loss equal to the difference between the NET Fair Market Value (FMV) of the property received and the basis of the stock surrendered.

Some corporations adopt plans of liquidation which on the surface appear to meet the various statutory requirements for liquidations. When the substance of these transactions is analyzed, however, the liquidations may actually be corporate reorganizations or other schemes which have been devised for the purpose of tax avoidance.

"Complete liquidation" is a term not defined by the Code. The regulations under IRC Section 332 suggest that the status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders. The Tax Court applies a three-pronged test to determine whether a complete liquidation has taken place (see Joseph Olmstead v. Commissioner T.C. Memo 1984-381):

- Was there a manifest intent to liquidate?
- Was there a continuing purpose to terminate corporate affairs and dissolve?
- Were the corporate activities directed and confined to that purpose?

Dissolution under state law, or lack thereof, will not be controlling for Federal tax purposes. Intent coupled with actual distributions to the shareholders are the usual determining elements.

IRC Section 346(a) allows for a series of distributions pursuant to a plan of liquidation to be treated as being part of a complete liquidation. If the plan is not formal or is ambiguous, there may be uncertainty as to which distributions are made pursuant to the plan. Distributions made before there is evidence to support an intention to liquidate should be taxable as dividends (ordinary income to a shareholder).

The U.S. Tax Court's decision in Pittsburgh Realty Investment Trust v. Commissioner, 67 T.C. 260, 1976, shed some light on a corporate liquidation.

The Court stated that:

1. The determination as to whether and/or when a corporation has liquidated is a question of fact. Proof of a distribution in complete liquidation not only depends on an intent to liquidate but also requires acts which demonstrate and effect that intent.
2. A corporation in existence during any portion of a taxable year is required to make a return. If a corporation was not in existence throughout an annual accounting period (either calendar year or fiscal year), the corporation is required to make a return for that fractional part of a year during which it was in existence. A corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or not under State law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with winding up its affairs, such as for the purposes of suing and being sued. If the corporation has valuable claims for which it will bring suit during this period, it has retained assets and therefore continues to exist. A corporation does not go out of existence if it is turned over to receivers or trustees who continue to operate it.

As a general rule, the fair market value of property received by a shareholder via a corporate liquidation less the stock's adjusted basis represents the gain or loss to the shareholder as governed by IRC Section 1001(a). Pursuant to IRC Section 336(a), a corporation will recognize gain or loss separately on each asset that is distributed in liquidation equal to the asset's fair market value less the asset's adjusted basis. Generally, the expenses incurred to liquidate a corporation are deductible. The expenses of selling the assets are normally charged against the gain for each asset.

Closing a Business

There are typical actions that are taken when closing a business. The taxpayer must file an annual return for the year he or she goes out of business. If the taxpayer has employees, he or she must file the final employment tax returns, in addition to making final Federal tax deposits of these taxes. Also attach a statement to the return showing the name of the person keeping the payroll records and the address where those records will be kept.

The annual tax return for a partnership, corporation, S corporation, limited liability company or trust includes check boxes near the top front page just below the entity information. For the tax year in which the business ceases to exist, check the box that indicates this tax return is a final return. If there are Schedule K-1s, repeat the same procedure on the Schedule K-1.

The taxpayer will also need to file returns to report disposing of business property, reporting the exchange of like-kind property, and/or changing the form of the business.

A corporation (or a farmer's cooperative) must file Form 966 - Corporate Dissolution or Liquidation if it adopts a resolution or plan to dissolve the corporation or liquidate any of its stock. The corporation must file Form 966 within 30 days after the resolution or plan is adopted to dissolve the corporation or liquidate any of its stock. If the resolution or plan is amended or supplemented after Form 966 is filed, file another Form 966 within 30 days after the amendment or supplement is adopted. The additional form will be sufficient if the date the earlier form was filed is entered on line 11 and a certified copy of the amendment or supplement is attached. Include all information required by Form 966 that was not given in the earlier form.

A corporation must recognize gain or loss on the distribution of its assets in the complete liquidation of its stock. For purposes of determining gain or loss, the distributed assets are valued at fair market value. Exceptions to this rule apply to a liquidation of a subsidiary and to a distribution that is made according to a plan of reorganization.

When completing Form 966 the corporation should identify the code section under which the corporation is to be dissolved or liquidated. For example, enter "Section 331" for a complete or partial liquidation of a corporation or enter "Section 332" for a complete liquidation of a subsidiary corporation that meets the requirements of Section 332(b).

Section 302(b)(4) - Redemption from Noncorporate Shareholder in Partial Liquidation states that a noncorporate shareholder who receives a distribution in redemption of stock in a partial liquidation treats the distribution as payment in exchange for the stock. Any gain or loss on the exchange will be treated as capital in nature.

S Corporations and Limited Liability Companies

S Corporations

S corporations are corporations that elect to pass corporate income, losses, deductions and credit through to their shareholders for Federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income. To qualify for S corporation status, the corporation must meet the following requirements:

- Be a domestic corporation.
- Have only allowable shareholders:
    - Including individuals, certain trust, and estates and
    - May not include partnerships, corporations or non-resident alien shareholders.
- Have no more than 100 shareholders.
- Have one class of stock.
- Not be an ineligible corporation i.e. certain financial institutions, insurance companies, and domestic international sales corporations.

In order to become an S corporation, the corporation must submit Form 2553 - Election by a Small Business Corporation signed by all the shareholders. The taxpayer's corporation must file the Form 2553 to elect "S" status within two months and 15 days after the beginning of the tax year or any time before the tax year for the status to be in effect.

For this purpose, the 2-month period begins on the day of the month the tax year begins and ends with the close of the day before the numerically corresponding day of the second calendar month following that month. If there is no corresponding day, use the close of the last day of the calendar month. [4]

Advantages of an S Corporation

One of the best features of the S Corp is the tax savings for the taxpayer and his or her business. While members of an LLC are subject to employment tax on the entire net income of the business, only the wages of the S Corp shareholder who is an employee are subject to employment tax. The remaining income is paid to the owner as a "distribution," which is taxed at a lower rate, if at all.

Some expenses that shareholder/employees incur can be written off as business expenses. Nevertheless, if such an employee owns 2% or more shares, then benefits like health and life insurance are deemed taxable income.

An S Corp designation also allows a business to have an independent life, separate from its shareholders. If a shareholder leaves the company, or sells his or her shares, the S Corp can continue doing business relatively undisturbed. Maintaining the business as a distinct corporate entity defines clear lines between the shareholders and the business that improve the protection of the shareholders. [33]

Disadvantages of an S Corporation

As a separate structure, S Corps require scheduled director and shareholder meetings, minutes from those meetings, adoption and updates to by-laws, stock transfers and records maintenance. A shareholder must receive reasonable compensation. The IRS takes notice of shareholder red flags like low salary/high distribution combinations and may reclassify the taxpayer's distributions as wages. He or she could pay a higher employment tax because of an audit with these results. A corporation may not carry a capital loss from, or to, a year for which it is an S corporation. Also, in general, an S corporation does not pay a tax on its income. Instead, its income and expenses are passed through to the shareholders, who then report these items on their own income tax returns.

If the taxpayer is an S corporation shareholder, his or her share of the corporation's current year income or loss and other tax items are taxed to him or her whether or not he or she receives any amount. Generally, those items increase or decrease the basis of the S corporation stock as appropriate.

The taxpayer must increase his or her basis in stock of an S corporation by his or her pro rata share of the following items: [32]

- All income items of the S corporation, including tax-exempt income, that are separately stated and passed through to the taxpayer as a shareholder.
- The non-separately stated income of the S corporation.
- The amount of the deduction for depletion (other than oil and gas depletion) that is more than the basis of the property being depleted.

The taxpayer must decrease his or her basis in stock of an S corporation by his or her pro rata share of the following items: [32]

- Distributions by the S corporation that were not included in the taxpayer's income.
- All loss and deduction items of the S corporation that are separately stated and passed through to the taxpayer.
- Any non-separately stated loss of the S corporation.
- Any expense of the S corporation that is not deductible in figuring its taxable income and not properly chargeable to a capital account.
- The amount of the taxpayer's deduction for depletion of oil and gas wells to the extent the deduction is not more than his or her share of the adjusted basis of the wells.

The basis in the stock cannot be reduced below zero.

Generally, S corporation distributions, except dividend distributions, are considered a return of capital and reduce the taxpayer's basis in the stock of the corporation. The part of any distribution that is more than the basis is treated as a gain from the sale or exchange of property. The corporation's distributions may be in the form of cash or property.

S corporation distributions are not treated as dividends except in certain cases in which the corporation has accumulated earnings and profits from years before it became an S corporation.

The S corporation should send the taxpayer a copy of Schedule K-1 (Form 1120S) showing his or her share of the S corporation's income, credits, and deductions for the tax year. The taxpayer must report his or her distributive share of the S corporation's income, gain, loss, deductions, or credits on the appropriate lines and schedules of the Form 1040.

The deduction for a taxpayer's share of losses and deductions shown on Schedule K-1 (Form 1120S) is limited to the adjusted basis of his or her stock and any debt the corporation owes the taxpayer. Any loss or deduction not allowed because of this limit is carried over and treated as a loss or deduction in the next tax year.

Rules apply that limit losses from passive activities. The taxpayer's copy of Schedule K-1 (Form 1120S) and its instructions will explain the limits and tell him or her where on the return to report his or her share of S corporation items from passive activities. If the taxpayer has a passive activity loss from an S corporation, he or she must complete Form 8582 - Passive Activity Loss Limitations to figure the allowable loss to enter on the return. [34]

Taxes

Most businesses need to register with the IRS, register with state and local revenue agencies, and obtain a tax ID number or permit. All states do not tax S Corps equally. Most recognize them similarly to the Federal government and tax the shareholders accordingly. However, some states (like Massachusetts) tax S Corps on profits above a specified limit. Other states do not recognize the S Corp election and treat the business as a C Corp with all of the tax ramifications. Some states (like New York and New Jersey) tax both the S Corps profits and the shareholder's proportional shares of the profits.

Built-in Gains Tax

Section 1374 provides for a tax on built-in gains. The built-in gains tax may apply to the following S corporations: [35]

1. An S corporation that was a C corporation before it elected to be an S corporation.
2. An S corporation that acquired an asset with a basis determined (in whole or in part) by reference to its basis (or the basis of any other property) in the hands of a C corporation (a transferred-basis acquisition). See Section 1374(d)(8).

An S corporation may owe the tax if it has a net recognized built-in gain during the applicable recognition period. For tax years beginning after 2011, the applicable recognition period is the 5-year period beginning:

- For an asset held when the S corporation was a C corporation, on the first day of the first tax year for which the corporation is an S corporation; or
- For an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation, on the date the asset was acquired by the S corporation.

A corporation described in both (1) and (2), above, must figure the built-in gains tax separately for the group of assets it held at the time its S election became effective and for each group of assets it acquired from a C corporation with basis determined (in whole or in part) by reference to the basis of the asset (or any other property) in the hands of the C corporation. For details, see Regulations Section 1.1374-8.

Tip

Certain transactions involving the disposal of timber, coal, or domestic iron ore under Section 631 are not subject to the built-in gains tax.

Excess Net Passive Income Tax

S corporations that have previously been a C corporation and have accumulated earnings and profits at the end of the tax year will be assessed a passive income tax if passive investment income for the year exceeds 25% of gross receipts for the year. The tax is assessed at the maximum corporate tax rate of 21%. Recognized built-in gains and losses are not taken into account in determining the amount of passive investment income.

Code Section 1362(d) (3(C)(i) defines passive investment income to be income derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. An exception is made for interest on notes from sales of inventory (Code Section 1362(d) (3(C)(ii)), and for income derived directly from the active and regular conduct of a lending or finance business (Code Section 1362(d) (3(C)(iii)).

If passive investment income exceeds 25% of gross receipts for three consecutive years, then the S corporation election is terminated immediately following the third tax year.

To avoid the passive income tax, the S corporation can either distribute E&P from C corporation years as an actual or deemed dividend or generate enough operating income so that passive investment income does not exceed 25% of gross receipts for the year. Also, the passive income tax calculated using the lesser of "excessive net passive income" or taxable income. By reducing taxable income, the S corporation is able to minimize the passive income tax. Keep in mind, however, that the S corporation election will still terminate if passive investment income exceeds 25% of gross receipts for three consecutive years.

Any passive income tax paid is a reduction to income that passes to the S corporation shareholders.

Return of S Corporation

Every S corporation shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, the names and addresses of all persons owning stock in the corporation at any time during the taxable year, the number of shares of stock owned by each shareholder at all times during the taxable year, the amount of money and other property distributed by the corporation during the taxable year to each shareholder, the date of each such distribution, each shareholder's pro rata share of each item of the corporation for the taxable year, and such other information.

Each S corporation required to file a return for any taxable year shall (on or before the day on which the return for such taxable year was filed) furnish to each person who is a shareholder at any time during such taxable year a copy of such information shown on such return as may be required by regulations.

S Corporation Compensation

S corporations must pay reasonable compensation to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made to the shareholder-employee. The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly.

Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for the service rendered to the corporation.

The instructions to the Form 1120S - U.S. Income Tax Return for an S Corporation, state "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation. As such, we need to look to the source of the S corporation's gross receipts. The three major sources are:

1. Services of shareholder,
2. Services of non-shareholder employees, or
3. Capital and equipment.

If the gross receipts and profits come from items 2 and 3, then that should not be associated with the shareholder-employee's personal services and not be allocated as compensation.

On the other hand, if most of the gross receipts and profits are associated with the shareholder's personal services, then most of the profit distribution should be allocated as compensation.

In addition to the shareholder-employee direct generation of gross receipts, the shareholder-employee should also be compensated for administrative work performed for the other income producing employees or assets. For example, a manager may not directly produce gross receipts, but he assists the other employees or assets which are producing the day-to-day gross receipts.

Some factors in determining reasonable compensation:

- Training and experience.
- Duties and responsibilities.
- Time and effort devoted to the business.
- Dividend history.
- Payments to non-shareholder employees.
- Timing and manner of paying bonuses to key people.
- What comparable businesses pay for similar services.
- Compensation agreements.
- The use of a formula to determine compensation.

Health and accident insurance premiums paid on behalf of the greater than two percent S corporation shareholder-employee are deductible and reportable by the S corporation as wages for income tax withholding purposes on the shareholder-employee's Form W-2.

These benefits are not subject to Social Security or Medicare (FICA) or Unemployment (FUTA) taxes. The additional compensation is included in Box 1 (Wages) of the Form W-2, Wage and Tax Statement, issued to the shareholder-employee, but would not be included in Boxes 3 and 5 of Form W-2.

A 2% shareholder-employee is eligible for an Adjusted Gross Income (AGI) deduction for amounts paid during the year for medical care premiums if the medical care coverage is established by the S corporation and the shareholder meets the other self-employed medical insurance deduction requirements. If, however, the shareholder or the shareholder's spouse is eligible to participate in any subsidized health care plan then the shareholder is not entitled to the AGI deduction.

A medical plan can be considered established by the S corporation if the S corporation paid or reimbursed the shareholder-employee for premiums and reported:

- The premium payment.
- Reimbursement as wages on the shareholder-employee's W-2.

S Corporation Stock and Debt Basis Shareholder Loss Limitations

An S corporation is a corporation with an election in effect. The impact of the election is that the S corporation's items of income, loss and deduction flow to the shareholder and thus taxed on the shareholder's personal return.

The two main reasons for electing S corporation status are:

1. Avoid double taxation on distributions.
2. Allow corporate losses to flow through to its owners.

There are three shareholder loss limitations:

1. Stock and Debt Basis Limitations.
2. At Risk Limitations.
3. Passive Activity Loss Limitations.

Each limitation must be met, and in the order presented, before a shareholder is allowed to claim a flow-through loss. The fact that a shareholder receives a K-1 reflecting a loss does not mean that the shareholder is automatically entitled to claim the loss.

The amount of a shareholder's stock and debt basis in the S corporation is very important. Unlike a C corporation, each year a shareholder's stock and/or debt basis of an S corporation increases or decreases based upon the S corporation's operations. The S corporation will issue a shareholder a Schedule K-1.

It is important to understand that the K-1 reflects the S corporation's items of income, loss and deduction that are allocated to the shareholder for the year. The K-1 shows the amount of non-dividend distribution the shareholder receives; it does not state the taxable amount of a distribution. The taxable amount of a distribution is contingent on the shareholder's stock basis. It is not the corporation's responsibility to track a shareholder's stock and debt basis but rather it is the shareholder's responsibility.

If a shareholder receives a non-dividend distribution from an S corporation, the distribution is tax-free to the extent it does not exceed the shareholder's stock basis. Debt basis is not considered when determining the taxability of a distribution.

If a shareholder is allocated an item of S corporation loss or deduction, the shareholder must first have adequate stock and/or debt basis to claim that loss and/or deduction item. In addition, it is important to remember that, even when the shareholder has adequate stock and/or debt basis to claim the S corporation loss or deduction item, the shareholder must also consider the at-risk and passive activity loss limitations and therefore may not be able to claim the loss and/or deduction item. It is important that a shareholder know his or her stock basis when:

- **The S corporation allocates a loss and/or deduction item to the shareholder -** In order for the shareholder to claim a loss, they need to demonstrate they have adequate stock and/or debt basis.
- **The S corporation makes a non-dividend distribution to the shareholder -** In order for the shareholder to determine whether or not the distribution is non-taxable they need to demonstrate they have adequate stock basis.
- **The shareholder disposes of their stock -** As with any asset, including C corporation stock, when the asset is sold or disposed of, basis needs to be established in order to reflect the proper gain or loss on the disposition.

Since basis changes every year, it must be computed every year.

In computing stock basis, the shareholder starts with their initial capital contribution to the S corporation or the initial cost of the stock they purchased (the same as a C corporation). That amount is then increased and/or decreased based on the flow-through amounts from the S corporation. An income item will increase stock basis while a loss, deduction or distribution will decrease stock basis.

Additional S Corporation Information

- A non-dividend distribution in excess of stock basis is taxed as a capital gain on the shareholder's personal return. Stock held for longer than one year is a long-term capital gain (LTCG).
- Non-deductible expenses reduce a shareholder's stock and/or debt basis before loss and deduction items. If non-deductible expenses exceed stock and/or debt basis, they are not suspended and carried forward.
- If the current year has different types of loss and deduction items, which exceed stock and/or debt basis, the allowable loss and deduction items must be allocated pro rata based on the size of the particular loss and deduction items.
- A shareholder is not allowed to claim loss and deduction items in excess of stock and/or debt basis. Loss and deduction items not allowable in the current year are suspended due to basis limitations.
- Suspended losses and deductions due to basis limitations retain their character in subsequent years. Any suspended loss or deduction items in excess of stock and/or debt basis are carried forward indefinitely.
- In determining current year allowable losses, current year loss and deduction items are combined with the suspended loss and deduction items carried over from the prior year, though the current year and suspended items should be separately stated on the Form 1040 Schedule E or other appropriate schedule on the return.
- A shareholder is only allowed debt basis to the extent he or she has personally lent money to the S corporation. A loan guarantee is not sufficient to allow the shareholder debt basis.
- If a shareholder contends he or she has contributed or loaned substantial funds to the S corporation, consideration should be given to whether the shareholder had the financial means to make the contribution or loan.
- Part or all of the repayment of a reduced basis debt is taxable to the shareholder.
- If a shareholder sells their stock, suspended losses due to basis limitations are lost. Any gain on the sale of the stock does not increase the shareholder's stock basis. A stock basis computation should be reviewed in the year stock is sold or disposed of.

Termination of Election

Once the election is made, it stays in effect until it is terminated. If the election is terminated, the corporation (or a successor corporation) can make another election on Form 2553 only with IRS consent for any tax year before the 5th tax year after the first tax year in which the termination took effect. See Regulations Section 1.1362-5 for details. An election terminates automatically in any of the following cases: [36]

1. The corporation is no longer a small business corporation as defined in Section 1361(b). This kind of termination of an election is effective as of the day the corporation no longer meets the definition of a small business corporation. Attach to Form 1120S for the final year of the S corporation a statement notifying the IRS of the termination and the date it occurred.
2. The corporation, for each of three consecutive tax years, (a) has accumulated earnings and profits and (b) derives more than 25% of its gross receipts from passive investment income as defined in Section 1362(d)(3)(C). The election terminates on the first day of the first tax year beginning after the third consecutive tax year. The corporation must pay a tax for each year it has excess net passive income. See the line 22a instructions for details on how to figure the tax.
3. The election is revoked. An election can be revoked only with the consent of shareholders who, at the time the revocation is made, hold more than 50% of the number of issued and outstanding shares of stock (including non-voting stock). The revocation can specify an effective revocation date that is on or after the day the revocation is filed. If no date is specified, the revocation is effective at the start of the tax year if the revocation is made on or before the 15th day of the 3rd month of that tax year. If no date is specified and the revocation is made after the 15th day of the 3rd month of the tax year, the revocation is effective at the start of the next tax year.

To revoke the election, the corporation must file a statement with the appropriate service center listed under Where To File in the Instructions for Form 2553. In the statement, the corporation must notify the IRS that it is revoking its election to be an S corporation. The statement must be signed by each shareholder who consents to the revocation and contain the information required by Regulations Section 1.1362-6(a)(3).

Limited Liability Company (LLC)

A limited liability company (LLC) is a business entity organized in the United States under state law. Unlike a partnership, all of the members of an LLC have limited personal liability for its debts. An LLC may be classified for Federal income tax purposes as a partnership, corporation, or an entity disregarded as separate from its owner by applying the rules in Regulations Section 301.7701-3.

A Limited Liability Company (LLC) is a business structure allowed by state statute. Each state may use different regulations, and the taxpayer should check with his or her state if he or she is interested in starting a Limited Liability Company.

Owners of an LLC are called members. Most states do not restrict ownership, and so members may include individuals, corporations, other LLCs and foreign entities. There is no maximum number of members. Most states also permit “single-member” LLCs, those having only one owner.

A few types of businesses generally cannot be LLCs, such as banks and insurance companies. Check the taxpayer’s state’s requirements and the Federal tax regulations for further information. There are special rules for foreign LLCs.

Classifications

Depending on elections made by the LLC and the number of members, the IRS will treat an LLC as either a corporation, partnership, or as part of the LLC’s owner’s tax return (a “disregarded entity”). Specifically, a domestic LLC with at least two members is classified as a partnership for Federal income tax purposes unless it files Form 8832 - Entity Classification Election and affirmatively elects to be treated as a corporation. And an LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes), unless it files Form 8832 and affirmatively elects to be treated as a corporation.

LLCs Classified as Partnerships

If an LLC has at least two members and is classified as a partnership, it generally must file Form 1065, U.S. Return of Partnership Income. Generally, an LLC classified as a partnership is subject to the same filing and reporting requirements as partnerships. For certain purposes, members of an LLC are treated as limited partners in a limited partnership. For example, LLC members are treated as limited partners for purposes of material participation under the passive activity limitation rules (see Temporary Regulation Section 1.469-5T(e)).

LLCs Classified as Disregarded Entities

If an LLC has only one member and is classified as an entity disregarded as separate from its owner, its income, deductions, gains, losses, and credits are reported on the owner's income tax return. For example, if the owner of the LLC is an individual, the LLC's income and expenses would be reported on the following schedules filed with the owner's Form 1040:

- Schedule C, Profit or Loss from Business (Sole Proprietorship).
- Schedule E, Supplemental Income and Loss.
- Schedule F, Profit or Loss From Farming.

LLCs Classified as Corporations

An LLC with either a single member or more than one member can elect to be classified as a corporation rather than be classified as a partnership or disregarded entity under the default rules. The taxpayer should file Form 8832 - Entity Classification Election, to elect classification as a C corporation. He or she should file Form 2553 - Election by a Small Business Corporation, to elect classification as an S corporation. LLCs electing classification as an S corporation are not required to file Form 8832 to elect classification as a corporation before filing Form 2553. By filing Form 2553, an LLC is deemed to have elected classification as a corporation in addition to the S corporation classification.

If the LLC elects to be classified as a corporation by filing Form 8832, a copy of the LLC's Form 8832 must be attached to the Federal income tax return of each direct and indirect owner of the LLC for the tax year of the owner that includes the date on which the election took effect.

If the LLC is classified as a corporation, it must file a corporation income tax return. If it is a C corporation, it is taxed on its taxable income and distributions to the members are includible in the members' gross income to the extent of the corporation's earnings and profits (double taxation). If it is an S corporation, the corporation is generally not subject to any income tax and the income, deductions, gains, losses, and credits of the corporation “pass through” to the members.

Corporations generally file either: (37)

- Form 1120 - U.S. Corporation Income Tax Return.
- Form 1120S - U.S. Income Tax Return for an S Corporation.

Effective Date of Election

An LLC that does not want to accept its default Federal tax classification, or that wishes to change its classification, uses Form 8832 - Entity Classification Election, to elect how it will be classified for Federal tax purposes. Generally, an election specifying an LLC’s classification cannot take effect more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date the election is filed. An LLC may be eligible for late election relief in certain circumstances. See Form 8832 General Instructions for more information.

Subsequent Elections

An LLC can elect to change its classification. Generally, once an LLC has elected to change its classification, it cannot elect again to change its classification during the 60 months after the effective date of the election. An election by a newly formed LLC that is effective on the date of formation is not considered a change for purposes of this limitation. For more information and exceptions, see Regulations Section 301.7701-3(c) and the Form 8832 instructions.

An election to change classification can have significant tax consequences based on the following transactions that are deemed to occur as a result of the election.

An election to change classification from a partnership to a corporation will be treated as if the partnership contributed all of its assets and liabilities to the corporation in exchange for stock and the partnership then immediately liquidated by distributing the stock to its partners.

An election to change classification from a corporation to a partnership will be treated as if the corporation distributed all of its assets and liabilities to its shareholders in liquidation and the shareholders then immediately contributed all of the distributed assets and liabilities to a new partnership.

An election to change classification from a corporation to a disregarded entity will be treated as if the corporation distributed all of its assets and liabilities to its single owner in liquidation.

An election to change classification from a disregarded entity to a corporation will be treated as if the owner of the disregarded entity contributed all of the assets and liabilities to the corporation in exchange for stock.

Business Tax Preparation

Business Income

Business income is income received from the sale of products or services. For example, fees received by a professional person are considered business income. Rents received by a person in the real estate business are business income. Payments received in the form of property or services must be included in income at their fair market value.

Normally a business is organized as a sole proprietorship, partnership, or corporation. A sole proprietorship is an unincorporated business owned by an individual. A sole proprietorship has no existence apart from its owner. Business debts are personal debts of the owner. A limited liability company (LLC) with one individual owner generally is treated as a sole proprietorship for Federal income tax purposes, unless the owner elects to treat the LLC as a corporation. A sole proprietor files Form 1040, Schedule C - Profit or Loss From Business, to report the income and expenses of the business. A sole proprietor who had net earnings (from Schedule C excluding church employee income) of $400 or more or had church employee income of $108.28 or more must file Form 1040, Schedule SE - Self-Employment Tax. Schedule SE is used to figure self-employment tax, which is the combined Social Security and Medicare tax on self-employment income.

A partnership is an unincorporated business organization that is the result of two or more persons joining together to carry on a trade or business. Each person contributes money, property, services, or a combination thereof, in return for a right to share in the profits and losses of the partnership. An LLC with more than one owner is generally treated as a partnership for tax purposes. A partnership's income and expenses are generally reported on Form 1065 - U.S. Return of Partnership Income, annually. No income tax is paid by the partnership itself. Each partner receives a Form 1065, Schedule K-1 - Partner's Share of Income, Deductions, Credits, etc., which indicates the partner's distributive share of partnership income, expenses, and other items, determined in accordance with the terms of the partnership agreement. Partners report on their income tax returns the amounts reported on the Schedule K-1.

The term "corporation," for Federal income tax purposes, generally includes legal entities separate from the people who formed them under Federal or state law or the shareholders who own them. It also includes certain businesses that elect to be taxed as a corporation by filing Form 8832 - Entity Classification Election. The tax on a corporation's income is figured on Form 1120 - U.S. Corporation Income Tax Return. Corporations that meet certain requirements may elect to become S corporations, which are treated in a manner similar to partnerships.

An S corporation files Form 1120S - U.S. Income Tax Return for an S Corporation, and is generally not subject to tax. Most income and expenses of an S corporation are "passed through" to the shareholders on Form 1120S, Schedule K-1 - Shareholder's Share of Income, Deductions, Credits, etc. The shareholders report on their income tax returns the amounts indicated on the Schedules K-1.

Sole Proprietor Filing Information

Cost of Goods Sold

If the taxpayer makes or buys goods to sell, he or she can deduct the cost of goods sold from gross receipts on Schedule C. However, to determine these costs, the taxpayer must value the taxpayer’s inventory at the beginning and end of each tax year.

Figure the taxpayer’s cost of goods sold by filling out lines 35 through 42 of Schedule C. These lines are reproduced below.

35 - Inventory at beginning of year. If different from last year's closing inventory, attach explanation.
36 - Purchases less cost of items withdrawn for personal use.

37 - Cost of labor. Do not include any amounts paid to the taxpayer.
38 - Materials and supplies.
39 - Other costs.
40 - Add lines 35 through 39.
41 - Inventory at end of year.
42 - Cost of goods sold. Subtract line 41 from line 40.

If the taxpayer contributes inventory (property that he or she sells in the course of his or her business), the amount the taxpayer can claim as a contribution deduction is the smaller of its fair market value on the day he or she contributed it or its basis. The basis of donated inventory is any cost incurred for the inventory in an earlier year that the taxpayer would otherwise include in opening inventory for the year of the contribution. The taxpayer must remove the amount of the contribution deduction from opening inventory. It is not part of the cost of goods sold.

If the cost of donated inventory is not included in opening inventory, the inventory's basis is zero and the taxpayer cannot claim a charitable contribution deduction. Treat the inventory's cost as the taxpayer would ordinarily treat it under his or her method of accounting. For example, include the purchase price of inventory bought and donated in the same year in the cost of goods sold for that year. (23)

Items Generally Included in Inventory

The taxpayer should include the following items when accounting for inventory: (3)

1. Merchandise or stock in trade.
2. Raw materials.
3. Work in process.
4. Finished products.
5. Supplies that physically become a part of the item intended for sale.

Containers such as kegs, bottles, and cases, regardless of whether they are on hand or returnable, should be included in inventory if title has not passed to the buyer of the contents. If title has passed to the buyer, exclude the containers from inventory.

The following merchandise should be included in inventory: (3)

- Purchased merchandise if title has passed to the taxpayer, even if the merchandise is in transit or the taxpayer does not have physical possession for another reason.
- Goods under contract for sale that the taxpayer has not yet segregated and applied to the contract
- Goods out on consignment.
- Goods held for sale in display rooms, merchandise mart rooms, or booths located away from the taxpayer’s place of business.

The taxpayer does not include the following merchandise in inventory: (3)

- Goods he or she has sold, but only if title has passed to the buyer.
- Goods consigned to the taxpayer.
- Goods ordered for future delivery if the taxpayer does not yet have title.

Assets - Do not include in inventory assets such as: (3)

- Land, buildings, and equipment used in the taxpayer’s business.
- Notes, accounts receivable, and similar assets.
- Supplies that do not physically become part of the item intended for sale.

The three elements of work-in-process consist of: (3)

1. **Direct Materials** - Materials that become an integral part of the finished product, are consumed in the manufacturing process and are identified with specific units or processes.

2. **Direct Labor** - Labor which can be associated with particular units. Labor includes basic compensation, overtime pay, vacation and holiday pay, sick leave pay, and payroll taxes.
3. **Indirect Costs** - Costs necessary for production other than direct production costs. Indirect costs include variable and fixed overhead. They may be classified as to type for identification with various activities and to facilitate groupings for determining unit costs. Under prior law, manufacturers were required to comply with the full absorption rules under Section 1.471-11 of the Regulations. The full absorption rules provided three categories of indirect costs associated with production activities.

Valuing Inventory

The value of the taxpayer's inventory is a major factor in figuring his or her taxable income. The method he or she uses to value the inventory is very important. The following methods are those generally available for valuing inventory:

1. Cost.
2. Lower of cost or market.
3. Retail.

Once a method is chosen, it may not be changed to another method without consent from the IRS. (3)

FIFO Method

The FIFO (first-in first-out) method assumes the items the taxpayer purchased or produced first are the first items he or she sold, consumed, or otherwise disposed of. The items in inventory at the end of the tax year are matched with the costs of similar items that he or she most recently purchased or produced.

LIFO Method

The LIFO (last-in first-out) method assumes the items of inventory the taxpayer purchased or produced last are the first items he or she sold, consumed, or otherwise disposed of. Items included in closing inventory are considered to be from the opening inventory in the order of acquisition and from those acquired during the tax year.

Each method produces different income results, depending on the trend of price levels at the time. In times of inflation, when prices are rising, LIFO will produce a larger cost of goods sold and a lower closing inventory. Under FIFO, the cost of goods sold will be lower and the closing inventory will be higher. However, in times of falling prices, the opposite will hold.

Uniform Capitalization (UNICAP)

The uniform capitalization (UNICAP) rules require the capitalization of all direct costs and certain indirect costs properly allocable to real property and tangible personal property produced by the taxpayer. For purposes of the uniform capitalization rules, to "produce" means to construct, build, install, manufacture, develop, improve, create, raise or grow. Self-constructed assets and property built under contract are treated as property "produced" by the taxpayer and the rules under IRC Section 263A(a) govern.

In addition, Section 263A(f) requires the capitalization of interest expense when the taxpayer produces certain property. The interest capitalization rules under Treasury Regulation Section 1.263A-8 contain precise definitions of designated property and include inherently permanent structures in the definition of real property. In summary, all real property and certain tangible personal property are subject to the interest capitalization rules. Therefore, any change in the allocation of costs between real and tangible personal property may have an impact on the amount of capitalized interest.

Many taxpayers attempt to exclude all Section 1245 property from interest capitalization arguing that the Section 1245 property is tangible personal property that does not meet the classification thresholds of Treasury Regulation Section 1.263A-8(b)(1). Most of the Section 1245 property in these situations are inherently permanent structures (real property) subject to interest capitalization without any restrictions. (38)

Business Expenses, Deductions and Credits

A taxpayer can deduct the costs of operating his or her business. These costs are known as business expenses. These are costs the taxpayer does not have to capitalize or include in the cost of goods sold but can deduct in the current year.

To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the taxpayer's field of business. A necessary expense is one that is helpful and appropriate for his or her business. An expense does not have to be indispensable to be considered necessary.

Employee Pay

To be deductible, an employee's pay must be an ordinary and necessary business expense and the employer must pay or incur it. In addition, the pay must meet both of the following tests: (39)

- **Test 1** - It must be reasonable.
- **Test 2** - It must be for services performed.

The form or method of figuring the pay does not affect its deductibility. For example, bonuses and commissions based on sales or earnings, and paid under an agreement made before the services were performed, are both deductible.

Test 1 - Reasonableness

The employer must be able to prove that the pay is reasonable. Whether the pays is reasonable depends on the circumstances that existed when he or she contracted for the services, not those that exist when reasonableness is questioned. If the pay is excessive, the excess pay is disallowed as a deduction. The employer should determine the reasonableness of pay by the facts and circumstances. Generally, reasonable pay is the amount that a similar business would pay for the same or similar services. To determine if pay is reasonable, also consider the following items and any other pertinent facts: (39)

- The duties performed by the employee.
- The volume of business handled.
- The character and amount of responsibility.
- The complexities of the business.
- The amount of time required.
- The cost of living in the locality.
- The ability and achievements of the individual employee performing the service.
- The pay compared with the gross and net income of the business, as well as with distributions to shareholders if the business is a corporation.
- The employer's policy regarding pay for all his or her employees.
- The history of pay for each employee.

Test 2 - For Services Performed

The employer must be able to prove the payment was made for services actually performed. For example, if a corporation pays an employee who is also a shareholder a salary that is unreasonably high considering the services actually performed, the excessive part of the salary may be treated as a constructive dividend to the employee-shareholder. The excessive part of the salary would not be allowed as a salary deduction by the corporation.

Supplemental Wages

Supplemental wages are wage payments to an employee that are not regular wages. They include, but are not limited to, bonuses, commissions, overtime pay, payments for accumulated sick leave, severance pay, awards, prizes, back pay, retroactive pay increases, and payments for nondeductible moving expenses. Other payments subject to the supplemental wage rules include taxable fringe benefits and expense allowances paid under a nonaccountable plan. How the employer withholds on supplemental wages depends on whether the supplemental payment is identified as a separate payment from regular wages.

Bad Debts

If someone owes a taxpayer money that he or she cannot collect, the taxpayer has a bad debt. There are two kinds of bad debts, business bad debts and nonbusiness bad debts.

A business bad debt is generally one that comes from operating the taxpayer's trade or business. He or she may be able to deduct business bad debts as an expense on his or her business tax return. A business bad debt is a loss from the worthlessness of a debt that was either of the following:

- Created or acquired in the taxpayer's business.
- Closely related to the taxpayer's business when it became partly or totally worthless.

A debt is closely related to the taxpayer's business if his or her primary motive for incurring the debt is a business reason.

Business bad debts are mainly the result of credit sales to customers. They can also be the result of loans to suppliers, clients, employees, or distributors. Goods and services customers have not paid for are shown in the taxpayer's books as either accounts receivable or notes receivable. If the taxpayer is unable to collect any part of these accounts or notes receivable, the uncollectible part is a business bad debt.

Travel, Entertainment, Meals, and Gifts

For 2020, the treatment of certain meals and entertainment expenses was changed. In general, entertainment expenses are no longer deductible. The cost of business meals generally remains deductible, subject to the 50% limitation.

Travel Expenses

Travel expenses are the ordinary and necessary expenses of traveling away from home for the taxpayer's business, profession, or job. An ordinary expense is one that is common and accepted in the taxpayer's trade or business. A necessary expense is one that is helpful and appropriate for his or her business. An expense does not have to be required to be considered necessary. The taxpayer is traveling away from home if both the following conditions are met:

- His or her duties require him or her to be away from the general area of his or her tax home substantially longer than an ordinary day's work.
- The taxpayer needs to get sleep or rest to meet the demands of his or her work while away from home.

Generally, the tax home is the regular place of business, regardless of where the taxpayer maintains his or her family home. It includes the entire city or general area in which the business is located. If the taxpayer does not have a regular or main place of business or post of duty and there is no place where he or she regularly lives, he or she is considered an itinerant (a transient) and his or her tax home is wherever he or she works. As an itinerant, the taxpayer cannot claim a travel expense deduction because he or she is never considered to be traveling away from home.

If the taxpayer has more than one place of work, consider the following when determining which one is his or her main place of business or work.

- The total time he or she ordinarily spends in each place.
- The level of his or her business activity in each place.
- Whether his or her income from each place is significant or insignificant.

The taxpayer may have a tax home even if he or she does not have a regular or main place of work. His or her tax home may be the home where he or she regularly lives.

The following table summarizes expenses the taxpayer can deduct when he or she travels away from home for business purposes.

Travel Expenses the Taxpayer Can Deduct	
IF the taxpayer has expenses for...	**THEN he or she can deduct the cost of...**
Transportation	Travel by airplane, train, bus, or car between his or her home and his or her business destination. If he or she was provided with a free ticket or he or she is riding free as a result of a frequent traveler or similar program, his or her cost is zero.
Taxi, commuter bus, and airport limousine	Fares for these and other types of transportation that take him or her between: • The airport or station and his or her hotel; and • The hotel and the work location of his or her customers or clients, his or her business meeting place, or his or her temporary work location.
Baggage and shipping	Sending baggage and sample or display material between his or her regular and temporary work locations.
Car	Operating and maintaining his or her car when traveling away from home on business. He or she can deduct actual expenses or the standard mileage rate, as well as business-related tolls and parking. If he or she rents a car while away from home on business, he or she can deduct only the business-use portion of the expenses.
Lodging and meals	His or her lodging and non-entertainment-related meals if his or her business trip is overnight or long enough that he or she needs to stop for sleep or rest to properly perform his or her duties. Meals include amounts spent for food, beverages, taxes, and related tips.
Cleaning	Dry cleaning and laundry.
Telephone	Business calls while on his or her business trip. This includes business communication by fax machine or other communication devices.
Tips	Tips he or she pays for any expenses in this table.
Other	Other similar ordinary and necessary expenses related to his or her business travel. These expenses might include transportation to or from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.

Table 6-1 - Publication 463 - Table 1-1 - Travel Expenses You Can Deduct (2020)

Elimination of Entertainment Expenses

Ordinary and necessary business expenses are generally deductible, whereas personal consumption expenses are not. Under previous law an entertainment event, such as attendance at a professional sports event, can constitute a deductible business expense rather than an item of personal consumption if the expenditure is business-oriented and it is ordinary and necessary in nature.

The Tax Cuts and Jobs Act (TCJA) provides that effective for amounts incurred or paid after December 31, 2017, no deduction will be allowed for:

- An activity generally considered to be entertainment, amusement or recreation.
- Membership dues paid to any club organized for business, pleasure, recreation or other social purposes.
- A facility or any portion of a facility used in connection with entertainment, amusement or recreation.

Therefore, the TCJA repeals the exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to the active conduct of the taxpayer's trade or business. The new law also repeals the related rule applying a 50% limit to such deductions. Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Examples include entertaining guests at nightclubs; at social, athletic, and sporting clubs; at theaters; at sporting events; on yachts; or on hunting, fishing, vacation, and similar trips. Entertainment also may include meeting personal, living, or family needs of individuals, such as providing meals, a hotel suite, or a car to customers or their families.

If the taxpayer has one expense that includes the costs of entertainment and other services (such as lodging or transportation), he or she must allocate that expense between the cost of entertainment and the cost of other services. The taxpayer must have a reasonable basis for making this allocation. For example, he or she must allocate his or her expenses if a hotel includes entertainment in its lounge on the same bill with his or her room charge.

Meals

Taxpayers may still generally deduct 50% of the food and beverage expenses associated with operating their trade or business. For example, employers may deduct expenses incurred to provide meals consumed by employees on work travel. The taxpayer can also deduct the cost of meals if it is necessary for him or her to stop for substantial sleep or rest to properly perform his or her duties while traveling away from home on business.

The taxpayer cannot deduct expenses for meals that are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable based on the facts and circumstances. Meal expenses will not be disallowed merely because they are more than a fixed dollar amount or because the meals take place at deluxe restaurants, hotels, or resorts.

Food and beverages that are provided during entertainment events are not considered entertainment if purchased separately from the entertainment, or if the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. However, the entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

The 50% limit applies to employees or their employers, and to self-employed persons (including independent contractors) or their clients, depending on whether the expenses are reimbursed. Examples of meals might include:

- Meals while traveling away from home (whether eating alone or with others) on business, or
- Meal at a business convention or business league meeting.

Taxes and tips relating to a business meal are included as a cost of the meal and are subject to the 50% limit. However, the cost of transportation to and from the meal is not treated as part of the cost and would not be subject to the limit.

The 50% limit will apply after determining the amount that would otherwise qualify for a deduction. The taxpayer first has to determine the amount of meal expenses that would be deductible under the other rules previously discussed.

Gift Expenses

A taxpayer can deduct no more than $25 for business gifts he or she gives directly or indirectly to each person during the tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift.

If the taxpayer gives a gift to a member of a customer's family, the gift is generally considered to be an indirect gift to the customer. This rule does not apply if the taxpayer has a bona fide, independent business connection with that family member and the gift is not intended for the customer's eventual use. If the taxpayer and his or her spouse both give gifts, both are treated as one taxpayer. It does not matter whether the taxpayers have separate businesses, are separately employed, or whether each has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

De Minimis (Minimal) Benefits

An employer can exclude the value of a de minimis benefit they provide to an employee from the employee's wages. A de minimis benefit is any property or service the employer provides to an employee that has so little value (taking into account how frequently the employer provides similar benefits to the employees) that accounting for it would be unreasonable or administratively impracticable. Cash and cash equivalent fringe benefits (for example, gift certificates, gift cards, and the use of a charge card or credit card), no matter how little, are never excludable as a de minimis benefit. However, meal money and local transportation fare, if provided on an occasional basis and because of overtime work, may be excluded.

Examples of de minimis benefits include the following:

- Personal use of an employer-provided cell phone provided primarily for noncompensatory business purposes.
- Occasional personal use of a company copying machine if the employer sufficiently controls its use so that at least 85% of its use is for business purposes.
- Holiday or birthday gifts, other than cash, with a low fair market value. Also, flowers or fruit or similar items provided to employees under special circumstances (for example, on account of illness, a family crisis, or outstanding performance).
- Group-term life insurance payable on the death of an employee's spouse or dependent if the face amount is not more than $2,000.
- Certain meals.
- Occasional parties or picnics for employees and their guests.
- Occasional tickets for theater or sporting events.
- Certain transportation fare.

Some examples of benefits that are not excludable as de minimis fringe benefits are season tickets to sporting or theatrical events; the commuting use of an employer-provided automobile or other vehicle more than 1 day a month; membership in a private country club or athletic facility, regardless of the frequency with which the employee uses the facility; and use of employer-owned or leased facilities (such as an apartment, hunting lodge, boat, etc.) for a weekend. If a benefit provided to an employee does not qualify as de minimis then generally the entire benefit must be included in income.

In determining whether a benefit is de minimis, the employer should always consider its frequency and its value. An essential element of a de minimis benefit is that it is occasional or unusual in frequency. It also must not be a form of disguised compensation.

Whether an item or service is de minimis depends on all the facts and circumstances. In addition, if a benefit is too large to be considered de minimis, the entire value of the benefit is taxable to the employee, not just the excess over a designated de minimis amount. The IRS has ruled previously in a particular case that items with a value exceeding $100 could not be considered de minimis, even under unusual circumstances.

If the benefits qualify for exclusion, no reporting is necessary. If they are taxable, they should be included in wages on Form W-2 and subject to income tax withholding. If the employees are covered for Social Security and Medicare, the value of the benefits are also subject to withholding for these taxes. The employer may optionally report any information in box 14 of Form W-2.

De Minimis Meals

The employer can exclude any occasional meal or meal money he or she provide to an employee if it has so little value (taking into account how frequently the employer provides meals to his or her employees) that accounting for it would be unreasonable or administratively impracticable.

The exclusion applies, for example, to the following items: [40]

- Coffee, doughnuts, or soft drinks.
- Occasional meals or meal money provided to enable an employee to work overtime. However, the exclusion does not apply to meal money figured on the basis of hours worked.
- Occasional parties or picnics for employees and their guests.

This exclusion also applies to meals the employer provides at an employer-operated eating facility for employees if the annual revenue from the facility equals or exceeds the direct costs of the facility. For this purpose, the employer's revenue from providing a meal is considered equal to the facility's direct operating costs to provide that meal if its value can be excluded from an employee's wages.

No-Additional-Cost Services

The no-additional-cost services exclusion applies to a service the employer provides to an employee if it does not cause the employer to incur any substantial additional costs. The service must be offered to customers in the ordinary course of the line of business in which the employee performs substantial services.

No-additional-cost services are excess capacity services, such as airline, bus, or train tickets; hotel rooms; or telephone services provided free, at a reduced price, or through a cash rebate to employees working in those lines of business. Services that are not eligible for treatment as no-additional-cost services are non-excess capacity services, such as the facilitation by a stock brokerage firm of the purchase of stock by employees. These services may however be eligible for a qualified employee discount of up to 20% of the value of the service provided.

To determine whether the employer incurs substantial additional costs to provide a service to an employee, count any lost revenue as a cost. The employer does not reduce the costs they incur by any amount the employee pays for the service. The employer is considered to incur substantial additional costs if they or their employees spend a substantial amount of time in providing the service, even if the time spent would otherwise be idle or if the services are provided outside normal business hours. (41)

Interest Expenses

Business interest expense is an amount charged for the use of money the taxpayer borrowed for business activities. The rules for deducting interest vary, depending on whether the loan proceeds are used for business, personal, or investment activities. If the taxpayer uses the proceeds of a loan for more than one type of expense, he or she must allocate the interest based on the use of the loan's proceeds. The taxpayer should allocate his or her interest expense to the following categories: (42)

- Nonpassive trade or business activity interest.
- Passive trade or business activity interest.
- Investment interest.
- Portfolio interest.
- Personal interest.

In general, the taxpayer allocates interest on a loan the same way he or she allocates the loan proceeds. The taxpayer allocates loan proceeds by tracing disbursements to specific uses.

The taxpayer can generally deduct as a business expense all interest he or she pays or accrues during the tax year on debts related to his or her trade or business. Interest relates to the trade or business if the taxpayer uses the proceeds of the loan for a trade or business expense. It does not matter what type of property secures the loan.

The taxpayer can deduct interest on a debt only if he or she meets all the following requirements: (42)

- The taxpayer is legally liable for that debt.
- Both the taxpayer and the lender intend that the debt be repaid.
- The taxpayer and the lender have a true debtor-creditor relationship.

If the taxpayer is liable for part of a business debt, he or she can deduct only his or her share of the total interest paid or accrued.

Certain interest payments cannot be deducted. In addition, certain other expenses that may seem to be interest but are not, cannot be deducted as interest. The taxpayer cannot currently deduct interest that must be capitalized, and he or she generally cannot deduct personal interest.

When To Deduct Interest

If the uniform capitalization rules do not apply deduct interest as follows:

- **Cash method** - Under the cash method, the taxpayer can generally deduct only the interest he or she actually paid during the tax year. The taxpayer cannot deduct a promissory note he or she gave as payment because it is a promise to pay and not an actual payment.
- **Prepaid interest** - The taxpayer generally cannot deduct any interest paid before the year it is due. Interest paid in advance can be deducted only in the tax year in which it is due.
- **Discounted loan** - If interest or a discount is subtracted from the taxpayer's loan proceeds, it is not a payment of interest and he or she cannot deduct it when he or she gets the loan.
- **Refunds of interest** - If the taxpayer pays interest and then receives a refund in the same tax year of any part of the interest, reduce his or her interest deduction by the refund. If the taxpayer receives the refund in a later tax year, include the refund in his or her income to the extent the deduction for the interest reduced his or her tax.
- **Accrual method** - Under an accrual method, the taxpayer can deduct only interest that has accrued during the tax year.

Under the Tax Cuts and Jobs Act (TCJA), for taxable years beginning after December 31, 2017, the deduction for business interest was limited to the sum of business income, floor plan financing interest, and 30% of the "adjusted taxable income" of the taxpayer for the taxable year, with the amount of disallowed interest generally carried forward indefinitely. However, the Coronavirus Aid, Relief, and Economic Security Act (CARES) increases that limit to 50% of adjusted taxable income for taxable years beginning in 2019 and 2020, thus allowing taxpayers to deduct more of their business interest. In addition, a business can elect to use its 2019 adjusted taxable income in computing its 2020 limitation if that would produce a greater interest deduction. In the case of a partnership, that election is made by the partnership.

Insurance Expenses

A taxpayer can generally deduct premiums he or she pays for the following kinds of insurance related to his or her business: (23)

1. Fire, theft, flood, or similar insurance.
2. Credit insurance that covers losses from business bad debts.
3. Group hospitalization and medical insurance for employees, including long-term care insurance.
4. Liability insurance.
5. Malpractice insurance that covers his or her personal liability for professional negligence resulting in injury or damage to patients or clients.
6. Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in his or her business, regardless of fault.
7. Contributions to a state unemployment insurance fund are deductible as taxes if they are considered taxes under state law.
8. Overhead insurance that pays for business overhead expenses the taxpayer has during long periods of disability caused by his or her injury or sickness.
9. Car and other vehicle insurance that covers vehicles used in his or her business for liability, damages, and other losses. If the taxpayer operates a vehicle partly for personal use, deduct only the part of the insurance premium that applies to the business use of the vehicle. If he or she uses the standard mileage rate to figure his or her car expenses, he or she cannot deduct any car insurance premiums.
10. Life insurance covering his or her employees if the taxpayer is not directly or indirectly the beneficiary under the contract.
11. Business interruption insurance that pays for lost profits if his or her business is shut down due to a fire or other cause.

The taxpayer cannot deduct premiums on the following kinds of insurance: (23)

- **Self-insurance reserve funds** - The taxpayer cannot deduct amounts credited to a reserve set up for self-insurance. This applies even if he or she cannot get business insurance coverage for certain business risks. However, the actual losses may be deductible.

- **Loss of earnings** - The taxpayer cannot deduct premiums for a policy that pays for his or her lost earnings due to sickness or disability. However, see item (8) in the previous list.
- **Certain life insurance and annuities**:
  - For contracts issued before June 9, 1997, the taxpayer cannot deduct the premiums on a life insurance policy covering him or her, an employee, or any person with a financial interest in his or her business if the taxpayer is directly or indirectly a beneficiary of the policy. The taxpayer is included among possible beneficiaries of the policy if the policy owner is obligated to repay a loan from him or her using the proceeds of the policy. A person has a financial interest in his or her business if the person is an owner or part owner of the business or has lent money to the business.

  - For contracts issued after June 8, 1997, the taxpayer generally cannot deduct the premiums on any life insurance policy, endowment contract, or annuity contract if he or she is directly or indirectly a beneficiary. The disallowance applies without regard to whom the policy covers.
- **Insurance to secure a loan** - If the taxpayer takes out a policy on his or her life or on the life of another person with a financial interest in his or her business to get or protect a business loan, he or she cannot deduct the premiums as a business expense. Nor can the taxpayer deduct the premiums as interest on business loans or as an expense of financing loans. In the event of death, the proceeds of the policy are not taxed as income even if they are used to liquidate the debt.

Tip

A self-employed taxpayer may be able to deduct the amount he or she paid for medical and dental insurance and qualified long-term care insurance for him or herself and his or her family.

Generally, the taxpayer can use the worksheet in the Form 1040 instructions to figure his or her deduction. However, if any of the following apply, the taxpayer must use the worksheet in chapter 6 of Publication 535: (23)

- The taxpayer has more than one source of income subject to self-employment tax.
- The taxpayer files Form 2555 or Form 2555-EZ (relating to foreign earned income).
- The taxpayer is using amounts paid for qualified long-term care insurance to figure the deduction.

The taxpayer cannot deduct expenses in advance, even if he or she pays them in advance. This rule applies to any expense paid far enough in advance to, in effect, create an asset with a useful life extending substantially beyond the end of the current tax year.

Miscellaneous Expenses

Advertising Expenses

The taxpayer generally can deduct reasonable advertising expenses that are directly related to his or her business activities. Generally, the taxpayer cannot deduct amounts paid to influence legislation (i.e., lobbying). The taxpayer can usually deduct as a business expense the cost of institutional or goodwill advertising to keep his or her name before the public if it relates to business he or she reasonably expects to gain in the future. For example, the cost of advertising that encourages people to contribute to the Red Cross, to buy U.S. Savings Bonds, or to participate in similar causes is usually deductible. (16)

Charitable Contributions

Cash payments to an organization, charitable or otherwise, may be deductible as business expenses if the payments are not charitable contributions or gifts and are directly related to the taxpayer's business. If the payments are charitable contributions or gifts, he or she cannot deduct them as business expenses. However, corporations (other than S corporations) can deduct charitable contributions on their income tax returns, subject to limitations. See the Instructions for Form 1120 for more information. Sole proprietors, partners in a partnership, or shareholders in an S corporation may be able to deduct charitable contributions made by their business on Schedule A (Form 1040).

A corporation may deduct qualified contributions of up to 25% of its taxable income. Figure taxable income for this purpose without the following: (28)

1. The deduction for charitable contributions.

2. The dividends-received deduction.
3. The deduction allowed under Section 249 of the Internal Revenue Code.
4. The domestic production activities deduction.
5. Any net operating loss carryback to the tax year.
6. Any capital loss carryback to the tax year.

The taxpayer can carry over, within certain limits, to each of the subsequent 5 years any charitable contributions made during the current year that exceed the 25% limit. He or she loses any excess not used within that period. For example, if a corporation has a carryover of excess contributions paid 2019 and it does not use all the excess on its return for 2020, it can carry any excess over to 2021, 2022, 2023, and 2024, if applicable. Any excess not used in 2024 is lost. Do not deduct a carryover of excess contributions in the carryover year until after the taxpayer deducts contributions made in that year (subject to the 25% limit). The taxpayer cannot deduct a carryover of excess contributions to the extent it increases a net operating loss carryover.

The Coronavirus Aid, Relief, and Economic Security Act (CARES) changes the limitations on deductions for certain cash contributions during 2020. For corporations, the 10% limitation is increased to 25%. The Act also increases the limitation on deductions for contributions of food inventory from 15% to 25%.

Credit Card Convenience Fees

Credit card companies charge a fee to businesses who accept their cards. This fee when paid or incurred by the business can be deducted as a business expense.

Demolition Expenses or Losses

Amounts paid or incurred to demolish a structure are not deductible. These amounts are added to the basis of the land where the demolished structure was located. Any loss for the remaining undepreciated basis of a demolished structure would not be recognized until the property is disposed of.

Franchise, Trademark, Trade Name

If the taxpayer buys a franchise, trademark, or trade name, he or she can deduct the amount he or she pays or incurs as a business expense only if his or her payments are part of a series of payments that are:

1. Contingent on productivity, use, or disposition of the item.
2. Payable at least annually for the entire term of the transfer agreement.
3. Substantially equal in amount (or payable under a fixed formula).

When determining the term of the transfer agreement, include all renewal options and any other period for which the taxpayer and the transferrer reasonably expect the agreement to be renewed. A franchise includes an agreement that gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities within a specified area.

Internet-Related Expenses

Generally, the taxpayer can deduct internet-related expenses including domain registrations fees and webmaster consulting costs. If he or she is starting a business, he or she may have to amortize these expenses as start-up costs.

Taxes

The taxpayer can deduct on Schedule C various Federal, state, local, and foreign taxes directly attributable to his or her business:

- **Income taxes** - The taxpayer can deduct income taxes on Schedule C a state tax on gross income (as distinguished from net income) directly attributable to his or her business. The taxpayer can deduct other state and local income taxes on Schedule A (Form 1040) if he or she itemizes the deductions. The taxpayer cannot deduct Federal income tax.

- **Employment taxes** - The taxpayer can deduct the Social Security, Medicare, and Federal unemployment (FUTA) taxes he or she paid out of his or her own funds as an employer. The taxpayer can also deduct payments he or she made as an employer to a state unemployment compensation fund or to a state disability benefit fund. Deduct these payments as taxes.
- **Self-employment tax** - The taxpayer can deduct the employer-equivalent portion of his or her self-employment tax on line 14 of Schedule 1 (Form 1040).
- **Personal property tax** - The taxpayer can deduct on Schedule C any tax imposed by a state or local government on personal property used in his or her business.
- **Registration fees** - The taxpayer can also deduct registration fees for the right to use property within a state or local area.
- **Real estate taxes** - The taxpayer can deduct on Schedule C the real estate taxes he or she pays on his or her business property. Deductible real estate taxes are any state, local, or foreign taxes on real estate levied for the general public welfare. The taxing authority must base the taxes on the assessed value of the real estate and charge them uniformly against all property under its jurisdiction.
- **Sales tax** - Treat any sales tax the taxpayer pays on a service or on the purchase or use of property as part of the cost of the service or property. If the service or the cost or use of the property is a deductible business expense, he or she can deduct the tax as part of that service or cost. If the property is merchandise bought for resale, the sales tax is part of the cost of the merchandise. If the property is depreciable, add the sales tax to the basis for depreciation. (Do not deduct state and local sales taxes imposed on the buyer that he or she must collect and pay over to the state or local government. Do not include these taxes in gross receipts or sales.)
- **Excise taxes** - The taxpayer can deduct on Schedule C all excise taxes that are ordinary and necessary expenses of carrying on his or her business.
- **Fuel taxes** - Taxes on gasoline, diesel fuel, and other motor fuels the taxpayer uses in his or her business are usually included as part of the cost of the fuel. Do not deduct these taxes as a separate item.

Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real estate levied for the general public welfare. The taxing authority must base the taxes on the assessed value of the real estate and charge them uniformly against all property under its jurisdiction. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of the property.

Generally, the taxpayer cannot deduct taxes charged for local benefits and improvements that tend to increase the value of his or her property. These include assessments for streets, sidewalks, water mains, sewer lines, and public parking facilities. The taxpayer should increase the basis of his or her property by the amount of the assessment.

The taxpayer can deduct taxes for these local benefits only if the taxes are for maintenance, repairs, or interest charges related to those benefits. If part of the tax is for maintenance, repairs, or interest, the taxpayer must be able to show how much of the tax is for these expenses to claim a deduction for that part of the tax.

Example
To improve downtown commercial business, Waterfront City converted a downtown business area street into an enclosed pedestrian mall. The city assessed the full cost of construction, financed with 10-year bonds, against the affected properties. The city is paying the principal and interest with the annual payments made by the property owners.

The assessments for construction costs are not deductible as taxes or as business expenses but are depreciable capital expenses. The part of the payments used to pay the interest charges on the bonds is deductible as taxes.

Employment Taxes

Employers must deposit and report employment taxes. Also, at the end of the year, the employer must prepare and file Form W-2 -Wage and Tax Statement to report wages, tips and other compensation paid to an employee. Use Form W-3 - Transmittal of Wage and Tax Statements to transmit Forms W-2 to the Social Security Administration.

Federal Income Tax

Employers generally must withhold Federal income tax from employees' wages. To figure out how much tax to withhold, use the employee's Form W-4 and the withholding tables described in Publication 15 - Employer's Tax Guide. The employer must deposit his or her withholdings. The requirements for depositing vary based on the business and the amount the employer withholds.

Social Security and Medicare Taxes

Employers generally must withhold part of Social Security and Medicare taxes from employees' wages and pay a matching amount. To figure how much to withhold from each wage payment use the employee's Form W-4 and the methods described in Publication 15 - Employer's Tax Guide. The employer must deposit the wages he or she withholds.

For 2020, the employee tax rate for Social Security increased to 6.2%. The Social Security wage base limit increases to $137,700.

Additional Medicare Tax

As of January 1, 2013, employers are responsible for withholding the 0.9% Additional Medicare Tax on an employee's wages and compensation that exceeds a threshold amount based on the employee's filing status. The employer is required to begin withholding Additional Medicare Tax in the pay period in which it pays wages and compensation in excess of the threshold amount to an employee. There is no employer match for the Additional Medicare Tax.

Federal Unemployment Tax Act (FUTA)

Employers report and pay FUTA tax separately from Federal Income tax, and Social Security and Medicare taxes. The employer pays FUTA tax only from his or her own funds. Employees do not pay this tax, or have it withheld from their pay.

Self-Employment Tax

Self-Employment Tax (SE tax) is a Social Security and Medicare tax primarily for individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most employees.

Excise Tax

Excise taxes are taxes paid when purchases are made on a specific good, such as gasoline. Excise taxes are often included in the price of the product. There are also excise taxes on activities, such as on wagering or on highway usage by trucks. Excise Tax has several general excise tax programs. One of the major components of the excise program is motor fuel. A taxpayer can deduct as a business expense all excise taxes that are ordinary and necessary expenses of carrying on his or her trade or business. Generally, taxes on gasoline, diesel fuel, and other motor fuels that a taxpayer uses in his or her business are included as part of the cost of the fuel. The taxpayer should not deduct these taxes as a separate item.

The taxpayer may have to pay excise taxes if he or she does any of the following:

- Manufacture or sell certain products.
- Operate certain kinds of businesses.
- Use various kinds of equipment, facilities, or products.
- Receive payment for certain services.

The Federal excise taxes reported on Form 720 - Quarterly Federal Excise Tax Return, consist of several broad categories of taxes, including the following:

- Environmental taxes on the sale or use of ozone-depleting chemicals and imported products containing or manufactured with these chemicals.
- Communications and air transportation taxes.

- Fuel taxes.
- Tax on the first retail sale of heavy trucks, trailers, and tractors.
- Manufacturers taxes on the sale or use of a variety of different articles.
- Tax on indoor tanning services.

If the taxpayer has to file a quarterly excise tax return on Form 720, he or she may have to deposit his or her excise taxes before the return is due.

Casualty, Disaster, and Theft Losses

Generally, a taxpayer may deduct losses of property from fire, storm, shipwreck, or other casualty, or theft (for example, larceny, embezzlement, and robbery). The taxpayer may not deduct casualty and theft losses covered by insurance unless he or she files a timely claim for reimbursement, and he or she reduces the loss by the amount of any reimbursement or expected reimbursement. However, the part of the loss that is not covered by insurance is still deductible.

The amount of a theft loss is generally the adjusted basis of the property because the fair market value of the property immediately after the theft is considered to be zero. If the taxpayer's property is business or income-producing property, such as rental property, and is completely destroyed, then the amount of the loss is the adjusted basis. Adjusted basis usually means original cost plus improvements, minus depreciation allowed or allowable (including any Section 179 expense deduction), amortization, depletion, etc. If the taxpayer did not acquire the property by purchasing it, his or her basis is determined as discussed in Publication 551 - Basis of Assets.

If the taxpayer inherited the property from someone who died in 2010 and the executor of the decedent's estate made the election to file Form 8939 - Allocation of Increase in Basis for Property Received From a Decedent, refer to the information provided by the executor or see Publication 4895 - Tax Treatment of Property Acquired From a Decedent Dying in 2010.

If the taxpayer's casualty or theft loss involved a home he or she used for business or rented out, the deductible loss may be limited. See the Instructions for Form 4684, Section B. If the casualty or theft loss involved property used in a passive activity, see Form 8582, Passive Activity Loss Limitations, and its instructions.

The casualty and theft loss deduction for employee property, when added to the taxpayer's job expenses and most other miscellaneous itemized deductions on Schedule A (Form 1040), must be reduced by 2% of adjusted gross income. Employee property is property used in performing services as an employee.

IRC Section 199A Deduction

For tax years beginning after 2017, the taxpayer may be entitled to a deduction of up to 20% of his or her qualified business income from his or her qualified trade or businesses plus 20% of the aggregate amount of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income. The deduction is subject to various limitations, such as limitations based on the type of the taxpayer's trade or business, his or her taxable income, the amount of W-2 wages paid with respect to the qualified trade or business, and the unadjusted basis of qualified property held by his or her trade or business. The taxpayer will claim this deduction on Form 1040, not on Schedule C. Unlike other deductions, this deduction can be taken in addition to the standard or itemized deductions.

The provision is actually comprised of three separate deductions. The first deduction is the "20% pass-through deduction." In its most simple terms, Section 199A grants an individual business owner (as well as some trusts and estates) a deduction equal to 20% of the taxpayer's qualified business income. In 2020, for business owners with taxable income in excess of $213,300 ($426,600 in the case of taxpayers married filing jointly), however, no deduction is allowed against income earned in a "specified service trade or business." In addition, at these same income levels, the deduction against income earned in an eligible business is limited to the greater of:

- 50% of the taxpayer's share of the W-2 wages with respect to the qualified trade or business, or
- The sum of 25% of the taxpayer's share of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the taxpayer's share of the unadjusted basis immediately after acquisition of all qualified property.

Once this deduction is computed and limited, as appropriate, it is added to the second deduction for 20% of the taxpayer's qualified REIT dividends and publicly traded partnership (PTP) income for the year.

These two deductions are truly separate and distinct. For example, if a taxpayer has a net loss from his or her flow-through businesses, it does not preclude the taxpayer's ability to claim a deduction of 20% of REIT dividends and PTP income. Likewise, if a taxpayer's sum of REIT dividends and PTP income is a loss, it does not reduce the taxpayer's pass-through deduction. After each separate deduction is computed, they are added together and then subjected to an overall limitation, equal to 20% of the excess of:

- The taxpayer's taxable income for the year (before considering the Section 199A deduction), over
- The sum of net capital gain (as defined in Section 1(h)). This includes qualified dividend income taxed at capital gains rates, as well as any unrecaptured Section 1250 gain taxed at 25% and any collectibles gain taxed at 28%.

The third deduction applies only to specified agricultural and horticultural cooperatives.

Specified Service Trades or Businesses (SSTB)

A taxpayer must be engaged in a “qualified trade or business” in order to claim the Section 199A deduction. Section 199A defines a qualified trade or business by exclusion; every trade or business is a qualified business other than:

- The trade or business of performing services as an employee, and
- A specified service trade or business.

The first prohibition prevents an employee from claiming a 20% deduction against his or her wage income.

Qualified Business Income

Once a taxpayer has established that he or she is engaged in a Section 162 trade or business, the taxpayer must determine the “qualified business income (QBI)” for each separate qualified trade or business. QBI is defined as the net amount of qualified items of income, gain, deduction and loss with respect to a qualified trade or business that is effectively connected with the conduct of a business within the United States. As a result, QBI does not include certain investment-related income, including the following:

- Any item of short-term capital gain, short-term capital loss, long-term capital gain, long-term capital loss, or any item treated as capital gain or loss.
- Dividend income, income equivalent to a dividend, or payment in lieu of a dividend described in Section 954(c)(1)(G).
- Any interest income other than interest income properly allocable to a trade or business.
- Net gain from foreign currency transactions and commodities transactions.
- Income from notional principal contracts.
- Any amount received from an annuity which is not received in connection with the trade or business.
- Any deduction or loss properly allocable to the items described above.

Additionally, the Section 199A deduction does not reduce a partner or shareholder’s basis in the partnership interest or stock. The deduction does not reduce net earnings from self-employment or net investment income tax. The same Section 199A deduction for regular tax purposes is allowed for AMT purposes. The threshold for the accuracy related penalty under Section 6662 for anyone claiming the Section 199A deduction is reduced so that it applies to any understatement that exceeds the greater of $5,000 or 5% of the tax required to be shown on the return (it is normally 10%).

Figuring the Deduction

The taxpayer should use Form 8995 - Qualified Business Income Deduction Simplified Computation to figure his or her qualified business income (QBI) deduction. Individual taxpayers and some trusts and estates may be entitled to a deduction up to 20% of their net QBI from a trade or business, including income from a pass-through entity, but not from a C corporation, plus 20% of qualified real estate investment trust (REIT) dividends and qualified publicly trade partnership (PTP) income. However, the taxpayer’s total QBI deduction is limited to 20% of his or her taxable income, calculated before the QBI deduction, minus net capital gain.

The taxpayer should use Form 8995-A - Qualified Business Income Deduction to figure his or her qualified business income (QBI) deduction. He or she includes the following schedules as appropriate:

- Schedule A (Form 8995-A), Specified Service Trades or Businesses (SSTB).
- Schedule B (Form 8995-A), Aggregation of Business Operations.
- Schedule C (Form 8995-A), Loss Netting and Carryforward.
- Schedule D (Form 8995-A), Special Rules for Patrons of Agricultural or Horticultural Cooperatives.

Depending on the taxpayer's taxable income, his or her QBI component may also be limited based on the type of trade or business, W-2 wages paid by that business, and unadjusted basis immediately after acquisition (UBIA) of qualified property held by the business.

Disclosure Requirements

A pass-through entity is required to allocate and disclose QBI, W-2 wages, and UBIA of property. If any one item is not allocated, that item is presumed to be zero. There is no exception for pass-through entities that know that all of its owners have taxable income below the thresholds. In addition, a pass-through entity is required to disclose whether it has multiple trades or businesses, and if any of those businesses are a specified service trade or business (SSTB).

Net Operating Loss (NOL)

If the taxpayer's deductions for the year are more than his or her income for the year, the taxpayer may have a net operating loss (NOL). He or she can use an NOL by deducting it from his or her income in another year or years. Examples of typical losses that may produce an NOL include, but are not limited to, losses incurred from the following:

- Trade or business.
- Work as an employee (although not deductible for most taxpayers in 2019).
- Casualty and theft losses resulting from a federally declared disaster.
- Moving expenses (although not deductible for most taxpayers in 2019).
- Rental property.

A loss from operating a business is the most common reason for an NOL. [9]

Partnerships and S corporations generally cannot use an NOL. However, partners or shareholders can use their separate shares of the partnership's or S corporation's business income and business deductions to figure their individual NOLs.

Prior to 2018, net operating losses of a business or individual could be carried back two years and forward 20, and when carried forward, they could offset 100% of taxable income. The TCJA altered these rules, disallowing all carrybacks related to post-2017 losses, providing for an indefinite carryforward period, and limiting the use of post-2017 losses when carried forward to 80% of taxable income.

The CARES Act retroactively suspends the 80% income limitation on use of NOL carryovers for taxable years beginning before January 1, 2021 and allows 100% of any such taxable income of offset the amount of such NOL carryforward. This 80% income limitation is reinstated (with slight modifications) for tax years beginning after December 31, 2021. Also, losses from 2018, 2019 and 2020, will be permitted to be carried back for up to five years. As was previously the case, a taxpayer will be permitted to forgo the carryback, and instead carry the loss forward. The bill also eliminates loss limitation rules applicable to sole proprietors and pass-through entities to allow them to take advantage of the NOL carryback.

Alternative Tax Net Operating Loss Deduction (ATNOLD)

The ATNOLD is the sum of the alternative tax net operating loss (ATNOL) carrybacks and carryforwards to the tax year, subject to the limitation explained later. Figure the ATNOLD as follows:

The ATNOL for a loss year is the excess of the deductions allowed for figuring AMTI (excluding the ATNOLD) over the income included in AMTI. Figure this excess with the modifications in Section 172(d), taking into account AMT adjustments and preferences (that is, the Section 172(d) modifications must be separately figured for the ATNOL). For example, the limitation of nonbusiness deductions to the amount of nonbusiness income must be separately figured for the ATNOL, using only nonbusiness income and deductions that are included in AMTI.

The ATNOLD may be limited. To figure the ATNOLD limitation, first figure AMTI without regard to the ATNOLD and any domestic production activities deduction. To do this, first figure a tentative amount for line 2d of Form 6251 by treating line 2f as if it were zero. Next, figure a tentative total of lines 1 through 3 using the tentative line 2d amount and treating line 2f as if it were zero. This is the taxpayer's AMTI figured without regard to the ATNOLD. Add any domestic production activities deduction to this tentative total. The ATNOLD is limited to 90% of the result.

Corporation Filing Information

Rules on income and deductions that apply to sole proprietors also apply, for the most part, to corporations. However, the following are some of the special provisions that apply only to corporations. Generally, a corporation must file its income tax return by the 15th day of the 4th month after the end of its tax year. A new corporation filing a short-period return must generally file by the 15th day of the 4th month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 4th month after the date it dissolved.

However, a corporation with a fiscal tax year ending June 30 must file by the 15th day of the 3rd month after the end of its tax year until 2025. A corporation with a short tax year ending anytime in June will be treated as if the short year ended on June 30 and must file by the 15th day of the 3rd month after the end of its tax year. If the due date falls on a Saturday, Sunday, or legal holiday, the corporation can file on the next business day.

Income

A corporation should use Form 1120 - U.S. Corporation Income Tax Return, to report the income, gains, losses, deductions, credits, and to figure the income tax liability of a corporation. Unless exempt under Section 501, all domestic corporations (including corporations in bankruptcy) must file an income tax return whether or not they have taxable income. Domestic corporations must file Form 1120, unless they are required, or elect to file a special return.

Except as otherwise provided in the Internal Revenue Code, gross income includes all income from whatever source derived. Gross income does not include income from qualifying shipping activities if the corporation makes an election under Section 1354 to be taxed on its notional shipping income (as defined in Section 1353) at the highest corporate tax rate (21%). If the election is made, the corporation generally may not claim any loss, deduction, or credit with respect to qualifying shipping activities. A corporation making this election also may elect to defer gain on the disposition of a qualifying vessel. In general, advance payments are reported in the year of receipt.

For exceptions to this general rule for corporations that use the accrual method of accounting, see the following: [28]

- To report income from long-term contracts, see Section 460.
- For special rules for reporting certain advance payments for goods and long-term contracts, see Regulations Section 1.451-5.
- For rules that allow a limited deferral of advance payments beyond the current tax year, see Revenue Procedure 2004-34, 2004-22 I.R.B. 991, as modified and clarified by Revenue Procedure 2011-18, 2011-5 I.R.B. 443, for advance payments from the sale of certain gift cards.
- For information on adopting or changing to a permissible method for reporting advance payments for services and certain goods by an accrual method corporation, see the Instructions for Form 3115.

Generally, the installment method cannot be used for dealer dispositions of property. A "dealer disposition" is any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan or real property held for sale to customers in the ordinary course of the taxpayer's trade or business. The restrictions on using the installment method do not apply to the following: [28]

- Dealer dispositions of property before March 1, 1986.
- Dispositions of property used or produced in the trade or business of farming.
- Certain dispositions of timeshares and residential lots reported under the installment method for which the corporation elects to pay interest under Section 453(l)(3).

Accrual method corporations are not required to accrue certain amounts to be received from the performance of services that, on the basis of their experience, will not be collected, if: [(28)]

- The services are in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or
- The corporation's average annual gross receipts have not exceeded $5 million for any prior 3-tax-year period. For more details, see Regulations Sections 1.448-2(a)(2) and 1.448-1T(f)(2).

This provision does not apply to any amount if interest is required to be paid on the amount or if there is any penalty for failure to timely pay the amount. See Regulations Section 1.448-2 for information on the nonaccrual experience method, including information on safe harbor methods. See Revenue Procedure 2011-46, 2011-42 I.R.B. 518, for information on a book safe harbor method of accounting for corporations that use the nonaccrual experience method of accounting.

Corporations that qualify to use the nonaccrual experience method should attach a statement showing total gross receipts, the amount not accrued as a result of the application of Section 448(d)(5), and the net amount accrued.

Cost of Goods Sold

Filers of Form 1120, 1120-C, 1120-F, 1120S, 1065 or 1065-B, use Form 1125-A - Cost of Goods Sold to calculate and deduct cost of goods sold. Enter on Form 1120, line 2, the amount from Form 1125-A, line 8.

Interest

Figure the taxable interest on U.S. obligations and on loans, notes, mortgages, bonds, bank deposits, corporate bonds, tax refunds, etc. Do not offset interest expense against interest income. Special rules apply to interest income from certain below-market-rate loans.

Gross Rents

Include the gross amount received for the rental of property. Deduct expenses such as repairs, interest, taxes, and depreciation on the proper lines for deductions. A rental activity held by a closely held corporation or a personal service corporation may be subject to the passive activity loss rules.

Other Income

Examples of other income to report on line 10 include the following:

- Recoveries of bad debts deducted in prior years under the specific charge-off method.
- The amount included in income from Form 6478 - Alcohol and Cellulosic Biofuel Fuels Credit.
- The amount included in income from Form 8864 - Biodiesel and Renewable Diesel Fuels Credit.
- Refunds of taxes deducted in prior years to the extent they reduced the amount of tax imposed. See Section 111 and the related regulations. Do not offset current year taxes against tax refunds.
- Ordinary income from trade or business activities of a partnership (from Schedule K-1 (Form 1065 or 1065-B)). Do not offset ordinary losses against ordinary income. Instead, include the losses on line 26. Show the partnership's name, address, and EIN on a separate statement attached to this return. If the amount entered is from more than one partnership, identify the amount from each partnership.
- Any LIFO recapture amount under Section 1363(d). The corporation may have to include a LIFO recapture amount in income if it:
  - Used the LIFO inventory method for its last tax year before the first tax year for which it elected to become an S corporation, or
  - Transferred LIFO inventory assets to an S corporation in a non-recognition transaction in which those assets were transferred basis property.

  Note: The LIFO recapture amount is the amount by which the C corporation's inventory under the FIFO method exceeds the inventory amount under the LIFO method at the close of the corporation's last tax year as a C corporation (or for the year of the transfer, if (2) above applies). For more information, see Regulations Section 1.1363-2 and Revenue Procedure 94-61, 1994-2 C.B. 775. Also, see the instructions for Schedule J, Part I, line 11.

- Any net positive Section 481(a) adjustment.
- Part or all of the proceeds received from certain corporate-owned life insurance contracts issued after August 17, 2006. Corporations that own one or more employer-owned life insurance contracts issued after this date must file Form 8925, Report of Employer-Owned Life Insurance Contracts. See Section 101(j) for details.
- Income from cancellation of debt (COD) for the repurchase of a debt instrument for less than its adjusted issue price. However, if a corporation elected under Section 108(i), to defer the income from COD in connection with the reacquisition of an applicable debt instrument in 2009 and 2010, the income is deferred and ratably included in income over the 5-year period beginning with:
    - For a reacquisition that occurred in 2009, the fifth tax year following the tax year in which the reacquisition occurred, and
    - For a reacquisition that occurred in 2010, the fourth tax year following the tax year in which the reacquisition occurred.

  Note: Once made, the election is irrevocable and the exclusions for COD income under Section 108(a)(1)(A), (B), (C), and (D) do not apply for the tax year of the election or any later tax year. An annual information statement is required.
- The corporation's share of the following income from Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.
    - Ordinary earnings of a qualified electing fund.
    - Gain or loss from marking passive foreign investment company (PFIC) stock to market.
    - Gain or loss from sale or other disposition of Section 1296 stock.
    - Excess distributions from a Section 1291 fund.

Uniform Capitalization Rules

The uniform capitalization rules of Section 263A require corporations to capitalize, or include in inventory, certain costs. Corporations subject to the Section 263A uniform capitalization rules are required to capitalize:

1. Direct costs, and
2. An allocable part of most indirect costs (including taxes) that (a) benefit the assets produced or acquired for resale, or (b) are incurred because of the performance of production or resale activities.

The costs required to be capitalized under Section 263A are not deductible until the property (to which the costs relate) is sold, used, or otherwise disposed of by the corporation. Recover these costs through depreciation, amortization, or cost of goods sold.

Cost of Going Into Business

When a company goes into business, it treats all costs it incurs to get its business started as capital expenses. However, a corporation can elect to deduct a limited amount of start-up or organizational costs. Any costs not deducted can be amortized. Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Organizational costs are the direct costs of creating the corporation.

A corporation can elect to deduct up to $5,000 of business start-up and up to $5,000 of organizational costs paid or incurred after October 22, 2004. Any remaining costs must be amortized ratably over a 180-month period. The $5,000 deduction is reduced (but not below zero) by the amount the total costs exceed $50,000. If the total costs are $55,000 or more, the deduction is reduced to zero.

Related Persons

A corporation that uses an accrual method of accounting cannot deduct business expenses and interest owed to a related person who uses the cash method of accounting until the corporation makes the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship, for this rule, as of the end of the tax year for which the expense or interest would otherwise be deductible.

If a deduction is denied, the rule will continue to apply even if the corporation's relationship with the person ends before the expense or interest is includible in the gross income of that person. These rules also deny the deduction of losses on the sale or exchange of property between related persons.

Income From Qualifying Shipping Activities

A corporation may make an election to be taxed on its notional shipping income at the highest corporate tax rate. If a corporation makes this election it may exclude income from qualifying shipping activities from gross income. Also, if the election is made, the corporation generally may not claim any loss, deduction, or credit with respect to qualifying shipping activities. A corporation making this election may also elect to defer gain on the disposition of a qualifying vessel.

Election to Expense Qualified Refinery Property

A corporation can make an irrevocable election on its tax return filed by the due date (including extensions) to deduct 50% of the cost of qualified refinery property (defined in Section 179C(c) of the Internal Revenue Code), placed in service before January 1, 2014. The deduction is allowed for the year in which the property is placed in service. A subchapter T cooperative can make an irrevocable election on its return by the due date (including extensions) to allocate this deduction to its owners based on their ownership interest.

Energy-Efficient Commercial Building Property Deduction

A corporation can claim a deduction for costs associated with energy-efficient commercial building property, placed in service before January 1, 2014. In order to qualify for the deduction: (28)

- The costs must be associated with depreciable or amortizable property in a Standard 90.1-2001 domestic building;
- The property must be either a part of the interior lighting system, the heating, cooling, ventilation and hot water system, or the building envelope (defined in Section 179D(c)(1)(C) of the Internal Revenue Code); and
- The property must be installed as part of a plan to reduce the total annual energy and power costs of the building by 50% or more.

The deduction is limited to $1.80 per square foot of the building less the total amount of deductions taken for this property in prior tax years. Other rules and limitations apply. The corporation must reduce the basis of any property by any deduction taken. The deduction is subject to recapture if the corporation fails to fully implement an energy savings plan.

Corporate Preference Items

A corporation must make special adjustments to certain items before it takes them into account in determining its taxable income. These items are known as corporate preference items and they include the following: (28)

- Gain on the disposition of Section 1250 property.
- Percentage depletion for iron ore and coal (including lignite).
- Amortization of pollution control facilities.
- Mineral exploration and development costs.

Dividends-Received Deduction

A corporation can deduct a percentage of certain dividends received during its tax year. This section discusses the general rules that apply. The deduction is figured on Form 1120, Schedule C, or the applicable schedule of the income tax return.
Corporations cannot take a deduction for dividends received from the following entities: (28)

- A real estate investment trust (REIT).
- A corporation exempt from tax under Section 501 or 521 of the Internal Revenue Code either for the tax year of the distribution or the preceding tax year.
- A corporation whose stock was held less than 46 days during the 91-day period beginning 45 days before the stock became ex-dividend with respect to the dividend. Ex-dividend means the holder has no rights to the dividend.
- A corporation whose preferred stock was held less than 91 days during the 181-day period beginning 90 days before the stock became ex-dividend with respect to the dividend if the dividends received are for a period or periods totaling more than 366 days.

- Any corporation, if the corporation is under an obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Dividends on deposits or withdrawable accounts in domestic building and loan associations, mutual savings banks, cooperative banks, and similar organizations are interest, not dividends. They do not qualify for this deduction. The total deduction for dividends received or accrued is generally limited (in the following order) to: (28)

1. 65% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from 20%-owned corporations, then
2. 80% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from less-than-20%-owned corporations (reducing taxable income by the total dividends received from 20%-owned corporations).

In figuring the limit, determine taxable income without the following items: (28)

1. The net operating loss deduction.
2. The domestic production activities deduction.
3. The deduction for dividends received.
4. Any adjustment due to the nontaxable part of an extraordinary dividend.
5. Any capital loss carryback to the tax year.

If a corporation has a net operating loss (NOL) for a tax year, the limit of 65% (or 50%) of taxable income does not apply. To determine whether a corporation has an NOL, figure the dividends-received deduction without the 65% (or 50%) of taxable income limit.

Extraordinary Dividends

If a corporation receives an extraordinary dividend on stock held 2 years or less before the dividend announcement date, it generally must reduce its basis in the stock by the nontaxed part of the dividend. The nontaxed part is any dividends-received deduction allowable for the dividends. An extraordinary dividend is any dividend on stock that equals or exceeds a certain percentage of the corporation's adjusted basis in the stock.

The percentages are: (28)

- 5% for stock preferred as to dividends, or
- 10% for other stock.

Treat all dividends received that have ex-dividend dates within an 85-consecutive-day period as one dividend. Treat all dividends received that have ex-dividend dates within a 365-consecutive-day period as extraordinary dividends if the total of the dividends exceeds 20% of the corporation's adjusted basis in the stock.

Below-Market Loans

If a corporation receives a below-market loan and uses the proceeds for its trade or business, it may be able to deduct the forgone interest. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the long-term applicable Federal rate. A below-market loan generally is treated as an arm's-length transaction in which the borrower is considered as having received both the following: (28)

1. A loan in exchange for a note that requires payment of interest at the long-term applicable Federal rate, and
2. An additional payment in an amount equal to the forgone interest.

Treat the additional payment as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction.

Charitable Contributions

A corporation can claim a limited deduction for charitable contributions made in cash or other property. The contribution is deductible if made to, or for the use of, a qualified organization. A corporation cannot take a deduction if any of the net earnings of an organization receiving contributions benefit any private shareholder or individual.

A corporation using the cash method of accounting deducts contributions in the tax year paid. A corporation using an accrual method of accounting can choose to deduct unpaid contributions for the tax year the board of directors authorizes them if it pays them by the due date for filing the corporation’s tax return (not including extensions). Make the choice by reporting the contribution on the corporation's return for the tax year. A declaration stating that the board of directors adopted the resolution during the tax year must accompany the return. The declaration must include the date the resolution was adopted.

A corporation may deduct qualified contributions of up to 25% of its taxable income. Figure taxable income for this purpose without the following:

1. The deduction for charitable contributions.
2. The dividends-received deduction.
3. The deduction allowed under Section 249 of the Internal Revenue Code.
4. The domestic production activities deduction.
5. Any net operating loss carryback to the tax year.
6. Any capital loss carryback to the tax year.

The corporation can carry over, within certain limits, to each of the subsequent 5 years any charitable contributions made during the current year that exceed the 25% limit. It loses any excess not used within that period. For example, if a corporation has a carryover of excess contributions paid in 2010 and it does not use all the excess on its return for 2011, it can carry any excess over to 2012, 2013, 2014, and 2015, if applicable. Any excess not used in 2015 is lost. Do not deduct a carryover of excess contributions in the carryover year until after the corporation deducts contributions made in that year (subject to the 25% limit). The corporation cannot deduct a carryover of excess contributions to the extent it increases a net operating loss carryover.

Capital Losses

A corporation can deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has an excess capital loss, it cannot deduct the loss in the current tax year. Instead, it carries the loss to other tax years and deducts it from any net capital gains that occur in those years. A capital loss is carried to other years in the following order: (28)

- 3 years prior to the loss year.
- 2 years prior to the loss year.
- 1 year prior to the loss year.
- Any loss remaining is carried forward for 5 years.

When the corporation carries a net capital loss to another tax year, treat it as a short-term loss. It does not retain its original identity as long-term or short-term.

Net Operating Loss

A corporation generally figures and deducts a net operating loss (NOL) the same way an individual, estate, or trust does. For more information on these general rules, including the sequencing rule for when the corporation carries two of more NOLs to the same year. A corporation's NOL generally differs from individual, estate, and trust NOLs in the following ways: (28)

1. A corporation can take different deductions when figuring an NOL.
2. A corporation must make different modifications to its taxable income in the carryback or carryforward year when figuring how much of the NOL is used and how much is carried over to the next year.
3. A corporation uses different forms when claiming an NOL deduction.
4. A corporation is not subject to Section 461, which limits the amount of losses from the trades or businesses of noncorporate taxpayers.

Claiming the NOL Deduction

Prior to 2018, if a C corporation incurred (NOL) in a tax year, it was generally permitted to carry back and use such losses against its income for the prior two tax years. This permitted the corporation to receive a refund for taxes paid for the prior two years. Any NOLs not used against prior year income was generally permitted to be carried forward and used against future income for 20 years. The 2017 Tax Cuts and Jobs Act (TCJA) generally eliminated the ability to carry back corporate NOLs and permitted the corporate NOL arising in tax years beginning after December 31, 2017 to be carried forward indefinitely, limited to 80% of the taxpayer's income. Certain exceptions to those 2017 Act provisions were provided for certain industries (e.g., farming, certain insurance companies, etc.). The NOL rules existing prior to the 2017 Act continued to apply to NOLs arising prior to the effective date of the 2017 Act.

Under the CARES Act, a net operating loss (NOL) arising in a tax year beginning in 2018, 2019 or 2020 can be carried back for five years. It also allows for NOLs arising before January 1, 2021 to fully offset income.

Accordingly, the CARES Act temporarily removes limitations put in place by the 2017 Tax Cuts and Jobs Act (TCJA) where, for taxable years beginning after December 31, 2017, NOLs were limited to 80% of taxable income and could not be carried back to reduce income in a prior tax year. Under the CARES Act, losses must be carried back to the earliest year available for offset. As losses will be carried back to pre-2018 tax years, corporate taxpayers may benefit from a tax refund at favorable rates of up to 35%.

For tax years beginning after December 31, 2020, the limitations imposed by TCJA will remain, but deductions for qualified business income under IRC Section 199A and for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI) under IRC Section 250 will not be taken into account.

NOL Carryback

Under the Coronavirus Aid, Relief, and Economic Security Act (CARES) a net operating loss (NOL) arising in a tax year beginning in 2018, 2019 or 2020 can be carried back for five years. It also allows for NOLs arising before January 1, 2021 to fully offset income. Taxpayers may elect to irrevocably waive the entire 5-year carryback period with respect to an NOL. Such election must be made by the due date (including extensions) for filing the taxpayer's return (i) for the first tax year ending after the date the CARES Act is enacted, with respect to 2018 and 2019 NOLs, and (ii) for the tax year the loss is incurred, with respect to a 2020 NOL.

Taxpayers carrying back an NOL to a year with Section 965 (transition) income from foreign subsidiaries will automatically be treated as having made an IRC Section 965(n) election, which excludes Section 965 income from determining the NOL for that year. As a result, taxpayers will only be able to carry back NOLs to offset non-Section 965 income, which may impact foreign tax credit calculations and subsequent transition tax installments. In the alternative, a taxpayer may affirmatively elect to exclude Section 965 years from the carryback period.

For tax years beginning after December 31, 2020, the limitations imposed by TCJA will remain, but deductions for qualified business income under IRC Section 199A and for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI) under IRC Section 250 will not be taken into account.

The following rules apply: [43]

- If a corporation carries back the NOL, it can use either Form 1120X or Form 1139. A corporation can get a refund faster by using Form 1139. It cannot file Form 1139 before filing the return for the corporation's NOL year, but it must file Form 1139 no later than 1 year after the year it sustains the NOL.
- If the corporation does not file Form 1139, it must file Form 1120X within 3 years of the due date, plus extensions, for filing the return for the year in which it sustains the NOL.

NOL Carryforward

If a corporation carries forward its NOL, it enters the carryover on Form 1120, Schedule K, line 12. It also enters the deduction for the carryover (but not more than the corporation's taxable income after special deductions) on Form 1120, line 29a, or the applicable line of the corporation's income tax return.

Figuring the NOL Carryover

The CARES Act retroactively suspends the 80% income limitation on use of NOL carryovers for taxable years beginning before January 1, 2021 and allows 100% of any such taxable income to be offset by the amount of such NOL carryforward. This 80% income limitation is reinstated (with slight modifications) for tax years beginning after December 31, 2021.

If the NOL available for a carryback or carryforward year is greater than 100% of the taxable income for that year the corporation must modify its taxable income to figure how much of the NOL it will use up in that year and how much it can carry over to the next tax year. Its carryover is the excess of the available NOL over its modified taxable income for the carryback or carryforward year.

A corporation figures its modified taxable income the same way it figures its taxable income, with the following exceptions:

- It can deduct NOLs only from years before the NOL year whose carryover is being figured.
- The corporation must figure its deduction for charitable contributions without considering any NOL carrybacks.
- It cannot take any domestic activities production deduction.
- It cannot take any deduction for foreign-derived international income.
- The modified taxable income for any year cannot be less than zero.

Modified taxable income is used only to figure how much of an NOL the corporation uses up in the carryback or carryforward year and how much it carries to the next year. It is not used to fill out the corporation's tax return or figure its tax.

A loss corporation (one with cumulative losses) that has an ownership change is limited on the taxable income it can offset by NOL carryforwards arising before the date of the ownership change. This limit applies to any year ending after the change of ownership. See Section 269 and Sections 381 through 384 of the Internal Revenue Code and the related regulations for more information about the limits on corporate NOL carryovers and corporate ownership changes.

Distributions to Shareholders

Common kinds of distributions by a corporation to shareholders are ordinary dividends, capital gain distributions and nontaxable distributions. Most distributions are in money, but they may also be in stock or other property. For this purpose, “property” generally does not include stock in the corporation or rights to acquire this stock. A corporation generally does not recognize a gain or loss on the distributions covered by the rules in this section however some exceptions appear below.

The amount of a distribution is generally the amount of any money paid to the shareholder plus the fair market value (FMV) of any property transferred to the shareholder. However, this amount is reduced (but not below zero) by the following liabilities: (28)

- Any liability of the corporation the shareholder assumes in connection with the distribution.
- Any liability to which the property is subject immediately before, and immediately after, the distribution.

The FMV of any property distributed to a shareholder becomes the shareholder's basis in that property.

A corporation will recognize a gain on the distribution of property to a shareholder if the FMV of the property is more than its adjusted basis. This is generally the same treatment the corporation would receive if the property were sold.

However, for this purpose, the FMV of the property is the greater of the following amounts: (28)

- The actual FMV.
- The amount of any liabilities the shareholder assumed in connection with the distribution of the property.

If the property was depreciable or amortizable, the corporation may have to treat all or part of the gain as ordinary income from depreciation recapture.

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as “stock options”) are distributions by a corporation of rights to acquire its stock. Distributions of stock dividends and stock rights are generally tax-free to shareholders.

However, if any of the following apply to their distribution, stock and stock rights are treated as property: (28)

1. Any shareholder has the choice to receive cash or other property instead of stock or stock rights.
2. The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders.
3. The distribution is in convertible preferred stock and has the same result as in (2).
4. The distribution gives preferred stock to some common stock shareholders and gives common stock to other common stock shareholders.
5. The distribution is on preferred stock. (An increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right is not a distribution on preferred stock.)

The term “stock” includes rights to acquire stock and the term “shareholder” includes a holder of rights or convertible securities.

Reporting Dividends and Other Distributions

A corporate distribution to a shareholder is generally treated as a distribution of earnings and profits. Any part of a distribution from either current or accumulated earnings and profits is reported to the shareholder as a dividend. Any part of a distribution that is not from earnings and profits is applied against and reduces the adjusted basis of the stock in the hands of the shareholder. To the extent the balance is more than the adjusted basis of the stock, the shareholder has a gain (usually a capital gain) from the sale or exchange of property.

File Form 1099-DIV - Dividends and Distributions with the IRS for each shareholder to whom the corporation has paid dividends and other distributions on stock of $10 or more during a calendar year. A corporation must generally send Forms 1099-DIV to the IRS with Form 1096, Annual Summary and Transmittal of U.S. Information Returns, by February 28 (March 31 if filing electronically) of the year following the year of the distribution. For more information, see the General Instructions for Certain Information Returns (Forms 1096, 1097, 1098, 1099, 3921, 3922, 5498, and W-2G).

Generally, the corporation must furnish Forms 1099-DIV to shareholders by January 31 of the year following the close of the calendar year during which it made the distributions. However, the corporation may furnish the Form 1099-DIV to shareholders after November 30 of the year of the distributions if it has made its final distributions for the year. The corporation may furnish the Form 1099-DIV to shareholders any time after April 30 of the year of the distributions if it gives the Form 1099-DIV with the final distributions for the calendar year. If any regular due date falls on a Saturday, Sunday, or legal holiday, file by the next business day. A business day is any day that is not a Saturday, Sunday, or legal holiday.

File Form 5452 - Corporate Report of Nondividend Distributions, if nondividend distributions were made to shareholders. A calendar tax year corporation must file Form 5452 with its income tax return for the tax year in which the nondividend distributions were made. A fiscal tax year corporation must file Form 5452 with its income tax return due for the first fiscal year ending after the calendar year in which the nondividend distributions were made.

If a corporation's earnings and profits for the year (figured as of the close of the year without reduction for any distributions made during the year) are more than the total amount of distributions made during the year, all distributions made during the year are treated as distributions of current year earnings and profits.

If a corporation's current year earnings and profits (figured as of the close of the year without reduction for any distributions made during the year) are less than the total distributions made during the year, part or all of each distribution is treated as a distribution of accumulated earnings and profits. Accumulated earnings and profits are earnings and profits the corporation accumulated before the current year.

Partnership Filing Information

Generally, every domestic partnership must file Form 1065 - U.S. Return of Partnership Income, unless it neither receives income nor incurs any expenditures treated as deductions or credits for Federal income tax purposes. Entities formed as LLCs that are classified as partnerships for Federal income tax purposes have the same filing requirements as domestic partnerships. Generally, a domestic partnership must file Form 1065 by the 15th day of the 3rd month following the date its tax year ended as shown at the top of Form 1065.

Section 1224, of the Taxpayer Relief Act of 1997, requires partnerships with more than 100 partners (Schedules K-1) to file their return on magnetic media (electronically as prescribed by the IRS Commissioner). This law became effective for partnership returns with taxable years ending on or after December 31, 2000. The requirement to e-file applies only to the Form 1065 or 1065-B. Forms 7004, and the 94X family are not required to be e-filed.

A religious or apostolic organization exempt from income tax under Section 501(d) must file Form 1065 to report its taxable income, which must be allocated to its members as a dividend, whether distributed or not. Such an organization must figure its taxable income on an attached statement to Form 1065 in the same manner as a corporation. The organization may use Form 1120 - U.S. Corporation Income Tax Return, for this purpose. Enter the organization's taxable income, if any, on line 6a of Schedule K and each member's pro rata share in box 6a of Schedule K-1. Net operating losses are not deductible by the members but may be carried back or forward by the organization under the rules of Section 172.

The religious or apostolic organization also must make its annual information return available for public inspection. For this purpose, “annual information return” includes an exact copy of Form 1065 and all accompanying schedules and attached statements, except Schedules K-1. For more details, see Regulations Section 301.6104(d)-1.

A qualifying syndicate, pool, joint venture, or similar organization may elect under Section 761(a) not to be treated as a partnership for Federal income tax purposes and will not be required to file Form 1065 except for the year of election. For details, see Section 761(a) and Regulations Section 1.761-2.

An electing large partnership (as defined in Section 775) must file Form 1065-B, U.S. Return of Income for Electing Large Partnerships. Real estate mortgage investment conduits (REMICs) must file Form 1066, U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return. Certain publicly traded partnerships treated as corporations under Section 7704 must file Form 1120.

Generally, a foreign partnership that has gross income effectively connected with the conduct of a trade or business within the United States or has gross income derived from sources in the United States must file Form 1065, even if its principal place of business is outside the United States or all its members are foreign persons. A foreign partnership required to file a return generally must report all of its foreign and U.S. source income. A foreign partnership with U.S. source income is not required to file Form 1065 if it qualifies for either of the following two exceptions.

For foreign partnerships with U.S. partners a return is not required if: [(26)]

- The partnership had no effectively connected income (ECI) during its tax year,
- The partnership had U.S. source income of $20,000 or less during its tax year,
- Less than 1% of any partnership item of income, gain, loss, deduction, or credit was allocable in the aggregate to direct U.S. partners at any time during its tax year, and
- The partnership is not a withholding foreign partnership as defined in Regulations Section 1.1441-5(c)(2)(i).

For foreign partnerships with no U.S. partners a return is not required if: [(26)]

- The partnership had no ECI during its tax year,
- The partnership had no U.S. partners at any time during its tax year,
- All required Forms 1042 and 1042-S were filed by the partnership or another withholding agent as required by Regulations Section 1.1461-1(b) and (c),
- The tax liability of each partner for amounts reportable under Regulations Sections 1.1461-1(b) and (c) has been fully satisfied by the withholding of tax at the source, and
- The partnership is not a withholding foreign partnership as defined in Regulations Section 1.1441-5(c)(2)(i).

A foreign partnership filing Form 1065 solely to make an election (such as an election to amortize organization expenses) need only provide its name, address, and employer identification number (EIN) on page one of the form and attach a statement citing "Regulations Section 1.6031(a)-1(b)(5)" and identifying the election being made. A foreign partnership filing Form 1065 solely to make an election must obtain an EIN if it does not already have one.

Passive Activity Limitations

In general, Section 469 limits the amount of losses, deductions, and credits that partners can claim from "passive activities." The passive activity limitations do not apply to the partnership. Instead, they apply to each partner's share of any income or loss and credit attributable to a passive activity. Because the treatment of each partner's share of partnership income or loss and credit depends on the nature of the activity that generated it, the partnership must report income or loss and credits separately for each activity.

Generally, passive activities include activities that involve the conduct of a trade or business if the partner does not materially participate in the activity and all rental activities regardless of the partner's participation. The level of each partner's participation in an activity must be determined by the partner.

The passive activity rules provide that losses and credits from passive activities can generally be applied only against income and tax from passive activities. Thus, passive losses and credits cannot be applied against income from salaries, wages, professional fees, or a business in which the partner materially participates; against "portfolio income" or against the tax related to any of these types of income.

Special provisions apply to certain activities. First, the passive activity limitations must be applied separately with respect to a net loss from passive activities held through a publicly traded partnership. Second, special rules require that net income from certain activities that would otherwise be treated as passive income must be recharacterized as non-passive income for purposes of the passive activity limitations.

To allow each partner to correctly apply the passive activity limitations, the partnership must report income or loss and credits separately for each of the following: [26]

- Trade or business activities.
- Rental real estate activities.
- Rental activities other than real estate.
- Portfolio income.

Form 1065 - U.S. Return of Partnership Income

Form 1065 - U.S. Return of Partnership Income is an information return used to report the income, gains, losses, deductions, credits, etc., from the operation of a partnership. A partnership does not pay tax on its income but "passes through" any profits or losses to its partners. Partners must include partnership items on their tax or information returns.

Partnerships report only trade or business activity income on lines 1a through 8 of Form 1065. They do not report rental activity income or portfolio income on these lines. Also, they do not include any tax-exempt income on lines 1a through 8. A partnership that receives any tax-exempt income other than interest, or holds any property or engages in any activity that produces tax-exempt income, reports this income on line 18b of Schedule K and in box 18 of Schedule K-1 using code B. Partnerships report tax-exempt interest income, including exempt-interest dividends received as a shareholder in a mutual fund or other regulated investment company, on line 18a of Schedule K and in box 18 of Schedule K-1 using code A.

Enter on line 1a gross receipts or sales from all trade or business operations, except for amounts that must be reported on lines 4 through 7. In general, advance payments are reported in the year of receipt. To report income from long-term contracts, see Section 460. For special rules for reporting certain advance payments for goods and long-term contracts, see Regulations Section 1.451-5. For permissible methods for reporting advance payments for services and certain goods by an accrual method partnership, see Revenue Procedure 2004-34, 2004-22 I.R.B. 991, as clarified and modified by Revenue Procedure 2011-18, and modified by Revenue Procedure 2011-14.

Enter the ordinary income (loss) shown on Schedule K-1 (Form 1065) or Schedule K-1 (Form 1041), or other ordinary income (loss) from a foreign partnership, estate, or trust. Show the partnership's, estate's, or trust's name, address, and EIN on a separate statement attached to this return. If the amount entered is from more than one source, identify the amount from each source.

Do not include portfolio income or rental activity income (loss) from other partnerships, estates, or trusts on this line. Instead, report these amounts on Schedules K and K-1, or on line 20a of Form 8825 if the amount is from a rental real estate activity. Ordinary income (loss) from another partnership that is a publicly traded partnership is not reported on this line. Instead, report the amount separately on line 11 of Schedule K and in box 11 of Schedule K-1 using code F.

Treat shares of other items separately reported on Schedule K-1 issued by the other entity as if the items were realized or incurred by this partnership.

If there is a loss from another partnership, the amount of the loss that may be claimed is subject to the at-risk and basis limitations as appropriate. If the tax year of the partnership does not coincide with the tax year of the other partnership, estate, or trust, include the ordinary income (loss) from the other entity in the tax year in which the other entity's tax year ends.

Accounting Periods

A partnership is generally required to have one of the following tax years: (44)

1. The tax year of a majority of its partners (majority tax year).
2. If there is no majority tax year, then the tax year common to all of the partnership's principal partners (partners with an interest of 5% or more in the partnership profits or capital).
3. If there is neither a majority tax year nor a tax year common to all principal partners, then the tax year that results in the least aggregate deferral of income.
4. Some other tax year, if:
    a. The partnership can establish that there is a business purpose for the tax year; or
    b. The partnership elects under Section 444 to have a tax year other than a required tax year by filing Form 8716 - Election To Have a Tax Year Other Than a Required Tax Year. For a partnership to have this election in effect, it must make the payments required by Section 7519 and file Form 8752 - Required Payment or Refund Under Section 7519; or
    c. A Section 444 election ends if a partnership changes its accounting period to its required tax year or some other permitted year or it is penalized for willfully failing to comply with the requirements of Section 7519. If the termination results in a short tax year, type or legibly print at the top of the first page of Form 1065 for the short tax year, "SECTION 444 ELECTION TERMINATED"; or
    d. The partnership elects to use a 52-53-week tax year that ends with reference to either its required tax year or a tax year elected under Section 444.

To change its tax year or to adopt or retain a tax year other than its required tax year, the partnership must file Form 1128 - Application To Adopt, Change, or Retain a Tax Year, unless the partnership is making an election under Section 444. Also, the tax year of a common trust fund must be the calendar year.

Cost of Goods Sold

If the partnership has a cost of goods sold deduction, the taxpayer completes and attaches Form 1125-A - Cost of Goods Sold. He or she enters on Form 1065, page 1, line 2 the amount from Form 1125-A, line 8.

Other Income (Loss)

Enter any other trade or business income (loss) not included on lines 1a through 6. List the type and amount of income on an attached statement. Examples of other income include the following: (26)

1. Interest income derived in the ordinary course of the partnership's trade or business, such as interest charged on receivable balances.
2. Recoveries of bad debts deducted in prior years under the specific charge-off method.
3. Taxable income from insurance proceeds.
4. The amount included in income from line 7 of Form 6478, Alcohol and Cellulosic Biofuel Fuels Credit.
5. The amount included in income from line 8 of Form 8864, Biodiesel and Renewable Diesel Fuels Credit.

6. The recapture amount under Section 280F if the business use of listed property drops to 50% or less. To figure the recapture amount, complete Part IV of Form 4797.
7. Any recapture amount under Section 179A for clean-fuel vehicle refueling property that ceases to qualify. See Regulations Section 1.179A-1 for details.
8. All Section 481 income adjustments resulting from changes in accounting methods. Show the computation of the Section 481 adjustments on an attached statement.
9. Part or all of the proceeds received from certain employer-owned life insurance contracts issued after August 17, 2006. Partnerships that own one or more employer-owned life insurance contracts issued after that date must file Form 8925, Report of Employer-Owned Life Insurance Contracts. See Section 101(j) for details.

Do not include items requiring separate computations that must be reported on Schedules K and K-1. See the instructions for Schedules K and K-1. Do not report portfolio or rental activity income (loss) on this line.

Deductions

The following are some of the special provisions that apply to partnerships. The uniform capitalization rules of Section 263A generally require partnerships to capitalize or include in inventory costs, certain costs incurred in connection with the following: (26)

- The production of real property and tangible personal property held in inventory or held for sale in the ordinary course of business.
- Real property or personal property (tangible and intangible) acquired for resale.
- The production of real property and tangible personal property by a partnership for use in its trade or business or in an activity engaged in for profit.

Tangible personal property produced by a partnership includes a film, sound recording, videotape, book, or similar property.

The costs required to be capitalized under Section 263A are not deductible until the property to which the costs relate is sold, used, or otherwise disposed of by the partnership.

Section 263A does not apply to the following: (26)

- Inventoriable items accounted for in the same manner as materials and supplies that are not incidental. See Form 1125-A and its instructions for details.
- Personal property acquired for resale if the partnership's average annual gross receipts for the 3 prior tax years were $10 million or less.
- Timber.
- Most property produced under a long-term contract.
- Certain property produced in a farming business.
- Geological and geophysical costs amortized under Section 167(h).

The partnership must report the following costs separately to the partners for purposes of determinations under Section 59(e): (26)

- Research and experimental costs under Section 174.
- Intangible drilling costs for oil, gas, and geothermal property.
- Mining exploration and development costs.

Transactions Between Related Taxpayers

Generally, an accrual basis partnership can deduct business expenses and interest owed to a related party (including any partner) only in the tax year of the partnership that includes the day on which the payment is includible in the income of the related party.

Business Start-up and Organizational Costs

Generally, a partnership can elect to deduct up to $5,000 of business start-up and organizational costs paid or incurred after October 22, 2004. Any remaining costs must be amortized. The $5,000 deduction is reduced (but not below zero) by the amount the total costs exceed $50,000. If the total costs are $55,000 or more, the deduction is reduced to zero.

Guaranteed Payments to Partners

Deduct payments or credits to a partner for services or for the use of capital if the payments or credits are determined without regard to partnership income and are allocable to a trade or business activity. Also include on line 10 amounts paid during the tax year for insurance that constitutes medical care for a partner, a partner's spouse, a partner's dependents, or a partner's children under age 27 who are not dependents.

Repairs and Maintenance

Enter the costs of incidental repairs and maintenance that do not add to the value of the property or appreciably prolong its life, but only to the extent that such costs relate to a trade or business activity and are not claimed elsewhere on the return. The cost of new buildings, machinery, or permanent improvements that increase the value of the property are not deductible. They are chargeable to capital accounts and may be depreciated or amortized.

Bad Debts

Enter the total debts that became worthless in whole or in part during the year, but only to the extent such debts relate to a trade or business activity. Report deductible nonbusiness bad debts as a short-term capital loss on Form 8949.

Taxes and Licenses

Enter taxes and licenses paid or incurred in the trade or business activities of the partnership if not reflected elsewhere on the return. Federal import duties and Federal excise and stamp taxes are deductible only if paid or incurred in carrying on the trade or business of the partnership.

Schedules K and K-1 - Partners' Distributive Share Items

Although the partnership is not subject to income tax, the partners are liable for tax on their shares of the partnership income, whether or not distributed, and must include their shares on their tax returns. Schedule K is a summary schedule of all the partners' shares of the partnership's income, credits, deductions, etc. All partnerships must complete Schedule K. Rental activity income (loss) and portfolio income are not reported on page 1 of Form 1065. These amounts are not combined with trade or business activity income (loss). Schedule K is used to report the totals of these and other amounts.

Schedule K-1 - Partner’s Share of Income, Deductions, Credits, etc. shows each partner's separate share. Attach a copy of each Schedule K-1 to the Form 1065 filed with the IRS; keep a copy with a copy of the partnership return as a part of the partnership's records; and furnish a copy to each partner. If a partnership interest is held by a nominee on behalf of another person, the partnership may be required to furnish Schedule K-1 to the nominee. See Temporary Regulations Sections 1.6031(b)-1T and 1.6031(c)-1T for more information.

Depreciation

If property acquired for business is expected to last more than 1 year, generally a taxpayer cannot deduct the entire cost as a business expense in the year the item was acquired. The cost must be spread over more than 1 tax year and part of the cost should be deducted each year. This method of deducting the cost of business property is called depreciation. A corporation includes on line 20 of Form 1120 depreciation and the cost of certain property that the corporation elected to expense under Section 179 from Form 4562, it includes amounts not claimed on Form 1125-A or elsewhere on the return. The cost should be deducted each year on Schedule C for sole proprietors. (45)

Most types of tangible property (except, land), such as buildings, machinery, vehicles, furniture, and equipment are depreciable. Likewise, certain intangible property, such as patents, copyrights, and computer software is depreciable. In order for a taxpayer to be allowed a depreciation deduction for a property, the property must meet all the following requirements: (46)

1. It must be property the taxpayer owns.
2. It must be used in the taxpayer's business or income-producing activity.
3. It must have a determinable useful life.
4. It must be expected to last more than one year.

Tip

To claim depreciation, the taxpayer usually must be the owner of the property. He or she is considered as owning property even if it is subject to a debt. Also, a taxpayer can depreciate leased property only if he or she retains the incidents of ownership in the property. This means the taxpayer bears the burden of exhaustion of the capital investment in the property. Therefore, if he or she leases property from someone to use in his or her trade or business or for the production of income, the taxpayer generally cannot depreciate its cost because he or she does not retain the incidents of ownership. The taxpayer can, however, depreciate any capital improvements he or she makes to the property.

Even if a taxpayer meets the preceding requirements for a property, a taxpayer cannot depreciate the following property:

- Property placed in service and disposed of in same year.
- Equipment used to build capital improvements. A taxpayer must add otherwise allowable depreciation on the equipment during the period of construction to the basis of the improvements.
- Certain term interests.

Depreciation begins when a taxpayer places property in service for use in a trade or business or for the production of income. The property ceases to be depreciable when the taxpayer has fully recovered the property's cost or other basis or when the taxpayer retires it from service, whichever happens first. (47)

A taxpayer cannot depreciate the cost of land because land does not wear out, become obsolete, or get used up. The cost of land generally includes the cost of clearing, grading, planting, and landscaping. Although the taxpayer cannot depreciate land, he or she can depreciate certain land preparation costs, such as landscaping costs, incurred in preparing land for business use. These costs must be so closely associated with other depreciable property that the taxpayer can determine a life for them along with the life of the associated property. (48)

The following is a list of changes for the 2020 tax year:

- **Increased Section 179 deduction dollar limits.** For tax years beginning in 2020, the maximum section 179 expense deduction is $1,040,000 ($1,075,000 for qualified enterprise zone property). This limit is reduced by the amount by which the cost of section 179 property placed in service during the tax year exceeds $2,590,000. Also, the maximum section 179 expense deduction for sport utility vehicles placed in service in tax years beginning in 2020 is $25,900. The increased section 179 deduction for an enterprise zone business has been terminated for property placed in service in tax years beginning after December 31, 2020.

- **Extension of the treatment for certain racehorses.** The 3-year recovery period for racehorses 2 years old or younger has been extended to apply to horses placed in service before January 1, 2022.
- **Extension of the treatment for qualified motorsports entertainment complexes.** The treatment of qualified motorsports entertainment complexes as 7-year property under MACRS has been extended to apply to complexes placed in service before January 1, 2026.
- **Extension of the accelerated depreciation for qualified Indian reservation property.** The accelerated recovery period for qualified Indian reservation property has been extended to apply to property placed in service before January 1, 2022.
- **Depreciation limits on business vehicles.** The total section 179 deduction and depreciation you can deduct for a passenger automobile, including a truck or van, you use in your business and first placed in service in 2020 is $18,100, if the special depreciation allowance applies, or $10,100, if the special depreciation allowance does not apply.

Basis of Property

Basis is generally the amount of a taxpayer's capital investment in a property for tax purposes. Use the basis to figure depreciation, amortization, depletion, casualty losses, and any gain or loss on the sale, exchange or other disposition of the property.

In most situations, the basis of an asset the taxpayer purchases is its cost. The cost is the amount he or she pays for it in cash, debt obligations, and other property or services. Cost includes sales tax and other expenses connected with the purchase. The basis in some assets is not determined by cost (such as a gift or an inheritance). If the taxpayer acquired the property from an individual who died in 2010, special rules may apply to the calculation of basis. For more information refer to Publication 551 - Basis of Assets. [49]

Examples of Increases and Decreases to Basis	
Increases to Basis	**Decreases to Basis**
Capital improvements: • Putting an addition on a home. • Replacing an entire roof. • Paving a driveway. • Installing central air conditioning. Rewiring a home.	Exclusion from income of subsidies for energy conservation measures. Casualty or theft loss deductions and insurance reimbursements.
Assessments for local improvements: • Water connections. • Sidewalks. • Roads.	Vehicle credits.
Casualty losses: • Restoring damaged property.	Section 179 deduction.
Legal fees: • Cost of defending and perfecting a title.	Depreciation.
Zoning costs.	Nontaxable corporate distributions.

Table 7-1 - Publication 551 - Table 1 - Examples of Increases and Decreases to Basis (2020)

Cost Basis

The basis of property a taxpayer buys is usually its cost. The cost is the amount paid in cash, debt obligations, other property, or services. The cost also includes amounts the taxpayer pays for the following items: [50]

- Sales tax.

- Freight.
- Installation and testing.
- Excise taxes.
- Legal and accounting fees (when they must be capitalized).
- Revenue stamps.
- Recording fees.
- Real estate taxes (if assumed for the seller).

The taxpayer may also have to capitalize (add to basis) certain other costs related to buying or producing property.

The basis of stocks or bonds a taxpayer buys is generally the purchase price plus any costs of purchase, such as commissions and recording or transfer fees. If the taxpayer receives stocks or bonds other than by purchase, the basis is usually determined by the fair market value (FMV) or the previous owner's adjusted basis of the stock.

The taxpayer must adjust the basis of stocks for certain events that occur after purchase. See Stocks and Bonds in Publication 550 - Investment Income and Expenses for more information on the basis of stock.

Real property, also called real estate, is land and generally anything built on or attached to it. If the taxpayer buys real property, certain fees and other expenses become part of the cost basis in the property. The basis includes the settlement fees and closing costs for buying property. The taxpayer cannot include in the basis the fees and costs for getting a loan on property. A fee for buying property is a cost that must be paid even if the taxpayer bought the property for cash.

The following items are some of the settlement fees or closing costs the taxpayer can include in the basis of the property: [(50)]

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including title search and preparation of the sales contract and deed).
- Recording fees.
- Surveys.
- Transfer taxes.
- Owner's title insurance.
- Any amounts the seller owes that the taxpayer agrees to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement costs do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

The following items are some settlement fees and closing costs the taxpayer cannot include in the basis of the property:

1. Casualty insurance premiums.
2. Rent for occupancy of the property before closing.
3. Charges for utilities or other services related to occupancy of the property before closing.
4. Charges connected with getting a loan. The following are examples of these charges:
    a. Points (discount points, loan origination fees).
    b. Mortgage insurance premiums.
    c. Loan assumption fees.
    d. Cost of a credit report.
    e. Fees for an appraisal required by a lender.
5. Fees for refinancing a mortgage.

If these costs relate to business property, items (1) through (3) are deductible as business expenses. Items (4) and (5) must be capitalized as costs of getting a loan and can be deducted over the period of the loan.

If the taxpayer pays points to obtain a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), do not add the points to the basis of the related property. Generally, he or she deducts the points over the term of the loan.

If the taxpayer buys property and assumes (or buys subject to) an existing mortgage on the property, his or her basis includes the amount he or she pays for the property plus the amount to be paid on the mortgage. (50)

Liabilities

Acquisition basis is increased for notes to the seller (minus unstated interest) and increased for liabilities to which the acquired property is subject. The Fair Market Value (FMV) of property received in exchange for services is income (compensation) to the provider when it is not subject to a substantial risk of forfeiture and not restricted as to transfer. The property acquired has a tax cost basis equal to the FMV of the property.

Sale of restricted stock to an employee is treated as gross income (bonus compensations) to the extent that any price paid is less than the stock's FMV. While restricted, the basis is any price paid other than by services. Upon lapse of the restriction, the recipient has ordinary gross income of the spread between FMV on that date and any amounts otherwise paid (basis is increased by that same amount). The transferee may elect to include the FMV minus the cost spread in gross income when the stock is purchased. Basis includes tax cost, but no subsequent deduction (recovery of the tax cost) is allowed if the stock is forfeited by the operation of the restrictions.

Inherited Property

Basis is the Fair Market Value (FMV) on the date of death or 6 months thereafter is the executor elects the alternate valuation date for the estate tax return.

The FMV basis rule also applies to the following property:

- Property received prior to death without full and adequate consideration (if a life estate was retained in it) or subject to the right of revocation. Reduce basis by depreciation deductions allowed the done.
- One-half of community property interests.
- Property acquired by form of ownership, for example, by right of survivorship, except if consideration was paid to acquire the property from a nonspouse.
- A shareholder must report his or her ratable share of any corporate income that is income in respect to a decedent as if he or she received it directly from the decedent.

The FMV rule does not apply to an appreciated property the taxpayer receives from a decedent if the taxpayer or his or her spouse originally gave the property to the decedent within one year before the decedent's death. The basis in this property is the same as the decedent's adjusted basis in the property immediately before his or her death, rather than the Fair Market Value (FMV). Appreciated property is any property whose FMV on the day it was given to the decedent is more than its adjusted basis.

In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), husbands and wives are each usually considered to own half the community property. When either spouse dies, the total value of the community property, even the part belonging to the surviving spouse, generally becomes the basis of the entire property. For this rule to apply, at least half the value of the community property interest must be includable in the decedent's gross estate, whether or not the estate must file a return. (50)

Basis of Property Received as a Gift

To figure the basis of property a taxpayer receives as a gift, it is necessary to have: (51)

- Adjusted basis to the donor just before it was given to the taxpayer.
- The Fair Market Value (FMV) at the time it was given to the taxpayer.
- Any gift tax paid on the property.

If the FMV of the property at the time of the gift is less than the donor's adjusted basis, the basis depends on whether the taxpayer has a gain or a loss when he or she disposes of the property. The basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustment to basis while holding the property. The basis for figuring loss is its FMV when the taxpayer received the gift plus or minus any required adjustment to basis while holding the property.

Property Changed to Business or Rental Use

If the taxpayer holds property for personal use and then change it to business use or use it to produce rent, he or she must figure its basis for depreciation. An example of changing property held for personal use to business use would be renting out a former main home.

The basis for depreciation is the lesser of the following amounts: (50)

- The FMV of the property on the date of the change.
- The taxpayer's adjusted basis on the date of the change.

Example
Several years ago, Virginia paid $160,000 to have her home built on a lot that cost $25,000. She paid $20,000 for permanent improvements to the house and claimed a $2,000 casualty loss deduction for damage to the house before changing the property to rental use last year. Because land is not depreciable, Virginia includes only the cost of the house when figuring the basis for depreciation.

Her adjusted basis in the house when she changed its use was $178,000 ($160,000 + $20,000 − $2,000). On the same date, Virginia's property had an FMV of $180,000, of which $15,000 was for the land and $165,000 was for the house. The basis for figuring depreciation on the house is its FMV on the date of change ($165,000) because it is less than her adjusted basis ($178,000).

Leasehold Improvements

Lessors may use the adjusted basis of a leasehold improvement made by the lessor to calculate their gain or loss upon termination of the lease. Lessors may then report that gain or loss even though the property underlying the lease on which the leasehold improvements are situated is not sold or otherwise exchanged. Lessees may also do this upon termination of the lease if they created and abandoned a leasehold improvement.

The depreciable recovery period for leasehold improvements is 15 years. The cost of an addition or improvement made by a lease to real property subject to MACRS is depreciated the same way as the property would be if the property had been placed in service at the same time as the addition or improvement without regard to the lease term.

Methods of Depreciation

There are three systems involved in the computation of depreciation. The depreciation system that applies to a particular piece of property is determined by the type of property and when the property was placed in service. For tangible property use: (46)

- MACRS (Modified Accelerated Cost Recovery System) if placed in service after December 31, 1986.
- ACRS (Accelerated Cost Recovery System) if placed in service after December 31, 1980, but before January 1, 1987.
- Straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before January 1, 1981.

Tangible property is any property that a person can see and touch. This includes automobiles, buildings, and equipment. The total of all the yearly depreciation deductions cannot be more than the cost or other basis of the property. Section 168(i)(8) provides that the cost of any building erected or improvements made on leased property is recovered as a MACRS deduction. This means the recovery period is determined by the type of property the improvements consist of, regardless of the remaining term of the lease. The taxpayer cannot use MACRS to depreciate the following property: (46)

- Property placed in service before 1987.
- Certain property owned or used in 1986.
- Intangible property.
- Films, video tapes, and recordings.
- Certain corporate or partnership property acquired in a nontaxable transfer.
- Property elected to exclude from MACRS.

The taxpayer stops depreciating property when he or she has fully recovered the cost or other basis. He or she recovers the basis when the Section 179 and allowed or allowable depreciation deductions equal the cost or investment in the property.

Recovery Periods

The following is a list of the nine property classifications under GDS and examples of the types of property included in each class. These property classes are also listed under column (a) in Section B, Part III, of Form 4562. In 2020, under MACRS, most property used in business (income-producing) activities that is placed in service during the current tax year would fall into one of the following nine property classifications under GDS:

- **3-year property** includes:
    - Any racehorse over 2 years old when placed in service before January 1, 2009. (Any racehorse placed in service after December 31, 2008, and before January 1, 2022, is treated as 3-year property regardless of the age of the racehorse).
    - Any other horse (other than a racehorse) that is more than 12 years old at the time it is placed in service.
    - Any qualified rent-to-own property (as defined in Section 168(i)(14)).
- **5-year property** includes:
    - Automobiles.
    - Light general-purpose trucks.
    - Office machinery (such as typewriters, calculators, copiers, and duplicating equipment.)
    - Any semi-conductor manufacturing equipment.
    - Any qualified technological equipment.
    - Any Section 1245 property used in connection with research and experimentation.
    - Certain energy property specified in Section 168(e)(3)(B)(vi).
    - Appliances, carpets, furniture, etc., used in a rental real estate activity.
    - Any new machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business and placed in service after 2017, in tax years ending after 2017. The original use of the property must begin with the taxpayer after 2017.
- **7-year property** includes:
    - Office furniture and fixtures (such as desks, files, and safes).
    - Railroad track.
    - Any motorsports entertainment complex property (as defined in Section 168(i) (15)).
    - Any natural gas gathering line (as defined in Section 168(i)(17)) placed in service after April 11, 2005, the original use of which begins with the taxpayer after April 11, 2005 and is not under self-construction or subject to a binding contract in existence before April 12, 2005. Also, no AMT adjustment is required.
    - Any used agricultural machinery and equipment placed in service after 2017, grain bins, cotton ginning assets, or fences used in a farming business (but no other land improvements).
    - Any property that does not have a class life and is not otherwise classified.
- **10-year property** includes:
    - Vessels, barges, tugs, and similar water transportation equipment.
    - Any single-purpose agricultural or horticultural structure (see Section 168(i)(13)).
    - Any tree or vine bearing fruits or nuts.
    - Any qualified smart electric grid system property.
- **15-year property** includes:
    - Any municipal wastewater treatment plant.
    - Any telephone distribution plant and comparable equipment used for 2-way exchange of voice and data communications.
    - Any Section 1250 property that is a retail motor fuels outlet (whether or not food or other convenience items are sold there).
    - Initial clearing and grading land improvements for gas utility property.
    - Certain electric transmission property (that is Section 1245 property) used in the transmission at 69 or more kilovolts of electricity placed in service after April 11, 2005, the original use of which begins with the taxpayer after April 11, 2005 and is not under self-construction or subject to a binding contract in existence before April 12, 2005.
    - Qualified improvement property, as defined in Section 168(e)(6), placed in service by the taxpayer after December 31, 2017.

- **20-year property** includes:
  - Farm buildings (other than single purpose agricultural or horticultural structures).
  - Municipal sewers not classified as 25-year property.
  - Initial clearing and grading land improvements for electric utility transmission and distribution plants.
- **25-year property** is water utility property, which is:
  - Property that is an integral part of the gathering, treatment, or commercial distribution of water, and that, without regard to this provision, would be 20-year property.
  - Municipal sewers other than property placed in service under a binding contract in effect at all times since June 9, 1996.
- **Residential Rental Property** is any building or structure, such as a rental home (including a mobile home), if 80% or more of its gross rental income for the tax year is from dwelling units.
- **Nonresidential Real Property** is any real property that is neither residential rental property nor property with a class life of less than 27.5 years.
- **50-year property** includes any improvements necessary to construct or improve a roadbed or right-of-way for railroad track that qualifies as a railroad grading or tunnel bore under Section 168(e)(4).

Qualified Improvement Property

The CARES Act corrects a drafting error in TCJA, which unintentionally resulted in "qualified improvement property" being depreciated as 39-year property and therefore not qualifying for bonus depreciation (currently 100%). Qualified improvement property generally is any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date the building was first placed in service (excluding expenditures attributable to the enlargement of the building, any elevator or escalator or the internal structural framework of the building).

As corrected by the CARES Act, qualified improvement property is treated as 15-year property, and, therefore, bonus depreciation eligible. The change is made as if included in TCJA, and thus is effective for property placed in service after December 31, 2017. This may necessitate the filing of an automatic change of accounting method or amending a previously filed tax return. As a result of this correction, taxpayers who made certain elections may not be able to claim bonus depreciation on qualified improvement property.

Qualified Rent-to-Own Property

Qualified rent-to-own property is property held by a rent-to-own dealer for purposes of being subject to a rent-to-own contract. It is tangible personal property generally used in the home for personal use. It includes computers and peripheral equipment, televisions, videocassette recorders, stereos, camcorders, appliances, furniture, washing machines and dryers, refrigerators, and other similar consumer durable property. Consumer durable property does not include real property, aircraft, boats, motor vehicles, or trailers.

Depreciation Systems

Tip

Use of either the General Depreciation System (GDS) or the Alternative Depreciation System (ADS) to depreciate property under MACRS determines what depreciation method and recovery period is used. Generally, the taxpayer must use GDS unless specifically required by law to use ADS or if he or she elects to use ADS. The General Depreciation System (GDS) is the most commonly used MACRS system as this method provides for greater deduction during the early years of a property's life.

MACRS provides three depreciation methods under GDS and one depreciation method under ADS: [52]

- The regular MACRS 200% declining balance method over a GDS recovery period (listed above).
- The 150% declining balance method over a GDS recovery period.
- The straight line method over a GDS recovery period.
- The straight line method over an ADS recovery period.

For property placed in service before 1999, the taxpayer could have elected the 150% declining balance method using the ADS recovery periods for certain property classes. If the taxpayer made this election, he or she should continue to use the same method and recovery period for that property.

Instead of using either the 200% or 150% declining balance methods over the GDS recovery period, the taxpayer can elect to use the straight line method over the GDS recovery period. Make the election by entering "S/L" under column (f) in Part III of Form 4562.

Under GDS, property is depreciated over one of the following recovery periods in 2020: [(48)]

Property Class	Recovery Period
3-year property	3 years[1]
5-year property	5 years
7-year property	7 years
10-year property	10 years
15-year property	15 years[2]
20-year property	20 years
25-year property	25 years[3]
Residential rental property	27.5 years
Nonresidential real property	39 years[4]
[1]5 years for qualified rent-to-own property placed in service before August 6, 1997.	
[2]39 years for property that is a retail motor fuels outlet placed in service before August 20, 1996 (31.5 years if placed in service before May 13, 1993), unless the taxpayer elected to depreciate it over 15 years.	
[3]20 years for property placed in service before June 13, 1996, or under a binding contract in effect before June 10, 1996	
[4]31.5 years for property placed in service before May 13, 1993 (or before January 1, 1994, if the purchase or construction of the property is under a binding contract in effect before May 13, 1993, or if construction began before May 13, 1993).	

Table 7-2 - IRS Publication 946 - Recovery Periods Under GDS (2020)

The taxpayer can elect to use the Alternative Depreciation System (ADS) even though his or her property may come under GDS. ADS uses the straight line method of depreciation over fixed ADS recovery periods. Make the election by completing line 20 in Part III of Form 4562.

The following table shows some of the ADS recovery periods:

Property	ADS Recovery Period
Rent-to-own property	4 years
Automobiles and light duty trucks	5 years
Computers and peripheral equipment	5 years
High technology telephone station equipment installed on customer premises	5 years
High technology medical equipment	5 years
Personal property with no class life	12 years
Natural gas gathering lines	14 years
Single purpose agricultural and horticultural structures	15 years
Any tree or vine bearing fruit or nuts	20 years
Initial clearing and grading land improvements for gas utility property	20 years
Initial clearing and grading land improvements for electric utility transmission and distribution plants	25 years
Electric transmission property used in the transmission at 69 or more kilovolts of electricity	30 years
Natural gas distribution lines	35 years
Nonresidential real property	40 years
Residential rental property	30 years[1]
Section 1245 real property not listed in Appendix B of Publication 946	40 years
Railroad grading and tunnel bore	50 years
[1]40 years for property placed in service before January 1, 2018.	

Table 7-3 - Publication 946 - Recovery Periods Under ADS (2020)

The recovery periods for most property generally are longer under ADS than they are under GDS. The following table shows some of the ADS recovery periods in relation to class life and GDS recovery periods.

Property	Class Life (In years)	GDS Recovery Period (in years)	ADS Recovery Period (In years)
Automobiles and taxis	3	5	5
Light general-purpose trucks	4	5	5
Information systems including computers and peripheral equipment	6	5	5
Data Handling Equipment; except computers	6	5	6
Heavy general-purpose Trucks	6	5	6
Buses	9	5	9
Office Furniture, Fixtures and Equipment	10	7	10
Vessels, Barges Tugs and Similar Water Transportation Equipment, except those used in marine construction	18	10	18
Airplanes (airframes and engines) except those used in commercial or contract carrying of passengers of freight, and all Helicopters	6	5	6
Tractor Units for Use Over-the-road	4	3	4
Trailers and Trailer-mounted Containers	6	5	6
Land Improvements	20	15	20
Industrial Steam and Electric Generation and/or Distribution Systems	22	15	22

Table 7-4 - Publication 946 -Table B-1. Table of Class Lives and Recovery Periods (2020)

A taxpayer must use ADS for the following property:

- Listed property used 50% or less in a qualified business.
- Any tangible property used predominantly outside the United States during the year.
- Any tax-exempt use property.
- Any tax-exempt bond-financed property.
- All property used predominantly in a farming business and placed in service in any tax year during which an election not to apply the uniform capitalization rules to certain farming costs is in effect.
- Any property imported from a foreign country for which an Executive Order is in effect because the country maintains trade restrictions or engages in other discriminatory acts.

If the taxpayer elects to use a different method for one item in a property class, he or she must apply the same method to all property in that class placed in service during the year of the election. However, the taxpayer can make the election on a property-by-property basis for nonresidential real and residential rental property.

Depreciation Conventions

Under MACRS, averaging conventions establish when the recovery period begins and ends. The convention a taxpayer uses determines the number of months for which he or she can claim depreciation in the year the property was placed in service and in the year the property is disposed. Use the mid-month convention for nonresidential real property, residential rental property, and any railroad grading or tunnel bore.

Use the mid-quarter convention if the mid-month convention does not apply and the total depreciable bases of MACRS property placed in service during the last 3 months of the tax year (excluding nonresidential real property, residential rental property, any railroad grading or tunnel bore, property placed in service and disposed of in the same year, and property that is being depreciated under a method other than MACRS) are more than 40% of the total depreciable bases of all MACRS property the taxpayer placed in service during the entire year.

Use the half-year convention if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, the taxpayer treats all property placed in service or disposed of during a tax year as placed in service or disposed of at the midpoint of the year. This means that a one-half year of depreciation is allowed for the year the property is placed in service or disposed. (52)

Rental Property

A taxpayer can depreciate rental property if it meets all the following requirements. (53)

1. The taxpayer owns the property.
2. The property is used in a business or income-producing activity (such as rental property).
3. The property has a determinable useful life.
4. The property is expected to last more than one year.

Three factors determine how much depreciation a taxpayer can deduct each year: (53)

1. Basis in the property.
2. The recovery period for the property.
3. The depreciation method used.

A taxpayer cannot simply deduct the mortgage or principal payments, or the cost of furniture, fixtures and equipment, as an expense.

The basis of property is usually its cost. The cost is the amount paid for the property in cash, in debt obligation, in other property, or in services. The cost also includes: (53)

- Sales tax charged on the purchase.
- Freight charges to obtain the property.
- Installation and testing charges.

The taxpayer begins to depreciate his or her rental property when he or she places it in service for the production of income. The taxpayer stops depreciating it either when he or she has fully recovered his or her cost or other basis, or when he or she retires it from service, whichever happens first. The taxpayer places property in service in a rental activity when it is ready and available for a specific use in that activity. Even if he or she is not using the property, it is in service when it is ready and available for its specific use.

If the taxpayer places property in service in a personal activity, he or she cannot claim depreciation. However, if he or she changes the property's use to business or the production of income, he or she can begin to depreciate it at the time of the change. The taxpayer places the property in service for business or income-producing use on the date of the change. Under MACRS, property that a taxpayer placed in service during 2020 for rental activities generally falls into one of the following classes: (53)

- **5-year property** - This class includes computers and peripheral equipment, office machinery (typewriters, calculators, copiers, etc.), automobiles, and light trucks. This class also includes appliances, carpeting, furniture, etc., used in a residential rental real estate activity. Depreciation on automobiles, other property used for transportation, computers and related peripheral equipment, and property of a type generally used for entertainment, recreation, or amusement is limited.
- **7-year property** - This class includes office furniture and equipment (desks, file cabinets, etc.). This class also includes any property that does not have a class life and that has not been designated by law as being in any other class.
- **15-year property** - This class includes roads, fences, and shrubbery (if depreciable).
- **Residential rental property** - This class includes any real property that is a rental building or structure (including a mobile home) for which 80% or more of the gross rental income for the tax year is from dwelling units. It does not include a unit in a hotel, motel, inn, or other establishment where more than half of the units are used on a transient basis. If the taxpayer lives in any part of the building or structure, the gross rental income includes the fair rental value of the part he or she lives in.

The recovery period of property is the number of years over which the taxpayer recovers its cost or other basis. The recovery periods are generally longer under ADS than GDS. The recovery period of property depends on its property class. Under GDS, the recovery period of an asset is generally the same as its property class. The following table contains some of the MACRS recovery periods for property used in rental activities for 2020.

Type of Property	General Depreciation System	Alternative Depreciation System
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as typewriters, calculators, copiers	5 years	6 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Appliances, such as stoves, refrigerators	5 years	9 years
Carpets	5 years	9 years
Furniture used in rental property	5 years	9 years
Office furniture and equipment, such as desks, files	7 years	10 years
Any property that does not have a class life and that has not been designated by law as being in any other class	7 years	12 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Fences	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc.	27.5 years	30 years[1]
Additions and improvements, such as a new roof	The same recovery period as that of the property to which the addition or improvement is made, determined as if the property was placed in service at the same time as the addition or improvement	
[1]If placed in service after 2017; otherwise, 40 years		

Table 7-5 - IRS Publication 527 - Table 2-1 - MACRS Recovery Periods for Property Used in Rental Activities (2020)

For rental properties, MACRS consists of two systems that determine how a taxpayer depreciates property; the General Depreciation System (GDS) and the Alternative Depreciation System (ADS). The taxpayer must use GDS unless he or she is specifically required by law to use ADS or he or she elects to use ADS.

Figuring MACRS Depreciation

The following information is necessary to calculate the depreciation using MACRS:

- Depreciation System:
    - ADS or GDS.
    - Property class.
    - Recovery period.
- Date placed in service.
- Basis amount.
- Depreciation convention.
- Depreciation method (200 DB, 150 DB, S/L).

The taxpayer can figure his or her MACRS depreciation in one of two ways:

- Actually compute the deduction using the applicable depreciation method and convention over the recovery period.
- Use the percentage from the optional MACRS tables.

The deduction is the same under both methods.

Can Employees Claim a Deduction?

An employee can claim a depreciation deduction for the use of his or her listed property (whether owned or rented) in performing services as an employee only if his or her use is a business use. The use of the employee's property in performing services as an employee is a business use only if both the following requirements are met: (46)

- The use is for the employer's convenience.
- The use is required as a condition of the employee's employment.

If these requirements are not met, the employee cannot deduct depreciation (including the Section 179 deduction) or rent expenses for his or her use of the property as an employee.

Section 179 Election

When it comes to tax planning, there's an old adage that says, "When in doubt, accelerate deductions and postpone income". This concept is based on the time value of money. When it comes to depreciating property, following this adage can be difficult. Remember, as a general rule, business assets are depreciated over a specified period of years. There is one major exception under the Code. It is the so-called **Section 179 Election**.

Under Section 179 of the Internal Revenue Code, a taxpayer might be able to treat all or part of the cost of certain qualifying property as an expense in the year that the property was acquired. This means that instead of treating a depreciable asset as a capital expenditure, where he or she can only recover the cost of the asset through the general depreciation system, the taxpayer might be able to take an immediate current year's deduction for all or part of the cost of the asset. In common tax jargon, we say that he might be able to expense the asset instead of capitalizing and depreciating the asset.

When Can the Section 179 Election Be Made?

We say that this is an election. By that we mean that the taxpayer has to make a decision during the first year that the asset is placed in service as to whether he wants a current year's deduction, or instead wants to depreciate it over a period of years. An asset placed in service under Section 179 means that the decision must be made in the first year that the asset is placed in a condition or state of readiness and availability for a specifically assigned function. Be careful with this concept.

For example, let us say that the taxpayer bought a car last year and used it entirely for personal purposes. This year, he or she starts using the car for legitimate business use. Can the taxpayer take a Section 179 deduction for the car this year? No, they cannot. Any Section 179 expense that would have been allowed is only allowed during the first year that the asset was placed in service which, in our example, was last year. However, because the property was not used in a trade or business, or held for production of income last year, the taxpayer could not take the deduction during last year. Although this year may be the first year that the car was placed in business use, that does not matter. Any deduction now available has to be taken through the general depreciation system (GDS).

What Property Can Be Expensed?

Not only is a Section 179 expense deduction available only in the first year that the property is placed in service, it is only available for qualifying property. The asset must be used more than **50%** of the time for business in the first year it is placed in service and must have a useful life of more than one year.

Property that may be written off in the tax year of purchase, rather than depreciated over the asset's useful life, includes: (54)

- Tangible personal property including:
  - Machinery and equipment.
  - Property contained in or attached to a building (other than structural components), such as refrigerators, grocery store counters, office equipment, printing presses, testing equipment, and signs.
  - Gasoline storage tanks and pumps at retail service stations.
  - Livestock, including horses, cattle, hogs, sheep, goats, and mink and other furbearing animals.

  - Portable air conditioners or heaters placed in service by the taxpayer in tax years beginning after 2015.
  - Certain property used predominantly to furnish lodging or in connection with the furnishing of lodging (except as provided in Section 50(b)(2)).
- Other tangible property (except most buildings and their structural components) that:
  - Is used as an integral part of manufacturing, production, or extraction, or of providing transportation, communications, electricity, gas, water, or sewage disposal services.
  - Is a research facility used in connection with any of the activities listed above.
  - Is a facility used in connection with any of the activities referred to above for the bulk storage of interchangeable commodities such as grain.
- Single purpose livestock or horticultural structures.
- Storage facilities, again excluding buildings and their structural components, that are used in connection with the distribution of petroleum or any primary product of petroleum.
- Off-the-shelf computer software.
- Qualified Section 179 real property.

Although some of this may seem technical, it is not really very difficult to understand. The vast majority of all tangible personal property can be expensed if it is used in the taxpayer's trade or business in the first year that the property was acquired. This would include, for example, machinery, equipment, and even most livestock. However, some types of property are specifically excluded, and therefore cannot be expensed under Section 179.

Some examples of non-qualifying property are:

- Property held for investment (Section 212 property).
- Land and land improvements do not qualify as Section 179 property. Land improvements include swimming pools, paved parking areas, wharves, docks, bridges, and fences.
- Certain property the taxpayer leases to others (if he or she is a noncorporate lessor).
- Property used predominantly outside the United States, except property described in Section 168(g)(4) of the Internal Revenue Code.
- Property used by certain tax-exempt organizations, except property used in connection with the production of income subject to the tax on unrelated trade or business income.
- Property used by governmental units or foreign persons or entities, except property used under a lease with a term of less than 6 months.

To qualify for the Section 179 deduction, the taxpayer’s property must have been acquired for use in a trade or business. Property the taxpayer acquires only for the production of income, such as investment property, rental property (if renting property is not his or her trade or business), and property that produces royalties, does not qualify.

When the taxpayer uses property for both business and nonbusiness purposes, he or she can elect the Section 179 deduction only if he or she uses the property more than 50% for business in the year he or she places it in service. If the taxpayer uses the property more than 50% for business, multiply the cost of the property by the percentage of business use. Use the resulting business cost to figure the Section 179 deduction.

Property Acquired by Purchase

To qualify for the Section 179 deduction, the taxpayer’s property must have been acquired by purchase. For example, property acquired by gift or inheritance does not qualify. Property is not considered acquired by purchase in the following situations:

1. It is acquired by one component member of a controlled group from another component member of the same group.
2. Its basis is determined either:
   a. In whole or in part by its adjusted basis in the hands of the person from whom it was acquired.
   b. Under the stepped-up basis rules for property acquired from a decedent.
3. It is acquired from a related person.

For this purpose, related persons consist of the taxpayer and a member of his or her family, including only a spouse, child, parent, brother, sister, half-brother, half-sister, ancestor, and lineal descendant.

How Much Can the Taxpayer Deduct?

The taxpayer's Section 179 deduction is generally the cost of the qualifying property. However, the total amount he or she can elect to deduct under Section 179 is subject to a dollar limit and a business income limit. These limits apply to each taxpayer, not to each business. For a passenger automobile, the total Section 179 deduction and depreciation deduction are limited. If the taxpayer deducts only part of the cost of qualifying property as a Section 179 deduction, he or she can generally depreciate the cost he or she does not deduct.

If the taxpayer buys qualifying property with cash and a trade-in, its cost for purposes of the Section 179 deduction includes only the cash he or she paid.

Section 179 Dollar Limitations

With the passage and signing into law of the Tax Cuts and Jobs Act, the deduction limit for Section 179 increased from $1,020,000 to $1,040,000 for tax year 2020. The limit on equipment purchases likewise has increased, from $2,550,000 to $2,590,000. In addition, the deduction now includes any of the following improvements to existing nonresidential property (i.e., the improvement must be placed in service after the date the property itself was first placed in service): roofs; heating, air-conditioning, and ventilation systems; fire protection, alarm, and security systems. Further, the bonus depreciation increases from 50% to 100%. This part is retroactive to September 27, 2017 and is good through 2022. The bonus depreciation also now includes used equipment. (55)

The amount the taxpayer can elect to deduct is not affected if he or she places qualifying property in service in a short tax year or if he or she places qualifying property in service for only a part of a 12-month tax year. However, after the taxpayer applies the dollar limit to determine a tentative deduction, he or she must apply the business income limit to determine his or her actual Section 179 deduction.

Under certain circumstances, the general dollar limits on the Section 179 deduction may be reduced or increased or there may be additional dollar limits.

In 2020, the general dollar limit is affected by any of the following situations:

- The cost of the taxpayer's Section 179 property placed in service exceeds $2,590,000.
- The taxpayer's business is an enterprise zone business where the empowerment zone tax benefits were not extended beyond December 31, 2017.
- The taxpayer placed in service a sport utility or certain other vehicles.
- The taxpayer is married filing a joint or separate return.

If the cost of the taxpayer's qualifying Section 179 property placed in service in a year is more than $2,590,000, he or she generally must reduce the dollar limit (but not below zero) by the amount of cost over $2,590,000. If the cost of his or her Section 179 property placed in service during 2020 is $3,630,000 or more, the taxpayer cannot take a Section 179 deduction.

The total cost that can be deducted under Section 179 is also limited to the taxable income earned from the taxpayer's trade or business during the year. Taxable income (including salaries and wages paid to the taxpayer(s) from the business and reported as W-2 income) is figured without regard to any available Section 179 expense deduction. However, the amount of any disallowed deduction in this tax year can be carried over to next tax year and be added to the amount of qualified Section 179 property placed in service in that next tax year. To elect the Section 179 Deduction a taxpayer needs to fill out Part One of IRS Form 4562 - Depreciation and Amortization.

Section 179 property is property that the taxpayer acquires by purchase for use in the active conduct of his or her trade or business, and is one of the following:

- Qualified Section 179 real property.
- Tangible personal property, including cellular telephones, similar telecommunications equipment, and air conditioning or heating units (for example, portable air conditioners or heaters). Also, tangible personal property may include certain property used mainly to furnish lodging or connection with the furnishing of lodging (except as provided in Section 50(b)(2)).

- Other tangible property (except buildings and their structural components) used as:
    1. An integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services;
    2. A research facility used in connection with any of the activities in (1) above; or
    3. A facility used in connection with any of the activities in (1) above for the bulk storage of fungible commodities.
- Single purpose agricultural (livestock) or horticultural structures.
- Storage facilities (except buildings and their structural components) used in connection with distributing petroleum.
  or any primary product of petroleum.
- Off the shelf computer software.

Under special rules for qualified Section 179 real property the taxpayer can elect to treat certain qualified real property placed in service during the tax year as Section 179 property.

If the election is made, the term "Section 179 property" will include any qualified real property which is:

- Qualified improvement property as described in Section 168(e)(6), and
- Any of the following improvements to nonresidential real property placed in service after the date the nonresidential real property was first placed in service.
    1. Roofs.
    2. Heating, ventilation, and air-conditioning property.
    3. Fire protection and alarm systems.
    4. Security systems.

A deduction attributable to qualified Section 179 real property which is disallowed under the trade or business income limitation for 2020 can be carried over to 2021. Thus, the amount of any 2020 disallowed Section 179 expense deduction attributable to qualified Section 179 real property will be reported on line 13 of Form 4562.

Listed Property

Listed property is a specific class of depreciable property that is subject to a special set of tax rules if it is used for business no more than 50% of the time.

Listed property generally includes the following:

- Passenger automobiles weighing 6,000 pounds or less.
- Any other property used for transportation if the nature of the property lends itself to personal use, such as motorcycles, pick-up trucks, sport utility vehicles, etc.
- Any property used for entertainment or recreational purposes (such as photographic, phonographic, communication, and video recording equipment).
- Computers or peripheral equipment placed in service before 2018.

The Tax Cuts and Jobs Act (TCJA) removed computer or peripheral equipment from the definition of listed property. This change applies to property placed in service after December 31, 2017.
Listed property does not include:

- Photographic, phonographic, communication, or video equipment used exclusively in a taxpayer's trade or business or at the taxpayer's regular business establishment.
- Any computer or peripheral equipment used exclusively at a regular business establishment and owned or leased by the person operating the establishment.
- An ambulance, hearse, or vehicle used for transporting persons or property for compensation or hire.
- Any truck or van placed in service after July 6, 2003, that is a qualified nonpersonal use vehicle.

The TCJA also changed depreciation limits for passenger vehicles, trucks, and vans (not meeting the guidelines below), that are used more than 50% in a qualified business use and placed in service after December 31, 2017.

For passenger automobiles placed in service in 2020 for which the Section 168(k) bonus first-year depreciation deduction does not apply, the depreciation limit under Section 280F(d)(7) is:

- $10,100 for the first year,
- $16,100 for the second year,
- $9,700 for the third year, and
- $5,760 for each later taxable year in the recovery period.

For passenger automobiles to which the Section 168(k) bonus first-year depreciation deduction applies and that are acquired after September 27, 2017, and placed in service during calendar year 2020, the depreciation limit under Section 280F(d)(7) is:

- $18,100 for the first year,
- $16,100 for the second year,
- $9,700 for the third year, and
- $5,760 for each later taxable year in the recovery period.

Exceptions include the following vehicles:

- Taxis, transport vans, and other vehicles used to specifically transport people or property for hire.
- Ambulance or hearse used specifically in a taxpayer's business.
- Qualified non-personal use vehicles specifically modified for business (i.e., van without seating behind driver, permanent shelving installed, and exterior painted with company's name).

Also, the maximum Section 179 expense deduction for sport utility vehicles (SUV) placed in service in tax years beginning in 2020 is $25,900.

Many vehicles that by their nature are not likely to be used for personal purposes qualify for full Section 179 deduction including the following vehicles:

1. Heavy non-SUV vehicles with a cargo area at least six feet in interior length (this area must not be easily accessible from the passenger area).
2. Vehicles that can seat nine-plus passengers behind the driver's seat (i.e.: Hotel / Airport shuttle vans, etc.).
3. Vehicles with a fully enclosed driver's compartment / cargo area, no seating at all behind the driver's seat, and no part of the body Section protruding more than 30 inches ahead of the leading edge of the windshield.

Used Equipment (that is new to the taxpayer) qualifies for Section 179. Under the TCJA, used equipment also qualifies for Bonus Depreciation.

Bonus Depreciation

The Tax Cuts and Jobs Act (TCJA) increased the bonus depreciation percentage from 50% to 100% for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. The bonus depreciation percentage for qualified property that a taxpayer acquired before September 28, 2017, and placed in service before January 1, 2018, remains at 50%. Special rules apply for longer production period property and certain aircraft. The amount of allowable bonus depreciation is then phased down over four years: 80% will be allowed for property placed in service in 2023, 60% in 2024, 40% in 2025, and 20% in 2026. (For certain property with long production periods, the above dates will be pushed out a year.)

The 100% depreciation deduction generally applies to depreciable business assets with a recovery period of 20 years or less and certain other property. Machinery, equipment, computers, appliances and furniture generally qualify.

The definition of property eligible for 100% bonus depreciation was expanded to include used qualified property acquired and placed in service after September 27, 2017, if all the following factors apply:

- The taxpayer or its predecessor did not use the property at any time before acquiring it.
- The taxpayer did not acquire the property from a related party.
- The taxpayer did not acquire the property from a component member of a controlled group of corporations.

- The taxpayer's basis of the used property is not figured in whole or in part by reference to the adjusted basis of the property in the hands of the seller or transferor.
- The taxpayer's basis of the used property is not figured under the provision for deciding basis of property acquired from a decedent.
- Also, the cost of the used property eligible for bonus depreciation does not include the basis of property determined by reference to the basis of other property held at any time by the taxpayer (for example, in a like-kind exchange or involuntary conversion).

The TCJA added qualified film, television, and live theatrical productions as types of qualified property that may be eligible for 100% bonus depreciation. This provision applies to property acquired and placed in service after September 27, 2017.

Under the TCJA, certain types of property are not eligible for bonus depreciation in any taxable year beginning after December 31, 2017. One such exclusion from qualified property is for property primarily used in the trade or business of the furnishing or sale of:

- Electrical energy, water or sewage disposal services,
- Gas or steam through a local distribution system, or
- Transportation of gas or steam by pipeline.

This exclusion applies if the rates for the furnishing or sale have to be approved by a Federal, state or local government agency, a public service or public utility commission, or an electric cooperative.

The TCJA also added an exclusion for any property used in a trade or business that has had floor-plan financing indebtedness if the floor-plan financing interest was taken into account under Section 163(j)(1)(C). Floor-plan financing indebtedness is secured by motor vehicle inventory that in a business that sells or leases motor vehicles to retail customers.

Bonus Depreciation is useful to very large businesses spending more than the Section 179 Spending Cap on new capital equipment. Also, businesses with a net loss are still qualified to deduct some of the cost of new equipment and carry-forward the loss. When applying these provisions, Section 179 is generally taken first, followed by Bonus Depreciation - unless the business had no taxable profit, because the unprofitable business is allowed to carry the loss forward to future years.

Unrecovered Basis

There are limits on the amount a taxpayer can deduct for depreciation of his or her car, truck, or van. The Section 179 deduction is treated as depreciation for purposes of the limits. The maximum amount a taxpayer can deduct each year depends on the year he or she puts the car in service. If the depreciation deductions for the taxpayer's car are reduced, he or she will have unrecovered basis in his or her car at the end of the recovery period. If the taxpayer continues to use his or her car for business, he or she can deduct that unrecovered basis (subject to depreciation limits) after the recovery period ends.

Unrecovered basis is the cost or other basis of the passenger automobile reduced by any clean-fuel vehicle deduction, electric vehicle credit, depreciation, and Section 179 deductions that would have been allowable if the taxpayer had used the car 100% for business and investment use and the passenger automobile limits had not applied.

The taxpayer cannot claim a depreciation deduction for listed property other than passenger automobiles after the recovery period ends. There is no unrecovered basis at the end of the recovery period because he or she is considered to have used this property 100% for business and investment purposes during all of the recovery period.

For 5-year property, the taxpayer's recovery period is 6 calendar years. A part year's depreciation is allowed in the first calendar year, a full year's depreciation is allowed in each of the next 4 calendar years, and a part year's depreciation is allowed in the 6th calendar year. Under MACRS, the taxpayer's recovery period is the same whether he or she utilizes declining balance or straight line depreciation. The taxpayer determines his or her unrecovered basis in the 7th year after he or she placed the car in service.

If the taxpayer continues to use his or her car for business after the recovery period, he or she is due a depreciation deduction in each succeeding tax year until he or she recovers the basis in the car. The maximum amount the taxpayer can deduct each year is determined by the date he or she placed the car in service and his or her business-use percentage. For example, no deduction is allowed for a year the taxpayer uses a car 100% for personal purposes.

Per Revenue Procedure 2011-26 the IRS provides a safe harbor accounting method. This procedure provides guidance with respect to the 100% additional first year depreciation deduction under Section 168(k)(5) of the Code, and the extension of the 50% bonus depreciation deduction for qualified property placed in service in 2010. This procedure defines which property is eligible for the 100% bonus depreciation deduction and provides guidance regarding the time and manner for making certain elections under Sections 168(k)(2) and (5). The procedure also provides a safe harbor method of accounting for passenger automobiles that qualify for the 100% additional first year depreciation deduction and that are subject to first-year limitations under Section 280F.

The taxpayer selects the safe harbor method by choosing it to deduct depreciation on a passenger car on the return of the year that follows the placed-in-service year of the car when the cost exceeded the first-year luxury auto limit and the 100% bonus depreciation deduction was claimed.

Recapture

The taxpayer may have to recapture the Section 179 deduction if, in any year during the property's recovery period, the percentage of business use drops to 50% or less. In the year the business use drops to 50% or less, he or she includes the recapture amount as ordinary income in Part IV of Form 4797. The taxpayer also increases the basis of the property by the recapture amount.

Amortization

Amortization is a method of recovering (deducting) certain capital costs over a fixed period of time. It is similar to the straight line method of depreciation. An amortizable asset is generally property that is intangible, is personal, has a determinable useful life and is used in a trade or business or for the production of income. Examples of non-personal use assets are patents, leases, customer lists and mortgages. A deduction is allowed for assets used in a trade or business for the production of income. The deduction is ratable (straight-line) over the useful life of the asset starting with the month the asset is acquired. The useful life of a patent is the 20 years for which it is afforded legal protection.

Section 197 Intangibles

Generally, the taxpayer may amortize the capitalized costs of "Section 197 intangibles" ratably over a 15-year period. He or she must amortize these costs if he or she holds the Section 197 intangibles in connection with his or her trade or business or in an activity engaged in for the production of income. The taxpayer's amortization deduction each year is the applicable part of the intangible's adjusted basis (for purposes of determining gain), figured by amortizing it ratably over 15 years (180 months).

The 15-year period begins with the later of: [27]

- The month the intangible is acquired.
- The month the trade or business or activity engaged in for the production of income begins.

The taxpayer cannot deduct amortization for the month he or she disposes of the intangible. If the taxpayer pays or incurs an amount that increases the basis of an amortizable Section 197 intangible after the 15-year period begins, amortize it over the remainder of the 15-year period beginning with the month the basis increase occurs.

Note

The taxpayer is not allowed any other depreciation or amortization deduction for an amortizable Section 197 intangible.

The following assets are Section 197 intangibles and must be amortized over 180 months: [27]

1. Goodwill.
2. Going concern value.
3. Workforce in place.

4. Business books and records, operating systems, or any other information base, including lists or other information concerning current or prospective customers.
5. A patent, copyright, formula, process, design, pattern, know-how, format, or similar item.
6. A customer-based intangible.
7. A supplier-based intangible.
8. Any item similar to items (3) through (7).
9. A license, permit, or other right granted by a governmental unit or agency (including issuances and renewals).
10. A covenant not to compete entered into in connection with the acquisition of an interest in a trade or business.
11. Any franchise, trademark, or trade name.
12. A contract for the use of, or a term interest in, any item in this list.

Tip

A taxpayer cannot amortize any of the intangibles listed in items (1) through (8) that he or she created rather than acquired unless he or she created them in acquiring assets that make up a trade or business or a substantial part of a trade or business.

The following assets are not Section 197 intangibles: (27)

1. Any interest in a corporation, partnership, trust, or estate.
2. Any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or similar financial contract.
3. Any interest in land.
4. Most computer software.
5. Any of the following assets not acquired in connection with the acquisition of a trade or business or a substantial part of a trade or business:
    a. An interest in a film, sound recording, video tape, book, or similar property.
    b. A right to receive tangible property or services under a contract or from a governmental agency.
    c. An interest in a patent or copyright.
    d. Certain rights that have a fixed duration or amount.
6. An interest under either of the following:
    a. An existing lease or sublease of tangible property.
    b. A debt that was in existence when the interest was acquired.
7. A right to service residential mortgages unless the right is acquired in connection with the acquisition of a trade or business or a substantial part of a trade or business.
8. Certain transaction costs incurred by parties to a corporate organization or reorganization in which any part of a gain or loss is not recognized.

Intangible property that is not amortizable under the rules for Section 197 intangibles can be depreciated if it meets certain requirements. The taxpayer generally must use the straight line method over its useful life. For certain intangibles, the depreciation period is specified in the law and regulations. For example, the depreciation period for computer software that is not a Section 197 intangible is generally 36 months.

To deduct amortization that begins during the current tax year, complete Part VI of Form 4562 and attach it to the income tax return. To report amortization from previous years, in addition to amortization that begins in the current year, list on Form 4562 each item separately. For example, in 2019, the taxpayer began to amortize a lease. In 2020, he or she began to amortize a second lease. The taxpayer should report amortization from the new lease on line 42 of the 2020 Form 4562. He or she should report amortization from the 2019 lease on line 43 of the 2020 Form 4562. If the taxpayer does not have any new amortizable expenses for the current year, he or she is not required to complete Form 4562 (unless he or she is claiming depreciation). Report the current year's deduction for amortization that began in a prior year directly on the “Other deduction” or “Other expense line” of the return.

Capitalization and Repairs

In the past, the ability to take an immediate deduction for certain expenditures was somewhat liberal. However, the IRS began to take notice and as a result, the Treasury Department has attempted to produce rules that will tighten this flexibility with Treasury Decision 9636. These new rules are commonly referred to as the “Cap and Repair Regs”. There are two different versions of the regulation:

- The temporary cap and repair regulations were issued in 2011. If the taxpayer's operation elected to implement the temporary regulations, those would apply during the time period from 2011-2013, and new regulations would be effective for taxable years beginning January 1, 2014.
- The final cap and repair regulations were issued in September 2013. If the taxpayer's operation did not elect to implement the temporary regulations, the final regulations will apply and are effective for taxable years beginning January 1, 2014.

Section 162 of the Internal Revenue Code (IRC) allows a taxpayer to deduct all the ordinary and necessary expenses he or she incurs during the taxable year in carrying on his or her trade or business, including the costs of certain materials, supplies, repairs, and maintenance. However, Section 263(a) of the IRC requires the taxpayer to capitalize the costs of acquiring, producing, and improving tangible property, regardless of the size or the cost incurred. The tax law has long required the taxpayer to determine whether expenditures related to tangible property are currently deductible business expenses or non-deductible capital expenditures. Before the issuance of the final tangible property regulations on September 17, 2013, [Treasury Decision 9636 (final regulations)], the taxpayer's decisions were guided by decades of often conflicting case law, as well as administrative rulings on specific factual situations.

The basic structure and requirements within the temporary regulations remained intact. Although the final regulations have been "simplified" in several key areas, they remain complex overall. The final regulations follow the basic outline of the proposed and temporary regulations, with changes made within each of five main areas:

1. Materials and supplies (Regulation 1.162-3).
2. Repairs and maintenance (Regulation 1.162-4).
3. Capital expenditures (Regulation 1.263(a)-1).
4. Amounts paid for the acquisition or production of tangible property (Regulation 1.263(a)-2).
5. Amounts paid for the improvement of tangible property (Regulation 1.263(a)-3).

The changes emphasized by the IRS include:

1. A revised and simplified de minimis safe harbor under Regulation 1.263(a)-1(f).
2. The extension of the safe harbor for routine maintenance to buildings.
3. An annual election for buildings that cost $1 million or less to deduct up to $10,000 of maintenance costs or, if less, 2% of the building's adjusted basis.
4. A new annual election to capitalize repair costs that are capitalized on a taxpayer's books and records.
5. The refinement of the criteria for defining betterments and restorations to tangible property.

The final regulations apply to anyone who pays or incurs amounts to acquire, produce, or improve tangible real or personal property. These regulations apply to corporations, S corporations, partnerships, LLCs, and individuals filing a Form 1040 with Schedule C, E, or F. The final regulations affect the taxpayer if he or she incurs amounts to acquire, produce or improve tangible real or personal property in carrying on his or her trades or businesses. The rules are most significant for those that regularly incur large capital expenditures, e.g., electric utilities, telecommunications companies, and businesses with substantial real estate holdings. The final regulations are effective for taxable years beginning on or after January 1, 2014.

De Minimis Safe Harbor Election

Effective for taxable years beginning on or after January 1, 2016, the Internal Revenue Service in Notice 2015-82 increased the de minimis safe harbor threshold from $500 to $2,500 per invoice or item for taxpayers without applicable financial statements. In addition, the IRS will provide audit protection to eligible businesses by not challenging the use of the $2,500 threshold for tax years ending before January 1, 2016 if the taxpayer otherwise satisfies the requirements of Treasury Regulation Section 1.263(a)-1(f)(1)(ii).

Under the final regulations, the taxpayer may elect to apply a de minimis safe harbor to amounts paid to acquire or produce tangible property to the extent such amounts are deducted by him or her for financial accounting purposes or in keeping his or her books and records. If the taxpayer has an applicable financial statement (AFS), he or she may use this safe harbor to deduct amounts paid for tangible property up to $5,000 per invoice or item. If the taxpayer does not have an AFS, he or she may use the safe harbor to deduct amounts up to $500 (prior to January 1, 2016) per item or invoice.

These limitations are for purposes of determining whether particular expenses qualify under the safe harbor; they are not intended as a ceiling on the amount the taxpayer can deduct as business expenses under the IRC.

Amounts paid for the acquisition or production of tangible property that exceed the safe harbor limitations are not subject to the de minimis safe harbor election. Therefore, the safe harbor does not require the taxpayer to capitalize all amounts paid for tangible property in excess of the applicable limitation. If an amount does not qualify under the de minimis safe harbor, the taxpayer should treat the amount under the normal rules that apply, i.e., currently deductible if paid for incidental materials and supplies or for repair and maintenance. This treatment is proper regardless of whether the amount exceeds the applicable de minimis safe harbor limitation. The de minimis safe harbor is simply an administrative convenience that generally allows the taxpayer to elect to deduct small-dollar expenditures for the acquisition or production of property that otherwise must be capitalized under the general rules.

The facts and circumstances analysis for distinguishing capital improvements from deductible repairs are:

- *For buildings* – The unit of property is generally the entire building including its structural components. However, under the final regulations and for these purposes only, the improvement analysis applies to the building structure and each of the key building systems. The key building systems are the plumbing system, electrical system, HVAC system, elevator system, escalator system, fire protection and alarm system, gas distribution system, and the security system. Lessees of portions of buildings apply the analysis to the portion of the building structure and portion of each building system subject to the lease. Lessors of an entire building apply the improvement rules to the entire building structure and each of the key building systems.
- *For non-buildings* – The unit of property is, and the analysis applies to, all components that are functionally interdependent. Components of property are functionally interdependent if the taxpayer cannot place in service one component of property without placing in service another component of property.
- *For plant property, e.g., manufacturing plant, generation plant, etc*. – The unit of property is, and the analysis applies to, each component or group of components within the plant that performs a discrete and major function or operation.
- *For network assets, e.g., railroad track, oil and gas pipelines, etc*. – The taxpayer's particular facts and circumstances or industry guidance from the Treasury Department and the IRS determines the unit of property and the application of the improvement analysis.

To reduce the difficulty with applying the facts and circumstances analysis to identify the tax treatment of costs and to recognize simpler administration by permitting the taxpayer to follow financial accounting policies for Federal tax purposes, the final regulations include an election to capitalize repair and maintenance expenses as improvements, if he or she treats such costs as capital expenditures for financial accounting purposes.

The taxpayer may elect to treat repair and maintenance costs paid during the taxable year as amounts paid to improve property if he or she:

1. Pays these amounts in carrying on a trade or business; and
2. Treats these amounts as capital expenditures on his or her books and records regularly used in computing his or her income.
3. Makes the election to capitalize for each taxable year in which qualifying amounts are incurred by attaching a statement to his or her timely filed original Federal tax return including extensions for the taxable year that the amounts are paid.
    a. If he or she makes the election to capitalize repair and maintenance expenses, he or she must apply the election to all amounts paid for repair and maintenance that he or she treats as capital expenditures on his or her books and records in that taxable year.
    b. An annual election is not a change in method of accounting. Therefore, he or she should not file Form 3115 - Application for Change in Accounting Method to make this election or to stop capitalizing repairs and maintenance costs for a subsequent year.

Materials and Supplies Costs

In most cases, the final regulations do not change the general rules for deducting materials and supplies. The final regulations merely incorporate pre-existing precedents on the definition and treatment of materials and supplies and add some safe harbors to provide the taxpayer with additional certainty. The final regulations also provide additional elections and methods for those using rotable spare parts. Materials and supplies are tangible, non-inventory property used and consumed in the taxpayer's operations including:

- *Acquired components* – Costs of components acquired to maintain, repair, or improve tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of a larger item of tangible property.
- *Consumables* – Costs of fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in operations.
- *12-month property* – Costs of tangible property that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations.
- *$200 property* – Costs of tangible property that has an acquisition cost or production cost of $200 or less.

As under prior rules, the taxpayer may deduct the costs of incidental and nonincidental materials and supplies in the following manner:

- *Incidental materials and supplies* – If the materials and supplies are incidental, i.e., of minor or secondary importance, carried on hand without keeping a record of consumption, and no beginning and ending inventories are recorded, e.g., pens, paper, staplers, toner, trash baskets, then the taxpayer deducts the materials and supplies costs in the taxable year in which the amounts are paid or incurred, provided taxable income is clearly reflected.
- *Nonincidental materials and supplies* – If the materials and supplies are not incidental, then the taxpayer deducts the materials and supplies costs in the taxable year in which the materials and supplies are first used or consumed in his or her operations. For example, the taxpayer deducts certain expendable spare parts in a trucking business for which records of consumption are kept and inventories are recorded in the taxable year the part is removed from his or her storage area and installed in one of his or her trucks. However, an otherwise deductible material or supply cost could be subject to capitalization under Section 263(a) if he or she uses the material or supply to improve property or under Section 263A if he or she incorporates the material or supply into property he or she produces or acquires for resale.
- *Application with de minimis safe harbor* – If the taxpayer elects to use the de minimis safe harbor and any materials and supplies also qualify for the safe harbor, he or she must deduct amounts paid for these materials or supplies under the safe harbor in the taxable year the amounts are paid or incurred. Such amounts are not treated as amounts paid for materials and supplies and may be deducted as business expenses in the taxable year they are paid or incurred.

Because the final regulations governing the treatment of materials and supplies are based primarily on prior law, if the taxpayer was previously in compliance with the rules he or she generally will still be in compliance and generally no action will be required to continue to apply these rules on a prospective basis.

Also, the final regulations governing the treatment of material and supplies apply to amounts paid or incurred in taxable years beginning on or after January 1, 2014. Therefore, for the taxpayer's first taxable year beginning January 1, 2014, most taxpayers will not have a change in accounting method for his or her materials and supplies. If the taxpayer desires to change his or her method of accounting for materials and supplies in a subsequent taxable year, he or she would file Form 3115 and compute a Section 481(a) adjustment taking into account only amounts paid after January 1, 2014.

Nothing in the final regulations under Section 263(a) changes the treatment of any amount that is specifically provided for under any provision of the IRC or the Treasury regulations other than Section 162(a) or Section 212. For example, the final regulations do not eliminate the requirements of Section 263(a), which generally provides that the taxpayer must capitalize the direct and allocable indirect costs of producing real or tangible personal property and acquiring property for resale.

Generally, the final regulations apply to taxable years beginning on or after January 1, 2014, or in certain circumstances, apply to costs paid or incurred in taxable years beginning on or after January 1, 2014.

Sales, Dispositions and Analysis of Capital Assets

A sale is a transfer of property for money or a mortgage, note, or other promise to pay money. An exchange is a transfer of property for other property or services.

Some agreements that seem to be leases may really be conditional sales contracts. The intention of the parties to the agreement can help the taxpayer distinguish between a sale and a lease. There is no test or group of tests to prove what the parties intended when they made the agreement. The taxpayer should consider each agreement based on its own facts and circumstances.

Payments received by a tenant for the cancellation of a lease are treated as an amount realized from the sale of property. Payments received by a landlord (lessor) for the cancellation of a lease are essentially a substitute for rental payments and are taxed as ordinary income in the year in which they are received.

Payments a taxpayer receives for granting the exclusive use of (or right to exploit) a copyright throughout its life in a particular medium are treated as received from the sale of property. It does not matter if the payments are a fixed amount or a percentage of receipts from the sale, performance, exhibition, or publication of the copyrighted work, or an amount based on the number of copies sold, performances given, or exhibitions made. Nor does it matter if the payments are made over the same period as that covering the grantee's use of the copyrighted work.

Tip

If the copyright was used in the taxpayer's trade or business and he or she held it longer than a year, the gain or loss may be a Section 1231 gain or loss.

The amount received for granting an easement is subtracted from the basis of the property. If only a specific part of the entire tract of property is affected by the easement, only the basis of that part is reduced by the amount received. If it is impossible or impractical to separate the basis of the part of the property on which the easement is granted, the basis of the whole property is reduced by the amount received. Any amount received that is more than the basis to be reduced is a taxable gain. The transaction is reported as a sale of property. [56]

A transfer of property to satisfy a debt is an exchange.

The transfer of property of a decedent to an executor or administrator of the estate, or to the heirs or beneficiaries, is not a sale or exchange or other disposition. No taxable gain or deductible loss results from the transfer.

Generally, a transfer (other than by sale or exchange) of property from a debtor to a bankruptcy estate is not treated as a disposition. Consequently, the transfer generally does not result in gain or loss.

The taxpayer usually realizes gain or loss when property is sold or exchanged. A gain is the amount he or she realizes from a sale or exchange of property that is more than its adjusted basis. A loss is the adjusted basis of the property that is more than the amount he or she realizes.

The taxpayer must know the basis of his or her property to determine whether he or she has a gain or loss from its sale or other disposition. The basis of property is usually its cost. However, if the taxpayer acquired the property by gift, inheritance, or in some way other than buying it, he or she must use a basis other than its cost. The adjusted basis of property is the original cost or other basis plus (increased by) certain additions and minus (decreased by) certain deductions. Increases include costs of any improvements having a useful life of more than 1 year. Decreases include depreciation and casualty losses.

The amount the taxpayer realizes from a sale or exchange is the total of all money he or she receives plus the fair market value of all property or services he or she receives. The amount the taxpayer realizes also includes any of his or her liabilities that were assumed by the buyer and any liabilities to which the property the taxpayer transferred is subject, such as real estate taxes or a mortgage.

Fair market value (FMV) is the price at which the property would change hands between a buyer and a seller when both have reasonable knowledge of all the necessary facts and neither is being forced to buy or sell. If parties with adverse interests place a value on property in an arm's-length transaction, that is strong evidence of FMV. If there is a stated price for services, this price is treated as the FMV unless there is evidence to the contrary.

The taxpayer's gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes. Recognized gains must be included in gross income. Recognized losses are deductible from gross income. However, the taxpayer's gain or loss realized from certain exchanges of property is not recognized for tax purposes. Also, a loss from the sale or other disposition of property held for personal use is not deductible, except in the case of a casualty or theft.

The amount the taxpayer realizes from the disposition of a life interest in property, an interest in property for a set number of years, or an income interest in a trust is a recognized gain under certain circumstances. If the taxpayer received the interest as a gift, inheritance, or in a transfer from a spouse or former spouse incident to a divorce, the amount realized is a recognized gain. The taxpayer's basis in the property is disregarded. This rule does not apply if all interests in the property are disposed of at the same time.

Form 8949 – Sales and Other Dispositions of Capital Assets is a relatively new form. Many transactions that, in previous years, would have been reported by corporations and partnerships on Schedule D must now be reported on Form 8949. Schedule D-1 is no longer in use. Form 8949 replaces it. Individuals use Form 8949 to report: (57)

- The sale or exchange of a capital asset not reported on another form or schedule.
- Gains from involuntary conversions (other than from casualty or theft) of capital assets not held for business or profit.
- Nonbusiness bad debts.

Corporations and partnerships use Form 8949 to report: (58)

- The sale or exchange of a capital asset not reported on another form or schedule.
- Nonbusiness bad debts.
- Undistributed long-term capital gains from Form 2439.

Electing large partnerships and corporations also use Form 8949 to report their share of gain or (loss) from a partnership, S corporation, estate or trust.

Complete all necessary pages of Form 8949 before completing line 1, 2, 3, 8, 9, or 10 of Schedule D. Use Schedule D:

- To figure the overall gain or loss from transactions reported on Form 8949.
- To report a gain from Form 2439 or 6252 or Part I of Form 4797.
- To report a gain or loss from Form 4684, 6781, or 8824.
- To report a gain or loss from a partnership, S corporation, estate or trust.
- To report capital gain distributions not reported directly on Form 1040, line 6 (or effectively connected capital gain distributions not reported directly on Form 1040NR, line 14).
- To report a capital loss carryover from the previous tax year to the current tax year.
- To report the taxpayer's share of a gain or (loss) from a partnership, S corporation, estate, or trust. (However, corporations report this type of gain or (loss) on Form 8949).
- To report transactions reported to the taxpayer on a Form 1099-B (or substitute statement) showing basis was reported to the IRS and for which he or she has no adjustments.

Individuals, estates, and trusts also use Schedule D to report undistributed long-term capital gains from Form 2439.

Use Form 4797 - Sales of Business Property to report the following: (35)

- The sale or exchange of:
  - Property used in a trade or business.
  - Depreciable and amortizable property.
  - Oil, gas, geothermal, or other mineral property.
  - Section 126 property.

- The involuntary conversion (other than from casualty or theft) of property used in a trade or business and capital assets held for business or profit.
- The disposition of noncapital assets other than inventory or property held primarily for sale to customers in the ordinary course of a trade or business.
- Ordinary loss on the sale, exchange, or worthlessness of small business investment company (Section 1242) stock.
- Ordinary loss on the sale, exchange, or worthlessness of small business (Section 1244) stock.
- Ordinary gain or loss on securities held in connection with the trading business, if the taxpayer previously made a mark-to-market election.

Use Form 4684 - Casualties and Thefts to report involuntary conversions of property due to casualty or theft.

Use Form 6781 - Gains and Losses From Section 1256 Contracts and Straddles to report any gain or loss on Section 1256 contracts under the market-to-market rules and gains and losses under Section 1092 from straddle positions.

A Section 1256 contract is any: (59)

- Regulated futures contract.
- Foreign currency contract.
- Non-equity option.
- Dealer equity option.
- Dealer securities futures contract.

A Section 1256 contract does not include any interest rate swap, currency swap, basis swap, commodity swap, equity swap, equity index swap, credit default swap, interest rate cap, interest rate floor, or similar agreement.

Use Parts I, II, and III of Form 8824 - Like-Kind Exchanges to report each exchange of business or investment property for property of a like kind. Certain members of the executive branch of the Federal Government and judicial officers of the Federal Government use Part IV to elect to defer gain on conflict-of-interest sales. Judicial officers of the Federal Government are the following: (60)

- Chief Justice of the United States.
- Associate Justices of the Supreme Court.
- Judges of the:
    - United States courts of appeals.
    - United States district courts, including the district courts in Guam, the Northern Mariana Islands, and the Virgin Islands.
    - Court of Appeals for the Federal Circuit.
    - Court of International Trade.
    - Tax Court.
    - Court of Federal Claims.
    - Court of Appeals for Veterans Claims.
    - United States Court of Appeals for the Armed Forces.
    - Any court created by Act of Congress, the judges of which are entitled to hold office during good behavior.

See the instructions for the Schedule D if the taxpayer is filing for detailed information about the following: (58)

- Other forms he or she may have to file.
- The definition of capital asset.
- Reporting capital gain distributions, undistributed capital gains, the sale of a main home, the sale of capital assets held for personal use, or the sale of a partnership interest.
- Capital losses, nondeductible losses, and losses from wash sales.
- Traders in securities.
- Short sales.
- Gain or loss from options.
- Installment sales.
- Demutualization of life insurance companies.
- Exclusion or rollover of gain from the sale of qualified small business stock.

- Any other rollover of gain, such as gain from the sale of publicly traded securities.
- Exclusion of gain from the sale of DC Zone assets or qualified community assets.
- Certain other items that get special treatment.
- Special reporting rules for corporations and partnerships in certain situations.

Basis

The taxpayer must know the basis of his or her property to determine whether he or she has a gain or loss from its sale or other disposition. The basis of property the taxpayer buys is usually its cost. However, if the taxpayer acquired the property by gift, inheritance, or in some way other than buying it, he or she must use a basis other than its cost.

The adjusted basis of property is the taxpayer's original cost or other basis plus certain additions and minus certain deductions, such as depreciation and casualty losses.

The amount the taxpayer realizes from a sale or exchange is the total of all money he or she receives plus the fair market value (defined below) of all property or services he or she receives. The amount the taxpayer realizes also includes any of his or her liabilities that were assumed by the buyer and any liabilities to which the property he or she transferred is subject, such as real estate taxes or a mortgage.

Fair market value (FMV) is the price at which the property would change hands between a buyer and a seller when both have reasonable knowledge of all the necessary facts, and neither is being forced to buy or sell. If parties with adverse interests place a value on property in an arm's-length transaction, that is strong evidence of FMV. If there is a stated price for services, this price is treated as the FMV unless there is evidence to the contrary.

The taxpayer must keep accurate records that show the basis and, if applicable, adjusted basis of the property. The records should show the purchase price, including commissions; increases to basis, such as the cost of improvements; and decreases to basis, such as depreciation, non-dividend distributions on stock, and stock splits. (56)

Adjusted Basis

Before figuring gain or loss on a sale, exchange, or other disposition of property or figuring allowable depreciation, depletion, or amortization, the taxpayer must usually make certain adjustments to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increase the basis of any property by all items properly added to a capital account. These include the cost of any improvements having a useful life of more than 1 year. Rehabilitation expenses also increase basis. However, the taxpayer must subtract any rehabilitation credit allowed for these expenses before he or she adds them to his or her basis. If the taxpayer has to recapture any of the credit, increase his or her basis by the recaptured amount.

If the taxpayer makes additions or improvements to business property, keep separate accounts for them. Also, he or she must depreciate the basis of each according to the depreciation rules that would apply to the underlying property if he or she had placed it in service at the same time he or she placed the addition or improvement in service.

The following items increase the basis of property: (51)

- The cost of extending utility service lines to the property.
- Impact fees.
- Legal fees, such as the cost of defending and perfecting title.
- Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements.
- Zoning costs.
- The capitalized value of a redeemable ground rent.

The taxpayer does not add to his or her basis costs he or she can deduct as current expenses. For example, amounts paid for incidental repairs or maintenance that are deductible as business expenses cannot be added to basis. However, the taxpayer can choose either to deduct or to capitalize certain other costs. If he or she capitalizes these costs, include them in his or her basis. If he or she deducts them, do not include them in his or her basis.

The costs the taxpayer can choose to deduct or to capitalize include the following:

- Carrying charges, such as interest and taxes, that he or she pays to own property, except carrying charges that must be capitalized under the uniform capitalization rules.
- Research and experimentation costs.
- Intangible drilling and development costs for oil, gas, and geothermal wells.
- Exploration costs for new mineral deposits.
- Mining development costs for a new mineral deposit.
- Costs of establishing, maintaining, or increasing the circulation of a newspaper or other periodical.
- Costs of removing architectural and transportation barriers to people with disabilities and the elderly. If the taxpayer claims the disabled access credit, he or she must reduce the amount he or she deducts or capitalize by the amount of the credit.

The following are some items that reduce the basis of property: [51]

- Section 179 deduction.
- Nontaxable corporate distributions.
- Deductions previously allowed (or allowable) for amortization, depreciation, and depletion.
- Exclusion of subsidies for energy conservation measures.
- Vehicle credits.
- Residential energy credits.
- Postponed gain from sale of home.
- Investment credit (part or all) taken.
- Casualty and theft losses and insurance reimbursement.
- Certain canceled debt excluded from income.
- Rebates from a manufacturer or seller.
- Easements.
- Gas-guzzler tax.
- Adoption tax benefits.
- Credit for employer-provided childcare.

Capital Asset

Each item of property the corporation held (whether or not connected with its trade or business) is a capital asset except the following: [35]

- Stock in trade or other property included in inventory or held mainly for sale to customers. However, see the Note below.
- Accounts or notes receivable acquired in the ordinary course of the trade or business for services rendered or from the sale of stock in trade or other property included in inventory or held mainly for sale to customers.
- Depreciable or real property used in the trade or business, even if it is fully depreciated.
- Certain copyrights; literary, musical, or artistic compositions; letters or memoranda; or similar property. However, see the note below.
- U.S. Government publications, including the Congressional Record, that the corporation received from the Government, other than by purchase at the normal sales price, or that the corporation got from another taxpayer who had received it in a similar way, if the corporation's basis is determined by reference to the previous owner's basis.
- Certain commodities derivative financial instruments held by a dealer in connection with its dealer activities.
- Certain identified hedging transactions entered into in the normal course of the trade or business.
- Supplies regularly used in the trade or business.

Note

The corporation can elect to treat as capital assets certain musical compositions or copyrights it sold or exchanged.

Capital Losses

For a corporation, capital losses are allowed in the current tax year only to the extent of capital gains. A net capital loss is carried back 3 years and forward up to 5 years as a short-term capital loss. Carry back a capital loss to the extent it does not increase or produce a net operating loss in the tax year to which it is carried. Foreign expropriation capital losses cannot be carried back but are carried forward up to 10 years. A net capital loss of a regulated investment company (RIC) incurred in tax years beginning before December 23, 2010, is carried forward up to 8 years. There is no limit on the number of tax years a RIC is allowed to carryover a net capital loss incurred in tax years beginning after December 22, 2010.

Sale of a Business

The sale of a business usually is not a sale of one asset. Instead, all the assets of the business are sold. Generally, when this occurs, each asset is treated as being sold separately for determining the treatment of gain or loss.

A business usually has many assets. When sold, these assets must be classified as capital assets, depreciable property used in the business, real property used in the business, or property held for sale to customers, such as inventory or stock in trade. The gain or loss on each asset is figured separately. The sale of capital assets results in capital gain or loss. The sale of real property or depreciable property used in the business and held longer than 1-year results in gain or loss from a Section 1231 transaction. The sale of inventory results in ordinary income or loss.

Section 1231 Gains and Losses

Section 1231 gains and losses are the taxable gains and losses from Section 1231 transactions. Their treatment as ordinary or capital depends on whether the taxpayer has a net gain or a net loss from all his or her Section 1231 transactions. If the taxpayer has a gain from a Section 1231 transaction, first determine whether any of the gain is ordinary income under the depreciation recapture rules. Do not take that gain into account as Section 1231 gain.

The following transactions result in gain or loss subject to Section 1231 treatment: [56]

Sales or exchanges of real property or depreciable personal property - This property must be used in a trade or business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business. Depreciable personal property includes amortizable Section 197 intangibles.

Sales or exchanges of leaseholds - The leasehold must be used in a trade or business and held longer than 1 year.

Sales or exchanges of cattle and horses - The cattle and horses must be held for draft, breeding, dairy, or sporting purposes and held for 2 years or longer.

Sales or exchanges of other livestock - This livestock does not include poultry. It must be held for draft, breeding, dairy, or sporting purposes and held for 1 year or longer.

Sales or exchanges of unharvested crops - The crop and land must be sold, exchanged, or involuntarily converted at the same time and to the same person and the land must be held longer than 1 year. The taxpayer cannot keep any right or option to directly or indirectly reacquire the land (other than a right customarily incident to a mortgage or other security transaction). Growing crops sold with a lease on the land, though sold to the same person in the same transaction, are not included.

Cutting of timber or disposal of timber, coal, or iron ore - The cutting or disposal must be treated as a sale.

Condemnations - The condemned property must have been held longer than 1 year. It must be business property or a capital asset held in connection with a trade or business or a transaction entered into for profit, such as investment property. It cannot be property held for personal use.

Casualties and thefts - The casualty or theft must have affected business property, property held for the production of rents and royalties, or investment property (such as notes and bonds). The taxpayer must have held the property longer than 1 year. However, if his or her casualty or theft losses are more than his or her casualty or theft gains, neither the gains nor the losses are taken into account in the Section 1231 computation. For more information on casualties and thefts, see Publication 547. A sale, exchange, or involuntary conversion of property held mainly for sale to customers is not a Section 1231 transaction. If the taxpayer will get back all, or nearly all, of his or her investment in the property by selling it rather than by using it up in his or her business, it is property held mainly for sale to customers.

The sale of a copyright, a literary, musical, or artistic composition, or similar property is not a Section 1231 transaction if the taxpayer's personal efforts created the property, or if he or she acquired the property in a way that entitled him or her to the basis of the previous owner whose personal efforts created it (for example, if the taxpayer received the property as a gift). The sale of such property results in ordinary income and generally is reported in Part II of Form 4797.

To determine the treatment of Section 1231 gains and losses, combine all the taxpayer's Section 1231 gains and losses for the year: [56]

- If he or she has a net Section 1231 loss, it is ordinary loss.
- If he or she has a net Section 1231 gain, it is ordinary income up to the amount of his or her nonrecaptured Section 1231 losses from previous years. The rest, if any, is long-term capital gain.

The taxpayer's nonrecaptured Section 1231 losses are his or her net Section 1231 losses for the previous 5 years that have not been applied against a net Section 1231 gain. Therefore, if in any of the taxpayer's five preceding tax years he or she had Section 1231 losses, a net gain for the current year from the sale of Section 1231 assets is ordinary gain to the extent of his or her prior losses. These losses are applied against the taxpayer's net Section 1231 gain beginning with the earliest loss in the 5-year period.

If the taxpayer disposes of depreciable or amortizable property at a gain, he or she may have to treat all or part of the gain (even if otherwise nontaxable) as ordinary income. To figure any gain that must be reported as ordinary income, the taxpayer must keep permanent records of the facts necessary to figure the depreciation or amortization allowed or allowable on his or her property. This includes the date and manner of acquisition, cost or other basis, depreciation or amortization, and all other adjustments that affect basis.

Section 1245 Property

A gain on the disposition of Section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable. Any recognized gain that is more than the part that is ordinary income because of depreciation is a Section 1231 gain.

Section 1245 property includes any property that is or has been subject to an allowance for depreciation or amortization and that is any of the following types of property:

1. Personal property (either tangible or intangible).
2. Other tangible property (except buildings and their structural components) used as any of the following:
    a. An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
    b. A research facility in any of the activities in (a).
    c. A facility in any of the activities in (a) above, for the bulk storage of fungible commodities.
3. That part of real property (not included in (2)) with an adjusted basis reduced by (but not limited to) the following:
    a. Amortization of certified pollution control facilities.
    b. The Section 179 expense deduction.
    c. Deduction for clean-fuel vehicles and certain refueling property.
    d. Certain expenditures for childcare facilities. (Repealed by Public Law 101-58, Omnibus Budget Reconciliation Act of 1990, Section 11801(a)(13) except with regards to deductions made prior to November 5, 1990.)
    e. Expenditures to remove architectural and transportation barriers to the handicapped and elderly.
    f. Certain reforestation expenditures.
4. Single purpose agricultural (livestock) or horticultural structures.
5. Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.
6. Any railroad grading or tunnel bore.

Section 1245 property does not include buildings and structural components. The term building includes a house, barn, warehouse, or garage. The term structural component includes walls, floors, windows, doors, central air conditioning systems, light fixtures, etc.

Do not treat a structure that is essentially machinery or equipment as a building or structural component. Also, do not treat a structure that houses property used as an integral part of an activity as a building or structural component if the structure's use is so closely related to the property's use that the structure can be expected to be replaced when the property it initially houses is replaced.

The fact that the structure is specially designed to withstand the stress and other demands of the property and cannot be used economically for other purposes indicates it is closely related to the use of the property it houses. Structures such as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples are not treated as buildings, but as Section 1245 property.

The gain treated as ordinary income on the sale, exchange, or involuntary conversion of Section 1245 property, including a sale and leaseback transaction, is the lesser of the following amounts: [56]

1. The depreciation and amortization allowed or allowable on the property.
2. The gain realized on the disposition (the amount realized from the disposition minus the adjusted basis of the property).

Section 1250 Property

Gain on the disposition of Section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. Section 1250 property includes all real property that is subject to an allowance for depreciation and that is not and never has been Section 1245 property. It includes a leasehold of land or Section 1250 property subject to an allowance for depreciation. A fee simple interest in land is not included because it is not depreciable. If the taxpayer's Section 1250 property becomes Section 1245 property because he or she changes its use, the taxpayer can never again treat it as Section 1250 property.

If the taxpayer holds Section 1250 property longer than 1 year, the additional depreciation is the actual depreciation adjustments that are more than the depreciation figured using the straight line method. If the taxpayer holds Section 1250 property for 1 year or less, all the depreciation is additional depreciation.

The taxpayer will not have additional depreciation if any of the following conditions apply to the property disposed of: [56]

- He or she figured depreciation for the property using the straight line method or any other method that does not result in depreciation that is more than the amount figured by the straight line method; he or she held the property longer than 1 year; and, if the property was qualified property, he or she made a timely election not to claim any special depreciation allowance. In addition, if the property was in a renewal community, he or she must not have elected to claim a commercial revitalization deduction for property placed in service before January 1, 2010.
- The property was residential low-income rental property he or she held for 16 ⅔ years or longer. For low-income rental housing on which the special 60-month depreciation for rehabilitation expenses was allowed, the 16 ⅔ years start when the rehabilitated property is placed in service.
- He or she chose the alternate ACRS method for the property, which was a type of 15-, 18-, or 19-year real property covered by the Section 1250 rules.
- The property was residential rental property or nonresidential real property placed in service after 1986 (or after July 31, 1986, if the choice to use MACRS was made); he or she held it longer than 1 year; and, if the property was qualified property, he or she made a timely election not to claim any special depreciation allowance. These properties are depreciated using the straight line method. In addition, if the property was in a renewal community, he or she must not have elected to claim a commercial revitalization deduction.

Tip

Additional depreciation includes all depreciation adjustments to the basis of Section 1250 property whether allowed to the taxpayer or another person (as carryover basis property).

Dispositions of Intangible Property

Intangible property is any personal property that has value but cannot be seen or touched. It includes such items as patents, copyrights, and the goodwill value of a business. Gain or loss on the sale or exchange of amortizable or depreciable intangible property held longer than 1 year (other than an amount recaptured as ordinary income) is a Section 1231 gain or loss. See chapter 8 of Publication 535, Business Expenses, for information on amortizable intangible property and chapter 1 of Publication 946, How To Depreciate Property, for information on intangible property that can and cannot be depreciated. Gain or loss on dispositions of other intangible property is ordinary or capital depending on whether the property is a capital asset or a noncapital asset.

Section 197 intangibles are certain intangible assets acquired after August 10, 1993 (after July 25, 1991, if chosen), and held in connection with the conduct of a trade or business or an activity entered into for profit whose costs are amortized over 15 years.

They include the following assets:

- Goodwill.
- Going concern value.
- Workforce in place.
- Business books and records, operating systems, and other information bases.
- Patents, copyrights, formulas, processes, designs, patterns, know how, formats, and similar items.
- Customer-based intangibles.
- Supplier-based intangibles.
- Licenses, permits, and other rights granted by a governmental unit.
- Covenants not to compete entered into in connection with the acquisition of a business.
- Franchises, trademarks, and trade names.

Patents

The transfer of a patent by an individual is treated as a sale or exchange of a capital asset held longer than 1 year. This applies even if the payments for the patent are made periodically during the transferee's use or are contingent on the productivity, use, or disposition of the patent. This treatment applies to the transfer of a patent if all the following conditions are met: [(56)]

1. The taxpayer is the holder of the patent.
2. The taxpayer transfers the patent other than by gift, inheritance, or devise.
3. The taxpayer transfers all substantial rights to the patent or an undivided interest in all such rights.
4. The taxpayers do not transfer the patent to a related person.

Franchise, Trademark, or Trade Name

If the taxpayer transfers or renews a franchise, trademark, or trade name for a price contingent on its productivity, use, or disposition, the amount he or she receives generally is treated as an amount realized from the sale of a noncapital asset. A franchise includes an agreement that gives one of the parties the right to distribute, sell, or provide goods, services, or facilities within a specified area.

Sale or Exchange of Partnership Interest

The rules for disposing of a partnership interest, in general, treat the partnership as an entity separate and apart from its partners. This is sometimes referred to as the “entity theory” of partnership taxation. All aspects of the disposition (for example, basis, holding period, and character of the gain or loss) are determined without reference (except for IRC Section 751 assets) to the underlying assets of the partnership.

A partner who sells or exchanges a partnership interest must recognize gain or loss. Because a partnership interest is considered a capital asset, such gain or loss is considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in IRC Section 751 (relating generally to the presence of assets within the partnership that would generate ordinary income if sold).

The gain or loss from the disposition of a partnership interest is the difference between the amount realized and the partner’s adjusted basis (outside basis) in the interest immediately before the disposition. Although the formula for calculating gain or loss is simply stated, the actual calculation can be difficult at times.

The amount realized upon the sale of a partnership interest consists of cash plus the fair market value of property received plus the selling partner’s share of partnership liabilities assumed by the buyer or otherwise relieved in the transaction (IRC Section 752(b)).

The calculation of the partner's adjusted basis in the partnership interest begins with the initial partnership basis as determined under IRC Sections 722 or 742. This initial basis, which refers to the partner's original basis upon acquisition of his/her interest, is then increased by those items specified in IRC Sections 705(a)(1) and 752(a) and decreased by those specified in IRC Sections 705(a)(2) and 752(b). At the time of the sale or exchange, IRC Section 752(d) includes the selling partner's share of partnership liabilities in the amount realized.

Because the transferring partner's basis in the partnership must be determined as of the date of disposition, any adjustments to basis must also include the transferring partner's share of partnership income or losses from the beginning of the partnership year to the date the partner ceases to be a partner.

As noted, a partnership interest is a capital asset under IRC Section 741. Therefore, the sale of a partnership interest generally gives rise to capital gain or loss. However, under IRC Section 751, capital gain or loss treatment is not available to the extent of the partner's share of "hot assets" (generally ordinary income generating assets) that would generate ordinary income if sold or collected by the partnership. In essence, this treats the partner's sale of his/her interest in the partnership entity as a sale of an interest in underlying assets. To the extent the partner is treated as disposing of his/her interest in hot assets, he or she recognizes ordinary income.

When the sale of the partnership interest includes both cold assets (capital assets) and hot assets (assets with built in ordinary income potential), the sale is divided into two components:

1. Capital gains and losses from the cold assets.
2. Ordinary gains and losses from the hot assets.

Complications arise when a single asset has both hot and cold asset attributes subject to the recapture provisions of IRC Section 751(c). IRC Section 751(c) treats the amount to be recaptured as an unrealized receivable. Upon the sale of a partnership interest, recapture will generate ordinary income even though depreciable assets are capital assets (Treasury Regulation Section 1.751-1(c)(4)). The ordinary income component of the gain is computed first. Any remaining amount of the gain is capital.

The amount of the disposing partner's ordinary gain or loss is the difference between the amount realized attributable to the hot assets less the partnership's adjusted basis associated with these assets.

The sale of a partnership interest resulting in a gain can be reported under the installment method under IRC Section 453 if at least one payment is received after the year of sale. However, the gain resulting from unrealized receivables and inventory items cannot be reported under the installment method. See IRC Section 453(i). Moreover, a sale resulting in a loss cannot be reported under the installment method. See IRC Section 453(a).

Taxable Exchanges

A taxable exchange is one in which the gain is taxable or the loss is deductible. A taxable gain or deductible loss is also known as a recognized gain or loss. If the taxpayer receives property in exchange for other property in a taxable exchange, the basis of property he or she receives is usually its FMV at the time of the exchange. A taxable exchange occurs when the taxpayer receives cash or property not similar or related in use to the property exchanged.

Example
Sophia trades a tract of farmland with an adjusted basis of $3,000 for a tractor that has an FMV of $6,000. She must report a taxable gain of $3,000 for the land. The tractor has a basis of $6,000.

Section 1202 Exclusion

A taxpayer generally can exclude from his or her income up to 50% of his or her gain from the sale or trade of qualified small business stock held by him or her for more than 5 years. The exclusion can be up to 75% for stock acquired after February 17, 2009, and no later than September 27, 2010, and up to 100% for stock acquired after September 27, 2010. The exclusion can be up to 60% for certain empowerment zone business stock. The eligible gain minus the taxpayer's Section 1202 exclusion is a 28% rate gain.

If the stock is Specialized small business investment company (SSBIC) stock the taxpayer bought as replacement property for publicly traded securities he or she sold at a gain, the taxpayer must reduce the basis of the stock by the amount of any postponed gain on that earlier sale. But the taxpayer does not reduce his or her basis by that amount when figuring his or her Section 1202 exclusion.

The amount of the taxpayer's gain from the stock of any one issuer that is eligible for the exclusion in 2020 is limited to the greater of: [32]

- Ten times his or her basis in all qualified stock of the issuer he or she sold or exchanged during the year.
- $10 million ($5 million for married individuals filing separately) minus the amount of gain from the stock of the same issuer the taxpayer used to figure his or her exclusion in earlier years.

Section 1256 Contracts Marked-to-Market

A Section 1256 contract is any:

- Regulated futures contract.
- Foreign currency contract.
- Nonequity option.
- Dealer equity option.
- Dealer securities futures contract.

A Section 1256 contract does not include:

- Interest rate swaps.
- Currency swaps.
- Basis swaps.
- Interest rate caps.
- Interest rate floors.
- Commodity swaps.
- Equity swaps.
- Equity index swaps.
- Credit default swaps.
- Similar agreements.

A Section 1256 contract that the taxpayer holds at the end of the tax year will generally be treated as sold at its fair market value on the last business day of the tax year, and he or she must recognize any gain or loss that results. That gain or loss is taken into account in figuring his or her gain or loss when he or she later disposes of the contract. The marked-to-market rules do not apply to hedging transactions.

Under the marked-to-market system, 60% of taxpayer's capital gain or loss will be treated as a long-term capital gain or loss, and 40% will be treated as a short-term capital gain or loss. This is true regardless of how long the taxpayer actually held the property.

Like-Kind Exchanges

Generally, if the taxpayer exchanges real property he or she uses in his or her business or holds for investment solely for other business or investment real property of a like-kind, he or she does not recognize the gain or loss from the exchange. However, if the taxpayer also receives non-like-kind property or money as part of the exchange, he or she recognizes gain to the extent of the value of the other property or money he or she received in the exchange. And, he or she does not recognize any loss. In general, the taxpayer's gain or loss will not be recognized until he or she sells or otherwise disposes of the property he or she receives in the exchange.

Under the Tax Cuts and Jobs Act (TCJA), for exchanges completed after December 31, 2017, the nonrecognition rules for like-kind exchanges apply only to exchanges of real property not held primarily for sale. The nonrecognition rules no longer apply to personal property. Exceptions apply to property disposed of before January 1, 2018, and to property received in an exchange before January 1, 2018.

Also, effective December 22, 2017, Section 1400Z-2 provides a temporary deferral of inclusion in gross income for eligible capital gains invested in Qualified Opportunity Funds (QOF) within 180 days of sale or exchange. Section

1400Z-2 also provides a permanent exclusion of capital gains from the sale or exchange of an investment in the QOF if the investment is held for at least 10 years. See the Instructions for Form 8949 for information on how to report the taxpayer's election to defer eligible capital gains invested in a QOF.

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be a like-kind exchange, the property traded and the property received must be both of the following: (56)

- Qualifying property.
- Like-kind property.

Additional requirements apply to exchanges in which the property received as like-kind property is not received immediately upon the transfer of the property given up. Also, if the like-kind exchange involves the receipt of money or unlike property or the assumption of the taxpayer's liabilities, he or she may have to recognize gain.

The like-kind exchange rules also apply to property exchanges that involve three- and four-party transactions. Any part of these multiple-party transactions can qualify as a like-kind exchange if it meets all the requirements. Also, if the taxpayer receives property in a like-kind exchange and the other party who transfers the property to the taxpayer does not give him or her the title, but a third party does, the taxpayer still can treat this transaction as a like-kind exchange if it meets all the requirements.

If the taxpayer acquires property in a like-kind exchange, the basis of the property he or she receives is generally the same as the basis of the property he or she transferred.

Example
The taxpayer exchanged real estate held for investment with an adjusted basis of $25,000 for other real estate held for investment. The basis of his or her new property is the same as the basis of the old property ($25,000).

If, in addition to giving up like-kind property, the taxpayer pays money in a like-kind exchange, he or she still has no recognized gain or loss. The basis of the property received is the basis of the property given up, increased by the money paid.

Report the exchange of like-kind property, even though no gain or loss is recognized, on Form 8824 - Like-Kind Exchanges. The instructions for Form 8824 explain how to report the details of the exchange. If the taxpayer has any recognized gain because he or she received money or unlike property, report it on Form 8949 and Schedule D or Form 4797. The taxpayer may have to report the recognized gain as ordinary income from depreciation recapture.

Exchange expenses generally are the closing costs the taxpayer pays. They include such items as brokerage commissions, attorney fees, and deed preparation fees. Subtract these expenses from the consideration received to figure the amount realized on the exchange. If the taxpayer receives cash or unlike property in addition to the like-kind property and realizes a gain on the exchange, subtract the expenses from the cash or fair market value of the unlike property. Then, use the net amount to figure the recognized gain.

Qualified Property

The nonrecognition rules for like-kind exchanges apply only to exchanges of real property held for investment or for productive use in the taxpayer's trade or business and not held primarily for sale. Exceptions apply to property disposed of before January 1, 2018, or to property received in an exchange before January 1, 2018.

In a like-kind exchange, both the real property the taxpayer gives up and the real property he or she receives must be held by him or her for investment or for productive use in his or her trade or business. Buildings, land, and rental property are examples of property that may qualify.

The rules for like-kind exchanges do not apply to exchanges of the following property: (56)

- Real property use for personal purposes, such as the taxpayer's home.
- Real property held primarily for sale.
- Any personal or intangible property.

A dwelling unit (home, apartment, condominium, or similar property) may, for purposes of a like-kind exchange, qualify as property held for productive use in a trade or business or for investment purposes if certain requirements are met. See Revenue Procedure 2008-16, 2008-10 I.R.B. 547.

An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of one property for another property. Whether the taxpayer engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange.

Like-Kind Property

To qualify for the non-recognition rules, there must be an exchange of like-kind property. Like-kind properties are properties of the same nature or character, even if they differ in grade or quality. The exchange of real estate for real estate is an exchange of like-kind property. An exchange of personal property for real property does not qualify as a like-kind exchange. An exchange of city property for farm property, or improved property for unimproved property, is a like-kind exchange.

The exchange of real estate the taxpayer owns for a real estate lease that runs 30 years or longer is a like-kind exchange. However, not all exchanges of interests in real property qualify. The exchange of a life estate expected to last less than 30 years for a remainder interest is not a like-kind exchange. An exchange of a remainder interest in real estate for a remainder interest in other real estate is a like-kind exchange if the nature or character of the two property interests is the same.

Real property located in the United States and real property located outside the United States are not considered like-kind exchange rules. If the taxpayer exchanges foreign real property for property located in the United States, his or her gain or loss on the exchange is recognized. Foreign real property is real property not located in a state or the District of Columbia.

This foreign real property exchange rule does not apply to the replacement of condemned real property. Foreign and U.S. real property can still be considered like-kind property under the rules for replacing condemned property to postpone reporting gain on the condemnation.

Like-Kind Exchanges Between Related Persons

Special rules apply to like-kind exchanges between related persons. These rules affect both direct and indirect exchanges. Under these rules, if either person disposes of the property within 2 years after the exchange, the exchange is disqualified from nonrecognition treatment. The gain or loss on the original exchange must be recognized as of the date of the later disposition.

Under these rules, related persons include, for example, the taxpayer and a member of his or her family (spouse, brother, sister, parent, child, etc.), the taxpayer and a corporation in which he or she has more than 50% ownership, the taxpayer and a partnership in which he or she directly or indirectly owns more than a 50% interest of the capital or profits, and two partnerships in which the taxpayer directly or indirectly owns more than 50% of the capital interests or profits.

Sales and Exchanges Between Related Persons

If a gain is recognized on the sale or exchange of property to a related person, the gain may be ordinary income even if the property is a capital asset. It is ordinary income if the sale or exchange is a depreciable property transaction or a controlled partnership transaction. Gain on the sale or exchange of property, including a leasehold or a patent application, that is depreciable property in the hands of the person who receives it is ordinary income if the transaction is either directly or indirectly between any of the following pairs of entities: [56]

1. A person and the person's controlled entity or entities.
2. A taxpayer and any trust in which the taxpayer (or his or her spouse) is a beneficiary unless the beneficiary's interest in the trust is a remote contingent interest; that is, the value of the interest computed actuarially is 5% or less of the value of the trust property.
3. An executor and a beneficiary of an estate unless the sale or exchange is in satisfaction of a pecuniary bequest (a bequest for a sum of money).

4. An employer (or any person related to the employer under rules (1), (2), or (3)) and a welfare benefit fund (within the meaning of Section 419(e) of the Internal Revenue Code) that is controlled directly or indirectly by the employer (or any person related to the employer).

A person's controlled entity is either of the following: (56)

1. A corporation in which more than 50% of the value of all outstanding stock, or a partnership in which more than 50% of the capital interest or profits interest, is directly or indirectly owned by or for that person.
2. An entity whose relationship with that person is one of the following:
    a. A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest or profits interest in the partnership.
    b. Two corporations that are members of the same controlled group as defined in Section 1563(a) of the Internal Revenue Code, except that “more than 50%” is substituted for “at least 80%” in that definition.
    c. Two S corporations, if the same persons own more than 50% in value of the outstanding stock of each corporation.
    d. Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.

A gain recognized in a controlled partnership transaction may be ordinary income. The gain is ordinary income if it results from the sale or exchange of property that, in the hands of the party who receives it, is a noncapital asset such as trade accounts receivable, inventory, stock in trade, or depreciable or real property used in a trade or business.

A controlled partnership transaction is a transaction directly or indirectly between either of the following pairs of entities: (56)

1. A partnership and a person who directly or indirectly owns more than 50% of the capital interest or profits interest in the partnership.
2. Two partnerships, if the same persons directly or indirectly own more than 50% of the capital interests or profits interests in both partnerships.

In the transactions under Depreciable property transaction and Controlled partnership transaction, earlier, use the following rules to determine the ownership of stock or a partnership interest: (56)

1. Stock or a partnership interest directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries. (However, for a partnership interest owned by or for a C corporation, this applies only to shareholders who directly or indirectly own 5% or more in value of the stock of the corporation.)
2. An individual is considered as owning the stock or partnership interest directly or indirectly owned by or for his or her family. Family includes only brothers, sisters, half-brothers, half-sisters, spouse, ancestors, and lineal descendants.
3. For purposes of applying (1) or (2), above, stock or a partnership interest constructively owned by a person under (1) is treated as actually owned by that person. But stock or a partnership interest constructively owned by an individual under (2) is not treated as owned by the individual for reapplying (2) to make another person the constructive owner of that stock or partnership interest.

Nondeductible Loss

A loss on the sale or exchange of property between related persons is not deductible. This applies to both direct and indirect transactions, but not to distributions of property from a corporation in a complete liquidation.

If a sale or exchange is between any of these related persons and involves the lump-sum sale of a number of blocks of stock or pieces of property, the gain or loss must be figured separately for each block of stock or piece of property. The gain on each item is taxable. The loss on any item is nondeductible. Gains from the sales of any of these items may not be offset by losses on the sales of any of the other items.

In determining whether an individual directly or indirectly owns any of the outstanding stock of a corporation or an interest in a partnership for a loss on a sale or exchange, the following rules apply: (56)

1. Stock or a partnership interest directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries. (However, for a partnership interest owned by or for a C corporation, this applies only to shareholders who directly or indirectly own 5% or more in value of the stock of the corporation.)
2. An individual is considered as owning the stock or partnership interest directly or indirectly owned by or for his or her family. Family includes only brothers, sisters, half-brothers, half-sisters, spouse, ancestors, and lineal descendants.
3. An individual owning (other than by applying (2)) any stock in a corporation is considered to own the stock directly or indirectly owned by or for his or her partner.
4. For purposes of applying (1), (2), or (3), stock or a partnership interest constructively owned by a person under (1) is treated as actually owned by that person. But stock or a partnership interest constructively owned by an individual under (2) or (3) is not treated as owned by the individual for reapplying either (2) or (3) to make another person the constructive owner of that stock or partnership interest.

The taxpayer cannot deduct his or her loss on the sale of stock through his or her broker if under a prearranged plan a related person or entity buys the same stock he or she had owned. This does not apply to a cross-trade between related parties through an exchange that is purely coincidental and is not prearranged.

If, in a purchase or exchange, the taxpayer received property from a related person who had a loss that was not allowable and he or she later sells or exchanges the property at a gain, the taxpayer generally recognizes the gain only to the extent it is more than the loss previously disallowed to the related person. This rule applies only to the original transferee. This rule does not apply if the sale or exchange is subject to the wash sale rules of Section 1091 of the Internal Revenue Code. In addition, for sales and exchanges of property acquired after December 31, 2015, this rule does not apply if the gain or loss with respect to the property received from a related person is not subject to Federal income tax in the hands of the transferor immediately before the transfer but is subject to Federal income tax in the hands of the transferee immediately after the transfer.

Other Nontaxable Exchanges

Partnership Interests

Exchanges of partnership interests do not qualify as nontaxable exchanges of like-kind property. This applies regardless of whether they are general or limited partnership interests or are interests in the same partnership or different partnerships. However, under certain circumstances the exchange may be treated as a tax-free contribution of property to a partnership.

An interest in a partnership that has a valid election to be excluded from being treated as a partnership for federal tax purposes is treated as an interest in each of the partnership assets and not as a partnership interest.

U.S. Treasury Notes and Bonds

Certain issues of U.S. Treasury obligations may be exchanged for certain other issues designated by the Secretary of the Treasury with no gain or loss recognized on the exchange.

Insurance Policies and Annuities

No gain or loss is recognized if the taxpayer makes any of the following exchanges, and if the insured or the annuitant is the same under both contracts: [56]

- A life insurance contract for another life insurance contract, or for an endowment or annuity contract, or for a qualified long-term care insurance contract.
- An endowment contract for an annuity contract or for another endowment contract providing for regular payments beginning at a date not later than the beginning date under the old contract, or for a qualified long-term insurance contract.
- One annuity contract for another annuity contract.
- An annuity contract for a qualified long-term care insurance contract.
- A qualified long-term care insurance contract for another qualified long-term insurance contract.

In addition, if certain conditions are met, no gain or loss is recognized on the direct transfer of a portion of the cash surrender value of an existing annuity contract for a second contract, regardless of whether the contracts are issued by the same or different companies.

Also, if the taxpayer realizes a gain on the exchange of an endowment contract or annuity contract for a life insurance contract or an exchange of an annuity contract for an endowment contract, he or she must recognize the gain.

Converted Property

If the taxpayer changes his or her home or other property (or a part of it) to rental use at any time other than the beginning of his or her tax year, he or she must divide yearly expenses, such as taxes and insurance, between rental use and personal use. The taxpayer can deduct as rental expenses only the part of the expense that is for the part of the year the property was used or held for rental purposes.

The taxpayer cannot deduct depreciation or insurance for the part of the year the property was held for personal use. However, he or she can include the home mortgage interest and real estate tax expenses for the part of the year the property was held for personal use as an itemized deduction on Schedule A (Form 1040).

If the taxpayer holds property for personal use and then changes it to business use or uses it to produce rent, he or she can begin to depreciate the property at the time of the change. To do so, the taxpayer must figure its basis for depreciation at the time of the change. An example of changing property held for personal use to business or rental use would be renting out the taxpayer's former personal residence.

The basis for depreciation is the lesser of:

- The fair market value (FMV) of the property on the date the taxpayer changed it to rental use, or
- The taxpayer's adjusted basis on the date of the change - that is, his or her original cost or other basis of the property, plus the cost of permanent additions or improvements since he or she acquired it, minus deductions for any casualty or theft losses claimed on earlier years' income tax returns and other decreases to basis.

Fair market value (FMV) is the price at which the property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts. Sales of similar property, on or about the same date, may be helpful in figuring the fair market value of the property.

Analysis of Financial Records

There are many types of business a taxpayer can operate including:

Nonprofit Organizations - Nonprofit organizations use profit to improve services, rather than pay dividends to investors. If the taxpayer's business is registered as a nonprofit, he or she is eligible for certain government resources.

Home-Based Businesses - Many well-known companies like Apple™ and Ford™ started as home-based businesses.

Online Businesses - Establishing a business presence on the Internet can be a great way to sell and market goods and services.

Franchise Businesses - Franchises can provide an opportunity for ready-made business success, but they also come with a variety of challenges.

Buying Existing Businesses - Buying an existing business can be less risky than starting one from scratch.

The form of business the taxpayer operates determines what taxes he or she must pay and how he or she pays them. The following are the general types of business taxes:

- Income Tax.

- Estimated Taxes.
- Self-Employment Tax.
- Employment Taxes.
- Excise Tax.

Income Tax - All businesses except partnerships must file an annual income tax return. Partnerships file an information return. The form the taxpayer uses depends on how his or her business is organized.

Estimated tax - Generally, the taxpayer must pay taxes on income, including self-employment tax, by making regular payments of estimated tax during the year.

Self-Employment Tax - Self-employment tax (SE tax) is a Social Security and Medicare tax primarily for individuals who work for themselves. The taxpayer's payments of SE tax contribute to his or her coverage under the Social Security system. Social Security coverage provides the taxpayer with retirement benefits, disability benefits, survivor benefits, and hospital insurance (Medicare) benefits.

Employment Taxes - When a taxpayer has employees, he or she as the employer has certain employment tax responsibilities that he or she must pay and forms he or she must file. Employment taxes include Social Security and Medicare taxes, Federal income tax withholding and Federal unemployment (FUTA) tax.

Excise Taxes - The Federal excise taxes reported on Form 720 - Quarterly Federal Excise Tax Return consist of several broad categories of taxes, including environmental taxes, communications and air transportation taxes, fuel taxes, tax on the first retail sale of heavy trucks, trailers, and tractors and manufacturers taxes on the sale or use of a variety of different articles.

There is a Federal excise tax on certain trucks, truck tractors, and buses used on public highways. The tax applies to vehicles having a taxable gross weight of 55,000 pounds or more. Report the tax on Form 2290 - Heavy Highway Vehicle Use Tax Return.

If the taxpayer is in the business of accepting wagers or conducting a wagering pool or lottery, he or she may be liable for the Federal excise tax on wagering. Use Form 730 - Monthly Tax Return for Wagers, to figure the tax on the wagers he or she receives.

The taxpayer should use Form 11-C - Occupational Tax and Registration Return for Wagering, to register for any wagering activity and to pay the Federal occupational tax on wagering.

Income Statement

The income statement is a financial statement that measures a company's financial performance over a specific accounting period. Financial performance is assessed by giving a summary of how the business incurs its revenues and expenses through both operating and non-operating activities. It also shows the net profit or loss incurred over a specific accounting period, typically over a fiscal quarter or year. It is also known as the "profit and loss statement" or "statement of revenue and expense."

Balance Sheets

Generally, balance sheets are necessary where a corporation or partnership is the business organization of choice. Entries made to many, if not most, balance sheet accounts have corresponding entries to the income statement. Audit planning which considers this duplication of entries will save time and effort. Remember that partnership return balance sheets entries shown on Form 1065 are sometimes, but not always reported at Fair Market Value.

Balance sheet accounts are "real" accounts. These accounts represent things the business owns or owes. Their balances are carried forward from year to year. This differs from income statement accounts, which are closed out at yearend and only reflect business operations within a specified cycle. These operating accounts are closed to retained earnings and result in net income or loss to the business.

Tax classification of balance sheet accounts, performed when the books are reconciled to the return, is paramount to a successful balance sheet audit. This classification gives the IRS the ability to spot curious relationships that may occur with these accounts. As an example, loans to shareholders are often grouped in the other current liability account. If the balance sheet does not specifically list this loan, its existence may never be discovered. This audit tool assists in the determination of the examination scope.

Frequently, adjustments to balance sheet accounts result in an increase to taxable income. Remember that all income statement accounts are run through the balance sheet, but not all balance sheet accounts are run through the income statement. An example of entries in balance sheet accounts not affecting the income statement could be a loan to the shareholder eliminated through retained earnings.

Accounting Methods

An accounting method is a set of rules used to determine when income and expenses are reported on the tax return. The taxpayer's accounting method includes not only his or her overall method of accounting, but also the accounting treatment he or she uses for any material item.

In general, the taxpayer can compute his or her taxable income under any of the following accounting methods: (3)

- Cash method.
- Accrual method.
- Special methods of accounting for certain items of income and expenses.
- A hybrid method which combines elements of two or more of the above accounting methods.

Generally, the taxpayer can use any combination of cash, accrual, and special methods of accounting, a hybrid method, if the combination clearly reflects his or her income and he or she uses it consistently.

However, the following restrictions apply: (3)

- If an inventory is necessary to account for the taxpayer's income, he or she must use an accrual method for purchases and sales. Generally, he or she can use the cash method for all other items of income and expenses.
- If the taxpayer uses the cash method for reporting his or her income, he or she must use the cash method for reporting his or her expenses.
- If the taxpayer uses an accrual method for reporting his or her expenses, he or she must use an accrual method for figuring his or her income.
- Any combination that includes the cash method is treated as the cash method for purposes of Section 448 of the Internal Revenue Code.

Depreciation

If property the taxpayer acquires to use in his or her business is expected to last more than 1 year, he or she generally cannot deduct the entire cost as a business expense in the year he or she acquires it. The taxpayer must spread the cost over more than 1 tax year and deduct part of it each year on Schedule C or Form 1120 from amount on Form 4562. This method of deducting the cost of business property is called depreciation. The method for depreciating most business and investment property placed in service after 1986 is called the Modified Accelerated Cost Recovery System (MACRS).

Penalties and Interest

The law provides for the following penalties if the taxpayer does not file Form 1099-MISC - Miscellaneous Income or Form W-2 - Wage and Tax Statement or does not correctly report the information. The failure to file information returns penalty applies if the taxpayer does not file information returns by the due date, does not include all required information, or reports incorrect information. The failure to furnish correct payee statements penalty applies if the taxpayer does not furnish a required statement to a payee by the required date, does not include all required information, or reports incorrect information. Penalties and interest may also result from any of the following acts: (61)

- Failing to collect and pay over tax as the collecting agent.
- Failing to keep adequate records.

- Failing to file returns.
- Failing to pay taxes.
- Filing returns late.
- Filing false or fraudulent returns.
- Paying taxes late.
- Failing to make deposits.
- Depositing taxes late.
- Making false statements relating to tax.
- Failing to register.
- Misrepresenting that tax is excluded from the price of an article.

The penalty for failure to register if the taxpayer is required to register, unless due to reasonable cause, is $10,000 for the initial failure, and then $1,000 each day thereafter he or she fails to register.

There are criminal penalties for false or fraudulent claims. In addition, any person who files a refund claim, for an excessive amount (without reasonable cause) may have to pay a penalty. An excessive amount is the amount claimed that is more than the allowable amount. The penalty is the greater of two times the excessive amount or $10.

Also the taxpayer must file Form 8300 - Report of Cash Payments Over $10,000 Received in a Trade or Business, if he or she receives more than $10,000 in cash in one transaction, or two or more related business transactions. Cash includes U.S. and foreign coin and currency. It also includes certain monetary instruments such as cashier's and traveler's checks and money orders. Cash does not include a check drawn on an individual's personal account (personal check). There are civil and criminal penalties, including up to 5 years in prison, for not filing Form 8300, filing (or causing the filing of) a false or fraudulent Form 8300, or structuring a transaction to evade reporting requirements.

Specialized Returns and Taxpayers

Trust and Estate Income Tax

A trust or a decedent's estate is a separate legal entity for Federal tax purposes. A decedent's estate comes into existence at the time of death of an individual. A trust may be created during an individual's life (inter vivos) or at the time of his or her death under a will (testamentary). If the trust instrument contains certain provisions, then the person creating the trust (the grantor) is treated as the owner of the trust's assets. Such a trust is a grantor type trust.

A trust or decedent's estate figures its gross income in much the same manner as an individual. Most deductions and credits allowed to individuals are also allowed to estates and trusts. However, there is one major distinction. A trust or decedent's estate is allowed an income distribution deduction for distributions to beneficiaries. To figure this deduction, the fiduciary must complete Schedule B. The income distribution deduction determines the amount of any distributions taxed to the beneficiaries.

For this reason, a trust or decedent's estate sometimes is referred to as a “pass-through” entity. The beneficiary, and not the trust or decedent's estate, pays income tax on his or her distributive share of income. Schedule K-1 (Form 1041) is used to notify the beneficiaries of the amounts to be included on their income tax returns.

Before preparing Form 1041, the fiduciary must figure the accounting income of the estate or trust under the will or trust instrument and applicable local law to determine the amount, if any, of income that is required to be distributed, because the income distribution deduction is based, in part, on that amount.

The fiduciary of a domestic decedent's estate, trust, or bankruptcy estate uses Form 1041 to report: [62]

- The income, deductions, gains, losses, etc., of the estate or trust.
- The income that is either accumulated or held for future distribution or distributed currently to the beneficiaries.
- Any income tax liability of the estate or trust.
- Employment taxes on wages paid to household employees.

The IRS ordinarily has 3 years from the date an income tax return is filed, or its due date, whichever is later, to charge any additional tax due. However, a personal representative may request a prompt assessment of tax after the return has been filed. This reduces the time for making the assessment to 18 months from the date the written request for prompt assessment was received. This request can be made for any tax return (except the estate tax return) of the decedent or the decedent's estate. This may permit a quicker settlement of the tax liability of the estate and an earlier final distribution of the assets to the beneficiaries. Form 4810 - Request for Prompt Assessment Under Internal Revenue Code Section 6501(d) can be used for making this request. It must be filed separately from any other document. [63]

Form 706 - United States Estate (and Generation-Skipping Transfer) Tax Return

The executor of a decedent's estate uses Form 706 to figure the estate tax imposed by Chapter 11 of the Internal Revenue Code. This tax is levied on the entire taxable estate and not just on the share received by a particular beneficiary. Form 706 is also used to figure the generation-skipping transfer (GST) tax imposed by Chapter 13 on direct skips (transfers to skip persons of interests in property included in the decedent's gross estate).

For decedents who died in 2020, Form 706 must be filed by the executor of the estate of every U.S. citizen or resident whose gross estate, plus adjusted taxable gifts and specific exemption, is more than $11,580,000 or whose executor elects to transfer the Deceased Spousal Unused Exclusion (DSUE) amount to the surviving spouse, regardless of the size of the decedent's gross estate.

Section 303 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 authorized estates of decedents dying on or after January 1, 2011, to elect to transfer any unused exclusion to the surviving spouse. The amount received by the surviving spouse is called the deceased spousal unused exclusion, or DSUE, amount. If the executor of the decedent's estate elects transfer, or portability, of the DSUE amount, the surviving spouse can apply the DSUE amount received from the estate of his or her last deceased spouse against any tax liability arising from subsequent lifetime gifts and transfers at death.

The taxpayer must file Form 706 to report estate and/or GST tax within 9 months after the date of the decedent's death. If he or she is unable to file Form 706 by the due date, he or she may receive an extension of time to file. Use Form 4768, Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes, to apply for an automatic 6-month extension of time to file.

An executor can only elect to transfer the Deceased Spousal Unused Exclusion (DSUE) amount to the surviving spouse if the Form 706 is filed timely; that is, within 9 months of the decedent's date of death or, if he or she has received an extension of time to file, before the 6-month extension period ends.

The estate and GST taxes are due within 9 months of the date of the decedent's death. The taxpayer may request an extension of time for payment by filing Form 4768. He or she may also elect under Section 6166 to pay in installments or under Section 6163 to postpone the part of the tax attributable to a reversionary or remainder interest.

Form 709 - United States Gift (and Generation-Skipping Transfer) Tax Return

An individual taxpayer uses Form 709 - United States Gift (and Generation-Skipping Transfer) Tax Return to report the following: (64)

1. Transfers subject to the Federal gift and certain generation-skipping transfer (GST) taxes and to figure the tax due, if any, on those transfers, and
2. Allocation of the lifetime GST exemption to property transferred during the transferor's lifetime. (For more details, Regulations Section 26.2632-1).

All gift and GST taxes must be computed and filed on a calendar year basis. List all reportable gifts made during the calendar year on one Form 709. This means the taxpayer must file a separate return for each calendar year a reportable gift is given (for example, a gift given in 2020 must be reported on a 2020 Form 709). Do not file more than one Form 709 for any one calendar year.

In general, if the taxpayer is a citizen or resident of the United States, he or she must file a gift tax return (whether or not any tax is ultimately due) in the following situations: (64)

- If he or she gave gifts to someone in 2020 totaling more than $15,000 (other than to his or he spouse), he or she probably must file Form 709.
- Certain gifts, called future interests, are not subject to the $15,000 annual exclusion and the taxpayer must file Form 709 even if the gift was under $15,000.
- A husband and wife may not file a joint gift tax return. Each individual is responsible for his or her own Form 709.
- The taxpayer must file a gift tax return to split gifts with his or her spouse (regardless of their amount).
- If a gift is of community property, it is considered made one-half by each spouse. For example, a gift of $100,000 of community property is considered a gift of $50,000 made by each spouse, and each spouse must file a gift tax return.
- Likewise, each spouse must file a gift tax return if they have made a gift of property held by them as joint tenants or tenants by the entirety.
- Only individuals are required to file gift tax returns. If a trust, estate, partnership, or corporation makes a gift, the individual beneficiaries, partners, or stockholders are considered donors and may be liable for the gift and GST taxes.
- The donor is responsible for paying the gift tax. However, if the donor does not pay the tax, the person receiving the gift may have to pay the tax.
- If a donor dies before filing a return, the donor's executor must file the return.

If the taxpayer meets all of the following requirements, he or she is not required to file Form 709: (64)

1. He or she made no gifts during the year to his or her spouse.
2. He or she did not give more than $15,000 to any one person.
3. All the gifts he or she made were of present interests.

If the only gifts a taxpayer made during the year are deductible as gifts to charities, he or she does not need to file a return as long as he or she transferred the entire interest in the property to qualifying charities. If the taxpayer transferred only a partial interest or transferred part of the interest to someone other than a charity, he or she must still file a return and report all of his or her gifts to charities.

Applicable Credit Amount

The applicable credit (formerly unified credit) applies to both the gift tax and the estate tax and it equals the tax on the applicable exclusion amount. The taxpayer must subtract the unified credit from any gift or estate tax that he or she owes. Any applicable credit the taxpayer uses against gift tax in one year reduces the amount of credit that he or she can use against gift or estate taxes in a later year.

Beginning in 2011, the amount of applicable credit available to a person will equal the tax on the basic exclusion amount plus the tax on any deceased spousal unused exclusion (DSUE) amount. The DSUE is only available if an election was made on the deceased spouse's Form 706. In 2020, the applicable credit on the basic exclusion amount is $4,505,800 (based on the basic exclusion amount of $11,580,000).

Annual Exclusion

The first $15,000 of gifts of present interest to each donee during the calendar year is subtracted from total gifts in figuring the amount of taxable gifts. For a gift in trust, each beneficiary of the trust is treated as a separate donee for purposes of the annual exclusion. All of the gifts made during the calendar year to a donee are fully excluded under the annual exclusion if they are all gifts of present interest and they total $15,000 or less. For gifts made to spouses who are not U.S. citizens, the annual exclusion has been increased to $157,000 in 2020, provided the additional (above the $15,000 annual exclusion) $142,000 gift would otherwise qualify for the gift tax marital deduction.

A gift of a future interest cannot be excluded under the annual exclusion. A gift is considered a present interest if the donee has all immediate rights to the use, possession, and enjoyment of the property or income from the property. A gift is considered a future interest if the donee's rights to the use, possession, and enjoyment of the property or income from the property will not begin until some future date. Future interests include reversions, remainders, and other similar interests or estates.

Gift Splitting

In 2020, a taxpayer and his or her spouse can make a gift up to $30,000 to a third party without making a taxable gift. The gift can be considered as made one-half by the taxpayer and one-half by his or her spouse. If the taxpayer splits a gift he or she made, the taxpayer must file a gift tax return to show that he or she and his or her spouse agree to use gift splitting. The taxpayer must file a Form 709 - United States Gift (and Generation-Skipping Transfer) Tax Return, even if half of the split gift is less than the annual exclusion.

Decedent's Estate

The fiduciary (or one of the joint fiduciaries) must file Form 1041 - U.S. Income Tax Return for Estates and Trusts for a domestic estate that has: (62)

- Gross income for the tax year of $600 or more.
- A beneficiary who is a nonresident alien.

An estate is a domestic estate if it is not a foreign estate. A foreign estate is one the income of which is from sources outside the United States that is not effectively connected with the conduct of a U.S. trade or business and is not includible in gross income. If the taxpayer is the fiduciary of a foreign estate, file Form 1040NR - U.S. Nonresident Alien Income Tax Return, instead of Form 1041.

Trust

The fiduciary (or one of the joint fiduciaries) must file Form 1041 for a domestic trust taxable under Section 641 that has: [62]

- Any taxable income for the tax year.
- Gross income of $600 or more (regardless of taxable income).
- A beneficiary who is a nonresident alien.

Two or more trusts are treated as one trust if the trusts have substantially the same grantor(s) and substantially the same primary beneficiary(ies) and a principal purpose of such trusts is avoidance of tax. This provision applies only to that portion of the trust that is attributable to contributions to corpus made after March 1, 1984.

A trust is a domestic trust if: [62]

- A U.S. court is able to exercise primary supervision over the administration of the trust (court test), and
- One or more U.S. persons have the authority to control all substantial decisions of the trust (control test).

Also treated as a domestic trust is a trust (other than a trust treated as wholly owned by the grantor) that: [62]

- Was in existence on August 20, 1996,
- Was treated as a domestic trust on August 19, 1996, and
- Elected to continue to be treated as a domestic trust.

A trust that is not a domestic trust is treated as a foreign trust. If the taxpayer is the trustee of a foreign trust, file Form 1040NR instead of Form 1041. Also, a foreign trust with a U.S. owner generally must file Form 3520-A - Annual Information Return of Foreign Trust With a U.S. Owner.

If a domestic trust becomes a foreign trust, it is treated under Section 684 as having transferred all of its assets to a foreign trust, except to the extent a grantor or another person is treated as the owner of the trust when the trust becomes a foreign trust.

Simple Trust

A trust may qualify as a simple trust if:

1. The trust instrument requires that all income must be distributed currently;
2. The trust instrument does not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes; and
3. The trust does not distribute amounts allocated to the corpus of the trust.

A complex trust is any trust that does not qualify as a simple trust as explained above.

Qualified Disability Trust

A qualified disability trust is any nongrantor trust:

1. Described in 42 USC Section1396p(c)(2)(B)(iv) and established solely for the benefit of an individual under 65 years of age who is disabled, and
2. All the beneficiaries of which are determined by the Commissioner of Social Security to have been disabled for some part of the tax year within the meaning of 42 USC Section 1382c(a)(3).

A trust will not fail to meet item 2 above just because the trust's corpus may revert to a person who is not disabled after the trust ceases to have any disabled beneficiaries.

Grantor Type Trusts

A trust is a grantor trust if the grantor retains certain powers or ownership benefits. This can also apply to only a portion of a trust. In general, a grantor trust is ignored for income tax purposes and all of the income, deductions, etc., are treated as belonging directly to the grantor. This also applies to any portion of a trust that is treated as a grantor trust.

If only a portion of the trust is a grantor type trust, indicate both grantor trust and the other type of trust, for example, simple or complex trust, as the type of entities checked in Section A on page 1 of Form 1041.

If the entire trust is a grantor trust, fill in only the entity information of Form 1041. Do not show any dollar amounts on the form itself; show dollar amounts only on an attachment to the form. Do not use Schedule K-1 (Form 1041) as the attachment.

If only part of the trust is a grantor type trust, the portion of the income, deductions, etc., that is allocable to the non-grantor part of the trust is reported on Form 1041, under normal reporting rules. The amounts that are allocable directly to the grantor are shown only on an attachment to the form. Do not use Schedule K-1 (Form 1041) as the attachment. However, Schedule K-1 is used to reflect any income distributed from the portion of the trust that is not taxable directly to the grantor or owner.

The fiduciary must give the grantor (owner) of the trust a copy of the attachment. On the attachment, show:

- The name, identifying number, and address of the person(s) to whom the income is taxable.
- The income of the trust that is taxable to the grantor or another person under Sections 671 through 678. Report the income in the same detail as it would be reported on the grantor's return had it been received directly by the grantor.
- Any deductions or credits that apply to this income. Report these deductions and credits in the same detail as they would be reported on the grantor's return had they been received directly by the grantor.

The income taxable to the grantor or another person under Sections 671 through 678 and the deductions and credits that apply to that income must be reported by that person on their own income tax return.

Special Rule for Certain Revocable Trusts

Section 645 provides that if both the executor (if any) of an estate (the related estate) and the trustee of a qualified revocable trust (QRT) elect the treatment in Section 645, the trust must be treated and taxed as part of the related estate during the election period. This election may be made by a QRT even if no executor is appointed for the related estate.

In general, Form 8855 - Election To Treat a Qualified Revocable Trust as Part of an Estate, must be filed by the due date for Form 1041 for the first tax year of the related estate. This applies even if the combined related estate and electing trust do not have sufficient income to be required to file Form 1041. However, if the estate is granted an extension of time to file Form 1041 for its first tax year, the due date for Form 8855 is the extended due date.

Once made, the election is irrevocable.

In general, a QRT is any trust (or part of a trust) that, on the day the decedent died, was treated as owned by the decedent because the decedent held the power to revoke the trust as described in Section 676. An electing trust is a QRT for which a Section 645 election has been made.

The election period is the period of time during which an electing trust is treated as part of its related estate. The election period begins on the date of the decedent's death and terminates on the earlier of:

- The day on which the electing trust and related estate, if any, distribute all of their assets.
- The day before the applicable date.

To determine the applicable date, first determine whether a Form 706 - United States Estate (and Generation-Skipping Transfer) Tax Return, is required to be filed as a result of the decedent's death. If no Form 706 is required to be filed, the applicable date is 2 years after the date of the decedent's death. If Form 706 is required, the applicable date is the later of 2 years after the date of the decedent's death or 6 months after the final determination of liability for estate tax. For additional information, see Regulations Section 1.645-1(f).

Income

The extraterritorial income exclusion is not allowed for transactions after 2006. However, income from certain long-term sales and leases may still qualify for the exclusion. For details and to figure the amount of the exclusion, see Form 8873 - Extraterritorial Income Exclusion, and its separate instructions. The estate or trust must report the extraterritorial income exclusion on line 15a of Form 1041, page 1. Although the extraterritorial income exclusion is entered on line 15a on Form 1041, it is an exclusion from income and should be treated as tax-exempt income when completing other parts of the return. Report the estate's or trust's share of all taxable interest income that was received during the tax year. Examples of taxable interest include interest from:

- Accounts (including certificates of deposit and money market accounts) with banks, credit unions, and thrift institutions.
- Notes, loans, and mortgages.
- U.S. Treasury bills, notes, and bonds.
- U.S. savings bonds.
- Original issue discount.
- Income received as a regular interest holder of a real estate mortgage investment conduit (REMIC).

For taxable bonds acquired after 1987, amortizable bond premium is treated as an offset to the interest income instead of as a separate interest deduction.

Report the estate's or trust's share of all ordinary dividends received during the tax year.

For the year of the decedent's death, Forms 1099-DIV issued in the decedent's name may include dividends earned after the date of death that should be reported on the income tax return of the decedent's estate. When preparing the decedent's final income tax return, report on Schedule B (Form 1040), line 5 the ordinary dividends shown on Form 1099-DIV. Under the last entry on line 5, subtotal all the dividends reported on line 5. Below the subtotal, write "Form 1041" and the name and address shown on Form 1041 for the decedent's estate. Also, show the part of the ordinary dividends reported on Form 1041 and subtract it from the subtotal. Report capital gain distributions on Schedule D (Form 1041), line 9.

Enter the beneficiary's allocable share of qualified dividends on line 2b(1) on Form 1041 and enter the estate's or trust's allocable share on line 2b(2).

If the estate or trust received qualified dividends that were derived from IRD, the taxpayer must reduce the amount on line 2b(2) by the portion of the estate tax deduction claimed on Form 1041, page 1, line 19, that is attributable to those qualified dividends. Do not reduce the amounts on line 2b by any other allocable expenses.

Tip

The beneficiary's share (as figured above) may differ from the amount entered on line 2b of Schedule K-1 (Form 1041).

If the estate operated a business, report the income and expenses on Schedule C (Form 1040), Profit or Loss From Business. Enter the net profit or (loss) from Schedule C on line 3 on Form 1041.

Enter the gain from Schedule D (Form 1041), Part III, line 15, column (3) or the loss from Part IV, line 16 on Form 1041. Do not substitute Schedule D (Form 1040) for Schedule D (Form 1041).

Use Schedule E (Form 1040), Supplemental Income and Loss, to report the estate's or trust's share of income or (losses) from rents, royalties, partnerships, S corporations, other estates and trusts, and REMICs. Also, use Schedule E (Form 1040) to report farm rental income and expenses based on crops or livestock produced by a tenant. Enter the net profit or (loss) from Schedule E on line 5 on Form 1041. See the Instructions for Schedule E (Form 1040) for reporting requirements.

If the estate or trust received a Schedule K-1 from a partnership, S corporation, or other flow-through entity, use the corresponding lines on Form 1041 to report the interest, dividends, capital gains, etc., from the flow-through entity.
If the estate or trust operated a farm, use Schedule F (Form 1040), Profit or Loss From Farming, to report farm income and expenses. Enter the net profit or (loss) from Schedule F on line 6 of Form 1041.

If an estate or trust has farm rental income and expenses based on crops or livestock produced by a tenant, report the income and expenses on Schedule E (Form 1040). Do not use Form 4835, Farm Rental Income and Expenses, or Schedule F (Form 1040) to report such income and expenses and do not include the net profit or (loss) from such income and expenses on line 6.

Enter from line 17, Form 4797 - Sales of Business Property, the ordinary gain or loss from the sale or exchange of property other than capital assets and also from involuntary conversions (other than casualty or theft).

Enter other items of income not included on lines 1, 2a, and 3 through 7 of Form 1041. List the type and amount on an attached schedule if the estate or trust has more than one item.

Items to be reported on line 8 include:

- Unpaid compensation received by the decedent's estate that is IRD.
- Any part of a total distribution shown on Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., that is treated as ordinary income. For more information, see Form 4972, Tax on Lump-Sum Distributions, and its instructions.

Distributable Net Income (DNI)

The income distribution deduction allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries is limited to DNI. This amount, which is figured on Schedule B, line 7, is also used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includible in his or her gross income.

Figuring Distributable Net Income

- Taxable income before:
  - Exemption.
  - Distribution deduction.
  - Special deductions.
- Add back:
  - Capital losses.
  - Municipal income (net of allocable expenses).
- Subtract capital gains (generally).

Tiers of Distributions

- Tier I
  - Income required to be distributed.
  - Receives DNI first.
- Tier II
  - Other amounts paid credited or otherwise set aside.
  - Taxed on distributions only to the extent there is remaining DNI.

Deductions

- All ordinary and necessary expenses allowed:
  - Administration.
  - Trustee Fees.
  - Litigation Costs.
- Charitable deduction:
  - Must be from trust's gross income.
  - Must be allowed by trust instrument.
- No double deduction if expense was allowed on Form 706.
- Exception - deductions "in respect of a decedent" are allowed on both Form 706 and Form 1041:
  - Property taxes.
  - Accrued interest paid.

Allocation of DNI

- Direct expenses are allocated to the class of DNI to which they relate.
- Indirect expenses are allocated:
    - A portion to non-taxable income.
    - Remainder to any class of income included in DNI.

When completing Form 1041, the taxpayer must take into account any items that are income in respect of a decedent (IRD). In general, IRD is income that a decedent was entitled to receive but that was not properly includible in the decedent's final income tax return under the decedent's method of accounting.
IRD includes:

- All accrued income of a decedent who reported his or her income on the cash method of accounting.
- Income accrued solely because of the decedent's death in the case of a decedent who reported his or her income on the accrual method of accounting.
- Income to which the decedent had a contingent claim at the time of his or her death.

Some examples of IRD for a decedent who kept his or her books on the cash method are:

- Deferred salary payments that are payable to the decedent's estate.
- Uncollected interest on U.S. savings bonds.
- Proceeds from the completed sale of farm produce.
- The portion of a lump-sum distribution to the beneficiary of a decedent's IRA that equals the balance in the IRA at the time of the owner's death. This includes unrealized appreciation and income accrued to that date, less the aggregate amount of the owner's nondeductible contributions to the IRA. Such amounts are included in the beneficiary's gross income in the tax year that the distribution is received.

The IRD has the same character it would have had if the decedent had lived and received such amount.

The following deductions and credits, when paid by the decedent's estate, are allowed on Form 1041 even though they were not allowable on the decedent's final income tax return.

- Business expenses deductible under Section 162.
- Interest deductible under Section 163.
- Taxes deductible under Section 164.
- Investment expenses described in Section 212 (in excess of 2% of adjusted gross income (AGI)).
- Percentage depletion allowed under Section 611.
- Foreign tax credit.

Income required to be distributed currently is income that is required under the terms of the governing instrument and applicable local law to be distributed in the year it is received. The fiduciary must be under a duty to distribute the income currently, even if the actual distribution is not made until after the close of the trust's tax year. A fiduciary is a trustee of a trust, or an executor, executrix, administrator, personal representative, or person in possession of property of a decedent's estate.

Estate or Trust Income Distribution Deductions (Schedule B)

The Income Distribution Deduction (Schedule B) is unique to trusts and estates. When trusts and estates give income payments to beneficiaries, those payments carry income tax consequences for the trust or estate and for the beneficiaries. The trust or estate receives a deduction, and the beneficiaries must include the amount deducted from the Form 1041 - U.S. Income Tax Return for Estates and Trusts on their individual Form 1040. To complete Schedule B - Interest and Ordinary Dividends, follow these steps (unless the trust or estate is in its final year):

1. Take the total from line 17 on the front of Form 1041 (line 1).
2. Add that total to the adjusted tax-exempt interest (the contents of line 2).
3. Enter the net capital.
4. Subtract that number from the total of Schedule B, lines 1 and 2, to arrive at the distributable net income (DNI).

For an estate or simple trust, ignore Schedule B, line 8. When dealing with a complex trust and it is either not required to distribute all income or it distributed more than just income, calculate trust accounting income (TAI).

To calculate TAI, add lines 1 through 8 from the front of Form 1041 and the tax-exempt income from line 1 of "Other Information" on the back of Form 1041. Subtract capital gains or losses (line 4, Form 1041) and all fees and expenses charged against the income earned in the trust.

Exclude fees and expenses charged against principal (including whatever fees paid from the capital gains) when calculating TAI. Also, do not allocate any of the income fees paid between taxable and tax-exempt income.

On Schedule B, line 11, put the total amount of distributions made from the estate or trust to beneficiaries during the tax year. These amounts may be mandatory. For example, in the case of a simple trust, all income must be distributed in the tax year.

Misuse of Trusts

For years, unscrupulous promoters have urged taxpayers to transfer assets into trusts. While there are legitimate uses of trusts in tax and estate planning, some highly questionable transactions promise reduction of income subject to tax, deductions for personal expenses and reduced estate or gift taxes. Such trusts rarely deliver the tax benefits promised and are used primarily as a means of avoiding income tax liability and hiding assets from creditors, including the IRS.

IRS personnel have seen an increase in the improper use of private annuity trusts and foreign trusts to shift income and deduct personal expenses. As with other arrangements, taxpayers should seek the advice of a trusted professional before entering a trust arrangement.

Promoters of fraudulent trust arrangements use a variety of methods to advertise their schemes. They may include seminars, flyers, and even the Internet. The main selling point of fraudulent trust arrangements is that the paperwork will look like the taxpayer is giving up control of his or her assets and money; when in reality he or she still controls how his or her money and assets are used.

A fraudulent trust only has the appearance of a trust. It is typically promoted by the promise of tax benefits or avoidance with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets.

Using the name "trust" in association with financial arrangements does not make it a legitimate trust. No matter how carefully written the trust documents are, if the intent is to evade taxes, the trust will be treated as fraudulent. Fraudulent trusts are illegal and are a specific area of concern for IRS Criminal Investigation.

Estate Tax Deduction

Income that the decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This income in respect of a decedent is also taxed when received by the recipient (estate or beneficiary). However, an income tax deduction is allowed to the recipient for the estate tax paid on the income. The deduction for estate tax paid can only be claimed for the same tax year in which the income in respect of a decedent must be included in the recipient's income. (This also is true for income in respect of a prior decedent.) Individuals can claim this deduction only as an itemized deduction on line 16 of Schedule A (Form 1040). Estates can claim the deduction on line 19 of Form 1041. If income in respect of a decedent is capital gain income, the taxpayer must reduce the gain, but not below zero, by any deduction for estate tax paid on such gain.

This applies in figuring the following: [63]

- The maximum tax on net capital gain (including qualified dividends).
- The exclusion for gain on small business stock.
- The limitation on capital losses.

To figure a recipient's estate tax deduction, determine: [63]

1. The estate tax that qualifies for the deduction, and
2. The recipient's part of the deductible tax.

The estate tax is the tax on the taxable estate, reduced by any credits allowed. The estate tax qualifying for the deduction is the part of the net value of all the items in the estate that represents income in respect of a decedent. Net value is the excess of the items of income in respect of a decedent over the items of expenses in respect of a decedent. The deductible estate tax is the difference between the actual estate tax and the estate tax determined without including net value.

When To File

For calendar year estates and trusts, file Form 1041 and Schedule(s) K-1 on or before April 15, 2020. For fiscal year estates and trusts, file Form 1041 by the 15th day of the 4th month following the close of the tax year. For example, an estate that has a tax year that ends on June 30, 2020, must file Form 1041 by October 15, 2020. If the due date falls on a Saturday, Sunday, or legal holiday, file on the next business day.

Extension of Time To File

If more time is needed to file the estate or trust return, use Form 7004 - Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns, to apply for an automatic 5½ month extension of time to file.

Period Covered

File the 2020 return for calendar year 2020 and fiscal years beginning in 2020 and ending in 2021. If the return is for a fiscal year or a short tax year (less than 12 months), fill in the tax year space at the top of the form. The 2020 Form 1041 may also be used for a tax year beginning in 2021 if:

1. The estate or trust has a tax year of less than 12 months that begins and ends in 2021, and
2. The 2021 Form 1041 is not available by the time the estate or trust is required to file its tax return. However, the estate or trust must show its 2021 tax year on the 2020 Form 1041 and incorporate any tax law changes that are effective for tax years beginning after December 31, 2020.

Estimated Tax

Generally, an estate or trust must pay estimated income tax for 2020 if it expects to owe, after subtracting any withholding and credits, at least $1,000 in tax, and it expects the withholding and credits to be less than the smaller of:

1. 90% of the tax shown on the 2020 tax return, or
2. 100% of the tax shown on the 2019 tax return (110% of that amount if the estate's or trust's adjusted gross income on that return is more than $150,000, and less than ⅔ of gross income for 2019 or 2020 is from farming or fishing).

However, if a return was not filed for 2019 or that return did not cover a full 12 months, item 2 does not apply.

For this purpose, include household employment taxes in the tax shown on the tax return, but only if either of the following is true:

- The estate or trust will have Federal income tax withheld for 2020.
- The estate or trust would be required to make estimated tax payments for 2020 even if it did not include household employment taxes when figuring estimated tax.

Estimated tax payments are not required from: (62)

1. An estate of a domestic decedent or a domestic trust that had no tax liability for the full 12-month 2016 tax year;
2. A decedent's estate for any tax year ending before the date that is 2 years after the decedent's death; or
3. A trust that was treated as owned by the decedent if the trust will receive the residue of the decedent's estate under the will (or if no will is admitted to probate, the trust primarily responsible for paying debts, taxes, and expenses of administration) for any tax year ending before the date that is 2 years after the decedent's death.

Section 643(g) Election

Fiduciaries of trusts that pay estimated tax may elect under Section 643(g) to have any portion of their estimated tax payments allocated to any of the beneficiaries. The fiduciary of a decedent's estate may make a Section 643(g) election only for the final year of the estate.

Interest

Interest is charged on taxes not paid by the due date, even if an extension of time to file is granted. Interest is also charged on penalties imposed for failure to file, negligence, fraud, substantial valuation misstatements, substantial understatements of tax, and reportable transaction understatements. Interest is charged on the penalty from the due date of the return (including extensions). The interest charge is figured at a rate determined under Section 6621.

Late Filing of Return

The law provides a penalty of 5% of the tax due for each month, or part of a month, for which a return is not filed up to a maximum of 25% of the tax due (15% for each month, or part of a month, up to a maximum of 75% if the failure to file is fraudulent). If the return is more than 60 days late, the minimum penalty is the smaller of $435 or the tax due for 2020. The penalty will not be imposed if the taxpayer can show that the failure to file on time was due to reasonable cause. If he or she receives a notice about penalty and interest after he or she files this return, send the IRS an explanation and they will determine if the taxpayer meets reasonable-cause criteria. The taxpayer does not attach an explanation when he or she files Form 1041.

Late Payment of Tax

Generally, the penalty for not paying tax when due is ½ of 1% of the unpaid amount for each month or part of a month it remains unpaid. The maximum penalty is 25% of the unpaid amount. The penalty applies to any unpaid tax on the return. Any penalty is in addition to interest charges on late payments.

Failure To Provide Information Timely

The taxpayer must provide Schedule K-1 (Form 1041), on or before the day he or she is required to file Form 1041, to each beneficiary who receives a distribution of property or an allocation of an item of the estate.

In 2020, for each failure to provide Schedule K-1 to a beneficiary when due and each failure to include on Schedule K-1 all the information required to be shown (or the inclusion of incorrect information), a $280 penalty may be imposed with regard to each Schedule K-1 for which a failure occurs. The maximum penalty is $3,392,000 for all such failures during a calendar year. If the requirement to report information is intentionally disregarded, each $280 penalty is increased to $560 or, if greater, 10% of the aggregate amount of items required to be reported, and the $3,392,000 maximum does not apply. The penalty will not be imposed if the fiduciary can show that not providing information timely was due to reasonable cause and not due to willful neglect.

Underpaid Estimated Tax

If the fiduciary underpaid estimated tax, use Form 2210 - Underpayment of Estimated Tax by Individuals, Estates, and Trusts, to figure any penalty. Enter the amount of any penalty on Form 1041, line 26.

Trust Fund Recovery Penalty

This penalty may apply if certain excise, income, Social Security, and Medicare taxes that must be collected or withheld are not collected or withheld, or these taxes are not paid. These taxes are generally reported on Forms 720, 941, 943, 944, or 945. The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to have been responsible for collecting, accounting for, or paying over these taxes, and who acted willfully in not doing so. The penalty is equal to the unpaid trust fund tax. See the Instructions for Form 720, Publication 15 (Circular E) - Employer's Tax Guide, or Publication 51 (Circular A) - Agricultural Employer's Tax Guide, for more details, including the definition of responsible persons.

Tax-Exempt Organizations

To be tax-exempt under Section 501(c)(3) of the Internal Revenue Code, an organization must be organized and operated exclusively for exempt purposes set forth in Section 501(c)(3), and none of its earnings may inure to any private shareholder or individual. In addition, it may not be an action organization, i.e., it may not attempt to influence legislation as a substantial part of its activities, and it may not participate in any campaign activity for or against political candidates. Organizations described in Section 501(c)(3) are commonly referred to as charitable organizations. Organizations described in Section 501(c)(3), other than testing for public safety organizations, are eligible to receive tax-deductible contributions in accordance with Code Section 170.

The organization must not be organized or operated for the benefit of private interests, and no part of a Section 501(c)(3) organization's net earnings may inure to the benefit of any private shareholder or individual. If the organization engages in an excess benefit transaction with a person having substantial influence over the organization, an excise tax may be imposed on the person and any organization managers agreeing to the transaction. Section 501(c)(3) organizations are restricted in how much political and legislative (lobbying) activities they may conduct.

Form 1023 - Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code is used to apply for recognition as a tax-exempt organization under Section 501(c)(3). Organizations that may qualify for exemption under Section 501(c)(3) include corporations, unincorporated associations and trusts. A partnership may not qualify for exemption and therefore may not file Form 1023.

A limited liability company that files Form 1023 is treated as a corporation rather than a partnership. As a corporation, it may file Form 1023. Note, however, that a limited liability company should not file an exemption application if it wants to be treated as a disregarded entity by its tax-exempt parent. The IRS will only recognize a limited liability company under Section 501(c)(3) if all its members are Section 501(c)(3) organizations.

A charity's organizing document must limit the organization's purposes to exempt purposes set forth in Section 501(c)(3) and must not expressly empower it to engage, other than as an insubstantial part of its activities, in activities that do not further those purposes. This requirement may be met if the purposes stated in the organizing document are limited by reference to Section 501(c)(3). In addition, an organization's assets must be permanently dedicated to an exempt purpose. This means that if an organization dissolves, its assets must be distributed for an exempt purpose described in Section 501(c)(3), or to the Federal government or to a state or local government for a public purpose.

To establish that an organization's assets will be permanently dedicated to an exempt purpose, the organizing document should contain a provision insuring their distribution for an exempt purpose if the organization dissolves. Although reliance may be placed upon state law to establish permanent dedication of assets for exempt purposes, an organization's application can be processed by the IRS more rapidly if its organizing document includes a provision ensuring permanent dedication of assets for exempt purposes.

If the organizing document does not contain these provisions, an organization should amend it before submitting its exemption application. State officials can provide more information about how to amend organizing documents.

Organizations applying for recognition of exemption under a provision other than Section 501(c)(3) generally use Form 1024 - Application for Recognition of Exemption Under Section 501(a). Even if these organizations are not required to file Form 1024 to be tax-exempt, they may wish to file Form 1024 to receive a determination letter of IRS recognition of their Section 501(c) status in order to obtain certain incidental benefits such as:

- Public recognition of tax-exempt status.
- Exemption from certain state taxes.
- Advance assurance to donors of deductibility of contributions (in certain cases).
- Nonprofit mailing privileges.

Generally, Form 1024 is not used to apply for a group exemption letter.

Exempt Organizations - Required Filings

Although they are exempt from income taxation, exempt organizations are generally required to file annual returns of their income and expenses with the Internal Revenue Service. Beginning in 2008, small tax-exempt organizations that previously were not required to file returns because their gross receipts did not exceed a certain threshold may be required to file an annual electronic notice. Some organizations, such as churches and certain church-affiliated organizations, are not required to file annual returns or notices.

If an organization has unrelated business income, it must file an unrelated business income tax return. In addition to filing an annual exempt organization return, exempt organizations may be required to file other returns of and pay employment taxes. Some organizations may be required to file certain returns electronically. In addition to required filings, a charity may have other ongoing compliance obligations.

Unrelated Business Taxable Income (UBTI)

Even though an organization is recognized as tax-exempt, it still may be liable for tax on its unrelated business income. For most organizations, unrelated business income is income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis of the organization's exemption. An exempt organization that has $1,000 or more of gross income from an unrelated business must file Form 990-T - Exempt Organization Business Income Tax Return. An organization must pay estimated tax if it expects its tax for the year to be $500 or more. However, the following activities are specifically excluded from the definition of unrelated trade or business:

- *Volunteer Labor* - Any trade or business is excluded in which substantially all the work is performed for the organization without compensation. Some fundraising activities, such as volunteer operated bake sales, may meet this exception.
- *Convenience of Members* - Any trade or business is excluded that is carried on by an organization described in Section 501(c)(3) or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees. A typical example of this is a school cafeteria.
- *Selling Donated Merchandise* - Any trade or business is excluded that consists of selling merchandise, substantially all of which the organization received as gifts or contributions. Many thrift shop operations of exempt organizations would meet this exception.
- *Bingo* - Certain bingo games are not unrelated trade or business.

The obligation to file Form 990-T is in addition to the obligation to file the annual information return, Form 990, 990-EZ or 990-PF. Each organization must file a separate Form 990-T, except title holding corporations and organizations receiving their earnings that file a consolidated return under Internal Revenue Code Section 1501.

Employment Taxes

If a tax-exempt organization (EO) has employees, the EO is responsible for Federal Income Tax Withholding and Social Security and Medicare taxes. In addition, some EOs are responsible for Federal Unemployment Tax.

Annual Exempt Organization Information Returns

In general, exempt organizations are required to file annual returns, although exceptions apply. If an organization does not file a required return or files late, penalties may be assessed. In addition, if an organization does not file as required for three consecutive years, the law provides that it automatically loses its tax-exempt status. Forms 990 and 990-EZ are used by tax-exempt organizations, nonexempt charitable trusts, and Section 527 political organizations to provide the IRS with the information required by Section 6033.

Every organization exempt from Federal income tax under Internal Revenue Code Section 501(a) must file an annual information return except:

1. A church, an interchurch organization of local units of a church, a convention or association of churches,
2. An integrated auxiliary of a church,
3. A church-affiliated organization that is exclusively engaged in managing funds or maintaining retirement programs,
4. A school below college level affiliated with a church or operated by a religious order,

5. Church-affiliated mission societies if more than half of their activities are conducted in, or are directed at persons in, foreign countries,
6. An exclusively religious activity of any religious order,
7. A state institution, the income of which is excluded from gross income under Section 115,
8. A corporation described in Section 501(c)(1) that is organized under an Act of Congress, an instrumentality of the United States, and is exempt from Federal income taxes,
9. A stock bonus, pension, or profit-sharing trust that qualifies under Section 401(required to file Form 5500, Annual Return/Report of Employee Benefit Plan),
10. A religious or apostolic organization described in Section 501(d) (required to file Form 1065, U.S. Return of Partnership Income),
11. A governmental unit or an affiliate of a governmental unit that meets the requirements of Revenue Procedure 95-48, 1995-2 C.B. 418,
12. A private foundation described in Section 501(c)(3) and exempt under Section 501(a) (required to file Form 990-PF, Return of Private Foundation),
13. A political organization that is a state or local committee of a political party, a political committee of a state or local candidate, a caucus or association of state or local officials, or required to report under the Federal Election Campaign Act of 1971 as a political committee,
14. An exempt organization (other than a private foundation) that normally has annual gross receipts of $50,000 or less ($25,000 for tax years ending before December 31, 2010) and therefore is eligible to file an annual electronic notice Form 990-N instead of an annual information return), or
15. A foreign organization, or an organization located in a U.S. possession, that normally has annual gross receipts from sources within the United States of $50,000 or less ($25,000 for tax years ending before December 31, 2010) and therefore is eligible to file an annual electronic notice (Form 990-N instead of an annual information return).

Tip

For tax years ending after August 17, 2006, a Section 509(a)(3) supporting organization must generally file Form 990 or 990-EZ. The exceptions listed above are not available to a supporting organization unless it is an integrated auxiliary of a church (paragraph 2) or an exclusively religious activity of a religious order (paragraph 6).

Retirement Plans

SEP, SIMPLE, and qualified plans offer the employer and his or her employees a tax-favored way to save for retirement. The employer can deduct contributions he or she makes to the plan for his or her employees. If the taxpayer is a sole proprietor, he or she can deduct contributions he or she makes to the plan for him or herself. An employer can also deduct trustees' fees if contributions to the plan do not cover them. Earnings on the contributions are generally tax free until the employer or his or her employees receive distributions from the plan. Under a 401(k) plan, employees can have an employer contribute limited amounts of their before-tax (after-tax, in the case of a qualified Roth contribution program) wages to the plan. These amounts (and the earnings on them) are generally tax free until his or her employees receive distributions from the plan or, in the case of a qualified distribution from a designated Roth account, completely tax free.

Simplified Employee Pension Plans (SEP)

SEPs provide a simplified method for an employer to make contributions to a retirement plan for him or herself and his or her employees. Instead of setting up a profit-sharing or money purchase plan with a trust, the employer can adopt a SEP agreement and make contributions directly to a traditional individual retirement account or a traditional individual retirement annuity (SEP-IRA) set up for him or herself and each eligible employee.

Contributions an employer makes for 2020 to a common-law employee's SEP-IRA cannot exceed the lesser of 25% of the employee's compensation or $57,000. Compensation generally does not include the employer's contributions to the SEP. The SEP plan document will specify how the employer contribution is determined and how it will be allocated to participants. If the employer contributes to a defined contribution plan, annual additions to an account are limited to the lesser of $56,000 or 100% of the participant's compensation. When the employer figures this limit, he or she must add his or her contributions to all defined contribution plans maintained by him or her. Because a SEP is considered a defined contribution plan for this limit, the employer's contributions to a SEP must be added to the employer's contributions to other defined contribution plans he or she maintains.

Generally, the employer can deduct the contributions he or she makes each year to each employee's SEP-IRA. If the taxpayer is self-employed, he or she can deduct the contributions he or she makes each year to his or her own SEP-IRA. The most an employer can deduct for his or her contributions to the employer's or his or her employee's SEP-IRA is the lesser of the following amounts: [65]

1. The employer's contributions (including any excess contributions carryover).
2. 25% of the compensation (compensation is limited to $285,000 per participant) paid to the participants during 2020 from the business that has the plan, not to exceed $57,000 maximum contribution per participant.

Example
An employee, Susan Green, earned $210,000 for 2020. Because of the maximum contribution limit for 2020, her employer can only contribute $57,000 to her SEP-IRA.

Savings Incentive Match Plans (SIMPLE)

Generally, if an employer had 100 or fewer employees who received at least $5,000 in compensation last year, he or she can set up a SIMPLE plan. Under a SIMPLE plan, employees can choose to make salary reduction contributions rather than receiving these amounts as part of their regular pay. In addition, the employer will contribute matching or non-elective contributions. The two types of SIMPLE plans are the SIMPLE IRA plan and the SIMPLE 401(k) plan. Contributions are made up of salary reduction contributions and employer contributions. The employer must make either matching contributions or non-elective contributions. No other contributions can be made to the SIMPLE IRA plan. These contributions, which the employer can deduct, must be made timely.

The amount the employee chooses to have the employer contribute to a SIMPLE IRA on his or her behalf cannot be more than $13,500 for 2020. These contributions must be expressed as a percentage of the employee's compensation unless the employer permits the employee to express them as a specific dollar amount. The employer cannot place restrictions on the contribution amount (such as limiting the contribution percentage), except to comply with the $13,500 limit.

If the employer or an employee participates in any other qualified plan during the year and the employer's or his or her employee have salary reduction contributions (elective deferrals) under those plans, the salary reduction contributions under a SIMPLE IRA plan also count toward the overall annual limit $19,500 for 2020 on exclusion of salary reduction contributions and other elective deferrals.

A SIMPLE IRA plan can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2020 for SIMPLE IRA plans is $3,000. Salary reduction contributions are not treated as catch-up contributions for 2020 until they exceed $13,500.

However, the catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts: [65]

- The catch-up contribution limit.
- The excess of the participant's compensation over the salary reduction contributions that are not catch-up contributions.

The employer is generally required to match each employee's salary reduction contributions on a dollar-for-dollar basis up to 3% of the employee's compensation. This requirement does not apply if the employer makes non-elective contributions.

Instead of matching contributions, the employer can choose to make non-elective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 (or some lower amount if the employer selects) of compensation from him or her for the year. If the employer makes this choice, he or she must make non-elective contributions whether or not the employee chooses to make salary reduction contributions. Only $285,000 of the employee's compensation can be taken into account to figure the contribution limit in 2020. If the employer chooses this 2% contribution formula, he or she must notify the employees within a reasonable period of time before the 60-day election period for the calendar year.

The employer can deduct SIMPLE IRA contributions in the tax year within which the calendar year for which contributions were made ends. The employer can deduct contributions for a particular tax year if they are made for that tax year and are made by the due date (including extensions) of his or her Federal income tax return for that year.

Qualified Plans

The qualified plan rules are more complex than the SEP plan and SIMPLE plan rules. However, there are advantages to qualified plans, such as increased flexibility in designing plans and increased contribution and deduction limits in some cases.

Qualified retirement plans set up by self-employed individuals are sometimes called Keogh or H.R.10 plans. A sole proprietor or a partnership can set up one of these plans. A common-law employee or a partner cannot set up one of these plans. These plans can also be set up and maintained by employers that are corporations. All the rules discussed here apply to corporations except where specifically limited to the self-employed.

There are two basic kinds of qualified plans, defined contribution plans and defined benefit plans, and different rules apply to each. The employer can have more than one qualified plan, but his or her contributions to all the plans must not total more than the overall limits.

Defined Contribution Plan

A defined contribution plan provides an individual account for each participant in the plan. It provides benefits to a participant largely based on the amount contributed to that participant's account. Benefits are also affected by any income, expenses, gains, losses, and forfeitures of other accounts that may be allocated to an account. A defined contribution plan can be either a profit-sharing plan or a money purchase pension plan.

Although it is called a “profit-sharing plan,” the employer does not actually have to make a business profit for the year in order to make a contribution (except for him or herself if he or she is self-employed). A profit-sharing plan can be set up to allow for discretionary employer contributions, meaning the amount contributed each year to the plan is not fixed. An employer may even make no contribution to the plan for a given year.

The plan must provide a definite formula for allocating the contribution among the participants and for distributing the accumulated funds to the employees after they reach a certain age, after a fixed number of years, or upon certain other occurrences. In general, the employer can be more flexible in making contributions to a profit-sharing plan than to a money purchase pension plan or a defined benefit plan.

Contributions to a money purchase pension plan are fixed and are not based on the employer’s business profits. For example, if the plan requires that contributions be 10% of the participants' compensation without regard to whether the employer has profits (or the self-employed person has earned income), the plan is a money purchase pension plan. This applies even though the compensation of a self-employed individual as a participant is based on earned income derived from business profits.

Defined Benefit Plan

A defined benefit plan is any plan that is not a defined contribution plan. Contributions to a defined benefit plan are based on what is needed to provide definitely determinable benefits to plan participants. Actuarial assumptions and computations are required to figure these contributions. Generally, the taxpayer will need continuing professional help to have a defined benefit plan.

A qualified plan is generally funded by the employer’s contributions. However, employees participating in the plan may be permitted to make contributions, and the employer may be permitted to make contributions on his or her own behalf.

An employer can make deductible contributions for a tax year up to the due date of his or he return (plus extensions) for that year. The plan must provide that contributions or benefits cannot exceed certain limits. The limits differ depending on whether the plan is a defined contribution plan or a defined benefit plan.

For 2020, the annual benefit for a participant under a defined benefit plan cannot exceed the lesser of either of the following amounts:

- 100% of the participant's average compensation for his or her highest 3 consecutive calendar years.
- $230,000.

For 2020, a defined contribution plan's annual contributions and other additions (excluding earnings) to the account of a participant cannot exceed the lesser of the following amounts:

- 100% of the participant's compensation.
- $57,000.

Catch-up contributions are not subject to the above limit.

Employees may be permitted to make nondeductible contributions to a plan in addition to an employer's contributions. Even though these employee contributions are not deductible, the earnings on them are tax free until distributed in later years. Also, these contributions must satisfy the nondiscrimination test of Section 401(m). See Regulations Sections 1.401(k)-2 and 1.401(m)-2 for further guidance relating to the nondiscrimination rules under Sections 401(k) and 401(m).

An employer can usually deduct, subject to limits, contributions he or she makes to a qualified plan, including those made for his or her own retirement. The contributions (and earnings and gains on them) are generally tax free until distributed by the plan. The deduction limit for the contributions to a qualified plan depends on the kind of plan the employer has.

The deduction for contributions to a defined contribution plan (profit-sharing plan or money purchase pension plan) cannot be more than 25% of the compensation paid (or accrued) during the year to the employer's eligible employees participating in the plan. If the taxpayer is self-employed, he or she must reduce this limit in figuring the deduction for contributions he or she makes for his or her own account.

When figuring the deduction limit, the following rules apply:

- Elective deferrals are not subject to the limit.
- Compensation includes elective deferrals.
- The maximum compensation that can be taken into account for each employee in 2020 is $285,000.

The deduction for contributions to a defined benefit plan is based on actuarial assumptions and computations. Consequently, an actuary must figure the deduction limit.

Prohibited Transactions

Prohibited transactions are transactions between the plan and a disqualified person that are prohibited by law. If the employer is a disqualified person who takes part in a prohibited transaction, he or she must pay a tax. Prohibited transactions generally include the following transactions: (65)

1. A transfer of plan income or assets to or use of them by or for the benefit of, a disqualified person.
2. Any act of a fiduciary by which he or she deals with plan income or assets in his or her own interest.
3. The receipt of consideration by a fiduciary for his or her own account from any party dealing with the plan in a transaction that involves plan income or assets.
4. Any of the following acts between the plan and a disqualified person.
    a. Selling, exchanging, or leasing property.
    b. Lending money or extending credit.
    c. Furnishing goods, services, or facilities.

Certain transactions are exempt from being treated as prohibited transactions. For example, a prohibited transaction does not take place if the employer is a disqualified person and receives any benefit to which he or she is entitled as a plan participant or beneficiary. However, the benefit must be figured and paid under the same terms as for all other participants and beneficiaries.

The taxpayer is a disqualified person if he or she is any of the following:

1. A fiduciary of the plan.
2. A person providing services to the plan.
3. An employer, any of whose employees are covered by the plan.
4. An employee organization, any of whose members are covered by the plan.
5. Any direct or indirect owner of 50% or more of any of the following:
    a. The combined voting power of all classes of stock entitled to vote, or the total value of shares of all classes of stock of a corporation that is an employer or employee organization described in (3) or (4).
    b. The capital interest or profits interest of a partnership that is an employer or employee organization described in (3) or (4).
    c. The beneficial interest of a trust or unincorporated enterprise that is an employer or an employee organization described in (3) or (4).
6. A member of the family of any individual described in (1), (2), (3), or (5). (A member of a family is the spouse, ancestor, lineal descendant, or any spouse of a lineal descendant.)
7. A corporation, partnership, trust, or estate of which (or in which) any direct or indirect owner described in (1) through (5) holds 50% or more of any of the following:
    a. The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation.
    b. The capital interest or profits interest of a partnership.
    c. The beneficial interest of a trust or estate.
8. An officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10% or more shareholder, or highly compensated employee (earning 10% or more of the yearly wages of an employer) of a person described in (3), (4), (5), or (7).
9. A 10% or more (in capital or profits) partner or joint venture of a person described in (3), (4), (5), or (7).
10. Any disqualified person, as described in (1) through (9) above, who is a disqualified person with respect to any plan to which a Section 501(c)(22) trust is permitted to make payments under Section 4223 of ERISA.

The term "highly compensated employee" means any employee who:

- Owned more than 5% of the interest in the business at any time during the year or the preceding year, regardless of how much compensation that person earned or received, or
- For the preceding year:
    - Had compensation from the employer in excess of $130,000 if the preceding year is 2020, and
    - If the employer elects the application of this clause for such preceding year, was in the top 20% of employees when ranked by compensation for such preceding year.

The initial tax on a prohibited transaction is 15% of the amount involved for each year (or part of a year) in the taxable period. If the transaction is not corrected within the taxable period, an additional tax of 100% of the amount involved is imposed. Both taxes are payable by any disqualified person who participated in the transaction (other than a fiduciary acting only as such). If more than one person takes part in the transaction, each person can be jointly and severally liable for the entire tax.

Required Minimum Distribution Method

A taxpayer cannot keep retirement funds in his or her account indefinitely. The taxpayer generally has to start taking withdrawals from his or her IRA, SIMPLE IRA, SEP IRA, or retirement plan account when he or she reaches age 70½. However, changes were made by the Setting Every Community Up for Retirement Enhancement (SECURE) Act which was part of the Further Consolidated Appropriations Act, signed by the President on December 20, 2019. Due to changes made by the SECURE Act, if the taxpayer's 70th birthday is July 1, 2019 or later, he or she does not have to take withdrawals until he or she reaches age 72. Roth IRAs do not require withdrawals until after the death of the owner.

The taxpayer's required minimum distribution is the minimum amount he or she must withdraw from his or her account each year. The taxpayer can withdraw more than the minimum required amount. Also, the taxpayer's withdrawals will be included in his or her taxable income except for any part that was taxed before (his or her basis) or that can be received tax-free (such as qualified distributions from designated Roth accounts).

These minimum distribution rules apply to: [66]

- Traditional IRAs.
- SEP IRAs.
- SIMPLE IRAs.
- 401(k) plans.
- 403(b) plans.
- 457(b) plans.
- Profit sharing plans.
- Other defined contribution plans.

The required minimum distribution for any year is the account balance as of the end of the immediately preceding calendar year divided by a distribution period from the IRS's Uniform Lifetime Table. A separate table is used if the sole beneficiary is the owner's spouse who is ten or more years younger than the owner.

The beginning dates for the first required minimum distribution are:

- **IRAs (including SEPs and SIMPLE IRAs):**
  - April 1 of the year following the calendar year in which the taxpayer reaches age 70½, if he or she was born before July 1, 1949.
  - April 1 of the year following the calendar year in which the taxpayer reaches age 72, if he or she was born after Jun 30, 1949.
- **401(k), profit-sharing, 403(b), or other defined contribution plan:**
  - Generally, April 1 following the later of the calendar year in which the taxpayer:
    - Reaches age 72 (age 70½ if born before July 1, 1949), or
    - Retires (if his or her plan allows this).

For each year after the taxpayer's required beginning date, he or she must withdraw his or her RMD by December 31.

For the first year following the year the taxpayer reaches age 70½ (age 72 if born after June 30, 1949), he or she will generally have two required distribution dates: an April 1 withdrawal (for the year he or she turns 70½ (or 72 if born after June 30, 1949)) and an additional withdrawal by December 31 (for the year following the year he or she turns 70½ (or 72 if born after June 30, 1949)). The taxpayer can make his or her first withdrawal by December 31 of the year he or she turns 70½ (or 72 if born after June 30, 1949) instead of waiting until April 1 of the following year which would allow the distributions to be included in his or her income in separate tax years.

If the taxpayer owns 5% or more of the business sponsoring the plan, then he or she must begin receiving distributions by April 1 of the year after the calendar year in which he or she reaches age 70½ (age 72 if born after June 30, 1949), even if he or she has not retired.

For each subsequent year after the taxpayer's required beginning date, he or she must withdraw his or her RMD by December 31. If the taxpayer does not take any distributions, or if the distributions are not large enough, he or she may have to pay a 50% excise tax on the amount not distributed as required. To report the excise tax, the taxpayer may have to file Form 5329 - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

For the year of the account owner's death, use the RMD the account owner would have received. For the year following the owner's death, the RMD will depend on the identity of the designated beneficiary. The account balance is divided by this life expectancy to determine the RMD.

A qualified charitable distribution (QCD)will count towards the taxpayer's required minimum distribution. The maximum annual exclusion for QCDs is $100,000. Any QCD in excess of the $100,000 exclusion limit is included in income as any other distribution. If the taxpayer files a joint return, his or her spouse can also have a QCD and exclude up to $100,000. The amount of the QCD is limited to the amount of the distribution that would otherwise be included in income. If the taxpayer's IRA includes nondeductible contributions, the distribution is first considered to be paid out of otherwise taxable income. The SECURE Act preserved the ability to make qualified charitable distributions (QCDs) at age 70½ even though the required minimum distribution age was increased to age 72. Qualified charitable distributions can satisfy all or part the amount of the taxpayer's required minimum distribution (RMD) from his or her IRA. IRA owners reported charitable donations from an IRA on Form 1040.

International Information Returns

The Internal Revenue Code (IRC) requires the filing of a number of different information returns with respect to foreign entities or transactions. These "international information returns" include Form 5471 (for U.S. persons who own shares in certain foreign corporations), Form 5472 (for U.S. corporations that are 25% owned by foreign persons), Form 8865 (for U.S. persons who are partners in certain foreign partnerships), Form 3520 (for transactions with foreign trusts and for the receipt of certain foreign gifts) and Form 8938 (for foreign assets generally). For each, there is a significant penalty for failing to timely and correctly file the form. The penalty does not apply, however, if the failure was due to reasonable cause (sometimes with the additional condition that the failure was not due to willful disregard).

The modified streamlined filing compliance procedures are designed only for individual taxpayers, including estates of individual taxpayers. The streamlined procedures are available to both U.S. individual taxpayers residing outside the United States and U.S. individual taxpayers residing in the United States. Taxpayers eligible to use the streamlined procedures who have previously filed delinquent or amended returns in an attempt to address U.S. tax and information reporting obligations with respect to foreign financial assets (so-called "quiet disclosures" made outside of the Offshore Voluntary Disclosure Program (OVDP) or its predecessor programs) may still use the streamlined procedures. However, any penalty assessments previously made with respect to those filing will not be abated.

Taxpayers who do not need to use the Offshore Voluntary Disclosure Program (OVDP) or the Streamlined Filing Compliance Procedures to file delinquent or amended tax returns to report and pay additional tax, but who: (67)

- Have not filed one or more required international information returns,
- Have reasonable cause for not timely filing the information returns,
- Are not under a civil examination or a criminal investigation by the IRS, and
- Have not already been contacted by the IRS about the delinquent information returns,

should file the delinquent information returns with a statement of all facts establishing reasonable cause for the failure to file.

As part of the reasonable cause statement, taxpayers must also certify that any entity for which the information returns are being filed was not engaged in tax evasion. If a reasonable cause statement is not attached to each delinquent information return filed, penalties may be assessed in accordance with existing procedures.

Information returns filed with amended returns will not be automatically subject to audit but may be selected for audit through the existing audit selection processes that are in place for any tax or information returns.

Rental Property

A rental activity is a passive activity even if the taxpayer materially participated in that activity, unless he or she materially participated as a real estate professional. An activity is a rental activity if tangible property (real or personal) is used by customers or held for use by customers, and the gross income (or expected gross income) from the activity represents amounts paid (or to be paid) mainly for the use of the property. It does not matter whether the use is under a lease, a service contract, or some other arrangement.

The taxpayer cannot take a rental deduction for unreasonable rent. Ordinarily, the issue of reasonableness arises only if he or she and the lessor are related. Rent paid to a related person is reasonable if it is the same amount the taxpayer would pay to a stranger for use of the same property. Rent is not unreasonable just because it is figured as a percentage of gross sales.

If the taxpayer rents his or her home and uses part of it as his or her place of business, he or she may be able to deduct the rent he or she pays for that part. The taxpayer must meet the requirements for business use of the home.

Generally, rent paid in a trade or business is deductible in the year paid or accrued. If the taxpayer pays rent in advance, he or she can deduct only the amount that applies to the use of the rented property during the tax year. The taxpayer can deduct the rest of the payment only over the period to which it applies.

If the taxpayer or his or her spouse actively participated in a passive rental real estate activity, the amount of the passive activity loss that is disallowed is decreased and he or she therefore can deduct up to $25,000 of loss from the activity from his or her nonpassive income. This special allowance is an exception to the general rule disallowing the passive activity loss. Similarly, the taxpayer can offset credits from the activity against the tax on up to $25,000 of nonpassive income after taking into account any losses allowed under this exception.

If the taxpayer is married, filing a separate return, and lived apart from his or her spouse for the entire tax year, his or her special allowance cannot be more than $12,500. If the taxpayer lived with his or her spouse at any time during the year and are filing a separate return, he or she cannot use the special allowance to reduce his or her nonpassive income or tax on nonpassive income.

If property acquired for business is expected to last more than one year, generally a taxpayer cannot deduct the entire cost as a business expense in the year the item was acquired. The cost must be spread over more than one tax year and part of the cost should be deducted each year on Schedule C. This method of deducting the cost of business property is called depreciation. [(68)]

Most types of tangible property (except land), such as buildings, machinery, vehicles, furniture, and equipment are depreciable. Likewise, certain intangible property, such as patents, copyrights, and computer software is depreciable. In order for a taxpayer to be allowed a depreciation deduction for a property, the property must meet all the following requirements: [(69)]

- The taxpayer must own the property. Taxpayers may also depreciate any capital improvements for property the taxpayer leases.
- A taxpayer must use the property in business or in an income-producing activity. If a taxpayer uses a property for business and for personal purposes, the taxpayer can only deduct depreciation based only on the business use of that property.
- The property must have a determinable useful life of more than one year.

Even if a taxpayer meets the preceding requirements for a property, a taxpayer cannot depreciate the following property:

- Property placed in service and disposed of in same year.
- Equipment used to build capital improvements. A taxpayer must add otherwise allowable depreciation on the equipment during the period of construction to the basis of the improvements.
- Certain term interests.

Real Estate Professionals

Generally, rental activities are passive activities even if the taxpayer materially participated in them. However, if he or she qualified as a real estate professional, rental real estate activities in which he or she materially participated are not passive activities. For this purpose, each interest the taxpayer has in a rental real estate activity is a separate activity, unless he or she chooses to treat all interests in rental real estate activities as one activity. See the Instructions for Schedule E (Form 1040) - Supplemental Income and Loss, for information about making this choice.

The taxpayer qualifies as a real estate professional for the tax year if he or she meets both of the following requirements: [(53)]

- More than half of the personal services the taxpayer performs in all trades or businesses during the tax year are performed in real property trades or businesses in which he or she materially participates.
- The taxpayer performs more than 750 hours of services during the tax year in real property trades or businesses in which he or she materially participates.

If the taxpayer qualifies as a real estate professional, rental real estate activities in which he or she materially participated are not passive activities. For purposes of determining whether the taxpayer materially participated in his or her rental real estate activities, each interest in rental real estate is a separate activity unless he or she elects to treat all his or her interests in rental real estate as one activity.

Do not count personal services the taxpayer performs as an employee in real property trades or businesses unless he or she is a 5% owner of his or her employer. The taxpayer is a 5% owner if he or she owns (or is considered to own) more than 5% of his or her employer's outstanding stock, or capital or profits interest.

Do not count the taxpayer's spouse's personal services to determine whether he or she met the requirements listed earlier to qualify as a real estate professional. However, the taxpayer can count his or her spouse's participation in an activity in determining if he or she materially participated.

Commercial Rentals

Residential real estate is all single-family homes and one to four-unit rental residences. In contrast, commercial property is anything with five or more units. Condos, duplexes, and quadruplexes make up residential real estate, while office, retail, industrial, multifamily (of five units or more), hotel, and special purpose buildings are considered commercial real estate. Residential properties are typically leased to families and individuals, while commercial properties are leased to businesses. Commercial real estate tends to award investors a much wider range of potential investment. For example, there are more commercial property investment funds than residential ones. On the other hand, residential real estate investing tends to give investors a more active role in the property.

Vacation Home

If the taxpayer has any personal use of a dwelling unit (including a vacation home) that he or she rents, he or she must divide his or her expenses between rental use and personal use. In general, the taxpayer's rental expenses will be no more than his or her total expenses multiplied by a fraction, the denominator of which is the total number of days the dwelling unit is used and the numerator of which is the total number of days actually rented at a fair rental price. Only the taxpayer's rental expenses may be deducted on Schedule E (Form 1040). Some of his or her personal expenses may be deductible on Schedule A (Form 1040) if he or she itemizes his or her deductions.

The taxpayer must also determine if the dwelling unit is considered a home. The amount of rental expenses that the taxpayer can deduct may be limited if the dwelling unit is considered a home. Whether a dwelling unit is considered a home depends on how many days during the year are considered to be days of personal use. There is a special rule if the taxpayer used the dwelling unit as a home and he or she rented it for less than 15 days during the year.

Passive Loss Limitation

If the taxpayer or his or her spouse actively participated in a passive rental real estate activity, the amount of the passive activity loss that is disallowed is decreased and the taxpayer therefore can deduct up to $25,000 of loss from the activity from his or her nonpassive income. This special allowance is an exception to the general rule disallowing the passive activity loss. Similarly, the taxpayer can offset credits from the activity against the tax on up to $25,000 of nonpassive income after taking into account any losses allowed under this exception.

The maximum special allowance of $25,000 ($12,500 for married individuals filing separate returns and living apart at all times during the year) is reduced by 50% of the amount of the taxpayer's modified adjusted gross income that is more than $100,000 ($50,000 if he or she is married filing separately). If the taxpayer's modified adjusted gross income is $150,000 or more ($75,000 or more if he or she is married filing separately), he or she generally cannot use the special allowance. This is because the special allowance is reduced to $0 since the modified adjusted gross income is over the $100,000 amount.

Rental Income

In most cases, the taxpayer must include in his or her gross income all amounts he or she receives as rent. Rental income is any payment the taxpayer receives for the use or occupation of property. It is not limited to amounts he or she receive as normal rental payments. The following are common types of rental income:

Advance rent. Advance rent is any amount the taxpayer receives before the period that it covers. Include advance rent in his or her rental income in the year he or she receives it regardless of the period covered or the method of accounting he or she uses.

Canceling a lease. If the taxpayer's tenant pays him or her to cancel a lease, the amount he or she receives is rent. Include the payment in the taxpayer's rental income in the year he or she receives it regardless of his or her method of accounting.

Expenses paid by tenant. If the taxpayer's tenant pays any of his or her expenses, those payments are rental income. Because the taxpayer must include this amount in income, he or she can also deduct the expenses if they are deductible rental expenses.

Property or services. If the taxpayer receives property or services as rent, instead of money, include the fair market value of the property or services in his or her rental income. If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary

Security deposits. Do not include a security deposit in the taxpayer's income when he or she receives it if he or she plans to return it to his or her tenant at the end of the lease. But if the taxpayer keeps part or all of the security deposit during any year because his or her tenant does not live up to the terms of the lease, include the amount he or she keeps in his or her income in that year. If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in the taxpayer's income when he or she receives it.

Rental Expenses

In most cases, the expenses of renting the taxpayer's property, such as maintenance, insurance, taxes, and interest, can be deducted from his or her rental income. If the taxpayer sometimes uses his or her rental property for personal purposes, he or she must divide his or her expenses between rental and personal use. Also, his or her rental expense deductions may be limited. If the taxpayer owns a part interest in rental property, he or she can deduct expenses he or she paid according to his or her percentage of ownership.

The following are common types of rental expenses:

- Advertising.
- Auto and travel expenses.
- Cleaning and maintenance.
- Commissions.
- Depreciation.
- Insurance.
- Interest.
- Legal and other professional fees.
- Local transportation expenses.
- Management fees.
- Mortgage interest paid to banks, etc.
- Points.
- Rental payments.
- Repairs.
- Taxes.
- Utilities.

Generally, an expense for repairing or maintaining the taxpayer's rental property may be deducted if he or she is not required to capitalize the expense. The taxpayer must capitalize any expense he or she pays to improve his or her rental property. An expense is for an improvement if it results in a betterment to his or her property, restores his or her property, or adapts his or her property to a new or different use. Expenses that may result in a betterment to the taxpayer's property include expenses for fixing a pre-existing defect or condition, enlarging or expanding his or her property, or increasing the capacity, strength, or quality of his or her property.

Farmers

The taxpayer is in the business of farming if he or she cultivates, operates, or manages a farm for profit, either as owner or tenant. A farm includes livestock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards.

Gross farm income refers to the monetary and non-monetary income received by farm operators. Its main components include cash receipts from the sale of farm products, government payments, other farm income (such as income from custom work), value of food and fuel produced and consumed on the same farm, rental value of farm dwellings, and change in value of year-end inventories of crops and livestock.

Schedule F (Form 1040)

Individuals, trusts, and partnerships report farm income on Schedule F (Form 1040) - Profit or Loss From Farming. Use this schedule to figure the net profit or loss from regular farming operations.

Income from farming reported on Schedule F includes amounts the taxpayer receives from cultivating, operating, or managing a farm for gain or profit, either as owner or tenant. This includes income from operating a stock, dairy, poultry, fish, fruit, or truck farm and income from operating a plantation, ranch, range, or orchard. It also includes income from the sale of crop shares if the taxpayer materially participates in producing the crop. Income received from operating a nursery, which specializes in growing ornamental plants, is considered to be income from farming.

Income reported on Schedule F does not include gains or losses from sales or other dispositions of the following farm assets: [70]

- Land.
- Depreciable farm equipment.
- Buildings and structures.
- Livestock held for draft, breeding, sport, or dairy purposes.

Amounts received from the sales of products the taxpayer raised on his or her farm for sale (or bought for resale), such as livestock, produce, or grains, are reported on Schedule F. This includes money and the fair market value of any property or services the taxpayer receives. When he or she sells farm products bought for resale, the profit or loss is the difference between the selling price (money plus the fair market value of any property) and the basis in the item (usually the cost). The taxpayer generally reports these amounts on Schedule F for the year he or she receives payment.

Sales of livestock held for draft, breeding, sport, or dairy purposes may result in ordinary or capital gains or losses, depending on the circumstances. In either case, the taxpayer should always report these sales on Form 4797 - Sales of Business Property instead of Schedule F. Animals the taxpayer does not hold primarily for sale are considered business assets of his or her farm.

Accounting Methods

A farmer must use an accounting method that clearly shows his or her income and expenses. He or she must also figure his or her taxable income and file an income tax return for an annual accounting period called a tax year.

Cash Method

Most farmers use the cash method because they find it easier to keep records using the cash method. However, certain farm corporations and partnerships and all tax shelters must use an accrual method of accounting. Under the cash method, include in the taxpayer's gross income all items of income he or she actually or constructively received during the tax year. Items of income include money received as well as property or services received. If the taxpayer receives property or services, he or she must include the fair market value (FMV) of the property or services in income.

Income is constructively received when an amount is credited to the taxpayer's account or made available to him or her without restriction. The taxpayer does not need to have possession of the income for it to be treated as income for the tax year. If he or she authorizes someone to be his or her agent and receive income for him or her, the taxpayer is considered to have received the income when the agent receives it. Income is not constructively received if the taxpayer's receipt of the income is subject to substantial restrictions or limitations.

The taxpayer cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying tax on the income. He or she must report the income in the year the money or property is received or made available to him or her without restriction.

Accrual Method

Under an accrual method of accounting, a farmer generally reports income in the year earned and deducts or capitalizes expenses in the year incurred. The purpose of an accrual method of accounting is to correctly match income and expenses. Certain businesses engaged in farming must use an accrual method of accounting for its farm business and for sales and purchases of inventory items.

Generally, the taxpayer includes an amount in income for the tax year in which all events that fix his or her right to receive the income have occurred, and he or she can determine the amount with reasonable accuracy. Under this rule, include an amount in income on the earliest of the following dates: (70)

- When the taxpayer receives payment.
- When the income amount is due to the taxpayer.
- When the taxpayer earns the income.
- When title passes.

If the taxpayer keeps an inventory, generally he or she must use an accrual method of accounting to determine his or her gross income. An inventory is necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor.

Under an accrual method of accounting, the taxpayer generally deducts or capitalizes a business expense when both of the following apply: (70)

1. The all-events test has been met. This test is met when:
    a. All events have occurred that fix the fact that the taxpayer has a liability.
    b. The amount of the liability can be determined with reasonable accuracy.
2. Economic performance has occurred.

Generally, the taxpayer cannot deduct or capitalize a business expense until economic performance occurs. If his or her expense is for property or services provided to him or her, or for his or her use of property, economic performance occurs as the property or services are provided or as the property is used. If the taxpayer's expense is for property or services he or she provides to others, economic performance occurs as he or she provides the property or services.

Generally, the following businesses, if engaged in farming, must use an accrual method of accounting: (70)

1. A corporation (other than a family corporation) that had gross receipts of more than $1,000,000 for any tax year beginning after 1975.
2. A family corporation that had gross receipts of more than $25,000,000 for any tax year beginning after 1985.
3. A partnership with a corporation as a partner, if that corporation meets the requirements of (1) or (2) above.
4. A tax shelter.

Note

Items (1), (2), and (3) above do not apply to an S corporation or a business operating a nursery or sod farm, or the raising or harvesting of trees (other than fruit and nut trees).

Sales and Exchanges

If the taxpayer sells, exchanges, or otherwise disposes of his or her property, he or she usually has a gain or a loss. A sale is a transfer of property for money or a mortgage, note, or other promise to pay money. An exchange is a transfer of property for other property or services.

Amounts received from the sales of products the taxpayer raised on his or her farm for sale (or bought for resale), such as livestock, produce, or grains, are reported on Schedule F - Profit or Loss From Farming. This includes money and the fair market value of any property or services he or she receives. When the taxpayer sells farm products bought for resale, his or her profit or loss is the difference between the selling price (money plus the fair market value of any property) and the basis in the item (usually the cost). The taxpayer generally reports these amounts on Schedule F for the year he or she receives payment.

Ordinary or Capital Gain or Loss

Generally, the taxpayer will have a capital gain or loss if he or she sells or exchanges a capital asset. He or she may also have a capital gain if his or her Section 1231 transactions result in a net gain. To figure the net capital gain or loss, the taxpayer must classify his or her gains and losses as either ordinary or capital (and his or her capital gains or losses as either short-term or long-term). The net capital gains may be taxed at a lower tax rate than ordinary income. The deduction for a net capital loss may be limited.

Livestock

This part discusses the sale or exchange of livestock used in a farm business. Gain or loss from the sale or exchange of this livestock may qualify as a Section 1231 gain or loss. However, any part of the gain that is ordinary income from the recapture of depreciation is not included as Section 1231 gain. The rules discussed here do not apply to the sale of livestock held primarily for sale to customers. The sale of this livestock is reported on Schedule F. The sale or exchange of livestock used in a farm business qualifies as a Section 1231 transaction if the taxpayer held the livestock for 12 months or more (24 months or more for horses and cattle). For Section 1231 transactions, livestock includes: cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. Also, for Section 1231 transactions, livestock does not include chickens, turkeys, pigeons, geese, emus, ostriches, rheas, or other birds, fish, frogs, reptiles, etc.

If livestock is held primarily for draft, breeding, dairy, or sporting purposes, it is used in a farm business. The purpose for which an animal is held ordinarily is determined by a farmer's actual use of the animal. An animal is not held for draft, breeding, dairy, or sporting purposes merely because it is suitable for that purpose, or because it is held for sale to other persons for use by them for that purpose. However, a draft, breeding, or sporting purpose may be present if an animal is disposed of within a reasonable time after it is prevented from its intended use or made undesirable as a result of an accident, disease, drought, or unfitness of the animal.

Example
Ben discovers an animal that he intends to use for breeding purposes is sterile. He disposes of it within a reasonable time. This animal was held for breeding purposes.

Gain on the sale of raised livestock is generally the gross sales price reduced by any expenses of the sale. Expenses of sale include sales commissions, freight or hauling from a farm to a commission company, and other similar expenses. The basis of the animal sold is zero if the costs of raising it were deducted during the years the animal was being raised.

Rents

The rent a taxpayer receives for the use of his or her farmland is generally rental income, not farm income. However, if the taxpayer materially participates in farming operations on the land, the rent is farm income. If the taxpayer pastures someone else's livestock and takes care of them for a fee, the income is from his or her farming business. The taxpayer must enter it as *Other income* on Schedule F. If the taxpayer simply rents his or her pasture for a flat cash amount without providing services, report the income as rent on Part I of Schedule E (Form 1040) - Supplemental Income and Loss.

Crop Shares

The taxpayer must include rent he or she receives in the form of crop shares in income in the year he or she converts the shares to money or the equivalent of money. It does not matter whether the taxpayer uses the cash method of accounting or an accrual method of accounting.

If the taxpayer materially participates in operating a farm from which he or she receives rent in the form of crop shares or livestock, the rental income is included in self-employment income. If the taxpayer does not materially participate in operating the farm, report this income on Form 4835 and carry the net income or loss to Schedule E (Form 1040). The income is not included in self-employment income.

Sales Caused by Weather-Related Conditions

If the taxpayer sells or exchanges more livestock, including poultry, than he or she normally would in a year because of a drought, flood, or other weather-related condition, he or she may be able to postpone reporting the gain from the additional animals until the next year. The taxpayer must meet all the following conditions to qualify: [70]

- His or her principal trade or business is farming.
- He or she uses the cash method of accounting.
- He or she can show that, under his or her usual business practices, he or she would not have sold or exchanged the additional animals this year except for the weather-related condition.
- The weather-related condition caused an area to be designated as eligible for assistance by the Federal government.

Sales or exchanges made before an area became eligible for Federal assistance qualify if the weather-related condition that caused the sale or exchange also caused the area to be designated as eligible for Federal assistance. The designation can be made by the President, the Department of Agriculture (or any of its agencies), or by other Federal departments or agencies.

The taxpayer should follow these steps to figure the amount of gain to be postponed for each class of animals:

1. Divide the total income realized from the sale of all livestock in the class during the tax year by the total number of such livestock sold. For this purpose, do not treat any postponed gain from the previous year as income received from the sale of livestock.
2. Multiply the result in (1) by the excess number of such livestock sold solely because of weather-related conditions.

Deductible Expenses

The ordinary and necessary costs of operating a farm for profit are deductible business expenses. Schedule F, Part II, lists some common farm expenses that are typically deductible.

If the reimbursement is received in the same year that the expense is claimed, reduce the expense by the amount of the reimbursement. If the reimbursement is received in a year after the expense is claimed, include the reimbursement amount in income.

Some expenses the taxpayer pays during the tax year may be part personal and part business. These may include expenses for gasoline, oil, fuel, water, rent, electricity, telephone, automobile upkeep, repairs, insurance, interest, and taxes. The taxpayer must allocate these mixed expenses between their business and personal parts. Generally, the personal part of these expenses is not deductible. The business portion of the expenses is deductible on Schedule F.

Prepaid Farm Supplies

Prepaid farm supplies include the following items if paid for during the year:

- Feed, seed, fertilizer, and similar farm supplies not used or consumed during the year, but not including farm supplies that the taxpayer would have consumed during the year if not for a fire, storm, flood, other casualty, disease, or drought.

- Poultry (including egg-laying hens and baby chicks) bought for use (or for both use and resale) in the taxpayer's farm business. However, include only the amount that would be deductible in the following year if he or she had capitalized the cost and deducted it ratably over the lesser of 12 months or the useful life of the poultry.
- Poultry bought for resale and not resold during the year.

If the taxpayer uses the cash method of accounting to report his or her income and expenses, the deduction for prepaid farm supplies in the year he or she pays for them may be limited to 50% of the other deductible farm expenses for the year (all Schedule F deductions except prepaid farm supplies). This limit does not apply if the taxpayer meets certain exceptions.

If the limit applies, the taxpayer can deduct the excess cost of farm supplies other than poultry in the year he or she uses or consumes the supplies. The excess cost of poultry bought for use (or for both use and resale) in the taxpayer's farm business is deductible in the year following the year he or she pays for it. The excess cost of poultry bought for resale is deductible in the year he or she sells or otherwise dispose of that poultry.

Conservation Expenses

A taxpayer can deduct conservation expenses only for land he or she or his or her tenant are using, or have used in the past, for farming. These expenses include, but are not limited to, the following:

1. The treatment or movement of earth, such as:
   a. Leveling,
   b. Conditioning,
   c. Grading,
   d. Terracing,
   e. Contour furrowing, and
   f. Restoration of soil fertility.
2. The construction, control, and protection of:
   a. Diversion channels,
   b. Drainage ditches,
   c. Irrigation ditches,
   d. Earthen dams, and
   e. Watercourses, outlets, and ponds.
   f. The eradication of brush.
   g. The planting of windbreaks.

The taxpayer cannot deduct expenses to drain or fill wetlands, or to prepare land for center pivot irrigation systems, as soil and water conservation expenses. These expenses are added to the basis of the land.

The basis of property a taxpayer buys is usually its cost. Cost is the amount he or she pays in cash, debt obligations, other property, or services. The taxpayer's cost includes amounts he or she pays for sales tax, freight, installation, and testing. The basis of real estate and business assets will include other items. Basis generally does not include interest payments.

Dispositions of Property Used in Farming

When the taxpayer disposes of property used in his or her farm business, the taxable gain or loss is usually treated as ordinary income (which is taxed at the same rates as wages and interest income) or capital gain (which is generally taxed at lower rates) under the rules for Section 1231 transactions.

When the taxpayer disposes of depreciable property (Section 1245 property or Section 1250 property) at a gain, he or she may have to recognize all or part of the gain as ordinary income under the depreciation recapture rules. Any gain remaining after applying the depreciation recapture rules is a Section 1231 gain, which may be taxed as a capital gain. Gains and losses from property used in farming are reported on Form 4797 - Sales of Business Property.

Gain or loss on the following transactions is subject to Section 1231 treatment: (70)

- **Sale or exchange of cattle and horses** - The cattle and horses must be held for draft, breeding, dairy, or sporting purposes and held for 24 months or longer.
- **Sale or exchange of other livestock** - This livestock must be held for draft, breeding, dairy, or sporting purposes and held for 12 months or longer. Other livestock includes hogs, mules, sheep, goats, donkeys, and other fur-bearing animals. Other livestock does not include poultry.
- **Sale or exchange of depreciable personal property** - This property must be used in the taxpayer's business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business. Examples of depreciable personal property include farm machinery and trucks. It also includes amortizable Section 197 intangibles.
- **Sale or exchange of real estate** - This property must be used in the taxpayer's business and held longer than 1 year. Examples are his or her farm or ranch (including barns and sheds).
- **Sale or exchange of unharvested crops** - The crop and land must be sold, exchanged, or involuntarily converted at the same time and to the same person, and the land must have been held longer than 1 year. The taxpayer cannot keep any right or option to reacquire the land directly or indirectly (other than a right customarily incident to a mortgage or other security transaction). Growing crops sold with a leasehold on the land, even if sold to the same person in a single transaction, are not included.
- **Distributive share of partnership gains and losses** - The taxpayer's distributive share must be from the sale or exchange of property listed earlier and held longer than 1 year (or for the required period for certain livestock).
- **Cutting or disposal of timber** - The taxpayer must treat the cutting or disposal of timber as a sale.
- **Condemnation** - The condemned property must have been held longer than 1 year. It must be business property or a capital asset held in connection with a trade or business or a transaction entered into for profit, such as investment property. It cannot be property held for personal use.
- **Casualty or theft** - The casualty or theft must have affected business property, property held for the production of rents or royalties, or investment property (such as notes and bonds). The taxpayer must have held the property longer than 1 year. However, if his or her casualty or theft losses are more than his or her casualty or theft gains, neither the gains nor the losses are taken into account in the Section 1231 computation. Section 1231 does not apply to personal casualty gains and losses.

Section 1245 Property

A gain on the disposition of Section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable. Any recognized gain that is more than the part that is ordinary income because of depreciation is a Section 1231 gain. Section 1245 property includes any property that is or has been subject to an allowance for depreciation or amortization and that is any of the following types of property:

1. Personal property (either tangible or intangible).
2. Other tangible property (except buildings and their structural components) used as any of the following:
    a. An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
    b. A research facility in any of the activities in (a).
    c. A facility in any of the activities in (a) above, for the bulk storage of fungible commodities.
3. That part of real property (not included in (2)) with an adjusted basis reduced by (but not limited to) the following:
    a. Amortization of certified pollution control facilities.
    b. The Section 179 expense deduction.
    c. Deduction for clean-fuel vehicles and certain refueling property.
    d. Certain expenditures for childcare facilities. (Repealed by Public Law 101-58, Omnibus Budget Reconciliation Act of 1990, Section 11801(a)(13) except with regards to deductions made prior to November 5, 1990.)
    e. Expenditures to remove architectural and transportation barriers to the handicapped and elderly.
    f. Certain reforestation expenditures.
4. Single purpose agricultural (livestock) or horticultural structures.
5. Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.
6. Any railroad grading or tunnel bore.

The gain treated as ordinary income on the sale, exchange, or involuntary conversion of Section 1245 property, including a sale and leaseback transaction, is the lesser of the following amounts. The depreciation (which includes any Section 179 deduction claimed) and amortization allowed or allowable on the property. The gain realized on the disposition (the amount realized from the disposition minus the adjusted basis of the property). For any other disposition of Section 1245 property, ordinary income is the lesser of (1) above or the amount by which its fair market value (FMV) is more than its adjusted basis. For details, see chapter 3 of Publication 544.

If the taxpayer elects not to use the uniform capitalization rules, he or she must treat any plant he or she produces as Section 1245 property. If the taxpayer has a gain on the property's disposition, he or she must recapture the pre-productive expenses he or she would have capitalized if he or she had not made the election by treating the gain, up to the amount of these expenses, as ordinary income. For Section 1231 transactions, show these expenses as depreciation on Form 4797, Part III, line 22. For plant sales that are reported on Schedule F - Profit or Loss From Farming, this recapture rule does not change the reporting of income because the gain is already ordinary income. The taxpayer can use the farm-price method or the unit-livestock-price method to figure these expenses.

Farm Inventory

If the taxpayer is required to keep an inventory, he or she should keep a complete record of his or her inventory as part of his or her farm records. This record should show the actual count or measurement of the inventory. It should also show all factors that enter into its valuation, including quality and weight, if applicable.

If the taxpayer is in the hatchery business, and uses an accrual method of accounting, he or she must include in inventory eggs in the process of incubation. All harvested and purchased farm products held for sale or for feed or seed, such as grain, hay, silage, concentrates, cotton, tobacco, etc., must be included in inventory.

Supplies acquired for sale or that become a physical part of items held for sale must be included in inventory. Deduct the cost of supplies in the year used or consumed in operations. Do not include incidental supplies in inventory as these are deductible in the year of purchase.

Livestock held primarily for sale must be included in inventory. Livestock held for draft, breeding, or dairy purposes can either be depreciated or included in inventory. If the taxpayer is in the business of breeding and raising chinchillas, mink, foxes, or other fur-bearing animals, these animals are livestock for inventory purposes.

Generally, growing crops are not required to be included in inventory. However, if the crop has a preproductive period of more than 2 years, the taxpayer may have to capitalize (or include in inventory) costs associated with the crop. See Uniform capitalization rules below. The taxpayer's inventory should include all items held for sale, or for use as feed, seed, etc., whether raised or purchased, that are unsold at the end of the year.

Uniform Capitalization Rules

Under the uniform capitalization rules, the taxpayer must include certain direct and indirect costs in the basis of property he or she produces or in his or her inventory costs, rather than claim them as a current deduction. The taxpayer recovers these costs through depreciation, amortization, or cost of goods sold when he or she uses, sells, or otherwise disposes of the property.

Generally, the taxpayer is subject to the uniform capitalization rules if he or she does any of the following: [70]

- Produce real or tangible personal property.
- Acquire property for resale.

The taxpayer is not subject to the uniform capitalization rules if the property is produced for personal use.

These rules do not apply to the following property:

1. Personal property the taxpayer acquires for resale if his or her average annual gross receipts are $10 million or less.
2. Property the taxpayer produces if he or she meets either of the following conditions:
    a. The taxpayer's indirect costs of producing the property are $200,000 or less.
    b. The taxpayer uses the cash method of accounting and does not account for inventories.

The taxpayer produces property if he or she constructs, builds, installs, manufactures, develops, improves, or creates the property. In a farming business, the taxpayer produces property if he or she raises or grows any agricultural or horticultural commodity, including plants and animals.

A plant produced in a farming business includes the following items: [70]

- A fruit, nut, or other crop-bearing tree.
- An ornamental tree.
- A vine.
- A bush.
- Sod.
- The crop or yield of a plant that will have more than one crop or yield.

An animal produced in a farming business includes any stock, poultry or other bird, and fish or other sea life.

The direct and indirect costs of producing plants or animals include preparatory costs and pre-productive period costs. Preparatory costs include the acquisition costs of the seed, seedling, plant, or animal. For plants, pre-productive period costs include the costs of items such as irrigation, pruning, frost protection, spraying, and harvesting. For animals, pre-productive period costs include the costs of items such as feed, maintaining pasture or pen areas, breeding, veterinary services, and bedding.

In a farming business, the uniform capitalization rules do not apply to:

1. Any animal.
2. Any plant with a pre-productive period of 2 years or less.
3. Any costs of replanting certain plants lost or damaged due to casualty.

Exceptions (1) and (2) do not apply to a corporation, partnership, or tax shelter required to use an accrual method of accounting.

In addition, the taxpayer can elect not to use the uniform capitalization rules for plants with a pre-productive period of more than 2 years. If he or she makes this election, special rules apply. This election cannot be made by a corporation, partnership, or tax shelter required to use an accrual method of accounting. This election also does not apply to any costs incurred for the planting, cultivation, maintenance, or development of any citrus or almond grove (or any part thereof) within the first 4 years the trees were planted.

Tip

If the taxpayer elects not to use the uniform capitalization rules, he or she must use the alternative depreciation system for all property used in any of his or her farming businesses and placed in service in any tax year during which the election is in effect.

Inventory Valuation Methods

The following methods are those generally available for valuing inventory. The method the taxpayer uses must conform to generally accepted accounting principles for similar businesses and must clearly reflect income:

- Cost.
- Lower of cost or market.
- Farm-price method.
- Unit-livestock-price method.

If the taxpayer values his or her livestock inventory at cost or the lower of cost or market, he or she does not need IRS approval to change to the unit-livestock-price method. However, if the taxpayer values his or her livestock inventory using the farm-price method, then he or she must obtain permission from the IRS to change to the unit-livestock-price method.

Depreciation

The taxpayer can depreciate most types of tangible property (except land), such as buildings, machinery, equipment, vehicles, certain livestock, and furniture. He or she can also depreciate certain intangible property, such as copyrights, patents, and computer software. To be depreciable, the property must meet all the following requirements: [(70)]

- It must be property the taxpayer owns.
- It must be used in the taxpayer's business or income-producing activity.
- It must have a determinable useful life.
- It must have a useful life that extends substantially beyond the year the taxpayer places it in service.

To claim depreciation on property, the taxpayer must use it in his or her business or income-producing activity. If the taxpayer uses property to produce income (investment use), the income must be taxable. The taxpayer cannot depreciate property that he or she uses solely for personal activities.

However, if the taxpayer uses property for business or investment purposes and for personal purposes, he or she can deduct depreciation based only on the percentage of business or investment use.

Example
If the taxpayer uses his or her car for farm business, he or she can deduct depreciation based on its percentage of use in farming. If he or she also uses it for investment purposes, he or she can depreciate it based on its percentage of investment use.

A taxpayer can never depreciate inventory because it is not held for use in his or her business. Inventory is any property the taxpayer holds primarily for sale to customers in the ordinary course of his or her business.

Livestock purchased for draft, breeding, or dairy purposes can be depreciated only if they are not kept in an inventory account. Livestock the taxpayer raises usually has no depreciable basis because the costs of raising them are deducted and not added to their basis.

Depreciation for livestock begins when the livestock reaches the age of maturity. If the taxpayer bought immature livestock for drafting purposes, depreciation begins when they can be worked. If the taxpayer bought immature livestock for dairy purposes, depreciation begins when they can be milked. If the taxpayer bought immature livestock for breeding purposes, depreciation begins when they can be bred. The taxpayer's basis for depreciation is his or her initial cost for the immature livestock.

If the taxpayer acquires an orchard, grove, or vineyard before the trees or vines have reached the income-producing stage, and they have a pre-productive period of more than 2 years, he or she must capitalize the pre-productive-period costs under the uniform capitalization rules (unless he or she elects not to use these rules). The depreciation begins when the trees and vines reach the income-producing stage (that is, when they bear fruit, nuts, or grapes in quantities sufficient to commercially warrant harvesting).

Certain property cannot be depreciated, even if the requirements explained earlier are met. This includes the following:

- The taxpayer can never depreciate the cost of land because land does not wear out, become obsolete, or get used up. The cost of land generally includes the cost of clearing, grading, planting, and landscaping. Although the taxpayer cannot depreciate land, he or she can depreciate certain costs incurred in preparing land for business use.
- Property placed in service and disposed of in the same year.
- Equipment used to build capital improvements. The taxpayer must add otherwise allowable depreciation on the equipment during the period of construction to the basis of the taxpayer's improvements.
- Intangible properties, such as Section 197 intangibles, are properties that do not have a determinable useful life and generally cannot be depreciated.
- Certain term interests.

Disaster Area Losses

Special rules apply to Federally declared disaster area losses. A Federally declared disaster is a disaster that occurred in an area declared by the President to be eligible for Federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. It includes a major disaster or emergency declaration under the act.

The taxpayer generally must deduct a casualty loss in the year it occurred. However, if he or she has a deductible loss from a disaster that occurred in an area warranting public or individual assistance (or both), he or she can choose to deduct that loss on his or her return or amended return for the tax year immediately preceding the tax year in which the disaster happened. If the taxpayer makes this choice, the loss is treated as having occurred in the preceding year.

Qualified disaster relief payments are not included in the income of individuals to the extent any expenses compensated by these payments are not otherwise compensated for by insurance or other reimbursement. These payments are not subject to income tax, self-employment tax, or employment taxes (Social Security, Medicare, and Federal unemployment taxes). No withholding applies to these payments.

Qualified disaster relief payments include payments the taxpayer receives (regardless of the source) for the following expenses: [(70)]

- Reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a Federally declared disaster.
- Reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence due to a Federally declared disaster. (A personal residence can be a rented residence or one the taxpayer owns.)
- Reasonable and necessary expenses incurred for the repair or replacement of the contents of a personal residence due to a Federally declared disaster.

Qualified disaster relief payments include amounts paid by a Federal, state, or local government in connection with a Federally declared disaster to individuals affected by the disaster.

Qualified disaster relief payments do not include:

- Payments for expenses otherwise paid for by insurance or other reimbursements, or
- Income replacement payments, such as payments of lost wages, lost business income, or unemployment compensation.

Income Averaging for Farmers

If the taxpayer is engaged in a farming business, he or she may be able to average all or some of his or her farm income by using income tax rates from the 3 prior years (base years) to calculate the tax on that income. This may give the taxpayer a lower tax if his or her current year income is high and his or her taxable income which includes income from farming from one or more of the 3 prior years was low.

The term "farming business" is defined in the Instructions for Schedule J - Income Averaging for Farmers and Fishermen.

The taxpayer can use income averaging to figure his or her tax for any year in which he or she was engaged in a farming business as an individual, a partner in a partnership, or a shareholder in an S corporation. Services performed as an employee are disregarded in determining whether an individual is engaged in a farming business. However, if the taxpayer is a shareholder of an S corporation engaged in a farming business, he or she may treat compensation received from the corporation that is attributable to the farming business as farm income. The taxpayer does not need to have been engaged in a farming business in any base year.

Note: Corporations, partnerships, S corporations, estates, and trusts cannot use income averaging.

Elected Farm Income (EFI)

EFI is the amount of income from the taxpayer's farming business that he or she elects to have taxed at base year rates. The taxpayer can designate as EFI any type of income attributable to his or her farming business. However, the taxpayer's EFI cannot be more than his or her taxable income, and any EFI from a net capital gain attributable to his or her farming business cannot be more than his or her total net capital gain.

The taxpayer can elect to use income averaging to compute his or her regular tax liability. However, income averaging is not used to determine his or her regular tax or tentative minimum tax when figuring his or her alternative minimum tax (AMT). Using income averaging may reduce the total tax even if he or she owes AMT.

The taxpayer can use income averaging by filing Schedule J (Form 1040) with his or her timely filed (including extensions) return for the year. The taxpayer can also use income averaging on a late return, or use, change, or cancel it on an amended return, if the time for filing a claim for refund has not expired for that election year. The taxpayer generally must file the claim for refund within 3 years from the date he or she filed his or her original return or 2 years from the date he or she paid the tax, whichever is later.

Excise Taxes

The taxpayer may be eligible to claim a credit on his or her income tax return for the Federal excise tax on certain fuels. He or she may also be eligible to claim a quarterly refund of the fuel taxes during the year, instead of waiting to claim a credit on his or her income tax return. Whether the taxpayer can claim a credit or refund depends on whether the fuel was taxed and the purpose (nontaxable use) for which he or she used the fuel. The nontaxable uses of fuel for which a farmer may claim a credit or refund are generally the following:

- Use on a farm for farming purposes.
- Off-highway business use.
- Uses other than as a fuel in a propulsion engine, such as home use.

Farm Employment Taxes

In general, the taxpayer is an employer of farmworkers if his or her employees do any of the following types of work:

- Raising or harvesting agricultural or horticultural products on a farm, including raising and feeding of livestock.
- Operating, managing, conserving, improving, or maintaining his or her farm and its tools and equipment.
- Services performed in salvaging timber, or clearing land of brush and other debris, left by a hurricane (also known as hurricane labor).
- Handling, processing, or packaging any agricultural or horticultural commodity if he or she produced more than half of the commodity (for a group of up to 20 unincorporated operators, all of the commodity).
- Work related to cotton ginning, turpentine, gum resin products, or the operation and maintenance of irrigation facilities.

Generally, a worker who performs services for the taxpayer is his or her employee if he or she has the right to control what will be done and how it will be done. This is so even when the taxpayer gives the employee freedom of action. What matters is that the taxpayer has the right to control the details of how the services are performed. The taxpayer is responsible for withholding and paying employment taxes for his or her employees. He or she is also required to file employment tax returns.

These requirements do not apply to amounts that the taxpayer pays to independent contractors. If the taxpayer employs a family of workers, each worker subject to his or her control (not just the head of the family) is an employee.

All cash wages the taxpayer pays to an employee during the year for farm work are subject to Social Security and Medicare taxes if he or she meets either of the following tests: (70)

- The taxpayer pays the employee $150 or more in cash wages (count all wages paid on a time, piecework, or other basis) during the year for farm work (the $150 test). The $150 test applies separately to each farmworker that he or she employs. If the taxpayer employs a family of workers, each member is treated separately. Do not count wages paid by other employers.
- The taxpayer pays cash and noncash wages of $2,500 or more during the year to all his or her employees for farm work (the $2,500 test).

If the $2,500 test for the group is not met, the $150 test for an employee still applies.

Annual cash wages of less than $150 the taxpayer pays to a seasonal farmworker are not subject to Social Security and Medicare taxes, even if he or she pays $2,500 or more to all his or her farmworkers. However, these wages count toward the $2,500 test for determining whether other farmworkers' wages are subject to Social Security and Medicare taxes. A seasonal farmworker is a worker who:

- Works as a hand-harvest laborer.
- Is paid piece rates in an operation usually paid on this basis in the region of employment.
- Commutes daily from his or her permanent home to the farm.
- Worked in agriculture less than 13 weeks in the preceding calendar year.

Only cash wages paid to farmworkers are subject to Social Security and Medicare taxes. Cash wages include checks, money orders, and any kind of money or cash. Noncash wages include food, lodging, clothing, transportation passes, and other goods and services. Noncash wages paid to farmworkers, including commodity wages, are not subject to Social Security and Medicare taxes. However, they are subject to these taxes if the substance of the transaction is a cash payment.

If the cash wages the taxpayer pays to farmworkers are subject to Social Security and Medicare taxes, they are also subject to Federal income tax withholding. Although noncash wages are subject to Federal income tax, the taxpayer should only withhold income tax he or she and the employee agree to do so. The amount to withhold is figured on gross wages without taking out Social Security and Medicare taxes, union dues, insurance, etc.

Special Estimated Tax Rules for Qualified Farmers

Special rules apply to the payment of estimated tax by individuals who are qualified farmers. An individual is a qualified farmer for 2020 if at least two-thirds of his or her gross income from all sources for 2019 or 2020 was from farming. For purposes of estimated tax exceptions for farmers, gross income from farming is income from cultivating the soil or raising agricultural commodities.

It includes the following amounts: (70)

- Income from operating a stock, dairy, poultry, bee, fruit, or truck farm.
- Income from a plantation, ranch, nursery, range, orchard, or oyster bed.
- Crop shares for the use of the taxpayer’s land.
- Gains from sales of draft, breeding, dairy, or sporting livestock.

Gross income from farming is the total of the following amounts from the taxpayer’s tax return:

- Gross farm income from Schedule F (Form 1040).
- Gross farm rental income from Form 4835.
- Gross farm income from Schedule E (Form 1040), Parts II and III.
- Gains from the sale of livestock used for draft, breeding, sport, or dairy purposes reported on Form 4797.

Farm income does not include any of the following:

- Wages the taxpayer receives as a farm employee.
- Income the taxpayer receives from contract grain harvesting and hauling with workers and machines he or she furnishes.
- Gains the taxpayer receives from the sale of farmland and depreciable farm equipment.

The following special estimated tax rules apply if the taxpayer was a qualified farmer for 2020:

- The taxpayer does not have to pay estimated tax if he or she files his or her 2020 tax return and pay all the tax due by March 1, 2021.
- The taxpayer does not have to pay estimated tax if his or her 2020 income tax withholding (including any amount applied to his or her 2020 estimated tax from his or her 2019 return) will be at least 66⅔% (.6667) of the total tax shown on his or her 2020 tax return or 100% of the total tax shown on his or her 2019 return.
- If the taxpayer must pay estimated tax, he or she is required to make only one estimated tax payment (his or her required annual payment) by January 15, 2021, using special rules to figure the amount of the payment.

If the taxpayer does not pay all his or her required estimated tax for 2020 by January 15, 2021 or file his or her 2020 return and pay any tax due by March 1, 2021, he or she may owe a penalty. The taxpayer should use Form 2210-F - Underpayment of Estimated Tax by Farmers and Fishermen to determine if he or she owes a penalty.

Bibliography

1. **116th Congress.** S.3548 - CARES Act. *congress.gov.* [Online] https://www.congress.gov/bill/116th-congress/senate-bill/3548/text.
2. **Tax Policy Center.** DISTRIBUTIONAL ANALYSIS OF THE CONFERENCE AGREEMENT FOR THE TAX CUTS AND JOBS ACT. *taxpolicycenter.org.* [Online] http://www.taxpolicycenter.org/publications/distributional-analysis-conference-agreement-tax-cuts-and-jobs-act/full.
3. **IRS.** Publication 538 - Accounting Periods and Methods. *irs.gov.* [Online] http://www.irs.gov/publications/p538/.
4. —. Instructions for Form 2553. *irs.gov.* [Online] https://www.irs.gov/pub/irs-pdf/i2553.pdf.
5. —. Instructions for Form 1128. *irs.gov.* [Online] https://www.irs.gov/pub/irs-pdf/i1128.pdf.
6. —. Form 8826 - Disabled Access Credit. *irs.gov.* [Online] https://www.irs.gov/pub/irs-pdf/f8826.pdf.
7. —. Instructions for Form 3468. *irs.gov.* [Online] https://www.irs.gov/instructions/i3468/index.html.
8. —. Small Business Health Care Tax Credit and the SHOP Marketplace. *irs.gov.* [Online] https://www.irs.gov/Affordable-Care-Act/Employers/Small-Business-Health-Care-Tax-Credit-and-the-SHOP-Marketplace.
9. —. Publication 536 - Net Operating Losses (NOLs) for Individuals, Estates, and Trusts. *irs.gov.* [Online] https://www.irs.gov/publications/p536/.
10. —. Affordable Care Act Tax Provisions for Large Employers. *irs.gov.* [Online] https://www.irs.gov/affordable-care-act/employers/affordable-care-act-tax-provisions-for-large-employers.
11. —. Information Reporting by Applicable Large Employers. *irs.gov.* [Online] https://www.irs.gov/affordable-care-act/employers/information-reporting-by-applicable-large-employers.
12. —. IRS Tax Tip 2013-46 - Top Six Tax Tips for the Self-Employed. *irs.gov.* [Online] http://www.irs.gov/uac/Newsroom/Top-Six-Tax-Tips-for-the-Self-Employed.
13. —. Instructions for Schedule C. *irs.gov.* [Online] http://www.irs.gov/pub/irs-pdf/i1040sc.pdf.
14. —. Publication 334 - Tax Guide for Small Business. *irs.gov.* [Online] http://www.irs.gov/publications/p334/.
15. —. Home Office Deduction. *irs.gov.* [Online] http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Home-Office-Deduction.
16. —. Publication 535, Chapter 11 - Other Expenses. *irs.gov.* [Online] http://www.irs.gov/publications/p535/ch11.html.
17. —. Publication 587 - Business Use of Your Home. *irs.gov.* [Online] http://www.irs.gov/publications/p587/.
18. —. Simplified Option for Home Office Deduction. *irs.gov.* [Online] http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Simplified-Option-for-Home-Office-Deduction.
19. —. Filing and Paying Business Taxes - Publication 334. *irs.gov.* [Online] http://www.irs.gov/publications/p334/ch01.html.
20. —. Schedule SE - Self-Employment Tax. *irs.gov.* [Online] https://www.irs.gov/pub/irs-pdf/f1040sse.pdf.
21. —. Publication 334 - Tax Guide for Small Business. *irs.gov.* [Online] http://www.irs.gov/publications/p334/.
22. —. Instructions for Schedule SE (Form 1040). *irs.gov.* [Online] http://www.irs.gov/instructions/i1040sse/.
23. —. Publication 334 - Tax Guide for Small Business. *irs.gov.* [Online] http://www.irs.gov/publications/p334/.
24. —. Publication 334 - Tax Guide for Small Business. *irs.gov.* [Online] http://www.irs.gov/publications/p334/.
25. —. Partnerships. *irs.gov.* [Online] http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Partnerships.
26. —. Publication 541 - Partnerships. *irs.gov.* [Online] http://www.irs.gov/publications/p541/.
27. —. Publication 535 - Chapter 8 - Amortization. *irs.gov.* [Online] http://www.irs.gov/publications/p535/ch08.html.
28. —. Publication 542 - Corporations. *irs.gov.* [Online] http://www.irs.gov/publications/p542/index.html.
29. —. Instructions for Form 1120 - U.S. Corporation Income Tax Return. *irs.gov.* [Online] http://www.irs.gov/instructions/i1120/index.html.
30. —. Instructions for Form 1099-DIV - Dividends and Distributions. *irs.gov.* [Online] http://www.irs.gov/instructions/i1099div/.
31. —. Publication 535 - Business Expenses. *irs.gov.* [Online] https://www.irs.gov/publications/p535/.
32. —. Publication 550 - Chapter 4 - Sales and Trades of Investment Property. *irs.gov.* [Online] http://www.irs.gov/publications/p550/ch04.html.
33. **SBA.** S Corporation. *sba.gov.* [Online] http://www.sba.gov/content/s-corporation.
34. **IRS.** Publication 550, Chapter 1 - Investment Income. *irs.gov.* [Online] http://www.irs.gov/publications/p550/ch01.html.
35. —. Instructions for Schedule D. *irs.gov.* [Online] http://www.irs.gov/instructions/i1040sd/.
36. —. Instruction for Form 1120S - U.S. Income Tax Return for an S Corporation. *irs.gov.* [Online] http://www.irs.gov/instructions/i1120s/.
37. —. Publication 3402 - Taxation of Limited Liability Companies. *irs.gov.* [Online] http://www.irs.gov/publications/p3402/.
38. —. Cost Segregation Audit Technique Guide - Chapter 6.1 Uniform Capitalization. *irs.gov.* [Online] http://www.irs.gov/Businesses/Cost-Segregation-Audit-Technique-Guide---Chapter-6.1-Uniform-Capitalization.
39. —. Publication 535 - Chapter 2 - Employees' Pay. *irs.gov.* [Online] http://www.irs.gov/publications/p535/ch02.html.
40. —. Publication 15-B - Employer's Tax Guide to Fringe Benefits. *irs.gov.* [Online] https://www.irs.gov/publications/p15b/index.html.
41. —. Publication 525 - Taxable and Nontaxable Income. *irs.gov.* [Online] http://www.irs.gov/publications/p525/.
42. —. Publication 535 - Chapter 4 - Interest. *irs.gov.* [Online] http://www.irs.gov/publications/p535/ch04.html.
43. —. Publication 542 - Corporations. *irs.gov.* [Online] http://www.irs.gov/publications/p542/index.html.
44. —. Instructions for Form 1065. *irs.gov.* [Online] https://www.irs.gov/instructions/i1065/.
45. —. Publication 334 - Tax Guide for Small Business. *irs.gov.* [Online] http://www.irs.gov/pub/irs-pdf/p334.pdf.
46. —. Publication 946 - How To Depreciate Property. *irs.gov.* [Online] [Cited:]
47. —. A Brief Overview of Depreciation. *irs.gov.* [Online] http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/A-Brief-Overview-of-Depreciation.
48. —. Publication 946 - Figuring Depreciation Under MACRS. *irs.gov.* [Online] http://www.irs.gov/publications/p946/ch04.html.
49. —. Topic 703 - Basis of Assets. *irs.gov.* [Online] http://www.irs.gov/taxtopics/tc703.html.
50. —. Publication 551 - Basis of Assets. *irs.gov.* [Online] http://www.irs.gov/publications/p551/.
51. —. Publication 551 - Basis of Assets. *irs.gov.* [Online] http://www.irs.gov/publications/p551/.
52. —. Publication 946 - Figuring Depreciation Under MACRS. *irs.gov.* [Online] http://www.irs.gov/publications/p946/ch04.html.
53. —. Publication 527 - Residential Rental Property. *irs.gov.* [Online] http://www.irs.gov/publications/p527/index.html.
54. —. Publication 946 - Electing the Section 179 Deduction. *irs.gov.* [Online] http://www.irs.gov/publications/p946/ch02.html.
55. **Section179.org.** The Section 179 Deduction. *www.section179.org.* [Online] http://www.section179.org/.
56. **IRS.** Publication 544 - Sales and Other Dispositions of Assets. *irs.gov.* [Online] http://www.irs.gov/publications/p544/.
57. —. 1040SD - Capital Gains and Losses. *irs.gov.* [Online] http://www.irs.gov/instructions/i1040sd/ar01.html.

58. —. Instructions for Form 8949. *irs.gov.* [Online] http://www.irs.gov/instructions/i8949/.
59. —. Form 6781 - Gains and Losses From Section 1256 Contracts and Straddles. *irs.gov.* [Online] http://www.irs.gov/pub/irs-pdf/f6781.pdf.
60. —. Form 8824 - Like-Kind Exchanges(and section 1043 conflict-of-interest sales). *irs.gov.* [Online] http://www.irs.gov/uac/Form-8824,-Like-Kind-Exchanges(and-section-1043-conflict-of-interest-sales).
61. —. Publication 510 - Excise Taxes. *irs.gov.* [Online] http://www.irs.gov/publications/p510/index.html.
62. —. Instructions for Form 1041 and Schedules A, B, G, J, and K-1. *irs.gov.* [Online] http://www.irs.gov/instructions/i1041/index.html.
63. —. Publication 559 - Survivors, Executors, and Administrators. *irs.gov.* [Online] http://www.irs.gov/uac/Publication-559,-Survivors,-Executors,-and-Administrators.
64. —. Form 709 - United States Gift (and Generation-Skipping Transfer) Tax Return. *irs.gov.* [Online] http://www.irs.gov/instructions/i709/.
65. —. Publication 560 - Retirement Plans for Small Business. *irs.gov.* [Online] https://www.irs.gov/publications/p560/.
66. —. Retirement Topics - Required Minimum Distributions (RMDs). *irs.gov.* [Online] http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics---Required-Minimum-Distributions-(RMDs).
67. —. Delinquent International Information Return Submission Procedures. *irs.gov.* [Online] https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures.
68. —. Publication 334 - Tax Guide for Small Business. *irs.gov.* [Online] http://www.irs.gov/pub/irs-pdf/p334.pdf.
69. —. A Brief Overview of Depreciation. *irs.gov.* [Online] http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/A-Brief-Overview-of-Depreciation.
70. —. Publication 225 - Farmer's Tax Guide. *irs.gov.* [Online] http://www.irs.gov/publications/p225/.

$

1

5

A

B

C

D

G

H

I

K

L

S

T

U

W

Practice Exam Instructions

The Special Enrollment Exam (SEE) is based on the results of a survey sent to over 10,000 enrolled agents and it represents the knowledge needed for the tasks performed by enrolled agents. For *Part 2 - Businesses* you will be tested on three subject areas:

Section 1: Business Entities - 30 Questions
Section 2: Business Financial Information - 37 Questions
Section 3: Specialized Returns and Taxpayers - 18 Questions

The *Part 2 - Businesses* exam contains 100 multiple-choice questions. There are 85 questions that are scored and 15 questions that are experimental and not scored.

IRSTaxTraining.com, Inc. has prepared two practice examinations that have the EXACT look, feel and functionality of the Special Enrollment Exam (SEE). You will see this exact screen on the day of your test. You have the ability to mark questions you would like to come back and answer later, as well as a review button that will give you an overview of what you have and have not answered. Also, a non-functioning calculator is provided for demonstration purposes. You will need to have a calculator on hand for the practice exams. Our practice tests also include the ability to 'clear' or 'reset' the tests so that you can take them more than once. We recommend you do this so that you become comfortable with the testing environment and time limitation.

When taking the exam remember to have patience. Always check and re-read the answers. Do not immediately select the answer that "looks right". Slow down and choose the best possible answer. Most people have plenty of time. Also, remember the exams usually use 1-year-old rules. Make sure you check to see which year is being tested.

For exams taken between **May 1, 2021 – February 28, 2022,** all references on the examination are to the Internal Revenue Code, forms and publications, as amended through December 31, 2020. Also, unless otherwise stated, all questions relate to the calendar year 2020. Questions that contain the term 'current tax year' refer to the calendar year 2020. In answering questions, candidates should not take into account any legislation or court decisions after December 31, 2020.

When answering questions in this study guide, candidates should account for any changes to tax law as a result of the Tax Cuts and Jobs Act (TCJA).

For this study guide, all questions relate to **tax year 2020**.

We advise that you take these practice tests in one continuous sitting, with a time limit of 3½ hours. You should set aside a period of time that you know you will not be interrupted. If you finish in less time that is fine but try to ensure you complete it within this time frame. When you are finished, submit your answers and you will see the questions you missed. While you are given an answer key, we strongly recommend you repeat the practice tests until you score 90% or better within the time limitation.

These practice exams can be taken online at www.IRSTaxTraining.com. You simply login using your e-mail address and password and click on the examination you wish to take. Your results will be made immediately available to you after you press the complete and submit button and you also have access to the answer keys for both practice tests. You can clear the exams of your answers and re-take them as often as you like and in fact, we recommend you do so. We are here to help you pass the exam, so if you have questions or comments please e-mail us at Support@irstaxtraining.com.

All questions pertain to Tax Year 2020 unless noted.

1. Which of the following statements about a sole proprietorship is correct?
   A. A sole proprietor may not use a business or trade name other than their legal name
   B. A sole proprietorship has the same government rules and regulations affecting it as corporations
   C. A sole proprietorship is a type of business entity that is owned and operated by one individual and in which there is no legal distinction between the owner and the business
   D. A sole proprietorship is owned and controlled by one person and there cannot be any employees working for him or her

2. Which of the following statements about taxation of a sole proprietorship is correct?
   A. Any income to the business is treated as income to the business owner
   B. It may be possible to defer income and therefore income tax to a different tax year
   C. The income earned from a sole proprietorship is not subject to income and self-employment tax
   D. Sole proprietors are taxed the same as other companies such as an LLC or partnership

3. When determining whether an individual is an independent contractor or an employee, which of the following can be used to make this determination?
   A. If the individual is compensated for services provided then they are an independent contractor
   B. If the individual withholds taxes on a payment for services then the individual is an independent contractor
   C. If an employer withholds income taxes, withholds and pays Social Security and Medicare taxes, and pays unemployment tax on wages paid, then the individual is an employee
   D. If there are benefits such as insurance or pension plans available then the individual is an independent contractor

4. When considering whether an activity is a hobby or a business, which of the following is correct?
   A. A hobby is defined as an activity done regularly in one's leisure time for pleasure and does not result in a profit
   B. Schedule C can be used to report income derived from a hobby
   C. An activity is a business if it makes a profit during at least three of the last five tax years, including the current year
   D. All of the above

5. Dustin is a sole proprietor who owns a small business that makes business cards for other companies. He started the company in 2020 and had $4,800 in total business expenses for the year. Which of the following applies to Dustin's small business?
   A. Dustin must use Schedule C when filing the business return
   B. Dustin can use Schedule C-EZ because he had less than $5,000 of expenses
   C. Dustin can use Schedule A because he had less than $5,000 of expenses
   D. Dustin does not have to file a Schedule C because his business had less than $5,000 in expenses

6. Which of the following would not be an acceptable tax year?
   A. A short tax year that occurs because a business changes its accounting period
   B. A short tax year that occurs because a business changes to the accrual method of accounting
   C. A tax year consisting of 12 consecutive months ending on the last day of the month
   D. A 52- or 53-week tax year

7. When determining the cost of goods sold for a business, which of the following are included in the calculation?
   A. Materials and supplies, such as hardware and chemicals, used in manufacturing goods
   B. The cost of merchandise on hand at the beginning of the year that will be available to sell to customers
   C. Overhead expenses such as rent, heat, light, power, insurance, depreciation, taxes, maintenance, labor, and supervision of a manufacturing operation
   D. All of the above

8. In 2020, Noelle, a calendar year taxpayer and a self-employed landscaper, signed a 3-year health insurance contract. She paid premiums of $500 for 2020, $550 for 2021, and $600 for 2022 when she signed the contract. What amount can she deduct for the premiums on her income tax return?
   A. $0
   B. $250
   C. $500
   D. $1,650

9. Tim's home is used as a daycare Monday through Friday for 12 hours per day for 250 days during the year. It is also used on 50 Saturdays for 8 hours per day. What is the total number of hours that the house was used for daycare during the year that Tim can include on *Form 8829 - Expenses for Business Use of Your Home*?
   A. 0 hours
   B. 1,700 hours
   C. 3,000 hours
   D. 3,400 hours

10. Mona is self-employed working as a fortune teller. Her net income from this activity was $250 in tax year 2020. Which of the following is true regarding her self-employment tax for the year?
   A. She has SE tax because net income was earned
   B. She has no SE tax since net income was less than $400
   C. She has no SE tax because net income was less than $1,000
   D. She has no SE tax because net income was less than $2,000

11. In 2020, Harvey is the sole proprietor of a flower shop. He drove his van 20,000 miles during the year. 16,000 miles were for delivering flowers to customers and 4,000 miles were for personal use. Instead of figuring actual expenses, Harvey decides to use the standard mileage rate to figure the deductible costs of operating his van. What amount can Harvey claim as the cost of operating his van as a business expense?
   A. $2,260
   B. $4,440
   C. $9,200
   D. $11,500

12. Gina is self-employed and uses the regular method to determine her net earnings. Her total earnings from this activity in 2020 were $72,000. What are the total earnings subject to self-employment tax?
   A. $62,892
   B. $66,492
   C. $68,652
   D. $70,092

13. A corporation makes a $100,000 term loan to a shareholder. The stated principal amount of the loan is payable in ten years. The test rate used to determine if the loan is a below-market loan is the:
   A. Short-term applicable Federal rate as of the day the loan is made
   B. Mid-term applicable Federal rate as of the day the loan is made
   C. Long-term applicable Federal rate as of the day the loan is made
   D. Adjusted applicable Federal rate as of the day the loan is made

14. Victor has a farm that he operates. He also derives $7,000 per year in income from non-farm activities. What method or methods can Victor use to report the income from his non-farm activities?
    A. Victor can use the farm and nonfarm methods whichever is most beneficially to him
    B. Victor must use the farm-only method for all income earned
    C. Victor must use the nonfarm method for all income earned
    D. Victor can use the nonfarm optional method for earnings that do not come from farming activities and only if he has used this method less than 5 years

15. An S corporation stockholders' basis is generally increased by:
    A. Distributions
    B. Taxable income
    C. Nontaxable discharge of indebtedness
    D. Separately stated loss items

16. A father sold 50% of his business to his son. The resulting partnership had a profit of $60,000. Capital is a material income-producing factor. The father performed services worth $24,000, which is reasonable compensation, and the son performed no services. The $24,000 must be allocated to the father as compensation. Of the remaining $36,000 of profit due to capital, at least what amount must be allocated to the father since he owns capital interest?
    A. $18,000
    B. $24,000
    C. $30,000
    D. $36,000

17. The adjusted basis of Joanne's partnership interest is $14,000. She receives a distribution of $8,000 cash and land that has an adjusted basis of $2,000 and a fair market value of $3,000. Because the cash received does not exceed the basis of her partnership interest, Joanne does not recognize any gain on the distribution. Any gain on the land will be recognized when she sells or otherwise disposes of it. The distribution decreases the adjusted basis of Joanne's partnership interest to what amount?
    A. $2,000
    B. $3,000
    C. $4,000
    D. $5,000

18. The adjusted basis of Emily's partnership interest is $30,000. She receives a distribution of property that has an adjusted basis of $20,000 to the partnership and $4,000 in cash. Her basis for the property is what amount?
    A. $10,000
    B. $16,000
    C. $20,000
    D. $30,000

19. Ken's basis in his partnership interest is $55,000. In a distribution in liquidation of his entire interest, he receives properties A and B, neither of which is inventory nor unrealized receivables. Property A has an adjusted basis to the partnership of $5,000 and a fair market value of $40,000. Property B has an adjusted basis to the partnership of $10,000 and a fair market value of $10,000. What is his basis in each property?
    A. Property A basis is $35,000 and property B basis is $10,000
    B. Property A basis is $39,000 and property B basis is $11,000
    C. Property A basis is $40,000 and property B basis is $10,000
    D. Property A basis is $44,000 and property B basis is $11,000

20. Ivan acquired a 20% interest in a partnership by contributing property that had an adjusted basis to him of $8,000 and a $4,000 mortgage. The partnership assumed payment of the mortgage. The basis of Ivan's partnership interest is what amount?
    A. $3,200
    B. $4,000
    C. $4,800
    D. $8,000

21. The John Doe Trust is a grantor type trust. During the year, the trust sold 100 shares of ABC stock for $1,010 in which it had a basis of $10 per share and 200 shares of XYZ stock for $10 per share in which it had a $1,020 basis. All of the following are true regarding reporting these transactions except:
    A. John Doe (grantor and owner) will need to report these transactions on his *Form 8949 - Sales and Other Dispositions of Capital Assets*
    B. The trust does not net the capital gains and losses
    C. The trust does not issue John Doe a Schedule K-1 (Form 1041) showing a $10 long-term capital loss
    D. The trust reports these transactions on Form 1041

22. Which form of business entity is not a legal entity separate and apart from its owner?
    A. Corporation
    B. Partnership
    C. Sole proprietorship
    D. S corporation

23. Under the terms of a partnership agreement, Erica is entitled to a fixed annual payment of $10,000 without regard to the income of the partnership. Her distributive share of the partnership income is 10%. The partnership has $50,000 of ordinary income after deducting the guaranteed payment. Erica must include what amount of ordinary income on her individual income tax return for her tax year in which the partnership's tax year ends?
    A. $0
    B. $5,000
    C. $10,000
    D. $15,000

24. Areta and Sofia formed an equal partnership. Areta contributed $10,000 in cash to the partnership and Sofia contributed depreciable property with a fair market value of $10,000 and an adjusted basis of $4,000. Assuming that the depreciation rate is 10% a year under the General Depreciation System (GDS) Areta is allowed a depreciation deduction of what amount per year based on her interest in the partnership, if the adjusted basis of the property equaled its fair market value when contributed (the depreciation deductions are determined without regard to any first-year depreciation conventions)?
    A. $0
    B. $100
    C. $400
    D. $500

25. Generally, no gain or loss is recognized by the partnership of a partner when the partner contributes property to the partnership on exchange for an interest in the partnership unless which of the following is true?
    A. The partnership has been in existence for five or more years
    B. The partnership is being newly formed
    C. A gain is realized on the transfer of property to a partnership that would be treated as an investment company if the partnership was incorporated
    D. The partnership's holding period for the property has been less than one year

26. A corporation loses $75,000 from operations. It receives $100,000 in dividends from a 20%-owned corporation. Its taxable income is $25,000 before the deduction for dividends received. If it claims the full dividends-received deduction of $65,000 and combines it with an operations loss of $75,000, it will have a Net Operating Loss (NOL) of ($40,000). Therefore, the corporation can deduct what amount for the dividends-received deduction?
    A. $5,000
    B. $25,000
    C. $40,000
    D. $65,000

27. Steve and Bruce transfer a property with a basis of $100,000 to a corporation in exchange for stock with a fair market value of $300,000. This represents only 75% of each class of stock of the corporation. The other 25% was already issued to someone else. What amount of taxable gain do Steve and Bruce recognize on the transaction?
    A. $0
    B. $100,000
    C. $200,000
    D. $300,000

28. Wanda and Sylvester are members of an LLC. They agree that the LLC should be classified as a corporation but do not want to elect to have the LLC be treated as an S corporation. The LLC must file which form?
    A. Form 1120 - U.S. Corporation Income Tax Return
    B. Form 1120S - U.S. Income Tax Return for an S Corporation
    C. Form 2553 - Election by a Small Business Corporation
    D. Form 8832 - Entity Classification Election

29. Farmer Mike paid $1,500 for electricity during the tax year. He used one-third of the electricity for personal purposes and two-thirds for farming. Under these circumstances, Mike can deduct what amount of his electricity expense as a farm business expense?
    A. $0
    B. $500
    C. $1,000
    D. $1,500

30. Kate is a calendar year taxpayer, who uses the cash method of accounting, and pays $3,000 in 2020 for a business insurance policy that is effective for three years (36 months), beginning on July 1, 2020. What amount is deductible in 2020?
    A. $0
    B. $500
    C. $1,000
    D. $3,000

31. Ivan owns a soccer academy. His tax year is a calendar year and he uses the accrual method of accounting. On October 1, 2020, he receives a $9,600 payment for a two-year contract for 96 one-hour lessons beginning on that date. He gives eight lessons in 2020. Under this method of including advance payments, Ivan must include what amount of the payment in income for 2020?
    A. $0
    B. $1,600
    C. $8,000
    D. $9,600

32. Steve is a calendar year taxpayer. He manufactures household furniture and uses an accrual method of accounting. Under this method, he accrues income for his financial reports when he ships the furniture. For tax purposes, Steve does not accrue income until the furniture has been delivered and accepted. In 2020, he received an advance payment of $8,000 for an order of furniture to be manufactured for a total price of $20,000. He shipped the furniture to the customer in December 2020, but it was not delivered and accepted until January 2021. For tax purposes, what amount should Steve include in gross income for 2020?
    A. $0
    B. $8,000
    C. $12,000
    D. $20,000

33. Jill is a calendar year taxpayer who uses an accrual method of accounting. In 2020 she contributed property from inventory to a church. It had a fair market value of $600. The closing inventory at the end of 2019 properly included $400 of costs due to the acquisition of the property, and in 2019, she properly deducted $50 of administrative and other expenses attributable to the property as business expenses. The cost of goods sold Jill uses in determining gross income for 2020 must not include what amount and must be removed from opening inventory for 2020?
    A. $50
    B. $200
    C. $400
    D. $600

34. Gwen is a calendar year taxpayer, and she leased a building for 5 years beginning July 1, 2020. Her rent is $12,000 per year. She paid the first year's rent ($12,000) on June 30. What amount can Gwen deduct as a rent expense in 2020?
    A. $0
    B. $1,000
    C. $6,000
    D. $12,000

35. If a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax of what percentage?
    A. 10%
    B. 12%
    C. 15%
    D. 20%

36. In February of 2020, Acme HVAC Inc. purchased $650,000 of manufacturing equipment to expand their operations. What is their first-year Section 179 Deduction amount?
    A. $0
    B. $325,000
    C. $510,000
    D. $650,000

37. Ken Larch is a tailor. He bought two industrial sewing machines from his father. He placed both machines in service in the same year he bought them. All of the following are true except:
    A. The sewing machines do not qualify as Section 179 property
    B. Ken can claim a partial Section 179 deduction
    C. The asset must be used at least 50% of the time for business in the first year it is placed in service to qualify for a Section 179 deduction
    D. The asset must have a useful life of more than one year to qualify for a Section 179 deduction

38. Bob Jones sells products to Local Company. He and his wife, Jan, gave Local Company three gourmet gift baskets to thank them for their business. They paid $80 for each gift basket, or $240 total. Three of Local Company's executives took the gift baskets home for their families' use. Bob and Jan have no independent business relationship with any of the executives' other family members. They can deduct a total of what amount as gift expenses for the gift baskets?
    A. $0
    B. $75
    C. $80
    D. $240

39. In 2020, Rose-Marie paid $600 interest on a car loan. During 2020, she used the car 60% for business and 40% for personal purposes. She is claiming actual expenses on the car. What amount of the interest can Rose-Marie deduct for 2020 on Schedule C?
    A. $0
    B. $240
    C. $360
    D. $600

40. May and Julius Winter drove their car 7,000 business miles out of a total of 10,000 miles. They had to pay $25 for their annual state license tags and $20 for their city registration sticker. They also paid $235 in city personal property tax on the car, for a total of $280. They are claiming their actual car expenses therefore they can deduct what amount as a business expense?
    A. $0
    B. $196
    C. $235
    D. $280

41. Angelica Bank's employee, Mary Plant, earned $21,000 for 2020. What is the maximum contribution Angelica can make to Mary's SEP-IRA?
    A. $0
    B. $5,250
    C. $11,500
    D. $21,000

42. Francis Butler owns ASAP Company. The company's tax year is a fiscal year ending June 30. Contributions under a SIMPLE IRA plan for the calendar year 2020 (including contributions made in 2020 before July 1, 2020) are deductible in the tax year ending on what date?
    A. April 15, 2020
    B. June 30, 2021
    C. April 15, 2022
    D. June 30, 2022

43. Janet Maple sold her apple orchard in 2020 for $80,000. Her adjusted basis at the time of sale was $60,000. She bought the orchard in 2013, but the trees did not produce a crop until 2016. Her pre-productive expenses were $6,000. She elected not to use the uniform capitalization rules. Janet must treat what amount of the gain as ordinary income?
    A. $4,000
    B. $6,000
    C. $8,000
    D. $10,000

44. What is the maximum number of shareholders a corporation may have to be eligible to elect to be treated as an S corporation?
    A. 25
    B. 50
    C. 75
    D. 100

45. Eric, a cash basis taxpayer, owned 25% of Watson, Inc. stock. Watson, Inc. files a calendar year U.S. Corporate Income Tax Return Form 1120 employing the accrual method of accounting. Eric loaned Watson, Inc. $100,000 at the beginning of 2019. The accrued interest on this loan was $5,000 as of December 31, 2019. Watson, Inc. paid Eric the $5,000 in January of 2020. How should Eric report the interest income and Watson, Inc. report the interest expense from this transaction?
    A. Watson, Inc. reports the expense in 2019 and Eric reports the income in 2019
    B. Watson, Inc. reports the expense in 2019 and Eric reports the income in 2020
    C. Watson, Inc. reports the expense in 2020 and Eric reports the income in 2019
    D. None of the above

46. Which of the following transactions qualifies as a like-kind exchange?
    A. Real property use for personal purposes, such as the taxpayer's home
    B. Personal or intangible property
    C. An exchange of land improved with an apartment house for land improved with a store building
    D. An exchange of property used predominantly in the United States for personal property used predominantly outside the United States

47. Special rules apply to like-kind exchanges between related persons. Under these rules, related persons are:
    A. The taxpayer and a member of his or her family
    B. The taxpayer and a corporation in which the taxpayer has a 25% ownership
    C. The taxpayer and a partnership in which the taxpayer directly or indirectly owns a 25% interest in the capital or profits
    D. All of the above

48. Which of the following does not qualify as a nontaxable exchange or transfer?
    A. A life insurance contract for an annuity contract
    B. A general partnership interest for a general partnership interest in the same partnership
    C. A transfer of property from an individual to a former spouse, incident to divorce
    D. An annuity contract for a qualified long-term care insurance contract

49. Mark is an accrual basis taxpayer. He shipped $500 worth of merchandise to Ralph on December 30, 2019. Mark sent Ralph an invoice January 2, 2020 that was payable in 30 days. Ralph mailed his check to Mark on February 2, 2020. Mark deposited the check on February 6, 2020. Mark received and reconciled his bank statement March 3, 2020. When does Mark record the $500 in income?
    A. January 2, 2020 because that is when he invoiced Ralph
    B. March 3, 2020 because that is when Mark verified that the $500 check had been accepted as a deposit
    C. December 30, 2019, the date when he shipped the merchandise to Ralph
    D. February 6, 2020 because that is when Mark deposited the check from Ralph

50. Which of the following items are generally included in inventory?
    A. Goods for sale that someone else has consigned to the taxpayer
    B. Equipment used in the taxpayer's business to manufacture goods
    C. Goods the taxpayer has sent out on consignment for someone else to sell
    D. Goods in transit to the taxpayer for which title has not yet passed to the taxpayer

51. Supplemental wages are compensation paid in addition to an employee's regular wages. They do not include payments for:
    A. Accumulated sick leave
    B. Nondeductible moving expenses
    C. Vacation pay in addition to regular wages for the vacation period
    D. Travel reimbursements paid at the Federal Government per diem rate

52. Griselda spends $200 (including tax and tip) for a business meal. If $110 of that amount is not allowable because it is lavish and extravagant, she cannot deduct more than what amount for the cost of the business meal on her income tax return?
    A. $20
    B. $45
    C. $90
    D. $110

53. Esther works as a computer programmer for a marketing firm. She performs 40% of her computer programming on a home computer during the weekend (her company is closed on the weekends) so she can take off 2 days during the regular work week. The home computer that Esther works on is identical to the computer she uses at work, and she uses it exclusively for her job-related duties. Esther's employer does not require Esther to take work home with her on the weekends - it is Esther's choice. Because she uses the home computer exclusively for business purposes, she can use the following percentage of business usage when computing her yearly depreciation for the computer:
    A. 0%
    B. 25%
    C. 40%
    D. 100%

54. Which of the following would not qualify for a depletion deduction?
    A. Gas well
    B. Timber lot
    C. Oil refinery
    D. Stone quarry

55. The Tax Cuts and Jobs Act (TCJA) provides that effective for amounts incurred or paid after December 31, 2017, a deduction for business expenses will be allowed for which of the following?
    A. Entertainment expenses that are directly related to the active conduct of the taxpayer's trade or business
    B. Food and beverage expenses that are associated with operating a trade or business
    C. Amusement expenses that are directly related to the active conduct of the taxpayer's trade or business
    D. Recreation expenses that are directly related to the active conduct of the taxpayer's trade or business

56. Under which situation below is a deduction allowable for an office in a taxpayer's home?
    A. The taxpayer's home is the only fixed location of his or her business of selling mechanics' tools at retail. The taxpayer regularly uses his or her walk-in closet for storage of inventory and product samples. The taxpayer also uses this area occasionally for personal purposes
    B. The taxpayer is an attorney and uses a den in his or her home to write legal briefs. The taxpayer's family also uses the den for recreation
    C. The taxpayer uses part of his or her home exclusively and regularly to read financial periodicals and reports, clip bond coupons, and carry out similar activities to monitor personal investments
    D. The taxpayer uses his or her walk-in closet at home exclusively and regularly to bill customers, clients, or patients; to set up appointments; and to order supplies. The taxpayer also rents office space downtown where he or she also conducts those same activities. The taxpayer uses the home office three days a week and the rented office space two days a week

57. Pleasant Beach City, to improve downtown commercial business, converted a downtown business area street into an enclosed pedestrian mall. The city assessed the full cost of construction, financed with 10-year bonds, against the affected business properties. The city is paying the principal and interest with the annual payments made by the property owners. The portion that the business owners were assessed to pay the construction costs is:
    A. Deductible as taxes
    B. Deductible as a business expense
    C. A non-depreciable capital expenditure
    D. A depreciable capital expenditure

58. On November 15, 2020, Partnership Z paid $10,000 in accounting and legal fees to prepare and file the partnership agreement. The partnership began business on December 1, 2020. Which of the following is a permissible election for treatment of the $10,000 payment?
    A. Deduct $10,000
    B. Deduct $5,000 and amortize the remaining $5,000 over a 5-year period
    C. Deduct $5,000 and amortize the remaining $5,000 over 180 months
    D. Amortize $10,000 over a 5-year period

59. Dennis made a $100,000 donation to a committee organized by the local Chamber of Commerce to bring a convention to his city, intended to increase business activity, including his. What amount of the payment can Dennis deduct as a business expense?
    A. $0
    B. $25,000
    C. $50,000
    D. $100,000

60. Amounts paid or incurred to demolish a structure are:
    A. Deductible as a casualty loss
    B. Capitalized and amortized over a 180-month period
    C. Treated as a reduction of the basis of the structure
    D. Capitalized and added to the basis of the land where the demolished structure was located

61. New ABC Partnership is organized in 2020 with three general partners. The partners include a corporation with a tax year ending on March 31 and a 60% interest in partnership capital and profits, and two individuals, each having a calendar tax year and a 20% interest in partnership capital and profits. The partnership's required tax year ends on:
    A. March 31
    B. September 30
    C. October 31
    D. December 31

62. Bill and Jimmy form a new partnership. Bill contributes property that has an adjusted basis of $1,400 and a fair market value of $2,000 to the partnership. Jimmy contributes $2,000 in cash to the partnership. Each partner's capital account as reflected on the partnership's books is $2,000. What is the adjusted basis of each partner's interest?
    A. Bill's at $1,400 and Jimmy's at $1,400
    B. Bill's at $1,400 and Jimmy's at $2,000
    C. Bill's at $1,700 and Jimmy's at $1,700
    D. Bill's at $2,000 and Jimmy's at $2,000

63. Which of the following earnings is not subject to self-employment tax?
    A. Gains and losses, by a dealer in options or commodities, from dealing or trading in foreign currency contracts
    B. Fees earned by a professional fiduciary who administers a deceased person's estate
    C. Fees received for services performed as a notary public
    D. All of the above

64. Given the fact patterns below, which of the following entities may not use the cash method of accounting?
    A. The Acme Partnership had gross receipts of $3,500,000 in 2020. Its gross receipts for 2019 were $8,000,000 and its gross receipts for 2018 were $3,000,000
    B. John Jones manufactures and sells fans. His average annual gross receipts since 2015 are $975,000
    C. Dallas Partnership has two partners in 2020 - Joe Dallas, an individual, and Deer, Inc. a corporation. Dallas Partnership averaged annual gross receipts are $6,500,000
    D. John Gibb files his 2020 Form 1040 with an attached Schedule C reflecting $11,000,000 in gross receipts from selling real estate

65. Mike purchased a building lot in 2017 for $25,000 and constructed his primary residence there for an additional $175,000. In 2020 Mike moved to a different city but kept the house he constructed in 2017 and converted it to a rental property. On the date Mike made this change the fair market value of the converted property was $225,000. For depreciation purposes, what is Mike's basis in this rental property?
    A. $150,000
    B. $175,000
    C. $200,000
    D. $225,000

66. Nelson, Inc. owned a manufacturing building with a fair market value of $95,000 and an adjusted basis of $75,000. Nelson, Inc. entered into an agreement to exchange the manufacturing building for a warehouse with an adjusted basis of $80,000 and a fair market value of $90,000 with Roberts Corporation. In addition, Nelson, Inc. would pay Roberts Corporation $5,000 in cash. Nelson, Inc. also incurred and paid attorney and deed preparation fees of $5,000 on this exchange. What is Nelson, Inc.'s basis in the warehouse it received in this like-kind exchange?
    A. $85,000
    B. $90,000
    C. $95,000
    D. $100,000

67. Arlene traded her old computer that she used in her business, for a new computer priced at $5,000 that she will also use in her business. In addition to her old computer, Arlene paid $4,000 cash for the new computer. Her old computer was worth $2,000 and had an adjusted basis of $500. What is Arlene's basis for depreciation in the new computer?
    A. $1,000
    B. $2,000
    C. $3,000
    D. $4,500

68. Kayla exchanged her unimproved land with an adjusted basis of $80,000 and a fair market value of $130,000 for unimproved land with a fair market value of $100,000 and $10,000 in cash. Kayla also paid $5,000 in closing costs. The unimproved land that Kayla gave up was subject to a $30,000 mortgage for which she was liable. The other party assumed this mortgage. What is Kayla's realized gain on this exchange?
    A. $25,000
    B. $35,000
    C. $40,000
    D. $55,000

69. Between November 1 and December 1, 2020, Gloria paid a total of $52,000 in start-up costs to create a new business. The business opened its doors on December 15, 2020. Which of the following is a permissible election for treatment of the $52,000 in start-up costs Gloria paid?
    A. Amortize $52,000 over a 5-year period
    B. Deduct $3,000 and amortize the remaining $49,000 over 180 months
    C. Deduct $5,000 and amortize the remaining $47,000 over 180 months
    D. Amortize $52,000 over 180 months

70. Farmer Bob sold a breeding cow on March 8, 2020 for $2,500. Expenses related to the sale were $250. Farmer Bob deducted $1,000 in costs of raising the cow during the years the cow was raised. What is Farmer Bob's gain or (loss) on the sale of the breeding cow, without regard to the Uniform Capitalization Rules?
    A. $(350)
    B. $1,150
    C. $2,250
    D. None of the above

71. In 2020, John and George formed a partnership that began business on July 1, 2020. They spent $4,000 in legal fees for negotiating and preparing the partnership agreement, $2,000 for accounting services setting up the partnership's books, and $1,000 in commissions associated with acquiring assets for the partnership. They made a proper election to amortize organization expenses over a 60-month period. Assuming these are their only expenses in starting their partnership, what is the proper amortization expense for 2020?
    A. $600
    B. $1,000
    C. $1,200
    D. $2,000

72. Carol owns 50% of the capital interest in ABC Partnership and 50% of the profits interest in XYZ Partnership. In 2017 for $100,000, ABC Partnership sells land to XYZ Partnership, which XYZ Partnership will use in its trade or business. The ABC Partnership's adjusted basis in the land at the time of the sale was $120,000. In 2020, the XYZ Partnership sells the land to an unrelated third party for $160,000. How much gain will the XYZ Partnership recognize in 2020?
    A. $20,000
    B. $30,000
    C. $40,000
    D. $60,000

73. Archie sells his 50% interest in XYZ partnership to Hal for $5,000 cash. His outside basis in the partnership is $3,500. The partnership has inventory and a capital asset with respect to basis of $6,000 and $2,000. The respective fair market values of the inventory and capital asset are $8,000 and $1,000. Archie should properly recognize:
    A. Ordinary income of $2,000 and a capital loss of $500
    B. Capital gain of $1,500 on the sale of his partnership interest
    C. Ordinary income of $1,500, the amount of cash he received
    D. None of the above

74. Gary is a calendar year, eligible small employer and wishes to take advantage of the Credit for Small Employer Pension Plan Startup Costs. He incurred $2,000 in qualified startup costs in 2020 for an eligible plan that will become effective on January 1, 2021. What is Gary's Pension Startup Costs credit amount for calendar year 2020?
    A. $0
    B. $500
    C. $1,000
    D. $2,000

75. Michael has a partnership interest with a zero basis. The partnership has inventory valued at $250,000. Michael's share of the ordinary income to be received from the sale of the inventory would be $10,000. In 2020, Michael sells his partnership interest for $30,000. Michael will report the following gain in 2020:
    A. $30,000 capital gain
    B. $20,000 ordinary gain and $10,000 capital gain
    C. $10,000 ordinary gain and $20,000 capital gain
    D. No gain or loss

76. Ryan runs a manufacturing business employing several people with young children. These employees require daycare as both parents work. He decided that, in order to make it easier for his employees to come to work each day, he would allocate some of the unused space in his manufacturing facility to a childcare facility. In 2020, he incurred $20,000 in qualified childcare facility expenditures. He had no qualified childcare resource and referral expenditures and had no pass-through credits. What is Ryan's Credit for Employer-Provided Childcare and Facilities Services in 2020?
    A. $2,000
    B. $5,000
    C. $10,000
    D. $20,000

77. In 2020, Linda sold her partnership interest for $25,000. Her adjusted basis at the time of the sale was $22,500 which included her $12,500 share of partnership liabilities. When she initially invested in the partnership, she contributed $10,000 worth of equipment. There was no profit or loss at the partnership level at the time she sold her interest. What is the amount and nature of her gain or loss from the sale of her partnership interest in 2020?
    A. $7,500 ordinary loss
    B. $10,000 capital gain
    C. $12,500 ordinary gain
    D. $15,000 capital gain

78. Alexandra, a calendar year taxpayer, is a partner in J&P Partnership that has a fiscal year ending March 31. Starting April 1, 2020, Alexandra received a fixed monthly guaranteed payment of $500 a month without regard to the income of the partnership. How much of the guaranteed payments will Alexandra report on her income tax return?
    A. $0
    B. $2,000
    C. $3,000
    D. $4,500

79. Farmer Jessica is a calendar year taxpayer, and she normally sells 100 head of beef cattle a year. As a result of drought, she sold 135 head during 2020. Jessica realized $236,250 from the sale. On August 10, 2020, as a result of drought, the affected area was declared a disaster area eligible for Federal assistance. What amount of income can Jessica postpone until 2021?
    A. $0
    B. $23,625
    C. $61,250
    D. $70,200

80. On June 17, 2019, Enrique bought a Section 1256 regulated futures contract for $50,000. On December 30, 2019 (the last business day of his tax year), the fair market value of the contract was $57,000. Enrique recognized a $7,000 gain on his 2019 income tax return, treated as 60% long-term and 40% short-term capital gain. On February 3, 2020, Enrique sold the contract for $56,000. How will Enrique treat the sale of the contract on his income tax return?
    A. $1,000 long-term capital loss
    B. $1,000 short-term capital loss
    C. $1,000 60% long-term and 40% short-term capital loss
    D. $1,000 ordinary gain

81. Nancy is a self-employer caterer. To encourage the continuation of an existing business relationship, she took one of her clients to a Broadway show. The visit to the show occurred directly after a substantial business discussion with that client. Nancy paid a ticket broker $300 for two tickets to that show. What is Nancy's total deductible entertainment expense for both tickets on her income tax return?
    A. $0
    B. $150
    C. $200
    D. $300

82. Sandy and Buffy formed the S&B Partnership in November of 2020. They began business operations in December 2020. During 2020 they incurred the following costs:
    - $2,500 to their attorney for negotiating and preparing the partnership agreement.
    - $250 for filing fees for the partnership agreement.
    - $1,000 to their CPA for services incident to the organization of the partnership.
    - $500 in costs associated with transferring assets to the partnership.

    What is the maximum dollar amount that S&B Partnership can elect to amortize as organizational costs?
    A. $1,750
    B. $3,750
    C. $4,000
    D. $4,250

83. John purchased a new gasoline-electric hybrid automobile on July 2, 2019, for $18,000. He also claimed a $2,000 clean-fuel vehicle deduction on his 2019 income tax return for that vehicle. In 2019, John used this automobile only for personal purposes. On January 1, 2020, he began using the hybrid automobile exclusively for business purposes. The fair market value of the automobile on that day was $17,000. What is the automobile's depreciable basis as of January 1, 2020?
    A. $15,000
    B. $16,000
    C. $17,000
    D. $18,000

84. Sally exchanges an apartment building with an adjusted basis of $400,000 for an office building with a fair market value of $750,000. She also agrees to assume the mortgage on the office building in the amount of $200,000 and paid exchange expenses of $25,000. The other party agreed to assume Sally's mortgage on the apartment building in the amount of $125,000. What is Sally's adjusted basis in the new office building?
    A. $425,000
    B. $500,000
    C. $625,000
    D. $750,000

85. Rich, Inc., a calendar year taxpayer employing the accrual method of accounting, acquired a business warehouse building in 2017 for $100,000. Rich, Inc. deducted $3,000 in warehouse asset depreciation expense on December 31, 2018. In January of 2019, Rich, Inc. incurred a $2,000 legal bill, successfully defending its title to the building. Later in the year a second-floor office was added to the warehouse at a cost of $10,000. Rich, Inc. deducted $5,000 in warehouse asset depreciation expense on December 31, 2019. What is Rich, Inc.'s adjusted basis in the warehouse asset on January 1, 2020?
    A. $100,000
    B. $104,000
    C. $110,000
    D. $112,000

86. ABC Corporation had operating income of $160,000, after deducting $10,000 for contributions to State University, but not including dividends of $2,000 received from a 20%-owned taxable domestic corporation (not from debt-financed portfolio stock). In computing the maximum allowable deduction for contributions, ABC Corp. should apply the percentage limitation to a base amount of:
    A. $162,000
    B. $170,000
    C. $170,400
    D. $172,000

87. Larry Johnson gives his son Section 1250 property on which he took $2,000 in depreciation deductions, of which $500 is additional depreciation. Immediately after the gift, the son's adjusted basis in the property is the same as his father's and reflects the $500 additional depreciation. On January 1 of the next year, after taking depreciation deductions of $1,000 on the property, of which $200 is additional depreciation, the son sells the property. At the time of sale, the additional depreciation is what amount?
    A. $0
    B. $200
    C. $500
    D. $700

88. Contributions to a simplified employee pension plan must not discriminate in favor of highly compensated employees. All of the following statements describe a 2020 highly compensated employee of FTP Company except:
    A. Harry was an officer of FTP Company and received 2020 compensation of $136,000
    B. Carl owned 4% of the capital interest in FTP Company
    C. Anastacia received 2020 annual compensation from FTP Company of $137,000 and was among the top 20% most highly paid employees during the year
    D. Julie received 2020 annual compensation from FTP Company of $140,000

89. Which one of the following individuals is not subject to self-employment tax?
    A. Claude, a real estate dealer, had net rental income of $112,000
    B. Tammy received $5,000 for serving as a director of a corporation
    C. Paulina, an attorney, received $43,000 as her distributive share of her law firm's partnership
    D. Stan, a limited partner, received $5,400 as his distributive share of the partnership income

90. All of the following are considered Section 197 intangibles except:
    A. A right to receive tangible property or services under a contract or granted by a governmental agency
    B. Workforce in place
    C. Covenant not to compete
    D. Permit

91. Mr. Harris, a self-employed seafood wholesaler, arranged a business meeting with his five principal clients during the current year. The night the clients arrived in town, Mr. and Mrs. Harris entertained the clients and their spouses at their home. The cost of the food and beverages was $400. As each client left, he or she was given a cheese and fruit basket, which cost $40 each. The business meeting was held the next day at Mr. Harris' office. Assuming no other similar expenses during the current year, what amount of the above expenses may Mr. Harris deduct?
    A. $0
    B. $125
    C. $300
    D. $325

92. How is the cost of a building or improvements constructed in 2020 on leased land recovered?
    A. Over the lease term
    B. Over a 60-month amortization period
    C. Over the lesser of the remaining period of the lease or the MACRS recovery period for the type of improvements
    D. As a MACRS deduction

93. For purposes of estimated tax exceptions for farmers, all of the following are considered gross income from farming except:
    A. Gross farm rental income
    B. Gains from the sale of livestock used for breeding, draft, sport, or dairy purposes
    C. Gains from the sale of investment stock (securities)
    D. Gross farm income from partnerships, S corporations, estates, and trusts

94. An incorporated exempt organization subject to tax on its current-year unrelated business taxable income (UBTI):
    A. Must pay at least 70% of the tax due as shown on the return when filed, with the balance of tax payable in the following quarter
    B. May defer payment of tax for up to 9 months following the due date of the return
    C. Must make estimated tax payments if its tax can reasonably be expected to be $100 or more
    D. Must comply with the Code provisions regarding installment payments of estimated income tax by corporations

95. In Year 1, Washington Trust had taxable interest of $2,000, capital gains of $6,000, and a fiduciary fee of $1,000. The trust instrument allocates capital gains to income. At the end of Year 1, the fiduciary retains $3,000 and distributes $4,000. What is the distributable net income (DNI) of Washington Trust for Year 1?
    A. $4,000
    B. $4,375
    C. $7,000
    D. $7,375

96. Which of the following is not information required to be included in an S corporation income tax return?
    A. Number of shares owned by each shareholder at all times during the tax year
    B. Each shareholder's adjusted basis in the corporation's stock
    C. Items of gross income and allowable deductions
    D. Names and addresses of all persons owning stock in the corporation at any time during the tax year

97. Simon and Maggie Partnership, a calendar year partnership with two partners, filed its 2019 Form 1065 tax return on December 1, 2020. An extension of time to file was not filed. What is the amount of their failure to file penalty?
    A. $200
    B. $400
    C. $2,000
    D. $3,600

98. Consultants, Inc. is a personal service corporation. Its taxable income for the current year was $45,000. What would the amount of tax be for Consultants, Inc., for the current year, before any credits?
    A. $0
    B. $9,450
    C. $15,750
    D. $17,370

99. Cathy, a single taxpayer, has $70,000 in wages, $15,000 income from a limited partnership, a $26,000 loss from rental real estate activities in which she actively participated, and is not subject to the modified adjusted gross income phaseout rule. She can use $15,000 of her $26,000 loss to offset her $15,000 passive income from the partnership. She actively participated in her rental real estate activities, so she can use what amount of the remaining $11,000 rental real estate loss to offset $11,000 of her nonpassive income (wages)?
    A. $0
    B. $5,500
    C. $10,000
    D. $11,000

100. Which of the following statements about the sale or exchange of a partner's interest in a partnership is true?
    A. Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership
    B. The amount realized by the selling partner does not include any partnership liabilities of which the selling partner is relieved
    C. Any amount realized due to inventory items held by the partnership results in capital gain or loss
    D. The exchange of a limited partnership interest for a limited interest in another partnership is a nontaxable exchange of like-kind property

All questions pertain to Tax Year 2020 unless noted.

1. The adjusted basis of Steve's partnership interest is $100,000. He receives a distribution of $40,000 cash and property that has an adjusted basis to the partnership of $80,000. His basis for the distributed property is limited to what amount?
   A. $40,000
   B. $60,000
   C. $80,000
   D. $100,000

2. Armando's basis in his partnership interest is $20,000. In a distribution in liquidation of his entire interest, he receives properties C and D, neither of which is inventory or unrealized receivables. Property C has an adjusted basis to the partnership of $15,000 and a fair market value of $15,000. Property D has an adjusted basis to the partnership of $15,000 and a fair market value of $5,000. What is his basis in each property?
   A. Property C basis is $15,000 and property D basis is $5,000
   B. Property C basis is $15,000 and property D basis is $10,000
   C. Property C basis is $20,000 and property D basis is $10,000
   D. Property C basis is $20,000 and property D basis is $5,000

3. Enzo contributes to his partnership property that has an adjusted basis of $400 and a fair market value of $1,000. His partner contributes $1,000 cash. While each partner has increased his capital account by $1,000, which will be reflected in the partnership books, the adjusted basis of Enzo's interest is only what amount?
   A. $0
   B. $200
   C. $400
   D. $1,000

4. Under a partnership agreement, Divya is to receive 30% of the partnership income, but not less than $8,000. The partnership has net income of $20,000. What is the amount of Divya's guaranteed payment that can be deducted by the partnership?
   A. $0
   B. $2,000
   C. $6,000
   D. $8,000

5. Lamont is a calendar year taxpayer who is a partner in a partnership. The partnership uses a fiscal year that ended January 31, 2020. Lamont received $10,000 in guaranteed payments from the partnership from February 1, 2020, until December 31, 2020. What amount must he include in income and report on his income tax return?
   A. $0
   B. $5,000
   C. $7,000
   D. $10,000

6. Kumar became a limited partner in the ABC Partnership by contributing $10,000 in cash on the formation of the partnership. The adjusted basis of his partnership interest at the end of the current year is $20,000, which includes his $15,000 share of partnership liabilities. The partnership has no unrealized receivables or inventory items. Kumar sells his interest in the partnership for $10,000 in cash. He had been paid his share of the partnership income for the tax year. What amount should Kumar report as a capital gain?
   A. $5,000
   B. $10,000
   C. $15,000
   D. $25,000

7. Mary Jane contributed property having an adjusted basis to her of $10,000 to the WHW Partnership for a 45% interest in the partnership. At the time of the contribution the property had a fair market value of $20,000. What is the amount and character of Mary Jane’s gain on this transaction that will be reported on her tax return?
   A. $0
   B. $5,000 ordinary income
   C. $10,000 long-term capital gain
   D. $20,000 long-term capital gain

8. A corporation loses $30,000 from operations. It receives $100,000 in dividends from a 20%-owned corporation. Its taxable income is $70,000 before the deduction for dividends received. If it claims the full dividends-received deduction of $65,000, it will have taxable income of $5,000. Therefore, the corporation can deduct what amount for the dividends-received deduction?
   A. $5,000
   B. $45,500
   C. $50,700
   D. $70,000

9. Ed Harris and Bill Jones buy property for $100,000. Together they organize a corporation when the property has a fair market value of $300,000. Ed transfers the property to the corporation for all its authorized capital stock, which has a par value of $300,000. What amount of taxable gain is recognized by Ed?
   A. $0
   B. $100,000
   C. $200,000
   D. $300,000

10. Roger owns a one-half undivided interest in a rental house. Last year, he paid $968 for necessary repairs on the property. Roger can deduct what amount as a rental expense on his income tax return?
   A. $0
   B. $242
   C. $484
   D. $968

11. During 2020, Jessica, a cash method taxpayer, bought fertilizer ($4,000), feed ($1,000), and seed ($500) for use on her farm in the following year. Her total prepaid farm supplies expense for 2020 is $5,500. Jessica’s other deductible farm expenses totaled $10,000 for 2020. Therefore, Jessica’s deduction for prepaid farm supplies cannot be more than what amount for 2020?
   A. $500
   B. $5,000
   C. $5,500
   D. $10,000

12. Amelia is a calendar year taxpayer and pays $10,000 on July 1, 2020, for a business insurance policy that is effective for only one year beginning on July 1, 2020. What amount is deductible in 2020?
   A. $834
   B. $1,667
   C. $5,000
   D. $10,000

13. Connor owns a dance studio. His tax year is a calendar year, and he uses the accrual method of accounting. On October 1, 2020, he receives a $4,800 payment for a one-year contract for 48 one-hour lessons beginning on that date. He gives eight lessons in 2020. Under this method of including advance payments, Connor must include what amount of the payment in income for 2020?
   A. $0
   B. $800
   C. $4,000
   D. $4,800

14. Daniel is a calendar year taxpayer. On January 1, 2020 he leased property for 3 years for $6,000 a year. He paid the full $18,000 during the first year of the lease. What amount can Daniel deduct as a rent expense in 2020?
    A. $0
    B. $6,000
    C. $12,000
    D. $18,000

15. Alyssa is an attorney. She maintains a library for use in her profession. She also buys technical books and journals for use in her business. Which of the following is true regarding Alyssa's depreciable property?
    A. She can depreciate any books and journals that have a useful life that extends substantially beyond the year she placed them in service
    B. She cannot depreciate her library
    C. She can depreciate all of her technical books and journals regardless of useful life
    D. She can depreciate her library but none of her technical books and journals

16. Dave buys a building for $20,000 cash and assumes a mortgage of $80,000 on it, what is his basis in the property?
    A. $0
    B. $20,000
    C. $80,000
    D. $100,000

17. Jeff and his brother borrow money. Jeff is liable for 50% of the note. He uses his half of the loan in his business, and he makes one-half of the loan payments. The total interest payments on the loan for the year are $1,000. What amount can Jeff deduct of the total interest payments as a business deduction?
    A. $0
    B. $250
    C. $500
    D. $1,000

18. The taxpayer generally can deduct all of the follow expenses that are directly related to his or her business activities except:
    A. Amounts paid to influence legislation (i.e., lobbying)
    B. Reasonable advertising expenses
    C. The cost of institutional advertising to keep his or her name before the public if it relates to business he or she reasonably expects to gain in the future
    D. The cost of goodwill advertising to keep his or her name before the public if it relates to business he or she reasonably expects to gain in the future

19. Gilbert exchanged real estate held for investment with an adjusted basis of $25,000 for other real estate held for investment. What is the basis of Gilbert's new property for this like-kind exchange?
    A. $0
    B. $12,500
    C. $15,000
    D. $25,000

20. Bill Smith trades an old cab for a new one. The new cab costs $30,000. He is allowed a trade in value of $8,000 for the old cab and pays $22,000 cash. What is Bill's recognized gain or loss on the like-kind exchange transaction?
    A. $0
    B. $8,000
    C. $22,000
    D. $30,000

21. Elvira used her car in her business for 2 years. Its adjusted basis is $3,500 and its trade-in value is $4,500. She is interested in a new car that costs $20,000. Ordinarily, she would trade her old car for the new one and pay the dealer $15,500. Her basis for depreciation of the new car would then be $19,000. However, Elvira wants her new car to have a larger basis for depreciation, so she arranges to sell her old car to the dealer for $4,500. She then buys the new one for $20,000 from the same dealer. What is Elvira's basis for depreciation for the new car?
    A. $3,500
    B. $4,500
    C. $19,000
    D. $20,000

22. Francisco sells products to the Sienna Company. To thank the company for its business, he gave the company three bottles of champagne. Each of the company's three executives took home a bottle for their families to share. Francisco has no business relationship with any of the executives' family members. If he paid $40 for each bottle, the total amount he can deduct for all three bottles is:
    A. $25
    B. $60
    C. $75
    D. $120

23. Farmer Judy is a calendar year taxpayer who uses the cash method of accounting. She normally sells 200 head of sheep a year. Because of a drought, she sold 250 head of sheep in 2020. Farmer Judy realized $50,000 from the sale. The affected area was declared a disaster area eligible for Federal assistance on March 12, 2020. How much, if any, income can Farmer Judy postpone to 2021?
    A. $10,000
    B. $50,000
    C. $12,500
    D. $0, since only sales because of flooding qualify for postponement

24. Bob Moon forms Moon Enterprises LLC (Limited Liability Company) during the year. What form must Moon Enterprises LLC file in order to elect to be taxed as a C corporation?
    A. Form 1065 (U. S. Partnership Tax Return)
    B. Form 8832 (Entity Classification Election)
    C. Form 1120 (U. S. Corporation Income Tax Return)
    D. Form 7004 (Application for Extension of time to file for corporations)

25. ABC Corporation is dissolved on July 9, 2020. What is the due date, without extensions, for the filing of the final corporate income tax return (not including weekends, holidays or automatic extensions)?
    A. October 9, 2020
    B. November 15, 2020
    C. April 15, 2021
    D. December 31, 2021

26. Croaker, Inc. is a taxable domestic corporation. Dana Corporation, a large manufacturing corporation, owns 15% of Croaker, Inc.'s outstanding stock. In 2020, Dana Corporation received $100,000 in dividends from Croaker, Inc. Dana Corporation received no other dividends in 2020. Dana Corporation may deduct, within certain limits, what percentage of the dividends received?
    A. 15%
    B. 50%
    C. 75%
    D. 80%

27. York, Inc. directly owns stock of Ajax Corporation. To determine if Ajax Corporation is a member of a controlled group with York, Inc. as the common parent, York, Inc. must own at least what percentage of the voting and total value of the Ajax Corporation stock?
    A. 51%
    B. 75%
    C. 80%
    D. 100%

28. Gene provides services to a partnership during the year in exchange for a capital interest of 30% worth $25,000. Which of the following best describes Gene's basis in the partnership?
    A. $0, since Gene exchanged services for his interest
    B. $0, since the services are considered solely a profits interest
    C. $25,000 equally divided by the following five years and reported as long-term capital gains
    D. $25,000 that must be reported by Gene as income in the year of receipt if the interest is vested

29. A corporate payer of an individual shareholder dividend does not have the taxpayer identification number for that shareholder. What backup withholding percentage rate must the corporate payer use for this shareholder's dividend payments?
    A. 21%
    B. 24%
    C. 35%
    D. 39%

30. The board of directors of Walden Corporation authorized a year end distribution to its three shareholders. Each distribution would be equal in value but the shareholder could choose to receive the distribution in cash or corporate stock. If a shareholder chose to receive corporate stock, the distribution should be treated as:
    A. A tax-free distribution of stock
    B. A distribution of property
    C. A like-kind exchange
    D. Recaptured credit

31. A fiduciary representing a dissolving corporation may file a request for prompt assessment of tax. Generally, this request reduces the time allowed for assessment to:
    A. 12 months
    B. 18 months
    C. 24 months
    D. 30 months

32. Which of the following conditions will prevent a corporation from qualifying as an S corporation?
    A. The corporation has both common and preferred stock
    B. The corporation has 70 shareholders
    C. One shareholder is an estate
    D. All of the above

33. Which of the following statements regarding the built-in gains tax of an S corporation is true?
    A. The built-in gains tax is treated as a loss sustained by the corporation during the same tax year
    B. S corporation built-in gains tax can be recognized only in the 5-year period beginning with the year the S election is made
    C. S corporation built-in gains tax is passed through and paid at the shareholder level
    D. The built-in gains tax may apply to an S corporation that was a sole proprietorship before it elected to be an S corporation

34. Which of the following statements about exempt organizations' requirements to file annual information returns is false?
    A. Public charities with less than $100,000 in gross receipts are exempt from filing
    B. Exempt status may be denied or revoked for failure to file
    C. Private foundations are required to file regardless of gross receipts
    D. Church-affiliated organizations are exempt from filing

35. Which of the following statements regarding the termination of an S corporation election is true?
    A. The election may be revoked with the consent of shareholders who, at the time the revocation is made, hold more than 50% of the number of issued and outstanding shares
    B. The election may be revoked by the board of directors of the corporation only if they are not shareholders
    C. The election terminates automatically if the corporation derives more than 25% of its gross receipts from passive investment income during the year
    D. The election may be revoked by the Internal Revenue Service if there is a history of 10 years of operating losses

36. Snickers Trust did not file an estate tax return Form 1041 for the 2019 tax year. At the beginning of 2020, Snickers Trust expects withholding and credits to be less than 90% of the tax reportable at year end. Snickers Trust must pay estimated income tax for 2020 if it expects to owe, after subtracting any withholding and credits, at least what amount?
    A. $100
    B. $600
    C. $1,000
    D. $2,500

37. If an extension is not granted, when must *Form 706 - United States Estate (and Generation-Skipping Transfer) Tax Return* be filed to report estate and/or generation-skipping transfer tax?
    A. By the 15th day of the fourth month following the date of death
    B. Within 6 months after the date of death
    C. Within 9 months after the date of death
    D. Within 1 year of the date of death

38. Which of the following statements regarding unrelated business taxable income (UBTI) is true?
    A. UBTI is subject to tax at the highest corporate income tax rate
    B. UBTI does not include income derived from services performed by unpaid volunteers
    C. UBTI includes income from business activity substantially related to furthering the exempt purpose of the organization
    D. UBTI is exempt from tax on condition that no part of it inures to the benefit of any shareholder/trustee, officer, or employee of the exempt organization

39. Which of the following statements concerning the deduction for estate taxes by individuals is true?
    A. The deduction for estate tax can be claimed only for the same tax year in which the income in respect of a decedent must be included in the recipient's income
    B. Individuals may claim the deduction for estate tax whether or not they itemize deductions
    C. The estate tax deduction is a miscellaneous itemized deduction subject to the 2% limitation
    D. For the alternative minimum tax computation, the estate tax deduction is included as an itemized deduction that is an adjustment to taxable income

40. Jack Sage used the cash method of accounting. At the time of his death, he was entitled to receive $12,000 from clients for his services and he had accrued bond interest of $8,000, for a total income in respect of a decedent of $20,000. He also owed $5,000 for business expenses for which his estate is liable. The income and expenses are reported on Jack's estate tax return. The tax on Jack's estate is $9,460 after credits. The net value of the items included as income in respect of the decedent is $15,000 ($20,000 − $5,000). The estate tax determined without including the $15,000 in the taxable estate is $4,840, after credits. The estate tax that qualifies for the deduction is what amount?
    A. $4,620
    B. $4,840
    C. $9,460
    D. $15,000

41. Which of the following entities are required to file *Form 709 - United States Gift Tax Return*?
    A. An individual
    B. An estate or trust
    C. A corporation
    D. All of the above

42. Which of the following is not a disqualified person for the purpose of determining whether a prohibited transaction has been entered into under the qualified retirement plan rules?
    A. A fiduciary's spouse who receives a loan from a plan
    B. A 70-year-old individual who receives a distribution of the full value of his or her retirement account from a plan established by a business that he or she owns
    C. A fiduciary that invests the plan's assets in FGH partnership. FGH deposits 10% of the plan's assets into the fiduciary's own account
    D. A plan fiduciary who deposits contributions into his or her own account and uses the funds to pay personal business expenses

43. The annual gift tax exclusion amount is allowed on which of the following gifts?
    A. $30,000 cash to Friend A
    B. $30,000 car to Friend B
    C. $30,000 remainder interest to Friend C
    D. Both A and B

44. Which of the following will disqualify a corporation from electing S corporation status?
    A. 75 shareholders
    B. Voting and non-voting stock
    C. A non-resident alien stockholder
    D. An employee stock option plan shareholder

45. The taxpayer may have to recapture the Section 179 deduction if, in any year during the property's recovery period, the percentage of business use drops to what percentage or less?
    A. 10%
    B. 25%
    C. 45%
    D. 50%

46. Charles retired 3 years ago at age 72 from working at his family's laminating business. His required minimum distribution for 2020 is $2,000. Charles elects to only withdraw $1,500 from his IRA account. How much excise tax may Charles have to pay for that year?
    A. $50
    B. $100
    C. $200
    D. $250

47. Paul reached age 70½ on January 28, 2020. Since Paul had not reached age 70½ before 2020, his first RMD is due for 2021, the year he turns 72. Therefore, Paul's first RMD is due by which date?
    A. January 1, 2022
    B. April 1, 2022
    C. April 15, 2022
    D. April 30, 2022

48. Catalina and Susan formed a new partnership called Planet Partnership. Catalina contributes property that has an adjusted basis of $1,400 and a fair market value of $2,000 to the partnership. Susan contributes $2,000 in cash to the partnership. Each partner's capital account as reflected on the partnership's books is $2,000. What is the adjusted basis of each partner's interest?
    A. Catalina's at $0 and Susan's at $1,400
    B. Catalina's at $600 and Susan's at $1,000
    C. Catalina's at $1,400 and Susan's at $2,000
    D. Catalina's at $2,000 and Susan's at $2,000

49. ABC Corporation made cash contributions totaling $50,000 to qualified charitable organizations. ABC received $30,000 in dividends from a domestic corporation in which it holds 24% stock ownership. ABC was able to deduct 65% of the dividends received from the domestic corporation. ABC's taxable income for the year was $150,000 after the dividends-received deduction but before the deduction for charitable contributions. What is ABC's charitable contribution deduction for the year?
    A. $20,000
    B. $25,000
    C. $42,375
    D. $50,000

50. Corporations can take a deduction for dividends received from which of the following?
    A. A corporation exempt from tax for the tax year of the distribution
    B. A corporation whose stock has been held for 90 days
    C. A real estate investment trust
    D. Any corporation, if the corporation is under an obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property

51. Bob and John make the following transfers to Builders Corporation in return for 100% of the stock in the corporation. Bob transferred to Builders $100,000 cash. Builders transferred to Bob $10,000 of land and he received 80% of Builder's stock. John Transferred $30,000 in property (basis of $10,000). Builders transferred to John $5,000 cash. John also received 20% of Builder's stock. What is the amount of gain Bob and John must recognize on the transfers?
    A. Bob must recognize $10,000 gain and John must recognize $25,000 gain
    B. Bob recognizes no gain and John recognizes $5,000 gain
    C. Bob recognizes $10,000 gain and John recognizes $5,000 gain
    D. Bob recognizes $10,000 gain and John recognizes $20,000 gain

52. Heather's brother sold stock to her for $7,600. His cost basis was $10,000. His loss of $2,400 was not deductible. Heather later sells the same stock to an unrelated party for $10,500, realizing a gain of $2,900. What is Heather's recognized gain?
    A. $500
    B. $2,900
    C. $7,600
    D. $10,500

53. Brady Corporation of Cleveland, OH is a multi-national conglomerate. In 1992 Brady Corporation established and owned 100% of the stock of Toms, Inc. of Dayton, OH. Toms, Inc. was established for the purpose of manufacturing rubber gaskets, which Brady Corporation uses in many of its international operations. By the beginning of 2020, Brady Corporation had sold 30% of the outstanding Toms, Inc. stock. In July of 2020 Toms, Inc. declares a dividend and pays $100,000 to Brady Corporation. In 2020 Brady Corporation, subject to certain limits, takes what amount as a dividends received deduction?
    A. $0
    B. $50,000
    C. $65,000
    D. $100,000

54. In tax year 2020, Roberts Corporation made a charitable contribution to a qualified organization of $40,000 in cash plus a vehicle with a fair market value of $15,000. For tax year 2020 Roberts Corporation had $200,000 in total income, $100,000 in total expenses not including the above charitable contributions and would have a reportable dividend received deduction of $50,000. How much of the charitable contribution can Roberts Corporation deduct for the 2020 tax year?
    A. $37,500
    B. $45,000
    C. $50,000
    D. $55,000

55. In tax year 2014, XYZ Corporation reported $1,000 in long-term capital gains and $4,000 in short-term capital gains. In tax year 2019, XYZ Corporation had a $10,000 long-term capital loss and a $5,000 short-term capital gain. XYZ Corporation reported no other capital gains or losses in any other tax year. How much net capital loss will be available for XYZ Corporation to carry into tax year 2020?
    A. $0
    B. $1,000
    C. $4,000
    D. $5,000

56. As of December 31, 2020, Doyle, Inc. had incurred $6,000 in potential market feasibility costs, $3,600 in legal fees for setting up the corporation, $2,400 in advertising costs for the opening of the business, and $18,000 for the purchase of equipment. Doyle, Inc. began business operations on January 1, 2020. If Doyle, Inc. chooses to amortize its organizational and start-up expenses over the minimum 60-month period, how much can Doyle, Inc. deduct as an amortization expense in 2020?
    A. $1,680
    B. $1,920
    C. $2,400
    D. $6,000

57. In 2020, Sean Grayce transfers property worth $35,000 and render services valued at $3,000 to a corporation in exchange for stock valued at $38,000. Right after the exchange, he owns 85% of the outstanding stock. No gain is recognized on the exchange of property. However, Sean recognizes ordinary income of what amount as payment for services he rendered to the corporation?
    A. $0
    B. $3,000
    C. $35,000
    D. $38,000

58. Under final regulations, a self-employed taxpayer may elect to apply a de minimis safe harbor to amounts he or she paid to acquire or produce tangible property to the extent such amounts are deducted by him or her for financial accounting purposes or in keeping his or her books and records. For taxable years beginning on or after January 1, 2016, the Internal Revenue Service increased the de minimis safe harbor threshold to what amount per invoice or item for self-employed taxpayers without applicable financial statements?
    A. $500
    B. $1,000
    C. $2,000
    D. $2,500

59. Rose Corporation is a calendar year filing corporation that had accumulated earnings and profits at the end of 2020 of $5,000. At the end of 2020 Rose Corporation had current-year earnings and profits of $1,000. On December 31, 2020 Rose Corporation distributed to sole shareholder Paul Rose an automobile purchased for $10,000 with a fair market value of $8,000. Paul Rose assumed a liability on the automobile of $1,000. What amount of dividend paid to Paul Rose must Rose Corporation report as an ordinary dividend in Box 1a of Form 1099-DIV?
    A. $6,000
    B. $7,000
    C. $8,000
    D. $10,000

60. With regard to the treatment of capital losses by corporations other than S corporations, which of the following statements is false?
    A. A capital loss carryover may not be used to determine the current-year net capital loss
    B. A net capital loss may be carried back 3 years and carried forward for up to 5 years
    C. A refund may be granted if tax is refigured due to a capital loss carryback
    D. When a corporation carries a short-term net loss to another tax year, the character becomes long-term

61. XYZ Corporation, under a plan of complete liquidation, distributed to its sole shareholder, Joel, property with an adjusted basis to XYZ of $34,000 and subject to a liability of $44,000. The fair market value of the property on the date of distribution was $40,000. What is the amount of XYZ's recognized gain or loss?
    A. $(10,000)
    B. $4,000
    C. $6,000
    D. $10,000

62. When is a corporation required to file a Form 1099-DIV for a liquidating distribution?
    A. When the liquidating distribution equals or exceeds $10 in a calendar year
    B. Never, liquidating distributions does not require a Form 1099-DIV
    C. Always, liquidating distributions in any amount requires the filing of a Form 1099-DIV
    D. When the liquidating distribution equals or exceeds $600 in a calendar year

63. How does a non-corporate shareholder treat the gain on a redemption of stock that qualifies as a partial liquidation of the distributing corporation?
    A. Partly as capital gain and partly as a dividend
    B. Entirely as a dividend
    C. As a tax-free transaction
    D. Entirely as capital gain

64. Arnold acquired 10 shares of Klesco, Inc. stock in 2008 for $50 per share. Klesco, Inc. decided in 2020 to reacquire all of its outstanding stock, which it did for $200 per share. What amount of capital gain in 2020 must Arnold report on the redemption of his Klesco, Inc. stock?
    A. $0
    B. $500
    C. $1,500
    D. $2,000

65. George and Helen are husband and wife. During 2020, George gave $32,000 to his brother and Helen gave $22,000 to her niece. George and Helen both agree to split the gifts they made during the year. What is the taxable amount of gifts, after the annual exclusion, each must report on *Form 709 - United States Gift (and Generation-Skipping Transfer) Tax Return*?
    A. George and Helen each have taxable gifts of $2,000
    B. George has a taxable gift of $16,000 and Helen has a taxable gift of $8,000
    C. George and Helen each have taxable gifts of $1,000
    D. George has a taxable gift of $16,000 and Helen has a taxable gift of zero

66. In 2020, Cinder Family Trust, a simple trust, reported the following items of income and expenses during the year:
    - Ordinary income from rental properties (gross): $ 5,000
    - Taxable dividend income: $1,500
    - Interest income from corporate bonds: $1,000
    - Interest income from tax-exempt municipal bonds: $500
    - Rental expenses: $2,500
    - Trustee fees allocable to income: $1,000
    - Trustee fees allocable to corpus: $500

    What is Cinder Family Trust's distributable net income (DNI) for 2020?
    A. $3,500
    B. $4,000
    C. $6,000
    D. $7,500

67. The Wilder Trust is a complex trust with a controlling instrument that specifically allocates capital transactions to the corpus of the trust. The instrument goes on to state that $2,000 will be set aside out of gross income for charitable purposes and that $10,000 in income is required to be distributed each year. At the end of 2020 the Wilder Trust had $20,000 in gross income, which included $5,000 in capital gains. If there was no other information to consider, what would the Wilder Trust's income distribution deduction be for 2020?
    A. $5,000
    B. $10,000
    C. $13,000
    D. $18,000

68. In 2018 Thomas Hatch established the TWH Trust. TWH is a revocable trust. Thomas contributed cash, a significant stock portfolio and tax-exempt bonds to this trust when he established it. In 2020 the TWH Trust had income consisting of $5,000 in taxable interest, $3,000 in ordinary dividends, and $2,000 in tax-exempt interest. Thomas has never relinquished dominion and control of the TWH Trust. What amount of TWH Trust's income is taxable to Thomas Hatch in 2020?
    A. $0
    B. $5,000
    C. $8,000
    D. $10,000

69. Which of the following statements regarding distributions of stock is not true?
    A. Expenses of issuing a stock dividend are not deductible but must be capitalized
    B. Distributions of stock and stock rights are never treated as property
    C. Distributions of stock dividends and stock rights are generally tax free to shareholders
    D. Stock rights are distributions by a corporation of rights to acquire its stock

70. In 2006 Adam purchased 100 shares of Call Corporation stock for $50 per share. During 2020 Call Corporation completely liquidated. After paying its liabilities, Call Corporation distributed to its shareholders $10,000 in cash and appreciated property sold for $90,000. Adam's portion received a liquidating distribution from Call Corporation of $10,000. Adam must report what amount of capital gains income from this distribution?
    A. $4,500
    B. $5,000
    C. $22,500
    D. $25,000

71. A domestic limited liability company that has two or more members (without making other elections) is generally treated as what type of business entity for Federal income tax purposes?
    A. Corporation
    B. S corporation
    C. Partnership
    D. Sole proprietorship

72. Warren purchased stock in 2018 for $10,000. In 2019 Warren sold this stock to his sister Gail for $8,000. In 2020, Gail sold this stock to an unrelated party for $11,000. How much gain must Gail recognize in 2020 on the sale of this stock?
    A. $0
    B. $1,000
    C. $2,000
    D. $3,000

73. S corporation elections are made for periods of how many years?
    A. 3 years
    B. 4 years
    C. 5 years
    D. Until election is terminated

74. Which of the following statements is **not** correct?
    A. Under an accrual method of accounting, the taxpayer generally reports income in the year earned and deducts or capitalize expenses in the year incurred
    B. Under an accrual method of accounting, the taxpayer generally reports receipt of an advance payment for services to be performed in a later tax year as income in the year he or she receives the payment
    C. Under an accrual method of accounting, business expenses and interest owed to a related person who uses the cash method of accounting are deductible when the all-events test has been met
    D. Under an accrual method of accounting, the taxpayer can take a current deduction for taxes when economic performance occurs

75. Which of the following property exchanges does not qualify as a like-kind exchange?
    A. Exchange of city property for farm property
    B. Exchange of partnership interests
    C. Exchange of improved property for unimproved property
    D. Exchange of an ownership in real estate for a thirty-year lease in real estate

76. Several years ago, Benjamin built his home for $140,000 on a lot that cost him $14,000. Before changing the property to rental use this year, he added $28,000 of permanent improvements to the house and claimed a $3,500 casualty loss deduction for damage to the house. Part of the improvements qualified for a $500 residential energy credit, which Benjamin claimed on his 2013 tax return. The adjusted basis of the house at the time of the change in its use was what amount?
    A. $140,000
    B. $154,000
    C. $164,000
    D. $168,000

77. With regard to depreciation computations made under the general MACRS method, the half-year convention provides that:
    A. The deduction will be based on the number of months the property was in service, so that one-half month's depreciation is allowed for the month in which the property is placed in service and for the month in which it is disposed of
    B. One-half of the first-year's depreciation is allowed in the year in which the property is placed in service, regardless of when the property is placed in service during the year, and a half-year's depreciation is allowed for the year in which the property is disposed of
    C. Depreciation will be allowed in the last year of the property's economic life only if the property is disposed of after June 30 of the year of disposition for calendar year corporations
    D. Depreciation will be allowed in the first year of acquisition of the property only if the property is placed in service no later than June 30 for calendar year corporations

78. Silver Corporation distributes land with a fair market value of $25,000 to its sole shareholder, Donna Silver, who assumes the mortgage on the land of $35,000. This land had an adjusted basis to Silver Corporation of $20,000. Silver Corporation must recognize how much of a gain on this distribution?
    A. $5,000
    B. $10,000
    C. $15,000
    D. $25,000

79. Which of the following transactions is **not** a transaction that results in a gain or loss subject to Section 1231 treatment?
    A. Sales or exchanges of leaseholds
    B. Sales or exchanges of cattle and horses
    C. The sale of a copyright, literary, musical, or artistic composition that the taxpayer created
    D. Sales or exchanges of unharvested crops sold together with land to the same buyer

80. Members of a family can be partners. Family members generally will be recognized as partners if:
    A. The partnership agreement states that the family members have a right to share in earnings and profits of the partnership
    B. Capital is not a material income-producing factor, the family members joined together in good faith to conduct a business. They agreed that contributions of each entitle them to a share in the profits, and some capital or service has been (or is) provided by each partner
    C. Capital is a material income-producing factor, the family members acquired their capital interest in a bona fide transaction, actually own the partnership interest but allow the related partner to control the interest
    D. The partnership agreement designates who the partners are, what degree of service they will perform for the partnership and the extent to which they share in the profits, losses and other attributes of the partnership

81. Generally, no gain or loss is recognized by the partnership or a partner when the partner contributes property to the partnership, unless:
    A. The partnership is being formed
    B. A gain is realized on the transfer of property to the partnership that would be treated as an investment company if the partnership was incorporated
    C. The partnership is already operating
    D. Unencumbered depreciable property is contributed

82. A loss incurred from the abandonment of a partnership interest is an ordinary loss when:
    A. The partner receives a de minimis or deemed distribution
    B. The partner's capital account reflects a positive balance
    C. The partner transfers the entire interest to a non-related party
    D. The transaction is not a sale or exchange and the partner has not received an actual or deemed distribution from the partnership

83. In 2020, travel expenses are the ordinary and necessary expenses of traveling away from home for business. Which of the following kinds of travel expenses are not applicable for deduction on Schedule C?
    A. Cost of travel by car between the taxpayer's tax home and the out-of-town business destination
    B. Cost of business calls while on the business trip
    C. Costs of dry cleaning and laundry while on the business trip
    D. Cost of a hotel stay in the general area in which the taxpayer's business is located

84. In 2020, Jane Ash placed in service machinery costing $2,690,000. This cost is $100,000 more than $2,590,000 Section 179 limit. Therefore, the maximum she can elect to deduct for the Section 179 property she placed in service in 2020 is what amount?
    A. $0
    B. $100,000
    C. $940,000
    D. $1,040,000

85. An organization may qualify under Section 501(c)(3) if it is organized exclusively for which of the following purposes?
    A. Business
    B. Political action
    C. Personal
    D. Charitable

86. Valeria transfers property worth $35,000 and renders services valued at $3,000 to a corporation in exchange for stock valued at $38,000. Right after the exchange, she owns 85% of the outstanding stock. No gain is recognized on the exchange of property. However, she must recognize ordinary income of what amount as payment for services she rendered to the corporation?
    A. $3,000
    B. $32,000
    C. $35,000
    D. $38,000

87. Which of the following would generally be reported as other income for a business on *Schedule C - Profit or Loss From Business*?
    A. Proceeds from international sales
    B. Sales tax collected
    C. Bad debts recovered
    D. Income from bartering activities

88. An S corporation will be subject to Excess Net Passive Income Tax:
    A. Even if it has always been an S corporation
    B. It has passive investment income for the year that is at least 20% of gross receipts
    C. Both A and B
    D. None of the above

89. Which of the following items is not a reduction to the basis of an asset?
    A. Casualty loss
    B. Amount received for granting an easement on property
    C. Personal property tax
    D. Rehabilitated Building Credit

90. In computing the ordinary income of a partnership, a deduction is allowed for:
    A. A net operating loss
    B. Guaranteed payments to partners
    C. Short-term capital losses
    D. Contributions to qualified charities

91. In figuring the amount of a distribution by a corporation to its shareholders, the term "property" includes all of the following except:
    A. Money
    B. Indebtedness of the distributing corporation
    C. Stock of the distributing corporation
    D. Securities

92. Tom and Jill form a cash basis general partnership with cash contributions of $20,000 each. They share all partnership profits and losses equally. They borrow $60,000 and purchase depreciable business equipment. Jill, however, is required to pay the creditor if the partnership defaults. Which of the following is correct?
    A. Tom and Jill each have a basis of $80,000 in the partnership
    B. Tom has a basis of $50,000 and Jill has a basis of $80,000 in the partnership
    C. Tom and Jill each have a basis of $50,000 in the partnership
    D. Tom has a basis of $20,000 and Jill has a basis of $80,000 in the partnership

93. Martina is the only shareholder of a corporation that uses the calendar year as its tax year. In January, she uses the worksheet in the Form 5452 instructions to figure her corporation's current year earnings and profits for the previous year. During the year, the corporation made four $1,000 distributions to her. At the end of the year (before subtracting distributions made during the year), the corporation had $10,000 of current year earnings and profits. Since the corporation's current year earnings and profits ($10,000) were more than the amount of the distributions it made during the year ($4,000), all of the distributions are treated as distributions of current year earnings and profits. The corporation must issue a Form 1099-DIV to Martina to report what amount distributed to her during the previous year as dividends?
    A. $0
    B. $1,000
    C. $4,000
    D. $10,000

94. Which of the following is not subject to the uniform capitalization rules?
    - A. Real property or tangible personal property that an individual produces for sale to customers
    - B. Personal property acquired for resale if an individual has average annual gross receipts of more than $10 million
    - C. Property produced under a long-term contract
    - D. Real property or tangible personal property that an individual produces for use in a trade or business

95. Generally, if a corporation has dissolved, its final income tax return must be filed by the 15th day of what month?
    - A. The fourth month after the date it dissolved
    - B. The third month after the date it dissolved
    - C. The fourth month after the end of its established tax year
    - D. The third month after the end of the calendar year

96. Section 197 intangibles are certain intangible assets acquired after August 10, 1993 (after July 25, 1991, if chosen), and held in connection with the conduct of a trade or business or an activity entered into for profit whose costs are amortized over how many years?
    - A. 5 years
    - B. 10 years
    - C. 15 years
    - D. 20 years

97. Generally, the deadline to file *Form 5500 - Annual Return/Report of Employee Benefit Plan* is which of the following?
    - A. Fifteenth day of the fourth month after the end of the plan year
    - B. Fifteenth day of the fifth month after the end of the plan year
    - C. Fifteenth day of the seventh month after the end of the plan year
    - D. Last day of the seventh month after the end of the plan year

98. Which of the following should **not** be reported on Schedule C?
    - A. Promissory notes and other evidences of debt issued to the taxpayer in a sale or exchange of property that is stock in trade or held primarily for sale to customers
    - B. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers
    - C. Any payment he or she receives for the lost income of the business from insurance or other sources if the taxpayer reduces or stops his or her business activities
    - D. Recovery of items previously deducted if the taxpayer recovers a bad debt or any other item deducted in a previous year

99. Ray is a self-employed lawyer. He performs legal services for a client, a small corporation. In payment for his services, Ray receives shares of stock in the corporation with a fair market value (FMV) of $3,000. Ray must include what amount of the shares in income?
    - A. $0
    - B. $1,000
    - C. $2,000
    - D. $3,000

100. A calendar year corporation has a net short-term capital gain of $3,000 and a net long-term capital loss of $9,000. The short-term gain offsets some of the long-term loss, leaving a net capital loss of $6,000. The corporation treats this $6,000 as a short-term loss when carried back or forward. The corporation carries the $6,000 short-term loss back 3 years. In year 1, the corporation had a net short-term capital gain of $8,000 and a net long-term capital gain of $5,000. The result is a net capital gain for year 1 of what amount?
    - A. $5,000
    - B. $7,000
    - C. $8,000
    - D. $13,000

Question 1 - C. A sole proprietorship is a type of business entity that is owned and operated by one individual and in which there is no legal distinction between the owner and the business
By definition, a sole proprietor is someone who owns an unincorporated business by himself or herself. A small business and a sole proprietorship (also known as the sole trader or simply a proprietorship), are types of business entities that are owned and operated by one individual and in which there is no legal distinction between the owner and the business. The owner thus receives all the profits (subject to taxation) and has responsibility for the losses. All assets as well as debts are owned by the proprietor.

Lesson 2 - Sole Proprietor
Source - IRS.GOV - Sole Proprietorships

Question 2 - A. Any income to the business is treated as income to the business owner
A potential downside of a sole proprietorship is that any income to the business is treated as income to the business owner. It is reported on their individual tax return (using Schedule C) and is taxed in the year it is received.

Lesson 2 - Sole Proprietor
Source - IRS.GOV - Sole Proprietorships

Question 3 - C. If an employer withholds income taxes, withholds and pays Social Security and Medicare taxes, and pays unemployment tax on wages paid, then the individual is an employee
It is critical that business owners correctly determine whether the individuals providing services are employees or independent contractors. Generally, the business owner must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. The business owner does not generally have to withhold or pay any taxes on payments to independent contractors.

Lesson 2 - Independent Contractor versus Employee
Source - IRS.GOV - Independent Contractor (Self-Employed) or Employee?

Question 4 - C. An activity is a business if it makes a profit during at least three of the last five tax years, including the current year
The IRS presumes that an activity is carried on for profit if it makes a profit during at least three of the last five tax years, including the current year or at least two of the last seven years for activities that consist primarily of breeding, showing, training or racing horses.

Lesson 2 - Hobby Income versus Business Income
Source - IRS.GOV - Is Your Hobby a For-Profit Endeavor?

Question 5 - A. Dustin must use Schedule C when filing the business return
The taxpayer should use Schedule C (Form 1040) to report income or loss from a business he or she operated or a profession he or she practiced as a sole proprietor. An activity qualifies as a business if:

- The taxpayer's primary purpose for engaging in the activity is for income or profit.
- The taxpayer is involved in the activity with continuity and regularity.

For tax year 2019 and later, the taxpayer will no longer use Schedule C-EZ, but instead will use the Schedule C.

Lesson 2 - Schedule C - Profit or Loss From Business
Source - Schedule C - Profit From Business (Sole Proprietorship)

Question 6 - B. A short tax year that occurs because a business changes to the accrual method of accounting
A return for a period of less than 12 months is required when either a taxpayer's annual accounting period changes or a taxpayer has been in existence for only part of a tax year. Thus, a short tax year cannot occur because a business changes to the accrual method of accounting.

Lesson 1 - Short Tax Year
Source - Publication 538 - Short Tax Year

Question 7 - D. All of the above
Figuring Cost of Goods Sold on Schedule C:

Line 35 - Inventory at beginning of year. If different from last year's closing inventory, attach explanation
Line 36 - Purchases less cost of items withdrawn for personal use.
Line 37 - Cost of labor. Do not include any amounts paid by the taxpayer to him or herself.
Line 38 - Materials and supplies.
Line 39 - Other costs.
Line 40 - Add lines 35 through 39.
Line 41 - Inventory at end of year.
Line 42 - Cost of goods sold. Subtract line 41 from line 40.

Lesson 2 - Figuring Cost of Goods Sold on Schedule C
Source - Publication 334 - Chapter 6 - How To Figure Cost of Goods Sold

Question 8 - C. $500
A calendar year taxpayer cannot deduct expenses in advance, even if he or she pays them in advance. This rule applies to any expense paid far enough in advance to, in effect, create an asset with a useful life extending substantially beyond the end of the current tax year. Noelle can only deduct the premium for 2020 on her 2020 tax return. She can deduct it in 2021 and 2022 the premium allocable to those years.

Lesson 6 - Insurance Expenses
Source - Publication 334 - Chapter 8 - Insurance

Question 9 - D. 3,400 hours
Taxpayers who use their personal residences on a regular basis in the business of providing qualifying day care services do not have to meet the “exclusive use” test in order to deduct business-related expenses. But the daycare business expenses are available only if the taxpayer has applied for and has been granted a license, or certification, or approval as a daycare center under the provisions of applicable state law. For this question the total is 3,400 hours (3,000 hours for weekdays plus 400 hours for Saturdays).

Lesson 2 - Daycare Services
Source - Publication 587 - Daycare Facility

Question 10 - B. She has no SE tax since net income was less than $400
For a sole proprietor, net income (as reported on Schedule C) must be counted as self-employment income. If net income is less than $400, the self-employment tax does not apply.

Lesson 2 - Self-Employment Tax
Source - Publication 334 - Chapter 10 - Self-Employment (SE) Tax

Question 11 - C. $9,200
If the taxpayer uses his or her vehicle for both business and personal purposes, he or she must divide his or her expenses between business and personal use. The taxpayer can divide his or her expenses based on the miles driven for each purpose. In this case, Harvey can claim only 80% (16,000 ÷ 20,000) of the cost of operating the van as a business expense. He then multiplies the number of business miles driven by the standard mileage rate for 2020 of 57.5 cents (16,000 X $0.575 = $9,200).

Lesson 2 - Expenses
Source - Publication 334 - Chapter 9 - Methods for Deducting Car and Truck Expenses

Question 12 - B. $66,492
The regular method is quite simple to use. In 2020, multiply total earnings subject to SE tax by 92.35% (0.9235) to determine net earnings. This is reported on Schedule SE, line 4. Net earnings, calculated using the regular method, are also referred to as actual net earnings.

Lesson 2 - Regular Method
Source - Publication 334 - Chapter 10 - Figuring Earnings Subject to SE Tax

Question 13 - C. Long-term applicable Federal rate as of the day the loan is made
A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the long-term applicable Federal rate. A below-market loan generally is treated as an arm's-length transaction in which the borrower is considered as having received both the following:

- A loan in exchange for a note that requires payment of interest at the long-term applicable Federal rate.
- An additional payment in an amount equal to the forgone interest.

Treat the additional payment as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction.

Lesson 4 - Below-Market Loans
Source - Publication 535 - Business Expenses

Question 14 - D. Victor can use the nonfarm optional method for earnings that do not come from farming activities and only if he has used this method less than 5 years
The taxpayer may use the nonfarm optional method only for earnings that do not come from farming activities. It may be used provided all of the following conditions are met:

- Taxpayer is self-employed on a regular basis. This means that the actual net earnings from self-employment were $400 or more in at least 2 of the 3 tax years before the one for which he or she uses this method. The net earnings can be from either farm or nonfarm earnings or both.
- Taxpayer has used this method less than 5 years. (There is a 5-year lifetime limit.) The years do not have to be consecutive.
- Taxpayer net nonfarm profits were less than $4,894, and also less than 72.189% of gross nonfarm income.

Lesson 2 - Nonfarm Optional Method
Source - Publication 334 - Chapter 10 - Figuring Earnings Subject to SE Tax

Question 15 - B. Taxable income
If the taxpayer is an S corporation shareholder, his or her share of the corporation's current year income or loss and other tax items are taxed to him or her whether or not he or she receives any amount. Generally, those items increase or decrease the basis of the S corporation stock as appropriate.

The taxpayer must increase his or her basis in stock of an S corporation by his or her pro rata share of the following items:

- All income items of the S corporation, including tax-exempt income, that are separately stated and passed through to the taxpayer as a shareholder.
- The non-separately stated income of the S corporation.
- The amount of the deduction for depletion (other than oil and gas depletion) that is more than the basis of the property being depleted.

The taxpayer must decrease his or her basis in stock of an S corporation by his or her pro rata share of the following items:

- Distributions by the S corporation that were not included in the taxpayer’s income.
- All loss and deduction items of the S corporation that are separately stated and passed through to the taxpayer.
- Any non-separately stated loss of the S corporation.
- Any expense of the S corporation that is not deductible in figuring its taxable income and not properly chargeable to a capital account.
- The amount of the taxpayer’s deduction for depletion of oil and gas wells to the extent the deduction is not more than his or her share of the adjusted basis of the wells.

Lesson 5 - Disadvantages of an S Corporation
Source - Publication 550 - S Corporations

Question 16 - A. $18,000
For purposes of determining a partner's distributive share, an interest purchased by one family member from another family member is considered a gift from the seller. The fair market value of the purchased interest is considered donated capital. For this purpose, members of a family include only spouses, ancestors, and lineal descendants (or a trust for the primary benefit of those persons). For this question, of the remaining $36,000 of profit due to capital, at least 50%, or $18,000, must be allocated to the father since he owns a 50% capital interest. The son's share of partnership profit cannot be more than $18,000.

Lesson 3 - Family Partnership
Source - Publication 541 - Family Partnership

Question 17 - C. $4,000
A partner generally recognizes gain on a partnership distribution only to the extent any money (and marketable securities treated as money) included in the distribution exceeds the adjusted basis of the partner's interest in the partnership. Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, he or she generally does not recognize any gain until the sale or other disposition of the property. In this case, the distribution decreases the adjusted basis of Joanne's partnership interest to $4,000 [$14,000 − ($8,000 + $2,000)].

Lesson 3 - Partner's Gain or Loss
Source - Publication 541 - Partner's Gain or Loss

Question 18 - C. $20,000
Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.

Lesson 3 - Partner's Basis for Distributed Property
Source - Publication 541 - Partner's Basis for Distributed Property

Question 19 - D. Property A basis is $44,000 and property B basis is $11,000
To figure his basis in each property, Ken first assigns bases of $5,000 to property A and $10,000 to property B (their adjusted bases to the partnership). This leaves a $40,000 basis increase (the $55,000 allocable basis minus the $15,000 total of the assigned bases). He first allocates $35,000 to property A (its unrealized appreciation). The remaining $5,000 is allocated between the properties based on their fair market values. $4,000 ($40,000/$50,000) is allocated to property A and $1,000 ($10,000/$50,000) is allocated to property B. Ken's basis in property A is $44,000 ($5,000 + $35,000 + $4,000) and his basis in property B is $11,000 ($10,000 + $1,000).

Lesson 3 - Partner's Basis for Distributed Property
Source - Publication 541 - Partner's Basis for Distributed Property

Question 20 - C. $4,800
If contributed property is subject to a debt or if a partner's liabilities are assumed by the partnership, the basis of that partner's interest is reduced (but not below zero) by the liability assumed by the other partners. This partner must reduce his or her basis because the assumption of the liability is treated as a distribution of money to that partner. The other partners' assumption of the liability is treated as a contribution by them of money to the partnership. For this question the basis of Ivan's interest is:

Adjusted basis of contributed property	$8,000
Minus: Part of mortgage assumed by other partners (80% × $4,000)	$3,200
Basis of Ivan's partnership interest	$4,800

Lesson 3 - Adjusted Basis
Source - Publication 541 - Adjusted Basis

Question 21 - D. The trust reports these transactions on Form 1041
The trust does not report these transactions on Form 1041. Instead, a schedule is attached to the Form 1041 showing each stock transaction separately and in the same detail as John Doe (grantor and owner) will need to report these transactions on his Form 8949, Sales and Other Dispositions of Capital Assets and Schedule D (Form 1040). The trust does not net the capital gains and losses, nor does it issue John Doe a Schedule K-1 (Form 1041) showing a $10 long-term capital loss.

Lesson 9 - Grantor Type Trusts
Source - Instructions for Form 1041 - Grantor Type Trusts

Question 22 - C. Sole proprietorship
Several different forms of businesses have been made available to taxpayers over the years. The sole proprietorship is the most common form of business entity. It is not a legal entity separate and apart from its owner. The owner has unlimited liability with regard to the sole proprietorship.

Lesson 2 - Unlimited Liability
Source - IRS.GOV - Sole Proprietorships

Question 23 - D. $15,000
Guaranteed payments are included in income in the partner's tax year in which the partnership's tax year ends. In this case, Erica must include ordinary income of $15,000 ($10,000 guaranteed payment + $5,000 ($50,000 × 10%) distributive share) on her individual income tax return for her tax year in which the partnership's tax year ends.

Lesson 3 - Guaranteed Payments
Source - Publication 541 - Guaranteed Payments

Question 24 - C. $400
In effect, Areta purchased an undivided one-half interest in the depreciable property with her contribution of $10,000. Assuming that the depreciation rate is 10% a year under the General Depreciation System (GDS), she would have been entitled to a depreciation deduction of $500 per year, based on her interest in the partnership, if the adjusted basis of the property equaled its fair market value when contributed. However, since the partnership is allowed only $400 per year of depreciation (10% of $4,000), no more than $400 can be allocated between the partners. The entire $400 must be allocated to Areta.

Lesson 3 - Contribution of Property
Source - Publication 541 - Contribution of Property

Question 25 - C. A gain is realized on the transfer of property to a partnership that would be treated as an investment company if the partnership was incorporated
Usually, neither the partner nor the partnership recognizes a gain or loss when property is contributed to the partnership in exchange for a partnership interest. This applies whether a partnership is being formed or is already operating. The partnership's holding period for the property includes the partner's holding period. However, gain is recognized when property is contributed (in exchange for an interest in the partnership) to a partnership that would be treated as an investment company if it were incorporated.

Lesson 3 - Contribution of Property
Source - Publication 541 - Contribution of Property

Question 26 - D. $65,000
If a corporation has a net operating loss (NOL) for a tax year, the limit of 65% (or 50%) of taxable income does not apply. To determine whether a corporation has an NOL, figure the dividends-received deduction without the 65% (or 50%) of taxable income limit. In this question, if the corporation claims the full dividends-received deduction of $65,000 ($100,000 × 65%) and combines it with an operations loss of $75,000, it will have an NOL of ($40,000). Therefore, the 65% of taxable income limit does not apply. The corporation can deduct the full $65,000.

Lesson 4 - Dividends from Regulated Investment Companies
Source - Publication 542 - Dividends-Received Deduction

Question 27 - C. $200,000
If the taxpayer transfers property (or money and property) to a corporation in exchange for stock in that corporation, and immediately afterward he or she is in control of the corporation, the exchange is usually not taxable. This rule applies both to individuals and to groups who transfer property to a corporation. It also applies whether the corporation is being formed or is already operating.

It does not apply in the following situations:

- The corporation is an investment company.
- The taxpayer transfers the property in a bankruptcy or similar proceeding in exchange for stock used to pay creditors.
- The stock is received in exchange for the corporation's debt (other than a security) or for interest on the corporation's debt (including a security) that accrued while the taxpayer held the debt.

However, to be in control of a corporation, the taxpayer or his or her group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock. Steve and Bruce only own 75% of each class of stock and therefore they are taxed on the $200,000 gain.

Lesson 4 - Property Exchanged for Stock
Source - Publication 542 - Property Exchanged for Stock

Question 28 - D. Form 8832 - Entity Classification Election
An LLC with either a single member or more than one member can elect to be classified as a corporation rather than be classified as a partnership or disregarded entity under the default rules. The taxpayer should file Form 8832 - Entity Classification Election, to elect classification as a C corporation.

Lesson 5 - LLCs Classified as Corporations
Source - Publication 3402 - LLCs Classified as Corporations

Question 29 - C. $1,000
Some expenses the taxpayer pays during the tax year may be part personal and part business. These may include expenses for gasoline, oil, fuel, water, rent, electricity, telephone, automobile upkeep, repairs, insurance, interest, and taxes. The taxpayer must allocate these mixed expenses between their business and personal parts. Generally, the personal part of these expenses is not deductible. The business portion of the expenses is deductible on Schedule F (⅔ of $1,500 = $1,000).

Lesson 10 - Deductible Expenses
Source - Publication 225 - Chapter 4 - Deductible Expenses

Question 30 - B. $500
If the taxpayer has not been applying the general rule (an expense paid in advance is deductible only in the year to which it applies) and/or the 12-month rule to the expenses he or she paid in advance, the taxpayer must obtain approval from the IRS before using the general rule and/or the 12-month rule. Therefore, only $500 (6/36 x $3,000) is deductible in 2020, $1,000 (12/36 x $3,000) is deductible in 2021, $1,000 (12/36 x $3,000) is deductible in 2022, and the remaining $500 is deductible in 2023.

Lesson 1 - Cash Method
Source - Publication 538 - Cash Method

Question 31 - D. $9,600
Generally, the taxpayer reports an advance payment for services to be performed in a later tax year as income in the year he or she receives the payment. However, if the taxpayer receives an advance payment for services he or she agrees to perform by the end of the next tax year, the taxpayer can elect to postpone including the advance payment in income until the next tax year. However, he or she cannot postpone including any payment beyond that tax year. In this case, Ivan must include the entire payment in income in 2020 since part of the services may be performed after the following year.

Lesson 1 - Advance Payment for Services
Source - Publication 538 - Accrual Method

Question 32 - B. $8,000
Special rules apply to including income from advance payments on agreements for future sales or other dispositions of goods held primarily for sale to customers in the ordinary course of a taxpayer's trade or business. However, the rules do not apply to a payment (or part of a payment) for services that are not an integral part of the main activities covered under the agreement. An agreement includes a gift certificate that can be redeemed for goods. Amounts due and payable are considered received. For the tax purposes in this case, Steve includes the $8,000 advance payment in gross income for 2020; and includes the remaining $12,000 of the contract price in gross income for 2021.

Lesson 1 - Advance Payment for Sales
Source - Publication 538 - Accrual Method

Question 33 - C. $400
If the taxpayer contributes inventory (property that he or she sells in the course of his or her business), the amount the taxpayer can claim as a contribution deduction is the smaller of its fair market value on the day he or she contributed it or its basis. The basis of donated inventory is any cost incurred for the inventory in an earlier year that the taxpayer would otherwise include in opening inventory for the year of the contribution. The taxpayer must remove the amount of the contribution deduction from opening inventory. It is not part of the cost of goods sold. If the cost of donated inventory is not included in opening inventory, the inventory's basis is zero and the taxpayer cannot claim a charitable contribution deduction.

Treat the inventory's cost as the taxpayer would ordinarily treat it under his or her method of accounting. For this question, the charitable contribution allowed for 2020 is $400 ($600 − $200). The $200 is the amount that would be ordinary income if she had sold the contributed inventory at fair market value on the date of the gift. The cost of goods sold Jill uses in determining gross income for 2020 must not include the $400. Jill removes that amount from opening inventory for 2020.

Lesson 6 - Cost of Goods Sold
Source - Publication 334 - Chapter 6 - Line 35 Inventory at Beginning of Year

Question 34 - C. $6,000
Generally, rent paid in a trade or business is deductible in the year paid or accrued. If the taxpayer pays rent in advance, he or she can deduct only the amount that applies to the use of the rented property during the tax year. The taxpayer can deduct the rest of the payment only over the period to which it applies. In this case, Gwen can deduct only $6,000 (6/12 × $12,000) for the rent that applies to the first year.

Lesson 6 - Rent Expenses
Source - Publication 535 - Chapter 3 - Rent

Question 35 - D. 20%
A corporation can accumulate its earnings for a possible expansion or other bona fide business reasons. However, if a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax of 20%. If the accumulated earnings tax applies, interest applies to the tax from the date the corporate return was originally due, without extensions.

Lesson 4 - Accumulated Earnings Tax
Source - Publication 542 - Accumulated Earnings Tax

Question 36 - D. $650,000
With the passage and signing into law of the Tax Cuts and Jobs Act, the deduction limit for Section 179 increased to $1,040,000 for 2020. The limit on equipment purchases likewise has increased to $2,590,000. In addition, the deduction now includes any of the following improvements to existing nonresidential property (i.e., the improvement must be placed in service after the date the property itself was first placed in service): roofs; heating, air-conditioning, and ventilation systems; fire protection, alarm, and security systems.

Lesson 7 - Section 179 Dollar Limitations
Source - Publication 946 - Electing the Section 179 Deduction

Question 37 - B. Ken can claim a partial Section 179 deduction
To qualify for the Section 179 deduction, the property must have been acquired by purchase. For example, property acquired by gift or inheritance does not qualify.

Property is not considered acquired by purchase in the following situations:

1. It is acquired by one member of a controlled group from another member of the same group.
2. Its basis is determined either:
   a. In whole or in part by its adjusted basis in the hands of the person from whom it was acquired.
   b. Under the stepped-up basis rules for property acquired from a decedent.
3. It is acquired from a related person.

The machines do not qualify as Section 179 property because Ken and his father are related persons. He cannot claim a Section 179 deduction for the cost of these machines.

Lesson 7 - Property Acquired by Purchase
Source - Publication 946 - Electing the Section 179 Deduction

Question 38 - B. $75
A taxpayer can deduct no more than $25 for business gifts he or she gives directly or indirectly to each person during the tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift. If the taxpayer and his or her spouse both give gifts, both are treated as one taxpayer. It does not matter whether the taxpayers have separate businesses, are separately employed, or whether each has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer. In this case, Bob and Jan can deduct a total of $75 ($25 limit × 3) for the gift baskets.

Lesson 6 - Gift Expenses
Source - Publication 463 - Chapter 3 - Gifts

Question 39 - C. $360
If the taxpayer is liable for part of a business debt, he or she can deduct only his or her share of the total interest paid or accrued. For this question, Rose-Marie can only deduct $360 (60% × $600) for 2020 on Schedule C. The remaining interest of $240 is a nondeductible personal expense.

Lesson 6 - Interest Expenses
Source - Publication 535 - Chapter 4 - Interest You Can Deduct

Question 40 - B. $196
A taxpayer can deduct registration fees for the right to use property within a state or local area. In this case, because May and Julius used the car 70% for business, they can deduct 70% of the $280, or $196, as a business expense.

Lesson 6 - Taxes
Source - Publication 334 - Chapter 8 - Taxes

Question 41 - B. $5,250
Contributions an employer makes for 2020 to a common-law employee's SEP-IRA cannot exceed the lesser of 25% of the employee's compensation or $57,000. Compensation generally does not include the employer's contributions to the SEP. The SEP plan document will specify how the employer contribution is determined and how it will be allocated to participants. In this question, the maximum contribution Angelica can make to Mary's SEP-IRA is $5,250 (25% x $21,000).

Lesson 9 - Simplified Employee Pension Plans (SEP)
Source - Publication 560 - Chapter 2 - SEP Contributions limits

Question 42 - B. June 30, 2021
The employer can deduct SIMPLE IRA contributions in the tax year within which the calendar year for which contributions were made ends. The employer can deduct contributions for a particular tax year if they are made for that tax year and are made by the due date (including extensions) of his or her Federal income tax return for that year. Contributions under a SIMPLE IRA plan for the calendar year 2020 (including contributions made in 2020 before July 1, 2020) are deductible in the tax year ending June 30, 2021.

Lesson 9 - Simplified Employee Pension Plans (SEP)
Source - Publication 560 - Chapter 3 - SIMPLE Contribution Limits

Question 43 - B. $6,000
If the taxpayer elects not to use the uniform capitalization rules, he or she must treat any plant he or she produces as Section 1245 property. If the taxpayer has a gain on the property's disposition, he or she must recapture the pre-productive expenses he or she would have capitalized if he or she had not made the election by treating the gain, up to the amount of these expenses, as ordinary income.

Lesson 10 - Section 1245 Property
Source - Publication 225 - Chapter 9 - Section 1245 Property

Question 44 - D. 100
To qualify for S corporation status, the corporation must meet the following requirements:

- Be a domestic corporation.
- Have only allowable shareholders:
  - Including individuals, certain trust, and estates, and
  - May not include partnerships, corporations or non-resident alien shareholders.
- Have no more than 100 shareholders.
- Have one class of stock.
- Not be an ineligible corporation i.e. certain financial institutions, insurance companies, and domestic international sales corporations.

In order to become an S corporation, the corporation must submit Form 2553 - Election by a Small Business Corporation signed by all the shareholders. The taxpayer's corporation must file the Form 2553 to elect "S" status within two months and 15 days after the beginning of the tax year or any time before the tax year for the status to be in effect.

Lesson 5 - S Corporations
Source - Instructions for Form 2553

Question 45 - B. Watson, Inc. reports the expense in 2019 and Eric reports the income in 2020
Under the cash method, Eric includes in his gross income all items of income he actually or constructively receives during the tax year. If he receives property or services, he must include their fair market value (FMV) in income. Under the accrual method of accounting, generally Watson Inc. reports income in the year it is earned and deducts or capitalizes expenses in the year incurred. The purpose of an accrual method of accounting is to match income and expenses in the correct year.

Lesson 1 - Accounting Methods
Source - Publication 538 - Accounting Methods

Question 46 - C. An exchange of land improved with an apartment house for land improved with a store building
There must be an exchange of like-kind property. Like-kind properties are properties of the same nature or character. The exchange of a copyright on a novel for a copyright on a song is not a like-kind exchange. The rules for like-kind exchanges do not apply to exchanges of the following property:

- Real property use for personal purposes, such as the taxpayer's home.
- Real property held primarily for sale.
- Any personal or intangible property.

Also, Real property located in the United States and real property located outside the United States are not considered like-kind exchanges.

Lesson 8 - Like-Kind Exchanges
Source - Publication 544 - Chapter 1 - Like-kind Exchange

Question 47 - A. The taxpayer and a member of his or her family
Related persons include, for example, the taxpayer and a member of his or her family (spouse, brother, sister, parent, child, etc.), the taxpayer and a corporation in which he or she has more than 50% ownership, the taxpayer and a partnership in which he or she directly or indirectly owns more than a 50% interest of the capital or profits, and two partnerships in which the taxpayer directly or indirectly owns more than 50% of the capital interests or profits.

Lesson 8 - Like-Kind Exchanges Between Related Persons
Source - Publication 544 - Chapter 1 - Like-Kind Exchanges Between Related Persons

Question 48 - B. A general partnership interest for a general partnership interest in the same partnership
Exchanges of partnership interests do not qualify as nontaxable exchanges of like-kind property. This applies regardless of whether they are general or limited partnership interests or are interests in the same partnership or different partnerships. However, under certain circumstances the exchange may be treated as a tax-free contribution of property to a partnership.

Lesson 8 - Other Nontaxable Exchanges
Source - Publication 544 - Chapter 1 - Other Nontaxable Exchanges

Question 49 - C. December 30, 2018, the date when he shipped the merchandise to Ralph
Generally, an accrual basis taxpayer includes an amount in gross income for the tax year in which all events that fix his or her right to receive the income have occurred and he or she can determine the amount with reasonable accuracy.

Under this rule, the taxpayer reports an amount in his gross income on the earliest of the following dates:

- When the taxpayer receives payment.
- When the income amount is due to the taxpayer.
- When the taxpayer earns the income.
- When title has passed.

Lesson 1 - Accrual Method
Source - Publication 538 - Accrual Method

Question 50 - C. Goods the taxpayer has sent out on consignment for someone else to sell
The taxpayer should include the following items when accounting for inventory:

1. Merchandise or stock in trade.
2. Raw materials.
3. Work in process.
4. Finished products.
5. Supplies that physically become a part of the item intended for sale.

Containers such as kegs, bottles, and cases, regardless of whether they are on hand or returnable, should be included in inventory if title has not passed to the buyer of the contents. If title has passed to the buyer, exclude the containers from inventory.

The following merchandise should be included in inventory:

- Purchased merchandise if title has passed to the taxpayer, even if the merchandise is in transit or the taxpayer does not have physical possession for another reason.
- Goods under contract for sale that the taxpayer has not yet segregated and applied to the contract
- Goods out on consignment.
- Goods held for sale in display rooms, merchandise mart rooms, or booths located away from the taxpayer's place of business.

The taxpayer does not include the following merchandise in inventory:

- Goods he or she has sold, but only if title has passed to the buyer.
- Goods consigned to the taxpayer.
- Goods ordered for future delivery if the taxpayer does not yet have title.

Lesson 6 - Items Generally Included in Inventory
Source - IRS.GOV - Inventory - Manufacturing Tax Tips

Question 51 - D. Travel reimbursements paid at the Federal Government per diem rate
Supplemental wages are wage payments to an employee that are not regular wages. They include, but are not limited to, bonuses, commissions, overtime pay, payments for accumulated sick leave, severance pay, awards, prizes, back pay, retroactive pay increases, and payments for nondeductible moving expenses. Other payments subject to the supplemental wage rules include taxable fringe benefits and expense allowances paid under a nonaccountable plan. Vacation pay is subject to withholding as if it were a regular wage payment. When vacation pay is in addition to regular wages for the vacation period, treat it as a supplemental wage payment.

Lesson 6 - Supplemental Wages
Source - Publication 15 - Supplemental Wages

Question 52 - B. $45
Taxpayers may still generally deduct 50% of the food and beverage expenses associated with operating their trade or business. For example, employers may deduct expenses incurred to provide meals consumed by employees on work travel. The taxpayer can also deduct the cost of meals if it is necessary for him or her to stop for substantial sleep or rest to properly perform his or her duties while traveling away from home on business.

The taxpayer cannot deduct expenses for meals that are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable based on the facts and circumstances. Meal expenses will not be disallowed merely because they are more than a fixed dollar amount or because the meals take place at deluxe restaurants, hotels, or resorts.

The 50% limit will apply after determining the amount that would otherwise qualify for a deduction. The taxpayer first has to determine the amount of meal expenses that would be deductible. In this question, $110 of the amount is not allowable because it is lavish and extravagant, the remaining $90 is subject to the 50% limit. Griselda's deduction cannot be more than $45 (50% (0.50) × $90).

Lesson 6 - Meals
Source - Publication 463 - Travel, Gift, and Car Expenses

Question 53 - A. 0%
An employee can claim a depreciation deduction for the use of his or her listed property (whether owned or rented) in performing services as an employee only if his or her use is a business use. The use of the employee's property in performing services as an employee is a business use only if both the following requirements are met:

- The use is for the employer's convenience.
- The use is required as a condition of the employee's employment.

If these requirements are not met, the employee cannot deduct depreciation (including the Section 179 deduction) or rent expenses for his or her use of the property as an employee.

Lesson 7 - Can Employees Claim a Deduction?
Source - Publication 946 - Chapter 5 - Can Employees Claim a Deduction?

Question 54 - C. Oil refinery
Depletion is a measure of the cost recovery of a natural resource as it is extracted and sold. Since the resource will not be replaced the taxpayer can take a deduction to account for this. Natural resources include but are not limited to mines, oil and gas wells, timber and any exhaustible natural deposit.

Lesson 2 - Expenses
Source - Publication 535 - Business Expenses

Question 55 - D. Food and beverage expenses that are associated with operating a trade or business
The TCJA repeals the exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to the active conduct of the taxpayer's trade or business. The new law also repeals the related rule applying a 50% limit to such deductions. Taxpayers may still generally deduct 50% of the food and beverage expenses associated with operating their trade or business. For example, employers may deduct expenses incurred to provide meals consumed by employees on work travel.

Lesson 6 - Elimination of Entertainment Expenses
Source - Publication 463 - Travel, Gift, and Car Expenses

Question 56 - A. The taxpayer's home is the only fixed location of his or her business of selling mechanics' tools at retail. The taxpayer regularly uses his or her walk-in closet for storage of inventory and product samples. The taxpayer also uses this area occasionally for personal purposes
To qualify to deduct expenses for business use of the taxpayer's home, he or she must use part of his or her home:

- Exclusively and regularly as the taxpayer's principal place of business.
- Exclusively and regularly as a place where the taxpayer meets or deal with patients, clients, or customers in the normal course of his or her trade or business.
- In the case of a separate structure which is not attached to the taxpayer's home, in connection with his or her trade or business.
- On a regular basis for certain storage use.
- For rental use.
- As a daycare facility.

Additionally, the home office will qualify as a principal place of business if the taxpayer meets the following requirements.

- He or she uses it exclusively and regularly for administrative or management activities of his or her trade or business.
- He or she has no other fixed location where he or she conduct substantial administrative or management activities of his or her trade or business.

Lesson 2 - Business Use of the Home
Source - Publication 587 - Qualifying for a Deduction

Question 57 - D. A depreciable capital expenditure
Generally, the taxpayer cannot deduct taxes charged for local benefits and improvements that tend to increase the value of his or her property. These include assessments for streets, sidewalks, water mains, sewer lines, and public parking facilities. The taxpayer should increase the basis of his or her property by the amount of the assessment.

Lesson 6 - Real Estate Taxes
Source - Publication 535 - Chapter 5 - Real Estate Taxes

Question 58 - C. Deduct $5,000 and amortize the remaining $5,000 over 180 months
Business start-up and organizational costs are generally capital expenditures. However, the taxpayer can elect to deduct up to $5,000 of business start-up and $5,000 of organizational costs paid or incurred after October 22, 2004. The $5,000 deduction is reduced by the amount his or her total start-up or organizational costs exceed $50,000. The costs that are not deducted currently can be amortized ratably over a 180-month period.

Lesson 4 - Costs of Going Into Business
Source - Publication 535 - Chapter 7 - Business Start-Up and Organizational Costs

Question 59 - D. $100,000
Cash payments to an organization, charitable or otherwise, may be deductible as business expenses if the payments are not charitable contributions or gifts and are directly related to the taxpayer's business. If the payments are charitable contributions or gifts, he or she cannot deduct them as business expenses. However, corporations (other than S corporations) can deduct charitable contributions on their income tax returns, subject to limitations. See the Instructions for Form 1120 for more information. Sole proprietors, partners in a partnership, or shareholders in an S corporation may be able to deduct charitable contributions made by their business on Schedule A (Form 1040). Dennis' payment is not a charitable contribution. He can deduct it as a business expense.

Lesson 6 - Charitable Contributions
Source - Publication 535 - Chapter 11 - Miscellaneous Expenses

Question 60 - D. Capitalized and added to the basis of the land where the demolished structure was located
Amounts paid or incurred to demolish a structure are not deductible. These amounts are added to the basis of the land where the demolished structure was located. Any loss for the remaining undepreciated basis of a demolished structure would not be recognized until the property is disposed of.

Lesson 6 - Demolition Expenses or Losses
Source - Publication 535 - Chapter 11 - Miscellaneous Expenses

Question 61 - A. March 31
The rules for the required tax year for partnerships are as follows.

- If one or more partners having the same tax year own a majority interest (more than 50%) in partnership profits and capital, the partnership must use the tax year of those partners.
- If there is no majority interest tax year, the partnership must use the tax year of all its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.
- If there is no majority interest tax year and the principal partners do not have the same tax year, the partnership generally must use a tax year that results in the least aggregate deferral of income to the partners.

Because one of the partners (the corporation) owns 60% interest, the partnership must use its fiscal tax year ending on March 31.

Lesson 1 - Partnership
Source - Publication 538 - Partnerships, S Corporations, and Personal Service Corporations (PSCs)

Question 62 - B. Bill's at $1,400 and Jimmy's at $2,000
If a partner contributes property to a partnership, the partnership's basis for determining depreciation, depletion, gain, or loss for the property is the same as the partner's **adjusted basis** for the property when it was contributed, increased by any gain recognized by the partner at the time of contribution.

Lesson 3 - Contribution of Property
Source - Publication 541 - Contribution of Property

Question 63 - C. Fees received for services performed as a notary public
Fees received for services performed as a notary public are not subject to self-employment tax. If the taxpayer had no other income subject to SE tax, enter "Exempt - Notary" on Schedule 2 (Form 1040), line 4. Do not file Schedule SE.

Lesson 2 - Income/Loss NOT Included in Net Earnings from Self-Employment
Source - Schedule SE Instructions - Income and Losses Not Included in Net Earnings From Self-Employment

Question 64 - C. Dallas Partnership has two partners in 2020 - Joe Dallas, an individual, and Deer, Inc. a corporation. Dallas Partnership averaged annual gross receipts are $6,500,000
The following entities cannot use the cash method, including any combination of methods that includes the cash method:

- A corporation (other than an S corporation) with average annual gross receipts exceeding $5 million.
- A partnership with a corporation (other than an S corporation) as a partner, and with the partnership having average annual gross receipts exceeding $5 million.
- A tax shelter.

Lesson 1 - Excluded Entities
Source - Publication 538 - Cash Method

Question 65 - B. $175,000
If the taxpayer holds property for personal use and then change it to business use or use it to produce rent, he or she must figure its basis for depreciation. An example of changing property held for personal use to business use would be renting out a former main home.

The basis for depreciation is the lesser of the following amounts:

- The fair market value (FMV) of the property on the date of the change.
- The taxpayer's adjusted basis on the date of the change.

In this case the taxpayer's basis for depreciation of $175,000 (land is not depreciable; the taxpayer only includes the cost of the house when figuring the basis for depreciation) is less than the FMV of $225,000. Therefore, the basis for depreciation is $175,000.

Lesson 7 - Property Changed to Business or Rental Use
Source - Publication 551 - Property Changed to Business or Rental Use

Question 66 - A. $85,000
If the taxpayer acquires property in a like-kind exchange, the basis of that property is generally the same as the basis of the property he or she transferred. If, in addition to giving up like-kind property, the taxpayer pays money in a like-kind exchange, he or she still has no recognized gain or loss. The basis of the property received is the basis of the property given up, increased by the money paid.

Lesson 8 - Like-Kind Exchanges
Source - Publication 544 - Chapter 1 - Like-kind Exchange

Question 67 - D. $4,500
If the taxpayer trades property in a like-kind exchange and also pays money, the basis of the property received is the basis of the property he or she gave up increased by the money he or she paid.

Lesson 8 - Like-Kind Exchanges
Source - Publication 551 - Nontaxable Exchanges

Question 68 - D. $55,000
A taxable exchange is one in which the gain is taxable or the loss is deductible. A taxable gain or deductible loss is also known as a recognized gain or loss. If the taxpayer receives property in exchange for other property in a taxable exchange, the basis of property he or she receives is usually its FMV at the time of the exchange. A taxable exchange occurs when the taxpayer receives cash or property not similar or related in use to the property exchanged.

$20,000 gain (100,000- 80,000) + $30,000 (mortgage assumed by purchasing party) + $10,000(cash received) - $5,000 (closing costs) = $55,000 gain

Lesson 8 - Taxable Exchanges
Source - Publication 551 - Taxable Exchanges

Question 69 - B. Deduct $3,000 and amortize the remaining $49,000 over 180 months
Business start-up and organizational costs are generally capital expenditures. However, the taxpayer can elect to deduct up to $5,000 of business start-up and $5,000 of organizational costs paid or incurred after October 22, 2004. The $5,000 deduction is reduced by the amount his or her total start-up or organizational costs exceed $50,000. The costs that are not deducted currently can be amortized ratably over a 180-month period.

Lesson 4 - Costs of Going Into Business
Source - Publication 535 - Chapter 7 - Business Start-Up and Organizational Costs

Question 70 - C. $2,250
Gain on the sale of raised livestock is generally the gross sales price reduced by any expenses of the sale. Expenses of sale include sales commissions, freight or hauling from a farm to a commission company, and other similar expenses. The basis of the animal sold is zero if the costs of raising it were deducted during the years the animal was being raised (in this case it was). Therefore $2,500 - $250 = $2,250 is correct.

Lesson 10 - Livestock
Source - Publication 225 - Chapter 8 - Livestock

Question 71 - A. $600
Organizational costs include the following fees for partnerships:

- Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of the partnership agreement.
- Accounting fees for services incident to the organization of the partnership.
- Filing fees.

The following non-qualifying costs cannot be amortized:

- The cost of acquiring assets for the partnership or transferring assets to the partnership.
- The cost of admitting or removing partners, other than at the time the partnership is first organized.
- The cost of making a contract concerning the operation of the partnership trade or business including a contract between a partner and the partnership.
- The costs for issuing and marketing interests in the partnership such as brokerage, registration, and legal fees and printing costs. These “syndication fees” are capital expenses that cannot be depreciated or amortized.

Lesson 3 - Costs of Organizing a Partnership
Source - Publication 535 - Chapter 8 - Costs of Organizing a Partnership

Question 72 - D. $60,000
The taxpayer must know the basis of his or her property to determine whether he or she has a gain or loss from its sale or other disposition. The basis of property the taxpayer buys is usually its cost. The question is looking for the gain of XYZ Partnership and it bought the land for only $100,000 which is their basis in the land. When they sold it for $160,000, they realized a gain of $60,000

Lesson 8 - Basis
Source - Publication 544 - Chapter 1 - Gain or Loss From Sales and Exchange

Question 73 - C. Ordinary income of $1,500, the amount of cash he received
The income or loss realized by a partner upon the sale or exchange of its interest in unrealized receivables and inventory items, is the amount that would have been allocated to the partner if the partnership, in this case ($4000 = FMV of $8,000 in inventory), had sold all of its property for cash at fair market value, in a fully taxable transaction, immediately prior to the partner's transfer of interest in the partnership. Any gain or loss recognized that is attributable to the unrealized receivables and inventory items will be ordinary gain or loss.

To determine gain or loss, first take the amount realized ($5,000) and subtract it from the adjusted basis of the partner. $5,000 - $3,500 = $1,500 of ordinary income. Because the partnership has "hot assets" or inventory which produces ordinary income, Archie's share of assets is $4,000 which is half of the FMV of the inventory. $1,500 is less than so $4,000 Archie has an ordinary loss of $2,500 ($4,000 - $1,500).

Lesson 3 - Disposition of Partner's Interest
Source - Publication 541 - Disposition of Partner's Interest

Question 74 - A. $0
Eligible small employers use Form 8881 - Credit for Small Employer Pension Plan Startup Costs to claim the credit for qualified startup costs incurred in establishing or administering an eligible employer plan. The credit is allowed under Section 45E and is part of the general business credit. The taxpayer may elect, however, to have Section 45E not apply for the tax year the credit is available by not claiming it on his or her tax return for that year. The question does not mention any election that Gary made and so he takes the credit in 2021 when the plan becomes effective.

Lesson 3 - Credit for Small Employer Pension Plan Startup Costs
Source - Form 8881 - Credit for Small Employer Pension Plan Startup Costs

Question 75 - C. $10,000 ordinary gain and $20,000 capital gain
As previously mentioned, the way to figure the ordinary gain and capital gain whenever a partner sells his or her interest in a partnership is to first find out how much of ordinary income is his or her share. And since Michael's share of interest has a zero basis, he treats the entire $30,000 as a gain. However, he realizes $10,000 as an ordinary gain and the remainder $20,000 as a capital gain.

Lesson 3 - Partner's Gain or Loss
Source - Publication 541 - Partner's Gain or Loss

Question 76 - B. $5,000
Employers use Form 8882 - Credit for Employer-Provided Childcare Facilities and Services credit for qualified childcare facility and resource and referral expenditures. The credit is part of the general business credit. The employer may claim the credit any time within 3 years from the due date of his or her return on either an original or amended return.

The credit is 25% of the qualified childcare facility expenditures plus 10% of the qualified childcare resource and referral expenditures paid or incurred during the tax year. The credit is limited to $150,000 per tax year. In this question $20,000(0.25) + $0(0.10) = $5,000

Lesson 3 - Credit for Employer-Provided Childcare Facilities and Services
Source - Form 8882 - Credit for Employer-Provided Childcare Facilities and Services

Question 77 - D. $15,000 capital gain
The equipment that Linda contributed is a capital asset. She has no share in ordinary income owed to her. Moreover, her adjusted basis involves the $10,000 in equipment and the $12,500 in liabilities. Linda recognizes $25,000 + $12,500 = $37,500 then subtract the adjusted basis from this amount [$37,500 - $22,500 = $15,000] and the entire amount is a capital gain.

Lesson 8 - Sale or Exchange of Partnership Interest
Source - IRS.GOV - Partnership - Audit Technique Guides

Question 78 - A. $0
Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership's income. A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income. However, guaranteed payments are included in income in the partner's tax year in which the partnership's tax year ends. Therefore, the guaranteed payments will not be reported in income until 2020.

Lesson 3 - Guaranteed Payments
Source - Publication 541 - Guaranteed Payments

Question 79 - C. $61,250
In order to find the total gain that can be postponed:

1) Divide the total income realized from the sale of all livestock in the class during the tax year ($236,250) by the total number of such livestock sold (135) = $1,750 per head.

2) Multiply the result in (1) by the excess number of such livestock sold solely because of weather-related conditions (135 -100 = 35)

The income that can be postponed until 2020 is $61,250 [($236,250 ÷ 135) × 35].

Lesson 10 - Sales Caused by Weather-Related Conditions
Source - Publication 225 - Chapter 3 - Sales Caused by Weather-Related Conditions

Question 80 - C. $1,000 60% long-term and 40% short-term capital loss
A Section 1256 contract that the taxpayer holds at the end of the tax year will generally be treated as sold at its fair market value on the last business day of the tax year, and he or she must recognize any gain or loss that results. That gain or loss is taken into account in figuring the taxpayer’s gain or loss when he or she later disposes of the contract. Under the marked-to-market system, 60% of the taxpayer's capital gain or loss will be treated as a long-term capital gain or loss, and 40% will be treated as a short-term capital gain or loss.

This is true regardless of how long he or she actually held the property. In this case, because Enrique recognized a $7,000 gain on his 2019 return, he recognizes a $1,000 loss ($57,000 − $56,000) on his 2020 tax return, treated as 60% long-term and 40% short-term capital loss.

Lesson 8 - Section 1256 - Contracts Marked to Market
Source - Publication 550 - Chapter 4 - Marked-to-Market Rules

Question 81 - A. $0
For 2020, the treatment of certain meals and entertainment expenses has changed. In general, entertainment expenses are no longer deductible. Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Facilities used in connection with entertainment and related membership dues (such as country club dues) are also nondeductible. Meal expenses are limited to 50% unless an exception applies.

Lesson 6 - Elimination of Entertainment Expenses
Source - Publication 463 - Travel, Gift, and Car Expenses

Question 82 - B. $3,750
Organizational costs include the following fees:

- Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of the partnership agreement.
- Accounting fees for services incident to the organization of the partnership.
- Filing fees.

The following non-qualifying costs cannot be amortized:

- The cost of acquiring assets for the partnership or transferring assets to the partnership.
- The cost of admitting or removing partners, other than at the time the partnership is first organized.
- The cost of making a contract concerning the operation of the partnership trade or business including a contract between a partner and the partnership.
- The costs for issuing and marketing interests in the partnership such as brokerage, registration, and legal fees and printing costs. These “syndication fees” are capital expenses that cannot be depreciated or amortized.

The only amounts that S&B Partnership can elect to amortize as organizational costs are $2,500 + $250 + $1,000 = $3,750.

Lesson 3 - Costs of Organizing a Partnership
Source - Publication 535 - Chapter 8 - Costs of Organizing a Partnership

Question 83 - B. $16,000
If the taxpayer holds property for personal use and then change it to business use or use it to produce rent, he or she must figure its basis for depreciation. An example of changing property held for personal use to business use would be renting out a former main home. The basis for depreciation is the lesser of the following amounts:

- The FMV of the property on the date of the change.
- The taxpayer’s adjusted basis on the date of the change.

The FMV on the date of the change is $17,000. The adjusted basis is $18,000 - $2,000 (the deduction taken) = $16,000 so the John uses the $16,000 as the basis.

Lesson 7 - Property Changed to Business or Rental Use
Source - Publication 551 - Property Changed to Business or Rental Use

Question 84 - B. $500,000
The basis of the property the taxpayer receives is the same as the basis of the property he or she gave up. Exchange expenses are generally the closing costs the taxpayer pays. They include such items as brokerage commissions, attorney fees, deed preparation fees, etc. Add them to the basis of the like-kind property received. The increases to basis are the exchange expenses ($25,000) and the assumption of mortgage of the other building ($200,000) which in total is $400,000 + $225,000 = $625,000. However, there is a decrease in basis with the other party agreeing to assume Sally's mortgage of $125,000 which results in $625,000 -$125,000 = $500,000 as the adjusted basis of the new building exchanged.

Lesson 8 - Like-Kind Exchanges
Source - Publication 551 - Nontaxable Exchanges

Question 85 - B. $104,000
At the end of 2018, the basis of the warehouse for Rich Inc. is $97,000 ($100,000 - $3,000 (deduction)). On January 1, 2020, the basis of the warehouse is $104,000 because $97,000 + $2,000 (legal bill) = $99,000 + $10,000 (second-floor addition) = $109,000 - $5,000 (deduction from warehouse asset depreciation) = $104,000.

Lesson 8 - Adjusted Basis
Source - Publication 551 - Adjusted Basis

Question 86 - D. $172,000
Section 170(b)(2) limits the charitable contribution deduction to 25% of a corporation's taxable income computed before the charitable contribution deduction, dividends-received deduction, and capital loss carryback. ABC's base amount to which the percentage limitation should be applied in computing the charitable contribution deduction is $172,000 ($160,000 operating income + $10,000 contributions + $2,000 dividends).

Lesson 6 - Charitable Contributions
Source - Publication 542 - Charitable Contributions

Question 87 - D. $700
Additional depreciation includes all depreciation adjustments to the basis of Section 1250 property whether allowed to the taxpayer or another person (as carryover basis property). In this question, at the time of sale, the additional depreciation is $700 ($500 allowed the father plus $200 allowed the son).

Lesson 8 - Section 1250 Property
Source - Publication 544 - Chapter 3 - Section 1250 Property

Question 88 - B. Carl owns 4% of the capital interest in FTP Company
Regarding simplified employee pension plans, a highly compensated employee is one who either:

- Owned more than 5% of the capital or profits interest in the employer at any time or
- Received compensation last year of more than $125,000 and, if the employer so elects, was in the top 20% of employees when ranked by compensation.

Lesson 9 - Prohibited Transactions
Source - GPO.GOV - 26 USC Section 414 - Definitions and special rules

Question 89 - D. Stan, a limited partner, received $5,400 as his distributive share of the partnership income
Under Section 1402(a) and Reg. 1.1402(a)-1, net earnings from self-employment include the net income from a trade or business, guaranteed payments for services from a partnership, and a general partner's distributive share of income from a partnership (whether the partner is active or not). Director's fees are self-employment income. Special rules apply to limited partners in determining self-employment income. Per Section 1402(a)(13) there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in Section 707 (c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

Lesson 3 - Partnership Distributions
Source - GPO.GOV - 26 USC Section 1402 - Definitions

Question 90 - A. A right to receive tangible property or services under a contract or granted by a governmental agency
Section 197 intangibles include goodwill, going-concern value, and covenants not to compete entered into in connection with a trade or business acquisition; workforce in place; information base; know-how; any customer- or supplier-based intangible; any license, permit, or other right granted by a governmental unit or agency; and any franchise, trademark, or trade name.

Lesson 7 - Section 197 Intangibles
Source - Publication 535 - Chapter 8 - Section 197 Intangibles

Question 91 - D. $325
Only $200 (50%) of the meal expense is deductible, and the deduction for gifts to clients is limited to $25 per person. Here, Mr. and Mrs. Harris gave each of five clients a $40 gift. They may deduct $125 of this $200 gift expense.

Lesson 6 - Travel, Meals, and Entertainment
Source - Publication 463 - Chapter 2 - Entertainment

Question 92 - D. As a MACRS deduction
Section 168(i)(8) provides that the cost of any building erected or improvements made on leased property is recovered as a MACRS deduction. This means the recovery period is determined by the type of property the improvements consist of, regardless of the remaining term of the lease.

Lesson 7 - Methods of Depreciation
Source - Publication 946 - Chapter 3 - Claiming the Special Depreciation Allowance

Question 93 - C. Gains from the sale of investment stock (securities)
Gross income from farming includes gross farm income, gross farm rental income, and gains from the sale of livestock. Gains from the sale of investment stock are neither farming related nor included in gross income from farming.

Lesson 10 - Special Estimated Tax Rules for Qualified Farmers
Source - Publication 225 - Chapter 15 - Special Estimated Tax Rules for Qualified Farmers

Question 94 - D. Must comply with the Code provisions regarding installment payments of estimated income tax by corporations
Exempt organizations subject to tax on UBTI are required to comply with the Code provisions regarding installment payments of estimated income tax by corporations

Lesson 9 - Unrelated Business Taxable Income (UBTI)
Source - IRS.GOV - Unrelated Business Income Tax

Question 95 - C. $7,000
The distributable net income from the trust equals $7,000 ($2,000 taxable interest + $6,000 capital gains – $1,000 fiduciary fee). The capital gains are included since the trust instrument allocates capital gains to income.

Lesson 9 - Distributable Net Income (DNI)
Source - Instructions for Form 1041

Question 96 - B. Each shareholder's adjusted basis in the corporation's stock
Section 6037 prescribes the requirements for information to be included in an S corporation tax return. There is no requirement that each shareholder's adjusted basis in the corporation's stock be included.

Lesson 5 - Return of S Corporation
Source - GPO.GOV - 26 USC Section 6037 - Return of S Corporation

Question 97 - D. $3,600
Generally, the tax return (Form 1065) is due by the 15th day of the third month following the close of the tax year. A penalty is assessed against the partnership if it is required to file a partnership return and it (a) fails to file the return by the due date, including extensions, or (b) files a return that fails to show all the information required, unless such failure is due to reasonable cause. The penalty is $200 for each month or part of a month (for a maximum of 12 months) the failure continues, multiplied by the total number of persons who were partners in the partnership during any part of the partnership's tax year for which the return is due. Therefore, the return was 8½ months late with two partners for a total of a $3,600 penalty (2 partners × $200/month × 9 months late).

Lesson 3 - Late Filing of Return
Source - Instructions for Form 1065

Question 98 - B. $9,450
The taxable income of a personal service corporation is taxed at a flat rate of 21%. Therefore, Consultants, Inc., will have a $9,450 tax liability ($45,000 × 21%).

Lesson 4 - Personal Service Corporations
Source - Publication 542 - Tax Rate Schedule

Question 99 - D. $11,000

If the taxpayer or his or her spouse actively participated in a passive rental real estate activity, the amount of the passive activity loss that is disallowed is decreased and he or she therefore can deduct up to $25,000 of loss from the activity from his or her nonpassive income. This special allowance is an exception to the general rule disallowing the passive activity loss. Similarly, the taxpayer can offset credits from the activity against the tax on up to $25,000 of nonpassive income after taking into account any losses allowed under this exception.

In this question, Cathy can use $15,000 of her $26,000 loss to offset her $15,000 passive income from the partnership. She actively participated in her rental real estate activities, so she can use the remaining $11,000 rental real estate loss to offset $11,000 of her nonpassive income (wages).

Lesson 9 - Rental Property
Source - Publication 925 - Passive Activity and At-Risk Rules

Question 100 - A. Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership

The sale or exchange of an interest in a going partnership is similar to the sale of stock in a corporation. The gain or loss on the sale of the partnership interest is a capital gain or loss, subject to long- or short-term treatment depending upon the length of time the selling partner owned the interest in the partnership. The rule also applies to the sale of a partial interest in a partnership. An exception to this rule applies when the partnership owns unrealized receivables or inventory. In this case, the selling partner must allocate a portion of the sales proceeds to the unrealized receivables and to the inventory and, to that extent, will realize ordinary income.

Lesson 3 - Partner's Gain or Loss
Source - Publication 541 - Partner's Gain or Loss

Question 1 - B. $60,000
Steve's basis for the distributed property is limited to $60,000 ($100,000 − $40,000, the cash he receives).

Lesson 3 - Adjusted Basis
Source - Publication 541 - Adjusted Basis

Question 2 - A. Property C basis is $15,000 and property D basis is $5,000
To figure his basis in each property, Armando first assigns bases of $15,000 to property C and $15,000 to property D (their adjusted bases to the partnership). This leaves a $10,000 basis decrease (the $30,000 total of the assigned bases minus the $20,000 allocable basis). He allocates the entire $10,000 to property D (its unrealized depreciation). Armando's basis in property C is $15,000 and his basis in property D is $5,000 ($15,000 − $10,000).

Lesson 3 - Partner's Basis for Distributed Property
Source - Publication 541 - Partner's Basis for Distributed Property

Question 3 - C. $400
The adjusted basis of a partner's interest is determined without considering any amount shown in the partnership books as a capital, equity, or similar account. The adjusted basis of Enzo's interest is only $400 and the adjusted basis of his partner's interest is $1,000.

Lesson 3 - Adjusted Basis
Source - Publication 541 - Adjusted Basis

Question 4 - B. $2,000
If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's distributive share of the partnership income before taking into account the guaranteed payment. The guaranteed payment that can be deducted by the partnership is $2,000 ($8,000 − $6,000). Divya's income from the partnership is $8,000, and the remaining $12,000 of partnership income will be reported by the other partners in proportion to their shares under the partnership agreement.

Lesson 3 - Guaranteed Payments
Source - Publication 541 - Guaranteed Payments

Question 5 - D. $10,000
Guaranteed payments are included in income in the partner's tax year in which the partnership's tax year ends. Lamont must include these guaranteed payments in income for 2020 and report them on his 2020 income tax return.

Lesson 3 - Guaranteed Payments
Source - Publication 541 - Guaranteed Payments

Question 6 - A. $5,000
Kumar realizes $25,000 from the sale of his partnership interest ($10,000 cash payment + $15,000 liability relief). He reports $5,000 ($25,000 realized − $20,000 basis) as a capital gain.

Lesson 8 - Sale or Exchange of Partnership Interest
Source - IRS.GOV - Partnership - Audit Technique Guides

Question 7 - A. $0
Usually, neither the partner nor the partnership recognizes a gain or loss when property is contributed to the partnership in exchange for a partnership interest. This applies whether a partnership is being formed or is already operating. The partnership's holding period for the property includes the partner's holding period.

Lesson 3 - Contribution of Property
Source - Publication 541 - Contribution of Property

Question 8 - B. $45,500
If a corporation has a net operating loss (NOL) for a tax year, the limit of 65% (or 50%) of taxable income does not apply. To determine whether a corporation has an NOL, figure the dividends-received deduction without the 65% (or 50%) of taxable income limit.

In this question, because the corporation will not have a NOL after applying a full dividends-received deduction, its allowable dividends-received deduction is limited to 65% of its taxable income, or $45,500 ($70,000 × 65%).

Lesson 4 - Dividends from Regulated Investment Companies
Source - Publication 542 - Dividends-Received Deduction

Question 9 - A. $0
If the taxpayer transfers property (or money and property) to a corporation in exchange for stock in that corporation (other than nonqualified preferred stock), and immediately afterward he or she is in control of the corporation, the exchange is usually not taxable. This rule applies both to individuals and to groups who transfer property to a corporation.

Lesson 4 - Property Exchanged for Stock
Source - Publication 542 - Property Exchanged for Stock

Question 10 - C. $484
A taxpayer's rental expense deductions may be limited. If the taxpayer owns a part interest in rental property, he or she can deduct expenses he or she paid according to his or her percentage of ownership. In this question, Roger can deduct $484 (50% × $968) as a rental expense on his income tax return. He is entitled to reimbursement for the remaining half from the co-owner.

Lesson 9 - Rental Expenses
Source - Publication 527 - Residential Rental Property

Question 11 - B. $5,000
Prepaid farm supplies include the following items if paid for during the year:

- Feed, seed, fertilizer, and similar farm supplies not used or consumed during the year, but not including farm supplies that the taxpayer would have consumed during the year if not for a fire, storm, flood, other casualty, disease, or drought.
- Poultry (including egg-laying hens and baby chicks) bought for use (or for both use and resale) in the taxpayer's farm business. However, include only the amount that would be deductible in the following year if he or she had capitalized the cost and deducted it ratably over the lesser of 12 months or the useful life of the poultry.
- Poultry bought for resale and not resold during the year.

If the taxpayer uses the cash method of accounting to report his or her income and expenses, the deduction for prepaid farm supplies in the year he or she pays for them may be limited to 50% of the other deductible farm expenses for the year (all Schedule F deductions except prepaid farm supplies). This limit does not apply if the taxpayer meets certain exceptions.

Her deduction for prepaid farm supplies cannot be more than $5,000 (50% of $10,000) for 2020. The excess prepaid farm supplies expense of $500 ($5,500 − $5,000) is deductible in a later tax year when she uses or consumes the supplies.

Lesson 10 - Prepaid Farm Supplies
Source - Publication 225 - Chapter 4 - Prepaid Farm Supplies

Question 12 - D. $10,000
An expense a taxpayer pays in advance is deductible only in the year to which it applies, unless the expense qualifies for the 12-month rule. Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain rights or benefits for the taxpayer that do not extend beyond the earlier of the following:

- 12 months after the right or benefit begins.
- The end of the tax year after the tax year in which payment is made.

If the taxpayer has not been applying the general rule (an expense paid in advance is deductible only in the year to which it applies) and/or the 12-month rule to the expenses he or she paid in advance, the taxpayer must obtain approval from the IRS before using the general rule and/or the 12-month rule. For this question, the 12-month rule applies. Therefore, the full $10,000 is deductible in 2020.

Lesson 1 - Cash Method
Source - Publication 538 - Cash Method

Question 13 - B. $800
Generally, the taxpayer reports an advance payment for services to be performed in a later tax year as income in the year he or she receives the payment. However, if the taxpayer receives an advance payment for services he or she agrees to perform by the end of the next tax year, the taxpayer can elect to postpone including the advance payment in income until the next tax year. However, he or she cannot postpone including any payment beyond that tax year. For this question, Connor must include one-sixth (8/48) of the payment in income for 2020, and five-sixths (40/48) of the payment in 2021, even if he does not give all the lessons by the end of 2022.

Lesson 1 - Advance Payment for Services
Source - Publication 538 - Accrual Method

Question 14 - B. $6,000
Generally, rent paid in a trade or business is deductible in the year paid or accrued. If the taxpayer pays rent in advance, he or she can deduct only the amount that applies to the use of the rented property during the tax year. The taxpayer can deduct the rest of the payment only over the period to which it applies. For this question, each year Daniel can deduct only $6,000, the part of the lease that applies to that year.

Lesson 6 - Rent Expenses
Source - Publication 535 - Chapter 3 - Rent

Question 15 - A. She can depreciate any books and journals that have a useful life that extends substantially beyond the year she placed them in service
The taxpayer can depreciate most types of tangible property (except land), such as buildings, machinery, equipment, vehicles, certain livestock, and furniture. He or she can also depreciate certain intangible property, such as copyrights, patents, and computer software.

To be depreciable, the property must meet all the following requirements.

- It must be property the taxpayer owns.
- It must be used in the taxpayer's business or income-producing activity.
- It must have a determinable useful life.
- It must have a useful life that extends substantially beyond the year the taxpayer places it in service.

To claim depreciation on property, the taxpayer must use it in his or her business or income-producing activity. If the taxpayer uses property to produce income (investment use), the income must be taxable. The taxpayer cannot depreciate property that he or she uses solely for personal activities. However, if the taxpayer uses property for business or investment purposes and for personal purposes, he or she can deduct depreciation based only on the percentage of business or investment use.

Lesson 10 - Depreciation
Source - Publication 225 - Chapter 7 - Overview of Depreciation

Question 16 - D. $100,000
If the taxpayer buys property and assumes (or buys subject to) an existing mortgage on the property, his or her basis includes the amount he or she pays for the property plus the amount to be paid on the mortgage. Dave's basis includes the $20,000 he pays for the property plus the $80,000 to be paid on the mortgage.

Lesson 7 - Cost Basis
Source - Publication 551 - Cost Basis

Question 17 - C. $500
If the taxpayer is liable for part of a business debt, he or she can deduct only his or her share of the total interest paid or accrued. Jeff can deduct his half of the total interest payments as a business deduction.

Lesson 6 - Interest Expenses
Source - Publication 535 - Chapter 4 - Interest You Can Deduct

Question 18 - A. Amounts paid to influence legislation (i.e., lobbying)
The taxpayer generally can deduct reasonable advertising expenses that are directly related to his or her business activities. Generally, he or she cannot deduct amounts paid to influence legislation (i.e., lobbying). Also, the taxpayer can usually deduct as a business expense the cost of institutional or goodwill advertising to keep his or her name before the public if it relates to business he or she reasonably expects to gain in the future. For example, the cost of advertising that encourages people to contribute to the Red Cross, to buy U.S. Savings Bonds, or to participate in similar causes is usually deductible.

Lesson 6 - Advertising Expenses
Source - Publication 535 - Chapter 11 - Miscellaneous Expenses

Question 19 - D. $25,000
If the like-kind exchange involves the receipt of money or unlike property or the assumption of the taxpayer's liabilities, he or she may have to recognize gain. The like-kind exchange rules also apply to property exchanges that involve three- and four-party transactions. Any part of these multiple-party transactions can qualify as a like-kind exchange if it meets all the requirements. If the taxpayer receives property in a like-kind exchange and the other party who transfers the property to the taxpayer does not give him or her the title, but a third party does, the taxpayer still can treat this transaction as a like-kind exchange if it meets all the requirements. If the taxpayer acquires property in a like-kind exchange, the basis of that property is generally the same as the basis of the property he or she transferred.

Gilbert exchanged real estate held for investment with an adjusted basis of $25,000 for other real estate held for investment. The basis of his new property is the same as the basis of the old ($25,000).

Lesson 8 - Like-Kind Exchanges
Source - Publication 544 - Chapter 1 - Like-kind Exchange

Question 20 - A. $0
If, in addition to giving up like-kind property, the taxpayer pays money in a like-kind exchange, he or she still has no recognized gain or loss. The basis of the property received is the basis of the property given up, increased by the money paid. If the taxpayer sells property and buys similar property in two mutually dependent transactions, he or she may have to treat the sale and purchase as a single nontaxable exchange If the taxpayer trades property in a like-kind exchange and also pays money, the basis of the property received is the basis of the property he or she gave up increased by the money he or she paid.

Bill has no recognized gain or loss on the transaction regardless of the adjusted basis of his old cab. If Bill sold the old cab to a third-party for $8,000 and bought a new one, he would have a recognized gain or loss on the sale of his old cab equal to the difference between the amount realized and the adjusted basis of the old cab.

Lesson 8 - Like-Kind Exchanges
Source - Publication 544 - Chapter 1 - Like-kind Exchange

Question 21 - C. $19,000
If, in addition to giving up like-kind property, the taxpayer pays money in a like-kind exchange, he or she still has no recognized gain or loss. The basis of the property received is the basis of the property given up, increased by the money paid. If the taxpayer sells property and buys similar property in two mutually dependent transactions, he or she may have to treat the sale and purchase as a single nontaxable exchange If the taxpayer trades property in a like-kind exchange and also pays money, the basis of the property received is the basis of the property he or she gave up increased by the money he or she paid. Elvira is treated as having exchanged her old car for the new one because the sale and purchase are reciprocal and mutually dependent. Her basis for depreciation for the new car is $19,000, the same as if she traded the old car.

Lesson 8 - Like-Kind Exchanges
Source - Publication 544 - Chapter 1 - Like-kind Exchange

Question 22 - C. $75
A taxpayer can deduct no more than $25 for business gifts he or she gives directly or indirectly to each person during the tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift. Thus $25 X 3 = $75.

Lesson 6 - Gift Expenses
Source - Publication 463 - Chapter 3 - Gifts

Question 23 - A. $10,000
If the taxpayer sells or exchanges more livestock, including poultry, than he or she normally would in a year because of a drought, flood, or other weather-related condition, he or she may be able to postpone reporting the gain from the additional animals until the next year. The taxpayer must meet all the following conditions to qualify:

- His or her principal trade or business is farming.
- He or she uses the cash method of accounting.
- He or she can show that, under his or her usual business practices, he or she would not have sold or exchanged the additional animals this year except for the weather-related condition.
- The weather-related condition caused an area to be designated as eligible for assistance by the Federal government.

Sales or exchanges made before an area became eligible for Federal assistance qualify if the weather-related condition that caused the sale or exchange also caused the area to be designated as eligible for Federal assistance. The designation can be made by the President, the Department of Agriculture (or any of its agencies), or by other Federal departments or agencies. In order to find the total gain that can be postponed:

1. Divide the total income realized from the sale of all livestock in the class during the tax year ($50,000) by the total number of such livestock sold (250).
2. Multiply the result in (1) by the excess number of such livestock sold solely because of weather-related conditions (250 - 200 = 50).

Therefore, (50,000/250) * 50 = $10,000 gain can be postponed until 2020.

Lesson 10 - Sales Caused by Weather-Related Conditions
Source - Publication 225 - Chapter 3 - Sales Caused by Weather-Related Conditions

Question 24 - B. Form 8832 (Entity Classification Election)
An eligible entity uses Form 8832 to elect how it will be classified for Federal tax purposes, as a corporation, a partnership, or an entity disregarded as separate from its owners.

Lesson 5 - LLCs Classified as Corporations
Source - Publication 3402 - LLCs Classified as Corporations

Question 25 - B. November 15, 2020
Generally, a corporation must file its income tax return by the 15th day of the 4th month after the end of its tax year. A new corporation filing a short-period return must generally file by the 15th day of the 4th month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 4th month after the date it dissolved.

Lesson 6 - Corporation Filing Information
Source - Publication 542 - Income Tax Return - When to File

Question 26 - B. 50%
A corporation can deduct, within certain limits, 50% of the dividends received if the corporation receiving the dividend owns less than 20% of the corporation distributing the dividend. If the corporation owns 20% or more of the distributing corporation's stock, it can, subject to certain limits, deduct 65% of the dividends received.

Lesson 4 - Dividends from Domestic Corporations
Source - Publication 542 - Dividends-Received Deduction

Question 27 - C. 80%
A parent-subsidiary controlled group exists when one or more chains of corporation are connected through stock ownership with a common parent corporation and 80% of the stock of each corporation, (except the common parent) is owned by one or more corporations in the group. Also, the parent corporation must own 80% of at least one other corporation.

Lesson 4 - Parent-Subsidiary Group
Source - IRS.GOV - Controlled and Affiliated Service Groups

Question 28 - D. $25,000 that must be reported by Gene as income in the year of receipt if the interest is vested
A partner can acquire an interest in partnership capital or profits as compensation for services performed or to be performed. The value of a capital interest in a partnership that is transferred to a partner in exchange for services is taxable as ordinary income. The income recognized is added to the basis of the partnership interest.

Lesson 3 - Contribution of Services
Source - Publication 541 - Contribution of Services

Question 29 - B. 24%
The payor generally withholds 24% of certain taxable payments if the payee fails to furnish it with his or her correct taxpayer identification number (TIN). This withholding is referred to as backup withholding. Payments subject to backup withholding include, interest, dividends, patronage dividends, rents, royalties, commissions, nonemployee compensation, and certain other payments the payor makes in the course of a trade or business.

Lesson 2 - Backup Withholding
Source - Publication 15 - Nonpayroll Income Tax Withholding

Question 30 - B. A distribution of property
The distributions of stock dividends and stock rights are generally tax-free to shareholders. However, stock and stock rights are treated as property under the rules if any of the following apply to their distributions:

1. Any shareholder has the choice to receive cash or other property instead of stock or stock rights.
2. The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders.
3. The distribution is in convertible preferred stock and has the same result as in (B).
4. The distribution gives preferred stock to some common stock shareholders and gives common stock to other common stock shareholders.
5. The distribution is on preferred stock. (An increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right is not a distribution on preferred stock).

In this case condition (A) applies because the stockholders have a choice between money or corporate stock.

Lesson 6 - Distributions to Shareholders
Source - Publication 542 - Figuring Tax

Question 31 - B. 18 months

The IRS ordinarily has 3 years from the date an income tax return is filed, or its due date, whichever is later, to charge any additional tax due. However, a personal representative may request a prompt assessment of tax after the return has been filed. This reduces the time for making the assessment to 18 months from the date the written request for prompt assessment was received. This request can be made for any tax return (except the estate tax return) of the decedent or the decedent's estate. This may permit a quicker settlement of the tax liability of the estate and an earlier final distribution of the assets to the beneficiaries.

Lesson 9 - Trust and Estate Income Tax
Source - Publication 559 - Personal Representative

Question 32 - A. The corporation has both common and preferred stock

To qualify for S corporation status, the corporation must be a domestic corporation, have only allowable shareholders including individuals, certain trust, and estates and may not include partnerships, corporations or non-resident alien shareholders. It may have no more than 100 shareholders and have one class of stock. Also, it may not be an ineligible corporation i.e., certain financial institutions, insurance companies, and domestic international sales corporations.

Lesson 5 - S Corporations
Source - IRS.GOV - S Corporations

Question 33 - B. S corporation built-in gains tax can be recognized only in the 5-year period beginning with the year the S election is made

Section 1374 provides for a tax on built-in gains. The built-in gains tax may apply to the following S corporations.

1. An S corporation that was a C corporation before it elected to be an S corporation.
2. An S corporation that acquired an asset with a basis determined (in whole or in part) by reference to its basis (or the basis of any other property) in the hands of a C corporation (a transferred-basis acquisition).

An S corporation may owe the tax if it has net recognized built-in gains during the applicable recognition period. For tax years beginning after 2011, the applicable recognition period is the 5-year period beginning:

- For an asset held when the S corporation was a C corporation, on the first day of the first tax year for which the corporation is an S corporation; or
- For an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation, on the date the asset was acquired by the S corporation.

A corporation described in both (1) and (2) above must figure the built-in gains tax separately for the group of assets it held at the time its S election became effective and for each group of assets it acquired from a C corporation with basis determined (in whole or in part) by reference to the basis of the asset (or any other property) in the hands of the C corporation.

Lesson 5 - Built-in Gains Tax
Source - Instructions for Schedule D (Form 1120S) - Part III. Built-in Gains Tax

Question 34 - A. Public charities with less than $100,000 in gross receipts are exempt from filing

Exempt organizations are generally required to file annual information returns on or before the 15th day of the fifth month following the close of the taxable year. Exempt status may be denied or revoked for failure to file. Those exempted from the filing requirement include:

- Churches or church-affiliated organizations,
- Exclusively religious activities or any religious orders,
- Organizations (other than private foundations) with annual gross receipts at or below $50,000, and
- Stock bonus, pension, or profit-sharing trusts that qualified under Section 401.

Private foundations are required to file annual information returns on Form 990 or Form 990-PF, regardless of the amounts of their gross receipts.

Lesson 9 - Annual Exempt Organization Information Returns
Source - IRS.GOV - Annual Exempt Organization Return: Who Must File

Question 35 - A. The election may be revoked with the consent of shareholders who, at the time the revocation is made, hold more than 50% of the number of issued and outstanding shares
An election terminates automatically in any of the following cases:

1. The corporation is no longer a small business corporation as defined in Section 1361(b). This kind of termination of an election is effective as of the day the corporation no longer meets the definition of a small business corporation. Attach to Form 1120S for the final year of the S corporation a statement notifying the IRS of the termination and the date it occurred.
2. The corporation, for each of three consecutive tax years, (a) has accumulated earnings and profits and (b) derives more than 25% of its gross receipts from passive investment income as defined in Section 1362(d)(3)(C). The election terminates on the first day of the first tax year beginning after the third consecutive tax year. The corporation must pay a tax for each year it has excess net passive income. See the line 22a instructions for details on how to figure the tax.
3. The election is revoked. An election can be revoked only with the consent of shareholders who, at the time the revocation is made, hold more than 50% of the number of issued and outstanding shares of stock (including non-voting stock). The revocation can specify an effective revocation date that is on or after the day the revocation is filed. If no date is specified, the revocation is effective at the start of the tax year if the revocation is made on or before the 15th day of the 3rd month of that tax year. If no date is specified and the revocation is made after the 15th day of the 3rd month of the tax year, the revocation is effective at the start of the next tax year.

Lesson 5 - Termination of Election
Source - Instructions for Form 1120S - Termination of Election

Question 36 - C. $1,000
Generally, an estate or trust must pay estimated income tax for 2020 if it expects to owe, after subtracting any withholding and credits, at least $1,000 in tax, and it expects the withholding and credits to be less than the smaller of:

1. 90% of the tax shown on the 2020 tax return, or
2. 100% of the tax shown on the 2019 tax return (110% of that amount if the estate's or trust's adjusted gross income on that return is more than $150,000, and less than ⅔ of gross income for 2019 or 2020 is from farming or fishing).

Lesson 9 - Estimated Tax
Source - Instructions for Form 1041 - Estimated Tax

Question 37 - C. Within 9 months after the date of death
For estate tax purposes, the taxpayer may be required to file *Form 706 - United States Estate (and Generation-Skipping Transfer) Tax Return*. Generally, if he or she must file Form 706, the return is due within 9 months after the date of the decedent's death.

Lesson 9 - Form 706 - United States Estate (and Generation-Skipping Transfer) Tax Return
Source - Form 706 - United States Estate (and Generation-Skipping Transfer) Tax Return

Question 38 - B. UBTI does not include income derived from services performed by unpaid volunteers
For most organizations, an activity is an unrelated business (and subject to unrelated business income tax) if it meets three requirements:

1. It is a trade or business.
2. It is regularly carried on.
3. It is not substantially related to furthering the exempt purpose of the organization.

However, any trade or business can exclude from UBTI any income in which substantially all the work is performed for the organization without compensation. Some fundraising activities, such as volunteer operated bake sales, may meet this exception.

Lesson 9 - Unrelated Business Taxable Income (UBTI)
Source - IRS.GOV - Unrelated Business Income Tax

Question 39 - A. The deduction for estate tax can be claimed only for the same tax year in which the income in respect of a decedent must be included in the recipient's income
Income a decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This income in respect of a decedent is also taxed when received by the recipient (estate or beneficiary). However, an income tax deduction is allowed to the recipient for the estate tax paid on the income. The deduction for estate tax can only be claimed for the same tax year in which the income in respect of a decedent must be included in the recipient's income. (This also is true for income in respect of a prior decedent).

Individuals can claim this deduction ONLY as an itemized deduction on line 16 of Schedule A (Form 1040). Estates can claim the deduction on line 19 of Form 1041. For the alternative minimum tax computation, the deduction is not included as an itemized deduction that is an adjustment to taxable income.

Lesson 9 - Estate Tax Deduction
Source - Publication 559 - Estate Tax Deduction

Question 40 - A. $4,620
The estate tax is the tax on the taxable estate, reduced by any credits allowed. The estate tax qualifying for the deduction is the part of the net value of all the items in the estate that represents income in respect of a decedent. Net value is the excess of the items of income in respect of a decedent over the items of expenses in respect of a decedent. The deductible estate tax is the difference between the actual estate tax and the estate tax determined without including net value.

For this example, the tax on Jack's estate is $9,460, after credits. The net value of the items included as income in respect of the decedent is $15,000 ($20,000 − $5,000). The estate tax determined without including the $15,000 in the taxable estate is $4,840, after credits. The estate tax that qualifies for the deduction is $4,620 ($9,460 − $4,840).

Lesson 9 - Estate Tax Deduction
Source - Publication 559 - Estate Tax Deduction

Question 41 - A. An individual
Only individuals are required to file gift tax returns. If a trust, estate, partnership, or corporation makes a gift, the individual beneficiaries, partners, or stockholders are considered donors and may be liable for the gift tax and GST taxes.

Lesson 9 - Form 709 - United States Gift (and Generation-Skipping Transfer) Tax Return
Source - Instructions for Form 709 - Who Must File

Question 42 - B. A 70-year-old individual who receives a distribution of the full value of his or her retirement account from a plan established by a business that he or she owns
Any prohibited transaction between a plan and a disqualified person is subject to an excise tax of 15% on the amount involved. An individual is a disqualified person if he or she is:

- An employer of any participants in the plan.
- A 10% or more partner in a partnership having the plan.
- A fiduciary of the plan.
- A highly compensated employee (10% or more of the employer's yearly wages).
- An employee organization.
- A person providing services to the plan.
- A related party to a disqualified person.

Prohibited transactions generally include:

- A transfer of plan income or assets to or use of them by or for the benefit of, a disqualified person.
- Dealing with plan income or assets by a fiduciary in his/her own interest.
- The receiving of consideration by a fiduciary for his/her own account from a party that is dealing with the plan in a transaction that involves plan income or assets.

Any of the following acts between the plan and a disqualified person:

- Selling, exchanging, or leasing property.
- Lending money or extending credit.
- Furthering goods, services, or facilities.

Prohibited transactions do not take place if a disqualified person receives benefits to which he or she is entitled as a plan participant and beneficiary. However, the same terms apply as for other qualified persons. Therefore, the 70-year-old individual is not a disqualified person.

Lesson 9 - Prohibited Transactions
Source - Publication 560 - Chapter 4 - Prohibited Transactions

Question 43 - D. Both A and B
A gift of a future interest cannot be excluded under the annual exclusion. A gift is considered a present interest if the donee has all immediate rights to the use, possession, and enjoyment of the property or income from the property. A gift is considered a future interest if the donee's rights to the use, possession, and enjoyment of the property or income from the property will not begin until some future date. Future interests include reversions, remainders, and other similar interests or estates.

Lesson 9 - Annual Exclusion
Source - Instructions for Form 709 - Annual Exclusion

Question 44 - C. A non-resident alien stockholder
To qualify for S corporation status, the corporation must meet the following requirements:

- Be a domestic corporation.
- Have only allowable shareholders:
  - Including individuals, certain trust, and estates and
  - May not include partnerships, corporations or non-resident alien shareholders.
- Have no more than 100 shareholders.
- Have one class of stock.
- Not be an ineligible corporation i.e. certain financial institutions, insurance companies, and domestic international sales corporations.

In order to become an S corporation, the corporation must submit Form 2553 - Election by a Small Business Corporation signed by all the shareholders. The taxpayer's corporation must file the Form 2553 to elect "S" status within two months and 15 days after the beginning of the tax year or any time before the tax year for the status to be in effect.

Lesson 5 - S Corporations
Source - Instructions for Form 2553

Question 45 - D. 50%
The taxpayer may have to recapture the Section 179 deduction if, in any year during the property's recovery period, the percentage of business use drops to 50% or less. In the year the business use drops to 50% or less, he or she includes the recapture amount as ordinary income in Part IV of Form 4797. The taxpayer also increases the basis of the property by the recapture amount.

Lesson 7 - Recapture
Source - Instructions for Form 4797

Question 46 - D. $250
Failure to meet the required minimum distributions can result in a 50% penalty (excise tax) for the year on the amount not distributed as required.

Lesson 9 - Required Minimum Distribution Method
Source - IRS.GOV - Retirement Topics - Required Minimum Distributions (RMDs)

Question 47 - B. April 1, 2022
For the first year following the year the taxpayer reaches age 70½ (age 72 if born after June 30, 1949), he or she will generally have two required distribution dates: an April 1 withdrawal (for the year he or she turns 70½ (or 72 if born after June 30, 1949)) and an additional withdrawal by December 31 (for the year following the year he or she turns 70½ (or 72 if born after June 30, 1949)).

In this question, Paul reached age 70½ on January 28, 2020. Since Paul had not reached age 70½ before 2020, his first RMD is due for 2021, the year he turns 72. Paul's first RMD is due by April 1, 2022, based on his 2020 year-end balance. Paul must receive his 2022 required minimum distribution by December 31, 2022, based on his 2021 year-end balance.

Lesson 9 - Required Minimum Distribution Method
Source - IRS.GOV - Retirement Topics - Required Minimum Distributions (RMDs)

Question 48 - C. Catalina's at $1,400 and Susan's at $2,000
The basis of a partnership interest is the money plus the adjusted basis of any property the partner contributed. If the partner must recognize gain as a result of the contribution, this gain is included in the basis of his or her interest. Any increase in a partner's individual liabilities because of an assumption of partnership liabilities is considered a contribution of money to the partnership by the partner. Therefore, Catalina's adjusted basis would equal $1,400 and Susan's adjusted basis would equal $2,000.

Lesson 3 - Basis of Partner's Interest
Source - Publication 541 - Basis of Partner's Interest

Question 49 - C. $42,375
A corporation's charitable deduction is limited to 25% of taxable income computed before the charitable contribution deduction, capital loss carryback, and the dividends-received deduction. The dividends-received deduction of $19,500 ($30,000 × 65%) must be added back to the taxable income of $150,000. ABC's charitable contribution deduction is $42,375 ($169,500 × 25%).

Lesson 6 - Charitable Contributions
Source - Publication 542 - Charitable Contributions

Question 50 - B. A corporation whose stock has been held for 90 days.
A dividends-received deduction is disallowed for dividends received on any share of stock that the corporate shareholder has held for 45 days or less. The holding-period rule prevents a corporation from claiming a dividends-received deduction if it purchases stock immediately before the ex-dividend date and sells the stock immediately thereafter.

Lesson 4 - Dividends from Regulated Investment Companies
Source - Publication 542 - Dividends-Received Deduction

Question 51 - B. Bob recognizes no gain and John recognizes $5,000 gain
Because Bob has control of the corporation (80%) he does NOT realize a gain or deduct a loss, in this case a gain of $10,000 because he is in control of the corporation. John recognizes a $5,000 gain on his transfer of property because he got 20% of stock in exchange of the property AND THEN the corporation transferred $5,000 to John on top of his 20% of stock. Moreover, John's basis in the stock is $10,000 because the adjusted basis carries over when an exchange between property and stock happens.

Lesson 4 - Property Exchanged for Stock
Source - Publication 542 - Property Exchanged for Stock

Question 52 - A. $500
If in a purchase or exchange, the taxpayer received property from a related person who had a loss that was not allowable and he or she later sells or exchanges the property at a gain, the taxpayer recognizes the gain only to the extent it is more than the loss previously disallowed to the related person. This rule applies only to the original transferee. Heather's recognized gain is only $500, the gain that is more than the $2,400 loss not allowed to her brother.

Lesson 8 - Nondeductible Loss
Source - Publication 544 - Chapter 2 - Nondeductible Loss

Question 53 - C. $65,000
A corporation can deduct, within certain limits, 50% of the dividends received if the corporation receiving the dividend owns less than 20% of the corporation distributing the dividend. If the corporation owns 20% or more of the distributing corporation's stock, it can, subject to certain limits, deduct 65% of the dividends received.

Lesson 4 - Dividends from Domestic Corporations
Source - Publication 542 - Dividends-Received Deduction

Question 54 - A. $37,500
In 2020, a corporation may deduct qualified contributions of up to 25% of its taxable income. Figure taxable income for this purpose without the following:

1. The deduction for charitable contributions.
2. The dividends-received deduction.
3. The deduction allowed under Section 249 of the Internal Revenue Code.
4. The domestic production activities deduction.
5. Any capital loss carryback to the tax year.

In this question, $200,000 total income less the $100,000 expense plus the dividends-received deduction of $50,000 = $150,000 X .25 = $37,500.

The CARES Act changes the limitations on deductions for certain cash contributions during 2020. For corporations, the 10% limitation is increased to 25%. The Act also increases the limitation on deductions for contributions of food inventory from 15% to 25%.

Lesson 4 - Charitable Contributions
Source - Publication 542 - Charitable Contributions

Question 55 - D. $5,000
A capital loss is carried to other years in the following order:

1. 3 years prior to the loss year (2015) no capital losses or gains.
2. 2 years prior to the loss year (2016) no capital losses or gains.
3. 1 year prior to the loss year (2017) no capital losses or gains.
4. Any loss remaining is carried forward for 5 years. ($10,000 - $5,000 = $5,000).

When the taxpayer carries a net capital loss to another tax year, he or she treats it as a short-term loss. It does not retain its original identity as long-term or short-term.

Lesson 6 - Capital Losses
Source - Publication 542 - Capital Losses

Question 56 - C. $2,400
When a taxpayer goes into business, treat all costs he or she incurs to get the business started as capital expenses. However, a corporation can elect to deduct a limited amount of start-up or organizational costs. Any costs not deducted can be amortized. Start-up costs include amounts paid for the following:

- An analysis or survey of potential markets, products, labor supply, transportation facilities, etc.

- Advertisements for the opening of the business.
- Salaries and wages for employees who are being trained and their instructors.
- Travel and other necessary costs for securing prospective distributors, suppliers, or customers.
- Salaries and fees for executives and consultants, or for similar professional services.

Start-up costs do not include deductible interest, taxes, or research and experimental costs.

Examples of organizational costs include:

- The cost of temporary directors.
- The cost of organizational meetings.
- State incorporation fees.
- The cost of legal services.

This means the only expenses that can be amortized as start-up and organizational costs are the feasibility costs, legal fees and advertisement cost.

Lesson 4 - Costs of Going Into Business
Source - Publication 535 - Chapter 8 - Business Start-Up Costs

Question 57 - B. $3,000
If the taxpayer transfers property (or money and property) to a corporation in exchange for stock in that corporation (other than nonqualified preferred stock, described later), and immediately afterward he or she is in control of the corporation, the exchange is usually not taxable. However, the term property does not include services rendered or to be rendered to the issuing corporation. The value of stock received for services is income to the recipient.

In this question, no gain is recognized on the exchange of property. However, Sean recognizes ordinary income of $3,000 as payment for services he rendered to the corporation.

Lesson 4 - Property Exchanged for Stock
Source - Publication 542 - Net Operating Losses

Question 58 - D. $2,500
Effective for taxable years beginning on or after January 1, 2016, the Internal Revenue Service in Notice 2015-82 increased the de minimis safe harbor threshold from $500 to $2,500 per invoice or item for taxpayers without applicable financial statements. In addition, the IRS will provide audit protection to eligible businesses by not challenging the use of the $2,500 threshold for tax years ending before January 1, 2016 if the taxpayer otherwise satisfies the requirements of Treasury Regulation Section 1.263(a)-1(f)(1)(ii).

Lesson 7 - De Minimis Safe Harbor Election
Source - IRS.GOV - Tangible Property Regulations - Frequently Asked Questions

Question 59 - A. $6,000
A corporate distribution to a shareholder is generally treated as a distribution of earnings and profits. Any part of a distribution from either current or accumulated earnings and profits is reported to the shareholder as a dividend. Any part of a distribution that is not from earnings and profits is applied against and reduces the adjusted basis of the stock in the hands of the shareholder. To the extent the balance is more than the adjusted basis of the stock, the shareholder has a gain (usually a capital gain) from the sale or exchange of property.

The amount of the distribution that the shareholder includes in his or her income and the corporation reports in Form 1099-DIV is the value of any property received (FMV-liability) to the extent the distribution is out of earnings and profits. Because Rose Corp. had a total E&P of $6,000, they can only report that much as dividends paid out to Paul Rose.

Lesson 4 - Reporting Dividends and Other Distributions
Source - Publication 542 - Reporting Dividends and Other Distributions

Question 60 - D. When a corporation carries a short-term net loss to another tax year, the character becomes long-term
A capital loss that cannot be offset in the current year may be carried back 3 years and carried forward for up to 5 years. When a capital loss is carried to another tax year, it is treated as a short-term loss regardless of its original characterization.

Lesson 6 - Capital Losses
Source - Publication 542 - Capital Losses

Question 61 - D. $10,000
A corporation should treat a complete liquidation as a sale using the fair market value. However, Section 336(b) requires that the fair market value used should not be less than any liability accepted by the distributee. Since XYZ Corp. is transferring property with a liability of $44,000, which is higher than the $40,000 FMV, the $44,000 is used as the new FMV. Therefore, XYZ Corporation recognizes a $10,000 gain ($44,000 new FMV – $34,000 adjusted basis).

Lesson 4 - Corporate Liquidations/Dissolutions
Source - GPO.GOV - 26 USC Section 336 - Gain or loss recognized on property distributed in complete liquidation

Question 62 - D. When the liquidating distribution equals or exceeds $600 in a calendar year.
A corporation should file Form 1099-DIV, Dividends and Distributions, for each person:

- To whom it has paid dividends (including capital gain dividends and exempt-interest dividends) and other distributions on stock of $10 or more.
- For whom it has withheld and paid any foreign tax on dividends and other distributions on stock.
- For whom it has withheld any Federal income tax on dividends under the backup withholding rules.
- To whom it has paid $600 or more as part of a liquidation.

Lesson 4 - Reporting Dividends and Other Distributions
Source - Instructions for 1099-DIV - Specific Instructions

Question 63 - D. Entirely as capital gain.
Section 302(b)(4) - Redemption from Noncorporate Shareholder in Partial Liquidation states that a noncorporate shareholder who receives a distribution in redemption of stock in a partial liquidation treats the distribution as payment in exchange for the stock. Any gain or loss on the exchange will be treated as capital in nature.

Lesson 4 - Closing a Business
Source - GPO.GOV - 26 USC Section 302 - Distributions in redemption of stock

Question 64 - C. $1,500
Arnold's basis in the stock is $500 (10 shares @ $50 per share). Klesco buys back its outstanding stock for $200 per share and buys back all 10 of Arnold's shares 200 X 10 = $2,000 (amount recognized by Arnold) - $500 (adjusted basis) = $1,500.

Lesson 8 - Capital Asset
Source - Publication 544 - Chapter 2 - Capital Assets

Question 65 - C. George and Helen each have taxable gifts of $1,000
When a couple decides to gift split each gift that they give will be divided among both of them and liability is split as well after any amount over the annual exclusion. And remember that the annual exclusion is applied to EACH gift. So, the $22,000 gift is split between George and Helen and each have a gift of $11,000 that they made and since it is under the annual exclusion the entire gift is nontaxable.

The $32,000 is also split between George and Helen. Each have $16,000 and because the annual exclusion in 2020 is $15,000 both George and Helen have a taxable gift of $1,000 ($16,000-$15,000).

Lesson 9 - Gift Splitting
Source - Publication 950 - Gift Splitting

Question 66 - B. $4,000
The Cinder Family Trust gross income is equal to $7,500 (Rental income $5,000 + Dividend income $1,500 + Interest income from corporate bonds $1,000). Total trust deductions allocable to income equal $3,500 (Rental expenses $(2,500) and trustee fees allocable to income $(1,000)). Distributable net income (DNI) equals $4,000 (Adjusted total income equals $4,000 + Adjusted tax-exempt interest $500 less capital gains allocable to corpus $0 and trustee fees allocable to corpus $(500)).

Lesson 9 - Distributable Net Income (DNI)
Source - IRS.GOV - Overview of Fiduciary Income Taxation

Question 67 - B. $10,000
Wilder Trust is a complex trust and it specifically states that $10,000 in income is distributed. The $10,000 is the distribution deduction.

Lesson 9 - Estate or Trust Income Distribution Deductions (Schedule B)
Source - Schedule B - Interest and Ordinary Dividends

Question 68 - C. $8,000
Taxable income for Thomas' trust is figured by simply adding the taxable interest and ordinary dividends to come to $8,000. Do not include the tax-exempt interest.

Lesson 9 - Income
Source - Instructions for Form 1041 and Schedules A, B, G, J, and K-1 - U.S. Income Tax Return for Estates and Trusts

Question 69 - B. Distributions of stock and stock rights are never treated as property
Distributions of stock and stock rights are generally not treated as property. Most distributions are in money, but they may also be in stock or other property. For this purpose, “property” generally does not include stock in the corporation or rights to acquire this stock.

Lesson 4 - Distributions of Stock or Stock Rights
Source - Publication 542 - Money or Property Distributions

Question 70 - B. $5,000
Under the general liquidation rules prescribed by Section 331, amounts received by shareholders in complete liquidation of a corporation are considered as payment in full for their stock. Each shareholder recognizes gain or loss equal to the difference between the NET Fair Market Value FMV of the property received and the basis of the stock surrendered.

Lesson 4 - Corporate Liquidations/Dissolutions
Source - GPO.GOV - 26 USC Section 331 - Gain or loss to shareholders in corporate liquidations

Question 71 - C. Partnership
A domestic LLC with at least two members that does not file Form 8832 is classified as a partnership for Federal income tax purposes.

Lesson 3 - Limited Liability Company
Source - Publication 541 - Organizations Classified as Partnerships

Question 72 - B. $1,000
When a sale of property is enacted between related persons and there is a loss, the seller of the property cannot deduct the loss. However, the buyer's basis in the property is the same as the seller's adjusted basis in the property.

Lesson 8 - Nondeductible Loss
Source - Publication 544 - Chapter 2 - Nondeductible Loss

Question 73 - D. Until election is terminated
Once the election is made, it stays in effect until it is terminated or revoked. If the election is terminated, the corporation (or a successor corporation) can make another election on Form 2553 only with IRS consent for any tax year before the 5th tax year after the first tax year in which the termination or revocation took effect.

Lesson 1 - S Corporation
Source - Instruction for From 2553 - Election by a Small Business Corporation

Question 74 - C. Under an accrual method of accounting, business expenses and interest owed to a related person who uses the cash method of accounting are deductible when the all-events test has been met
Business expenses and interest owed to a related person who uses the cash method of accounting are not deductible until the taxpayer makes the payment and the corresponding amount is includible in the related person's gross income.

Lesson 1 - Related Persons
Source - Publication 538 - Accrual Method

Question 75 - B. Exchange of partnership interests
An exchange of partnership interests generally does not qualify as a nontaxable exchange of like-kind property. This applies regardless of whether they are general or limited partnership interests or interests in the same or different partnerships. However, under certain circumstances, such an exchange may be treated as a tax-free contribution of property to a partnership.

Lesson 3 - Disposition of Partner's Interest
Source - Publication 541 - Sale, Exchange, or Other Transfer

Question 76 - C. $164,000
When a taxpayer changes property he or she held for personal use to rental use, the basis for depreciation will be the lesser of fair market value or adjusted basis on the date of conversion. The adjusted basis on the date of the change - that is, the taxpayer's original cost or other basis of the property, plus the cost of permanent additions or improvements since he or she acquired it, minus deductions for any casualty or theft losses claimed on earlier years' income tax returns and other decreases to basis. In this question, the adjusted basis of the house at the time of the change in its use was $164,000 ($140,000 + $28,000 − $3,500 − $500). Because land is not depreciable, the taxpayer can only include the cost of the house when figuring the basis for depreciation.

Lesson 8 - Converted Property
Source - Publication 527 - Chapter 4 - Basis of Property Changed to Rental Use

Question 77 - B. One-half of the first-year's depreciation is allowed in the year in which the property is placed in service, regardless of when the property is placed in service during the year, and a half-year's depreciation is allowed for the year in which the property is disposed of
Use the half-year convention if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, the taxpayer treats all property placed in service or disposed of during a tax year as placed in service or disposed of at the midpoint of the year. This means that a one-half year of depreciation is allowed for the year the property is placed in service or disposed.

Lesson 7 - Depreciation Conventions
Source - Publication 546 - Chapter 4 - Sale or Other Disposition Before the Recovery Period Ends

Question 78 - C. $15,000
When a corporation distributes property that has appreciated in value, the corporation must recognize a gain as if the corporation had sold its property for its FMV. If a liability attached to a distributed asset exceeds the FMV of the asset, the selling price is equal to the amount of the liability. Thus, Silver Corporation should recognize a gain of $15,000 ($35,000 liability transferred – $20,000 adjusted basis of land).

Lesson 4 - Money or Property Distributions
Source - Publication 542 - Money or Property Distributions

Question 79 - C. The sale of a copyright, literary, musical, or artistic composition that the taxpayer created
The sale of a copyright, a literary, musical, or artistic composition, or similar property is not a Section 1231 transaction if the taxpayer's personal efforts created the property, or if he or she acquired the property in a way that entitled him or her to the basis of the previous owner whose personal efforts created it. The sale of such property results in ordinary income and generally is reported in Part II of Form 4797.

Lesson 8 - Section 1231 Gains and Losses
Source - Publication 544 - Chapter 3 - Section 1231 Gains and Losses

Question 80 - B. Capital is not a material income-producing factor, the family members joined together in good faith to conduct a business. They agreed that contributions of each entitle them to a share in the profits, and some capital or service has been (or is) provided by each partner
Members of a family can be partners. However, family members (or any other person) will be recognized as partners only if one of the following requirements is met:

- If capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction (even if by gift or purchase from another family member), actually own the partnership interest, and actually control the interest.
- If capital is not a material income-producing factor, they joined together in good faith to conduct a business. They agreed that contributions of each entitle them to a share in the profits, and some capital or service has been (or is) provided by each partner.

Lesson 3 - Family Partnership
Source - Publication 541 - Family Partnership

Question 81 - B. A gain is realized on the transfer of property to the partnership that would be treated as an investment company if the partnership was incorporated
Gain is recognized when property is contributed (in exchange for an interest in the partnership) to a partnership that would be treated as an investment company if it were incorporated. A partnership is generally treated as an investment company if over 80% of the value of its assets is held for investment and consists of certain readily marketable items. These items include money, stocks and other equity interests in a corporation, and interests in regulated investment companies and real estate investment trusts.

Lesson 3 - Contribution of Property
Source - Publication 541 - Contribution of Property

Question 82 - D. The transaction is not a sale or exchange and the partner has not received an actual or deemed distribution from the partnership
A loss incurred from the abandonment or worthlessness of a partnership interest is an ordinary loss only if both of the following tests are met:

- The transaction is not a sale or exchange.
- The partner has not received an actual or deemed distribution from the partnership.

If the partner receives even a de minimis actual or deemed distribution, the entire loss generally is a capital loss.

Lesson 3 - Disposition of Partner's Interest
Source - Publication 541 - Disposition of Partner's Interest

Question 83 - D. Cost of a hotel stay in the general area in which the taxpayer's business is located
Generally, the tax home is the taxpayers regular place of business or post of duty, regardless of where he or she maintains the family home. It includes the entire city or general area in which his or her business or work is located. If the taxpayer temporarily travels away from his or her tax home he or she may have deductible travel expenses.

Lesson 6 - Travel Expenses
Source - Publication 463 - Travel, Gift, and Car Expenses

Question 84 - C. $940,000
If the cost of the taxpayer's qualifying Section 179 property placed in service in a year is more than $2,590,000, he or she generally must reduce the dollar limit (but not below zero) by the amount of cost over $2,590,000. If the cost of the taxpayer's Section 179 property placed in service during 2020 is $3,630,000 or more, he or she cannot take a Section 179 deduction. In this question, Jane Ash placed in service machinery costing $2,690,000. This cost is $100,000 more than $2,590,000 limit, so she must reduce her Section 179 dollar limit to $940,000 ($1,040,000 − $100,000).

Lesson 7 - Section 179 Dollar Limitations
Source - Publication 946 - Electing the Section 179 Deduction

Question 85 - D. Charitable
To be tax-exempt under Section 501(c)(3) of the Internal Revenue Code, an organization must be organized and operated exclusively for exempt purposes set forth in Section 501(c)(3), and none of its earnings may inure to any private shareholder or individual. In addition, it may not be an action organization, i.e., it may not attempt to influence legislation as a substantial part of its activities, and it may not participate in any campaign activity for or against political candidates.

Organizations described in Section 501(c)(3) are commonly referred to as charitable organizations. Organizations described in Section 501(c)(3), other than testing for public safety organizations, are eligible to receive tax-deductible contributions in accordance with Code Section 170.

Lesson 9 - Tax-Exempt Organizations
Source - IRS.GOV - Exemption Requirements - Section 501(c)(3) Organizations

Question 86 - A. $3,000
If a taxpayer transfer property (or money and property) to a corporation in exchange for stock in that corporation (other than nonqualified preferred stock), and immediately afterward he or she is in control of the corporation, the exchange is usually not taxable. This rule applies both to individuals and to groups who transfer property to a corporation. It also applies whether the corporation is being formed or is already operating. The term property does not include services rendered or to be rendered to the issuing corporation. The value of stock received for services is income to the recipient.

Lesson 4 - Property Exchanged for Stock
Source - Publication 542 - Property Exchanged for Stock

Question 87 - C. Bad debts recovered
The taxpayer reports on Line 6 - Other Income of Schedule C amounts from finance reserve income, scrap sales, bad debts the taxpayer recovered, interest (such as on notes and accounts receivable), state gasoline or fuel tax refunds the taxpayer received in 2020, any amount of credit for biofuel claimed on line 2 of Form 6478, any amount of credit for biodiesel and renewable diesel fuels claimed on line 8 of Form 8864, credit for Federal tax paid on fuels claimed on the taxpayer's 2018 Form 1040, prizes and awards related to the taxpayer's trade or business, and other kinds of miscellaneous business income. Include amounts the taxpayer received in his or her trade or business as shown on Form 1099-PATR.

Lesson 2 - Other Income
Source - Instructions for Schedule C - Line 6

Question 88 - D. None of the above
S corporations that have previously been a C corporation and have accumulated earnings and profits at the end of the tax year will be assessed a passive income tax if passive investment income for the year exceeds 25% of gross receipts for the year.

Lesson 5 - Taxes
Source - Instructions for Schedule D (Form 1120S)

Question 89 - C. Personal property tax
Expenditures, receipts, losses, or other items properly chargeable to capital result in an adjustment in the basis of the property. However, there is no adjustment for deductible taxes. A personal property tax is deductible and does not reduce the basis of the asset.

Lesson 7 - Basis of Property
Source - Publication 551 - Adjusted Basis

Question 90 - B. Guaranteed payments to partners
Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership's income. A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner. This treatment is for purposes of determining gross income and deductible business expenses only. Net operating losses, short term capital losses and contributions are not used when computing the ordinary income of a partnership.

Lesson 3 - Guaranteed Payments
Source - Publication 541 - Guaranteed Payments

Question 91 - C. Stock of the distributing corporation
“Property” is defined as money, securities, and any other property except stock or stock rights of the distributing corporation.

Lesson 4 - Money or Property Distributions
Source - Publication 542 - Money or Property Distributions

Question 92 - D. Tom has a basis of $20,000 and Jill has a basis of $80,000 in the partnership
If a partner's share of partnership liabilities increases, or a partner's individual liabilities increase because he or she assumes partnership liabilities, this increase is treated as a contribution of money by the partner to the partnership. Jill is fully liable for the liability, so the entire liability increases only Jill's basis in the partnership.

Lesson 3 - Adjusted Basis
Source - Publication 541 - Adjusted Basis

Question 93 - C. $4,000
If a corporation's earnings and profits for the year (figured as of the close of the year without reduction for any distributions made during the year) are more than the total amount of distributions made during the year, all distributions made during the year are treated as distributions of current year earnings and profits.

Lesson 6 - Reporting Dividends and Other Distributions
Source - Publication 542 - Net Operating Losses

Question 94 - C. Property produced under a long-term contract
Uniform capitalization rules determine the costs and expenditures, including interest, that must be capitalized by a taxpayer. These uniform capitalization rules apply to all real and tangible personal property that is produced by a taxpayer and to all real or personal property that is acquired by a taxpayer for resale. However, these rules apply only to property used in a taxpayer’s trade or business or in an activity engaged in for profit. They do not apply to property that is used for personal purposes, to timber, or to any property that is being produced under a long-term contract.

Lesson 10 - Uniform Capitalization Rules
Source - Publication 334 - Chapter 2 - Uniform Capitalization Rules

Question 95 - A. The fourth month after the date it dissolved
Generally, a corporation must file its income tax return by the 15th day of the 4th month after the end of its tax year. A new corporation filing a short-period return must generally file by the 15th day of the 4th month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 4th month after the date it dissolved.

Lesson 4 - Filing
Source - Instructions for Form 1120 - When to file

Question 96 - C. 15 years

The taxpayer must generally amortize over 15 years the capitalized costs of “Section 197 intangibles” he or she acquired after August 10, 1993. The taxpayer must amortize these costs if he or she holds the Section 197 intangibles in connection with a trade or business or in an activity engaged in for the production of income.

Lesson 7 - Section 197 Intangibles
Source - Publication 535 - Chapter 8 - Section 197 Intangibles

Question 97 - D. Last day of the seventh month after the end of the plan year

For plan years beginning on or after January 1, 2009, the *Form 5500 - Annual Return/Report of Employee Benefit Plan* and its schedules and the Form 5500-SF must be filed electronically under the computerized ERISA Filing Acceptance System (EFAST2). Form 5500 is due the last day of the seventh month after the plan year ends (July 31 for a calendar-year plan).

Lesson 2 - Line 19: Pension and Profit-Sharing Plans
Source - IRS.GOV - Form 5500 Corner

Question 98 - B. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers

Do not report on Schedule C a gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers. Instead, the taxpayer must report these gains and losses on other forms.

Lesson 2 - Gains and Losses
Source - Publication 334 - Chapter 5 - Other Income

Question 99 - D. $3,000

Bartering is an exchange of property or services. The taxpayer must include in his or her gross receipts, at the time received, the fair market value of property or services he or she receives in exchange for something else. If the taxpayer exchanges services with another person and both the taxpayer and the other person have agreed ahead of time on the value of the services, that value will be accepted as the fair market value unless the value can be shown to be otherwise.

Lesson 2 - Bartering for Property or Services
Source - Publication 334 - Chapter 5 - Other Income

Question 100 - B. $7,000

A corporation can deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has an excess capital loss, it cannot deduct the loss in the current tax year. Instead, it carries the loss to other tax years and deducts it from any net capital gains that occur in those years.

A capital loss is carried to other years in the following order:

1. 3 years prior to the loss year.
2. 2 years prior to the loss year.
3. 1 year prior to the loss year.
4. Any loss remaining is carried forward for 5 years.

When the corporation carries a net capital loss to another tax year, it treats the loss as a short-term loss. The loss does not retain its original identity as long term or short term. In this example, this consists of a net short-term capital gain of $2,000 ($8,000 − $6,000) and a net long-term capital gain of $5,000.

Lesson 6 - Capital Losses
Source - Publication 542 - Capital Losses