ENROLLED AGENT

PART II

Business Taxation

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What is an Enrolled Agent (EA) designation?

An Enrolled Agent (EA) is a person who has earned the privilege of representing taxpayers before the Internal Revenue Service (IRS). To become an Enrolled Agent, the person must pass the Special Enrollment Examination (SEE), as well as a suitability check. This book is the first part of a comprehensive course designed to help you prepare for the SEE and become an Enrolled Agent. Focused on Individual Taxation, it provides detailed guidance on this key topic.

The full course covers all three parts of the SEE, ensuring complete preparation for your certification journey. We wish you well in preparing for your examination. Follow these steps if you are interested in becoming an Enrolled Agent:

1. **Review this course thoroughly.**
2. **Schedule an appointment:** The applicant can schedule an examination appointment at any time online at www.prometric.com/see, by calling (800) 306-3926 between 8:00 a.m. and 9:00 p.m. Eastern Time (ET), Monday through Friday, or by completing Form 2587. The IRS has a new online registration process. It

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requires the applicant to create a user profile before they schedule and pay for the exam. The applicant has to refer to the job aid under "What's New" on Prometric.com/see to create an account. After the appointment has been scheduled, the applicant will receive a number confirming the appointment. The applicant has to keep this confirmation number in their records; they will need it to reschedule, cancel, or change the appointment. The applicant may take each part of the examination at their convenience and in any order. Examination parts do not have to be taken on the same day or on consecutive days. The applicant may take examination parts up to four times each during each test window. The current test window is from May 1st, 2025, to February 28, 2026. Testing is not available in the months of March and April each year while the examination is updated. The testing fee is $267 for each part of the examination.

3. **Prepare for your examination:** The examination topics covered in this course are the basis for the examination.
4. **Bring the required identification to the test center and take the scheduled examination:** The applicant must present a valid, nonexpired form of identification before they can take the test. That identification document must:
    a. Be government-issued (e.g., driver's license, passport, state-issued identification card or military identification card).
    b. Contain both a current photo and their signature (if it does not, the applicant must present two government-issued identification cards: one with their photo and one with their signature);
    c. Closely resemble their appearance on the date of testing; and
    d. Have a first and last name that exactly matches the first and last name used to register for the examination.

If a name on the candidate's government-issued ID does not match the name on the candidate's registration (for example, because of marriage) the candidate will not be permitted to test unless an original certified marriage certificate or original certified legal name change document is provided (no photocopies or digital images).

Photocopies and digital images are NOT acceptable. Failure to present proper identification will result in being denied access to take the test and forfeiture of your test fee.

5. **Apply for enrollment**: After passing all three parts of the examination, the candidate must apply for enrollment via Form 23, Application for enrollment to practice before the Internal Revenue Service, within one year of the date the applicant passed the third examination part. The applicant may electronically file Form 23 and pay the application fee at pay.gov. Copies of the score report do not need to be submitted to the IRS when submitting their application for enrollment (Form 23). As part of the evaluation of their enrollment application, the Internal Revenue Service will conduct a suitability check that will include a review of their personal tax compliance.

Anyone who prepares or assists in preparing federal tax returns for compensation, including Enrolled Agents, must have a valid Preparer Tax Identification Number (PTIN) before preparing returns. The IRS Tax Professional PTIN System is available at www.irs.gov/ptin. Once you enter the website, you will need to create your account and follow the steps to get your PTIN.

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This process takes about 15 minutes. If you opt to use the paper application, Form W-12, IRS paid Preparer Tax Identification Number application, it will take 4-6 weeks to process. PTINs must be renewed annually by December 31 for the following year. Renewal Open Season usually begins each year in mid-October.

Candidate Information Bulletin

Before you sign up to take the SEE, please review the Enrolled Agent Special Enrollment Examination Candidate Information Bulletin. This bulletin will provide you with important information about the examination and the process for becoming an Enrolled Agent.

- **Scratch paper**

You will be provided with a packet of scratch paper and a pencil to use during the examination. You may not bring your own scratch paper or pencil. The test center administrator will collect all scratch paper (used and unused) upon completion of the examination. Removing scratch paper from the test center is considered an act of misconduct.

- **Break Policy**

The Special Enrollment Exam (SEE) includes one scheduled 15-minute break. The exam clock stops after you have answered questions 1-50 and the first section of the test has been completed. Once you have answered questions 1-50, completed your review of your answers, and acknowledged you have completed section one, you will no longer be able to access the first section of the test content. You may choose to decline the scheduled break and continue testing, but the break will not be offered again. If you choose to take the scheduled break you will leave the testing room, adhering to all security protocols, and will be readmitted to the testing room once cleared by Prometric personnel. If you have not returned and started the second section (questions 51-100) of the exam prior to the expiration of the 15 minutes, the exam clock will restart.

You are required to sign out on the test center roster when you leave the test room. You must also sign back in and show your identification to the test center administrator in order to be re-admitted to the test room (this process is included in the 15-minute break).

You are allowed to take additional unscheduled breaks in order to access the bathroom or lockers; however, the exam clock will continue to count down during any unscheduled break. When taking a break, you are allowed to access your locker for food or medicine after notifying the test center administrator. You are not allowed to leave the locker area with any item such as a purse or bag. You are not allowed to leave the test center except to access the restroom.

You are not allowed to access notes, books, reference materials, electronic devices, or cell phones at any time during your appointment. Failure to follow test center rules may result in the disqualification of your examination.

- **Examination Results**

Upon completion of the examination, a pass/fail message will appear on your computer screen. Test scores are confidential and will be revealed only to you and the IRS. In addition, you will receive an email from Prometric containing your score report.

Scaled Scores: Scaled scores are determined by calculating the number of questions answered correctly from the total number of questions in the examination and converting to a scale that ranges from 40 to 130. The IRS has set

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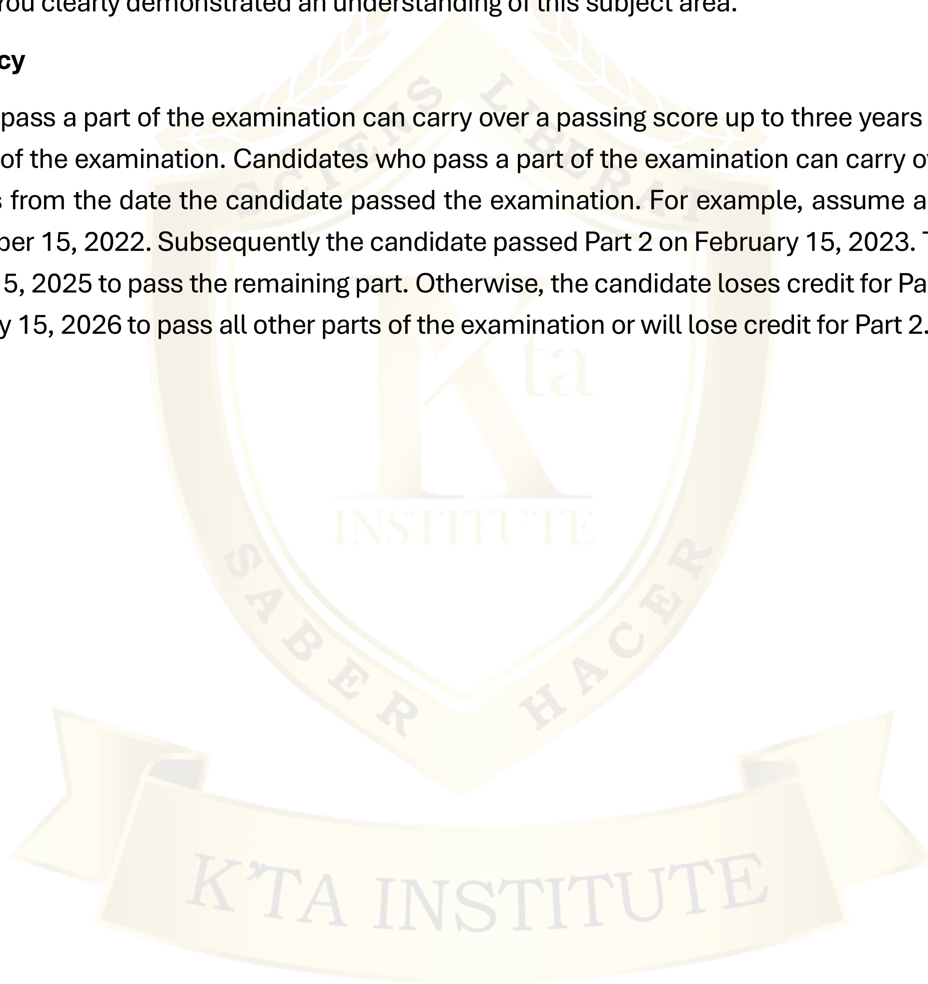
the scaled passing score at 105, which corresponds to a minimum level of knowledge deemed acceptable by those persons who will be practicing before the IRS as an Enrolled Agent.

If you pass, the score report will show a passing designation. It will not show a score. 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. **Weak.** 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.

• Carryover Policy

Candidates who pass a part of the examination can carry over a passing score up to three years from the date they passed that part of the examination. Candidates who pass a part of the examination can carry over passing scores up to three years from the date the candidate passed the examination. For example, assume a candidate passed Part 1 on November 15, 2022. Subsequently the candidate passed Part 2 on February 15, 2023. That candidate has until November 15, 2025 to pass the remaining part. Otherwise, the candidate loses credit for Part 1. The candidate has until February 15, 2026 to pass all other parts of the examination or will lose credit for Part 2.



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CHAPTER I Business Entities and Considerations

Module: Business Entities

For starting a business, the most important part is choosing the type of legal entity for the new business. An entity has both sides: tax and liability. Each form of business has pros and cons. Each taxpayer must calculate the taxable income on a tax year, being the most common one the calendar year. Each taxpayer must use an accurate accounting system (set of rules to determine when and what way to use to report income and expenses). Most common methods: cash and accrual.

The various types of business entities include the following:

- Sole proprietorships.
- Partnerships.
- Trusts and estates.
- S-Corp orations (also known as subchapter S-Corporations).
- Regular corporations (also called subchapter C or C-Corpo ratio ns).
- Limited Liability Companies (LLCs).
- Exempt organizations.

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- Farms.

When a taxpayer decides to begin a business, they must decide first the type of business they want to start up, which could be a sole proprietorship, a partnership, an LLC, among others. The form or nature of the business determines the kind of income tax to be paid as well as the kind of return forms to be filed. The most common kinds of businesses are sole proprietorships, Corporations and S corporations. LLCs are relatively new forms of business that are allowed by state statutes. Legal and tax considerations are considered into selecting a business structure.

Sole Proprietorships

This entity is an unincorporated business that is owned by one individual. The business is not a separate entity apart from its owner. Its liabilities are personal, and the owner has unlimited liability for all business debts and obligations. This means the owner's personal assets can be used to satisfy business debts if the business doesn't have enough funds.

Sole proprietors report profit or loss on Schedule C, Profit or loss from business, or for farmers doing business as a sole proprietorship, Schedule F, Profit or loss from farming. A net profit of $400 or more is subject to self-employment tax, reported on Schedule SE, Self-Employment tax.

Partnerships and Qualified Joint Ventures (QJV)

A partnership is the relationship between two or more persons who join to carry on a trade or business. Each person contributes money, property, labor or skill, and shares in the profits and losses of the business. The IRC describes a partnership as a syndicate, group, pool, join venture, or unincorporated organization through which any business, financial operation, or venture is carried on, and which is not, for federal income tax purposes, a corporation, trust, or estate.

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" profits or losses to its partners. Each partner reports their share of the partnership's income or loss on their personal tax return. In the event a partnership tax return is audited, by default, the partnership itself will be subject to paying income tax if it is determined that it had originally underreported its taxable income on the return. This is referred to as the centralized partnership audit regime. For more information about this Topic go to Page 67.

Partners are not employees and shouldn't be issued a Form W-2. The partnership must furnish copies of Schedule K-1 (Form 1065) to the partner.

Qualified Joint Ventures (QJV)

An unincorporated business jointly owned by a married couple is generally classified as a partnership for Federal tax purposes. For tax years beginning after December 31,2006, the Small Business and Work Opportunity Tax Act of 2007 (Public Law 110-28) provides that a "qualified joint venture," whose only members are a married couple filing a joint return, can elect not to be treated as a partnership for Federal tax purposes. Couples that are in civil unions or registered domestic partnerships are not considered “married” for tax purposes.

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By electing QJV status, certain married co-owners are permitted to avoid filing partnership returns, provided that each spouse separately reports a share of all of the businesses' items of income, gain, loss, deduction, and credit. Under the election, both spouses will receive credit for social security and Medicare coverage purposes.

Only businesses that are owned and operated by spouses as co-owners (and not in the name of a state law entity) qualify for the election, this means thar LLCs and LLPS are not eligible to make this election. Once the election is made, it can be revoked only with the permission of the IRS. However, the election technically remains in effect only for as long as the spouses filing as a qualified joint venture continue to meet the requirements for filing the election. If the spouses fail to meet the qualified joint venture requirements for a year, a new election will be necessary for any future year in which the spouses meet the requirements to be treated as a qualified joint venture.

Disregarded Entities for Employment and Excise Taxes

Disregarded entities, including Single Member Limited Liability Companies (SMLLCs) that are disregarded as separate from their owner and qualified subchapter S subsidiaries, must file certain excise tax returns using the disregarded entity's name and Employer Identification Number (EIN) rather than its owner's name and EIN.

This filing requirement for disregarded entities also applies to employment tax returns, effective for wages paid on or after January 1st, 2009. Disregarded entities must obtain an EIN for the payment and reporting of these taxes. A partnership does not pay income tax itself. Instead, it files an informational tax return on Form 1065, U.S. Return of Partnership Income, to report the income, deductions, gains, losses, etc., from operations. The partnership then passes through any profits or losses to the partners on a Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc. showing their allocable share of income or loss. Disregarded entity status applies not only to tax purposes but also for some legal and regulatory purposes.

Community Property

Spouses who wholly own an unincorporated business as community property under the community property laws of a state, foreign country, or U.S. possession can treat the business as either a sole proprietorship or a partnership. Some states have modified community property laws. Spouses should file Form 1065 to treat the entity as a partnership, or Schedule C or F in the name of one individual to treat the entity as a sole proprietorship. After the initial choice, a change in reporting is a conversion of the entity for federal tax purposes.

Corporations

A corporation is defined as a legal entity or structure created under the authority of the laws of a state, consisting of a person, or group of persons, who become shareholders. The entity's existence is considered separate and distinct from that of its members. Since a corporation is an entity in its own right, it is liable for its own debts and obligations. In forming a corporation, prospective shareholders transfer money, property, or both, for the corporation's capital stock. The profit of a corporation is taxed to this entity when earned, and then is taxed to the shareholders when distributed as dividends (double taxation). However, shareholders cannot deduct any loss of the corporation. The corporation pays taxes on its taxable income at a flat rate of 21%. Taxation as a corporation applies to the following businesses formed after 1996:

- A business formed under a federal or state law that refers to it as a corporation, body corporate, or body politic.

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- 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 file as a corporation. For example, a Limited Liability Companies (LLCs), can elect to be taxed as corporations by filing Form 8832.

S Corporations

An eligible domestic corporation can avoid double taxation (once to the corporation and again to the shareholders) by electing to be treated as an S corporation. S corporations 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. Generally, an S corporation is exempt from federal income tax other than tax on certain capital gains and passive income.

A corporation that meets the following requirements and tests can elect S corporation status:

- The corporation is a domestic corporation, or domestic entity eligible to elect corporation status, timely files Form 2553, Election by a small business corporation and meets other tests.
- The corporation has no more than 100 shareholders. Tax return preparers should treat an individual and their spouse as one shareholder and treat all members of a family and their estates as one shareholder for this test.
- The corporation has only individuals, estates, certain trusts that meet specific requirements, and certain exempt organizations.

S corporations that are required to file 10 or more returns in a calendar year (calculated by aggregating all returns of any type) are required to e-file their Forms 1120-S, effective for returns required to be filed on or after January 1, 2024.

Limited Liability Companies (LLCs)

An LLC is an entity formed under state law by filing articles of organization as an LLC, some states allow alternative methods like online filing or special forms. 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 (Form 1065), a corporation (Form 1120 or 1120-S) or disregarded as an entity separate from its owner if it has a single owner (Form 1040).

LLCs Default to Partnership Tax Treatment

A domestic LLC with at least two members that does not file Form 8832 is classified as a partnership for federal income tax purposes. Although the Limited Liability Company (LLC) has been a business format dating back to the 1970s, since 1988, when the IRS first ruled that it would treat qualifying LLCs as partnerships for tax purposes, the Limited Liability Company format increased in popularity.

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All 50 states and the District of Columbia have passed laws that allow LLCs therefore the number of LLCs continues to grow. As with a corporation, operating as an LLC allows an entity to avoid unlimited liability. LLCs offer significant flexibility in choosing their tax treatment. By default, they are treated as partnerships, but they can elect to be taxed as corporations (C corporations or S corporations) or disregarded entities for tax purposes.

When an eligible entity makes an election to change its classification, the entity generally cannot change (without permission of the IRS) its classification by election again during the 60 months after the effective date. The 60-month limitation does not apply if a newly formed eligible entity made the previous election, and the election was effective on the date of formation.

Single Member LLC

A single member LLC generally has the following choices:

1. File Form 8832 to be taxed as a corporation.
2. If qualified, file Form 2553, Election by a small business corporation (under Section 1362 of the IRC), to be taxed as an S corporation.
3. Be taxed (by default) as a disregarded entity:
    a. If the single member is an individual, the LLC will be taxed as a sole proprietorship.
    b. If the single member is a business entity, the LLC will be taxed as a division of the corporation.
4. Disregarded entity status for single member LLCs applies only for tax purposes.

The LLC remains a separate legal entity from its owner.

A single-member LLC cannot be classified as a partnership, because a partnership must have at least two owners.

Multiple Members LLC

A multiple members LLC generally has the following choices:

1. File Form 8832 to be taxed as a corporation.
2. If qualified, file Form 2553 to be taxed as an S-Corporation.
3. Be taxed (by default) as a partnership.

Digital Assets

A digital asset is a digital representation of value recorded on a cryptographically secured distributed ledger or similar technology. If a particular asset has characteristics of a digital asset, it's treated as one for federal income tax purposes. Examples of digital assets are:

- Convertible virtual currency and cryptocurrency.
- Stablecoins.
- Non-Fungible Tokens (NFTs).

A digital asset that has an equivalent value in real currency, or acts as a substitute for real currency, is referred to as convertible virtual currency, for example, a cryptocurrency.

It can be:

- Used to pay for goods and services.

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- Digitally traded.
- Exchanged for or into real currencies or other digital assets.

The IRS added a question about digital assets to business forms, including partnerships, corporations, s corporations and estates and trusts. The question is:

At any time during the year, did you:

a) receive (as a reward, award or payment for property or services); or
b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)?

Depending on the form, the digital assets question is written toward individual, corporate, partnership or estate and trust taxpayers. The question will be found on:

- Form 1041, U.S. Income Tax Return for Estates and Trusts, Schedule G, Other Information, Line 13.
- Form 1065, U.S. Return of Partnership Income, Schedule B, Line 30.
- Form 1120, U.S. Corporation Income Tax Return, Schedule K, Line 27.
- Form 1120-S, U.S. Income Tax Return for an S Corporation, Schedule B, Line 16.

Tax-exempt Entities and Associations

A tax-exempt status refers to federal income tax exemption under the IRC Section 501 (c). This means that an organization is exempt from paying federal corporate income tax on income generated from activities substantially related to the purposes for which the entity was organized: the purposes for which the organization was granted tax-exempt status.

However, the organization is to pay federal corporate income tax (at standard corporate tax rates) on income unrelated to its tax-exempt purposes, called Unrelated Business Taxable Income (UBTI). An organization meeting the requirements for federal tax exemption can usually rely on that status to exempt their income from state corporate income tax.

Regardless, the grand majority of associations that are tax-exempt are still subject to a wide variety of other taxes, including federal payroll taxes (Social Security, Medicare and unemployment), state and local unemployment taxes, real estate taxes, personal property taxes, sales and use taxes, franchise taxes, taxes on lobbying activities, among others.

Sometimes, exemptions for certain state and local taxes are provided for certain types of philanthropic organizations, as well as certain colleges and universities, hospitals and other entities. Tax-exempt entities are organized and operated exclusively for one or more of the following purposes:

- Charitable.
- Religious.
- Educational.
- Scientific.
- Literary.
- Testing for public safety.
- Fostering national or international amateur sports competition.
- Prevention of animal cruelty.

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To qualify, the organization must be a corporation, community chest, fund, unincorporated association or foundation. Organizations recognized as tax-exempt, may still be liable for tax on unrelated business income. Unrelated business income is income from a regularly carried on trade or business not relating substantially to the charitable, educational or other purpose that is the basis for the organization's exemption.

The majority of charitable organizations are required to apply for tax-exempt status using Form 1023, Application for Recognition of Exemption. Nonetheless, religious institutions such as churches, synagogues, temples, and mosques automatically qualify for tax exemption and are not obligated to seek formal exemption, although many still choose to do so.

An exempt organization meeting the filing requirements must file an exempt organization information return Form 990, Return of organization exempt from income tax, whether or not the organization has formal tax-exempt status. Most organizations that are not required to file Form 990, Form 990-EZ or Form 990-PF are required to submit a Form 990-N (e-Postcard).

Classifications and Elections of Entity Type by Default

When forming a business, choosing the right tax classification is crucial. This determines how the taxpayer's business profits and losses are taxed, a resolution must be made as to how the entity should be treated for U.S. income tax purposes (its tax classification).

Some entities are treated as pass-throughs entities; their income and expenses pass through the owners and are taxed on their personal tax returns. Examples include sole proprietorships, partnerships (by default) and S corporations (by election). Other entities, such as corporations (also known as associations) are taxed as separate entities and pay income tax on their profits. Owners pay taxes again when profits are distributed as dividends (double taxation).

An entity is a deemed corporation if it is formed that way under federal or state corporate statutes or is a type of foreign entity found on a comprehensive list found in Treas. Reg. 301.7701-2(b)(8) ("per se" foreign corporations). These entities are automatically classified as corporations and are not eligible to elect their classification. All other business entities are eligible to elect their classification. If no election is made, a default classification will apply, depending on the number of owners and for a foreign entity, whether the owners have limited or unlimited liability.

An eligible entity is classified for federal tax purposes under the default rules described below unless it files Form 8832, Entity Classification Election, or Form 2553, Election by a Small Business Corporation. An election to change an company'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 (although late elections are possible in some cases).

Default Rules

Certain domestic and foreign entities that were in existence before January 1st, 1997, and have an established federal tax classification generally do not need to make an election to continue that classification. If an existing entity decides to change its classification, it may do so subjected to the 60-month limitation rule.

Domestic default rule

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Unless an election is made on Form 8832, a domestic eligible entity is:

- Partnership with two or more owners.
- Disregarded as an entity separate from its owner if it has a single owner (treated as a sole proprietorship).
- A change in the number of members of an eligible entity classified as an association does not affect the entity's classification. However, an eligible entity classified as a partnership will become a disregarded entity when the entity's membership is reduced to one member and a disregarded entity will be classified as a partnership when the entity has more than one member.

Foreign default rule

Unless an election is made on Form 8832, a foreign eligible entity is:

- A partnership if it has two or more members with at least one having unlimited liability.
- An association taxable as a corporation if all members have limited liability.
- Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

However, if a qualified foreign entity files a valid election to be classified as a partnership based on the reasonable assumption that it had two or more owners as of the effective date of the election and the qualified entity is later determined to have a single owner, the IRS will deem the election to be classified as a disregarded entity provided:

- The qualified entity's owner and purported owners file amended returns that are consistent with the treatment of the entity as a disregarded entity.
- The amended returns are filed before the close of the period of limitations on assessments under Section 6501(a) for the relevant tax year.
- The corrected Form 8832, with the box checked entitled: Relief for a late change of entity classification election sought under Revenue Procedure 2010-32, is filed and attached to the amended tax return.
- Also, if the qualified foreign entity files a valid election to be classified as a disregarded entity based on the reasonable assumption that it had a single owner as of the effective date of the election and the qualified entity is later determined to have two or more owners, the IRS will deem the election to be classified as a partnership provided:
- The qualified entity files information returns and the actual owners file original or amended returns consistent with the treatment of the entity as a partnership.
- The amended returns are filed before the close of the period of limitations on assessments under Section 6501(a) for the relevant tax year.
- The corrected Form 8832, with the box checked entitled: Relief for a late change of entity classification election sought under Revenue Procedure 2010-32, is filed and attached to the amended tax returns.

Employer Identification Number

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. An EIN is similar to a Social Security number for businesses. It is used by the IRS to identify taxpayers and file various business tax returns. However, for employee plans, an alphabet letter (e.g., 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

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used by employers, sole proprietors, corporations, partnerships, non-profit associations, trusts, estates of decedents, government agencies, certain individuals, and other business entities.

It is not mandatory to use an EIN on all documents sent to the Social Security Administration (SSA). However, it can be helpful for efficient communication, especially for businesses that pay employee taxes. Although not everyone needs an EIN, it's often recommended for businesses to obtain one, even if they don't currently have employees. It simplifies tax filing and can help establish a business credit history.

An Employer Identification Number (EIN) is required for the following entities:

- Reporting employment taxes and excise taxes.
- A partnership.
- An limited liability company (LLC).
- A corporation.
- An exempt organization.
- An estate.
- A trust (except certain grantor-owned revocable trusts).
- A Retirement plan or individual retirement account (IRA).
- A Real estate mortgage investment conduit.
- A Farmers' cooperative.
- Some states may also require an EIN for specific business activities.

Accounting Periods (Tax Year)

The tax law requires taxpayers to report taxable income using the method of accounting they regularly use in keeping their books, provided the method clearly reflects the taxpayer's income. While the terms are related, it is helpful to distinguish between a tax year and an accounting period:

- **Tax year:** The period used for filing tax returns with the IRS.
- **Accounting period:** The period a business uses for its internal financial statements.

Individuals can generally choose to file tax returns using either a calendar year (January 1st - December 31st) or a fiscal year (any 12-month period ending on a specific day other than December 31st). It is the period for which financial statements are prepared. For example, the income statement and the cash flow statement report the amounts occurring during the accounting period and the balance sheet reports the amounts of assets and liabilities as of the final moment of the accounting period.

NOTE: Obtaining IRS approval to change a fiscal year can involve specific requirements and potential tax consequences.

Practically all individuals file tax returns using a calendar-year accounting period. Individuals reporting tax income on a fiscal year other than a calendar year are extremely rare since the tax system is set up to accommodate calendar-year taxpayers. Fiscal years are more commonly used by businesses than individuals. Businesses may choose a fiscal year that aligns with their peak selling seasons or funding cycles. However, there are no restrictions on an individual taking a tax year other than a calendar year. The choice to file on a fiscal year basis must be made with an initial tax return, books and records must be kept on that basis. An individual may also request IRS approval

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to change to a fiscal year if certain conditions are met. Unless the business has a required tax year, the business adopts a tax year by filing its first income tax return using that tax year. A required tax year is a tax year required under the Internal Revenue Code and the Income Tax Regulations. The business has not adopted a tax year if it merely did any of the following:

- Filed an application for an extension of time to file an income tax return.
- Filed an application for an employer identification number.
- Paid estimated taxes for that tax year.

If the business files its first tax return using the calendar tax year and it later begins business as a sole proprietor, becomes a partner in a partnership, or becomes a shareholder in an S corporation, the business must continue to use the calendar year unless it gets IRS approval to change it or meets one of the exceptions listed in the instructions to Form 1128, Application To Adopt, Change, or Retain a Tax Year.

52 - 53 Week Tax Year

A 52-53-week tax year can be beneficial for businesses with consistent seasonal fluctuations. It allows them to close their books on a day that falls within their natural business cycle, potentially minimizing distortions in income reporting. If making 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:

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

For example, if a taxpayer elects a tax year that always ends on the last Monday in March, their 2024 tax year will end on March 29th, 2025.

Calendar Year

A calendar year is simply the conventional year that begins on January 1st and ends on December 31*. Most businesses use the calendar year for financial calculations. If such a firm refers to its 2024 full-year profits, for example, it refers to the total money it has earned between January 1* and December 31*, 2024.

Unless otherwise stated, it is assumed that a firm uses the calendar year. However, to eliminate any possible confusion, the annual reports of most firms that use the calendar year will specifically state the beginning and end dates covered by the income statement, even if these days coincide with the beginning and end of the calendar year.

Fiscal Year

A fiscal year is a 12-month period that ends on the last day of any month except December. A fiscal year may end on April 30th, for example, this fiscal year would start on May 1st of the previous year since it must cover 12 full consecutive months. To find the start date of a fiscal year, add one day to the end date and then go back a full year.

If the last day of a fiscal year is August 31st, 2024, adding one day will take the person to September 1st, 2025, which is the start day of another fiscal year. Fiscal years are more commonly used by businesses than individuals. These deadlines can be extended by filing Form 4868 for an automatic extension of time to file various tax forms.

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Before switching to a fiscal year, a taxpayer must first obtain the approval of the IRS. Taxpayers who use a fiscal year must send their tax returns on the 15th day of the fourth month following the conclusion of their fiscal year. If, for example, a taxpayer's fiscal year ended on June 30th, their tax filing deadline is October 15th.

Short Year

A short tax year is a tax year of less than 12 months. A short period tax return may be required when the entity:

- Are not in existence for an entire tax year, or
- Change their accounting period.

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

Required Year for Partnership and S Corporation

Generally, partnerships, S corporations (including electing S corporations), and PSCs must use a required tax year. A required tax year is a tax year that is required under the Internal Revenue Code and Treasury Regulations. The entity does not have to use the required tax year if it receives IRS approval to use another permitted tax year or makes an election under section 444 of the Internal Revenue Code.

Partnership

A partnership must conform its tax year to its partners' tax years. 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.

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:

- Calendar year.
- A tax year elected under section 444 of the Internal Revenue Code. See Section 444 Election.
- 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, instead of filing Form 1128. For information about changing an S corporation's tax year and information about ruling requests, see the Instructions for Form 1128.

Section 444 Election

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A partnership, S corporation, or PSC can make a section 444 election. This election consists of requesting to use a tax year other than its required tax year by filing Form 8716, Election to Have a Tax Year Other than a Required Tax Year. A partnership, S corporation or PCS must meet all the following requirements to make the election:

- It is not a member of a tiered structure (defined in Treasury Regulations section 1.444-21).
- It has not previously had a section 444 election in effect.
- It elects a year that meets the deferral period requirement.

If this election is made, then the business must generally make certain required payments based upon the value of the tax deferral the owners receive by using a tax year different from the required tax year.

The determination of the deferral period depends on whether the partnership, S corporation, or PSC is retaining its tax year or adopting or changing its tax year with a section 444 election. Generally, a partnership, S corporation, or PSC can make a section 444 election to retain its tax year only if the deferral period of the new tax year is 3 months or less. This deferral period is the number of months between the beginning of the retained year and the close of the first required tax year.

If the partnership, S corporation, or PSC is adopting or changing to a tax year other than its required year, the deferral period is the number of months from the end of the new tax year to the end of the required tax year. The IRS will allow a section 444 election only if the deferral period of the new tax year is less than the shorter of:

- Three months, or
- The deferral period of the tax year being changed. This is the tax year immediately preceding the year for which the partnership, S corporation, or PSC wishes to make the section 444 election.

If the partnership, S corporation, or PSC's tax year is the same as its required tax year, the deferral period is zero. The section 444 election remains in effect until it is terminated. If the election is terminated, another section 444 election cannot be made for the any tax year. The election also ends automatically when any of the following occurs:

- The entity changes to its required tax year.
- The entity liquidates.
- The entity becomes a member of a tiered structure.
- The IRS determines that the entity willfully failed to comply with the required payments or distributions.
- The entity is an S corporation, and the S election is terminated.

Reporting Requirements

Any person engaged in a trade or business, including a corporation, partnership, individual, estate and trust, are subject to a series of reporting requirements including.

Form W-2: Employers must file a Form W-2 showing the wages paid for services performed, including noncash payments, and if income, Social Security, or Medicare tax was withheld. Federal Insurance Contributions Act (FICA) taxes (Social Security and Medicare) are taxes paid for benefits that workers and their families receive under the FICA. Social Security tax pays for benefits under the old age, survivors, and disability insurance part of FICA. Medicare tax pays for benefits under the hospital insurance part of FICA. Employers must withhold part of these taxes from their employee's wages and must pay a matching amount.

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The tax rate for Social Security is 6.2% for employees, 6.2% for employers and 12.4% for self-employed individuals. The Social Security tax applies only to the first $168,100 of wages for 2024. 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.

An additional Medicare tax of 0.9% applies to certain high-income employees. Employers are responsible for withholding the 0.9% Additional Medicare Tax on an individual's wages paid in excess of $200,000 (for Single, HOH and QSS; $250,000 for MFJ; and $125,000 for MFS) in a calendar year, without regard to filing status. An employer is required to begin withholding Additional Medicare Tax in the pay period in which it pays wages in excess of these amounts to an employee and continue to withhold it each pay period until the end of the calendar year. There is no employer match for Additional Medicare Tax.

Form W-4: The employee of a business must complete Form W-4 so that their employer can withhold the correct federal income tax from their pay. Federal law requires the employer to withhold certain taxes from their employees' pay. Each time the employer pays wages, they must withhold, or take out of the employees' pay, certain amounts for federal income tax, social security tax, and Medicare tax.

- If the employer pays wages subject to federal income tax withholding for social security and Medicare taxes, they must file Form 941, Employer's Quarterly Federal Tax Return, or Form 944, Employer's Annual Federal Tax Return, to report the following amounts:
- Wages the employer paid.
- Tips the employer's employees reported to the employer.
- Federal income tax the employer withheld.
- Both the employer and the employee share of social security and Medicare taxes.
- Additional Medicare Tax withheld from employees.
- Current quarter's adjustments to social security and Medicare taxes for fractions of cents, sick pay, tips, and group-term life insurance.
- Qualified small business payroll tax credit for increasing research activities.

The employer must use Form 940 to report their annual Federal Unemployment Tax Act (FUTA) tax. Together with state unemployment tax systems, the FUTA tax provides funds for paying unemployment compensation to workers who have lost their jobs. Most employers pay both a federal and a state unemployment tax. Only employers pay FUTA tax, this tax does not collect or deduct from the employees' wages. The FUTA tax rate is 6% on the first $7,000 paid to each employee.

Estimated Taxes: Generally, estimated tax payments are required to pay employment tax obligations.

- **Sole Proprietors, Partners, and S Corporation Shareholders:** When the owner(s) of such a business expect(s) to owe $1,000 or more in taxes, those individuals generally make estimated tax payments. Individual taxpayers use Form 1040-ES (Estimated Tax for Individuals) to figure and pay estimated tax. The four estimated payments are due by the 15th day of the fourth, sixth, ninth and the first month of the following year.
- **Corporations:** A corporation must make estimated tax payments during the tax year if it expects its total tax for the year (less applicable credits) to be $500 or more. The corporation must make the estimated tax payments for the tax year in four installments. The instalments are due by the 15th day of the fourth, sixth,

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ninth, and twelfth months of the tax year. If an installment due date falls on a Saturday, Sunday, or legal holiday, the installment is due on the next regular business day.

Electronic deposit of employment taxes: All taxpayers must use electronic funds transfer to make all federal tax deposits (such as deposits of employment tax, excise tax and corporate income tax). Electronic funds transfers are made using the Electronic Federal Tax Payment System (EFTPS). There are two deposit schedules (monthly and semi-weekly). Employers determine the required deposit schedule before the beginning of each calendar year by calculating prior employment tax liability within a look back period (begins July 1st and ends June 30th).

- **Monthly deposit schedule:** Tax liability during look back period was $50,000 or less.
- **Semi-weekly deposit schedule:** Tax liability during look back period was more than $50,000.

Form I-9 (Employment Eligibility Verification): Used by the employer to verify that each new employee is legally eligible to work in the United States. The employer must collect the U.S. Citizenship and Immigration Services Form I-9 from his employees and maintain in records.

Form 1099-B, Proceeds from broker and barter exchange transactions: In general, a securities broker must report and provide a Form 1099-B for each person for whom the broker has sold (including short sales) stocks, bonds, commodities, regulated futures contracts, foreign currency contracts, forward contracts, debt instruments, etc., for cash. Legislation requires brokers to report cost basis in addition to proceeds from these transactions. Cost basis information makes the calculation of gains and losses easier for taxpayers.

Form 1099-C, Cancellation of debt: Certain entities must issue a Form 1099-C to each borrower for canceled debts more than $600 on secured property. Under certain circumstances, a borrower may recognize taxable income because of a debt that is canceled.

Form 1099-DIV: A corporation must generally send Forms 1099-DIV to the IRS with Form 1096 by February 28th of the year following the year of a distribution. Generally, a corporation must file Forms 1099-DIV to shareholders by January 31st of the year following the close of the calendar year during which the corporation made the distributions. It is necessary to file a Form 1099-DIV with the IRS for each person the corporation:

- Paid dividends (including capital gain dividends) and other distributions on stock of $10 or more,
- Withheld and paid any foreign tax on dividends and other distributions on stock,
- Withheld any federal income tax on dividends under the backup withholding rules, or
- Paid $600 or more as part of a liquidation.

Form 1099-G, Certain government payments: This form is required for federal, state, and local governments to report specific payments they issue, such as unemployment compensation, tax refunds and agricultural assistance. Additionally, the form is used to report payments received on loans from the Commodity Credit Corporation.

Form 1099-INT, Interest income: Financial institutions that pay interest must report details regarding those payments in the following circumstances:

- The interest payments are at least $10. Certain types of interest, such as interest on delayed death benefits paid by a life insurance company or interest on a state or federal tax refund have a higher threshold of $600.
- If the institution withheld and paid any foreign tax on interest.

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- If the institution withheld (and did not refund) any federal income tax under the backup withholding rules regardless of the amount of the payment.

Form 1099-NEC, Nonemployment compensation: If the following four conditions are met, the business must generally report a payment as Non-Employment Compensation (NEC).

- The business made the payment to someone who is not their employee.
- The business made the payment for services in the course of their trade or business (including government agencies and nonprofit organizations).
- The business made the payment to an individual, partnership, estate, or, in some cases, a corporation.
- The business made payments to the payee of at least $600 during the year.

Form 1O99-MISC, Miscellaneous income: A business taxpayer uses Form 1O99-MISC to report certain business payments. These payments include the following items: • At least $10 in royalties or broker payments in lieu of dividends or tax-exempt interest.

- At least $600 in:
  - Rents.
  - Prizes and awards.
  - Other income payments.
  - Medical and health care payments.
  - Crop insurance proceeds.
  - Cash payments for fish (or other aquatic life) one purchases from anyone engaged in the trade or business of catching fish.
  - Generally, the cash paid from a notional principal contract to an individual, partnership, or estate.
  - Payments to an attorney.
  - Any fishing boat proceeds.
  - In addition, Form 1099-MISC should be used to report direct sales of at least $5,000 of consumer products to a buyer for resale anywhere other than a permanent retail establishment.

Form 1099-0ID: The Original Issue Discount (OID) is the difference between the purchase price of a debt instrument and its maturity value. Each year, a portion of the discount accrues as income to the recipient. A financial institution must report OID if it amounts to at least $10.

Form 1099-R, Distributions from pensions, annuities: For reportable distributions of $10 or more from retirement accounts, insurance contracts, and annuities. In addition to the amount distributed, a number or letter code in box 7 tells the taxpayer details about the type of distribution they received.

Electronic-Filing Requirements for Specified Returns and Other Documents

The Department of the Treasury and the Internal Revenue Service issued final regulations amending the rules for filing returns and other documents electronically (e-file). These regulations will require certain filers to e-file beginning in 2024.

These regulations affect filers of partnership returns, corporate income tax returns, unrelated business income tax returns, withholding tax returns, certain information returns, registration statements, disclosure statements,

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notifications, actuarial reports and certain excise tax returns. The final regulations reflect changes made by the Taxpayer First Act (TFA) to increase e-filing without undue hardship on taxpayers.

Specifically, the final regulations:

- Reduce the 250-retum threshold enacted in prior regulations to generally require electronic filing by filers of 10 or more returns in a calendar year. The final regulations also create several new regulations to require e-filing of certain returns and other documents not previously required to be e-filed;
- Require filers to aggregate almost all information return types covered by the regulation to determine whether a filer meets the 10-return threshold and is required to e-file their information returns. Earlier regulations applied the 250-return threshold separately to each type of information return covered by the regulations;
- Eliminate the e-filing exception for income tax returns of corporations that report total assets under $10 million at the end of their taxable year, and
- Require partnerships with more than 100 partners to e-file information returns, and they require partnerships required to file at least 10 returns of any type during the calendar year to e-file their partnership return.

To help with this process, the IRS created a new, free online portal last month to help businesses file Form 1099 series information returns electronically. Known as the Information Returns Intake System (IRIS), this free electronic filing service is secure, accurate and requires no special software. Though available to any business of any size, IRIS may be especially helpful to any small business that currently sends their 1099 forms on paper to the IRS.

The final regulations generally provide hardship waivers for filers that would experience hardship in complying with the e-filing requirements and administrative exemptions from the e-filing requirements to promote effective and efficient tax administration.

Hobby vs. Business Determination and Loss Limitations

For an activity to constitute a trade or business, taxpayers must have the express purpose of making a profit. If not engaging in the activity for profit, the regulations limit the deductibility of expenses and losses, commonly called the hobby loss rules. An individual, partnership, S corporation, estate, or trust, but not a C corporation, can generate hobby income.

Taxpayers engage in an activity for profit if gross income exceeds deductions from the activity for at least three of five consecutive tax years, and two of seven consecutive years in the case of breeding, training, showing, or racing horses.

Determination

The IRC provides nine relevant factors to make the determination of whether an activity is engaged in for profit. All of the following are taken into account when making this determination:

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1. **Manner in which the taxpayer carries on the activity:** If the taxpayer carries on the activity in a business-like manner and maintains complete and accurate books and records, it may indicate that the taxpayer engages in the activity for profit.
2. **The expertise of the taxpayer or their advisors:** If the taxpayer prepares for the activity by doing an extensive study of its accepted business, economic, and scientific practices, or consulting experts in the matter, it may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices.
3. **The time and effort expended by the taxpayer in carrying on the activity:** The fact that the taxpayer devotes much of their personal time and effort to carrying on an activity, particularly if said activity does not have personal or recreational aspects, may indicate an intention to derive a profit. A withdrawal from another occupation to devote most of their energies to the activity may also be evidence that the taxpayer engages in the activity for profit.
4. **Expectation that assets used in the activity may appreciate:** If the taxpayer expects to profit from the activity, this may indicate it is done for profit.
5. **The success of the taxpayer in carrying on other similar or dissimilar activities:** The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that they are engaged in the present activity for profit, even though the activity is presently unprofitable.
6. **The taxpayer's history of income or losses with respect to the activity:** A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the taxpayer is not engaged in the activity for profit. However, where losses continue to be sustained beyond the necessary period to bring the operation to profitable status, such continued losses, if not explainable as due to customary business risks or reverses, might be indicative that the taxpayer is not engaged in the activity for profit.
7. **The amount of occasional profits earned:** The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent.
8. **The financial status of the taxpayer:** The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that the taxpayer engages in the activity for profit Substantial income from sources other than the activity may indicate that the taxpayer does not engage in the activity for profit
9. **Elements of personal pleasure or recreation:** The presence of personal motives in carrying on an activity may indicate that the taxpayer does not engage in the activity for profit, especially where there are recreational or personal elements involved.

Reporting a Hobby

The taxpayer must report hobby activity income on Form 1040, Schedule 1, line 8: Other income. The expenses paid by the taxpayer for the activity not meant to make a profit, are miscellaneous itemized deductions and can no longer

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be deducted. Therefore, for the 2024 tax year hobby expenses deduction is not available. Since hobby expenses are no longer deductible, neither are expenses exceeding the income from hobby activity, i.e., hobby losses.

If a taxpayer receives income for an activity that they don't carry out to make a profit, the expenses they pay for the activity are miscellaneous itemized deductions and can no longer be deducted. The taxpayer must still report the income they receive on Schedule 1, Form 1040, line 21.

REVIEW QUESTIONS

1. On which schedule must a sole proprietor report profit or loss?

A. Schedule A
B. Schedule B
C. Schedule C
D. Schedule D

Answer: C

Sole proprietors report profit or loss on Schedule C, Profit or loss from business, or for farmers doing business as a sole proprietorship, Schedule F, Profit or loss from farming.

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2. BRG Corporation has 56 shareholders, whereas TECS Corporation has 161. Which of them may elect S-corporation status?

A. BRG
B. TECS
C. Both of them
D. Neither of them

Answer: A

One of the requirements for a corporation to be able to elect the S-corporation status is to have no more than 100 shareholders. Only BRG meets these requirements

3. For a taxpayer whose fiscal year ends on May 20, which is their filing deadline?

A. June 15
B. October 15
C. September 15
D. April 15

Answer: C

Taxpayers who use a fiscal year must send their tax returns on the 15th day of the fourth month following the conclusion of their fiscal year. In this case, as the taxpayer's fiscal year ended on May 20, its filing due date is in the 15th day of the fourth month following that date, which falls on September.

4. Carlos, a sole proprietor, expects to owe at least $1,200 in taxes. MK Corporation expects to owe at least the half of Carlos' expectation amount in taxes. Which of them is to make estimated tax payments?

A. Carlos
B. MK Corporation
C. Both of them
D. Neither of them

Answer. C

Sole proprietors must make estimated tax payments if they expect to owe at least $1,000 in taxes. Corporations must make estimated tax payments if they expect to owe at least $500. MK Corporation expects to owe at least the half of Carlos' expectation amount, namely $600, so that MK has to make estimated tax payments as well.

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5. Jose owed $700 to a government agency; the agency cancels the debt. Which form is the entity required to issue to Jose?

A. Form 1099-B
B. Form 1099-C
C. Form 1099-DIV
D. The entity is not required to issue any form.

Certain entities must issue a Form 1099-C to each borrower for canceled debts more than $600 on secured property.

6. A corporation paid $500 as part of a liquidation to a shareholder. Provided only this information, which is the form the corporation is to file?

A. Form 1099-B
B. Form 1099-C
C. Form 1099-DIV
D. The entity is not required to issue any form.

Answer: D

It is necessary to file a Form 1099-DIV with the IRS for each person the corporation:

- *Paid dividends (including capital gain dividends) and other distributions on stock of $10 or more,*
- *Withheld and paid any foreign tax on dividends and other distributions on stock,*
- *Withheld any federal income tax on dividends under the backup withholding rules, or*
- *Paid $600 or more as part of a liquidation.*

7. A multiple members LLC can be taxed as all of the following, except:

A. As a corporation
B. As a sole proprietorship
C. As a partnership
D. As an S-Corporation

Answer: B

A multiple members LLC generally has the following choices:

- *File Form 8832 to be taxed as a corporation.*
- *If qualified, file Form 2553 to be taxed as an S-Corporation.*
- *Be taxed (by default) as a partnership.*

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8. An Employer Identification Number (EIN) is required for the following entities, except:

A. A sole proprietorship with no employees.
B. A partnership.
C. A trust or an estate.
D. An employee plan.

Answer: A

An Employer Identification Number (EIN) is required for the following entities:

- *Reporting employment taxes and excise taxes.*
- *A partnership.*
- *An limited liability company (LLC).*
- *A corporation.*
- *An exempt organization.*
- *An estate.*
- *A trust (except certain grantor-owned revocable trusts).*
- *A Retirement plan or individual retirement account (IRA).*
- *A Real estate mortgage investment conduit.*
- *A Farmers' cooperative.*
- *Some states may also require an EIN for specific business activities.*

9. Which of these is a factor that determines whether an activity is engaged in for profit or not?

A. The success of the taxpayer in carrying on other similar or dissimilar activities.
B. The financial status of the taxpayer.
C. The family members that are involved in said activity.
D. A and B.

Answer: D

The IRC provides nine relevant factors to make the determination of whether an activity is engaged in for profit No factor is required in making this determination.

- *Manner in which the taxpayer carries on the activity.*
- *The expertise of the taxpayer or their advisors.*
- *The time and effort expended by the taxpayer in carrying on the activity.*

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- *Expectation that assets used in the activity may appreciate.*
- *The success of the taxpayer in carrying on other similar or dissimilar activities.*
- *The taxpayer's history of income or losses with respect to the activity.*
- *The amount of occasional profits earned.*
- *The financial status of the taxpayer.*
- *Elements of personal pleasure or recreation.*

10. 0n which date should the 52- or 53-week tax year end?

A. Whatever date the day of the week chosen by the taxpayer last occurs in a calendar month.
B. April 15.
C. A and D.
D. Whatever date the day of the week chosen by the taxpayer falls that is nearest to the last day of the calendar month.

Answer: C

The 52- or 53-week tax year must always end on:

- *Whatever date the day of the week chosen by the taxpayer last occurs in a calendar month, or*
- *Whatever date the day of the week chosen by the taxpayer falls that is nearest to the last day of the calendar month.*

11. For corporations, when are estimated tax payments due?

A. On the 15th day of the 3rd, 5th, 7th and 9th month of the corporation's tax year.
B. On the 30th day of the 3rd, 6th, and 12th months of the corporation's tax year.
C. On the 15th day of the 4th, 6th, 9th, and 12th months of the corporation's tax year.
D. On the 1st day of the 2nd, 6th, and 12th months of the corporation's tax year.

Answer: D

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.

12. What should be reported on Form 1099-C?

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A. Interest income
B. Distributions
C. Cancellation of debt
D. Payment card transactions

Answer: C

Form 1099-C is needed to report the cancellation of debt, and the responsible party for reporting this are financial institutions, credit unions, federal agencies and any organization that lends money on a regular and continuing basis. The amount to report is $600 or more, and it should be due to the recipient by January 31.

Module: Partnerships

A partnership is a business entity established by two or more persons to carry on a trade or business, with each person contributing money, property, labor or skill, and each expecting to share in the profits and losses of the business whether a formal partnership agreement is made. The term "partnership" includes a limited partnership, syndicate, group, pool, joint venture, or other unincorporated organization, through or by which any business, financial operation, or venture is carried on, that is not, within the meaning of the regulations under Section 7701, a corporation, trust, estate, or sole proprietorship.

A partnership can have an unlimited number of partners and can have partners that are foreign or domestic. The partnership must always have at least one general partner whose actions legally bind the business and who is legally responsible for a partnership's debts and liabilities.

Partnership Income, Expenses, Distributions, and Flow Through

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Certain rules determine the character of the partnership's gain or loss on a later disposition of specific types of contributed property. The partnership computes its income and files its return in the same manner as individuals do. However, a partnership must report certain items of gain, loss, income, etc., separately and exclude certain deductions.

Separately reported items are those that are subject to special calculations or limitations on the tax returns of the partners. Once the special items are separated, the partnership reports its ordinary income or loss. The ordinary income or loss of a partnership is calculated in the same manner as that of an individual, except the partnership is not allowed to deduct the standard deduction, amounts for exemptions, foreign taxes paid, charitable contributions, net operating losses, or personal itemized deductions.

Schedule K-1 of Form 1065 presents the allocation of ordinary income or loss, special income and deductions, and gains and losses to each partner. The partners report the amounts from their Schedule K-1s on their own tax returns. Portfolio income, stated separately to partners, includes all gross income, other than income derived in the ordinary course of a trade or business that is attributable to the following:

- Interest.
- Dividends.
- Royalties.
- Income from a Real Estate Investment Trust (REIT).
- A Regulated Investment Company (RIC).
- A Real Estate Mortgage Investment Conduit (REMIC).
- A common trust fund.
- A Controlled Foreign Corporation (CFC).
- A Qualified Electing Fund (QEF).
- A cooperative.
- Income from the disposition of property that produced portfolio income.
- Income from the disposition of property held for investment.

Income derived in the ordinary course of a trade or business, and includible in business ordinary income, include the following types of income:

- Interest income on loans and investments made in the ordinary course of a trade or business of lending money.
- Interest on accounts receivable.
- Income from investments made in the ordinary course of business of furnishing insurance or annuity contracts.
- Income and gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business.
- Royalties derived in the ordinary course of a trade or business of licensing intangible property.
- Amounts included in the gross income of a patron of a cooperative by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron.

Reporting Distributive Share

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Report the partner's distributive share of certain items of income, gain, loss, deduction, or credit on the partner's individual tax return, even if the partnership does not actually distribute any money to the partner. The character of certain items of income, gain, loss, deduction, or credit included in a partner's distributive share is determined as if the partner realized the item directly from the same source as the partnership and incurred the item in the same manner as the partnership.

The partnership generally specifies the treatment of an item, and the partner generally treats the item the same way on their individual return. If a partner treats an item differently, they should identify the different treatment by filing Form 8082, Notice of inconsistent treatment or Administrative Adjustment Request (AAR).

Schedules L, M-1, M-2, and M-3

If the partnership meets the following provisions, the partnership does not need to file Schedule L, Balance sheets per books, Schedule M-1, Reconciliation of income (loss) per books with income (loss) per return, and Schedule M-2, Analysis of partners' capital accounts:

- The partnership's total receipts were less than $250,000.
- The partnership's total assets at the end of the year were less than $1,000,000.
- The return includes Schedules K-1. Each partner receives a Schedule K-1 on or before the due date (including extensions) for the partnership return.
- The partnership is not required to file Schedule M-3.

Schedule M-3 is required instead of Schedule M-1 if any of the following are true:

- The amount of total assets at the end of the tax year reported on Schedule L is equal to $10 million or more.
- The amount of adjusted total assets for the year is equal to $10 million or more.
- The amount from total receipts is equal to $35 million or more.

An entity that is a reportable entity partner with respect to the partnership owns or is deemed to own, directly or indirectly, an interest of 50% or more in the partnership's capital, profit, or loss, on any day during the tax year.

For partnerships required to file Schedule M-3, the amounts reported on Schedule L must be amounts from financial statements used to complete Schedule M-3. A partnership required to file Schedule M-3 must also complete Schedule C (Form 1065), Additional information for Schedule M-3 filers. The balance sheet, Schedule L, should agree with the partnership's books and records. If not, attach a statement to the return explaining the difference.

Schedule M-1 is the partnership's reconciliation of income or loss per books with income or loss on the return. Many items of a partnership are separately stated and passed through to the partners and are not included in determining the income per the tax return.

Schedule M-2 is an analysis of the partners' capital accounts. The amounts reported on all of the partners' Schedules K-1, box L, equal the amounts reported on Schedule M-2. The partners' capital accounts maintained by the partnership are not the same as the partner's outside basis in their partnership interest. In the very basic of formats, these two amounts can be equal, but in most real-life partnership situations, they are not equal.

Self-Employment Income

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A partner is not an employee of the partnership. The partner's distributive share of ordinary income from a partnership is generally included in figuring net earnings from self-employment A limited partner generally does not include their distributive share of partnership income in computing earnings from self-employment. This exclusion does not apply to guaranteed payments to a limited partner for services rendered.

Expenses of a Partnership

The taxpayer can deduct their legitimate business expenses from their business income, which will greatly lower the profits they have to report to the IRS. Deductible expenses include start-up costs, operating expenses, travel costs, and product and advertising outlays, as well as a portion of the money the taxpayer spend on business-related meals and entertainment.

Family Partnerships

Family members can also form a partnership business: Any members, either family or not, will be identified as partners if they fulfill some requirements. If the capital contributed will result in income, or if the acquisition of the capital was through a donation or a purchase from a member of the family, the member either has the ownership of the interest in partnership or controls the interest.

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 the 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 must have joined together in good faith to conduct a business. In addition, they must have agreed that contributions of each entitle them to a share in the profits. Some capital or service must be provided by each partner.

Family Limited Partnership

For many years, the Family Limited Partnership (FLP) has been used as a vehicle to own and manage family property or family business enterprises in an entity to enable transfers of limited partnership interests (through gifts or sale) to descendants (or trusts for descendants) on a leveraged basis due to valuation discounts which are customarily associated with transfers of limited partnership interests. The discounts are consistent with discounts attributable to a minority interest position in a closely held corporation. Due to its use of transferring assets at discounted values, the IRS continues to monitor the validity and use of family limited partnerships.

Example: Diana, a mother, sold out 50% of her business to her daughter, Estela. They formed a partnership, which made a profit of $124,000. Diana performed services for which $48,000 were reasonable compensation, while Estela carried no activities. Diana should be compensated $48,000 and, regardless of that amount, the $124,000 should be divided at 50%, that is $62,000. The share of the daughter should not exceed $62,000.

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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 FMV 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).

Partner's Dealings with Partnership

Tax return preparers should treat a partner as not being a partner of the partnership for transactions listed below involving a partner and the partnership:

- Performing services for or transferring property to a partnership when the following apply:
  - There is a related allocation and distribution to a partner.
  - The entire transaction is between the partnership and a partner not acting in the capacity of a partner.
- Transferring money or other property to the partnership when the following apply:
  - There is a related transfer of money or other property by the partnership to the contributing partner or another partner.
  - The transactions equal a sale or exchange of property.

Partnerships using the accrual method of accounting cannot deduct any business expense owed to a cash basis partner who owns any interest in the partnership until the amount is paid. This rule does not apply to guaranteed payments made to a partner.

Sale or Exchange of Property

Gains

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:

- More than 50% of the capital or profits interest in the partnership is directly or indirectly owned by the same person(s).
- The property in the hands of the transferee immediately after the transfer occurs is not a capital asset Property that is not a capital asset includes:
  - Accounts receivable.
  - Inventory.
  - Depreciable or real property used in a trade or business.

More than 50% Ownership

1. To determine if there is more than 50% ownership in partnership capital or profits, the following rules apply:
2. 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.
3. 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.

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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.

Example: Individuals Antonia, Benito and Trust Flores are equal partners in Partnership ABF. Antonia's husband, Ricardo, is the sole beneficiary of Trust Flores. Trust Flores's partnership interest will be attributed to Ricardo only for the purpose of further attributing the interest to Antonia. As a result, Antonia is a more-than-50% partner. This means that any deduction for losses on transactions between her and ABF will not be allowed and gain from property that in the hands of the transferee is not a capital asset is treated as ordinary, rather than capital gain.

Losses

Losses will not be allowed from a sale or exchange of property (other than partnership interest) 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 person 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.

Guaranteed Payments

These are made by a partnership to a partner and 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 the 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.

The partnership generally deducts guaranteed payments on line 10 of Form 1065 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 their 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. 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.

Minimum payment: 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.

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Partner's Liabilities Assumed by Partnership

If contributed property is subject to 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 their 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 them contributing money to the partnership.

Example 1: 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 interest is:

Adjusted basis of contributed property	$8,000
Minus: Part of mortgage assumed by other partners (80% x $4,000)	$3,200
Basis of Ivan's partnership interest	$4,800

Example 2: If, in Example 1, the contributed property had a $12,000 mortgage, the basis of Ivan's partnership interest would be zero. The $1,600 difference between the mortgage assumed by the other partners, $9,600 (80% x $12,000), and his basis of $8,000 would be treated as capital gain from the sale or exchange of a partnership interest. However, this gain would not increase the basis of his partnership interest.

Contribution of Property and/or Services to a Partnership

Neither gain nor loss is recognized when property is contributed to exchange for a partnership interest. The general rule under IRC Section 721(a) is that 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 contributing partner's holding period.
- The contributing partner receives a basis in the partnership of the same amount as the contributing partner's basis in the asset contributed, as adjusted for liabilities and gain.

This general non-recognition rule provides partners with a significant element of flexibility for property contributions. In contrast, the contribution of property to a corporation is generally a taxable (recognition) event unless the control requirements of IRC Section 351 are satisfied (the 80% ownership test).

Section 704(c) property has a built-in gain or loss that accrued while the contributing partner held the property prior to contribution to secure a partnership interest. When a partner contributes appreciated or depreciated property to a partnership, the property has an inherent built-in gain or built-in loss that accrued in the hands of the partner.

Property with built-in gain or built-in loss is referred to as "Section 704(c) property". The Fair Market Value (FMV) at the time of contribution is the "book value". At the time of contribution, Section 704(c) property will have a tax basis that differs from its FMV. The property's FMV at the time of contribution is referred to as its "book value." Because of the IRC Section 721 non-recognition rule, any property with a built-in gain or built-in loss can be contributed to a partnership with no immediate tax consequences.

The above non-recognition rules do not apply in the following four circumstances:

1. If the property transferred to the partnership consists of appreciated stocks and securities, and the partnership is an investment partnership, the contributing partner recognizes the gain.

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2. If the transaction is essentially a taxable exchange of properties, recognize the gain or loss.
3. Contributions of assets to a partnership are followed by a distribution of assets to another partner. The partner receiving the distribution may be considered to have made a sale in disguise of the partnership interest to the contributing partner.
4. If a partnership interest is received for services, the non-recognition rule of IRC Section 721 does not apply. Instead, the partner generally is required under IRC Section 83 to recognize the FMV of the interest as ordinary income (compensation for services) which is subject to self-employment tax.

If the contributed property is subject to indebtedness or if liabilities of the partner are assumed by the partnership, the basis of the contributing partner's interest shall be reduced by the portion of the indebtedness assumed by the other partners, since the partnership's assumption of his indebtedness is treated as a distribution of money to the partner. Conversely, the assumption by the other partners of a portion of the contributor's indebtedness is treated as a contribution of money by them.

Services Rendered in Return for Partnership Interest

Contribution of Services

A partner can acquire an interest in partnership capital or profits as compensation for services performed or to be performed.

Capital 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 under Employee compensation in Pub. 525,

Taxable and nontaxable income.

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.

Profits Interest

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's 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 doesn't apply in the following situations:

- 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.

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- 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.

REVIEW QUESTIONS

1. PENTAGON and SIRIUS-B are both partnerships. PENTAGON had, for the 2024 tax year, receipts for a total of $213,400, and the amount of its total assets for the year was equal to $980,000. In the other hand, SIRIUS-B had total receipts of $40,000,000, and the amount of its total assets for the year was equal to $12,000,000. Which of them must file Schedule M-3?

A. PENTAGON
B. SIRIUS-B
C. Both of them
D. Neither of them

Answer: B

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PENTAGON has no need to file Schedule L, M-1, M-2 or M-3, as its total receipts were less than $250,000 and its total assets value less than $1,000,000 for the 2024 year. SIRIUS-B must file Schedule M-3 as its total receipts were more than $35,000,000 and its total assets value more than $10,000,000.

2. When is a partnership not required to file Schedule L, M-1 and M-2?

A. The partnership's total receipts were less than $250,000.
B. The partnership's total assets at the end of the year were less than $1,000,000.
C. The return includes Schedules K-1.
D. All of the above.

Answer: D

If the partnership meets the following provisions, The partnership does not need to file Schedule L, Balance sheets per books, Schedule M-1, Reconciliation of income (loss) per books with income (loss) per return, and Schedule M-2, Analysis of partners' capital accounts if their total receipts were less than $250,000, the partnership's total assets at the end of the year were less than $1,000,000, the return includes Schedules K-1 (each partner receives a Schedule K-1 on or before the due date, including extensions, for the partnership return) and the partnership is not required to file Schedule M-3.

3. Which of these statements is true regarding self-employment and partnerships?

A. The partner's distributive share of ordinary income from a partnership is included in self-employment net earnings.
B. A partner is considered an employee of the partnership.
C. B and D.
D. A limited partner generally does include their distributive share of partnership income in computing earnings from self-employment.

Answer: A

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A partner is not an employee of the partnership. The partner's distributive share of ordinary income from a partnership is generally included in figuring net earnings from self -employment. A limited partner generally does not include their distributive share of partnership income in computing earnings from self-employment.

4. When can family members be recognized as partners?

A. When the partnership agreement states that they have a right to share in earnings and profits of the partnership.
B. If capital is not a material income-producing factor, they joined together in good faith for the conduct of a business, and 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. If capital is a material income-producing factor, when they acquired their capital interest in a bona fide transaction.
D. All of the above.

Answer: B

Family members (or any other person) will be recognized as partners only if one of the following requirements is met:

- *If the 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 must have joined together in good faith to conduct a business. In addition, they must have agreed that the contributions of each entitle them to a share in the profits.*

Some capital or service must be provided by each partner.

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, include said gain in the basis of their 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.

Increases

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

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- 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 non-taxable 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.

Decreases

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 non-deductible 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 their 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.

Recognition of Gain

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 usually 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, they generally do not recognize any gain until the sale or other disposition of the property.

Marketable security distributed to a partner is treated as money in determining whether gain is recognized on the distribution.

Example: The adjusted basis of Joanna'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 an FMV of $3,000. Because the cash received does not exceed the basis of her partnership interest, Joanna 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 Joanna's partnership interest to $4,000 [$14,000 — ($8,000 +$2,000)].

Loss on Distribution

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

- 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.

Partner's Basis for Distributed Property

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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 their interest in the partnership reduced by any money received in the same transaction.

Example 1: The adjusted basis of Emilio's partnership interest is $30,000. He receives a distribution of property that has an adjusted basis of $20,000 to the partnership and $4,000 in cash. His basis for the property is $26,000.

Example 2: The adjusted basis of Esteban's partnership interest is $10,000. He receives a distribution of $4,000 cash and property that has an adjusted basis to the partnership of $8,000. His basis for the distributed property is limited to $6,000 ($10,000 - $4,000, the cash he receives).

Basis divided among properties: 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. Basis should be allocated using the following rules:

- 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 excess amount.
- Allocate any remaining basis to properties that are not 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 excess amount.

Allocating a Basis Increase

Any basis increase is allocated 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.

Example: Daniela's basis in her partnership interest is $55,000. In a distribution in liquidation of her entire interest, she 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 an FMV of $40,000. Property B has an adjusted basis to the partnership of $10,000 and an FMV of $10,000.

To figure her basis in each property, Daniela 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). She 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 = 0.8 x $5,000 = $4,000) is allocated to property A and $1,000 ($10,000/$50,000 = 0.2 x $5,000 = $1,000) is allocated to property B.

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Daniela's basis in property A is $44,000 ($5,000 + $35,000 + $4,000) and her basis in property B is $11,000 ($10,000 + $1,000).

Allocating a Basis Decrease

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)).

Example: 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 are inventory nor unrealized receivables. Property C has an adjusted basis to the partnership of $15,000 and an FMV of $15,000. Property D has an adjusted basis to the partnership of $15,000 and an FMV of $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).

Book Value of Partner's Interest

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.

Example: Vicente 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 Vicente's interest is only $400, and the adjusted basis of his partner's interest is $1,000.

Partner's Share of Recourse Liabilities

A partnership liability is a recourse liability to the extent that any partner or a related person has an economic risk of loss for that liability. A partner's share of a recourse liability equals their economic risk of loss for that liability. A partner has an economic risk of loss if that partner or a related person would be required (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 non-recourse liability of the partnership has an economic risk of loss in that liability.

Partner's Share of Non-Recourse Liabilities

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

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Disposition of Partner’s Interest

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

- 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 transfer of an interest in the partnership does not affect a partnership’s basis in its assets. In the year of transfer, a partnership can elect to make an optional adjustment to the basis of its assets.

Sale, Exchange, or Other Transfer

The sale or exchange of a partner's interest in a partnership usually results in capital gain or loss. However, the 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 their interest.

Payments for Unrealized Receivables and Inventory Items

If a partner receives money or property in exchange for any part of a partnership interest, the amount due to their 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, but only if that part is not treated as paid in exchange for partnership property.

Unrealized Receivables

These include any rights to payment not already included in income for the following items:

- 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 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.

The recognized gain or loss is the amount the contributing partner would have recognized if the property had been sold for its fair market value when it was distributed. This amount is the difference between the property's basis and its fair market value at the time of contribution.

The character of the gain or loss will be the same as the character of the gain or loss that would have resulted if the partnership had sold the property to the distribute partner. Appropriate adjustments must be made to the adjusted

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basis of the contributing partner’s partnership interest and to the adjusted basis of the property distributed to reflect the recognized gain or loss.

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:

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

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

Partner’s basis increased: If a partner's share of partnership liabilities increases, or a partner's individual liabilities increase because they assume partnership liabilities, treat the increase as a contribution of money by the partner to the partnership.

Partner’s basis decreased: If a partner's share of partnership liabilities decreases, or a partner’s individual liabilities decrease because the partnership assumes his individual liabilities, treat the decrease as a distribution of money to the partner by the partnership.

Limitations on Losses, Deductions, and Credits

A partner’s ability to deduct partnership losses are subject to three sets of limitations which are applied in the following order:

1. Under IRC Section 704(d), the loss must not exceed the amount of the partner's basis in the partnership interest;
2. The loss is subject to the at-risk rules of IRC Section 465;
3. The loss is subject to the passive activity rules of IRC Section 469.

Basis Rule

A partner’s distributive share of partnership loss will be allowed only to the extent of the partner’s adjusted basis in their partnership interest. This is calculated at the end of the partnership taxable year in which the loss occurs. The partner’s outside basis is not allowed to fall below zero.

At-Risk Limitations

The at-risk rules limit a partner's deductible loss to the amounts for which that partner is considered at risk in the activity.

A partner is considered at risk for all the following amounts:

- The money and adjusted basis of any property he contributed to the activity.
- The partner's share of net income retained by the partnership.

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- Certain amounts borrowed by the partnership for use in the activity if the partner is personally liable for repayment or the amounts borrowed are secured by the partner's property (other than property used in the activity).

A partner is not considered at risk for amounts protected against loss through guarantees, stop-loss agreements, or similar arrangements. The partner is not at risk either for amounts borrowed if the lender has an interest in the activity (other than as a creditor) or is related to a person (other than the partner) having an interest.

Passive Activities

Generally, the IRC limits the amount a partner can deduct for passive activity losses and credits. The passive activity limits do not apply at the partnership level. Instead, they apply to each partner's share of loss or credit. In general, taxpayers are allowed to deduct passive activity losses only to the extent of passive activity income.

Because the treatment of each partner's share of partnership income, loss, or credit depends on the nature of the activity that generated it, the partnership must report income, loss, and credits separately for each activity.

Partnership Formation

A joint undertaking merely to share expenses is not a partnership. Mere co-ownership of property that is maintained and leased or rented is not a partnership. However, if the co-owners provide services to the tenants, a partnership exists.

Definitions

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:** This is a partner who is personally liable for partnership debts.
- **General partnership:** A general partnership is composed only of general partners.

Limited partner: This 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: This is a partnership that is formed under a state limited partnership law and is 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

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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. Certain organizations are not partnerships:

- 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.
- A tax-exempt organization.
- A Real Estate Investment Trust (REIT).
- An organization classified as a trust or otherwise subject to special treatment under the Internal Revenue Code.
- Any other organization that elects classification as a corporation by filing Form 8832.

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.

A partnership is required to obtain an EIN.

New EIN required

A partnership will need a new EIN if any of the following are true:

- Incorporating.
- One partner takes over and operates as a sole proprietorship.
- The partnership is terminated, and a new partnership is begun.

New EIN not required

A partnership will not need a new EIN if any of the following are true:

- The partnership declares bankruptcy.
- The partnership name changes.
- The partnership changes locations, or has locations added to it.
- The partnership terminates under IRC Section 708(b)(1)(B). A partnership shall be considered terminated if, within a 12-month period, there is a sale or exchange of at least 50% of the total interest in partnership capital and profits to another partner. If the purchaser and remaining partners immediately contribute the properties to a new partnership, they can retain the old partnership EIN.

Partnership Agreements

The agreement, or any modification to it, can be oral or written. Partners can modify the agreement for a particular tax year after the close of the year, but no later than the date for filing (excluding extensions) the partnership return

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for that year. The modifications must be agreed to by all the partners or adopted in any other manner provided by the partnership agreement.

A partner's share of income, gains, losses, deductions, or credits is usually determined by the partnership agreement If the partnership agreement (or its modifications) is silent on any matter, the provisions of local law are treated as part of the agreement.

Exclusion from Partnership Treatment

Certain partnerships that do not actively conduct a business can choose to be completely or partially excluded from being treated as partnerships for federal income tax purposes.

All the partners must agree to make the choice, and the partners must be able to compute their own taxable income without computing the partnership's income.

Capital Contributions

In partnership, a capital contribution is an amount of money, or assets given to a partnership by one of the partners. The capital contribution increases the partner's equity interest in the entity. Capital contributions are not considered business income unless given in the form of a loan.

Dissolution of 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.

Date of Termination

The partnership's tax year ends on the date of termination. For the event described in (1), above, the date of termination is the date the partnership completes the winding up of its affairs. For the event described in (2), above, the date of termination is the date of the sale or exchange of a partnership interest that, by itself or together with other sales or exchanges in the preceding 12 months, transfers an interest of 50% or more in both capital and profits.

Converting to LLC

Converting a partnership to an LLC taxed as a partnership does not terminate the partnership. The partnership's tax year does not close, and the LLC continues to use the old partnership's EIN. The same rules apply for an LLC classified as a partnership converting to a partnership.

Conversions may change some of the partners' bases in their partnership interest when the partnership has recourse liabilities that become non-recourse liabilities. Tax return preparers should adjust the partner's bases to reflect the new sharing ratios. Partners with an adjustment resulting in a decrease of liabilities exceeding their basis must recognize a gain on the excess.

Death of a Partner

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The death of a partner in a partnership with two members will terminate the partnership for federal tax purposes if it results in the partnership's immediately winding up its business. If this occurs, the partnership's tax year closes on the partner's date of death.

Similarly, the death of a partner generally will cause the technical termination of the partnership under Rev. Rul. 99-6. The regulations, however, provide two exceptions that prevent an immediate termination of the partnership with two members upon a partner's death.

1. A partnership with two members does not terminate upon a partner's death if the deceased partner's successor in interest (usually the estate) continues to share in the partnership's profits or losses. The partnership's tax year does not close, and the partner's distributive share of partnership income from the date of death through the end of the partnership tax year is reported on the tax return of the successor in interest.
2. If a partnership begins or continues to make liquidating payments to a deceased partner's successor in interest, the successor in interest is treated as a partner until the deceased partner's interest in the partnership has been completely. In a partnership with two members, the partnership does not terminate, nor does the partnership year end (other than the partnership's normal tax year), until the final liquidating payment is made to the successor in interest.

Filing Requirements, Due Dates, Penalties, and Audit Notice Requirements

Partnership Return (Form 1065) Filing Requirements, Due Dates

Following the end of the tax year, a partnership should file Form 1065 on the 15th day of the third month after the end of the tax year. It is usually March 1 5, for calendar-year partnerships. To request an automatic 6-month extension to file, Form 7004 may be used.

If the due date falls on a Saturday, Sunday, or legal holiday in the District of Columbia or the state in which the partnership files its return, a return filed by the next day that isn't a Saturday, Sunday, or legal holiday will be treated as timely. Calendar year partnerships may therefore timely file their returns for the 2024 partnership year by March 17, 2025.

Every partnership that engages in a trade or business or has gross income must file Form 1065. A partnership is not considered to engage in a trade or business, and is not required to file a Form 1065, for any tax year in which it neither receives income nor has any expenses treated as deductions or credits for federal tax purposes. The partnership return must be signed by a general partner. If a limited liability company is treated as a partnership, it must file Form 1065 and one of its members must sign the return.

The first return of the partnership is not required to be filed until the first tax year the partnership has income or deductions.

Audit Notice

The IRS notifies the partnership at each stage of a Bipartisan Budget Act (BBA) audit, also called an examination. The partnership, partnership representative, or both will receive notices by mail. These are:

- Notice of Selection for Examination - Letter 2205-D

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- Notice of Administrative Proceeding (NAP) - Letters 5893 and 5893-A
- Summary Report
- Notice of Proposed Partnership Adjustments (NOPPA or PPA)
- Notice of Final Partnership Adjustments (FPA).

E-Filing Exceptions

Unless otherwise noted, this requirement or option does not apply to:

- Bankruptcy returns.
- Returns with pre-computed penalty and interest.
- Returns with reasonable cause for failing to file timely.

Monthly Penalty for Failure to File Form 1065

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 $245 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.

In a case where the partnership receives a penalty notice after filing its return, it should send an explanation letter to the IRS, and the IRS will determine whether the explanations satisfy a sensible criterion for cancellation of the penalty. The business should not attach an explanation to the filing returns.

Penalty for Failure to Furnish Each Accurate K-1 Timely

For each failure to furnish Schedule K-1 to a partner when due and for each failure to include on Schedule K-1 all the information required to be shown (or the inclusion of incorrect information), the partnership can be assessed a penalty. If a person fails to file a correct information return or any information required, the amount of the penalty is, for 2024 tax year, $330 per return, with a maximum penalty of $3,987,000 per calendar year.

In the case of a nominee intentionally disregarding the requirement to report correct information, each $330 penalty increases to $660 or, if greater, 10% of the aggregate amount of items required to be reported, and there is no limit to the amount of the penalty.

Reasonable Cause

No penalty applies if the partnership can show reasonable cause for its failure to file a complete or timely return. Under Rev. Proc. 84-35, a small partnership (ten or fewer partners) meets the reasonable cause test if all of the following apply:

- All partners are individuals other than non-resident aliens, estates, or C corporations.
- All partners have timely filed income tax returns fully reporting their shares of the partnership's income, deductions, and credits.
- The partnership has not elected to be subject to the rules for consolidated audit procedures.

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Trust Fund Recovery Penalty

The trust fund recovery penalty applies for a failure to collect or withhold, or the failure to pay in certain excise, income, social security, and Medicare taxes. Trust fund taxes include withheld wages and the withheld employee portion of the social security tax.

All persons 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, can be subject to this penalty. The penalty is equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over (100%).

Partnership Cancellation of Debt

On the cancellation of a partnership's debt because of bankruptcy or insolvency, tax return preparers should apply the rules for excluding canceled debt from gross income and for reducing tax attributes at the individual partner level. Each partner reports their share of debt cancellation income on their return unless a partner meets the bankruptcy or insolvency exclusions. The individual partners, not the partnership, make all choices, including the following:

- Reducing the basis of depreciable property before reducing other tax attributes.
- Treating real property inventory as depreciable property.
- Ending the tax year on the day before filing the bankruptcy case.

When reducing the basis of depreciable property in attribute reduction, partners treat their partnership interest as depreciable property to the extent of their proportionate interest in the partnership's depreciable property. This only applies when partnerships make a corresponding reduction to the partnership’s basis in depreciable property with respect to the partner.

Allocating canceled debt income to a partner result in the partner’s basis in the Partnership increasing by the debt cancellation amount. Reducing a partner's share of partnership liabilities caused by the debt cancellation results in a deemed distribution. A deemed distribution results in a reduction of the partner's basis in the partnership.

Form 1065, Schedule B (Other information), line 6 asks if the partnership had any cancellation of debt transactions during the year. If the partnership did have debt cancellation, the partner’s Schedule K-1, line 11 should have some income amounts reported under Code E.

If the payment of the discharged liability results in a deduction (such as accrued interest for a cash-basis taxpayer), the discharge of the amount the taxpayer could deduct as interest does not give way to taxable cancellation of debt (COD) income. The character of the COD income for partners recognizing COD income with debt allocable to a passive activity is passive income. The IRS states that the character of COD income from forgiven accrued interest on a loan used to acquire investment property, is investment income, for purposes of the investment interest expense limitation.

For partnerships acquiring indebtedness issued by a partner and subsequently distributing the indebtedness to that partner, the distribute partner may recognize COD income. Tax return preparers should treat the partner as having satisfied the debt for FMV and recognize COD income to the extent the debt's issue price (adjusted for any premium or discount) exceeds its FMV.

Partnership Level Audit and Opt-Out

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Bipartisan Budget Act of 2015 (BBA)

The BBA created a new Centralized Partnership Audit Regime effective for partnership tax years beginning after 2017. The new regime replaces the consolidated audit proceedings under TEFRA and the electing large partnership provisions. The new audit regime applies to all partnerships unless the partnership is an eligible partnership and elects out by making a valid election.

Partnerships that file returns for tax years since January 2018 must follow rules under the BBA. Partnerships under the BBA must follow certain filing requirements including designating a partnership representative or, if eligible, elect out of the regime on a timely filed return. Under the BBA, the IRS generally assesses and collects any understatement of tax (called an imputed underpayment or IU) at the partnership level. Partnerships may request to modify the IU and may elect to push out the adjustments underlying the IU instead of paying.

The partnership representative will have the sole authority to act on behalf of the partnership under the centralized partnership audit regime. The designated partnership representative is a partner or other person with substantial presence in the United States.

If the designated partnership representative is an entity, the partnership must also appoint a designated individual to act on behalf of the entity partnership representative. The partnership must include information regarding the partnership representative and designated individual (if applicable) on Form 1065, Schedule B.

Opt-Out

A partnership can elect out of the centralized partnership audit regime for a tax year if the partnership is an eligible partnership that year. A partnership is an eligible partnership for a tax year if it has 100 or fewer eligible partners. A partner is an eligible partner if it is an individual, C corporation, foreign entity that would be treated as a C corporation if it were domestic, S corporation, or an estate of a deceased partner. The determination as to whether the partnership has 100 or fewer partners is made by adding the number of Schedules K-1 required to be issued by the partnership to the number of Schedules K-1 required to be issued by any partner that is an S corporation to its shareholders for the tax year of the S corporation ending with or within the partnership tax year.

A partnership is not an eligible partnership if it is required to issue a Schedule K-1 to any of the following partners:

- A partnership.
- A trust.
- A foreign entity that would not be treated as a C corporation were it a domestic entity.
- A disregarded entity described in Regulations Section 301.7701-2(c)(2)(i).
- An estate of an individual other than a deceased partner.
- Any person that holds an interest in the partnership on behalf of another person.

An annual election out of the centralized partnership audit regime must be made on the eligible partnership's timely filed return, including extensions, for the tax year to which the election applies. The election is made by including the following information on Schedule B-2 (Form 1065) and filing with the tax return:

- The name of each partner.
- The Taxpayer Identification Number (TIN) of each partner.
- The federal tax classification for each partner.

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- If an S corporation is a partner, provide the names, TINs, and federal tax classification of any shareholder of the S corporation for the tax year of the S corporation ending with or within the partnership's tax year.

This annual election once made may not be revoked without the consent of the IRS. A partnership that elects out of the centralized partnership audit regime must notify each of its partners of the election within 30 days of making the election. By making the election out of the centralized partnership audit regime, the taxpayer is affirming that all of the partners in the partnership meet the eligibility requirements under section 6221(b)(1)(C) of the Internal Revenue Code and they have provided all of the required information with the Form 1065.

REVIEW QUESTIONS

1. Which of these organizations are not partnerships?

A. Certain banks.
B. A real estate investment trust.
C. Organizations not classified as a trust.
D. None of the above are partnerships.

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Answer: D

Certain organizations are not partnerships:

- *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.*
- *A tax-exempt organization.*
- *A real estate investment trust (REIT).*
- *An organization classified as a trust or otherwise subject to special treatment under the Internal Revenue Code.*
- *Any other organization that elects classification as a corporation by filing Form 8832.*

2. A partnership will need a new EIN for which of the following?

A. Changing the name of the partnership.
B. Incorporating.
C. At the end of every tax year.
D. Changing locations or adding locations.

Answer: B

A partnership will need a new EIN if any of the following are true:

- *Incorporating.*
- *One partner takes over and operates as a sole proprietorship.*
- *The partnership is terminated, and a new partnership is begun.*

A partnership will not need a new EIN if declares bankruptcy, change their name, locations or terminates under IRS Section 708 (b)(1)(B).

3. Regarding cancelation of debt of a partnership, which choice must be made by individual partners?

A. Reducing the basis of depreciable property before reducing other tax attributes.
B. Ending the tax year on the day before filing the bankruptcy case.
C. Treating real property inventory as depreciable property.
D. All of the above.

Answer: D

On the cancellation of a partnership's debt because of bankruptcy or insolvency, tax return preparers should apply the rules for excluding canceled debt from gross income and for reducing tax attributes at the individual partner level.

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Each partner reports their share of debt cancellation income on their return unless a partner meets the bankruptcy or insolvency exclusions. The individual partners, not the partnership, make all choices, including the following:

- *Reducing the basis of depreciable property before reducing other tax attributes.*
- *Treating real property inventory as depreciable property.*
- *Ending the tax year on the day before filing the bankruptcy case.*

4. When should partnerships return, on Form 1065, with each K-1 for each partner, be filed for the fiscal year 2024?

A. April 15, 2025.
B. January 1st, 2025.
C. July 1st, 2025.
D. March 17, 2025.

Answer: D

A partnership should file Form 1065 on the 15th day of the third month after the end of the tax year. It is usually March 15, for calendar-year partnerships. If the due date falls on a Saturday, Sunday, or legal holiday in the District of Columbia or the state in which the partnership files its return, a return filed by the next day that isn't a Saturday, Sunday, or legal holiday will be treated as timely. Calendar year partnerships may therefore timely file their returns for the 2024 partnership year by March 17, 2025.

Module: Corporations in General

Filing Requirements, Due Dates, and Penalties

A corporation is defined as a legal entity or structure created under the authority of the laws of a state consisting of a person, or group of persons, who become shareholders. The entity's existence is considered separate and distinct from that of its members.

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Since a corporation is an entity, it is liable for its own debts and obligations. In forming a corporation, prospective shareholders transfer money, property, or both, for the corporation's capital stock.

NOTE: For corporations, in 2024 tax year, the tax rate is 21%, in a flat-tax system. C Corporations usually file a Form 1120 series return, plus other returns that apply (such as employment or excise tax returns).

A corporation is required to obtain an EIN.

New EIN required

A corporation will need a new EIN if any of the following are true:

- The corporation is a subsidiary of a corporation and currently uses the parent's corporate EIN.
- The corporation becomes a subsidiary of a corporation.
- The corporation becomes a partnership or a sole proprietorship.
- The corporation creates a new corporation after a statutory merger.
- The corporation receives a new corporate charter.

New EIN not required

A corporation will not need a new EIN if any of the following are true:

- The corporation is a division of a corporation.
- After a corporate merger, the surviving corporation uses its existing EIN.
- A corporation declares bankruptcy. However, if a liquidating trust is established for a corporation that is in bankruptcy, an EIN for that trust is required.
- Corporate name changes or change in location or add locations.
- The corporation elects to be taxed as an S Corporation by filing Form 2553.
- The corporation is sold, and the assets, liabilities and charters are obtained by the
- buyer.
- After a corporate reorganization, the corporation only changes identity, form, or place of organization.

Income Tax Return and Due Dates

The IRS filing requirements for a corporation explain who should file, which form to file, and electronic filing. For all operating businesses, it is mandatory for income tax returns to be filed regardless of having or not having earned income subject to tax, unless it is exempt under IRC Section 501.

A corporation generally must file Form 1120, U.S. corporation income tax return, to report its income, gains, losses, deductions, credits, and to figure its income tax liability.

Certain organizations and entities must file special returns.

Electronic Filing

For returns filed on or after January 1, 2024, corporations that file 10 or more returns are required to efile. However, these corporations can request a waiver of the electronic filing requirements. For more information on electronic filing, see the Instructions for Form 1120, or the applicable instructions for your income tax return.

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When to File

Generally, a corporation must file its income tax return by the 15th day of the 4th month after the end of its tax year. This means that the filing due date is April 15, for corporations using the calendar 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. A corporation with a short tax year ending anytime in June will be treated as if the short period ended 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 due date is extended to the next business day.

Extension of Time to File

File Form 7004, Application for automatic extension of time to file certain business income tax, information and other returns, to request an extension of time to file a corporation income tax return. The IRS will grant the extension if the taxpayer completes the form properly, files it, and pays any tax due by the original due date for the return.

Form 7004 does not extend the time for paying the tax due on the return. Interest, and possibly penalties, will be charged on any part of the final tax due not shown as a balance due on Form 7004. The interest is figured from the original due date of the return to the date of payment.

Penalties

Late filing of return

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 (discussed next) 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 $510. The penalty will not be imposed if the corporation can show the failure to file on time was due to a reasonable cause.

Late payment of tax

A corporation that does not pay the tax when due may be penalized % 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.

Earnings and Profits

If the corporation obtains property or money other than stock apart from the non-taxable exchange of assets for corporate stock, the corporation may have to identify it again. The gain is identified simply by the value of cash, as well as the current selling price of other possessions received on the market. The rules for comprehending the identified profits in these circumstances normally adhere to those of a non-taxable trade. If the assets a corporation loses are inclusive of asset reducing value over time, the identity profits may be filed as ordinary earnings.

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Example: Pedro reassigns assets to a corporation for stock. Pedro obtains $9,000 in the trade. Pedro's modified basis within assets reassigned is $18,000. The current price in the market of stock received by Pedro is $14,000. The company takes a $4,000 credit on the possessions that Pedro is liable. The gain will be recognized as below:

FMV of stock obtained	$14,000
(+) Money obtained	$9,000
(+) Liability assumed by company	$4,000
Total received	$27,000
(-) Adjusted basis of property transferred	$18,000
Realized gain	$9,000

Current Year Earnings and Profits

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.

Example: Enrique is the only shareholder of a corporation that uses the calendar year as its tax year. In January, he uses the worksheet in the Form 5452 instructions to figure his corporation's current year earnings and profits for the previous year. During the year, the corporation made four $1,000 distributions to him. 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 Enrique by January 31 to report the $4,000 distributed to him during the previous year as dividends. The corporation must use Form 1096 to report this information to the IRS by February 28 (March 31 if filing electronically). The corporation does not deduct these dividends on its income tax return.

Accumulated 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.

Used with current year earnings and profits: If the corporation has current year earnings and profits, figure the use of accumulated and current earnings and profits as follows:

1. Divide the current year earnings and profits by the total distributions made during the year.
2. Multiply each distribution by the percentage figured in (1) to get the amount treated as a distribution of current year earnings and profits.
3. Start with the first distribution and treat the part of each distribution greater than the allocated current year earnings and profits figured in (2) as a distribution of accumulated earnings and profits.
4. If accumulated earnings and profits are reduced to zero, the remaining part of each distribution is applied against and reduces the adjusted basis of the stock in the hands of the shareholders. To the extent that the

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balance is more than the adjusted basis of the stock, it is treated as a gain from the sale or exchange of property.

Example: Anabel 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. At the beginning of the year, the corporation's accumulated earnings and profits balance was $20,000.

During the year, the corporation made four distributions of $4,000 to Anabel ($4,000 x 4 = $16,000). 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 less than the distributions it made during the year ($16,000), part of each distribution is treated as a distribution of accumulated earnings and profits. Treat the distributions as follows:

- Divide the current year earnings and profits ($10,000) by the total amount of distributions made during the year ($16,000). The result is .625.
- Multiply each $4,000 distribution by the .625 figured in (1) to get the amount ($2,500) of each distribution treated as a distribution of current year earnings and profits.
- The remaining $1,500 of each distribution is treated as a distribution of accumulated earnings and profits. The corporation distributed $6,000 ($1,500 x 4) of accumulated earnings and profits.

The remaining $14,000 ($20,000 — $6,000) of accumulated earnings and profits is available for use in the following year. The corporation must issue a Form 1099-DIV to Anabel by January 31 to report the $16,000 distributed to her during the previous year as dividends. The corporation must use Form 1096 to report this information to the IRS by February 28 (March 31 if filing electronically). The corporation does not deduct these dividends on its income tax return.

Used without current year earnings and profits: If the corporation has no current year earnings and profits, figure the use of accumulated earnings and profits as follows:

1. If the current year earnings and profits balance is negative, prorate the negative balance to the date of each distribution made during the year.
2. Figure the available accumulated earnings and profits balance on the date of each distribution by subtracting the prorated amount of current year earnings and profits from the accumulated balance.
3. Treat each distribution as a distribution of these adjusted accumulated earnings and profits.
4. If adjusted accumulated earnings and profits are reduced to zero, the remaining distributions are applied against and reduce the adjusted basis of the stock in the hands of the shareholders. To the extent that the balance is more than the adjusted basis of the stock, it is treated as a gain from the sale or exchange of property.

Example: David is the only shareholder of a corporation that uses the calendar year as its tax year. In January, he uses the worksheet in the Form 5452 instructions to figure his corporation's current year earnings and profits for the previous year. At the beginning of the year, the corporation's accumulated earnings and profits balance was $20,000. During the year, the corporation made four $4,000 distributions to David on March 31, June 30, September 30, and December 31. At the end of the year (before subtracting distributions made during the year), the corporation had a

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negative $10,000 current year earnings and profits balance. Since the corporation had no current year earnings and profits, all of the distributions are treated as distributions of accumulated earnings and profits. Treat the distributions as follows:

- Prorate the negative current year earnings and profits balance to the date of each distribution made during the year. The negative $10,000 can be spread evenly by prorating a negative $2,500 to each distribution.
- The following table shows how to figure the available accumulated earnings and profits balance on the date of each distribution:

March 31 Distribution	
Accumulated earnings and profits	$20,000
Prorated current year earnings and profits	($2,500)
Accumulated earnings and profits available	$17,500
Amount of distribution treated as a dividend	($4,000)
June 30 Distribution	
Accumulated earnings and profits	$13,500
Prorated current year earnings and profits	($2,500)
Accumulated earnings and profits available	$11,000
Amount of distribution treated as a dividend	($4,000)
September 30 Distribution	
Accumulated earnings and profits	$7,000
Prorated current year earnings and profits	($2,500)
Accumulated earnings and profits available	$4,500
Amount of distribution treated as a dividend	($4,000)
December 31 Distribution	
Accumulated earnings and profits	$500
Prorated current year earnings and profits	($2,500)
Accumulated earnings and profits available	($2,000)
Amount of distribution treated as a dividend	$0
Non-dividend amount (reduction of stock basis or gain from sale/exchange of property)	$4,000
Year-end accumulated earnings and profits	($2,000)

The corporation must issue a Form 1099-DIV to David by the end of January to report $12,000 of the $16,000 distributed to him during the previous year as dividends. The corporation must use Form 1096 to report this information to the IRS by February 28 (March 31 if filing electronically). The corporation does not deduct these dividends on its income tax return. However, the corporation must attach Form 5452 to this return to report the non-dividend distribution.

Shareholder Dividends, Distributions and Recognition Requirements

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 or 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.

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Form 1099-DIV

File Form 1099-DIV, Dividends and distributions, with the IRS for each shareholder to whom a taxpayer has paid dividends and other distributions on stock of $10 or more during a calendar year. Generally, they are to 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 General instructions for certain information returns (Forms 1097, 1098, 1099, 3921, 3922, 5498, and W-2G).

A corporation must provide shareholders with Forms 1099-DIV by January 31 of the year following the close of the calendar year during which the corporation made the distributions. However, they may provide shareholders with Form 1099-DIV after November 30 of the year of the distributions if the corporation has made its final distributions for the year. Similarly, a taxpayer can give shareholders this form any time after April 30 of the year of the distributions if they give Form 1099-DIV with the final distributions for the calendar year.

Special Deductions and Credits

Dividends Received Deductions

A percentage can be deducted from specific dividends obtained during a tax year by a corporation. The percentage to be deducted is determined on Form 1120, or in the appropriate agenda for return. Dividends from domestic corporations can be deducted to a maximum of 70% in obtained dividend when the company obtaining dividends has a smaller amount than 20% of the corporation allocating it. However, if the company has more than 20% of the corporation allocating then 80% is deducted of the received dividends.

A deduction of 100% of the dividends received from a corporation that pays taxes can be made by small investment businesses. When a regulated investment company distributes capital gain dividends, the dividends are not qualified for deductions. Domestic corporations cannot take dividends from certain businesses, including real estate investment trust and corporations that are tax-exempt under Section 501.

In addition, a corporation can have its stock withheld less than 46 days during the 91-day period, starting 45 days prior to the stock being ex-dividend in relation to dividends. A corporation can have its preferred stock withheld within 91 days through the 181-day period, starting 90 days prior to the stock becoming ex-dividend in relation to dividends obtained for a period of 366 days.

For instance, if a corporation goes through a loss of $50,000 in its normal functions, and then obtains $200,000 in dividends by a 20% possessed business, the earning to tax is $150,000 ($200,000 - $50,000) prior to deducting dividends received. If the corporation holds the entirety of dividends received of $160,000 ($200,000 and 80%) and sums it with the operating loss of $50,000, a net operating loss (NOL) of ($10,000) is obtained. Consequently, the earnings tax limit of 80% is not applicable. The company deducts $160,000.

Limit on Deduction for Dividends

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

1. 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 20%-owned corporations, then

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2. 70% 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).

The dividend's received deduction is limited to the applicable deduction percentage times the corporation's taxable income calculated before the dividends received deduction, the net operating loss deduction, and capital loss carrybacks. This taxable income limitation, however, does not apply if the receiving corporation has a net operating loss after reducing taxable income by the dividends received deduction. In other words, there is no taxable income limit if the dividend received deduction creates or increases a net operating loss.

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

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

Effect of Net Operating Loss

If a corporation has a net operating loss (NOL) for a tax year, the limit of 80% (or 70%) of taxable income does not apply. To determine whether a corporation has an NOL, figure the dividends-received deduction without the 80% (or 70%) of taxable income limit.

Example 1: A corporation loses $25,000 from operations. It receives $100,000 in dividends from a 20%-owned corporation. Its taxable income is $75,000 ($100,000 -$25,000) before the deduction for dividends received. If it claims the full dividends-received deduction of $80,000 ($100,000 x 80%) and combines it with an operations loss of $25,000, it will have an NOL of ($5,000). Therefore, the 80% of taxable income limit does not apply. The corporation can deduct the full $80,000.

Example 2: Assume the same facts as in Example 1, except that the corporation only loses $15,000 from operations. Its taxable income is $85,000 before the deduction for dividends received. After claiming the dividends-received deduction of $80,000 ($100,000 x 80%), its taxable income is $5,000. Because the corporation will not have an NOL after applying a full dividends-received deduction, its allowable dividends-received deduction is limited to 80% of its taxable income, or $68,000 ($85,000 x80%).

Charitable Deductions

For charitable contributions of money or in the form of additional possessions, a company can claim a limited deduction. If contributions are made for the use of, or to, a business that qualifies to be a corporation then they are deductible. When a contribution is charitable then the company can deduct the donation with the total of short-term gain, together with ordinary income that would be obtained if the possessions were traded at their current price in the market. Additionally, specific donations, future capital profits that would be obtained if the possessions were traded at their current price in the market would also be deducted.

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Cash method corporation: A corporation using the cash method of accounting deducts contributions in the tax year paid.

Accrual method corporation: 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. The declaration must include the date the resolution was adopted.

Limitations on deduction: Generally, a corporation cannot deduct charitable contributions that exceed 10% of its taxable income for the tax year.

Figure taxable income for this purpose without the following:

- The deduction for charitable contributions.
- The dividends-received deduction.
- The deduction allowed under section 249 of the Internal Revenue Code for bond premium.
- Any domestic production activities deduction.
- Any net operating loss carryback to the tax year.
- Any capital loss carryback to the tax year.

Carryover of excess contributions: The taxpayer can carry over, within certain limits, to each of the subsequent 5 years any charitable contributions made during the 2024 year that exceed the 10% limit The taxpayer loses any excess not used within that period. For example, if a corporation has a carryover of excess contributions paid in 2024 and it does not use all the excess on its return for 2025, the corporation can carry any excess over to 2026, 2027, 2028, and 2029, if applicable. Any excess not used in 2029 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 limit of that year). The taxpayer cannot deduct the carryover of excess contributions to the extent it increases a net operating loss carryover.

There is a special rule allowing enhanced deductions by businesses for contributions of food inventory for the care of the ill, needy or infants. The amount of charitable contributions of food inventory a business taxpayer can deduct under this rule is limited to 1 5% of the company's aggregate net income or taxable income.

Cash contributions: 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.

Gifts of $250 or more: Generally, no deduction is allowed for any contribution of $250 or more unless the corporation gets a written acknowledgement from the done organization. The acknowledgement should show the amount of cash contributed, a description of the property contributed (but not its value), 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 must be

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obtained 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.

Contributions of property other than cash: 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, Non-cash 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).

Qualified conservation contributions: If a corporation makes a qualified conservation contribution, the corporation must provide information regarding the legal interest being donated, the fair market value of the underlying property before and after the donation, and a description of the conservation purpose for which the property will be used.

Contributions of used vehicles: A corporation is allowed a deduction for the contribution of used motor vehicles, boats, and airplanes. The deduction is limited, and other special rules apply.

Reduction for contributions of certain property: 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 fair market value.
- For certain contributions, the long-term capital gain that would have resulted if the property were sold at its fair market value.
- The reduction for the long-term capital gain applies to:
  - 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 section 197 intangible), or similar property, or applications or registrations of such property.

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Contributions to organizations conducting lobbying activities: Contributions made to an organization that conducts lobbying activities are not deductible if:

- The lobbying activities relate to matters of direct financial interest to the donor's trade or business.
- The principal purpose of the contribution was to avoid federal income tax by obtaining a deduction for activities that would have been non-deductible under the lobbying expense rules if conducted directly by the donor.

Liquidations and Stock Redemptions

A corporate liquidation occurs when a corporation ceases undertaking its normal business operations. The corporation continues exclusively to bring their affairs to an end, to distribute any property to shareholders, and to pay off debts. For taxation purposes, the corporation does not require legal dissolution within the state law. Liquidation can still be present even if the corporation maintains a nominal amount of property to settle outstanding debts and safeguard legal status. The tax court implements three different examinations to establish whether a complete liquidation has occurred. These include, if there was a demonstrated liquidation objective, the existence of a continuous goal to abolish the company's dealings and liquidate, and if the company's functions aimed at and focused on the goal.

Redemption of stock is categorized as a trade or sale and is exposed to the capital loss or gain or loss provisions apart from when the redemption is a dividend or other distributions on stock. The circumstances in each case determine whether it is categorized as a sale, trade, dividend, or other distributions. Additionally, both the indirect and direct ownership of stock will be considered. For instance, the redemption of stock is a trade or sale if the redemption is not in essence, equal to the dividend or there is considerably inconsistent redemption of stock. In addition, if there is complete redemption of all stock of corporation owned by the stakeholder or the redemption is an allocation in partial liquidation of the corporation.

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.

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:

- Specific, definite, and feasible plans for use of the earnings accumulation in the business.

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- 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.

Estimated Tax Payments

A corporation must make estimated tax payments when expecting to have a tax liability for the year of $500 or more, which is lower than the individual requirement of a tax liability of $1,000 or more.

Corporations making estimated tax payments must do so by making required installment payments. The required installment is the smallest installment payment under the following two methods:

1. Each required installment is 25% of the income tax the corporation will show on its return for the current year.
2. Each required installment is 25% of the income tax shown on the corporation's return for the previous year. The corporation is not allowed to base the required annual payment on the prior year's tax unless the following requirements are satisfied:
    a. The corporation must have filed a return for the preceding tax year, showing a positive tax liability.
    b. The preceding year's return must have been for a full 12 months.

If a corporation is a large corporation, it can use the prior year tax method for the first installment only. Corporations with modified taxable income of $1,000,000 or more for any of the three immediately preceding years are large corporations. Modified taxable income is taxable income figured without NOL or capital loss carrybacks or carryovers.

Estimated tax payments are due four times during the year based on the following schedule:

- The 15th day of the 4th month.
- The 15th day of the 6th month.
- The 15th day of the 9th month.
- The 15th day of the 12th month.

Corporations must use electronic funds transfer to make installment payments of estimated taxes. Corporations use the Electronic Federal Tax Payment System (EFTPS) to make electronic funds transfers and deposits of all depository tax liabilities (including social security, Medicare, withheld income, excise, and corporate income taxes).

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Corporations are subject to a penalty for not timely paying a required installment of estimated tax. The penalty is figured separately for each installment due date and can apply to an earlier due date even if enough tax is paid in later to make up for the underpayment.

Tax return preparers should use Form 2220, Underpayment of estimated tax by corporations, to determine the underpayment penalty.

Corporations can file for a refund of overestimated taxes prior to filing the corporate return for the current tax year by filing Form 4466, Corporation application for quick refund of overpayment of estimated tax, to claim a refund.

Corporate Minimum Tax Credit

The Corporate Alternative Minimum Tax (CAMT), introduced by the Inflation Reduction Act of 2022, applies to certain C corporations with significant Adjusted Financial Statement Income (AFSI). The CAMT imposes a 15% minimum tax on the AFSI of corporations that qualify as "Applicable Corporations." The CAMT is only calculated if it exceeds the corporation's regular income tax liability.

An Applicable Corporation is defined as one whose average annual AFSI exceeds $1 billion over the three prior tax years.

- For corporations that are part of a Foreign-Parented Multinational Group (FPMG), the threshold for the U.S. subgroup is $100 million.
- If a corporation is part of a controlled group (i.e., multiple corporations under common control), the combined AFSI of all members of the group must be considered to determine whether the $1 billion threshold is exceeded.
- Certain corporations are explicitly excluded from the CAMT, such as Flow-Through Entities and some tax-exempt organizations.
- If a corporation undergoes a significant ownership change or fails to meet the income threshold for several consecutive years, it may cease to be classified as an Applicable Corporation.

Safe Harbor Method:

Proposed Regulation Section 1.59-2(g)(2) provides that a corporation may elect to apply a safe harbor method (a simplified method) instead of the standard AFSI test to determine whether it is an Applicable Corporation. Under this simplified method, the corporation determines its status with the following modifications:

- The general AFSI test and the $1 billion AFSI test for FPMGs are applied by substituting "$500 million" for "$1 billion".
- The $100 million AFSI test for FPMGs is applied by substituting "$50 million" for "$100 million".
- AFSI is determined considering only the following adjustments:
  - If the financial results of a CAMT entity are reported in the same consolidated financial statement as other entities in a CAMT Group (AFS Group), the group members included in the test group are treated as a single CAMT entity.
  - Federal income taxes or foreign income, war profits, and excess profits taxes (as defined under section 901) reflected in the corporation's AFS are excluded from AFSI.

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- For an organization subject to tax under section 511, the AFSI includes only the AFSI (if any) of its unrelated business (as defined in section 513), subject to the modifications to unrelated business taxable income described in section 512(b). This includes any debt-financed unrelated income as defined under section 514.

If the corporation qualifies under the safe harbor method, it must check the box on Schedule K, Line 29c of Form 1120, indicating that it meets the requirements and is therefore not required to file Form 4626.

REVIEW QUESTIONS

1. Which is the tax rate for corporations in the tax year 2024?

A. 21%.
B. 39%.

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C. 37%.
D. 34%.

Answer: A

The tax rate for corporations in tax year 2024 is of 21%, in a flat tax system.

2. Dividends from domestic corporations can be deducted to a maximum of in obtained dividend when the company obtaining dividends has a smaller amount than of the corporation allocating it.

A. 75%, 25%
B. 25%, 75%
C. 70%, 20%
D. 20%, 70%

Answer: C

Dividends from domestic corporations can be deducted to a maximum of 70% in obtained dividend when the company obtaining dividends has a smaller amount than 20% of the corporation allocating it.

3. Alberto is the only shareholder of a corporation that uses the calendar year as its tax year. In January, he uses the worksheet in the Form 5452 instructions to figure his corporation's current year earnings and profits. At the beginning of the year, the corporation's accumulated earnings and profits balance was $40,000. During the year, the corporation made four $8,000 distributions to Alberto. At the end of the year, the corporation had $30,000 of the current year earnings and profits. Which is the distribution of accumulated earnings and profits?

A. $2,000.
B. $4,000.
C. $8,000.
D. $16,000.

Answer: A

Since the corporation's current year earnings and profits ($30,000) were less than the distributions it made during the year ($32,000), part of each distribution is treated as a distribution of accumulated earnings and profits. Treat the distributions as follows:

1. *Divide the current year earnings and profits ($30,000) by the total amount of distributions made during the year ($32,000). The result is 0.9375.*
2. *Multiply each $8,000 distribution by the 0.9375 figured in (1) to get the amount ($7,500) of each distribution treated as a distribution of current year earnings and profits.*
3. *The remaining $500 of each distribution is treated as a distribution from accumulated earnings and profits. The corporation distributed $2,000 ($500 x 4) of accumulated earnings and profits.*

The remaining $38,000 ($40,000 — $2,000) of accumulated earnings and profits is available for use in the following year.

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4. When should a business taxpayer send forms 1099-DIV and 1096 to the IRS?

A. July 1st (August 1st if filing electronically) of the year that follows the year of the distribution.
B. By February 28 (March 31 if filing electronically) of the year following the year of the distribution.
C. By March 31 (same date if filing electronically).
D. April 15th.

Answer: B

File Form 1099-DIV, Dividends and distributions, with the IRS for each shareholder to whom a taxpayer has paid dividends and other distributions on stock of $10 or more during a calendar year. Generally, they are to 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.

Module: Forming a Corporation

Services Rendered to a Corporation in Return for Stock

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If a taxpayer decides to transfer property to a corporation in exchange for stock in that corporation and immediately afterward, they are 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 property is transferred 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 non-taxable exchange of property for stock must attach to their income tax returns a complete statement of all facts pertinent to the exchange.

Services Rendered: 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.

Example: Karina 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, Karina owns 85% of the outstanding stock. No gain is recognized on the exchange of property. However, Karina recognizes ordinary income of $3,000 as payment for services rendered to the corporation.

Personal Service Corporations

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

- 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:
  - The last day of its tax year, or
  - The last day of the calendar year in which its tax year begins.
- Its employee-owners substantially perform the services 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.
- Its employee-owners own more than 10% of the FMV of its outstanding stock on the last day of the testing period.

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

Affiliated Group: It consists of a parent corporation and one or more subsidiary corporations. The parent corporation must own at least 80% of its subsidiary's stock and consolidates the subsidiaries financial statements with its own.

IRC Section 351 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

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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.

Transfer and/or Receipt of Money or Property in Addition to Corporate Stock

If, in an otherwise non-taxable exchange of property for corporate stock, a taxpayer also receives money or property other than stock, they may have to recognize the gain. Only recognize gain up to the amount of money received by the taxpayer, plus the FMV of the other property they receive.

Basis of Stock or Other Property Received

The basis of the stock a taxpayer receives is generally the adjusted basis of the property they transfer. Increase this amount by any amount treated as a dividend, plus any gain recognized on the exchange. Decrease this amount by any cash the taxpayer received, the fair market value of any other property they received, and any loss recognized on the exchange. Also decrease this amount by the amount of any liability the corporation or another party to the exchange assumed from the taxpayer unless payment of the liability gives rise to a deduction when paid.

Further decreases may be required when the corporation or another party to the exchange assumes from the taxpayer a liability that gives rise to a deduction when paid if the basis of the stock would otherwise be higher than its fair market value on the date of the exchange. This rule does not apply if the entity assuming the liability acquired either substantially all of the assets or the trade or business with which the liability is associated.

Basis of Property Transferred

A corporation that receives property from the taxpayer in exchange for its stock generally has the same basis they had in the property, increased by any gain the taxpayer recognized on the exchange. However, the increase for the gain recognized may be limited.

Transfer of Property Subject to Indebtedness

In many cases, real estate may be heavily mortgaged. For example, the owners could have claimed depreciation or held the building for a considerable number of years. They may have used the land and building as security for refinancing in times when the values of the property have risen considerably above their initial acquisition costs. When real estate is subject to liabilities, there may be some special hazards in the transfer of property to a corporation, even when the transfer would otherwise meet the tax-free exchange criteria of Section 351. The problem arises at the moment when the corporation assumes liabilities from the shareholder or takes the property subject to the liabilities.

Generally, the corporation's relief of shareholder liabilities does not cause the transfer to be taxable, though it reduces the shareholder's basis when comparing it to a basis that would not have the liabilities.

If the corporation assumes a taxpayer's liabilities, the exchange generally is not treated as if they received money or other property. There are two exceptions to this treatment:

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If the liabilities the corporation assumes are more than the taxpayer's adjusted basis in the property they transferred, 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.

If there is no good business reason for the corporation to assume a taxpayer's liabilities, or if the taxpayer's main purpose in the exchange is to avoid federal income tax, the assumption is treated as if they received money in the amount of the liabilities.

Example: Emilio transfers property to a corporation for stock. Immediately after the transfer, Emilio controls the corporation. He also receives $10,000 in the exchange. Emilio's adjusted basis in the transferred property is $20,000. The stock he receives has an FMV of $16,000. The corporation also assumes a $5,000 mortgage on the property for which Emilio is personally liable. Gain is realized as follows:

FMV of stock received	$16,000
(+) Cash received	$10,000
(+) Liability assumed by corporation	$5,000
Total received	**$31,000**
(-) Adjusted basis of property transferred	$20,000
Realized gain	**$11,000**

The liability assumed is not treated as money or other property. The recognized gain is limited to $10,000, the cash received.

Controlled Groups

A controlled group is defined as a group of two or more corporations, trades, or businesses (including partnerships and proprietorships) that have one of the following relationships:

- Parent-subsidiary.
- Brother-sister.
- Combination of parent-subsidiary and brother-sister.

Constructive ownership rules also apply to determine whether a group is a controlled group under the IRC, treating a person as having an interest in an organization that is not actually owned by that person. Attribution may result from family or business relationships.

Parent-Subsidiary Controlled Group: A parent-subsidiary controlled group is a chain or organization that is connected through ownership of a controlling interest with a common parent organization. A controlling interest in each of the organizations, excluding the common parent, must be owned by one or more of the other organizations in the group and the common parent organization must own a controlling interest in at least one of the other organizations.

Brother-Sister Controlled Group: A brother-sister controlled group means that two or more corporations with the same five or fewer individuals, estates or trusts own controlling interest (80% or more) in each organization and have effective control, typically more than 50% of the organization's stock or profits. This only applies if the extent of ownership is identical with respect to each such organization.

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Combined Controlled Group: A combined controlled group is defined as three or more organizations, each a member of either a parent-subsidiary or brother-sister controlled group with at least one organization being the common parent organization of a parent-subsidiary controlled group as well as a member of a brother-sister controlled group.

Closely Held Corporations

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

- It is not a personal service corporation.
- 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.

REVIEW QUESTIONS

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1. Michael, a taxpayer, transferred property that is worth $30,000 and rendered services valued at $4,000 to a corporation in exchange for stock valued at $34,000. Michael owns 90% of the outstanding stock. Which is the amount of gain recognized on the exchange of property?

A. $0.
B. $4,000.
C. $26,000.
D. $38,000.

Answer: A

If a taxpayer decides to transfer property to a corporation in exchange for stock in that corporation, and immediately afterward they are in control of the corporation, the exchange is usually not taxable. This rule applies both individuals and to groups who transfer property to a corporation.

2. Orlando, a taxpayer, transferred property that is worth $25,000 and rendered services valued at $3,000 to a corporation in exchange for stock valued at $28,000. Orlando owns 70% of the outstanding stock. Which is the ordinary income amount Orlando is to recognize?

A. $0.
B. $3,000.
C. $22,000.
D. $31,000.

Answer: B

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.

3. Which of the following is the basis of stock received?

A. The amount increased to the basis of the property that is treated as a dividend.
B. The gain recognized on the exchange.
C. The adjusted basis of the property received.
D. All of the above are correct.

Answer: C

The basis of the stock a taxpayer receives is generally the adjusted basis of the property they transfer. Increase this amount by any amount treated as a dividend, plus any gain recognized on the exchange. Decrease this amount by any cash the taxpayer received, the fair market value of any other property they received, and any loss recognized on the exchange.

Module: S Corporations

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S corporations are corporations that elect to pass corporate income, losses, deductions, and credits 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 at the entity level.

S corporations are exempt from corporate taxes, but they still have to report their earnings to the federal government and file tax returns. Use Form 1120-S to report the income, gains, losses, deductions, credits, etc., of a domestic corporation or other entity for any tax year covered by an election to be an S corporation.

Form 1120-S generally must be filed by March 15 of the year immediately following the calendar year covered by the return or, if a fiscal year is used, by the 15th day of the third month immediately following the last day of the fiscal year. The corporation must complete a Schedule K-1 for each person who was a shareholder at any time during the tax year and file it with the IRS along with Form 1120-S. The second copy of the Schedule K-1 must be mailed to the shareholder.

To extend the time to file an S Corporation tax return the corporation must file Form 7004.

Penalties

Late Filing of Return

A penalty may be assessed if the return is filed after the due date (including extensions) or the return doesn't show all the information required, unless each failure is due to reasonable cause. For returns on which no tax is due, the penalty is $245 for each month or part of a month (up to 12 months) the return is late or doesn't include the required information, multiplied by the total number of persons who were shareholders in the corporation during any part of the corporation's tax year for which the return is due. If tax is due, the penalty is the amount stated above plus 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. The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or $510.

Failure to Furnish Information Timely

For each failure to furnish Schedule K-1 to a shareholder 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 $330 penalty may be imposed with respect to each Schedule K-1 for which a failure occurs. If the requirement to report correct information is intentionally disregarded, each $330 penalty is increased to $660 or, if greater, 10% of the aggregate amount of items required to be reported, for 2025 tax year.

The penalty won't be imposed if the corporation can show that not furnishing information timely was due to reasonable cause.

Requirements to Qualify

Section 1361 defines an S corporation as a small business corporation with an election under Section 1362(a) in effect for the year. Each shareholder must consent to the S corporation election.

A corporation or other entity eligible to elect to be treated as a corporation may elect to be an S corporation only if it meets all the following tests:

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1. It is (a) a domestic corporation, or (b) a domestic entity eligible to elect to be treated as a corporation, that timely files Form 2553 and meets all the other tests listed below.
2. It has no more than 100 shareholders. An individual and their spouse (and their estates) can be treated as one shareholder for this test. All members of a family (as defined in Section 1361(c)(1)(B)) and their estates can also be treated as one shareholder for this test.
3. Its only shareholders are individuals, estates, exempt organizations described in Section 401(a) or 501 (cX3), or certain trusts described in Section 1361(c)(2)(A).
4. It has no non-resident alien shareholders (other than as potential current beneficiaries of an ESBT).
5. It has only one class of stock (disregarding differences in voting rights). Generally, a corporation is treated as having only one class of stock if all outstanding shares of the corporation's stock confer identical rights to distribution and liquidation proceeds.
6. It is not one of the following corporations, which are ineligible:
   a. A bank or thrift institution that uses the reserve method of accounting for bad debts under Section 585.
   b. An insurance company subject to tax under subchapter L of the Code.
   c. A Domestic International Sales Corporation (DISC) or former DISC.
7. It has or will adopt or change to one of the following tax years:
   a. A tax year ending December 31.
   b. A natural business year.
   c. An ownership tax year.
   d. A tax year elected under Section 444.
   e. A 52-53-week tax year ending with reference to a year listed above.
   f. Any other tax year (including a 52-53-week tax year) for which the corporation establishes a business purpose.

A parent S corporation can elect to treat an eligible wholly owned subsidiary as a qualified subchapter S subsidiary. If the election is made, the subsidiary's assets, liabilities, and items of income, deduction, and credit generally are treated as those of the parent. For details, see Form 8869, Qualified Subchapter S Subsidiary Election.

An S corporation generally cannot have the following entities or individuals as shareholders:

- Partnerships.
- Corporations.
- Non-resident aliens.
- Foreign trusts.

A U.S. shareholder whose spouse is a non-resident alien with actual interest property in the shares through the community property state law or a foreign country law.

IRAs under Section 408(a), including a Roth IRA under Section 408(a), unless the S-Corporation is a bank or a bank holding company and the stock was held by said IRA on October 22, 2004.

Election Procedure

Complete and file Form 2553:

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- No more than two months and 15 days after the beginning of the tax year the election is to take effect, or
- At any time during the tax year preceding the tax year it is to take 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.

Example 1: A calendar year small business corporation begins its first tax year on January 7. The 2-month period ends March 6 and 15 days after that is March 21. To be an S corporation beginning with its first tax year, the corporation must file Form 2553 during the period that begins January 7 and ends March 21. Because the corporation had no prior tax year, an election made before January 7 will not be valid.

Example 2: A calendar year small business corporation has been filing Form 1120 as a C corporation but wishes to make an S election for its next tax year beginning January 1st. The 2-month period ends February 28 (29 in leap years) and 15 days after that is March 15. To be an S corporation beginning with its next tax year, the corporation must file Form 2553 during the period that begins the first day (January 1st) of its last year as a C corporation and ends March 15th of the year it wishes to be an S corporation.

Because the corporation had a prior tax year, it can make the election at any time during that prior tax year.

Example 3: A calendar year small business corporation begins its first tax year on November 8. The 2-month period ends January 7 and 15 days after that is January 22.

To be an S corporation beginning with its short tax year, the corporation must file Form 2553 during the period that begins November 8 and ends January 22. Because the corporation had no prior tax year, an election made before November 8 will not be valid.

Relief for Late Elections

Relief for a Late S Corporation Election Filed by a Corporation

A late election to be an S corporation generally is effective for the tax year following the tax year beginning on the date entered on line E of Form 2553. However, relief for a late election may be available if the corporation can show that the failure to file on time was due to reasonable cause.

To request relief for a late election, a corporation that meets the following requirements can explain the reasonable cause in the designated space on page 1 of Form 2553:

1. The corporation intended to be classified as an S corporation as of the date entered on line E of Form 2553;
2. The corporation fails to qualify as an S corporation on the effective date entered on line E of Form 2553 solely because Form 2553 was not filed by the due date.
3. The corporation has reasonable cause for its failure to timely file Form 2553 and has acted diligently to correct the mistake upon discovery of its failure to timely file Form 2553;
4. Form 2553 will be filed within 3 years and 75 days of the date entered on line E of Form 2553; and
5. A corporation that meets requirements (1) through (4) must also be able to provide statements from all shareholders who were shareholders during the period between the date entered on line E of Form 2553 and the date the completed Form 2553 is filed stating that they have reported their income on all affected

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returns consistent with the S corporation election for the year the election should have been made and all subsequent years. Completion of Form 2553, Part I, column K, Shareholder's Consent Statement (or similar document attached to Form 2553), will meet this requirement; or

6. A corporation that meets requirements (1) through (3) but not requirement (4) can still request relief for a late election on Form 2553 if the following statements are true.
    a. The corporation and all its shareholders reported their income consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent tax year (if any);
    b. At least 6 months have elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation; and
    c. Neither the corporation nor any of its shareholders was notified by the IRS of any problem regarding the S corporation status within 6 months of the date on which the Form 1120-S for the first year was timely filed.

To request relief for a late election when the above requirements are not met, the corporation generally must request a private letter ruling and pay a user fee in accordance with Rev. Proc. 2014-1, 2014-1 I.R.B. 1 (or its successor).

Relief for a Late S Corporation Election Filed by an Entity Eligible to Elect to Be Treated as a Corporation.

A late election to be an S corporation and a late entity classification election for the same entity may be available if the entity can show that the failure to file Form 2553 on time was due to reasonable cause. Relief must be requested within 3 years and 75 days of the effective date entered on line E of Form 2553.

To request relief for a late election, an entity that meets the following requirements can explain the reasonable cause in the designated space on page 1 of Form 2553:

1. The entity is an eligible entity.
2. The entity intended to be classified as an S corporation as of the date entered online E of Form 2553.
3. Form 2553 will be filed within 3 years and 75 days of the date entered on line E of Form 2553.
4. The entity failed to qualify as a corporation solely because Form 8832 was not timely filed under Regulations Section 301.7701 -3(c)(1)(i), or Form 8832 was not deemed to have been filed under said regulations.
5. The entity fails to qualify as an S corporation on the effective date entered on line E of Form 2553 because Form 2553 was not filed by the due date.
6. The entity either:
    a. Timely filed all forms 1120-S consistent with its requested classification as an S corporation, or
    b. Did not file Form 1120-S because the due date for the first year's Form 1120-S has not passed.
7. The entity has reasonable cause for its failure to timely file Form 2553 and has acted diligently to correct the mistake upon discovery of its failure to timely file Form 2553.

The S corporation can provide statements from all shareholders who were shareholders during the period between the date entered online E of Form 2553 and the date the completed Form 2553 is filed stating that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have

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been made and all subsequent years. Completion of Form 2553, Part I, column K, Shareholder's consent statement (or similar document attached to Form 2553), will meet this requirement.

To request relief for a late election when the above requirements are not met, the entity generally must request a private letter ruling and pay a user fee in accordance with Rev. Proc. 2014-1, 2014-1 I.R.B. 1 (or its successor).

Generally, send the original election (no photocopies) or fax it to the IRS Center assigned to the taxpayer. If the corporation files this election by fax, keep the original Form 2553 with the corporation's permanent records. However, certain late elections can be filed attached to Form 1120-S.

Acceptance or Non-acceptance of Election

The service center will notify the corporation if its election is accepted and when it will take effect. The corporation will also be notified if its election is not accepted. The corporation should generally receive a determination on its election within 60 days after it has filed Form 2553. If box Q1 in Part II is checked, the corporation will receive a ruling letter from the IRS that either approves or denies the selected tax year. When box Q1 is checked, it will generally take an additional 90 days for the Form 2553 to be accepted.

Care should be exercised to ensure that the IRS receives the election. If the corporation is not notified of acceptance or non-acceptance of its election within 2 months of the date of filing (date faxed or mailed), or within 5 months if box Q1 is checked, take follow-up action by calling 1-800-829-4933.

If the IRS questions whether Form 2553 was filed, an acceptable proof of filing is:

- A certified or registered mail receipt (timely postmarked) from the U.S. Postal Service, or its equivalent from a designated private delivery service.
- Form 2553 with an accepted stamp.
- Form 2553 with a stamped IRS received date; or
- An IRS letter stating that Form 2553 has been accepted.

Do not file Form 1120-S for any tax year before the year the election takes effect. If the corporation is now required to file Form 1120, U.S. corporation income tax return, or any other applicable tax return, continue filing it until the election takes effect.

Income, Expenses and Separately Stated Items

In general, an S-Corporation does not pay a tax on its income. Instead, all S-Corporation items of income, loss, deduction, or credit are passed through to the shareholders and reported on their individual returns. Any items the separate treatment of which could affect a shareholder's tax liability must be passed through separately. These items are referred to as separately stated items.

Items allocated based on ownership

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Both the separately stated items and the non-separately stated income or loss are passed through to the shareholders by the S-Corporation in proportion to their ownership. Before they are passed through to the shareholders, some items may be reduced.

The list of items that must be separately stated includes:

- Net income or loss from rental real estate activities.
- Net income or loss from other rental activities.
- Portfolio income or loss:
    - Interest income.
    - Dividend income.
    - Royalty income.
    - Short-term capital gain or loss.
    - Long-term capital gain or loss.
- Section 1231 net gain or loss.
- Charitable contributions.
- Section 179 expense deduction.
- Expenses related to portfolio income or loss.
- Credits:
    - Low-income housing credit
    - Qualified rehabilitation expenses.
    - Other credits.
- Investment interest expense.
- Tax preference and adjustment items needed to figure shareholders' alternative minimum tax.

Stated Items

The following outlines specific treatment of some reportable items by an S-Corporation.

Non-business bad debts: An S-Corporation that has a non-business bad debt must separately state the debt as a short-term capital loss in the year it becomes wholly worthless.

Choosing income tax treatment of an item: The S-Corporation makes all the elections that affect the computation of items it has to report on its return, except:

- The elections on deduction and recapture of certain mining exploration costs.
- The election on whether to deduct or claim a foreign tax credit for taxes the S-Corporation pays or accrues to foreign countries.

Carryback restriction: An S-Corporation cannot carryback any item from a year that the corporation is not an S-Corporation to a year that the corporation is an S-Corporation.

Limits for certain items: The limits for the following items are applied to both the S-Corporation and to the shareholder.

- The limit on Section 179 deduction is $1,250,000 for 2025 tax year.
- The limit on reforestation costs is $10,000. The remaining costs can be amortized over an 84-month period.

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Indirect deduction not allowed: The indirect deduction through an S-Corporation of amounts that are not allowable as a deduction if paid or incurred directly by an individual is not allowed.

Related party losses not allowed: Losses realized on sales or exchanges of property between related parties generally cannot be deducted.

If the related party who acquired the property on which the loss was denied later resells the property at a gain, the gain is recognized only to the extent the gain is more than the disallowed loss.

Related parties: For purposes of this rule, related parties include:

- A grantor and fiduciary, or the fiduciary and beneficiary of any trust.
- Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust
- 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 the profits interest, in the partnership.
- Two S-Corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
- Two corporations, one of which is an S-Corporation, if the same person owns more than 50% in value of the outstanding stock of each corporation.
- Two corporations that are members of the same controlled group (under certain conditions, however, such losses are not disallowed but must be deferred).
- Two partnerships if the same person owns, directly or indirectly, more than 50% of the capital interests or the profits interests.

Treatment of Distributions

Property distributions (including cash) are applied in the following order (to reduce accounts of the S corporation that are used to figure the tax effect of distributions made by the corporation to its shareholders):

1. Reduce the Accumulated Adjustments Account (AAA) determined without regard to any net negative adjustment for the tax year (but not below zero). If distributions during the tax year exceed the AAA at the close of the tax year determined without regard to any net negative adjustment for the tax year, the AAA is allocated pro rata to each distribution made during the tax year.
2. Reduce shareholders' Previously Taxed Income (PTI) account for any section 1375(d) (as in effect before 1983) distributions. A distribution from the PTI account is tax free to the extent of a shareholder's basis in their stock in the corporation.
3. Reduce accumulated E&P. Generally, the S corporation has accumulated E&P only if it has not distributed E&P accumulated in prior years when the S corporation was a C corporation. See IRC Section 312. The only adjustments that can be made to the accumulated E&P of an S corporation are:
    - Reductions for dividend distributions.
    - Adjustments for redemptions, liquidations, reorganizations, etc., and
    - Reductions for investment credit recapture tax for which the corporation is liable.

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- Reduce the Other Adjustments Account (OAA).

4. Reduce any remaining shareholders' equity accounts.

Unpaid business expenses and interest owed to related party: An accrual method S-Corporation must use the cash method to deduct business expenses and interest owed to cash method related parties. An S-Corporation cannot deduct business expenses or interest owed to a cash basis related party until the day the payment is made, and the amount is includible in the related party's gross income.

S-Corporation pass-through entity: Pass-through income or loss adjusts shareholder's stock basis. If the taxpayer is an S-Corporation shareholder, all current year income or loss and other tax items are taxed to the taxpayer at the corporation's year-end (generally, the end of the calendar year) whether he actually received any amount or not. Those items usually increase or decrease the basis of the taxpayer's S-Corporation stock as appropriate.

Distributions are generally a return of capital: S-Corporation distributions, except dividend distributions, are generally considered a return of capital and reduce the shareholder'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.

Limit on losses and deductions may be carried over to the next tax year: The deduction for a shareholder's share of losses is limited to the adjusted basis of his stock and any debt the corporation owes the shareholder. 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.

Shareholder's Basis

The amount of a shareholder's stock and debt basis in 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, losses 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 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.

It is important that a shareholder knows their 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.

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- 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 an 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, a basis needs to be established in order to reflect the proper gain or loss on the disposition.

Since shareholder stock basis in an S Corporation changes every year, it must be computed every year.

Loan Basis

A shareholder has a basis in a loan if they make a direct loan to the S corporation. If the shareholder merely guarantees the debt of the S corporation, the shareholder does not have basis in debt to the S corporation. For a guarantee, the shareholder must have actually paid the guaranteed debt in order to obtain a tax basis in the debt. Prior to the actual payment, liability* may exist, but not debt to the shareholder. The denial of tax basis is due to the simple fact that there is no direct indebtedness between the shareholder and the S corporation.

When determining basis in loans to the corporation, remember that:

- Distributions do not reduce loan basis, and
- Loans that a shareholder guarantees, or co-signs are not part of a shareholder's loan basis.

Property Exchanged for Stock

If an individual 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 they are in control of the corporation, the exchange is usually not taxable.

Services Rendered

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.

Example: Ana 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, Ana recognizes ordinary income of $3,000 as payment for services she rendered to the corporation.

Computing Stock Basis

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.

Adjustments to Basis of Shareholder Stock

During the time the corporation is an S-Corporation, each shareholder will increase or decrease the basis of his stock, but not below zero.

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S-Corporation stock basis increases with:

1. All income items of the S-Corporation, including tax-exempt income, which are separately stated, and passed through to the taxpayer as a shareholder.
2. The non-separately stated income of the S-Corporation.
3. The amount of the deduction for depletion (other than oil and gas depletion) that is more than the basis of the property being depleted.

If an amount described in (1) or (2) above, is required to be included in income, a shareholder can increase the basis of the stock only by the amount actually included as gross income on their tax return.

S-Corporation stock basis decreases with:

1. Distributions by the S-Corporation that were not included in the shareholder's income.
2. All loss and deduction items of the S-Corporation that are separately stated and passed through to the shareholder.
3. Any non-separately stated loss of the S-Corporation.
4. Any expense of the S-Corporation that is not deductible in figuring its taxable income and not properly chargeable to a capital account.
5. The shareholder's deduction for depletion of oil and gas wells held by the S-Corporation to the extent it is not more than the shareholder's share of the adjusted basis of the wells.

IMPORTANT: The basis in the stock cannot be reduced below zero.

Charitable contributions: For these contributions, shareholders must reduce their stock basis using their share of the adjusted basis, instead of the fair market value, of contributed property. The AAA account is also adjusted by the property's adjusted basis.

Adjustments to basis of indebtedness: In certain cases, a shareholder may decrease the basis of any loans made to the S-Corporation, and in later years restore the basis.

Reduction of basis: If, for any year, the amounts specified in items (2), (3), (4), and (5) above are more than the amount needed to reduce the shareholder's basis in stock to zero, the excess must be used to reduce the shareholder's basis in any loans made to the S-Corporation, but not below zero.

Restoring basis of loans: If the shareholder's basis in any loans ade to an S-Corporation is reduced, any net increase for a later tax year should first be used to restore the basis of the loans and next to increase the basis of the stock.

S-Corporation loan repayments: If the shareholder's basis in the loan was reduced (and has not subsequently been completely restored), he will have income (other than interest) when the S-Corporation makes a payment on the loan. Each loan payment (other than interest) must be allocated in part to a return of the shareholder's basis in the loan and in part to income.

To figure the amount of income to report from the loan payments, the shareholder should:

1. Figure the adjusted basis of the loan before payment.
2. Divide the adjusted basis in the loan by the outstanding loan balance.

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3. Multiply the payment by the percentage from step (2). This amount is the part of the payment that will be a return of basis in the loan.
4. Take the difference between the amount of the payment and the amount from step (3). This is the amount that the shareholder must report as ordinary income.

The basis of the loan is reduced, even if the shareholder has no tax benefit from the deduction for the basis reduction. To figure the adjusted basis of the loan for a later payment, for a later restoration of basis, or for a later reduction of basis in the loan because of additional losses, the shareholder should subtract any amounts that are a return of basis from the adjusted basis of the loan.

Distribution of appreciated property is treated as sale: An S-Corporation that distributes appreciated property to a shareholder will be treated as if it had sold the property to FMV. It will have to recognize any gain and pass that gain through to its shareholders.

Shareholder Loss Limitations

An S corporation is a corporation with an “S" election in effect. The impact of the election is that the S corporation's items of income, loss, deductions and credits flow to the shareholder and are taxed on the shareholder’s personal return.

The two main reasons for electing S corporation status are:

- To avoid double taxation on distributions.
- To allow corporate losses to flow through to its owners.

There are three shareholder loss limitations:

- Stock and debt basis limitations.
- At-risk limitations.
- 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.

Loss or Deduction Flow-Through Items

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.

S-Corporation Shareholder Income or Loss

Each shareholder reports a pro-rata share of each item of income, loss, deduction, or credit that is separately stated and a pro rata share of non-separately stated income or loss on the shareholder’s income tax return.

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When it is reported on the return, the character of the item included in a shareholder's pro rata share is determined as if the item were realized directly from the source from which the S-Corporation realized it or incurred in the same manner in which the corporation incurred it.

Any time it is necessary to determine a shareholder's gross income, the shareholder's pro-rata share of the gross income of the corporation is included.

S-corporation shareholder's treatment of items determined at corporate level: The tax treatment of any S-Corporation item is determined at the corporate level. For tax years beginning after 1996, the Act requires every shareholder to report Subchapter S items the same way the corporation treated the items on its return, unless the shareholder files Form 8082, Notice of inconsistent treatment or administrative adjustment request.

Self-employment income: A shareholder's share of the corporation's taxable income is not self-employment income, even though it is included in gross income of the shareholder. However, if a shareholder is an officer of the corporation and performs substantial services, he is considered an employee. Reasonable compensation for these services is subject to FICA, FUTA, and income tax withholding, no matter what the corporation calls the payments.

Limit on Shareholder Losses and Deductions

S-Corporation shareholders who hold stock at any time during the year claim their share of corporate losses and deductions, subject to certain limitations on their individual tax returns.

The amount of losses and deductions a shareholder can take is limited to the adjusted basis of.

1. The shareholder's stock, plus
2. Any loans the shareholder makes to the corporation (must be a direct loan to the S-Corporation).

NOTE: ***For purposes of determining the limit, the adjusted basis is figured at year end and includes the increases, but not the decreases, for that year.***

Excess loss or deduction may be carried over until used: If the shareholder's loss or deduction is limited, the excess is treated as incurred by the corporation in the next tax year for that shareholder and may be carried over until used by that shareholder, unless limited by some other provision.

Excess loss or deduction in last tax year as S-Corporation: If the losses or deductions are limited for the last tax year the corporation is an S-Corporation, the excess is treated as incurred by the shareholder on the last day of the corporation's post-termination transition period.

This excess amount cannot be more than the shareholder's adjusted basis of the stock in the corporation, determined at the close of the last day of the post-termination transition period. The losses or deductions taken into account during this period reduce the shareholder's basis in the stock of the corporation.

Revocation, Termination and Reinstatement

An S-Corporation election terminates automatically in any of the following cases:

1. The corporation is no longer a small business corporation when:
    a. It is no longer a national corporation: The first requirement for making an S election is that the corporation needs to be a national corporation or entity eligible to elect to be treated as an S

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corporation. If the corporation no longer operates as a national corporation, but as a foreign corporation, the S election is terminated.

   b. It has over 100 shareholders: To be eligible for an S election, a corporation cannot have more than 100 shareholders. In determining the number of shareholders, a husband and wife and their estates are considered one shareholder. Also, all members of a family, as defined in IRC Section 1361(c)(1)(B), and their estate are treated as one shareholder.

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).

Election Revoked

An election may be revoked only with the consent of shareholders who, at the time the revocation is made, hold more than 50% of the number of 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). A revocation can be rescinded before it takes effect. For rules on allocating income and deductions between an S corporation's short year and a C corporation's short year and other special rules that apply when an election is terminated, see Section 1362(e) and Regulations Section 1.1362-3.

If an election was terminated under (1) or (2) above, and the corporation believes the termination was inadvertent, the corporation can ask for permission from the IRS to continue to be treated as an S corporation.

Usually, the causes of the termination are obvious. However, some situations that are not so obvious include the following:

- Shares are transferred in the form of co-ownership and the receiving shareholders are independent shareholders, resulting in more than 100 shareholders being exceeded.
- A successor beneficiary of a Qualified Subchapter S Trust (QSST) refuses to accept the original QSST election.
- An individual that pledges their shares of the S corporation as collateral on a personal loan, they default, and the shares are transferred to an ineligible shareholder.
- An S Corporation has accrued benefits and earnings (AE&P) and receives more than 25% of its gross income from passive investment sources in three consecutive years. The effective date of termination is the first day of the fourth fiscal year.

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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 fifth tax year after the first tax year in which the termination took effect.

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).

Transition Period from Termination of Operation

When an S election ends, and the corporation becomes a C corporation, there is a transition period following termination. During this time, there are special rules governing the bases and distributions.

The post-termination transition period begins on the day the election is no longer effective. The period ends no later than the expiration date of the final Form 1120-S, including extensions, or one year after termination. There are also special rules for audit adjustments that occur after the normal time period.

Conversion from S Corporation to C Corporation

If the termination is not involuntary, or if the corporation voluntarily revokes its election, there may be one year of termination. This happens when the event of termination or revocation occurs on a day other than the beginning of the corporation's tax year. The period from the beginning of the year to the day before the termination event is called the "short S year". The date of termination begins the "short C year", which ends on the last day of the corporation's tax year.

Short year S income and other tax items flow through its shareholders on the last day of the final year S. Short year C requires annualization of taxable income to calculate the corporation's tax liability.

A C corporation is subject to a fixed rate of 21% on all of its taxable income. Therefore, annualization has no impact on the corporation's tax liability, although the requirement remains in law. It has an impact if the corporation's tax year began before 2018, since, at that time, there was a graduated rate structure in place for C corporations.

Reinstatement of the S Corporation

There is a general prohibition against electing a new S corporation if the corporation terminates an election within five years. Therefore, if a corporation decides to terminate its S status and become a C corporation, it must remain a C corporation for at least five years. If the corporation decides to reselect its S status, it may be subject to taxation at the entity level (such as the incorporated income tax). The IRS may reduce the period to one year. The IRS will allow early re-election if there was a change in ownership of more than 50% of the corporation's stock since the end of the previous election, and the previous ending was beyond the control of the current shareholders.

Debt Discharge

An S corporation derives income when a creditor discharges the S corporation from a debt The income derived from the cancellation of indebtedness of an S corporation is not distributed to the shareholders of an S corporation. However, the income that each shareholder derives generally from an S corporation is subject to taxation.

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For the purpose of taxation, an S corporation and its shareholders are considered two separate entities. The method adopted for taxing an S corporation and a partnership is the same. But the rules adopted for distribution of Cancellation of Debt Income (COD) in an S corporation are different from that of a partnership.

As mentioned earlier, the income of a shareholder does not increase with the cancellation of indebtedness. It is only the general income, tax credits, and deductions of the S corporation that are distributed at the shareholder level.

However, the liability of an S corporation in insolvency, bankruptcy and indebtedness is not distributed at the shareholder level of an S corporation. Similarly, the income that is received from the discharge of debt due to insolvency and bankruptcy is distributed at the corporation level and it is not distributed at the shareholder level.

Occasionally, a loss incurred by an S corporation is also not distributed among the shareholders. Hence, such losses are considered income to the shareholders, and it is called Net Operating Losses (NOLs). A NOL is reduced from the gross income of the S corporation. The income derived from the discharge of indebtedness is also excluded from the gross income of an S corporation.

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REVIEW QUESTIONS

1. Which of these entities is eligible for an election to be an S corporation?

A. A bank or thrift institution that uses the reserve method of accounting for bad debts under Section 585.
B. A Domestic International Sales Corporation (DISC) or former DISC.
C. An insurance company subject to tax under subchapter L of the IRC.
D. None of the above.

Answer: D

The following corporations are not eligible to elect the S-Corporation status:

- *A bank or thrift institution that uses the reserve method of accounting for bad debts under Section 585.*
- *An insurance company subject to tax under subchapter L of the IRC.*
- *A Domestic International Sales Corporation (DISC) or former DISC.*

2. Which of the following is an acceptable proof of filing Form 2553?

A. Form 2553 with an accepted stamp.
B. Form 2553 without a stamped IRS received date.
C. An IRS letter stating that Form 2553 has been denied.
D. All of the above.

Answer: A

If the IRS questions whether Form 2553 was filed, an acceptable proof of filing is:

- *A certified or registered mail receipt (timely postmarked) from the U.S. Postal Service, or its equivalent from a designated private delivery service.*
- *Form 2553 with an accepted stamp.*
- *Form 2553 with a stamped IRS received date.*
- *An IRS letter stating that Form 2553 has been accepted.*

3. For an S corporation, which of these items must be separately stated?

A. Section 179 expense deduction.
B. Investment interest expense.
C. Net income or loss from rental real estate activities.
D. All of the above.

Answer: D

Both the separately stated items and the non-separately stated income or loss are passed through to the shareholders by the S-Corporation in proportion to their ownership. Before they are passed through to the shareholders, some items may be reduced. The list of items that must be separately stated includes:

- *Net income or loss from rental real estate activities.*
- *Net income or loss from other rental activities.*

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- *Portfolio income or loss.*
- *Section 1231 net gain or loss.*
- *Charitable contributions.*
- *Section 179 expense deduction.*
- *Expenses related to portfolio income or loss.*
- *Credits.*
- *Investment interest expense.*
- *Tax preference and adjustment items needed to figure shareholders' AMT.*

4. For purposes of the losses realized on sales or exchanges of property, which of the following are included as related parties?

A. Two S-Corporations if the same persons own more than 10% in value of the outstanding stock of each corporation.
B. Two corporations that are members of the same controlled group.
C. Fiduciaries of two different trusts if different persons are the grantor of both trusts.
D. All of the above.

Answer: B

For purposes of losses realized on sales or exchanges of property, related parties include:

- *A grantor and fiduciary, or the fiduciary and beneficiary of any trust.*
- *Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.*
- *A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust*
- *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 the profits interest, in the partnership.*
- *Two S-Corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.*
- *Two corporations, one of which is an S-Corporation, if the same person owns more than 50% in value of the outstanding stock of each corporation.*
- *Two corporations that are members of the same controlled group.*
- *Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital interests or the profits interests.*

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5. When does an S-corporation election terminate automatically?

A. When the business is a national corporation.
B. When the corporation is still a small business corporation.
C. When the corporation, for each of three consecutive years, has accumulated earnings and profits and derives more than 25% of its gross receipts from passive investment income.
D. All of the above.

Answer: C

An S-Corporation election terminates automatically in any of the following cases:

- *The corporation is no longer a small business corporation:*
  - *It is no longer a national corporation.*
  - *It has over 100 shareholders.*
- *The corporation, for each of three consecutive tax years:*
  - *Has accumulated earnings and profits, and*
  - *Derives more than 25% of its gross receipts from passive investment income.*

6. Which of these is a situation that may provoke the termination of the S election?

A. A successor beneficiary of a qualified Subchapter S trust accepts the original Qualified Subchapter S Trust (QSST) election.
B. At least 10 shareholders exit the business abruptly.
C. An individual pledges his shares of the S corporation as collateral on a personal loan, they default, and the shares are transferred to an ineligible shareholder.
D. The S Corporation has accrued benefits and earnings and receives 10% of its gross income from passive investment sources in three consecutive years.

Answer: C

Usually, the causes of the termination are obvious. However, some situations when they are not so obvious include the following:

- *Shares are transferred in the form of co-ownership and the receiving shareholders are independent shareholders, resulting in more than 100 shareholders being exceeded.*
- *A successor beneficiary of a qualified Subchapter S Trust refuses to accept the original QSST election.*
- *An individual pledges his shares of the S corporation as collateral on a personal loan, they default and the shares are transferred to an ineligible shareholder.*
- *An S corporation has Accrued Earnings and Profits (AE&P) and receives more than 25% of its gross income from passive investment sources in three consecutive years. The effective date of termination is the first day of the fourth fiscal year.*

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7. When does the transition period post-termination of an S corporation end?

A. The first day of the first tax month after the termination was made.
B. No later than the expiration date of the final Form 1120-S, including extensions, or one year after termination.
C. On the day after the election is no longer effective.
D. Exactly three months after the election is no longer effective.

Answer: B

The post-termination transition period begins on the day the election is no longer effective. The period ends no later than the expiration date of the form 1120-S, including extensions, or one year after the termination. There are also special rules for audit adjustments that occur after the normal time period.

8. If an S corporation made a change to be a C corporation, when is the corporation able to make the election to be an S corporation again?

A. After 5 years have passed.
B. Immediately after the election is no longer effective.
C. After 2 years have passed.
D. A C corporation cannot be an S corporation again.

Answer: A

There is a general prohibition against electing a new S corporation if the corporation terminates an election within five years. Therefore, if a corporation decides to terminate its S status and become a C corporation, it must remain a C corporation for at least five years. If the corporation decides to reselect its S status, it may be subject to taxation at the entity level (such as the incorporated income tax). The IRS may reduce the period to one year. The IRS will allow early re-election if there was a change in ownership of more than 50% of the corporation's stock since the end of the previous election, and the previous ending was beyond the control of the current shareholders.

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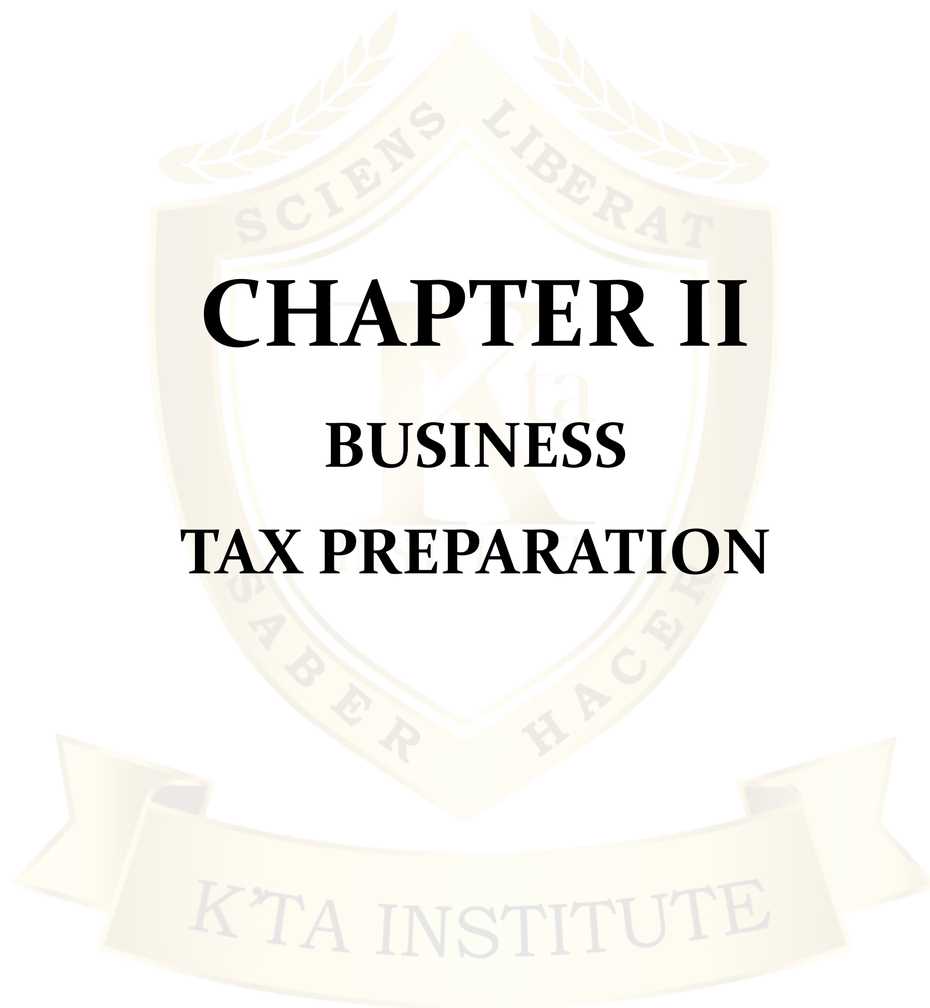

CHAPTER II

BUSINESS

TAX PREPARATION

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Module: Business Income

This kind of income includes income received from the sale of products or services, for instance, fees received by a person from the regular practice of a profession. Rents that are received by a person in the real estate business are business income. Additionally, a business must include in income payments received in the form of property or services at the FMV of the property or services.

Gross Receipts and Other Income

Gross receipts are the total amounts the organization received from all sources during its annual accounting period, without subtracting any costs or expenses. The term "gross receipt" means the taxpayer recognizes the receipts under the accounting method used in that tax year. Gross receipts include the following:

- Total sales and all amounts received for services.
- Any income from investments.
- Any income from incidental or outside sources.

At the end of each business day, the taxpayer must make sure their records balance with their actual cash and credit receipts for the day. It may be helpful to use cash registers to keep track of receipts. The taxpayer should also use a proper invoicing system and keep a separate bank account for their business.

Miscellaneous Income

This section discusses various types of income. A taxpayer could have taxable income from certain transactions even if no money changes hands. For example, they may have taxable income if the taxpayer lent money at a below-market interest rate or has canceled a debt they owed.

Rental Income

The taxpayer generally must include in gross income all amounts received as rent. Rental income is any payment received for the use or occupation of property. If the taxpayer is in the business of lending money, any payment received on a discounted loan usually includes interest and principal.

- For a cash-basis taxpayer, part of the discount is interest income upon receipt of each payment.
- For an accrual-basis taxpayer, the amount of the discount is includible in income as it accrues over the term of the loan, or it is includible upon receipt of payment if made before it accrues.

If a loan becomes uncollectible during the year and the taxpayer uses the accrual method of accounting, interest that has accrued up to the date the loan became non-collectible is included in gross income. Claim a bad debt deduction when accrued interest is later determined to be uncollectible.

When there is little or no interest charged on an installment sale, each payment includes unstated interest.

Cost of Goods Sold

If the taxpayer makes or buys goods to sell, they can deduct the Cost Of Goods Sold (COGS) from their gross receipts on Schedule C. However, in order to determine these costs, at the beginning and end of each tax year, the taxpayer has to value their inventory.

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When a business purchases goods meant for sale, the COGS (also known as the cost of sale) should be deducted from the gross receipts received. For the purpose of accurately determining the COGS, it is critical to find the value of stock at the end, as well as the beginning, of every tax period.

If a business manufactures products, or purchases them for resale, it generally must value inventory at the beginning and end of each tax year to determine the COGS. Some of the business's expenses may be included in figuring the cost of goods sold. The COGS is deducted from the business's gross receipts to determine the gross profit for the year. If a taxpayer includes an expense in the COGS, they cannot deduct it again as a business expense. The form used to calculate the cost of goods sold is Form 1125-A.

The following are the types of expenses that go into figuring the cost of goods sold:

- The cost of products or raw materials, including freight.
- Storage.
- Direct labor costs (including contributions to pensions or annuity plans) for workers who produce the products.
- Factory overhead.

Under the uniform capitalization rules, they must capitalize the direct costs and part of the indirect costs for certain production or resale activities. Indirect costs include rent, interest, taxes, storage, purchasing, processing, repackaging, handling, and administrative costs.

This rule does not apply to personal property the taxpayer acquires for resale if the average annual gross receipts (or those of the taxpayer's predecessor) for the preceding 3 tax years are not more than $10 million.

For example, if the business cost of goods sold is determined to be $20,000, then in the tax return form the business owner is supposed to record $20,000 for taxation purposes.

Inventories

Generally, if a taxpayer produces, purchases, or sells merchandise in their business, the taxpayer has to keep an inventory and use the accrual method for purchases and sales of merchandise. However, the following taxpayers can use the cash method of accounting even if they produce, purchase, or sell merchandise. These taxpayers can also account for inventoriable items as materials and supplies that are not incidental:

- The taxpayer's average annual gross receipts for each prior tax year ending on or after December 17, 1998, is $1 million or less. (The average annual gross receipts for a tax year are figured by adding the gross receipts for that tax year and the 2 preceding tax years and dividing by 3).
- The taxpayer's business is not a tax shelter, as defined under Section 448(d)(3) of the IRC.

Definitions

Qualifying small business taxpayer: The taxpayer is a qualifying small business taxpayer if:

- The taxpayer's average annual gross receipts for each prior tax year ending on or after December 31, 2000, is more than $1 million but not more than $10 million.
- The taxpayer is not prohibited from using the cash method under section 448 of the IRC.
- The taxpayer's principal business activity is an eligible business.

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Business not owned or not in existence for 3 years: If the taxpayer did not own the business for all of the 3-tax-year period used in figuring their average annual gross receipts, include the period of any predecessor. If the taxpayer's business has not been in existence for the 3-tax-year period, base the average on the period it has existed, including any short tax years, annualizing the short tax year's gross receipts.

Materials and supplies that are not incidental: If the taxpayer accounts for inventoriable items as materials and supplies that are not incidental, they must deduct the cost of the items otherwise included in inventory in the year they sell the items, or the year paid for them, whichever is later. If the taxpayer is a producer, they can use any reasonable method to estimate the raw material in their work in process and finished goods on hand at the end of the year, in order to determine the raw material used to produce finished goods sold during the year.

Changing accounting method: If the 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, they are to file Form 3115, Application for change in accounting method.

Items Included in Inventory

- Merchandise or stock in trade. Merchandise includes the following:
  - Purchased merchandise if the title has passed to the taxpayer.
  - Goods under contract for sale that have not yet been 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 place of business.
- Merchandise not included in inventory:
  - Goods sold, but only if the title has passed to buyer.
  - Goods consigned to the taxpayer.
  - Goods ordered to future delivery if the taxpayer does not have title.
- Raw materials.
- Work in process.
- Finished products.
- Supplies that physically become a part of the item intended for sale.
- Cash on Delivery (COD) mail sales (COD payment not received).
- Containers.

Cost Identification

- There are three methods of identifying items in inventory:
- Specific identification method: This method is used to identify the cost of each inventoried item by matching the item with its cost of acquisition, in addition to other allocable costs, such as labor and transportation.
- First In - First Out (FIFO) method: This method assumes that the items of inventory purchased or produced first are sold first. The items in inventory at the end of the year are valued as the items most recently purchased or produced.
- Last In - First Out (LIFO) method: This method assumes that the items in inventory purchased or produced last are sold first. The items included in the closing inventory are considered to be those from the opening inventory plus those items acquired in the current year and not sold.

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Valuing Inventory

The following are common ways to value inventory:

- Cost method
- Cost of acquisition in addition to costs allocable to the merchandise.
- Lower of cost or market method
- Retail method

Lower of cost or market method

This method compares the market value of each item in inventory with its cost and uses the lower value as its inventory value. This method applies to:

- Goods purchased and on hand.
- The basic elements of cost (direct materials, direct labor, and an allocable share of indirect costs) of goods being manufactured and finished goods are on hand.

Example: Under the lower of cost or market method, the following items would be valued at $600 in closing inventory.

Item	Cost	Market	Lower
R	$300	$500	$300
S	$200	$100	$100
T	$450	$200	$200
TOTAL	$950	$800	$600

Value each item separately: Do not value the entire inventory at cost ($950 total) and at market ($800 total) and then use the lower of the two figures.

Retail method

The total retail selling price of goods on hand at the end of the year in each department or of each class of goods is reduced to approximate cost by using an average markup expressed as a percentage of the total selling price.

Inventory at Beginning of Year

If the taxpayer is a merchant, the beginning inventory is the cost of merchandise on hand at the beginning of the year that the taxpayer will 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. The opening inventory, usually, will be identical to the closing inventory of the year before. The taxpayer must explain any difference in a schedule that is attached to their return.

If the taxpayer contributes inventory, the amount they may claim as a contribution deduction is the smaller of its FMV on the day the taxpayer 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 their opening inventory for the year of the contribution. The taxpayer is to remove the amount of their contribution deduction from their opening inventory. It is not part of the cost of goods sold.

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If the cost of donated inventory is not included in the taxpayer's 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 their 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. A special rule may apply to certain donations of food inventory.

Figuring Cost of Goods Sold on Schedule C

Figure the cost of goods sold by filling out lines 35 through 42 of Schedule C (Form 1040) 2024. These lines are reproduced below:

Line	Description
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. Enter the result here and in line 4

Uniform Capitalization Rules

Under the uniform capitalization rules, a taxpayer has to capitalize the direct costs and part of the indirect costs for production or resale activities. These costs must be included in the basis of property the taxpayer produces or acquires for resale, rather than claiming them as a current deduction. The taxpayer recovers the costs through depreciation, amortization, or cost of goods sold when they use, sell, or otherwise dispose of the property.

Activities Subject to the Uniform Capitalization Rules

A taxpayer may be subject to the uniform capitalization rules if they do any of the following, unless the property is produced for the taxpayer's use other than in a business or an activity carried on for profit:

- Produces real or tangible personal property. For this purpose, tangible personal property includes a film, sound recording, video tape, book, or similar property.
- Acquires property for resale.

These rules do not apply to the following property:

- Personal property acquired for resale if the taxpayer's average annual gross receipts are $30 million or less.
- Property produced by the taxpayer if they meet either of the following conditions:
    - The indirect costs of producing the property are $200,000 or less.
    - The taxpayer uses the cash method of accounting and does not account for inventories.

Net Income/Loss Limitations and At-Risk Limitations

Net income represents the remaining amount of money after all operating expenses, interest, taxes and preferred stock dividends (but not common stock dividends) have been deducted from a company's total revenue. Net income is also referred to as the bottom line, net profit or net earnings.

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Loss Limitations

There are two rules that usually limit the figure of losses that a business can deduct from payable taxes. The at-risk rule argues that if the business has an investment in the area of real estate for rental purposes, then it is not considered to be at risk.

Second, the passive activity limits, the real estate rental activities that a business engages in, are referred to as passive activities; thus, losses incurred from them are not deductible, except in a scenario where there is other income generated from passive activities so as to offset them. For instance, if a business records a loss of $50,000, it must report this loss on its tax return, as well as indicate all figures leading to the loss.

At-Risk Limitations

These limit the taxpayer's losses from most activities to their amount at risk in the activity. Any loss that is disallowed because of the at-risk limits is treated as a deduction from the same activity in the next tax year. If the taxpayer's losses from an at-risk activity are allowed, they are subject to recapture in later years if the taxpayer's amount at risk is reduced below zero.

Loss Limits for Partners and S Corporation Shareholders

Four separate limits may apply to a partner's or shareholder's distributive share of an item of deduction or loss from a partnership or S corporation, respectively. The limits determine the amount each partner or shareholder can deduct on their own return. These limits and the order in which they apply are:

- The adjusted basis of:
  - The partner's partnership interest, or
  - The shareholder's stock, plus any loans the shareholder takes to the corporation,
- The excess farm loss rules,
- The at-risk rules, and
- The passive activity rules.

More information is available in Limitations on losses, deductions, and credits in partner's instructions for Schedule K-1 (Form 1065) and Shareholder's instructions for Schedule K-1 (Form 1120-S).

Cancellation of Business Debt

In most cases, if an owed debt is canceled or forgiven, other than as a gift or bequest, the taxpayer must include the canceled amount in their income. A taxpayer has no income from the canceled debt if it is intended as a gift to him or her. A debt includes any indebtedness for which the taxpayer is liable, or which attaches to property held by him or her.

If the debt is a non-business debt, report the canceled amount on line 8, Schedule 1, Form 1040. If it is a business debt, report the amount as taxable income in the appropriate form (Schedule C, Schedule F, Form 1065, Form 1120, Form 1120-S).

If a federal government agency, financial institution, or credit union cancels or forgives a debt the taxpayer owes that amounts to $600 or more, the taxpayer may receive a Form 1099-C. Form 1099-C, box 2, shows the amount of debt

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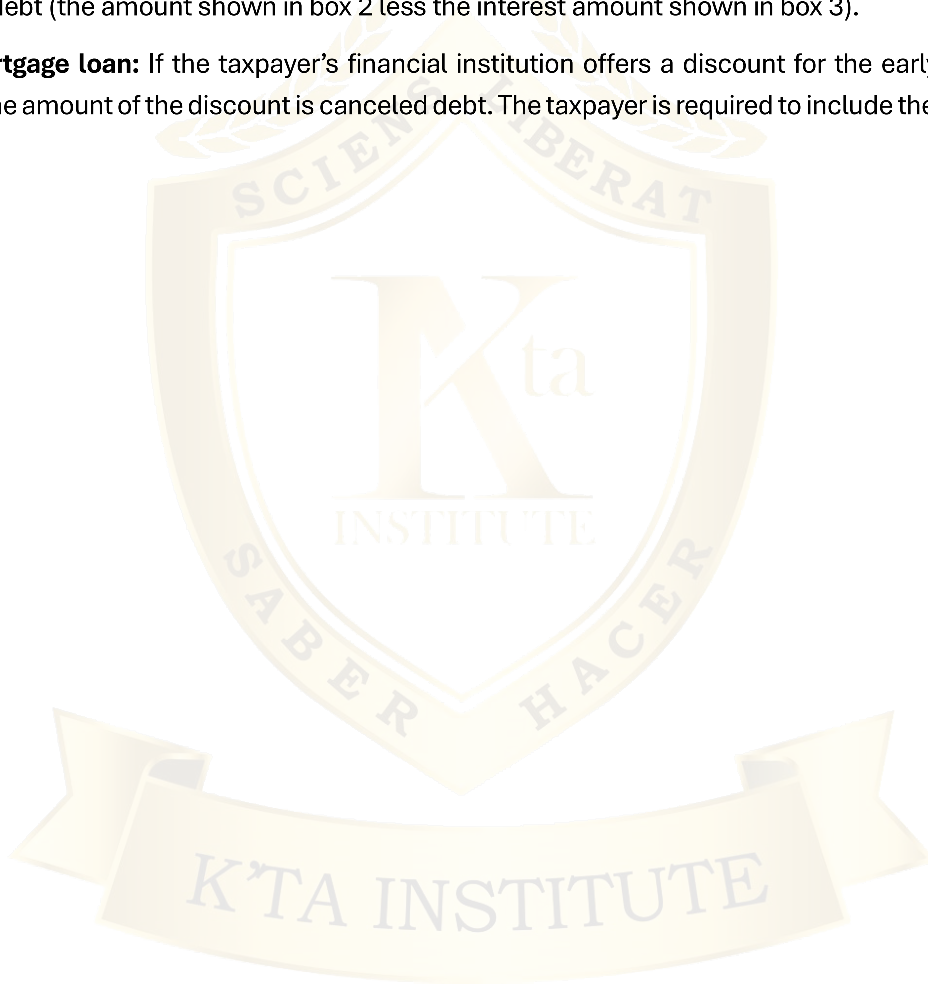
that is either actually or deemed discharged. If the taxpayer does not agree with the amount reported in box 2, it is recommended for the taxpayer contact their creditor.

Interest included in canceled debt

If any interest is forgiven and included in the amount of canceled debt in box 2, the amount of interest also will be shown in box 3. Whether or not the taxpayer must include the interest portion of the canceled debt in their income depends on whether the interest would be deductible if they paid it If the interest would not be deductible (such as interest on a personal loan), the taxpayer must include in their income the amount from Form 1099-C, box 2. If the interest would be deductible (such as on a business loan), the taxpayer has to include in their income the net amount of the canceled debt (the amount shown in box 2 less the interest amount shown in box 3).

Discounted mortgage loan: If the taxpayer's financial institution offers a discount for the early payment of their mortgage loan, the amount of the discount is canceled debt. The taxpayer is required to include the canceled amount in their income.



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REVIEW QUESTIONS

1. Which of the following is used to report costs of goods sold?

A. Schedule A.

B. Form 1125-A.

C. Form 7004.

D. Form 1099-K.

Answer: B

The form used to calculate the cost of goods sold is Form 1125-A.

2. Humberto, a taxpayer under the cash method, owned and operated a business. He began having difficulty paying his business debts. Humberto owed Sara, his computer consultant, $900 for non-business services rendered at his home. Sara forgave the entire debt Humberto is neither bankrupt nor insolvent. What amount will Humberto be required to include in income on his tax return?

A. $0.

B. $450.

C. $900.

D. $200.

Answer: C

In most cases, if an owed debt is canceled or forgiven, other than as a gift or bequest, the taxpayer must include the canceled amount in their income. A taxpayer has no income from the canceled debt if it is intended as a gift to him or her. A debt includes any indebtedness for which the taxpayer is liable, or which attaches to property held by him or her. Since the amount forgiven by Sara, $900, was due to non-business services, and as such, it counts as a non-business debt, Humberto must include said $900 as other income.

3. Which of the following expenses goes into figuring the cost of goods sold?

A. Storage expenses.

B. Factory overhead expenses.

C. The cost of products or raw materials, including freight.

D. All of the above.

Answer: D

The following are types of expenses that go into figuring the cost of goods sold:

- *The cost of products or raw materials, including freight.*
- *Storage.*
- *Direct labor costs for workers who produce the products.*

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- *Factory overhead.*

4. If a taxpayer has a cancelled debt, what form should he receive?

A. 1099-NEC.
B. 1099-DIV.
C. 1099-MISC.
D. 1099-C.

Answer: D

If a federal government agency, financial institution, or credit union cancels or forgives a debt the taxpayer owes that amounts to $600 or more, the taxpayer may receive a Form 1099-C. Form 1099-C, box 2, shows the amount of debt that is either actually or deemed discharged. If the taxpayer does not agree with the amount reported in box 2, it is recommended for the taxpayer contact their creditor.

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Module: Business Expenses, Deductions and Credits

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 trade or business. A necessary expense is one that is helpful and appropriate for their trade or business. An expense does not have to be indispensable to be considered necessary. It is important to separate business expenses from the following expenses:

- The expenses are used to figure the cost of goods sold.
- Capital expenses.
- Personal expenses.

Officers and Employees' Compensation

Form W-2, Wage and tax statement, is used to report to employees the annual amount of salaries and withholdings. In some cases, taxable compensation is not subject to withholding of income taxes and the compensation is not reported on Form W-2.

The employer is required to provide or send Form W-2 to the taxpayer not later than January 31,2025. The taxpayer should receive a separate Form W-2 from each employer they worked for.

If the taxpayer stopped working before the end of 2024, the employer could have given the taxpayer their Form W-2 at any time after the taxpayer stopped working. However, the employer must provide or send it to the taxpayer by January 31, 2025.

If the taxpayer asks for the form, the employer must send it to him or her within 30 days after receiving the written request or within 30 days after the taxpayer's final wage payment, whichever is later. If the taxpayer has not received their Form W-2 by January 31, the taxpayer should ask their employer for it. If it is not received by February 15, they have to call the IRS.

Form W-2 shows the taxpayer's total pay and other compensation and the income tax, social security tax, and Medicare tax that was withheld during the year. The taxpayer must include the federal income tax withheld (as shown in box 2 of Form W-2) on Line 17 of Form 1040. In addition, Form W-2 is used to report any taxable sick pay the taxpayer received and any income tax withheld from the taxpayer's sick pay.

All compensation for personal services is subject to income tax. Compensation means more than just salaries and wages. The term also includes tips, commissions, fees for personal services, overtime pay, vacation pay and every other payment for personal services.

Virtually every payment made by an employer to an employee or by a customer for personal services is compensation and therefore, taxable income to the employee/recipient. Taxability of a payment is not affected by what the payment is called. For example, bonuses and performance awards are usually taxable as compensation.

Miscellaneous Compensation

- Some of the payments that qualify as miscellaneous compensation are:
- Advance commissions and other earnings.
- Allowances and reimbursements.

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- Back pay awards.
- Bonuses and awards.
- Differential wage payments.
- Government cost-of-living allowances.
- Nonqualified deferred compensation plans.
- Notes received for services.
- Severance pay.
- Sick pay.
- Social Security and Medicare taxes paid by the taxpayer's employer.

Tip Income

All tips received are considered income and are subject to federal income tax: All tips received directly from customers, tips from charge customers that are paid to a taxpayer by an employer, and a taxpayer's share of any tips received under a tip-splitting arrangement with fellow employees must be reported in gross income. The value of non-cash tips, such as tickets, passes, or other items of value, is also income and subject to federal income tax.

$20 rule for Form W-2 tip income: A worker who receives more than $20 per month in tips from any one job must report these tips to the employer at least once a month. Employers must withhold federal income tax and FICA tax on wages and reported tips and match the FICA amount. Reported tip income is included as part of wages on Form W-2 in Box 1.

Tip income allocation on Form 8027: An establishment that meets certain criteria must file Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, with the IRS, reporting annual sales, charge-card sales, and employee-reported tips.

Employers must allocate tips among employees who receive them if the total tips reported to the employer during any payroll period are less than 8% (or an approved lower rate, if applicable) of the organizations gross receipts for that pay period. Such allocated tips are reported on the Form W-2 in Box 8.

An example of non-allocable receipts would generally be carryout revenue, because tips are generally not paid on carryout food orders.

50% penalty: If tips are not reported to the employer as required, the taxpayer may be subject to a penalty equal to 50% of the employee's Social Security and Medicare taxes, or Railroad Retirement taxes, in addition to the income tax owed.

Form 4137 tip income is subject to FICA taxes as Form 1040, line 1 wages. If a taxpayer does not report tips to his employer, then the tip income must be reported using Form 4137, Social Security and Medicare tax on unreported tip income, and attached to the taxpayer's Form 1040. Tip amounts reported on Form 4137 are also reported on the taxpayer's Form 1040, line 1 as taxable wages subject to FICA taxes.

The following items are included in Form W-2, box 1, as wages, tips and other compensations:

1. Total wages, bonuses (including signing bonuses), prizes, and awards paid to employees during the year.
2. Total non-cash payments, including certain fringe benefits.
3. Total tips reported by the employee to the employer (not allocated tips).

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4. Certain employee business expense reimbursements.
5. The cost of accident and health insurance premiums for 2%-or-more shareholder employees paid by an S-Corporation.
6. Taxable benefits from a Section 125 (cafeteria) plan if the employee chooses cash.
7. Employee contributions to an Archer MSA.
8. Employer contributions to an Archer MSA if includible in the income of the employee.
9. Employer contributions for qualified long-term care services to the extent that such coverage is provided through a flexible spending or similar arrangement.
10. Taxable cost of group-term life insurance in excess of $50,000.
11. Unless excludable under qualified educational assistance programs, payments for non-job-related education expenses or for payments under a non-accountable plan.
12. The amount includible as wages because the employer paid the employee's share of Social Security and Medicare taxes (or railroad retirement taxes, if applicable). The taxpayer also paid your employee's income tax withholding, treat the grossed-up amount of that withholding as supplemental wages and report those wages in boxes 1, 3, 5, and 7.
13. Designated Roth contributions made under a section 401 (k) plan, a section 403(b) salary reduction agreement, or a governmental section 457(b) plan. Distributions to an employee or former employee from a Nonqualified Deferred Contribution (NQDC) plan (including a rabbi trust) or a non-governmental Section 457(b) plan.
14. Distributions to an employee or former employee from an NQDC plan (including a rabbi trust) or a nongovernmental section 457(b) plan.
15. Amounts includible in income under Section 457(f) because the amounts are no longer subject to a substantial risk of forfeiture.
16. Payments to statutory employees who are subject to Social Security and Medicare taxes but not subject to federal income tax withholding must be shown in box 1 as other compensation.
17. Cost of current insurance protection under a compensatory split-dollar life insurance arrangement.
18. Employee contributions to a Health Savings Account (HSA).
19. Employer contributions to an HSA if includible in the income of the employee.
20. Amounts includible in income under section 409A from an NQDC because the amounts are no longer subject to a substantial risk of forfeiture and were not previously included in income.
21. Non-qualified moving expenses and expense reimbursements.
22. Payments made to former employees while they are on active duty in the Armed Forces or other uniformed services.
23. All other compensation, including certain scholarships and fellowship grants. Other compensation includes taxable amounts paid to employees from which federal income tax was not withheld.
24. Salary reduction contributions made to a Roth IRA pursuant to a SEP arrangement or SIMPLE IRA plan.

Deductibility

A business can claim a tax deduction for the salary, wages, commissions, bonuses, and other compensation it pays to its employees. However, compensation paid to business owners may be subject to serious scrutiny by the IRS. The compensation must be:

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- Ordinary and necessary,
- Reasonable in amount,
- Paid for services actually provided, and
- Actually paid or incurred in the year for which the business claims the deduction.

Employee Fringe Benefits

Fringe benefits are an "add-on" form of employee compensation that employees can offer career professionals in addition to just a wage or salary.

Typical forms of fringe benefits include:

- Medical and dental insurance.
- Year-end and performance bonuses.
- 401k, IRA or other employer-sponsored retirement plan, including employee matching contribution plans.
- Employee profit sharing.
- A company car or SUV.
- Housing allowance.
- Educational assistance.
- Vacation and vacation pay.
- Sick days and sick pay.
- Free meals, drinks and snacks.
- Wellness stipends (like paying for a gym membership).
- Permission to keep an individual's frequent flyer points and card rewards earned on business trips, which can be used for private trips.
- Qualified transportation.

Structurally, employers will provide an employee benefits statement that lists all the fringe benefits given, and present it to the employee, both for organizational and tax reasons.

For tax years beginning after December 31, 2017, until January 1st, 2026, the exclusion from gross income and wages for qualified bicycle commuting reimbursements is suspended.

The following limits apply to qualified transportation fringe benefits:

Maximum amount excluded per month	2024
Qualified parking	$315
Transit passes and commuter highway vehicle	$315

Rules of Family Employment

Families that own a business tend to develop family employment policies in order to help family members in understanding their relationship to the business. The policies may differ from family to family, but it is a fact that these are capable of enhancing results in family relationships and business performance.

The involvement of family members in a business can deliver positive results. When working together with family members, an employee can feel connected. In the case of multiple siblings, they can encourage an environment of positive peer pressure, resulting in a need to perform at their best, as well as support each other's success. In order

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for the involvement of a family in a business to yield the most satisfying results, there needs to be several clear and precise rules, as well as the implementation of lines of authority, accountability and a regular performance review on behalf of the management. These practices should include:

- The family owning a business is advised not to ask others to accomplish something that the family will not do for itself.
- The family members should not report to anyone related to them by blood or marriage.
- The levels of compensation should be based on market value.
- Before joining the business full-time, the family members are to be subjected to clearly defined expectations regarding education and prior work experience.
- In order to ensure proper feedback, it is advised that the business uses regular performance review systems. A good example is the 360-degree feedback, in which the employees receive anonymous, confidential feedback from their fellow coworkers, including their peers and manager.
- Business should establish goals that are feasible and measurable. Said goals should be based on feedback.

Statutory Employee

If a worker is an independent contractor under common law, for certain employment purposes, they may be treated as employees by statute, if they fit one of the following categories:

- A driver distributing beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is the taxpayer's agent or is paid on commission.
- A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
- An individual working at home on materials or goods supplied by the employer and that must be returned to the employer or to a person named by him or her, if they also provide specifications for the work to be done.
- A full-time traveling or city salesperson working on the business's behalf and turning in orders to the employer from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for the business must be the salesperson's principal business activity.

Additionally, the individual must fulfill the three following requirements in order for them to qualify as a statutory employee:

- The service contract states or implies that substantially all the services are to be performed personally by them.
- They do not have a substantial investment in the equipment and property used to perform the services (other than an investment in transportation facilities).
- The services are performed on a continuing basis for the same payer.

Ordinary and Necessary Business Expenses

To be deductible as a business expense, the expense must be both ordinary and necessary. Ordinary and necessary expenses, as defined below, must also be “reasonable,” or the IRS may disallow the expense.

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Ordinary expenses

Expenses commonly used and accepted by general industry standards, i.e., expenses that are typical in the taxpayer's trade or business that are needed to run their business. Ordinary expenses must also be necessary in order to deduct them from the taxpayer's business taxes.

Necessary expenses

Expenses that are helpful and appropriate in running the taxpayer's trade or business. Necessary expenses are not tax deductible unless they are also ordinary expenses. An example of a reasonable ordinary and necessary business expense is costs associated with sending out holiday cards, newsletters, or other promotional literature that is distributed to promote customer relations or generate new business prompts.

Conversely, an example of an unreasonable business expense is paying a large sum for designer curtains for the taxpayer's home office. This expense would not be considered ordinary or necessary. To determine if a business expense is ordinary and necessary, it may be useful that the taxpayers ask themselves two questions:

1. Does the expense directly pertain to running the business? If the expense is for personal benefit, for instance, to make the taxpayer's job easier or more comfortable (for example, a taxpayer that buys a seat cushion for their car because they drive for a good amount of time), it is not deductible.
2. Can the expense be deducted under "cost of goods sold" or "capital expenses"? In this case, the taxpayer cannot deduct the item as an "ordinary and necessary" business expense.

Business Rental Deduction, Including Self-Rentals

Rental real estate activities are generally considered passive activities, and the amount of deductible loss is limited. Generally, the taxpayer cannot deduct losses from rental real estate activities unless the taxpayer has income from other passive activities. Losses from passive activities are first subject to the at-risk rules.

NOTE: The passive activity rules apply to individuals, estates, trusts (other than grantor trusts), personal service corporations, and closely held corporations.

At-risk rules limit the amount of deductible losses from holding most real property placed in service after 1986. Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount the taxpayer has at risk in the activity at the end of the tax year.

Exception to passive rental real estate activity loss limit

If the taxpayer actively participated in a passive rental real estate activity, he may be able to deduct up to $25,000 of loss from the activity from non-passive income. This special allowance cannot be more than $12,500 if the taxpayer was married and lived apart from his spouse at all times during the year. The exception is not available if the taxpayer was married, filed a separate return, and did not live apart from his spouse at all times during the year.

The maximum amount of the special allowance is reduced if modified adjusted gross income is more than $100,000 ($50,000 if married filing separately).

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Self-Rental Rule

Self-Rental is a term describing the activity when a taxpayer rents property to their own business. For instance, a group of lawyers may organize as a partnership and purchase an office suite. This real estate partnership becomes the landlord, and the tenant is the lawyers' law practice, a separate legal entity.

Self-rental differs from other business activities because the owning and renting out of real estate is typically a passive activity; a taxpayer with other sources of passive loss may try to artificially inflate the income of the self-rental in order to use the unrelated losses. With no passive income, passive losses are suspended until there is income or until the entity producing the losses is sold. Because a taxpayer that engages in self rental controls the amount of rent, they charge, to profit from this real estate entity, they could have the business pay very high rent. This possibility encouraged the establishment of rules that state that self-rental is treated as passive if there is a loss, but it is treated as active if there is a gain.

The Qualified Business Income (QBI) deduction created by the TCJA allows the owner of a business to deduct 20% of the qualified income from his taxable income as long as the business is not a C corporation.

There are certain limitations and rules that apply, one of the most important being is total taxable income. If a taxpayer's taxable income is below the lower threshold (which is $383,900 for a married taxpayer filing a joint return for 2024 tax year), they are eligible for the deduction, with a few exceptions. Furthermore, if a rental activity rents or licenses tangible or intangible property to a commonly controlled business, it qualifies as a trade or business for purposes of the QBI deduction. Businesses are commonly controlled if the same person or group of people owns at least 50% of each entity.

Depreciation, Amortization, IRC Section 179, Depletion, Bonus

Depreciation, and Correcting Errors

Depreciation

Depreciation is an annual income tax deduction that allows the taxpayer to recover the cost or other basis of business or income-producing property over the time the property is used in the taxpayer's trade or business. It is an allowance for the wear and tear, deterioration, or obsolescence of the property.

Prior to the enactment of Section 179, all business assets and real property were written off over time using depreciation. The deduction for depreciation is still available. Therefore, instead of immediately deducting the cost of business property, such as the Section 179 expensing deduction, a depreciation deduction is allowed to recover the basis of business property over the life of the property.

The depreciation deduction is determined by applying the depreciation method to the depreciable basis of the property over the applicable recovery period, subject to the applicable placed-in-service conventions. To be depreciable, the property must meet all the following requirements:

- The taxpayer must own the property, not lease or rent.
- The taxpayer must use the property in a trade or business or hold to produce income.
- The property must have a determinable useful life expected to last longer than one year.

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- The property must be something that is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence.

Certain types of property meet these requirements but are specifically identified as non depreciable property. Assets not eligible for depreciation include the following:

- Tangible personal property placed in service and disposed of within the same tax year.
- Land, including the cost of clearing, grading, planting, and landscaping (if distinguishable from land preparation costs).
- Section 197 intangible assets (goodwill, patents, franchises, etc.). Amortize these items.
- Natural resources, which are subject to depletion.
- Inventory or stock in trade.

Recordkeeping for depreciation is usually recorded in the fixed asset section of the tax software, although it can also be recorded manually by updating depreciation worksheets each year.

Total depreciation is limited to the depreciable basis of the property. The basis and amounts claimed for depreciation are part of the taxpayer's books and records. In order to determine both the best depreciation option and the accuracy of software calculations, tax professionals need to know all the following:

- Depreciable basis of asset.
- Placed-in-service date.
- **MACRS options:** ADS and GDS.
- **Asset classes:** 3-year, 5-year, 7-year, 10-year, 15-year, 20-year, 25-year, 27. 5-year and 39-year.
- **Methods of depreciation:** 200% DB, 150% DB and SL.
- **Conventions:** MM, HY and MQ.

Amortization

Amortization is similar to the SL method of depreciation in that costs are recovered equally over a fixed period of time. Costs subject to amortization include starting a business, reforestation, pollution control centers, goodwill, and certain other items referred to as Section 197 intangible assets. Assets eligible for amortization include:

- 15-year amortization:
    - Business books and records, operating systems, or any other information base.
    - Covenant not to compete that was entered into in connection with the acquisition of a business.
    - Customer-based intangibles.
    - Franchise (other than a sports franchise), trademark, or trade name.
    - Going concern value.
    - Goodwill.
    - License, permit, or other right granted by a governmental unit.
    - Patent, copyright, formula, process, design, pattern, know-how, format, or similar item.
    - Supplier-based intangibles.
    - Workforce in place.
- Geological and geophysical expenditures.
- Pollution control facilities.

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- Certain bond premiums.
- Research and experimental expenditures.
- Cost of acquiring a lease.
- Qualified forestation and reforestation costs.
- Optional write-off of certain tax preferences over the period specified in Section 59(e). The taxpayer can elect to amortize certain tax preference items over an optional period. If the taxpayer makes this election, there is no AMT adjustment for those expenditures. The period of mortization and the applicable expenditures are:
    - Three years for circulation expenditures.
    - 60 months for intangible drilling and development costs
    - 10 years for research and experimental expenditures.
    - 10 years for mining exploration and development cost.

Report amortization in Form 4562, Part VI. Property subject to amortization is not eligible for depreciation or Section 179 expenses.

Start-up and Organizational Costs

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.

Start-up costs include any amounts paid or incurred in connection with creating an active trade or business or investigating the creation or acquisition of an active trade or business. Organizational costs include the costs of creating a corporation or partnership.

Creating a trade or business (or investigating the creation or acquisition of an active trade or business): Some of these costs might include surveying markets, analyzing products and the labor supply, visiting potential business locations, and any other costs associated with creating or investigating a new or existing business.

Preparing the business to open: Any costs incurred before the taxpayer opens their business is included in this category. There are some exceptions, such as equipment, which will have to be depreciated. Other eligible expenses in this category could include employee training, travel expenses to locate suppliers and distributors, advertising expenses, and consultant fees.

Organizational costs: If a taxpayer legally sets up their business as a partnership or corporation before the end of the first year in business, they may deduct these costs as well. The expenses typically associated with incorporating are legal fees, state organization fees, salaries for temporary directors, and organizational meetings. Expenses associated with setting up a partnership agreement include legal expenses, as well as filing and accounting fees.

For costs paid or incurred after September 8, 2008, the taxpayer may elect to currently deduct up to $5,000 of business start-up costs, reduced by the amount by which the start-up expenditures exceed $50,000. This means that if the start-up costs do not exceed 50,000, the taxpayer may claim the deduction in full. The taxpayer can elect

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to amortize over 180 months the costs that were not deductible at the time of start-up. Before September 9, 2008, an actual election was required. The remainder of the start up expenditures is amortized (deducted ratably) over a 180-month period.

Purchasing an active trade or business: Amortizable start-up costs for purchasing an active trade or business include only investigative costs incurred in the course of a general search for or preliminary investigation of the business. These costs help the taxpayer decide whether to purchase a business. Costs incurred in an attempt to purchase a specific business are capital expenses that the taxpayer cannot amortize.

All amounts paid or incurred to investigate the business before October 22 are amortizable investigative costs. Amounts paid on or after that date relate to the attempt to purchase the business and therefore must be capitalized.

Disposition of Business

If a taxpayer disposes of their business in its entirety before the end of the amortization period, it can be deducted any remaining deferred start-up costs. However, the taxpayer may deduct these deferred start-up costs only to the extent these costs qualify as a loss from a business.

IRC Section 179

This section was implemented to decrease the cost of investments in business property by permitting small business to expense the costs of certain property that would otherwise be capitalized and depreciated over time.

A taxpayer can elect to expense part or all the cost of qualifying property in the year the taxpayer placed the asset in service as opposed to depreciating the asset over a number of years. In years where the taxpayer has very high gross income, the Section 179 expense election can move the taxpayer into a lower income tax bracket. For self-employed individuals, Section 179 expense reduces income subject to self-employment tax. However, it is important to keep in mind that by electing Section 179, the taxpayer is foregoing future depreciation deductions.

To qualify for current year expensing under Section 179, the property must meet the following conditions:

- Property must be tangible personal property that the taxpayer actively uses in a trade or business.
- The property can be new or used property.
- The taxpayer must use the property more than 50% for business.
- The taxpayer cannot acquire the property by gift, inheritance, or from a related individual.
- The taxpayer must have purchased qualified property and placed it in service during the current tax year.

To qualify for Section 179 property must

- Be eligible property.
- Be acquired for business use.
- Be acquired by purchase.
- Not to be excepted property.

Eligible Property

To qualify for Section 179, the property must be one of the following types of depreciable property:

- Tangible personal property.

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- Other tangible property (except buildings and their structural components) used as:
    - An integral part of manufacturing, production, extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
    - A research facility used in connection with any of the aforementioned items.
    - A facility used in connection with any of the activities listed 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.
    - Qualified real property.

Eligible property must be acquired for use in the taxpayer's trade or business to qualify for the Section 179 deduction. Property acquired only for the production of income such as investment property, rental property, and property that produces royalties does not qualify.

When property is used for both business and non-business purposes, the Section 179 deduction is allowed only if the property is used more than 50% for business purposes in the year placed in service. Multiply the cost of the property by the percentage of business use to determine the amount eligible for the Section 179 deduction.

Excepted Property

The Section 179 deduction is not available for the following types of property:

- Certain property that is leased to others.
- Certain property used predominantly to furnish lodging or in connection with the furnishing of lodging (but is allowed for hotels or motels whose lodging is predominantly used by transients).
- Property used predominantly outside the United States.
- Property used by governmental units and tax-exempt organizations.
- Property used by foreign persons or entities.

Deduction Limit

The Section 179 deduction is limited by two factors:

- A dollar limitation.
- A business income limitation.

Dollar Limitation

For 2024 tax year, the maximum Section 179 expense deduction is $1,220,000. Reduce the dollar limitation by the amount by which the cost of Section 179 property placed in service during the tax year exceeds $3,050,000. If the property cost is greater than the expense deduction, the taxpayer recovers the remaining basis through normal depreciation.

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Example: During the current tax year, Luis Ramos bought and placed in service a $1,050,000 machine and a $190,000 circular saw for his sawmill business. He elected to deduct the $1,050,000 for the machine and $170,000 for the saw, for a total of $1,220,000. The remaining $20,000 cost of the saw is subject to depreciation.

As long as the taxpayer places the property in service any time during the year and the cost of qualified property does not exceed $3,050,000, the IRS allows a deduction of the full cost, up to the maximum expense amount.

Business Income Limitation

The total deduction cannot exceed the taxable income from the active conduct of all the taxpayer's trade or business activities during the year. Taxpayers can carry forward any cost not deductible because of this limit to the next year.

Electing Section 179

The election to expense an asset under Section 179 is reported on Form 4562 and is made on either the original return filed for the tax year the property was placed in service or on an amended return filed no later than the due date (including extensions) for filing the return.

The instructions for Form 4562 provide a worksheet to determine the amounts to enter on Form 4562, lines 1—3.

Carryover of Disallowed Deduction

An unused Section 179 deduction due to the business income limitation is carried over an unlimited number of years. This disallowed deduction amount is shown on Form 4562, Line 13. In addition, the amount carried over is used to determine the Section 179 deduction in the next year. Enter that amount on Form 4562, line 10, for the next year.

If the taxpayer places more than one property in service in a year, they can select the properties for which all or a part of the costs carry forward. The taxpayer must show these selections in the books and records. If the taxpayer does not make any selections, allocate the total carryover equally among the properties expensed for the year.

If costs from more than one year carry forward to a subsequent year in which only part of the total carryover can be deducted, ordering rules require the taxpayer to first deduct the costs being carried forward from the earliest year.

Depletion

Depletion is the using up of natural resources by mining, drilling, quarrying stone, or cutting timber. The depletion deduction allows an owner or operator to account for the reduction of a product's reserves.

There are two ways of figuring depletion: cost depletion and percentage depletion. For mineral property, a taxpayer has to use the method that gives him or her the larger deduction. For standing timber, the taxpayer is to use cost depletion.

A taxpayer may take a deduction for depletion if they have an economic interest in mineral property or standing timber. It is possible for more than one person to have an economic interest in the same mineral deposit or timber. In the case of leased property, the depletion deduction is divided between the lessor and the lessee. A taxpayer has an economic interest if both the following apply:

- Taxpayers have acquired by investment any interest in mineral deposits or standing timber.
- Taxpayers have a legal right to income from the extraction of the mineral or cutting of the timber to which they must look for a return of their capital investment.

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Bonus Depreciation — Special Depreciation Allowance

The 100% first-year depreciation deduction ("bonus" depreciation) was available for qualified property acquired and placed in service between September 27, 2017, and December 31, 2022.

Property acquired after September 27, 2017, and placed in service after December 31, 2023, and before January 1, 2025 (other than property with a long production period and certain aircraft), is limited to a special depreciation allowance of 60% of the depreciable basis of the property.

The special depreciation allowance for certain qualified property (other than certain long production period property and certain aircraft) placed in service after December 31, 2024, and before January 1, 2026, is limited to 40% of the depreciable basis of the property.

In summary, the bonus depreciation rate gradually phases down: 80% for property placed in service in 2023, 60% in 2024, 40% in 2025, 20% in 2026, and is eliminated (0%) starting in 2027, unless extended by new legislation.

New or used property acquired after September 27, 2017, and placed in service before January 1, 2025, is considered qualified property if it falls into one of the following categories:

- Tangible property depreciated under MACRS with a recovery period of 20 years or less. (This includes vehicles, equipment, furniture and fixtures, and machinery.

It does not include land or buildings.)

- Computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified.
- Qualified film, television, and live theatrical productions.
- Water utility property depreciated under MACRS.
- Specified plants for the tax year in which the plant is planted or grafted.

A specified plant includes:

- Any tree or vine that bears fruit or nuts, or
- Any other plant that will have more than one yield of fruit or nuts and generally has a pre-productive period of more than two years from the time of planting or grafting to the time it begins bearing fruit or nuts.

Any plant planted or grafted outside the United States does not qualify as a specified plant.

Used property acquired after September 27, 2017, may qualify for bonus depreciation.

Final regulations clarify that qualified used property must not have been used by the taxpayer or a predecessor during the prior five calendar years, and must not have been acquired from a related party. Property is considered previously used if the taxpayer or predecessor had a depreciable interest in the property—even if depreciation was not actually claimed.

Qualified improvement property is property that meets the following requirements:

- An improvement made to the interior portion of a building that is non-residential real property.
- The taxpayer places the improvement into service before December 31, 2017.

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Qualified improvements do not include the enlargement of a building, any elevator, or escalator, or the internal structural framework of the building. Property does not qualify for bonus depreciation if the following apply:

- Property placed in service and disposed of in the same tax year.
- Property converted from business use to personal use in the acquisition year.
- Property depreciable under the ADS.
- Property received by gift or inheritance.
- Qualified restaurant property.
- Qualified improvement property placed in service after December 31, 2017.
- Qualified retail improvement property placed in service before January 1, 2016.
- Property for which the taxpayer elected not to claim any special depreciation allowance.
- Property for which the taxpayer elected to accelerate certain credits in lieu of the special depreciation allowance.

Correcting Errors

In the year the taxpayer places a depreciable asset in service, the depreciation method and life to use must be determined, as provided under tax law. Compute future year depreciation deductions for this asset consistently based on the methods elected in the first year. If the method and life used in the first year are not valid under tax law, the taxpayer should correct the method and/or life by the due date of the taxpayer's return for the second year of the asset's life.

In general, the taxpayer adopts a method of accounting when they use a permissible method of determining depreciation on the first tax return, or when they use the same impermissible method of determining depreciation on two or more consecutively filed tax returns. A taxpayer who has used an impermissible method of depreciation for only one tax year has not adopted a method of accounting.

A change in method of accounting for depreciation includes the following:

- A change in the treatment of an asset from non-depreciable to depreciable or vice versa. For example, the taxpayer missed claiming allowable depreciation.
- A change in the depreciation method, recovery period, or convention of a depreciable asset.
- A change from not claiming to claiming bonus depreciation if the taxpayer did not elect out of bonus depreciation.

The following are not changes in the method of accounting for depreciation:

- The taxpayer claimed an incorrect amount of depreciation due to a mathematical or posting error.
- An adjustment in the useful life of an asset for which taxpayer determined depreciation under Section 167.
- A change in the use of an asset in the hands of the same taxpayer.
- Making a late depreciation election or revoking a timely valid depreciation election (including the election out of bonus depreciation). If the taxpayer elected out of bonus depreciation, a change from not claiming to claiming bonus depreciation is a revocation of the election and is not an accounting method change. In general, to make a late depreciation election or revoke a depreciation election, the taxpayer must get IRS approval by requesting a private letter ruling.
- Any change in the placed-in-service date of a depreciable asset.

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File Amended Return

Taxpayers can file an amended return to correct the amount of depreciation claimed if they:

- Do not have a change in method of accounting.
- Did not adopt a method of accounting for property placed in service in tax years ending after December 29, 2003.
- Claimed the incorrect amount on property placed in service in tax years ending before December 30, 2003.

If an amended return is allowable, file it by the later of the following:

- Three years from the date the taxpayer filed the original return for the year in which the taxpayer did not deduct the correct amount.
- Two years from the time the taxpayer paid the tax for that year.

Business Bad Debts

A business may have a bad debt if it cannot collect money owed to the business. A bad debt is either a business bad debt or a non-business bad debt.

A business bad debt is a loss from the worthlessness of a debt that was either:

- Created or acquired in the taxpayer's trade or business, or
- Closely related to the taxpayer's trade or business when it became partly or totally worthless.

A debt is closely related to the taxpayer's trade or business if their primary motive for incurring the debt is business related. Bad debts of a corporation (other than an S corporation) are always business bad debts.

Generally, a business bad debt is one that comes from operating a trade or business. Deduct business bad debts on Schedule C (Form 1040) or any applicable business income tax return.

A taxpayer may claim a business bad debt deduction only if the amount owed to him or her was previously included in gross income. This applies to amounts owed to the taxpayer from all sources of taxable income, including sales, services, rents, and interest.

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REVIEW QUESTIONS

1. For tax year 2024, which is the maximum Section 179 expense deduction?

A. $1,050,000.
B. $1,080,000
C. $1,040,000
D. $1,220,000.

Answer: D

For tax year 2024, the maximum Section 179 expense deduction is $1,220,000. Reduce the dollar limitation by the amount by which the cost of Section 179 property placed in service during the tax year exceeds $3,050,000. If the property cost is greater than the expense deduction, the taxpayer recovers remaining basis through normal depreciation.

2. If tips are not reported to the employer as required, the taxpayer may be subject to a penalty equal to:

A. 20% of the employee's Social Security and Medicare taxes.
B. 50% of the employee's Social Security and Medicare taxes.
C. 30% of the employee's Social Security and Medicare taxes.
D. 80% of the employee's Social Security and Medicare taxes.

Answer: B

If tips are not reported to the employer as required, the taxpayer may be subject to a penalty equal to 50% of the employee's Social Security and Medicare taxes, or Railroad Retirement taxes, in addition to the income tax owed.

3. It is recommended to separate business expenses from the following, except:

A. The expenses are used to figure the cost of goods sold.
B. Personal expenses.
C. Capital expenses.
D. Payroll expenses.

Answer: D

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 trade or business. A necessary expense is one that is helpful and appropriate for their trade or business. An expense does not have to be indispensable to be considered necessary. It is important to separate business expenses from the following expenses:

- *The expenses are used to figure the cost of goods sold.*
- *Capital expenses.*
- *Personal expenses.*

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4. Regarding the costs for starting up a business, which of the following qualify as such?

A. Organizational costs.

B. Preparing the business to open.

C. Creating a trade or business.

D. All of the above.

Answer: D

Start-up costs include the following:

- *Creating a trade or business.*
- *Preparing the business to open.*
- *Organizational costs.*
- *Purchasing an active trade or business.*

5. Which is the maximum amount excluded per month, for the 2024 tax year, regarding the qualified parking?

A. $315.

B. $265.

C. $270.

D. $280.

Answer: A

The maximum exclusion amount for 2024 tax year for qualified parking is $315.

6. Which of the following is a category under which a taxpayer, who is considered an independent contractor, may be treated as a statutory employee?

A. A driver distributing meat.

B. An employee o fan accounting firm.

C. A driver distributing milk beverages.

D.A and B

Answer: A

A worker who is an independent contractor may be treated as employees by statute, if they fit one of the following categories:

- *A driver distributing beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is the taxpayer's agent or is paid on commission.*
- *A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.*

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- *An individual working at home on materials or goods supplied by the taxpayer and that must be returned to the taxpayer or to a person named by them, if they also provide specifications for the work to be done.*

7. Which of the following is incorrect regarding requirements for depreciation of property?

A. The taxpayer must use the property in a trade or business or hold it to produce income.
B. The taxpayer must lease or rent the property.
C. The property must have a determinable useful life expected to last longer than one year.
D. The property must be something that is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence.

Answer: B

To be depreciable, the property must meet all the following requirements:

- *The taxpayer must own the property, not lease it or rent it.*
- *The taxpayer must use the property in a trade or business or hold it to produce income.*
- *The property must have a determinable useful life expected to last longer than one year.*
- *The property must be something that is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence.*

8. Which of the following may not be classified as miscellaneous compensation?

A. Government cost-of-living allowances.
B. Severance pay.
C. Notes received for services.
D. All of the above is treated as miscellaneous compensation.

Answer: D

Some of the items that are miscellaneous compensation are:

- *Advance commissions and other earnings.*
- *Allowances and reimbursements.*
- *Back pay awards.*
- *Bonuses and awards.*
- *Differential wage payments.*
- *Government cost-of-living allowances.*
- *Nonqualified deferred compensation plans.*
- *Notes received for services.*
- *Severance pay.*
- *Sick pay.*

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9. Which of these is the correct placed-in-service period regarding property that qualifies for 60% bonus depreciation?

A. After December 31, 2024, and before January 1st, 2026.

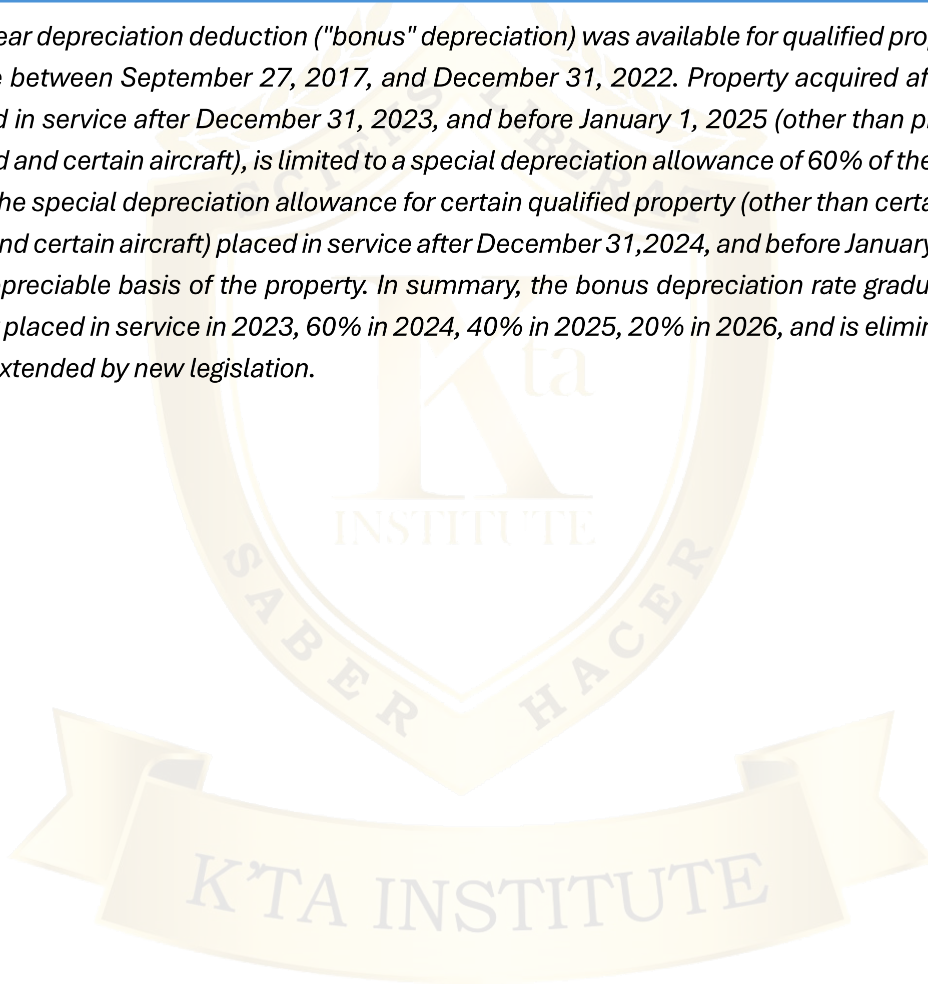
B. After December 31, 2023, and before January 1st, 2025.

C. After September 31, 2017, and before December 31st, 2025.

D. After September 31, 2018, and before January 1st, 2026.

Answer: D

The 100% first-year depreciation deduction ("bonus" depreciation) was available for qualified property acquired and placed in service between September 27, 2017, and December 31, 2022. Property acquired after September 27, 2017, and placed in service after December 31, 2023, and before January 1, 2025 (other than property with a long production period and certain aircraft), is limited to a special depreciation allowance of 60% of the depreciable basis of the property. The special depreciation allowance for certain qualified property (other than certain long production period property and certain aircraft) placed in service after December 31,2024, and before January 1, 2026, is limited to 40% of the depreciable basis of the property. In summary, the bonus depreciation rate gradually phases down: 80% for property placed in service in 2023, 60% in 2024, 40% in 2025, 20% in 2026, and is eliminated (0%) starting in 2027, unless extended by new legislation.



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Business Travel, Meals and Gift Expenses

Business Travel

Travel expenses are the necessary and ordinary travelling expenses away from a taxpayer's home for their profession, business or job. Prior to the TCJA, employees used Form 2106 to deduct these expenses. Post TCJA, these are no longer deductible.

A taxpayer is considered to be travelling away from home if their duties require them to be away from their general taxation area for a period longer than the usual day's work and they need to rest so as to meet the needs of their work while they are away. A taxpayer can deduct their travel expenses incurred or paid for in connection with a temporary job assignment away from their home.

Travel expenses deductible in Schedule C, for business owners, which are deductible include but are not limited to the following:

- Travel made via train, airplane, car or bus between a taxpayer's home and their place of business.
- Fares incurred in taxes while travelling between the airport, train station or the hotel one is staying in.
- Shipment costs for baggage and display or sample material between a taxpayer's temporary and regular work locations.
- Lodging and meals.
- Laundry and dry cleaning.
- Business calls made while on a business trip.
- Tips given while paying for any of the above services.
- Other necessary and similar expenses that are related to one's business travel.

When deducting meal expenses and deducting the actual cost, it is advised that the taxpayer use the usual meal allowance, which changes as they travel from one place to another. 50% limitation is put for the general unreimbursed costs.

Business Meals Expenses

Meals can only be deducted as a business expense if they are directly related or associated with the active conduct of a trade or business. There must be valid business purpose to the meal for it to be a deductible expense. Meals with employees or business partners are only deductible if there is a direct or indirect business purpose.

Meal expense that are 100% deductible:

- Recreational expenses primarily for employees who are not highly compensated, such as the business holiday party or the company picnic.
- Office snacks are provided to employees at the office.
- Meals provided on the employer's premises to more than half of the employees for the convenience of the employer, meaning meals provided to employees to keep them working late or on weekends for the employer's convenience.
- Meal expenses (or goods, services, and facilities) are made available to the public, usually for advertising and promotional purposes.
- Meals for which the business is reimbursed for the expense.

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- Meal expenses are included in the income of persons who are not employees.

Meal expense that are 50% deductible:

- Meals directly related to business meetings of employees, stockholders, agents, and directors.
- Office meetings and partner meetings.
- Meals with clients, customers, and vendors that will benefit the business.
- Meals while on business travel status.
- Meals while attending a business seminar, convention, or any other form of meeting.

The taxpayer must have appropriate documentation (such as a receipt) to substantiate these expenses.

No deduction is allowed for business meals unless:

1. The expense is not lavish or extravagant under the circumstances, and
2. The taxpayer or an employee of the taxpayer is present at the furnishing of the food and beverages, and
3. The food and beverages are provided to the taxpayer or a business associate.

Business Gifts Expenses

If the taxpayer gives business gifts in the course of their trade or business, they can deduct all or part of the costs subject to the following limitations:

- The deduction is not more than $25 of the cost of business gifts the taxpayer gives directly or indirectly to each person during the tax yean other taxpayer and their spouse both give gifts to the same person, both of them are treated as one taxpayer.
  - Incidental costs such as engraving, packing or shipping aren't included in the $25 limit if they don’t add substantial value to the gift.
  - For purposes of the $25 per person limit, don’t consider gifts costing $4 or less that have the taxpayer's business name permanently engraved on the item and which they distribute on a regular basis.
- Any item that could be considered either a gift or as entertainment is generally considered entertainment and cannot be deducted.
- The taxpayer needs to have records that prove the business purpose of the gift as well as the details of the amount spent.

Vehicle Use and Expenses

If a taxpayer uses their vehicle for business purposes, the taxpayer may deduce vehicle expenses. Typically, one of the following two methods is used to calculate deductible expenses:

- Standard Mileage Rate: The taxpayer may be able to use the standard mileage rate to figure the deductible costs of operating their vehicle for business purposes. The standard mileage rate for 2024 is:
  - 67 cents per mile driven for business use.
  - 21 cents per mile driven for medical or moving purposes for qualified active-duty members of the Armed Forces.
  - 14 cents per mile driven for gratuitous service to a charitable organization.
  - Actual Car Expenses

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- Actual Car Expenses: If the taxpayer does not use the standard mileage rate, they may be able to deduct their actual car expenses. These are depreciation, lease payments, registration fees, licenses, gas, oil, tolls, insurance, garage rent, parking fees, repairs and tires.

The cost for a taxpayer of using their car as an employee, whether measured using actual expenses or the standard mileage rate, will no longer be allowed to be claimed as an unreimbursed employee travel expense as a miscellaneous itemized deduction due to the suspension of miscellaneous itemized deductions that are subject to the 2% floor under Section 67(a). The suspension applies to tax years beginning after December 2017 and before January 2026.

If actual expenses are used to figure taxpayer's deduction for a car they lease, there are rules that affect the amount of taxpayer's lease payments they can deduct.

Interest Expense

This is defined as the cost incurred by an entity for borrowed funds. Interest expense is a non-operating expense that is shown on the income statement, and it stands for interest that is payable on any borrowings: bonds, loans, convertible debt, or lines of credit. Essentially, it is calculated as the interest rate multiplied by the outstanding principal amount of the debt. Interest expense on the income statement represents interest accrued during the period covered by the financial statements, and not the amount of interest paid over that period. Typically, mortgage interest is the single-biggest category of interest expense, since the interest can amount to tens of thousands of dollars over the life of a mortgage.

In general, a taxpayer can deduct the interest expense that they paid or accrued in the tax year, but if Section 163(j) applies, the amount of deductible business interest expense in a taxable year cannot exceed the sum of:

- The taxpayer’s business interest income for the year;
- 30% of the taxpayer’s Adjusted Taxable Income (ATI) for the year; and
- The taxpayer's floor plan financing interest expense for the year.

For tax years beginning after 2017, the Section 163 limitation applies to all taxpayers who have business interest expenses, other than certain small businesses that meet the gross receipts test in Section 448(c). The limitation does not apply to certain excepted trades or businesses.

The following are excepted trades or businesses:

- The trade or business of providing services as an employee;
- Certain real property trades or businesses that elect to be excepted;
- Certain farming businesses that elect to be excepted; and
- Certain regulated utility trades or businesses.

Insurance Expense

This expense is defined as the amount paid by a company in order to obtain an insurance contract, as well as any additional premium payments. This payment made by the company is listed as an expense for the accounting period. In the case of the insurance being used to cover production and operation, the insurance expense can be listed in an overhead cost pool and be divided into each unit produced during the period. At the time this happens, a part of the insurance expense will be listed in ending inventory, and some of it will be listed under cost of goods sold.

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The company is to pay premiums on all its insurance policies, as they are intended to cover its property and products, and to protect its employees, as well. In the event that a premium expires, it must be recorded as an expense.

Taxes

Failure to file penalty/late filing penalty: This penalty is issued when a taxpayer owes taxes, and they are not filed at the due date. This penalty is 5% a month, for a maximum of 25%.

Penalty for underpayment of estimated taxes: If a taxpayer does not pay at least 90% of their current year tax bill, the IRS will charge a penalty. The IRS prefers these payments to be made in equal installments; therefore, a penalty may still be issued if less is paid early, and more was paid later.

Accuracy related penalty: If there are errors on the taxpayer's tax return due to negligence, or that there was a substantial understatement of the taxes owed, the IRS will issue a 20% penalty to the taxpayer. This penalty is charged after an audit if the taxpayer is not able to prove tax deductions taken or if they failed to report all income.

Tax fraud penalty: If the IRS proves that the taxpayer under-reported their income or filed taxes with the intent to commit fraud, a 75% tax fraud penalty will be issued by the IRS, on the underpayment amount Failure to pay penalty/late payment penalty: The failure to pay penalty is 0.5% a month on the outstanding tax balance. This penalty can be reduced to 0.25% a month if the taxpayer agrees to enter into an installment agreement to pay back the taxes owed. This penalty can also increase to 1% a month if a notice of intent to levy has been issued. The maximum for this penalty is 25%.

Trust Fund Recovery Penalty (TFRP): If there are employees, a business must withhold and pay trust fund taxes (also known as payroll taxes, since these taxes are held in "trust”). Payroll taxes include income tax, FICA (Social Security & Medicare) and the federal unemployment tax. A small business with employees is required to withhold the former two from each employee’s paycheck and send it to the IRS on a monthly basis. The IRS can hold an employee(s) liable who is responsible for collecting or paying payroll taxes who willfully fails to pay them.

Treatment of Sales Taxes Paid

When it comes to sales taxes, three scenarios are possible, and the accounting treatment is different for each. These include:

Sales to customers: After a company sells its products to customers, they are charged a sales tax by the company on behalf of the jurisdiction. Then, the company is responsible for paying the taxes they collect to the said local jurisdiction. After this, the company pays cash to the government when the sales are due for payment. In this case, the sales tax is a liability that is eliminated when the business pays them to the government.

Purchased supplies: In this specific scenario, if a company buys any number of items from its vendors, it pays a sales tax on these items. In this case, the sales tax is charged to expense in the current period, plus the cost of the items bought.

Purchased assets: In this case, a company buys a fixed asset that includes a sales tax. In this case, it may include the sales tax in the capitalized cost of the fixed asset, in order to make the sales tax part of the asset itself. Eventually, the company will depreciate the asset gradually, and the sales tax will be charged to expense as depreciation.

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Excise Tax

Excise taxes are taxes that are imposed on various goods, services and activities. Such taxes may be imposed on the manufacturer, retailer or consumer, depending on the specific tax. Federal excise tax is usually imposed on the sale of things like fuel, airline tickets, heavy trucks and highway tractors, indoor tanning, tires, tobacco and other goods and services.

Businesses that are subject to excise tax generally must file a Form 720, Quarterly federal excise tax return, to report the tax to the IRS.

Excise taxes are imposed on a wide variety of goods, services and activities. The tax may be imposed at the time of:

- Import.
- Sale by the manufacturer.
- Sale by the retailer.
- Use by the manufacturer or consumer.

Many excise taxes go into trust funds for projects related to the taxed product or service, such as highway and airport improvements. Excise taxes are independent of income taxes. Often, the retailer, manufacturer or importer must pay the excise tax to the IRS and file Form 720. They may pass the cost of the excise tax on to the buyer. Some excise taxes are collected by a third party. The third party then sends the tax to the IRS and files the Form 720. For example, the tax on an airline ticket generally is paid by the purchaser and collected by the airline.

For the use of trucks, trucks tractors and buses driven on public highways, there is a specific federal excise tax. It also applies to vehicles that have a taxable gross weight exceeding 55,000 pounds. This tax is reported on Form 2290.

Deductibility of Taxes

The business can deduct various federal, state, local, and foreign taxes directly attributable to the taxpayer's trade or business as business expenses. The taxpayer cannot deduct federal income taxes, these are the taxes they pay on their business income, and they can't deduct the taxes paid to the IRS.

The taxpayer's state income taxes may be deductible, depending on their business type and their state. Corporations, S corporations, and partnerships deduct state income taxes on the business return. If the taxpayer is filing a Schedule C for their business, they can't deduct state income taxes on this form, but they can deduct sales taxes on their personal tax return (Schedule A).

Taxes the taxpayer's business pays are a cost of doing business. Other than income taxes, the taxpayer may deduct expenses for other taxes the business pays:

- City or state gross receipts tax.
- State unemployment insurance contributions and contributions to state disability funds (depending on the state).
- State income tax or state business franchise tax.
- State, city, or local sales taxes the taxpayer paid on business purchases.
- Real estate tax or property tax on real estate owned by the taxpayer's business.
- State income tax.

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- State unincorporated business tax.
- Tangible and intangible property tax.
- Customs, import, or tariff tax.
- License tax (for the taxpayer's business license, city license, or other).
- Business vehicle registration tax.
- Gasoline taxes, if the taxpayer calculates mileage using the actual expenses method, but not when they use the standard mileage deduction.
- Telephone and cell phone taxes.
- Taxes on business travel expenses, such as hotel taxes, air travel taxes, meal taxes, entertainment, laundry, etc.
- Excise taxes and fuel taxes.
- Miscellaneous taxes on items like membership dues, stamps, safe deposit box rental, and others.
- Taxes on membership dues are deductible if the dues themselves are deductible. Only dues for business-related organizations are deductible.

Sales Taxes Paid

Any sales tax the taxpayer pays on a service for the taxpayer business, or on the purchase or use of property in the taxpayer business is treated 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, the taxpayer 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 the taxpayer must collect and pay over to the state or local government. Also, do not include these taxes in gross receipts or sales.

Employment Taxes

Employers are responsible for the deposit and the reporting of employment taxes. They are to file Form W-2 to report wages, tips and other compensations that they pay to their employees. They must also use Form W-3 to transmit Forms W-2 to the SSA. The following are some of the taxes a business needs to take into account:

- **Federal Income Tax:** Usually, an employer in a business is required to withhold federal income tax from the wages of their employees. In order to calculate the amount of tax to withhold, he may use Form W-4, as well as the withholding tables seen on Publication 15 of the IRS.
- **Social Security and Medicare Taxes:** An employer also has the duty to withhold a portion of the Social Security and Medicare taxes from their employees' wages, as well as pay a matching amount. All withheld taxes must be deposited. The social security wage base limit, for tax year 2024, is $168,600, this means that the maximum amount of Social Security tax:
- is $10,453.20 ($168,600 x 6.2%) in 2024 for employees and $20,906.4 ($168,600 x 12.4%) for self-employed individuals.
- **Additional Medicare Tax:** An employer in a business is required to withhold an additional 0.9% Medicare Tax from employees that exceed the threshold amount of their filing status. This tax must be withheld in the pay period during which wages and compensations are paid in excess of the threshold amount.

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- **Federal Unemployment (FUTA) Tax:** The FUTA tax is to be reported in a separate manner from the Social Security and Medicare Taxes. It must be paid from the employer's own funds, and not withheld from the employees' pay.
- **Self-Employment (SE) Tax:** The SE tax is a social security and Medicare tax that is primarily for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of most employees.

Casualties, Thefts and Condemnations

Casualty

A casualty is defined as the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. A loss due to casualty is usually deductible during the tax year in which the loss is sustained.

If the taxpayer's property is business or income-producing property, such as rental property, and is completely destroyed, then the amount of their loss is their adjusted basis.

Theft

The IRS defines theft as the taking and removing of money or property with the intent to deprive the owner of it The taking of property must be illegal under the law of the state where it occurred, and it must have been done with criminal intent.

Usually, regarding casualty or theft loss, the FMV is decreased due to damage. In case of stolen property, the FMV is automatically zero, as the owner no longer has the property. If a business or income-producing property is destroyed in its entirety, or stolen, the decrease in FMV is not considered. Rather, the loss is figured in the following manner:

Taxpayers adjusted basis in the property	(-)	Any salvage value	(-)	Any insurance or other reimbursement the taxpayer expects to receive

Property used partly for business and partly for personal purposes: If a property is used partly for personal purposes and partly for business or income-producing purposes, then the casualty or theft loss deduction is to be figured separately for the personal-use portion and for the business or income-producing portion, as the losses attributed to the uses are calculated in a different manner. When figuring each loss, the taxpayer must allocate the total cost or basis, the FMV before and after the casualty or theft loss, and the insurance or other reimbursement between the business and personal use of the property. For the personal-use portion of the property, the taxpayer must apply other rules (The $100 rule and the 10% rule).

Condemnation

A condemnation is defined by the IRS as the process by which private property is legally taken for public use without the owner's consent. The property may be taken by the federal government, a state government, a political subdivision, or a private organization that has the power to legally take it. In exchange for the property taken, the owner receives a condemnation award (money or property), similar to a forced sale of sorts. A condemnation award is the money paid for the value of other property received by the taxpayer in exchange for their condemned property. The award also is the amount paid for the sale of the taxpayer's property under threat of condemnation.

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Example: A local government authorized to acquire land for public parks informed Sofia that it wished to acquire her property. After the local government took action to condemn Sofia's property, she went to court to keep it. The court, however, decided in favor of the local government, which took Sofia's property and paid her an amount fixed by the court. This is a condemnation of private property for public use.

Taxpayers whose property was condemned or disposed of under the threat of condemnation must figure their gain or loss by comparing the adjusted basis of the condemned property with the net condemnation award. If the amount of the award is more than the adjusted basis of the condemned property, the taxpayer has a gain. If they buy replacement property, they may postpone reporting gain from a condemnation. If only part of the property is condemned, the taxpayer may treat the cost of restoring the remaining part to its former usefulness as the cost of replacement property.

On the other hand, if the net condemnation award is less than the taxpayer's adjusted basis, they have a loss. If the said loss is from property held for personal use, the taxpayer cannot deduct it.

Gain or Loss from Condemnations

If the taxpayer's property was condemned or disposed of under the threat of condemnation, figure their gain or loss by comparing the adjusted basis of their condemned property with their net condemnation award. If the taxpayer's net condemnation award is more than the adjusted basis of the condemned property, they have a gain. The taxpayer can postpone reporting gain from a condemnation if they buy replacement property. If only part of their property is condemned, they can treat the cost of restoring the remaining part to its former usefulness as the cost of replacement property.

If the taxpayer's net condemnation award is less than their adjusted basis, they have a loss. If the taxpayer's loss is from property they held for personal use, they cannot deduct it. The taxpayer must report any deductible loss in the tax year it happened.

Main home condemned

If the taxpayer has a gain because their main home is condemned, generally they can exclude the gain from their income as if they had sold or exchanged their home. The taxpayer may be able to exclude up to $250,000 of the gain (up to $500,000 if married filing jointly). If the taxpayer's gain is more than they can exclude but they buy replacement property, the taxpayer may be able to postpone reporting the rest of the gain.

Example: The state condemned Jose's property for public use. The award was set at $200,000. The state paid Jose only $148,000 because it paid $50,000 to Jose's mortgage holder and $2,000 accrued real estate taxes. Jose is considered to have received the entire $200,000 as a condemnation award.

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REVIEW QUESTIONS

1. Which form must the employers file to report wages, tips and other compensations paid?

A. Form 2555.

B. Form 2106.

C. Schedule D.

D. Form W-2.

Answer: D

Employers are responsible for the deposit and the reporting of employment taxes. They are to file Form W-2 to report wages, tips and other compensations that they pay to their employees. They must also use Form W-3 to transmit forms W-2 to the SSA.

2. Which of these expenses do not qualify as a travel expense?

A. Laundry and dry cleaning.

B. Business calls made while on a business trip.

C. Fares while traveling between the airport (or train station) or the hotel the taxpayer is staying in.

D. All of the above are considered travel expenses.

Answer: D

The taxpayer can deduct their travel expenses incurred or paid for in connection with a temporary job assignment away from their home. Travel expenses that are deductible, but not limited to the following, are:

- *Travel made via train, airplane, car or bus between a taxpayer's home and their place of business.*
- *Fares incurred in taxes while travelling between the airport, train station or the hotel the taxpayer is staying in.*
- *Shipment costs for baggage and display or sample material between a taxpayer's temporary and regular work locations.*
- *Lodging and meals.*
- *Laundry and dry cleaning.*
- *Business calls made while on a business trip.*
- *Tips given while paying for any of the above services.*
- *Other necessary and similar expenses that are related to the taxpayer's business travel.*

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Qualified Business Income (QBI)

Since tax year 2018, owners of sole proprietorships, partnerships, S corporations and some trusts and estates may be eligible for a qualified business income (QBI) deduction.For eligible taxpayers, this deduction allows them to deduct up to 20% of their QBI, plus 20% of qualified Real Estate Investment Trust (REIT) dividends and Qualified Publicly Traded Partnership (PTP) income. Income that is earned through a C corporation or by providing services as an employee is not eligible for the deduction.

The term "QBI" is generally defined as the net amount of "qualified items of income, gain, deduction, and loss" relating to any qualified trade or business of the taxpayer. The term "qualified items of income, gain, deduction, and loss" is defined as items of income, gain, deduction, and loss to the extent these items are effectively connected with the conduct of a trade or business within the U.S. and included or allowed in determining taxable income for the year. If the net amount of qualified income, gain, deduction, and loss relating to qualified trades or businesses of the taxpayer for any tax year is less than zero, the amount is treated as a loss from a qualified trade or business in the succeeding tax year.

The term "QBI" does not include:

- Certain investment items;
- Reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business; or
- Any guaranteed payment to a partner for services rendered with respect to the trade or business.

As mentioned, the QBI deduction consists of two components:

1. **QBI component:** This component of the deduction equals 20% of QBI from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust or estate. The QBI component is subject to limitations, depending on the taxpayer's taxable income, which may include the type of trade or business, the amount of W-2 wages paid by the qualified trade or business and the Unadjusted Basis Immediately After Acquisition (UBIA) of qualified property held by the trade or business. It may also be reduced by the patron reduction if the taxpayer is a patron of an agricultural or horticultural cooperative.
2. **REIT/PTP Component:** This component of the deduction equals 20% of qualified REIT dividends and qualified PTP income. This component is not limited by W-2 wages or the UBIA of qualified property. Depending on the taxpayer's taxable income, the amount of PTP income that qualifies may be limited depending on the PI P's trade or business.

An eligible entity may deduct:

The lesser of:

- The "combined qualified business income amount" of the taxpayer, or • 20% of the excess, if any, of the taxable income of the taxpayer for the tax year over the sum of net capital gain and the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year; plus
- The lesser of:
    - 20% of the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year, or

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- 20% of taxable income (reduced by the net capital gain) of the taxpayer for the tax year.

The term "combined qualified business income amount" means, for any tax year, an amount equal to: (i) the deductible amount for each qualified trade or business of the taxpayer (defined as 20% of the taxpayer's QBI) subject to the W-2 wage limitation; plus (ii) 20% of the aggregate amount of qualified real estate investment trust (REM dividends and qualified publicly traded partnership income) of the taxpayer for the tax year.

Limitations

For pass-through entities, other than sole proprietorships, the deduction cannot exceed the greater of:

- 50% of the W-2 wages with respect to the qualified trade or business ("W-2 wage limit"), or
- The sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property." Qualified property is defined as meaning tangible, depreciable property which is held by and available for use in the qualified trade or business at the close of the tax year, which is used at any point during the tax year in the production of qualified business income, and the depreciable period which has not ended before the close of the tax year.

For a partnership or S corporation, each partner or shareholder is treated as having W-2 wages for the tax year in an amount equal to their allocable share of the W-2 wages of the entity for the tax year. A partner's or shareholder's allocable share of W-2 wages is determined in the same way as the partner's or shareholders allocable share of wage expenses. For an S corporation, an allocable share is the shareholder's pro rata share of an item. However, the W-2 wage limit does not apply in the case of a taxpayer with taxable income not exceeding $383,900 for married individuals filing jointly ($191,950 for all others filing statuses). The application of the W-2 wage limit is phased in for individuals with taxable income exceeding these thresholds, over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals).

Thresholds and Exclusions

For 2024, the threshold amounts under Section 199A and phase-in range amounts are:

Filing Status	MFJ	All other filing status
Threshold amount	$383,900	$191,950
Phase-in range amount	$483,900	$241,950

The deduction is taken "below the line," which means that it reduces the taxpayer's taxable income but not adjusted gross income. But it is available regardless of whether taxpayers itemize deductions or take the standard deduction. In general, the deduction cannot exceed 20% of the excess of the taxpayer's taxable income over net capital gain. If QBI is less than zero, it is treated as a loss from a qualified business in the following year.

Rules are in place to deter high-income taxpayers from attempting to convert wages or other compensation for personal services into income eligible for the deduction. For taxpayers with taxable income above $383,900 for married individuals filing jointly ($191,950 for all others filing statuses), an exclusion from QBI of income from "specified service" trades or businesses is phased in. These are trades or businesses involving the performance of services in the fields of health, law, consulting, athletics, financial or brokerage services, or where the principal asset is the reputation or skill of one or more employees or owners. The phase-in works as follows:

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- If taxable income is at least $50,000 above the threshold, i.e., $241,950 ($191,950 + $50,000), all the net income from the specified service trade or business is excluded from QBI. (Joint filers would use an amount $100,000 above the $383,900 threshold).
- If the taxpayer's taxable income is between $191,950 and $241,950, he or she would exclude only that percentage of income derived from a fraction the numerator of which is the excess of taxable income over $191,950 and the denominator of which is $50,000. So, for example, if taxable income is $201,950 ($10,000 above $191,950), only 20% of the specified service income would be excluded from QBI ($10,000/$50,000). (For joint filers, the same operation would apply using the $364,200 threshold, and a $100,000 phase-out range).

Additionally, for taxpayers with taxable income more than the above thresholds, a limitation on the amount of the deduction is phased in based either on wages paid or wages paid plus a capital element. This is how it works: If taxable income is at least $50,000 above the threshold, the taxpayer's deduction for QBI cannot exceed the greater of:

1. 50% of the taxpayer's allocable share of the W-2 wages paid with respect to the qualified trade or business, or
2. The sum of 25% of such wages plus 2.5% of the unadjusted basis immediately after acquisition of tangible depreciable property used in the business (including real estate).

If the taxpayer's QBI were $100,000, leading to a deduction of $20,000 (20% of $100,000), but the greater of (1) or (2) above were only $16,000, the taxpayer's deduction would be limited to $16,000. If the taxpayer's taxable income were between $191,950 and $241,950, the taxpayer would only incur a percentage of the $4,000 reduction, with the percentage worked out via the fraction discussed in the preceding paragraph. (For joint filers, the same operations would apply using the $383,900 threshold, and a $100,000 phase-out range).

Other limitations may apply in certain circumstances, e.g., for taxpayers with qualified cooperative dividends, qualified Real Estate Investment Trust (REIT) dividends, or income from publicly traded partnerships.

UBIA

"Qualified property" for purposes of Section 199A is any tangible property held in connection with any identified trade or business subject to the allowance for depreciation under IRC Section 167:

- which is held by, and available for use in, the trade or business at the close of the taxable year,
- which is used at any point during the taxable year in the production of QBI, and
- the depreciable period for which has not ended before the close of the taxable year.

The depreciable period ends on the later of 10 years after the property is first placed in service by on the last day of the last full year in the applicable recovery period under Section 168(c). Additional first-year depreciation under section 168 doesn't affect the applicable recovery period. Improvements to property that has already been placed in service are treated as separate qualified property.

UBIA means the basis, on the placed-in-service date, of the property. A taxpayer's UBIA of qualified property is its basis in the qualified property prior to any adjustments under Section 1016(a)(2) or (3), any adjustments for tax credits the taxpayer claimed, or any adjustments for any portion of the basis which the taxpayer has elected to treat

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as an expense. However, a taxpayer's UBIA of qualified property is adjusted to reflect the reduction in the basis for the percentage of taxpayer's use of the property for the tax year other than in the trade or business.

Eligibility

S corporations and partnerships are generally not taxable and cannot take the deduction themselves. However, all S corporations and partnerships report each shareholder's or partner's share of QBI items, W-2 wages, UBIA of qualified property, qualified REIT dividends and qualified PTP income, and whether or not a trade or business is a Specified Service Trade or Business (SSTB) on a statement attached to the Schedule K-1 so that the shareholders or partners may determine their deduction.

Qualified Trade or Business

A qualified trade or business is any section 162 trade or business, with three exceptions:

- A trade or business conducted by a C corporation.
- The trade or business of performing services as an employee.
- Specified Service Trades or Businesses (SSTBs), with taxable income that exceeds the threshold amount.

An SSTB is a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, trading or dealing in certain assets, or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. The principal asset of a trade or business is the reputation or skill of its employees or owners if the trade or business consists of the receipt of income from endorsing products or services, the use of an individual's image, likeness, voice, or other symbols associated with the individual's identity, or appearances at events or on radio, television, or other media formats.

There is a de minimis rule for a single trade or business that has income from both specified service activities and other activities. The de minimis rule states that if a trade or business has gross receipts of $25 million or less and less than 10% of its gross receipts are attributable to specified service activities, or gross receipts of more than $25 million and less than 5% of its gross receipts are attributable to specified service activities, the trade or business as a whole is not an SSTB. If, however, the gross receipts from specified service activities exceed the percentage specified in the de minimis rule, the entire trade or business is treated as an SSTB.

CAUTION: The SSTB limitation does not apply to any taxpayer whose taxable income (before the qualified business deduction) is at or below the threshold amounts. For taxpayers whose taxable income is within the phase-in range, the taxpayer's share of QBI, W-2 wages and UBIA of qualified property related to the SSTB will be limited. If the taxpayer's taxable income exceeds the phase-in range, no deduction is allowed with respect to any SSTB.

Eligibility and Deductibility of General Business Credits

Individuals have tax credits available for them, and so do businesses. A taxpayer's general business credit for the year consists of their carryforward of business credits from prior years, plus the total of the current year business credits. In addition, the taxpayer's general business credit for the current year may be increased later by the carryback of business credits from later years. A credit is directly subtracted from the taxpayer's tax.

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In order to apply for a credit, a taxpayer will need the credit form, as well as Form 3800, General business credit, where the taxpayer enters the amount of the credit they will be applying for. The following are some of the most relevant tax credits that a business may claim.

Investment Tax Credit (ITC)

The investment credit consists of the following credits:

- Rehabilitation,
- Energy,
- Qualifying advanced coal project,
- Qualifying gasification project, and
- Qualifying advanced energy project.

Generally, investment credit is available to property owners who engage in specific types of projects on their property. Taxpayers can claim the investment tax credit using Form 3468.

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

The business can't claim a credit for property that is:

- Used mainly outside the United States;
- Used by a governmental unit or foreign person or entity;
- Used for lodging or in the furnishing of lodging; or
- Certain MACRS business property to the extent it has been expensed under section 179.

Corporations use this credit to reduce their corporate income taxes. Sole proprietors use them to reduce their personal income taxes. Taxpayers who have ownership in pass-through entities, such as partnerships and S corporations, share these credits earned by the business with the other owners of the business. These taxpayers should receive information from the business telling them what to put on the form to claim their portion.

Work Opportunity Tax Credit (WOTC)

The Work Opportunity Tax Credit is a Federal tax credit available to employers for hiring and employing individuals from certain targeted groups who have faced significant barriers to employment. The Consolidated Appropriations Act, 2021 authorized the extension of the WOTC until December 31, 2025.

This credit is available for wages paid to certain individuals who begin work on or before December 31, 2025. The WOTC may be claimed by any employer that hires and pays or incurs wages to certain individuals who are certified by a designated local agency (sometimes referred to as a state workforce agency) as being a member of one of 10 targeted groups.

In general, the WOTC is equal to 40% of up to $6,000 of wages paid to, or incurred on behalf of, an individual who:

- Is in their first year of employment;
- Is certified as being a member of a targeted group; and
- Performs at least 400 hours of services for that employer.

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Thus, the maximum tax credit is generally $2,400. A 25% rate applies to wages for individuals who perform fewer than 400 but at least 120 hours of service for the employer. Up to $24,000 in wages may be taken into account in determining the WOTC for certain qualified veterans. An employer cannot claim the WOTC for employees who are rehired. In general, taxable employers may carry the current year's unused WOTC back one year and then forward 20 years.

On or before the day that an offer of employment is made, the employer and the job applicant must complete Form 8850 (Pre-Screening Notice and Certification Request for the Work Opportunity Credit). The employer has 28 calendar days from the new employee's start date to submit Form 8850 to the designated local agency located in the state in which the business is located (where the employee works). Additional forms may be required by the DOL to obtain certification.

Research and Development (R&D) Tax Credit

The Research and Development (R&D) Tax Credit is also known as the Research and Experimentation (R&E) tax credit. This is a non-refundable tax credit that allows businesses and eligible entities to obtain additional funds in order to pay for research-related expenses. In order to apply, the taxpayer has to file Form 6765. The following research expenses qualify:

- Wages paid to employees for qualified services (including amounts considered to be wages for federal income tax withholding purposes).
- Supplies (defined as any tangible property other than land or improvements to land, and property subject to depreciation) used and consumed in the R&D process.
- 100% of amounts the taxpayer paid (or incurred) for qualified energy research performed by an eligible small business, a university, or a federal laboratory.
- 75% of the amounts the taxpayer paid (or incurred) for qualified research by a qualified research consortium.
- 65% of the amounts the taxpayer paid (or incurred) for all other qualified research by any other person.

IMPORTANT: Form 6765 instructions detail information about what other payments are subject to the percentages above and to which extent they are to be included.

Likewise, the taxpayer must demonstrate that the activities comply with the following:

- The activity seeks to resolve technological uncertainty that exists at the outset of the project or initiative, is related to the capability or methodology for developing or improving the business component or the appropriate design of the business component.
- The activity relies on a hard science, such as engineering, computer science, biological science, or physical science.
- The activity relates to the development of a new or improved business component.
- This is defined as new or improved products, processes, internal use computer software, techniques, formulas, or inventions to be sold or used in the taxpayer's trade or business.
- The activity substantially all constitute a process of experimentation involving testing and evaluation of alternatives to eliminate technological uncertainty.

If the development is related to internal use software, it must comply with these additional requirements:

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- The software must be innovative. It should result in a reduction of costs or an improvement in speed that is substantial and economically significant.
- Developing the software involves significant economic risk, requiring the commitment of substantial resources and subject to substantial uncertainty of recovery in a reasonable time period.
- The software is not commercially available. The taxpayer cannot purchase, lease, or license and use the software for the intended purpose without having to make significant modifications that satisfy the first two requirements.

The TCJA made changes that indirectly affect the R&E credit. Specifically, the TCIA simplified the corporate tax rate by eliminating the tiered rate structure based on taxable income and provided a single 21% corporate tax rate under Sec. 11(b), and modified individual tax rates, setting the top individual tax rate at 37%. Although the corporate rate changes are permanent, the modified individual tax rates are only effective for tax years beginning after December 31, 2017, and ending before January 1st, 2026. While the tax rate changes may reduce some taxpayers' income tax liability, the modification of the corporate tax rate also increased the value of the R&E tax credit that corporate and noncorporate taxpayers may claim when electing to claim a reduced credit.

For a small business to qualify (Payroll Tax Credit Election), it must meet two requirements:

- Have less than $5 million in gross receipts for the tax year.
- Have no more than five years of gross receipts.

The R&D credit is calculated on the federal income tax return as usual and may be applied against payroll taxes starting the quarter after the credit is claimed. For calendar-year taxpayers, the R&D credit can be applied against payroll taxes as early as July of the following year.

Payroll Tax Credit Election

The payroll tax credit election is an annual election made by a qualified small business specifying the amount of research credit, not to exceed $500,000, that may be used against the employer portion of social security liability. The credit is the smallest of the current year research credit, an elected amount not to exceed $500,000, or the general business credit carryforward for the tax year (before the application of the payroll tax credit election for the tax year).

The general business credit carryforward limitation doesn’t apply to partnerships or S corporations. The election must be made on or before the due date of the originally filed income tax return (including extensions). An election can't be made for a tax year if an election was made for 5 or more preceding tax years. The election made by a partnership or S corporation is made at the entity level. Any election to take the payroll tax credit may be revoked only with the consent of the IRS.

The portion of the credit used against payroll taxes is allowed in the first calendar quarter beginning after the date that the qualified small business filed its income tax return. The election and determination of the credit amount that will be used against the employer's payroll taxes are made on Form 6765, Credit for Increasing Research Activities. The amount from Form 6765, line 36 (line 44 for income tax years beginning before January 1,2024), must then be reported on Form 8974.

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Disabled Access Credit

This credit is available for small businesses. For a small business to qualify, it must have gross receipts of less than $1,000,000 (This limitation, however, has been affected by the Disabled Access Credit Expansion Act of 2021 as detailed below), as well as have less than 30 employees working full-time. The credit covers upgrades or improvements made in order for the business to improve access for those with disabilities, such as making restroom doors wider, or the purchase of specialized equipment or devices to help individuals with disabilities. If a business wants to employ interpreters or incorporate a means to help visually impaired employees see better, it also qualifies for the credit.

The following upgrades are eligible for the tax credit:

- Removal of barriers that prevent a business from being accessible to or usable by individuals with disabilities.
- Providing qualified interpreters or other methods of making audio materials available to hearing-impaired individuals.
- Providing qualified readers, taped texts, and other means of making visual materials available to individuals with visual impairments.
- Purchase of or modification of equipment or devices for individuals with disabilities.

The taxpayer may take a tax credit for 50% of the aforementioned expenditures that are over $250, up to $10,000 a year, meaning the maximum credit is $5,000. The taxpayer is to use Form 8826 to apply for the credit on their business tax return.

The final step is to enter the amount of the credit on Form 3800, along with other tax credits the business is applying for.

Barrier Removal Tax Deduction

The IRS also provides business taxpayers with an Architectural Barrier Removal Tax Deduction, to further encourage removal of barriers to enhance mobility for individuals with disabilities and older adults. A business may deduct up to $15,000 a year for qualified expenses. A taxpayer can claim both the disability access tax credit and the barrier removal tax deduction in the same year if the expenses meet the requirements of both sections. The barrier reduction deduction makes up the difference between the maximum tax credit and the amount spent.

Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips

Certain food and beverage employers (restaurants) use Form 8846 to claim a credit for social security and Medicare taxes paid or incurred by the employer on certain employees' tips. The credit is part of the general business credit.

The business can claim or elect not to claim the credit any time within 3 years from the due date of their return on either their original return or on an amended return.

Partnerships and S corporations must file this form to claim the credit All other taxpayers are not required to complete or file this form if their only source for this credit is a partnership or S corporation. Instead, they can report this credit directly on line 4f in Part III of Form 3800, General Business Credit.

The business must file Form 8846 if they meet both of the following conditions:

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1. The employer had employees who received tips from customers for providing, delivering, or serving food or beverages for consumption if tipping of employees for delivering or serving food or beverages is customary.
2. During the tax year, the employer paid or incurred employer social security and Medicare taxes on those tips.

Generally, the credit equals the amount of employer social security and Medicare taxes paid or incurred by the employer on tips received by the employee. However, employers cannot claim the credit for taxes on any tips that are used to meet the federal minimum wage rate in effect on January 1, 2007, of $5.15 an hour.

Therefore, the amount of tips for any month that are used to figure the credit must be reduced by the amount by which the wages that would have been payable during that month at $5.15 an hour exceed the wages (excluding tips) paid by the employer during that month.

For example, an employee worked 100 hours and received $450 in tips for October 2024. The worker received $375 in wages (excluding tips) at the rate of $3.75 an hour.

If the employee had been paid $5.15 an hour, the employee would have received wages, excluding tips, of $515. For credit purposes, the $450 in tips is reduced by $140 (the difference between $515 and $375), and only $330 of the employee's tips for October 2024 is taken into account.

Example: Carmen's Cafe is a small breakfast eatery located in Florida. Carmen is the owner and files a Schedule C. Carmen does most of the cooking and cleaning. Her sole employee, Maria, takes breakfast orders and waits on tables in the cafe's dining area. Maria worked 100 hours and received $450 in tips for the month of October. She also received $375 in wages (excluding her tips) at the rate of $3.75 an hour. For the purposes of the this credit, the $450 in tips is reduced by $140 (the difference between $5.15 and $3.75), and only $330 of the employee's tips for October are taken into account.

Retirement Plans Startup Costs Tax Credit

Eligible employers may be able to claim a tax credit of up to $5,000, for three years, for the ordinary and necessary costs of starting a SEP, SIMPLE IRA or qualified plan (like a 401 (k) plan.) A tax credit reduces the amount of taxes the employer may owe on a dollar-for-dollar basis.

If the employer qualifies, they may claim the credit using Form 8881, Credit for Small Employer Pension Plan Startup Costs.

The employer qualifies to claim this credit if:

- They had 100 or fewer employees who received at least $5,000 in compensation from the employer for the preceding year;
- They had at least one plan participant who was a non-highly compensated employee (NHCE); and
- In the three tax years before the first year the employer is eligible for the credit, their employees weren't substantially the same employees who received contributions or accrued benefits in another plan sponsored by the employer, a member of a controlled group that includes the employer, or a predecessor of either.

The credit is 50% of the employer eligible startup costs, up to the greater of:

- $500; or

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- The lesser of:
  - $250 multiplied by the number of NHCEs who are eligible to participate in the plan, or
  - $5,000.
- The employer may claim the credit for ordinary and necessary costs to:
- Set up and administer the plan, and
- Educate their employees about the plan.

This credit can be claimed for each of the first 3 years of the plan and the employer may choose to start claiming the credit in the tax year before the tax year in which the plan becomes effective. The employer can't both deduct the startup costs and claim the credit for the same expenses. The employer is not required to claim the allowable credit.

An eligible employer that adds an auto-enrollment feature to their plan can claim a tax credit of $500 per year for a 3-year taxable period beginning with the first taxable year the employer includes the auto-enrollment feature.

Employer-provided Childcare Credit

If the employer provides childcare services to their employees, they may be eligible for this general business credit. It covers qualified expenditures for a childcare facility and for childcare resource and referral.

The Employer-Provided Childcare Credit offers employers a tax credit up to $150,000 per year. It equals 25% of the qualified childcare facility expenditures plus 10% of the qualified childcare resource and referral expenditures the taxpayer pays or incurs during the tax year.

The credit is an incentive for taxpayers to provide childcare services to their employees.

To be eligible for the credit, an employer must have paid or incurred qualified childcare expenditures during the tax year to provide childcare services to employees.

Qualified childcare expenditures are:

- Costs associated with acquiring, constructing, rehabilitating or expanding property used as the taxpayer's qualified childcare facility.
- Qualified childcare facility expenditures are operating expenses made by the taxpayer, including amounts paid to support childcare workers through training, scholarship programs, and providing increased compensation to employees with higher levels of childcare training.
- Qualified resource and referral expenditures which include amounts paid or incurred under a contract with a qualified childcare facility to provide childcare services to employees of the taxpayer.

To claim the credit the employer must use Form 8882, Credit for Employer-Provided Childcare Facilities and Services.

Commercial Clean Vehicle Credit

Businesses and tax-exempt organizations that buy a qualified commercial clean vehicle may qualify for a clean vehicle tax credit of up to $40,000 under Internal Revenue Code (IRQ 45W. The credit equals the lesser of:

- 15% of the taxpayer's basis in the vehicle (30% if the vehicle is not powered by gas or diesel).
- The incremental cost of the vehicle.

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The maximum credit is $7,500 for qualified vehicles with gross vehicle weight ratings (GVWRs) of under 14,000 pounds and $40,000 for all other vehicles.

Businesses and tax-exempt organizations qualify for the credit.

There is no limit on the number of credits the taxpayer's business can claim. For businesses, the credits are nonrefundable, so the taxpayer can't get back more on the credit than they owe in taxes. A 45W credit can be carried over as a general business credit.

To qualify, a vehicle must be subject to a depreciation allowance, with an exception for vehicles placed in service by a tax-exempt organization and not subject to a lease.

The vehicle must also:

- Be made by a qualified manufacturer.
- Be for use in the taxpayer's business, not for resale.
- Be for use primarily in the United States.
- Not have been allowed a credit under sections 30D or 45W.

In addition, the vehicle must either be:

- Treated as a motor vehicle for purposes of title II of the Clean Air Act and manufactured primarily for use on public roads (not including a vehicle operated exclusively on a rail or rails); or
- Mobile machinery as defined in IRC 4053(8) (including vehicles that are not designed to perform a function of transporting a load over a public highway).

The vehicle or machinery must also either be:

- A plug-in electric vehicle that draws significant propulsion from an electric motor with a battery capacity of at least:
    - 7 kilowatt hours if the gross vehicle weight rating (GVWR) is under 14,000 pounds.
    - 15 kilowatt hours if the GVWR is 14,000 pounds or more; or
- A fuel cell motor vehicle that satisfies the requirements of IRC 3OB(b)(3)(A) and (B).

Partnerships and S corporations must file Form 8936, Clean Vehicle Credits.

All other taxpayers are not required to complete Form 8936 if their only source for this credit is a partnership or S corporation. Instead, they can report this credit directly on line 1aa in Part III of Form 3800, General Business Credit.

The company will need to provide their vehicle's VIN along with the amount of the credit. The depreciable basis of the vehicle is reduced by the amount of the commercial clean vehicle credit received.

Small Business Healthcare Tax Credit

This credit, which was introduced by the ACA, is for the benefit of small employers that provide health coverage for their employees. In order to qualify, an employer must have a business that:

- Has fewer than 25 full-time equivalent employees.
- Pays its employees an average wage of less than $65,000 for 2024 tax year.

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- Offer a qualified health plan to its employees through a Small Business Health Options Program Marketplace (or qualify for a limited exception to this requirement).
- Pay at least 50 percent of the cost of employee-only - not family or dependent - health care coverage for each employee.

The maximum credit is:

- 50 percent of premiums paid for small business employers, and
- 35 percent of premiums paid for small tax-exempt employers.
- The credit is available to eligible employers for two consecutive taxable years.

The credit includes a phaseout that begins when average wages equal $32,000 and is phased out in its entirety when these equal $65,000.

This credit helps small businesses and small tax-exempt organizations afford the cost of covering their employees and are 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.

To calculate the credit, the small business taxpayer must use Form 8941, Credit for small employer health insurance premiums. A small business can include the amount as part of the general business credit on the income tax return.

If the business is a tax-exempt organization, include the amount on Line 44f of Form 990-T, Exempt organization business income tax return. The business must file Form 990-T in order to claim the credit, even if they do not ordinarily do so.

A small business employer may be able to carry the credit back or forward. A tax-exempt employer may be eligible for a refundable credit.

Employer Credit for Paid Family and Medical Leave

Internal Revenue Code Section 45S provides a tax credit for employers who provide paid family and medical leave to their employees. Eligible employers may claim the credit, which is equal to a percentage of wages they pay to qualifying employees while they're on family and medical leave. The credit is effective for wages paid in taxable years beginning after December 31, 2017, and before January 1,2026.

Employers must have a written policy in place that meets certain requirements, including providing:

1. At least two weeks of paid family and medical leave (annually) to all qualifying employees who work full time (prorated for employees who work part time), and
2. The paid leave is not less than 50 percent of the wages normally paid to the employee.

For 2024, a qualifying employee is an employee who has been employed by the employer for 1 year or more, and whose compensation for the preceding year (2023) doesn't exceed an amount equal to 60% of $150,000 ($90,000).

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Compensation Limit Per Year

Year	Prior Year 414(q)(1)(B) Amount	Prior Year Compensation Limit
2024	$150,000	$90,000
2025	$155,000	$93,000
2026	$160,000	$96,000

For this purpose, an employer whose tax year isn't the calendar year can choose to use as the preceding year either:

- The employer's immediately preceding fiscal year, or
- The calendar year ending in the employer's immediately preceding fiscal year.

Example: In 2024, Maria is considered a qualifying employee because she worked for the employer in 2023 and earned $88,000, which is less than the $90,000 threshold (60% of $150,000).

The credit is a percentage of the amount of wages paid to a qualifying employee while on family and medical leave for up to 12 weeks per taxable year. The minimum percentage is 12.5% and is increased by 0.25% for each percentage point by which the amount paid to a qualifying employee exceeds 50% of the employee's wages, with a maximum of 25%. In certain cases, an additional limit may apply.

An employer must reduce its deduction for wages or salaries paid or incurred by the amount determined as a credit. Also, any wages taken into account in determining any other general business credit may not be used in determining this credit. An eligible employer must use Form 8994 to figure the employer credit for paid family and medical leave.

Foreign Tax Credit

A corporation doing business overseas is required to pay its income tax, based on the foreign country's tax law. In order to avoid double taxation, corporations can file Form 1118 to claim foreign tax credit against the income tax they paid. The credit may be limited, based on the type of income and the foreign country's tax rate.

A U.S. corporation must separate its income into passive and active categories. The foreign tax credit is calculated in each category separately. The IRS defines passive income as gain realized from a stock sale, dividends and interest income. If a corporation receives rental income or royalties, but is not actively involved in the activity, the income is considered passive. Active income is derived from business activities and includes banking, insurance and financing corporations.

Companies in the United States can claim the foreign tax credit for taxes paid on their earned income, war profits and excess profits to a foreign country or U.S. possession. Foreign corporations can take the U.S. foreign tax credit for taxes paid on income earned while conducting their trade or business within the U.S. If a foreign company has an office in the United States but does not earn business or trade income from the country, it cannot take the foreign tax credit. Finally, no company, foreign or domestic, can take a foreign tax credit for taxes it does not owe or pay.

In order to take the credit, a corporation has to pay tax that is specifically related to earned income to the appropriate foreign taxing authority. It does not apply to the Value-Added Tax (VAT) or the Goods and Services Taxes (GST). It also does not apply to license or permit taxes, consumption tax, sales or capital tax.

Lastly, the same compliance issues regarding the foreign tax credit for individuals also apply here. These are:

- For a foreign tax credit claim, interest expense is apportioned between the U.S. and the foreign country.

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- Dividends or capital gains acquired from a foreign country must be adjusted to qualify for the credit.
- In practice, charitable contributions are claimed wholly without apportioning between the U.S. and the foreign country. However, charitable contributions are apportioned if the foreign country is Canada, Mexico, and Israel.
- The credit cannot be claimed from income excluded from the gross income of the U.S.

Generally, the foreign tax credit is equal to the amount of the taxes paid to foreign governments; however, there is an “overall" annual limitation on the amount of the credit, which is calculated as follows:

$$\frac{\text{Net foreign income}}{\text{U.S. taxable income}} \times \text{U.S. tax liability}$$

A taxpayer generally can choose to claim income taxes paid or accrued during the year to a foreign country or U.S. possession as a credit against U.S. income tax or elect to deduct the foreign tax as an itemized deduction. However, a taxpayer cannot take a credit or deduction for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion.

Net Operating Loss Deduction

A Net Operating Loss (NOL) is defined as a loss taken in a period where a company’s allowed tax deductions exceed its taxable income. For tax purposes, an NOL renders the company unprofitable. However, the NOL for the company can be used to recover past tax payments when more expenses than revenues are incurred during this period.

The NOL is taken in a period where the tax deductions of a company exceed its taxable income, and as such, the company is rendered unprofitable. Under the TCJA, the NOL deduction for a tax year is equal to the lesser of:

- The aggregate of the NOL carryovers to such year, plus the NOL carrybacks to such year, or
- 80% of taxable income (determined without regard to the deduction).

Generally, NOLs can no longer be carried back but are allowed to be carried forward indefinitely. It is important to note that the changes to the NOL regulations now put a greater emphasis on taxpayers’ understanding of the timing of their income and deductions when assessing expected future tax liabilities. A taxpayer can no longer rely on the NOL carryforward provisions to result in no federal tax liability in years of low taxable income relative to prior loss years.

To the extent the NOL is a farming loss, the carryback period is 2 years. Any such loss not applied in the 2 preceding years can be carried forward indefinitely (subject to limitations). The corporation can make an irrevocable election to forgo the 2-year carryback period. When a Net Operating Loss (NOL) includes both farm and non-farm losses, these should be treated separately. The farm loss is considered a separate NOL and is only recognized after the non-farm NOL has been applied.

If the NOL is from an insurance company (as defined in section 816(a)), other than a life insurance company, then the company can carry back the NOL to each of the 2 preceding tax years. Any such loss not applied in the 2 preceding years can be carried forward up to 20 years.

If the corporation has a loss for a year and has an ownership change, special rules apply for allocating NOLs.

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Example: In 2024 Tangerine Corp. (C Corp) has a taxable income of $1,100,000, and tax deductions of $1,500,000. Its NOL calculation is $1,100,000 - $1,500,000 = -$400,000. As Tangerine Corp, did not have any taxable income, it will not have to pay taxes that year. For 2025, the company received $600,000 in taxable income, which means it would need to pay $126,000 ($600,000 x 21%) in taxes, but since it incurred an NOL last year, it can apply it to that year's tax bill. Tangerine Corp, can use all they NOL of 2024 (-$400,000) since it is less than the 80% of $600,000 ($480,000). Their new taxable income for 2025 will be $200,000 ($600,000 - $400,000) and they will need to pay taxes of $42,000 ($200,000 x 21%).

There are rules that limit what a taxpayer can deduct when figuring an NOL. In general, the following items are not allowed when figuring an NOL:

- Capital losses in excess of capital gains.
- Section 1202 exclusion of the gain from the sale or exchange of qualified small business stock.
- Non-business deductions in excess of non-business income.
- The net operating loss deduction.
- The domestic production activities deduction.

Overall Business Limitation

The tax law places an annual limitation on non-corporate business losses for taxpayers. The limit is $610,000 for MFJ and $305,000 for all other filing status for 2024 tax year.

Home Office

Generally, a taxpayer cannot deduct items such as mortgage interest and real estate taxes incurred on their home as business expenses. However, if the taxpayer meets specific requirements, the taxpayer can deduct expenses related to the business-use of part of their home.

To qualify to deduct expenses for business use of a home, the taxpayer must use part of their home:

- Exclusively and regularly as a principal place of business.
- Exclusively and regularly as a place where the taxpayer meets or deals with patients, clients, or customers in the normal course of a trade or business.
- In the case of a separate structure, which is not attached to the home, in connection with the taxpayer's trade or business.
- On a regular basis for certain storage uses.
- For rental of the home.
- As a daycare facility.

When the exclusive use requirement applies, the taxpayer cannot deduct business expenses for any part of their home that is used for both personal and business purposes. For example, if the taxpayer is an attorney and uses the den of his home to write legal briefs and for personal purposes, they may not deduct any business use of their home expenses.

Further, under the principal place of business test, the taxpayer must determine that their home is the principal place of the trade or business after considering where their most important activities are performed and most of their time is spent, in order to deduct expenses for the business use of the home.

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Additionally, a portion of their home may qualify as the taxpayer principal place of business if is used for the administrative or management activities of the trade or business and the taxpayer has no other fixed location where they conduct substantial administrative and management activities for that trade or business.

Deductions also may be taken for business storage purposes when the dwelling unit is the sole fixed location of the business or for regular use of a residence for the provision of day care services; exclusive use is not required in these cases.

Deductible expenses for business use of the home include the business portion of real estate taxes, mortgage interest, rent, casualty losses, utilities, insurance, depreciation, maintenance, and repairs. The taxpayer may not deduct expenses for lawn care in general or for painting a room not used for business.

Regular Method

The taxpayer computes the business use of home deduction by dividing expenses of operating the home between personal and business use. They may deduct direct business expenses in full and may allocate the indirect total expenses of the home to the percentage of the home floor space used for business. A qualified daycare provider who does not use their home exclusively for business purposes, however, must figure the percentage based on the amount of time the applicable portion of the home is used for business. Self-employed taxpayers filing Form 1040, Schedule C, Profit or loss from business (sole proprietorship) first compute this deduction on Form 8829, Expenses for business use of your home.

Simplified Option

Qualifying taxpayers may use a prescribed rate of $5 per square foot of the portion of the home used for business (up to a maximum of 300 square feet) to compute the business use of home deduction. Under this safe harbor method, depreciation is treated as zero and the taxpayer claims the deduction directly on Form 1040, Schedule C. Instead of using Form 8829, the taxpayer indicates their election to use the safe harbor option by making two entries directly on Schedule C for the square footage of the home and the square footage of the office. Deductions attributable to the home that are otherwise allowable without regard to business use (such as qualified residence interest, property taxes, and casualty losses) are allowed in full in Schedule A, Itemized deductions.

Regardless of the method used to compute the deduction, the taxpayer may not deduct business expenses in excess of the gross income limitation. Under the regular method for computing the deduction, the taxpayer may be able to carry forward some of these business expenses to the next year, subject to the gross income limitation for that year.

There is no carryover provision under the safe harbor method, but the taxpayer may elect in to and out of the safe harbor method in any given year.

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REVIEW QUESTIONS

1. Which are the taxable income thresholds regarding the QBI deduction?

A. $343,200 for MFJ, $190,050 for the others.
B. $340,900 for MFJ, $191,050 for single and $172,200 for the others.
C. $383,900 for MFJ, $191,950 for the others.
D. $380,400 for MFJ, $191,050 for single and $170,125 for the others.

Answer: C

For 2024, the threshold and phase-in amounts under Section 199A are as follows: For taxpayers filing as Married Filing Jointly (MFJ), the threshold amount is $383,900, and the phase-in range extends up to $483,900. For all other filing statuses, the threshold amount is $191,950, with a phase-in range up to $241,950.

2. Regarding the disabled access credit, which is the maximum credit allowed for the expenses that qualify that were incurred in a year?

A. $5,000.
B. $10,000.
C. $20,500.
D. $10,250.

Answer: A

The taxpayer may take a tax credit for 50% of the expenditures that are over $250, up to $10,000 for 2024 tax year, meaning the maximum credit is of $5,000.

3. Regarding the R&D tax credit, if the development is related to internal use software, which of the following specific requirements must it comply with?

A. Developing the software involves significant economic risk, requiring the commitment of substantial resources and subject to substantial uncertainty of recovery in a reasonable time period.
B. The software must be innovative.
C. The software is not commercially available.
D. All of the above.

Answer: D

If the development is related to internal use software, it must comply with these requirements:

- *The software must be innovative.*
- *Developing the software involves significant economic risk, requiring the commitment of substantial resources and subject to substantial uncertainty of recovery in a reasonable time period.*
- *The software is not commercially available.*

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4. How much time can a farm with a loss, carry back the NOL?

A. 2 years.

B. 5 years.

C. 10 years.

D. Indefinitely.

Answer: A

The carryback period for a farming loss is 2 years. Only the farming loss portion of the NOL can be carried back 2 years.

5. These are some of the requirements needed to qualify to deduct expenses for business use of home, except:

A. The home must be used as a daycare facility.
B. The home must not be used for certain storage.
C. The home must be used exclusively and regularly as a place where the taxpayer meets or deals with patients, clients, or customers in the normal course of a trade or business.
D. For rental of the home.

Answer: B

To qualify to deduct expenses for business use of a home, the taxpayer must use part of their home:

- *Exclusively and regularly as a principal place of business.*
- *Exclusively and regularly as a place where the taxpayer meets or deals with patients, clients, or customers in the normal course of a trade or business.*
- *In the case of a separate structure, which is not attached to the home, in connection with the taxpayer's trade or business.*
- *On a regular basis for certain storage uses.*
- *As a daycare facility.*
- *For rental of the home.*

6. What should corporations doing business overseas do in order to avoid double taxation?

A. Notify the foreign country.

B. File Form 1118.

C. Notify the IRS.

D. Provide employees with Schedule K-1.

Answer: B

In order to avoid double taxation, corporations can file Form 1118 to claim foreign tax credit against the income tax they paid. The credit may be limited, based on the type of income and the foreign country's tax rate.

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7. Which form should be used to calculate the small business healthcare tax credit?

A. Form 6240.
B. Form 9351.
C. Form 7546.
D. Form 8941.

Answer: D

To calculate the credit, the small business taxpayer must use Form 8941, Credit for small employer health insurance premiums.

8. Which form should the taxpayer file for the R&D tax credit?

A. Form 5765.
B. Form 6765.
C. Form 7895.
D. Form 6385.

Answer: B

The R&D credit is a non-refundable tax credit that allows businesses and eligible entities the taxpayer is to file Form 6765.

9. Which of the following items is allowed when figuring a Net Operating Loss (NOL)?

A. Capital losses in excess of capital gains.
B. Nonbusiness deductions in excess of nonbusiness income.
C. The domestic production activities deduction.
D. Farming activity losses.

Answer: D

In general, the following items are not allowed when figuring a NOL:

- *Capital losses in excess of capital gains.*
- *Section 1202 exclusion of the gain from the sale or exchange of qualified small business stock.*
- *Nonbusiness deductions in excess of nonbusiness income.*
- *The Net Operating Loss deduction.*
- *The domestic production activities deduction.*

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Module: Business Assets

Basis of Assets

The basis of assets refers to the amount of capital investment in property by business for tax purposes. Companies often use their basis of assets to figure out amortization, depreciation, casualty losses and depletion, as well as loss or gain on the property disposition, sale or exchange. The basis of assets sometimes refers to its cost to the company.

Where cost will represent the amount, the company pays for assets in debt obligation, cash and other service or property including sale taxes as well as other expenses related to purchase. The basis of assets does not apply to other assets presented as a gift or inherited. For example, if a company owner acquired property from his father who passed away in 2024, special rules and regulations will apply in calculating tax. If a company purchases bonds or stocks, its basis of assets is the buying price plus any other cost such as commissions, recording, as well as additional transfer fees.

If a company possesses stocks or bonds it did not buy, the firm may determine its basis of an asset using the FMV of the bonds or stocks recorded on the transfer date or sometimes by the previous holder.

It is important for any business entity to consider the determination of adjusted basis in the assets before figuring loss or gain in exchange, sale or disposition of property or before considering allowable depreciation. Some events often occur during the ownership period that increases or decreases company basis of assets thus resulting to basis being adjusted. Items such as the cost of improvement, which adds to the value of property, often increase basis, while other items, such as insurance reimbursements for theft losses and allowable depreciation, often decrease the basis of the asset.

For a successful operation of any business, it is important for the business owners to acquire the right kind of assets that will be used to produce goods as well as providing services. Business assets, therefore, refer to the equipment or properties that a company or business entity owns that are majorly used to run the business. For example, when one visits a bank for a business loan, they are getting the loan to assist in paying for the business assets they need to buy such as equipment, machines, furniture among others. The assets are usually listed on the firms' balance sheet and sometimes depreciate over their useful time, yet they are expected to yield value.

Business assets are sometimes categorized into tangible, meaning those that can be seen and touched, and intangible, assets that are hard to measure, and something that cannot necessarily be touched or felt. Business assets form an integral part of every business entity since they represent greater parts of every business budget expenditure. The assets are usually important and more valuable to the firm since they ensure that business produces high-quality products and services within the scheduled budget and time. This makes it necessary for every business owner to understand every concept and idea related to business assets.

Disposition of Property or Assets

A property is disposed of when it is either sold, exchanged for other property, condemned or disposed of under threat of condemnation, repossessed, abandoned, or given away. When a property is disposed of, usually, a taxpayer will need to file one or more of the following: Schedule D, Form 4797, Form 8824, or Form 8949.

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If the business perceives a gain on the disposition of depreciable property, it must treat it as ordinary income to the extent of depreciation allowed or allowable. The business must also treat the gain as ordinary income if the transaction is either directly or indirectly between any of the following pairs of entities:

- A person and the controlled entity or entities belonging.
- A taxpayer and any trust in which the taxpayer (or their 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.
- 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).
- An employer (or any person related to the employer under the aforementioned rules) and a welfare benefit fund (as defined by Section 419 of the IRC) that is controlled directly or indirectly by the employer (or any person related to the employer).

Controlled Entity

An individual's-controlled entity is defined as either of the following:

- 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.
- An entity whose relationship with that person is one of the following:
  - 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.
  - Two corporations that are members of the same controlled group as defined in section 1563(a) of the IRC, except that "more than 50%" is substituted for "at least 80%" in that definition.
  - Two S corporations, if the same persons own more than 50% in value of the outstanding stock of each corporation.
  - 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.

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. Gain or loss on dispositions of other intangible property is ordinary or capital depending on whether the property is a capital asset or a non-capital asset.

Section 197 Intangibles

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:

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- 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.

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. This 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 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 they change its use, they may never again treat it as Section 1250 property.

Like-kind Exchanges

A 1031 exchange is the sale of an investment property to purchase one or more replacement properties, whereby the taxpayer can defer tax payment on the initial sale. Assuming the taxpayer complies with all various rules and requirements for a valid 1031 exchange, they would not have to pay any income tax that would otherwise be due in the year of the sale. These taxes are deferred into the future until the investor sells the replacement properties in a taxable transaction.

Prior to TCJA, taxpayers were allowed to exchange certain property without recognizing gain or loss. The theory of Section 1031 is that if a taxpayer exchanges one business (or investment) asset for another business (or investment) asset, and no cash is generated by the transaction, the gain should not be subject to taxation. After TCJA, the only assets that are allowed to be exchanged is real estate. No more other tangible assets (i.e., machines, cars, equipment, etc.)

The idea of a 1031 exchange is that the taxpayer is selling real estate and replacing it with real estate that is "like-kind". The property being sold must be held for "investment" or used in trade or business. The investment property could be a rental property in which the taxpayer invests to generate cash flow, or it could be a farming property that generates income from crops. It could even be a property that the taxpayer holds solely for appreciation benefits, such as undeveloped land. The eligible property could also include an office building or a warehouse that the taxpayer's company has maintained and used for its business operations.

"Like-kind" refers to the fact that the taxpayer needs to purchase a similar replacement property. It should be another investment property or another property used in trade or business. This does not mean that if the taxpayer sells a

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single-family rental home, they must replace it with another single-family rental home. It can be replaced with a hotel, an office building, or even vacant land.

Properties eligible for a 1031 exchange can include, among others, the following:

- Single-family rental
- Duplex, triplex, or quadruplex
- Apartment building
- Hotel
- Office building
- Shopping center or retail property
- Triple net lease property
- Vacant or farmland
- Leasehold interests
- Qualified property in one state for qualified property in another state
- Oil and gas interests
- Mineral, water, or timber rights

Although there are many different types of properties that are eligible to be sold in a 1031 exchange, there are also properties that are not eligible. These include the following:

- Primary residences not used as rentals
- Second/vacation homes not used as rentals
- Personal property such as furniture, fixtures, equipment, appliances
- Properties held for renovation
- Partnership and LLC interests
- Shares in an entity, such as a C corporation or an S corporation
- Bonds, promissory notes or loans, securities, or trust certificates
- Inventory or dealer properties
- Domestic (U.S.) property for foreign property (outside U.S.) (or vice versa).

Report the exchange of like-kind property, even though no gain or loss is recognized, on Form 8824, Like-Kind Exchanges.

Intermediary

For a valid 1031 exchange, it is important to note that the taxpayer must hire an independent third party to act as a qualified 1031 exchange intermediary. The taxpayer cannot do the transaction on their own or be their own intermediary. They cannot sell their existing property first and then involve an intermediary after the sale closes; they must have an intermediary involved prior to selling the relinquished property.

The taxpayer should look for an intermediary firm that is insured and bonded for their intermediary work. The taxpayer might also want to find a firm that holds their exchange funds in "segregated accounts" rather than pooled accounts. With segregated accounts, the taxpayer's funds are held in their own account with the intermediary, which are kept separate from the funds of the intermediary's other clients.

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The intermediary firm will assist the taxpayer with the paperwork and documents required for the exchange. They will hold the taxpayer's money and should act as one of their professional advisors during the process to answer their questions. They should also help the taxpayer comply with all the rules and timing requirements to ensure the taxpayer completes a valid exchange.

Who can be an intermediary?

Remember, the person or entity acting as an intermediary must be an independent third party. But like many things in the tax code, unfortunately, the IRS does not clearly or directly define who can be an intermediary. Instead, the IRS dictates who cannot be an intermediary. This list of "disqualified" persons or entities includes the following:

- The taxpayer.
- Any person related to the taxpayer (i.e., a family member).
- An entity or business owned by a family member.
- Anyone who works for the taxpayer.
- Any person who works for one of these disqualified persons or businesses.
- Any person who has a business or professional relationship with the taxpayer (i.e., their attorney, CPA, financial advisor, etc.).

If the tax preparer has recommended to the taxpayer that a 1031 exchange is a good strategy to help defer taxes on the sale of their investment properties, one of the first steps to take is to find an intermediary to assist with the transaction.

Requirements

- **45-day deadline to identify replacement properties**

The first requirement is the 45-day identification deadline. This rule states that, within 45 days after the closing of the sale of the "old" property, the taxpayer must identify in writing to their intermediary a list of potential replacement properties they are interested in purchasing. The 45 days are based on calendar days, not business days. This also does not skip holidays. If a holiday falls within the 45-day period, then it counts as one of the 45 days. For example, if the property was sold on March 1, the list of replacement properties must be identified and sent to the intermediary before April 15, which is 45 calendar days after March 1. This date is extremely important, as it needs to be reported on the taxpayer's tax return when reporting the exchange.

What many investors do not know is that the IRS requires that the list of potential replacement properties be sent to the intermediary in writing. This should not be done via a phone call or verbally in a face-to-face meeting. The written list should be delivered in person, by email, fax, or postal mail. If the taxpayer is going to have it delivered in person, the intermediary needs to have it in their hands before midnight on the forty-fifth day. If the taxpayer is going to mail the form to the intermediary, it needs to be postmarked before the forty-fifth day. Most good intermediaries already have a form that they will give the taxpayer to list their identified properties; the taxpayer should fill it out and return it to them before the deadline.

The taxpayer must identify at least one potential replacement property that they plan to buy in the exchange. Although the taxpayer only needs to identify one, they may want to identify more than one property that meets the investment requirements, because what happens if the purchase of one property doesn't go through? If that happens

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and the taxpayer has no other potential property identified within the 45-day period, the whole exchange would fail, and the taxpayer could end up paying taxes on the total gain from the property they sold.

The IRS generally allows the taxpayer to identify up to a maximum of three properties in a 1031 exchange. However, they are allowed to identify more than three properties as long as the total purchase price of all potential replacement properties identified does not exceed 200% of the sales price of the relinquished property.

The information provided must be the specific address of the property or the legal description of the property if it does not have an actual address. If the taxpayer plans to purchase a specific unit in a condominium complex, an office building, or a shopping center, make sure that the unit number or suite number is also included in the identification form.

Obviously, this also means that the identified replacement property cannot simply be a vague description like "a single-family home on Smith Ave. in San Francisco, CA" or "any property for sale in Austin, TX."

- **180-day purchase period**

The other time requirement involved in a 1031 exchange is the 180-day purchase period, which states that the taxpayer must close the purchase of the replacement property (or properties) within 180 days after the closing date of the sale of the relinquished property.

The 180-day requirement is also based on calendar days and not just weekdays. It also does not get extended if a holiday falls within this time period or even if a holiday falls on day 180. And similar to the 45-day requirement, the IRS does not allow extensions to this period.

For example, if the sale of the relinquished property closed on Saturday, June 28th, the 180-day deadline would be December 25th.

If the taxpayer is selling one property and purchasing a replacement property, the 180-day period is fairly straightforward to decipher. If the taxpayer is selling more than one property in the same kind of exchange, then the 180-day purchase deadline begins the day after the first property is sold.

If the taxpayer is buying more than one property in the same kind of exchange, then the 180-day purchase deadline ends after all the replacement properties are purchased.

The 45 and 180-day deadlines are mandatory under tax law. If the taxpayer does not meet the requirements for the 45-day identification deadline, then they have failed the 1031 exchange. This means that the sale of their relinquished property will be treated as a normal taxable sale, just like any other property sale.

Monetary requirements

To defer all gains for tax purposes from the 1031 exchange, there are two essential monetary target amounts that must be met. The replacement properties must match or exceed the relinquished property in both sales price and equity.

The first monetary requirement is that the total net purchase price of all replacement properties in the exchange must be equal to or greater than the net sales price of the relinquished properties. Keep in mind that selling costs and purchasing closing costs can generally reduce these target amounts.

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This also works the same way on the buying side. The taxpayer can add their purchase closing costs to the purchase price to determine whether they meet the target amount for the replacement purchase price.

The second requirement for the replacement monetary target is that the total amount of cash (i.e., the net equity) the taxpayer finance into their replacement property must be equal to or greater than the net equity they receive from the relinquished or sold properties.

Essentially, this 1031 exchange rule is designed to ensure that the taxpayer reinvests all the proceeds they would have received in a regular sale and that they have not walked away with cash from the transaction.

Converted Property

If a business receives property as a result of an involuntary conversion, such as a casualty, theft, or condemnation, it may figure the basis of the replacement property received using the basis of the converted property.

Similar or Related Property

If a taxpayer receives replacement property similar or related in service or use to the converted property, the replacement property's basis is the old property's basis on the date of the conversion. However, they must make the following adjustments:

- Decrease the basis by the following:
    - Any loss recognized by the taxpayer on the conversion, and o Any money received by the taxpayer that is not spent on similar property.
- Increase the basis by the following:
    - Any gain recognized by the taxpayer on the conversion, and o Any cost of acquiring the replacement property.

Money or Property not Similar or Related

If a taxpayer receives money or property not similar or related in service or use to the converted property, and they buy replacement property similar or related in service or use to the converted property, the basis of the new property is its cost decreased by the gain not recognized on the conversion.

Property Received as a Gift

To figure the basis of property received as a gift, the taxpayer is required to know its adjusted basis to the donor just before it was given to him or her, its FMV at the time it was given to him or her, and any gift tax paid on it.

FMV Less Than Donor's Adjusted Basis

If the FMV of the property at the time of the gift is less than the donor's adjusted basis, the taxpayer's basis depends on whether they have a gain or a loss when the property is disposed of. The basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustment to basis while the taxpayer held the property. The basis for figuring loss is its FMV when the gift was received the gift plus or minus any required adjustment to basis while the taxpayer held the property.

If the taxpayer uses the donor's adjusted basis for figuring a gain and get a loss, and then uses the FMV for figuring a loss and has a gain, they have neither gain nor loss on the sale or disposition of the property.

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Example: Valentina received an acre of land as a gift. At the time of the gift, the land had an FMV of $8,000. The donor's adjusted basis was $10,000. After she received the land, no events occurred to increase or decrease her basis. If Valentina sells the land for $12,000, she will have a $2,000 gain because she must use the donor's adjusted basis ($10,000) at the time of the gift as her basis to figure gain. If Valentina sells the land for $7,000, she will have a $1,000 loss because she must use the FMV ($8,000) at the time of the gift as her basis to figure a loss.

If the sales price is between $8,000 and $10,000, there is neither gain nor loss for the taxpayer. For instance, if the sales price was $9,000 and Valentina tried to figure a gain using the donor's adjusted basis ($10,000), she would get a $1,000 loss. If she then tried to figure a loss using the FMV ($8,000), Valentina would get a $1,000 gain.

Business Property

If a taxpayer holds the gift as business property, the basis for figuring any depreciation, depletion, or amortization deduction is the same as the donor's adjusted basis plus or minus any required adjustments to basis while the taxpayer holds the property.

FMV Equal to or More than Donor's Adjusted Basis

If the FMV of the property is equal to or greater than the donor's adjusted basis, the basis is the donor's adjusted basis at the time the gift was received. Increase the taxpayer's basis by all or part of any gift tax paid, depending on the date of the gift.

Also, for figuring gain or loss from a sale or other disposition of the property, or for figuring depreciation, depletion, or amortization deductions on business property, the taxpayer is to increase or decrease their basis by any required adjustments to basis while the property was held.

Inherited Property

The basis of property inherited from a decedent is generally one of the following:

1. The FMV of the property at the date of the individual's death.
2. The FMV on the alternate valuation date if the personal representative for the estate chooses to use alternate valuation. For information on the alternate valuation date, see the Instructions for Form 706.
3. The value under the special-use valuation method for real property used in farming or a closely held business if chosen for estate tax purposes.
4. The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement. For information on a qualified conservation easement, see the Instructions for Form 706.

If a federal estate tax return does not have to be filed, the taxpayer's basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

Capitalization and Repair Regulations

Capitalization is defined as the procedure in which an item is recorded as an asset, instead of as an expense. Business taxpayers may elect to capitalize certain items, such as repair and maintenance costs. 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

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final tangibles regulations include an election to capitalize repair and maintenance expenses as improvements, if they are treated as capital expenditures for financial accounting purposes.

A taxpayer is able to elect to treat repair and maintenance costs paid during the taxable year as amounts paid to improve property if:

- The taxpayer pays these amounts in carrying on a trade or business; and
- The taxpayer treats these amounts as capital expenditures on their books and records regularly used in computing their income.
- The taxpayer makes the election to capitalize for each taxable year in which qualifying amounts are incurred by attaching a statement to the taxpayer's timely filed original federal tax return including extensions for the taxable year that the amounts are paid.
- The taxpayer makes the election to capitalize repair and maintenance expenses. The taxpayer must apply the election to all amounts paid for repair and maintenance that they treat as capital expenditures on their books and records in that taxable year.

An annual election is not a change in method of accounting. Therefore, a taxpayer should not file Form 3115, Application for change in method of accounting, to make this election or to stop capitalizing repairs and maintenance costs for a subsequent year.

The final tangibles regulations add certain annual elections that may be made for a taxable year. These elections include:

- De minimis safe harbor election.
- Safe harbor election for small taxpayers.
- Election to capitalize repair and maintenance costs.

To make these elections, a taxpayer should attach a statement for each election to their timely filed original federal tax return, including any extension for the taxable year in which the amounts subject to the election are paid. Each statement should include the taxpayer's name, address, TIN, and a statement describing the election.

For some elections, the taxpayer will need to include a description of the property to which the election is applied. For example, if a taxpayer qualifies and desires to use the de minimis safe harbor election for qualifying amounts paid during their annual taxable year beginning January 1st, 2024, the taxpayer must file a statement with their timely filed original federal tax return for 2024. The taxpayer is also to file a statement with their timely filed original tax return for each subsequent taxable year for which the taxpayer intends to make such election.

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REVIEW QUESTIONS

1. If a business perceives a gain on the disposition of depreciable property, it must be treated as ordinary income if the transaction occurs directly or indirectly between the following, except:

A. A person and a corporation that this person does not own.
B. A taxpayer and any trust in which the taxpayer (or their spouse) is a beneficiary.
C. A person and the controlled entity or entities belonging.
D. An employer and a welfare benefit fund controlled directly or indirectly by said employer.

Answer: A

If the business perceives a gain on the disposition of depreciable property, it must treat it as ordinary income if the transaction is either directly or indirectly between any of the following pairs of entities:

- *A person and the controlled entity or entities belonging.*
- *A taxpayer and any trust in which the taxpayer (or their 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.*
- *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).*
- *An employer (or any person related to the employer under the aforementioned rules) and a welfare benefit fund (as defined by Section 419 of the IRC) that is controlled directly or indirectly by the employer (or any person related to the employer).*

2. Section 197 intangibles acquired after August 10, 1993 must be amortized over

A. 5 years.
B. 15 years.
C. 20 years.
D. 10 years.

Answer: B

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.

3. Which of the following properties qualifies as a like-kind exchange property?

A. Real property held primarily for sale.
B. A and C.
C. Stocks, bonds, notes, or receivables.
D. None of the above.

Answer: D

The following property is NOT qualifying property for like-kind exchange purposes:

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- *Personal-use property, such as a personal residence or family car.*
- *Personal property, including intangibles such as patents and other intellectual property, beginning in 2018.*
- *Real property held primarily for sale.*
- *Stock in trade or other property held primarily for resale, such as inventory, raw materials, or real estate held by dealers.*
- *Stocks, bonds, notes, or receivables.*
- *Other securities or evidence of indebtedness or interest*
- *Interests in a partnership, whether general or limited.*
- *Certificates of trust or beneficial interests.*
- *Choses in action (various rights of recovery).*
- *Certain tax-exempt use property subject to a lease.*

4. Which of these elements qualify as a Section 197 intangible?

A. Supplier-based intangibles.

B. Workforce in place.

C. Business books and records.

D. All of the above.

Answer: D

Section 197 intangibles include the following:

- *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.*

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Module: Analysis of Financial Records

Proper Business Type, the Use of Classification Codes and Year-to-Year Comparison

To facilitate the administration of the IRC, a business uses a principal business activity and associated code to classify a business by the type of activity in which it is involved. The North American Industry Classification System (NAICS) establishes these principal business activity codes. The NAICS codes are available at www.census.gov/naics.

The NAICS is the standard used by federal statistical agencies in classifying business establishments for collecting, analyzing, and publishing statistical data related to the U.S. business economy. The Office of Management and Budget (OMB) developed the NAICS in 1997 to replace the Standard Industrial Classification (SIC) system.

The IRS uses these codes for various purposes, such as identifying acceptable accounting procedures, identifying like property for a like-kind exchange, etc. The IRS also uses these codes to determine if the business reports reasonable amounts of income and expenses on the business form for that type of activity. If a deduction exceeds the standard reasonable range for the type of business, examination of the business return is more likely.

The instructions for the appropriate business form contain the list of codes applicable to that form of entity. Note that the codes for Schedule C are not the same as the codes for Form 1120, etc.

Year-to-Year Comparison: Total liabilities of a taxpayer divided by the net worth of the business will provide a year-to-year comparison of taxpayer's ownership in the company. This is known as Debt-to-Equity Ratio.

Income Statement

A business needs good records to prepare accurate financial statements. These include income (profit and loss) statements and balance sheets. These statements can help in dealing with a bank or creditors and help manage the business.

An income statement shows the income and expenses of the business for a given period of time. It contains most of the information, with some modifications (Schedule M-1), which show up on the income tax return for income and expense items.

Balance Sheet

A balance sheet shows the assets, liabilities, and equity in the business on a given date. It is a statement of a business's financial position at a particular point in time.

The foundation of a balance sheet is this fundamental accounting concept:

Assets = Liabilities + Capital (or Equity)

The balance sheet is a requirement for most partnership and corporation tax returns.

Partnerships that meet all four of the following requirements of Form 1065, Schedule B, Question 4, do not need to complete a balance sheet.

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		Yes	No
4	Does the partnership satisfy **all four** of the following conditions?		
a	The partnership's total receipts for the tax year were less than $250,000.		
b	The partnership's total assets at the end of the tax year were less than $1 million.		
c	Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return.		
d	The partnership is not filing and is not required to file Schedule M-3		
	If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2; item F on page 1 of Form 1065; or item L on Schedule K-1.		

Corporations that answer "Yes" in Form 1120, Schedule K, Question 13, does not need to complete a balance sheet.

Form 1120 (2024) Page **5**

Schedule K **Other Information** *(continued from page 4)*

		Yes	No
13	Are the corporation's total receipts (page 1, line 1a, plus lines 4 through 10) for the tax year **and** its total assets at the end of the tax year less than $250,000?		
	If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during this tax year $__________		

S Corporations that answer "Yes" in Form 1120-S, Schedule B, Question 11, does not need to complete a balance sheet.

11	Does the corporation satisfy **both** of the following conditions?		
a	The corporation's total receipts (see instructions) for the tax year were less than $250,000.		
b	The corporation's total assets at the end of the tax year were less than $250,000.		
	If "Yes," the corporation is not required to complete Schedules L and M-1.		

Form **1120-S** (2024)

Balance Sheet Depreciation Vs. Income Statement Depreciation

In short terms, Depreciation is the systematic allocation of assets' costs to expense over the useful life of the assets. However, it is important to notice that depreciation differs from income statement to balance sheet. The depreciation reported on the income statement is the amount of depreciation expense that is appropriate for the period of time indicated in the heading of the income statement.

The depreciation reported on the balance sheet is the accumulated or the cumulative total amount of depreciation that has been reported as depreciation expense on the income statement from the time the assets were acquired until the date of the balance sheet.

Beginning and Ending Balances

Beginning balance: The taxpayers must match the beginning balance in the account to the ending reconciliation detail from the prior period. If the amounts do not match, investigate the reason for the variance in the prior period. If the account has not been reconciled for some time, it is possible that the error lies several periods in the past.

Ending balance: The taxpayer must verify that the ending detail for the account matches the ending account balance.

Method of Accounting and Changes

As indicated in Chapter 2 — Business tax preparation, Module: Advising the business taxpayer, there are 3 types of accounting methods: cash, accrual and hybrid. The following is a summary of the accounting methods.

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Cash Method

Under the cash method, the taxpayer must include in the gross income all items of income they actually or constructively receive during the taxpayer's tax year. If the taxpayer receives property or services, they must include their fair market value in income.

Example: On December 30, 2023, Karina sent a check for interior decorating services provided. Julio received the check on January 2, 2024; thus he must include the amount of the check in his income for 2024.

Accrual Method

Under an accrual method of accounting, the taxpayer 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 match income and expenses in the correct year.

Example: Juana is a calendar year accrual method taxpayer. She sold a computer on December 28, 2024. She did not receive payment until February 2025. She must include the amount received for the computer in her 2024 income.

Hybrid Method

The hybrid method is a combination of the cash and accrual methods of accounting. According to the IRS, the taxpayer may generally use any combination of cash, accrual, and special methods of accounting if the combination reflects their income clearly and the taxpayer uses it consistently. However, some restrictions apply, such as the usage of an accrual method if the taxpayer needs an inventory to account for their income, or if the taxpayer uses an accrual method for reporting expenses, the taxpayer must likewise use an accrual method in figuring their income.

Form 3115

A taxpayer must file Form 3115 to request a change in either an overall method of accounting or the accounting treatment of any item. When filing Form 3115, the taxpayer must determine if the IRS has issued any new published guidance which includes revenue procedures, revenue rulings, notices, regulations, or other relevant guidance in the Internal Revenue Bulletin. Unless otherwise provided in published guidance, a taxpayer is to file under the automatic change procedures if they are eligible to request consent to make a change in their method of accounting under the automatic change procedures for the requested year of change.

A Form 3115 filed under these procedures may be reviewed by the IRS. If it is, the taxpayer will be notified if information in addition to that requested on Form 3115 is required or if the taxpayer's request is denied. No user fee is required. An applicant that timely files and complies with the automatic change procedures is granted consent to change its accounting method, subject to review by the IRS National Office and operating division director.

Under normal circumstances, a taxpayer is required to file a separate Form 3115 for each change in method of accounting. However, in some cases they are required or permitted to file a single Form 3115 for particular concurrent changes in method of accounting.

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Reduced filing requirement

A qualified small taxpayer qualifies for a reduced Form 3115 filing requirement for certain automatic accounting method changes (for example, a change under Section 6.01 of Rev. Proc. 2015-14 DCN, which stands for "Designated Automatic Accounting Method Change"). A qualified small taxpayer is a taxpayer with average annual gross receipts of less than or equal to $10 million for the three taxable years preceding the year of change.

Non-automatic change procedures

If a taxpayer does not qualify to file under the automatic change procedures for the requested change in method of accounting for the requested year of change, they may still be able to file under the non-automatic change procedures. If the requested change is approved by the IRS, the taxpayer will receive a letter ruling on the requested change. They are then to file a separate Form 3115 for each unrelated item or sub method. A user fee is required.

Filing exception for certain first-year tangible property changes

A small business taxpayer may make certain tangible property changes in method of accounting for its first taxable year beginning on or after January 1 without filing a Form 3115. Under these special procedures, the change in method of accounting is effectively made on a cut-off basis. These special methods change procedures apply to small business taxpayers making certain method changes to comply with Regulations sections 1.263(a)-3 and 1.168(i)-8. A small business taxpayer is a business with total assets of less than $10 million or average annual gross receipts of less than or equal to $10 million for the prior three taxable years.

Depreciation Recovery

If a taxpayer sells or otherwise disposes of depreciable or amortizable property, gain to the extent of depreciation or amortization allowed or allowable is taxable as ordinary income. Depreciation recapture is triggered by the disposition of depreciable property, including sales, exchanges, and involuntary conversions. Special rules apply for transfers by gift or at death, certain tax-free corporate or partnership transactions, disposal in a like-kind exchange or involuntary conversion where gain is not recognized, and property distributed by a partnership.

All gain realized on the disposition of Section 1245 property is taxable as ordinary income. In determining gain, depreciation allowed or allowable reduces the basis of the property. Therefore, even though a taxpayer did not claim a depreciation deduction, the taxpayer still reduces the basis by what is allowable.

On the disposition of Section 1250 property, gain due to depreciation taken in excess of what was allowable using the straight-line method is taxable as ordinary income. If the Section 1250 property is held for one year or less, all depreciation is recaptured as ordinary income.

The portion of the gain on disposition of Section 1250 property that is not recharacterized as ordinary income under the depreciation recapture rules is long-term gain. For non-corporate taxpayers, that portion of gain is subject to a capital gains rate of 25% as unrecaptured Section 1250 property gain. Unrecaptured Section 1250 property gain generally is the portion of the gain that would have been recharacterized as ordinary income if additional depreciation included all depreciation deductions, not merely the excess of accelerated depreciation over straight-line, over the excess, if any, of 28% loss over 28% gain.

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To the extent that the amount of long-term capital gain used in computing unrecaptured Section 1250 property gain is from the taxpayer's Section 1231 gain for the year under the capital gain/ordinary loss rules, the gain cannot exceed the taxpayer's net Section 1231 gain for the year.

Listed Property

Listed property is any of the following:

- Passenger automobiles (four-wheeled vehicle made primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less of unloaded gross vehicle weight).
- Any other property used for transportation unless it is an excepted vehicle.
- Property generally used for entertainment, recreation, or amusement (including photographic, phonographic, communication, and video recording equipment).

Recapture of Section 179

A recapture of depreciation on listed property or a Section 179 deduction may result when business use of the asset drops to 50% or less. This recapture is included in income on the appropriate business form. This differs from recapture required because of a disposition of property reported as ordinary income on Form 4797.

If, in any year during the Section 179 property's recovery period, the percentage of business use drops to 50% or less, all or a portion of the Section 179 deduction is recaptured. The recapture amount is included as ordinary income on Form 4797, Part IV. The recapture amount is equal to the amount of Section 179 deduction taken in excess of the MACRS depreciation that is allowable.

For a sale, exchange or other disposition of property, the Section 179 deduction is included as depreciation and the special Section 179 recapture provision for reduced business use does not apply.

Listed property used 50% or less for business is eligible for depreciation using the straight-line method. If using accelerated depreciation, the recapture applies to the excess of the depreciation claimed over that allowable using straight-line in the year the property is no longer predominantly business use. Report this recapture on Form 4797, Part IV, and carry the amount as other income to the business return. If property is disposed of using the installment method of reporting, the taxpayer recognizes any gain recaptured as ordinary income in the year of disposition. Only the gain in excess of the recapture amount is eligible for installment reporting. Use Form 4797 to calculate and report the amount of recaptured depreciation.

Section 280F - Limitation on Depreciation for Luxury Automobiles

The amount of the depreciation deduction for any taxable year for any passenger automobile placed in service in 2024 shall not exceed:

- $12,400 for the 1st taxable year in the recovery period ($20,400 if takes bonus depreciation),
- $19,800 for the 2nd taxable year in the recovery period,
- $11,900 for the 3rd taxable year in the recovery period, and
- $7,160 for each succeeding taxable year in the recovery period.

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Additional first year depreciation deduction is allowed or allowable for qualified property acquired by the taxpayer before September 28, 2017 and placed in service by the taxpayer after 2019. For qualified property acquired and placed in service after September 27, 2017, increases the first-year depreciation allowed by $8,000.

There has to be a recapture of this section if the use percentage for luxury automobiles falls to 50% or lower.

If property is predominantly used in a qualified business use in a taxable year in which it is placed in service, and such property is not predominantly used in a qualified business use for any subsequent taxable year, then any excess depreciation shall be included in gross income for the taxable year, and the depreciation deduction for the taxable year and any subsequent taxable years shall be determined under section 168(g) (relating to alternative depreciation system).

Pass-through Activity

Pass-through entities include partnerships, S corporations, and mutual funds that are not publicly offered. Deductions of pass-through entities are passed through to the partners or shareholders. The partner's or shareholder's share of passed-through deductions for investment expenses are miscellaneous itemized deductions and can no longer be deducted.

- **Schedules K and K-1 - Form 1065: Partner's Share of Distributive Items**

Although a partnership is not subject to income tax, the partners must pay tax on their share of the partnership's income, whether or not it is distributed, and must report their share on their individual tax returns.

Schedule K is a summary of all partners' shares of the partnership's income, credits, deductions, and other items. All partnerships are required to complete Schedule K. Rental activity income (loss) and portfolio income are not reported on page 1 of Form 1065 and are not combined with the business income (loss) reported there. Schedule K is used to report totals of these items, including those shown on page 1.

Schedule K-1 reports each partner's separate share of the distributive items. A copy of each Schedule K-1 must be attached to the Form 1065 filed with the IRS. One copy should be kept with the partnership's return for recordkeeping purposes, and another must be provided to each partner. If the partner is a Disregarded Entity (DE), the Schedule K-1 must be provided to the owner of the DE. If a nominee holds a partnership interest on behalf of another person, the partnership may be required to furnish Schedule K-1 to the nominee.

Each partner must also receive the partner instructions for Schedule K-1 (Form 1065), or specific guidance for each item reported on the partner's Schedule K-1.

Income, gain, loss, deduction, or credit items must be allocated among the partners according to the partnership agreement's general income or loss-sharing ratio. However, the partners may agree to specially allocate certain items in different ratios. For example, if net income (excluding specially allocated items) is split equally among three partners, but certain items are specially allocated 50% to one, 30% to another, and 20% to the third, then the specially allocated items should be reported on the appropriate lines of each partner's Schedule K-1 and in total on the corresponding lines of Schedule K, rather than on the numbered lines of page 1 of Form 1065, Form 1125-A, or Schedule D.

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- **Schedules K and K-1 — Form 1120-S: Shareholder's Share of Distributive Items**

The S corporation is subject to tax on lines 23a, 23b, and 23c of page 1 of Form 1120-S. Shareholders are subject to tax on their share of the corporation's income (reduced by any tax paid by the corporation on that income). Shareholders must report their share of income on their individual tax returns, whether or not it was distributed to them. Unlike most partnership income, income from an S corporation is generally not considered self-employment income and is not subject to self-employment tax.

In general, the corporation must prepare and issue a Schedule K-1 to each person who was a shareholder at any time during the tax year. Each Schedule K-1 must be provided to shareholders no later than the due date of the corporation's Form 1120-S..

Separately Stated Items

Some financial data must be tracked individually. The S-Corp or partnership must report certain income and expenses separately from the net profit or loss amount. These income and expense items retain their tax characteristics when passed-through to the shareholder and are subject to the limits and tax rates on each shareholder's personal Form 1040. Separately stated items are the following:

- Section 1231 gains and losses,
- Net short-term capital gains and losses,
- Net long-term capital gains and losses,
- Dividends eligible for the dividends received deduction (if a shareholder is a C-Corporation),
- Charitable contributions,
- Taxes paid to a foreign country,
- Tax-exempt interest and related expenses,
- Investment income and expenses,
- Amounts previously deducted, such as bad debts,
- Real estate income and expenses,
- Section 179 deductions,
- Tax credits, and
- Non-deductible expenses, such as 50% of meals and entertainment expenses.

The non-deductible expenses are not reported on Form 1040. Instead, the taxpayer should decrease their adjusted basis in the partnership or S-Corp by this amount.

Reconciliation of Tax versus Books

The IRS requires taxpayers to undertake a full reconciliation of their books to the taxable income. Therefore, it is imperative for a business to provide a disclosure note that compares accounting profit with taxable income. The differences often arise from the fact that the taxable basis differs from the generally accepted accounting profit. For instance, whereas some business entities are allowed to use cash accounting for tax purposes, this is not permitted under standard reporting. This would result in a situation where taxable income differs from profit reported under the U.S. Generally Accepted Accounting Principles (GAAPs).

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Schedule M-1

Schedule M-1 is used in reconciling taxable income versus accounting profit. This form requires taxpayers to indicate the net income per their accounting books. The next step is to indicate the tax expense for the period which is added back to arrive at the pre-tax income. Adjustments are then made by adding taxable items in the tax computation but not in the books such as the loss on disposal of securities (whereas such losses are treated as an expense in accounting records, they are not allowable expenses for tax purposes until the securities are disposed).

Schedule M-1 is the bridge between financial (book) accounting and tax reporting. Both a partnership and a corporate return have a Schedule M-1 to reconcile the income shown on the books with the income shown on the tax return. It begins with the book income and ends with the tax return income.

- **Form 1065**

Partnerships or LLCs must prepare Schedules M-1 and M-2. Schedule M-1 on Form 1065 must be prepared if the partnership's income for the year is at least $250,000 or the total assets on Schedule L are at least $1,000,000.

If there is a difference between book and tax income, Schedule M-1 accounts for these differences (often referred to as book/tax differences). For a partnership, there are two kinds of adjustments that occur between book and tax accounting records:

  - Timing or temporary adjustments: These adjustments eventually turn around. For example, the partnership claims more depreciation expense for tax purposes at the beginning of the life of an asset. If the asset is held for its depreciable life, the total depreciation for book and tax is the same. In the earlier years, the partnership has an adjustment on Schedule M-1 for excess tax over book depreciation while in the later years, the partnership has an adjustment on Schedule M-1 for excess book over tax depreciation.
  - Permanent adjustments: There are adjustments that never turn around. For example, penalties are deductible for book purposes, but a fine or similar penalty paid to a government for the violation of any law is never deductible for tax purposes. Thus, if the partnership has non-deductible penalties for tax purposes, the partnership records a Schedule M-1 adjustment for the penalties.

- **Form 1120**

Corporations must prepare Schedules M-1 and M-2. Schedule M-1 on Form 1120 must be prepared if the corporation's income or assets for the year is $250,000 or more.

Due to various provisions of the tax law, the taxable income of a corporation is rarely the same as its countable income. The purpose of Schedule M-1 of the corporate tax return is to reconcile countable income with taxable income, calculated before net operating loss and special deductions such as deduction of dividends received. On the left side of Schedule M-1 are the adjustments that must be added to book income, and on the right side the adjustments that must be subtracted from book income to get the amount of taxable income.

Amounts to be added to book income include the amount of federal income tax expense, net capital losses deducted for book purposes, income reported on the tax return but not on the books, and expenses recorded on the books but not deducted on the tax return. Alternatively, the amounts to be deducted from the book income are the income

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recorded on the books but not included on the tax return and the deductions on the return that are not deducted on the books.

- **Form 1120-S**

Corporations S must prepare Schedules M-1 and M-2. Schedule M-1 on Form 1120-S must be prepared if the corporation's income or assets for the year is $250,000 or more.

Many of the reconciling items on Form 1120 are also reconciling items on Form 1120-S. There are some differences, however. For example, there is no adjustment for federal income tax on Form 1120-S because S corporations are transfer entities; thus, ordinary income is taxable for shareholders.

Because an S corporation is a transfer entity, it is not subject to federal income taxes. It is not necessary to adjust this item on Form 1120S, Schedule M-1, as required on Form 1120. If an S corporation was a C corporation with Earnings & Profits (E&P) prior to the election of the S corporation, the corporation would be subject to federal taxes affecting the amounts reported to shareholders. These taxes are the following:

 - Excess income tax liability net.
 - Tax on "incorporated earnings".

An S corporation that has E&P remaining from the C corporation is subject to tax on excess net passive income if the corporation has excess net passive investment income (for example, interest, dividends, rentals, royalties). The excess net passive income is calculated for the year as net passive income x [(passive income - 25% of gross income) 4- passive income]. The tax is 21% of the excess net passive income. The amount of excess net passive income tax paid by the corporation reduces the amount of passive income that is reported to shareholders.

Schedule M-2

- **Form 1065**

Each partner has a separate equity account that represents the fair market value of the investment plus any retained earnings the partner has in the partnership. It is related to a basic concept: assets - liabilities = equity. The capital account is attached to interest so that when there is a transfer of an interest, a proportionate part goes with the transfer.

It should be noted that the capital account is not the same as the investment or capital contribution. Those terms refer to the amount of cash and the fair market value of the contributed property without adjustment. Although the capital account is intended to reflect the economic relationship of the partners, it cannot do so at any particular time until liquidation.

- **Form 1120**

In addition to reconciling net financial income with taxable income on Schedule M-1, the corporation must complete Schedule M-2, Analysis of Inappropriate Retained Earnings by Books. The purpose of Schedule M-2 is to reconcile the corporation's inappropriate retained earnings account as found at the beginning of the year and at the end of the balance sheets, which are listed on Schedule L An analysis of inappropriate retained earnings may be presented as a statement of retained earnings for financial reporting purposes.

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- **Form 1120-S**

Schedule M-2 is made up of the accumulated adjustments account (AAA), the other adjustments account (OOA) and the previously taxed income (PTI) undistributed to shareholder's account. The purpose of Schedule M-2 is to track separately itemized income, losses, and items that should have been reported on shareholders' tax returns.

Distributions to Shareholders

The tax treatment of distributions from an S corporation to its shareholders depends on whether the following conditions occur:

- The S corporation has retained earnings and profits (E&P).
- Cash or non-monetary assets are distributed.

There are three special elections that allow an S corporation to change the tax treatment of a distribution.

Typically, a corporation will not have E&P if it has always been an S corporation. An S corporation will have E&P in the following situations:

- It has E&P from tax years the corporation was a C corporation.
- It has E&P as a result of a tax-free liquidation or tax-free reorganization in which the acquired corporation has an E&P balance to transfer.

If an S corporation with E&P does not make any special elections, distributions are applied in the following order:

1. Reduce the AAA account (without regard to any negative adjustments).
2. Reduce the PTI account for any Section 1375 (d) distribution.
3. Reduce the corporation's E&P account.
4. Reduce the OAA account.
5. Reduce any remaining shareholder equity accounts.

S corporations may hold one or more of the following special elections and apply distributions accordingly:

  - Choose to distribute E&P first.
  - Choose to make a considered dividend and distribute AE&P first.
  - Choose to decline PTI.

Schedule M-3

Schedule M-3 is a more detailed and transparent version of Schedule M-1. It is used by certain large entities to reconcile financial statement income (book income) with taxable income reported on the return. Unlike M-1, which summarizes differences, M-3 itemizes each book-tax difference, separating them into temporary and permanent adjustments.

Schedule M-3 is divided into three parts:

- **Part I:** Reports financial statement information, including the type of financial statements used and net income (loss) per those statements.
- **Part II:** Reconciles book income items with tax return income items, line by line. It specifies if the difference is permanent (e.g., tax-exempt interest) or temporary (e.g., depreciation differences).

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- **Part III:** Reconciles book expense items with deductions on the tax return, again indicating temporary vs. permanent differences.

Schedule M-3 must be filed by any partnership, C corporation, or S corporation that meets either of the following conditions:

- Total assets at the end of the tax year are $10 million or more, or
- The entity is a reporting member of a consolidated group (for corporations) or has other specific filing requirements imposed by the IRS (such as involvement with foreign or tax-exempt partners for partnerships).

Entities required to file Schedule M-3 are not required to file Schedule M-1.

Schedule M-3 requires a detailed reconciliation of book income and tax return income, distinguishing between:

- Temporary differences: Items that affect both book and tax income, but in different tax years. Examples:
    - Depreciation (book vs. tax methods)
    - Bad debt reserve vs. actual write-offs
    - Deferred compensation
    - Accrued liabilities (when using accrual accounting for books but cash method for tax)
- Permanent differences: Items that only affect book income or tax income, not both. Examples:
    - Tax-exempt interest income
    - Non-deductible expenses (fines, penalties, 50% meals, lobbying costs)
    - Life insurance proceeds
    - Contributions over the deductible limit
- Book income items not taxable, or taxable income not in books: Such as certain gains/losses, income allocations to foreign partners, or timing differences from inventory methods.

Related Party Activity

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.

According to Section 267 related party rules, the IRS makes certain definition and attributions rules that help to assess whether two entities are related in the case of C Corporations. This includes family members, shareholders and related companies where constructive ownership rules are applied. This could include direct ownership or ownership to the family or both.

Related Persons

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

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- Another corporation, that is a member of the same controlled group (as defined in Section 267(f) of the IRQ.
- An individual who owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation.
- 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.
- An S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 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.
- Any employee-owner, if the corporation is a personal service corporation, regardless of the amount of stock owned by the employee-owner.

Related Party Transactions

There are special rules applying to the sale or trade of property occurring between parties that are related. For instance, gain from the sale or trade of property, if the property can be depreciated, may be ordinary income instead of capital gain. Related parties include the following:

- Members of the taxpayer's family. This includes only their brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- A partnership in which a taxpayer directly or indirectly owns more than 50% of the capital interest or the profits interest.
- A corporation in which a taxpayer directly or indirectly owns more than 50% in value of the outstanding stock.
- A tax-exempt charitable or educational organization directly or indirectly controlled, in any manner or by any method, by a taxpayer or a member of their family, whether or not this control is legally enforceable.

If a business or investment real property is traded in a like-kind exchange, then there is no gain or loss recognized. This also applies to trades of real property between related parties. If the taxpayer of their related party, however, disposes of the like-kind property less than 2 years after the trade occurred, they must report any gain or loss not recognized on the original trade of the taxpayer's return for the year in which the later disposition occurs.

Loans to and from Owners

The IRS has noted that tax losses would arise from related party activities, and so, it has come up with strict rules to restrict said tax losses. Therefore, loans are required to be granted at arm's-length and where such is not proved, fringe benefit tax is charged for any advances above $10,000 where such are made at interest rates below the Applicable Federal Rate (AFR).

The IRS usually publishes AFRs that indicate the minimum interest rates chargeable on loans. Lending below these rates is considered to be below the market rates and thus a tax benefit is construed. This results to a taxable benefit being the difference between the rate charged and the AFR. For instance, assuming that the AFR was 3%, if the Bamboo company grants its subsidiary (Tena Company) a loan at 1%, then the difference between AFR and the rate charged to Tena (2%) is subject to a fringe benefit tax.

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Ownership of Stock

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.

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REVIEW QUESTIONS

1. Elena must file Form 3115:

A. To request a change in either an overall method of accounting or the accounting treatment of an item.
B. To report her foreign income.
C. To report household taxes.
D. To report partnership interest.

Answer: A

A taxpayer must file Form 3115 to request a change in either an overall method of accounting or the accounting treatment of any item. When filing Form 3115, the taxpayer must determine if the IRS has issued any new published guidance which includes revenue procedures, revenue rulings, notices, regulations, or other relevant guidance in the Internal Revenue Bulletin.

2. For a partnership, there are two kinds of adjustments that occur between book and tax accounting records: time adjustments and:

A. Loss adjustments.
B. Permanent adjustments.
C. Cash adjustments.
D. Tax adjustments.

Answer: B

If there is a difference between book and tax income, Schedule M-1 accounts for these differences (often referred to as book/tax differences). For a partnership, there are two kinds of adjustments that occur between book and tax accounting records:

- *Timing adjustments*
- *Permanent adjustments*

3. Regarding loans to and from owners, above which amount is the fringe benefit tax charged?

A. $10,000.
B. $15,000.
C. $20,000.
D. $50,000.

Answer: A

The IRS has noted that tax losses would arise from related party activities, and so, it has come up with strict rules to restrict said tax losses. Therefore, loans are required to be granted at arm's-length and where such is not proved, fringe benefit tax is charged for any advances above $10,000 where such are made at interest rates below the Applicable Federal Rate (AFR).

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4. Regarding pass-through activity, the pass-through entities include:

A. Trusts.
B. C corporations.
C. Estates.
D. Partnerships.

Answer: D

Pass-through entities include partnerships, S corporations, and mutual funds that are not publicly offered. Deductions of pass-through entities are passed through to the partners or shareholders. The partner's or shareholder's share of passed-through deductions for investment expenses are miscellaneous itemized deductions and can no longer be deducted.

5. For Form 1120, Schedule M-2 must be prepared if the corporation's income or assets for the year is:

A. $500,000 or more.
B. $250,000 or more.
C. $100,000 or more.
D. $50,000 or more.

Answer: B

Corporations must prepare Schedules M-1 and M-2. Schedule M-1 on Form 1120 must be prepared if the corporation's income or assets for the year is $250,000 or more.

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Module: Advising the Business Taxpayer

Reporting and Filing Obligations

The filing and the payment of business taxes can certainly be complex. Employers have the responsibility in their hands to ensure that tax returns are filed, and deposits and payments are made, even if the employer contracts with a third party to perform these acts. If the third party does not perform any of the required actions, the employer still remains responsible. The employer is liable for all taxes, penalties and interest due. The employer may also be held personally liable for certain unpaid taxes.

Deadlines and Extended Returns

The following are the deadlines for the different business types:

- Sole proprietorship and single-member LLCs (Schedule C with the owner's personal tax return): April 15, 2025.
- Partnership, multi-member LLC (Form 1065) and S corporation returns: March 17, 2025.
- C Corporation (Form 1120): April 15, 2025, if operating on a calendar year.

In order to apply for an extension, a request for said extension must be made before the deadlines shown above. For 2024, the extension due dates for business tax returns include the following:

- Sole proprietorship and single-member LLCs (Schedule C with the owner's personal tax return: Extended until October 15, 2025, filed with Form 4868.
- Partnership, multi-member LLC (Form 1065) and S corporation returns: The extension deadline is September 15, 2025, filed with Form 7004.
- C Corporations: Extended until October 15, 2025, filed with Form 7004. Penalties for Not Filing on Time Just as the individual taxpayer, businesses that do not file tax returns on time before the due date (or extensions, if they requested them) may face a certain number of penalties.

The penalties vary depending on what the business failed to comply with. The following are the most relevant penalties:

Late filing of return

A penalty is assessed against the business if it is required to file a 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. It varies depending on the type of business:

- For partnerships, the penalty is of $245, 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.
- For C Corporations, there is a penalty of 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. The minimum penalty for a return that is over 60 days late is the smaller of the tax due or $510.
- For S Corporations, if there is no due tax, the penalty is of $245 for each month or part of a month (up to 12 months) the return is late or does not include the required information, multiplied by the total number of

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persons who were shareholders in the corporation during any part of the corporation's tax year for which the return is due. If tax is due, the penalty is the amount stated above plus 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. The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or $510.

Late payment of tax

If a business does not pay a tax when it is due, it may be penalized % of 1 % of the unpaid tax, for each month, or part of a month in which the tax is not paid, up to a maximum of 25% of the unpaid tax.

Failure to furnish information timely

For partnerships and S corporations that do not furnish Schedule K-1 to shareholders when due, as well as each failure to include on Schedule K-1 all of the needed information, there is a $330 penalty for each schedule, increased to $660 or, if greater, 10% of the aggregate amount of items required to be reported. The maximum penalty for a calendar year is of $3,987,000 for 2024 tax year.

Tax fraud

If a business owner knowingly or intentionally files fraudulent tax returns, and the IRS is able to prove that they under-reported the business income with malicious intent, the IRS will issue a 75% tax fraud penalty on the amount of the underpayment attributable to the fraud. Additionally, if the IRS believes the taxpayer acted with criminal intent, they may refer him or her to the IRS Special Agents from the Criminal Investigation department in order to launch a criminal investigation.

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:

- Form 720, Quarterly Federal Excise Tax Return.
- Form 941, Employer's Quarterly Federal Tax Return.
- Form 943, Employer's Annual Federal Tax Return for Agricultural Employees.
- Form 944, Employer's Annual Federal Tax Return.
- Form 945, Annual Return of Withheld Federal Income Tax.

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 full amount of the unpaid trust fund tax.

International Information Returns

While no tax is directly due with the filing of these returns, the failure to timely file or substantially complete these international information returns can result in significant penalties, as well as indefinitely extend the statute of limitation on assessment for the taxpayer's entire return.

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Congress has imposed penalties for the failure to timely file or substantially complete certain international information returns, such as Form 5471, Information return of U.S. persons with respect to certain foreign corporations, or Form 5472, Information return of a 25% foreign-owned U.S. corporation or a foreign corporation engaged in a U.S. trade or business. The failure to timely file or substantially complete one of these international information returns may result in a flat $25,000 penalty, per form, per year, even when no income tax was owed with the taxpayer's return.

Form 5472 is used to provide information required under sections 6038A and 6038C when reportable transactions occur during the tax year of a reporting corporation with a foreign or domestic related party.

A reporting corporation is either a 25% foreign-owned U.S. corporation (including a foreign-owned U.S. disregarded entity (DE)), or a foreign corporation engaged in a trade or business within the United States.

A corporation is 25% foreign owned if it has at least one direct or indirect 25% foreign shareholder at any time during the tax year.

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Form 1099 Series

It is important that a business taxpayer acknowledges that they have the responsibility to report a variety of situations. The following table addresses some of these, in the Form 1099 series:

Form	What needs to be reported	Amounts to report	Due to recipient
1099-A, Acquisition or abandonment of secured property	Information about the acquisition or abandonment of property that is security for a debt for which the taxpayer is the lender	All amounts	(To borrower) **January 31**
1099-B, Proceeds from broker and barter exchange transactions	Sales or redemptions of securities, futures transactions, commodities, and barter exchange transactions	All amounts	**February 15**
1099-C, Cancellation of debt	Cancellation of debt	$600 or more	**January 31**
1099-DIV, Dividends and distributions	Distributions, such as dividends, capital gain distributions	$10 or more, except $600 or more for liquidations	**January 31**
1099-INT, Interest income	Interest income	$10 or more ($600 or more in some cases)	**January 31**
1099-K, Payment card and third-party network transactions	Payment card transactions and third-party network transactions	$20,000 and 200 or more transactions	**January 31**
1099-MISC, Miscellaneous Income	Other income	$600 or more	**January 31**
1099-NEC, Non-employee compensation	Compensation as a no employee	$600 or more	**February 1**
1099-S, Proceeds from real estate transactions	Gross proceeds from the sale or exchange of real estate	Generally, $600 or more	**February 15**
1099-R, Distributions from pensions, annuities, retirement or profit-sharing plans, IRAs, insurance contracts, etc.	Distributions from retirement or profit-sharing plans, any IRA, insurance contracts, and IRA re-characterization	$10 or more	January 31

Form 8300

If a business receives a large cash payment as a result of a single transaction, or two or more related transactions, it is required to file Form 8300, Report of cash payments over $10,000 received in a trade or business. Any person in a trade or business who receives more than $10,000 in cash in a single transaction or in related transactions must file a Form 8300. This includes an individual, a company, a corporation, a partnership, an association, a trust, or an estate. A taxpayer is to file a Form 8300 with the IRS if any part of the transaction occurs within any of the 50 states,

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the District of Columbia, or a U.S. possession or territory (American Samoa, The Commonwealth of the Northern Mariana Islands, Guam, Puerto Rico and the U.S. Virgin Islands).

A taxpayer must file Form 8300 by the 15th day after the date of the cash transaction. The filing of the Form may be done by paper or electronically. Moreover, companies that file Form 8300 must furnish a written statement to each person whose name is required to be included in the Form 8300 by January 31 of the year following the transaction. This statement must include the name, address, contact person, and telephone number of the business filing Form 8300, the aggregate amount of reportable cash the business was required to report to the IRS from the person receiving the statement, and that the business provided this information to the IRS.

The penalty for negligent failure to timely file, to include all required information or to include correct information is $330 per return, not to exceed $3,987,000 per calendar year for 2024.

Payments and Deposit Obligations

A business taxpayer has the duty to deposit the federal income tax that is withheld, as well as both the employer's and employee's Social Security and Medicare taxes.

There are two deposit schedules, monthly and semi-weekly. Before the beginning of each calendar year, the taxpayer has to determine which of the two deposit schedules they are required to use, by using Forms 941,944 and 945 or Form 943. If the business taxpayer fails to make a timely deposit, he may face a failure-to-deposit penalty of up to 15%.

The deposits for FUTA Tax (Form 940) are required for the quarter within which the tax due exceeds $500. The tax must be deposited by the end of the month following the end of the quarter. The taxpayer is strictly required to use the electronic funds transfer (EFTPS) to make all federal tax deposits.

For excise taxes, which are paid when a specific product is purchased, the business taxpayer must report them on Form 720, Quarterly federal excise tax return. It is important to note that if a business accepts wagers or conducts a wagering pool (or lottery), it is possible that the business is liable for the federal excise tax regarding wagering. In this case. Form 730 must be used, as well as Form 11-C. The latter is necessary to register for any wagering activity, and also to pay the federal occupational tax on wagering.

Recordkeeping Requirements

Everyone in business must keep records. Good records will help the taxpayer/business owner:

1. **Monitor the progress of a business:** Good records can show whether a business is improving, which items are selling, or what changes are needed. Good records can increase the likelihood of business success.
2. **Prepare financial statements:** Business owners need good records to prepare accurate financial statements. These include income (profit and loss) statements and balance sheets. These statements can help when dealing with the bank or creditors and help manage the business. An income statement shows the income and expenses of the business for a given period of time. A balance sheet shows the assets, liabilities, and equity in the business on a given date.
3. **Identify source of receipts:** A business will receive money or property from many sources. Good records can identify the source of such receipts. This information is needed to separate business from non-business receipts and taxable from non-taxable income.

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4. **Keep track of deductible expenses:** It is easy to forget expenses when preparing a tax return unless there is a clear record of them indicating when they occur and the reason of the expense.
5. **Prepare tax returns:** Good records are needed when preparing tax returns. These records must support the income, expenses, and credits reported. Generally, these are the same records used to monitor a business and prepare financial statements.
6. **Support items reported on tax returns:** Business records must be kept available at all times for inspection by the IRS. If the IRS examines any tax returns, business owners may be asked to explain the items reported. A complete set of records will speed up the examination.

Records to Keep

Except in a few cases, the law does not require any specific kind of records. A business owner can choose any recordkeeping system suited to their business that clearly shows income and expenses.

The type of business affects the type of records needed to be kept for federal tax purposes. A business owner should set up a recordkeeping system using an accounting method that clearly shows the income for the tax year. If the taxpayer is in more than one business, they should keep a complete and separate set of records for each business. A corporation should keep minutes of any board of directors' meetings.

The recordkeeping system should include a summary of all business transactions. This summary is ordinarily made in the books (for example, accounting journals and ledgers).The books must show gross income, as well as deductions and credits. For most small businesses, the business checkbook is the main source for entries in the business books. In addition, supporting documents must also be kept.

Mileage Logs

Taxpayers, whether they deduct actual vehicle expenses (depreciation, gas, maintenance, insurance and other vehicle operating costs) or use the standard mileage method, must comply with the recordkeeping requirements for mileage. Vehicle logs must provide the following information for each business trip:

- Date.
- Destination.
- Business purpose.
- Start odometer reading.
- Stop odometer reading.
- Mileage.

Employees using their own vehicles must provide these details to their employer. If an employer reimburses an employee without the required documentation, the reimbursement is taxable income. If an employee uses a company vehicle, the IRS considers any usage that is unaccounted for as personal use and the value of unaccounted usage should be included in the employee's income for the employer to secure a deduction.

The IRS requires "contemporaneous" record-keeping for mileage. That means a recording at or near the time of the trip. A taxpayer may record the mileage at the time of the trip and enter the business purpose at the end of the week. To wait longer could raise suspicion about the validity of the vehicle log and potentially jeopardize the entire vehicle deduction for the taxpayer.

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Accountable Plan

This is defined as a plan that follows IRS regulations regarding the reimbursement of employees for business expenses in which reimbursements are not counted as income, meaning that they are not subject to the withholding of taxes or W-2 reporting. An accountable plan must comply with the following in order to qualify as such:

- Employees' expenses must have a business connection - that is, employees must have paid or incurred deductible expenses while performing services as an employee of their employer.
- Employees must adequately account to their employer for these expenses within a reasonable period of time.
- Employees must return any excess reimbursement or allowance within a reasonable period of time.

An employee is to adequately account to their employer for their expenses, by giving him or her a statement of expense, an account book, a diary, or a similar record in which the employee entered each expense at or near the time they had it, along with documentary evidence (such as receipts) of the employee's travel, mileage, and other employee business expenses.

An employee is to account for all amounts received from their employer during the year as advances, reimbursements, or allowances. This includes amounts charged to their employer by credit card or other method. An employee is also responsible for giving their employer the same type of records and supporting information that the employee would need to give to the IRS if it questioned a deduction on the taxpayer's return. The amount of any reimbursement or other expense allowance for which the taxpayer does not account for or that is more than the amount that was accounted for will need to be paid back by the employee.

The taxpayer also needs to maintain the documents regarding accountable plans.

How Long to Keep Records

The entity must keep their records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means the entity must keep records that support an item of income or deduction on a return until the period of limitations for that return runs out.

The period of limitations is the period of time in which the entity can amend their return to claim a credit or refund, or the IRS can assess additional tax. 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.

Businesses must maintain their tax records for three years from the date a tax return is due or filed, whichever is later, and must retain all employment tax records for at least four years. Records related to property transactions should be kept until the statute of limitations expires for the year in which the property was disposed of to calculate depreciation, amortization, depletion, or to compute gains and losses. Some records may need to be kept longer, especially those related to the basis of property for determining the basis of replacement property.

For specific conditions, if unreported income exceeds 25% of the gross income shown on the return, records must be kept for six years. If a fraudulent return is filed or no return is filed at all, there is no limitation period; thus, records should be kept indefinitely.

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Records for claims made for credit or refund after filing the tax return should be maintained for either three years from filing or two years from when the tax was paid, whichever is later. Additionally, records pertaining to losses from worthless securities or bad debt deductions must be preserved for seven years.

Selection of Business Entity

Every business entity has its advantages and disadvantages. When starting a business, a taxpayer must weigh the different options, according to what would best suit them, and based on that, make a choice.

Two of the most important factors in choosing a business entity or structure are the tax implications and the protection of personal legal liability. It is necessary to evaluate the Options that each of the entities offers with respect to these two issues, and to determine whether they would be beneficial in view of the current individual circumstances of each business owner, since each situation is different. There is no better business entity. The business entity that works best for a restaurant chain will not necessarily give the same results for a small restaurant. Other factors to consider are administrative costs or the future needs of the business, among others.

Sole Proprietorship

This is the simplest and most popular business entity in the country. According to the statistics supplied by the Small Business Administration of the United States, over 70% of the businesses in the United States are sole proprietorships. A sole proprietorship is a business entity that is not a corporation and is owned by only one person. Under this commercial structure, the company and the owner are one. The sole proprietorship is the creditor of all the income of the company, but is also unlimitedly liable for all debts, losses or lawsuits generated by the company.

Some of the advantages of choosing a sole proprietorship as a business entity are:

- **Easy to establish:** This business structure does not require formalities or endless bureaucratic processes to be established as long as one is the sole owner.
- **Affordable:** The costs to establish a sole proprietorship are minimal, and so are the administrative costs. Business expenses are easily identifiable. An owner has few employees, or in some cases none at all, so there are not many complications in withholding taxes to calculate or pay.
- **Easy tax preparing:** The tax preparation of a sole proprietorship is very simple because the owner and the company are one. The ease of this tax procedure makes it especially attractive, since both the income and expenses of the business are included in the owner's personal income tax return on Form 1040. However, it is important to note that the owner of a sole proprietorship is required to pay the self-employment tax, as well as estimated tax payments over their income.
- **No double taxation:** The income goes directly to the owner and is taxed by filing the individual tax return. As there is no difference between the company and the owner, the company's taxes are not reported separately as is the case with other business structures. This is known as pass-through taxation.
- **Total control regarding decision-making:** Because there is only one owner, this business structure offers complete management control to the taxpayer. The owner is the one who has complete control of the business and all important and not-so-important business decisions. Unlike other business structures that have multiple owners, the owner is not obligated to consult with a partner or shareholder about their decisions or activities.

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Some disadvantages affecting this business entity are:

- **Personal tax liability of the owner:** The lack of protection of a business owner's personal assets is the main disadvantage of this business structure. With unlimited liability, a business debt is also a debt of the owner. In the same way, a personal debt can also be claimed against the company's assets. Therefore, creditors, suppliers, or individuals who file a lawsuit against the company can make claims against the owner's personal assets, including his car, home, personal savings, and much more.
- **Difficulty in raising capital:** If a sole proprietorship does not have enough capital to support its operations, raising funds may be a difficult task because the responsibility rests solely with the business owner. Banking institutions are generally reluctant to lend money to a sole proprietorship because they are not sure if they will be able to get their money back if the business fails. The sole proprietorship will have to depend on its own sources of financing, whether through savings, mortgage loans, sale of property, financial help from family or friends.
- **Heavy responsibilities:** The flipside of having the total control and decision making power of a sole proprietorship is the immense pressure and even stress that it can cause in the business owner. Some people, however hard working and enterprising they may be, find it especially difficult to deal with this heavy burden on their shoulders because, ultimately, only the business owner is responsible for the successes and failures of their business.
- **Limited life:** A sole proprietorship cannot be transferred. It is and always will be the sole property of the owner. Unless the owner sells it, and then reports the sale of each asset, the life of a sole proprietorship is limited. In the event of death of the owner, a sole proprietorship is dissolved. If anything remains after the liquidation of all assets, it becomes part of the inheritance.

Partnership

Tax law defines a partnership as a union, group, joint venture, or other unincorporated organization through which any business, financial operation, or enterprise is conducted and which is not classified as a corporation. Simple co-ownership of property does not constitute a partnership; partners must engage in some form of business or financial activity.

Some advantages for choosing a partnership as a business entity include the following:

- **Easy to establish:** One of the advantages of this business entity lies in its ease at start-up. Although it could be possible to form a company without a written legal document, it is not the most advisable. A "partnership agreement" describes the roles of each partner, among other things.
- **Easy tax preparing:** Like sole proprietorships, companies also allow "pass-through taxation”, which prevents double taxation of income. This means that the company does not pay taxes; instead, the income goes directly to be declared by each partner. Said income is subject to tax.
- **Feasible attraction of capital and employees:** Due to the fact that the company has several partners, if it is necessary to obtain additional capital, each one of the partners may be called upon. It is also possible to create incentives to attract new qualified employees, such as offering the opportunity to acquire an interest in the company or become future partners.

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Partnerships report their income and expenses on Form 1065. The corporation itself does not pay income taxes. Each partner receives a Schedule K-1 to Form 1065, which indicates the partner's distributed portion of the partnership's income, expenses and other items as determined pursuant to the terms of the partnership agreement. It is noteworthy to add that partners are not considered employees; therefore, they will have to pay the SE tax. Moreover, they will have to make estimated tax payments over the income from the partnership.

Another thing to mention is that if the partnership has employees, it will have to pay the FUTA tax if it pays at least a total of $1,500 quarterly in salaries or has hired at least one employee for a 20-week calendar, counting every full-time, part-time employees and even temporary ones. However, partners should not be included, as they are not considered employees.

Some disadvantages to take into account when considering selecting a partnership are:

- **Unlimited joint and personal liability:** Just like a sole proprietorship, the unlimited liability of partnerships rests with the partners. The difference is that since the partners of a partnership are treated as equal owners, the partners are responsible not only for their own actions, but also for the company's debts and decisions made by other partners. In addition, the personal assets of all partners can be used to satisfy any debt of the partnership.
- **Taxes over earnings:** A company's profits (total sales minus expenses) are subject to tax, whether or not the partner has received his share. This includes any substantial amount of profit that each partner has set aside for future use in the business, such amounts being considered as taxable income of each partner.
- **Imputed underpayment:** In general, a partnership is not subject to any entity-level income tax. However, if the IRS adjusts a partnership return and determines that it has misreported its income, the partnership may be subject to the "imputed underpayment" rules. To determine an imputed underpayment, the partnership nets increase and decrease in taxable income as a result of the adjustment and multiplies the net amount by the highest rate currently in effect for C corporations or individuals in the year under review.
- **Complex procedures for dissolution:** While establishing a society is relatively easy, terminating it requires a somewhat complex process. This process includes notifications, distributions, or liquidations of the company's assets, among others.
- **Susceptibility to disputes between partners:** Oftentimes societies are made up of strong personalities who, beyond seeing collective progress, only see individual benefit and are not willing to work in teams or to reach compromises to resolve any dispute. Other times, it is the case that since the partners know that they will still receive the benefits derived from the success of the business, they commit abuses by not contributing in the same way as other partners regarding time, effort or resources. This behavior can lead to quarrels among partners.

Corporation

A corporation, broadly speaking, is a fully independent legal business entity that is created to operate a for-profit business. Unlike the other business structures mentioned above, in a corporation there is a fundamental separation between the entity itself and the people who created it or are in charge of its operations. This avoids the personal liability of the creators or those in charge of the corporation.

A corporation has a variety of advantages, including:

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- **Tax advantage:** The tax advantage of corporations is that when a corporation, an independent entity, has money in the bank or needs to accumulate additional money for the purchase of computers, for example, the IRS allows it to do so by paying a 15% tax, which is the federal corporate tax rate. If it were an LLC, said money would have had to pass as shares distributed to its members and thus pay taxes on their personal returns, even if they had not received the shares. Moreover, corporate tax rates are generally lower than the individual income tax rate.
- **Risk reduction of personal losses:** The personal liability of the owner of a corporation is protected, unless the owner has pledged their personal property, in case they fail to pay any debt to a creditor of the corporation. A corporation is a completely separate entity from its owner(s). A corporation has an autonomous legal personality.
- **Easy transfer:** Unlike other business entities, whose transfer of interests or shares can be very costly and require a lot of paperwork, corporations can easily do this by selling or simply endorsing their shares to the new shareholder. The key to a good transfer lies in the documentation that the shares themselves provide on the back.
- **Fundraising:** Corporations can raise funds or expand their capital by selling their securities or shares to the public. Investors, on the other hand, prefer the purchase of corporate stock because it offers them limited liability and the ease of transferring stock. Another way to raise capital is through commercial loans through banks.
- **Company credibility:** Sometimes the simple fact of having "Inc." or "Corp." at the end of a company's name gives the reliance and assurance that potential customers and suppliers need in order to approach the company and do business with it. A corporation symbolizes permanence, stability and the peace of mind of knowing that its activities are governed by strict laws and regulations.
- **Perpetual life:** A corporation has perpetual life since its existence does not depend on the life of its founders or owners as in other business entities. A corporation can exist even after the death of its owners.

When a person decides to incorporate a company, however, there are also some existing disadvantages to it:

- **Double taxation:** The nature of double taxation of corporations is one of the most important disadvantages of incorporating a business. Corporate double taxation means that:
  - The company itself is being taxed on the income it receives from its business transactions.
  - At the time the corporation makes distributions to its shareholders, pays dividends, or sells assets, for example, once the shareholders receive their dividends, they in turn will be taxed.
- **Costly incorporation:** Corporations are the business entities with the most expensive start-up expenses.
- **Difficult administrative management:** Since a corporation is a more complex legal entity, it requires more paperwork, detailed documentation, regular board meetings, and other requirements to maintain its legality. A corporation has to take minutes of each board meeting, draft by-laws and articles of incorporation, keep records of directors, shares and transfers, among many other requirements to follow to fulfill the duties of a corporation. In addition, additional tax returns and quarterly reports must be filed.
- **No tax credits:** Corporations cannot claim tax credits, unlike a sole proprietorship, which is able to claim them and deduct them from its income.
- **Personal guarantees granted to creditors:** Some creditors require the owner of a corporation to secure a loan in the name of the corporation with their personal property before receiving it. This is especially true if

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the corporation is new and does not yet have a credit history. If the corporation owner agrees to secure the corporation's loan with their personal property, the corporation's "limited liability" function becomes useless.

S Corporation

Unlike a C corporation, an S corporation does not have to pay tax at the corporate level. All items of income, deductions, credits, etc., are passed on from the corporation and are taxed to the shareholder. This concept of transfer creates unique additional advantages for S corporations, for example:

- **No double taxation:** Since income, deductions, credits, etc. are passed on to shareholders, the S corporation is generally not subject to tax. Therefore, income is only taxed once at the shareholder level.
- **Losses:** Shareholders may be able to take advantage of losses passed on to them from an S corporation on their personal tax return. However, they must have sufficient basis and must apply passive activity limitations.
- **Property distributions:** Similar to a C corporation, an S corporation that distributes an asset to a shareholder treats the asset as if it had been sold for its FMV. However, if some liabilities are assumed in connection with the distribution, the FMV cannot be less than those liabilities. For an S corporation, this does not create the problem of double taxation because the gain is not taxed by the S corporation. Instead, the gain is passed on and is taxed to the shareholder, which gives the shareholder an additional basis in the shares.
- **Charitable contributions:** Unlike a C corporation, charitable contributions made by an S corporation are not limited by the corporation's income. Charitable contributions are passed to shareholders as a separately established item and income limitations apply at the shareholder level.
- **Passive activities:** Income items that are passed on to shareholders who do not participate materially in the corporation's activities may be used to offset other passive losses.
- **Investment Interest Deduction:** Interest paid on debt to acquire shares of an S corporation is not automatically treated as a type of investment interest rate; instead, it can be deducted by shareholders as business interest if certain conditions are met.

An S corporation, like other business entities, has its share of disadvantages that should be taken into account Some of them are also found in a C corporation, as well as the following:

- **Professional fees:** In addition to the professional fees to establish the corporation, there are recurring professional fees involved in operating the corporation. These include accounting fees to establish and maintain the books, as well as legal fees to establish employee benefit programs, revise the corporation's bylaws as necessary, etc. There are professional fees for preparing the corporation's tax return.
- **Employee status:** Employee status can be either an advantage or a disadvantage. A shareholder who provides services for the corporation is generally treated as an employee. Thus, profits are reported to the shareholder on a Form W-2 and are subject to withholding tax, including FICA. An officer of the corporation is an employee in accordance with Section 3121(d)(1). This is the case whether the officer is a shareholder or not.
- **Employment taxes:** Employment taxes are generated on compensation paid to a shareholder/employee. There are special exceptions to withholding under FICA and FUTA for family members of a sole

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proprietorship. For example, a child under the age of 18 who works for their parent in a sole proprietorship is exempt from FICA withholding. These special exceptions do not apply in the case of corporations, even if the corporation has only one shareholder.

Commingling

This may be defined as the act of mixing the funds that belong to one party with those belonging to another party, particularly when one party is held responsible for keeping the funds separate. Spouses and business partners, in general, may commingle assets with no noticeable consequences, though partners need to account these to each other. A spouse also runs the risk of turning separate property into community property.

Trustees, guardians or lawyers that hold client funds must take especial care into not commingling those funds with their own, not even for investment, regardless of the benefits it may hold for the beneficiary and the trustee. If a businessperson commingles inadvertently or temporarily, it requires the immediate separation of funds, as well as accounting to the client or beneficiary.

Commingling is not recommended for any business entities, not even for sole proprietorships. The following are some reasons why it is advisable for the taxpayer to separate their business bank account from their personal bank account:

1. **Business or hobby:** Only businesses can deduct business expenses, according to the IRS. If the incurred expenses while the taxpayer runs their business go through a personal bank account, the IRS may be led to consider the business as a hobby.
2. **Difficulties during tax season:** It will be considerably difficult for a taxpayer to separate their personal transactions from the business transactions when the time comes to report the income and the expenses related to the latter.
3. **Limited audit trail:** While the U.S. government does not require a taxpayer for a specific recordkeeping method or a separate bank account for business, it does request that the records used are to be accurate, complete, permanent, and that they show a clear record of income and deductions. To not have a separate bank account for business will make the recordkeeping difficult and unclear.
4. **Possibility of missing deductions:** Related to the above point, the commingling of bank accounts may lead to several disorienting transactions, that may make easier the overlooking of deductions. This will cost time and money to the taxpayer.
5. **Lack of professionalism:** To write a check using a taxpayer's personal name instead of their business may denote a lack of competence in running a business. It is important that the taxpayer conducts their business in an orderly and respectable manner.

Separation of Business and Personal Accounts

- If a taxpayer seeks to establish a clear difference between business and personal income and expenses, they must take the following steps:
- **Step 1:** Define clearly the structure that will best suit a taxpayer's needs.
- **Step 2:** Apply for an Employer Identification Number (EIN), which the IRS uses to track a taxpayer's business earnings, as well as the number to be used to file a business tax return.

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- **Step 3:** Open separate spending accounts. For the opening of bank accounts as a sole proprietor, a taxpayer will need their EIN and their SSN. Partnerships have the additional requirement of presenting a copy of the partnership agreement.

Corporations will need an EIN, as well as a copy of the articles of incorporation.

- **Step 4:** The taxpayer will need to implement an accounting system that is beneficial for him or her, and consider whether they will be responsible for recordkeeping, or if it is better for the taxpayer to hire an accountant.
- **Step 5:** To open separate lines of credit for the business will benefit the taxpayer regarding the use of credits or loans to finance their activity.

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REVIEW QUESTIONS

1. Regarding the accrual method of accounting, the income should be reported on the earliest of the following dates, except:

A. When title has not passed.
B. When payment is received.
C. When the income is earned.
D. When the income is due.

Answer: A

Under an accrual method of accounting, report income on the earliest of the following dates:

- *When payment is received.*
- *When the income is due.*
- *When the income is earned.*
- *When title has passed.*

2. Over what amount should a business report a large cash payment in Form 8300?

A. $20,000.
B. $50,000.
C. $5,000.
D. $10,000.

Answer: D

Any person in a trade or business who receives more than $10,000 in cash in a single transaction or in related transactions must file a Form 8300. This includes an individual, a company, a corporation, a partnership, an association, a trust, or an estate.

3. Which is the penalty for failing to file Form 8300?

A. $50.
B. $100.
C. $250.
D. $1,000.

Answer: B

Failure to file Form 8300 may result in a late filing penalty of $100 for each occurrence, for a maximum amount of $500,000 per fiscal year if the business makes less than $5 million.

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4. Which of these advantages is specific to an S corporation?

A. Easy transfer.
B. Company credibility.
C. No double taxation.
D. None of the above.

Answer: C

These advantages are specific to an S corporation:

- *No double taxation.*
- *Possibility for shareholders to take advantage of losses.*

All other options (A and B) are advantages that may apply to both S and C

5. Which of these disadvantages specifically affects a partnership?

A. Limited joint and personal liability.

B. Complex procedures for dissolution.

C. A and B.

D. Double taxation.

Answer: B

These are the disadvantages that affect a partnership:

- *Unlimited joint and personal liability.*
- *Taxes over earnings.*
- *Imputed underpayment.*
- *Complex procedures for dissolution.*

The limited life disadvantage specifically affects a sole proprietorship, because it cannot be transferred.

6. Which of these is an advantage applying to sole proprietorships?

A. Risk reduction of personal losses.

B. Total control with decision-making.

C. Attraction of capital and employees.

D. Passive activities.

Answer: B

Sole proprietors enjoy the following advantages:

- *Easy to establish.*
- *Affordable.*
- *Easy tax preparing.*

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- *No double taxation.*
- *Total control regarding decision-making.*

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Advice on Accounting Methods and Procedures

An accounting method is a set of rules used to determine when and how income and expenses are reported. Accounting methods include not only the overall method of accounting, but also the accounting treatment used for any material item.

The method of accounting is chosen when the first tax return is filed: If a taxpayer wants to change the accounting method after that, the IRS must give its approval. No single method of accounting is required by all taxpayers. An accounting method clearly reflects income only if all items of gross income and expenses are treated the same from year to year.

Different accounting method may be used for another separate business: If a taxpayer operates two or more separate and distinct businesses, a different accounting method can be used for each business if the method clearly reflects the income of each business. However, if different accounting methods are used to create or shift profits or losses between businesses (for example, through inventory adjustments, sales, purchases, or expenses) so that income is not clearly reflected, the businesses will not be considered separate and distinct.

Types of Accounting Methods

There are 3 types of accounting methods:

- Cash method.
- Accrual method.
- A hybrid method which combines elements of two or more of the above accounting methods.

Cash Method

This is the accounting method that is used the most by individuals and small businesses. All items of income that are actually or constructively received during the tax year must be included in the taxpayer's gross income. In the case of property and services received, their FMV must be shown in the income.

If the taxpayer chooses the cash method, they are to deduct expenses in the tax year that they were paid, including business expenses for which the taxpayer contests liability. Expenses paid in advance may not be deductible.

Expenses paid in advance

These are deductible only in the year to which they apply, unless they qualify for the 12-month rule. Under said rule, the taxpayer does not need to capitalize amounts paid to create certain rights or benefits for him or her, as long as they do not extend beyond the earlier of the following:

- 12 months after the right or benefit begins, or
- 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 paid in advance, then they are required to obtain approval from the IRS before using the general rule and/or the 12-month rule.

Example: Amelia is a calendar year taxpayer and pays $3,000 in 2024 for a business insurance policy that is effective for three years (36 months), beginning on July 1st, 2025. The general rule that an expense paid in advance is

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deductible only in the year to which it applies is applicable to this payment because the payment does not qualify for the 12-month rule. Therefore, only $500 (6/36 x $3,000) is deductible in 2024, $1,000 (12/36 x $3,000) is deductible in 2025, $1,000 (12/36 x $3,000) is deductible in 2026, and the remaining $500 is deductible in 2027.

The following entities cannot use the cash method of accounting or any combination that includes it:

- A corporation (other than an S corporation) with average annual gross receipts for the 3 preceding tax years exceeding $30 million (indexed for inflation).
- A partnership with a corporation (other than an S corporation) as a partner, with average annual gross receipts for the 3 preceding tax years exceeding $30 million (indexed for inflation).
- A tax shelter.
- The following entities can use the cash method of accounting:
- Any corporation or partnership, other than a tax shelter, meeting the gross receipts test.
- A qualified Personal Service Corporation (PSC).

Gross receipts test

A corporation or a partnership meets the test if its average annual gross receipts for the 3 preceding tax years were $30 million or less (indexed for inflation). An entity's average annual gross receipts may be computed by:

- Adding the gross receipts for the 3 preceding tax years; and
- Dividing the total by 3.

Generally, a partnership applies to the test at the partnership level. Gross receipts for a short tax year are annualized. Organizations that are members of an affiliated service group or a controlled group of corporations treated as a single employer for tax purposes must aggregate their gross receipts to determine whether the gross receipts test is met.

If a corporation or partnership does not meet the gross receipts test for any tax year cannot use the cash method and must change to an accrual method of accounting, effective for the tax year in which the entity fails to meet this test.

Special rules for farming businesses

A taxpayer that engages 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, unless they meet the gross receipts test discussed above.

Accrual Method

Under this accounting method, a taxpayer reports income in the year it is earned, and deducts or capitalizes expenses in the year that they were incurred. In general, an amount is included in gross income for the tax year in which all the events fixing the right to receive the income have occurred, and the taxpayer can determine the amount with reasonable accuracy. The amount in the taxpayer's gross income is to be reported on the earliest of the following:

- When payment is received by the taxpayer.
- When the income amount is due to the taxpayer.
- When income is earned by the taxpayer.

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- When title passes.

If the taxpayer includes a reasonably estimated amount in gross income and later determines the exact amount is different, they must take the difference into account in the tax year that determination is made.

If a taxpayer performs services for a basic rate specified in a contract, they are to accrue the income at the basic rate, even if the taxpayer agreed to receive payments at a reduced rate. Until the services are completed, the taxpayer must continue this procedure, then account for the difference.

Advance payments

If using the accrual method, the inclusion of the advance payment in income may be postponed until the next year, but no further than that. For this purpose, advance payments are to be:

- Includible in gross receipts under the method of accounting used, and
- Included in income in the taxpayer's applicable financial statements.

When including income from advance payments on agreements for future sales or other dispositions of goods that are held primarily for sale to customers, then special rules apply. Agreements include a gift certificate that can be redeemed for goods. To report these advance payments, it is required to include them in income in the year that they were received, but a taxpayer may use the alternative method.

Alternative method of reporting

Here, advance payments are included in income in the earlier tax year in which the taxpayer:

- Included advance payments in gross receipt under the method of accounting used, and
- Included any part of advance payments in income for financial reports (to shareholders, partners, beneficiaries and other proprietors for credit purposes) under the method of accounting used.

Under the accrual method of accounting, business expenses are deducted or capitalized when both the following apply:

- The all-events test has been met. The test is met when:
  - All events have occurred that fix the fact of liability, and
  - The liability can be determined with reasonable accuracy.
- Economic performance has occurred.

Hybrid Method

Generally, a taxpayer may use any combination of cash, accrual, and special methods of accounting (these tend to be very specific, such as the crop method), as long as the combination reflects their income in a clear manner, and it is used consistently by the taxpayer, though the following restrictions apply:

- If the taxpayer needs an inventory to account for their income, they must use an accrual method for purchases and sales.
- If the taxpayer uses the cash method for reporting their income, the cash method must be used.
- If the taxpayer uses the accrual method for the reporting of expenses, they have to use this same method to figure the income.

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- Any combination including the cash method is treated as the cash method for purposes of Section 448 of the IRC.

Transfer of Property In or Out of the Business

Contributed Property

For purposes of defining what is the election to transfer goods, contributed property means each property, partnership interest, contract right or other asset, in such form as may be permitted by the Act, that is contributed or deemed contributed to a partnership by any partner. This includes any interest in any successor partnership occurring as a result of a termination of the partnership pursuant to IRC Section 708.

When contributing property to a partnership in exchange for partnership interest, a taxpayer usually does not recognize gain or loss on the contribution, so the basis that the taxpayer had on the property becomes both the basis the partnership obtains in the property and the basis gotten by the taxpayer in the partnership interest received.

If contributed property has a built-in loss, the built-in loss is taken into account only in determining the amount of items allocated to the contributing partner.

Section 704(c) of the IRC establishes certain rules in order to prevent a partner from contributing appreciated property to a partnership, and then shifting that pre-contribution gain to a non-contributing partners).

Example: Maria and Luis decide to form Comet, LLC. Maria will contribute raw land with a tax basis of $4,000 and a FMV of $10,000. Luis will contribute $10,000 cash. Maria and Luis will share all income and loss on a 50/50 basis. Upon formation, Section 721 provides that Maria recognizes no gain upon the transfer of the land to Comet, LLC., even though the land is appreciated by $6,000. Instead, the gain is deferred and preserved by virtue of sections 722 and 723, which provide that:

- Comet, LLC., takes a basis in the land equal to Maria's basis in the land, or $4,000; and
- Maria takes a tax basis in her LLC interest equal to her basis in the land, or $4,000.

This way, if either

- Comet, LLC., sells the land for its value of $10,000, or
- Maria sells her LLC interest for its value of $10,000, the $6,000 of gain inherent in the land will be recognized.

Distributions

A distribution is a company's payment of cash, stock, or physical product to its shareholders. Distributions are allocations of capital and income throughout the calendar year. When a corporation earns profits, it can choose to reinvest funds in the business and pay portions of profits to its shareholders.

Shareholders can receive distributions on a regular basis, such as monthly, quarterly, or annually. Said distributions are common with pass-through entities, such as an S Corporation or Limited Liability Company (LLC). Companies with pass-through taxation are not taxed directly. Instead, taxable company profits are passed through to shareholders.

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Although there are various payment options, distributions are normally given in the form of cash. A recipient of a cash distribution must treat the payout as a type of income, and the recipient must report payouts to the IRS using specific forms. S corporations, for instance, are to report income on Schedule K-1 to file a business tax return.

Other types of business distributions are:

- **Owner's distributions:** These are earnings an owner withdraws from their business. Business owners may utilize distributions for personal use or place distributions in business accounts for future use.
- **Mutual funds distributions:** A mutual fund company typically gives earnings and other types of payouts to investors or shareholders as distributions. Mutual fund distributions are earnings from a fund's operation. Unlike regular shareholder dividends, a mutual fund is required by law to pass profits back to investors or shareholders. Types of distributions for mutual funds include ordinary dividends, qualified dividends, and capital gains.

Life Cycle of a Business

As entities, business all has a determined cycle in which the owner establishes the business, it prospers and grows, and eventually it is dissolved for a number of reasons.

The life cycle of a business can usually be identified within 5 stages:

- Launch: As revenue is low and initial startup costs are high, businesses are prone to incur losses in this stage. In fact, throughout the entire business life cycle, the profit cycle lags behind the sales cycle and creates a time delay between sales growth and profit growth. This lag is important as it relates to the funding life cycle. At launch, when sales are the lowest, business risk is the highest. During this phase, it is impossible for a company to finance debt due to its unproven business model and uncertain ability to repay debt. As sales begin to slowly increase, the corporations' ability to finance debt also increases.

- Growth: As sales increase rapidly, businesses start seeing profit once they pass the break-even point. However, as the profit cycle still lags behind the sales cycle, the profit level is not as high as sales. Finally, the cash flow during the growth phase becomes positive, representing an excess cash inflow. During the growth stage, companies start seeing profit and positive cash flow, which evidences their ability to repay debt.

- Shakeout: Here, sales keep increasing, but at a lower rate, which in itself may be caused by either the market approaching saturation or the appearance of new competitors. In this phase, sales do tend to peak, but the profit slowly decreases, meaning that costs will increase significantly. The industry experiences steep growth, leading to fierce competition in the marketplace. However, as sales peak, the debt financing life cycle increases exponentially. Companies prove their successful positioning in the market, exhibiting their ability to repay debt.

- Maturity: In this stage, sales begin to decrease slowly, and profit margins get thinner, as the cash flow remains stagnant. As firms approach maturity, major capital spending is largely behind the business, and therefore cash generation is higher than the profit on the income statement. Business risk moves in correlation with sales to the point it carries no business risk. This stage is crucial, since a business in this stage may need to reinvent itself, invest in innovative technologies and in emerging markets in order to

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experience a renewed growth. Companies that fail to keep the pace will proceed to the next and final stage of a business.

- Decline: Sales, profit, and cash flow all decline. During this stage, companies accept their failure to extend their business life cycle by adapting to the changing business environment. Firms lose their competitive advantage and finally exit the market.

It is important that the owner of a business rightfully acknowledges the current state of their entity, so that they can make the right decisions on time, whether those decisions are changing the type of entity to encourage growth, or to accept that the company owned is failing, and that drastic changes will need to be made before the owner finds himself or herself in a dire situation. The business owner will also need to prepare himself or herself for the required paperwork regarding the election to change to another business entity, to terminate it, or to transfer it.

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REVIEW QUESTIONS

1. For partnerships, which is the penalty for late filing of the return?

A. $230.

B. $245.

C. $205.

D. None of the above.

Answer: B

A penalty is assessed against the business if it is required to file a 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. For partnerships, the penalty is of $245, 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.

2. When can shareholders receive distributions?

A. Quarterly, monthly and annually.

B. Monthly and annually.

C. Just quarterly.

D. Just monthly.

Answer: A

Shareholders can receive distributions on a regular basis, such as monthly, quarterly, or annually.

3. Which of the following taxpayers may use the cash method of accounting even if they produce, sell or purchase merchandise?

A. A partnership whose average annual gross receipts for the 3 preceding tax years are less than $30 million.

B. A and C.

C. A partnership whose business is a tax shelter.

D. A corporation otherwise prohibited to use the cash method.

Answer: A

- The following entities cannot use the cash method of accounting:
- A corporation (other than an S corporation) with average annual gross receipts for the 3 preceding tax years exceeding $30 million (indexed for inflation).
- A partnership with a corporation (other than an S corporation) as a partner, with average annual gross receipts for the 3 preceding tax years exceeding $30 million (indexed for inflation).
- A tax shelter.

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Types of Industry

Since 2018, the IRC Section 199A provides a 20% deduction of domestic qualified business income from a partnership, S corporation or sole proprietorship to non-corporate taxpayers, i.e., individuals, trusts and estates.

However, Specified Service Trade or Businesses (SSTBs) are excluded from this provision if the non-corporate taxpayer's taxable income, for 2024 year, exceeds $483,900 for married taxpayers filing jointly, $241,950 for all other returns.

In proposed regulations for the IRC Section 199A, the IRS and U.S. Department of the Treasury define an SSTB as any trade or business involved in the performance of services in any of the following categories:

Category	Includes	Does not Include
Health	Medical services provided by individuals directly to a patient (service recipient), such as physicians, pharmacists, nurses, etc.	Services not directly related to a medical service field, such as the operation of health clubs or health spas that provide physical exercise or conditioning to their customers.
Law	Performance of services in the field of law, such as lawyers, paralegals, legal arbitrators, mediators and similar professionals	Services that do not require skills unique to the field of law, e.g., printer services.
Athletics	Services performed by individuals who participate in athletic competitions, such as athletes, coaches and team managers in sports.	Services that do not require skills unique to athletic competition, such as the maintenance and operation of the equipment or facilities used in athletic event
Trading	Performance of services consisting of trading services, commodities or partnership interest.	A manufacturer or farmer who engages in hedging transactions as part of their trade or business of manufacturing or farming.
Dealing	Services consisting of dealing in securities, commodities or partnership interests, such as regularly purchasing and selling to customers in the ordinary course of business or regularly offering to enter into, assume, offset, assign or otherwise terminate positions in securities, commodities or partnership interests.	A taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans but engages in no more than negligible sales of loans.
Accounting	Services provided by accountants, enrolled agents, return preparers, financial auditors and similar professionals.	Payment processing and billing analysis.
Actuarial	Science Services provided by actuaries and similar professionals.	Analysts, economists, mathematicians and statisticians not engaged in analyzing or assessing the financial cost of risk or uncertainty of events.

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Brokerage Services	Services in which a person arranges transactions between a buyer and seller regarding securities, such as stockbrokers or similar professionals.	Services provided by real estate agents and brokers, or insurance agents and brokers.
Investment Management	Services that consist of investing and investment management involving the receipt of fees for providing investing, asset management or investment management, including providing advice with respect to buying and selling investments.	Management of real property.
Financial Services	Services provided by financial advisors, investment bankers, wealth planners and retirement advisors and other similar professionals. Managing wealth, advising clients and providing advisory and other similar services.	Banking.
Performing Arts	Services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors and similar professionals.	The maintenance and operation of equipment or facilities used in the performing arts or services by those who broadcast or otherwise disseminate video or audio of performing arts to the public.
Consulting	Professional advice and counsel to clients to assist the client in achieving goals and solving problems. Providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such.	Services other than advice and counsel, such as sales or economically similar services or providing training and educational courses.
Reputation or Skill of Employees/Owners	Fact patterns in which the taxpayer is engaged in the trade or business of one or more of the following: -Receiving income for endorsing products or services. -Licensing or receiving income for the use of an individual's image, likeness, name, signature, voice, trademark or other symbols associated with the individual's identity. -Receiving fees or income for an appearance at an event or on radio, television or other media formats.	

Worker Classification

An employee is anyone who has agreed to be employed, under a contract of service, to work for some form of payment. This can include wages, salary, commission and piece rates. People who can be classified as an employee are:

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- Homeworkers.
- People who have been offered and have accepted a job.
- Fixed-term employees.
- Seasonal employees.
- Casual and part-time employees.
- Employees on probationary and trial periods.

An employee is not:

- A self-employed or independent contractor.
- A real estate agent whose agreement says they are an independent contractor.
- A volunteer who does not receive a reward for working.
- In some cases, a person who is engaged in film production.

Generally, a taxpayer is self-employed if any of the following apply:

- They carry on a trade or business as a sole proprietor or an independent contractor.
- They are a member of a partnership that carries on a trade or business.
- They are otherwise in business for themselves (including a part-time business).

It is important to note the difference between an independent contractor and an employee, as while a business may pay both for similar services, for tax purposes, there are significant differences: a business withholds Social Security, Medicare and income tax for an employee, but not for an independent contractor. These questions may be useful in order to determine whether an individual is an employee or an independent contractor:

- Does the company control or have the right to control what the worker does and how the worker does the job?
- Does the company control the business aspects of the worker's job? These include arrangements like how the worker is paid, whether expenses are reimbursed, and who provides tools and supplies.
- Is there a written contract or employee benefits such as a pension plan, insurance, or vacation pay?
- Will the relationship continue?
- Is the work a key aspect of the business?

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The following table further highlights the difference between an employee and an independent contractor:

Description	Employee	Contractor
Employment Laws	Covered by a number of federal and state employment and labor laws.	Not covered by employment and labor laws.
Hiring Practice	A potential employee completes an application that is handled by Human Resources. The approved applicant receives a job offer. After a person accepts the position, the employer must ask for additional information about the employee such as date of birth, marital status, and citizenship status.	A potential contractor normally interacts with the person or department that wants a certain service or task completed. A potential contractor might complete a proposal. The contractor enters into a contract, including a Statement of Work with the legal or procurement section of the business.
Tax Documents	Provides name, address, Social Security number, tax filing status, and number of exemptions on a W-4.	Provides name, address, TIN, and certification about back up withholding on a W-9.
Payer's reporting requirements	Reports all money paid to the employee during the tax year on a W-2.	Reports payments of $600 or more in a calendar year on a Form 1099.
Reporting to Other agencies	Reports for state and federal Unemployment Insurance.	None.
Value of Work or Contract	Earns either an hourly rate or a salary.	A contract may be for a total amount. It could be for an hourly, daily, or weekly amount that ends on a specific date or a total amount to be paid when the job is completed.
When Paid	An employee pay period must remain the same unless formally changed. Pay periods vary from one week to one month. Federal and state laws require that an employee be paid on the normal pay date or earlier if the paycheck is not negotiable on the normal pay date, which can occur on holidays.	Accounts Payable pay a contractor after receiving an invoice. The terms of the contract or Statement of Work dictate when payments are made, such as upon completion of a task or by periodic amounts. Contractors are not paid by payroll staff in most businesses.

Independent Contractor Vs. Employee

For federal employment tax purposes, the usual common law rules are applicable to determine if a worker is an independent contractor or an employee. Under the common law, it must be examined the relationship between the worker and the business. The taxpayer should consider all evidence of the degree of control and independence in this relationship. The facts that provide this evidence fall into three categories as follows.

Behavioral Control

This covers facts that show if the business has a right to direct and control what work is accomplished and how the work is done, through instructions, training, or other means.

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Financial Control

This covers facts that show if the business has a right to direct or control the financial and business aspects of the worker's job. This includes:

- The extent to which the worker has unreimbursed business expenses,
- The extent of the worker's investment in the facilities or tools used in performing services,
- The extent to which the worker makes their services available to the relevant market,
- How the business pays the worker, and
- The extent to which the worker can realize a profit or incur a loss.

Relationship of the Parties

- This covers facts that show the type of relationship the parties had. This includes:
- Written contracts describing the relationship the parties intended to create.
- Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.
- The permanency of the relationship, and
- The extent to which services performed by the worker are a key aspect of the regular business of the company.

Full-time Employee Vs. Part Time Employee

For purposes of the employer shared responsibility provisions, a full-time employee is, for a calendar month, an employee employed on average at least 30 hours of service per week, or 130 hours of service per month.

- There are two methods for determining full-time employee status:
- The monthly measurement method.
- The look-back measurement method.

Under the monthly measurement method, the employer determines if an employee is a full-time employee on a month-by-month basis by looking at whether the employee has at least 130 hours of service for each month.

Part-time Employee Definition: Regularly scheduled work from 16 to 32 hours per week performed by an employee as defined in 5 USC Section 3401(a) through (f) with an appointment in Tenure Group I or II and who was employed on a part-time basis on or after April 8,1979.

Hours may temporarily change for up to two consecutive weeks; if necessary, to meet the needs of the organization's workload requirements, training, and the mission of the Service, but the employee’s schedule must remain at 32 hours per week or less.

An agency may permit an employee who has an appointment in Tenure Group I or II to perform regularly scheduled work from 1 to 15 hours per week under the exception contained in 5 CFR Section 340.101(a) and the authority in 5 USC Section 3402(a)(3).

Outside Sales

Outside sales employees, also known as “field sales," tend to work without a formalized schedule, which may offer flexibility but may also mean that a salesperson is always on call to meet the demands of a customer.

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Deductions and Credits for Tax Planning

Timing of Income and Expenses

It is important for a business owner to learn how the timing of expense and income recognition may affect their financial statements. Generally, the income is recognized in the period in which it is earned.

Example: Orquideas, Inc, enters into a new trading relationship with Juan, and it enters into an agreement to sell the buyer some of its goods. Orquideas, Inc. delivers the products but does not receive payment until 30 days after the delivery. While the company had an agreement with Juan and followed through on its end of the contract, since there was no pre-existing relationship with him prior to the sale, a conservative accountant might not recognize the revenue from that sale until Orquideas, Inc. receives payment 30 days later.

The assets produced and sold or services rendered to generate revenue also generate related expenses. Accounting standards require that companies using the accrual basis of accounting and match all expenses with their related revenues for the period, so that the income statement shows the revenues earned and expenses incurred in the correct accounting period.

The matching principle, part of the accrual accounting method, requires that expenses be recognized when obligations are:

- Incurred (usually when goods are transferred, such as when they are sold or services rendered) and
- The revenues that were generated from those expenses (based on cause and effect) are recognized.

If no cause-and-effect relationship exists (e.g., a sale is impossible), costs are recognized as expenses in the accounting period they expired (e.g., when they have been used up or consumed, spoiled, dated, related to the production of substandard goods, or the services are not in demand). Examples of costs that are expensed immediately or when used up include administrative costs, R&E, and prepaid service contracts over multiple accounting periods.

Often, a business will spend cash on producing their goods before it is sold or will receive cash for goods it has not yet delivered. Without the matching principle and the recognition rules, a business would be forced to record revenues and expenses when it received or paid cash. This could distort a business's income statement and make it look like they were doing much better or much worse than is actually the case. By tying revenues and expenses to the completion of sales and other money generating tasks, the income statement will better reflect what happened in terms of what revenue and expense generating activities during the accounting period.

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Depreciation Vs. Section 179 Vs. Bonus Depreciation

A responsible business owner must be aware of the difference between these three methods, in order to plan appropriately according to the assets they have in possession.

The following table resumes the key differences between depreciation, expenses under Section 179, and bonus depreciation:

Description	Depreciation	Section 179 Expenses	Bonus Depreciation
Qualified property	All of the following: - Property owned by the taxpayer. - Property used in trade or business or to generate income. - Determinable useful life longer than a year. - Subject to wear and tear, decay or decline from natural causes.	Section 1245 property, purchased computer software, qualified real property, acquired from unrelated party, used more than 50% in active business.	Eligible Section 168 recovery property with a recovery period of 20 years or less, depreciable computer software not amortizable under IRC Sec. 197, water utility property, qualified film or television production property, qualified live theatrical production property.
Maximum limit	None.	$1,220,000 (in 2024).	None.
Property ceiling	None.	Decreased by $1 for each $1 of property placed in service in excess of $3,050,000 (for 2024).	None.
Taxable income limitation	No.	Yes.	No.
AMT limitations	Same as regular tax.	Same as regular tax.	Same as regular tax.
Election required	No, but the recapture is required when selling the property.	Yes.	No, out it needs an election to opt out of it.
Statutory end date	Depends on the asset classes.	No.	80% until December 31, 2023, phases down to 60% in 2024, 40% in 2025, and 20% in 2026. An extra year is added for long-term production property.
Carryforward available	No.	Carried forward indefinitely as Section 179 deduction.	Carried forward indefinitely as part of general net operating loss carryforward.
Effect on MQ convention	MQ convention is an element of depreciation itself.	None Assets expensed under Section 179 are not considered in calculation.	Included in calculation. If 40% of assets purchased in last quarter, mid-quarter convention will apply. If all assets eligible for bonus depreciation, mid-quarter convention will have no effect on amount of depreciation claimed.
Effect on QBI deduction	None.	Assets for which Section 179 deduction is claimed are included in the wage/investment limitation calculation.	Assets for which 100% bonus depreciation is claimed are included in the wage / investment limitation calculation.

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Specific property selected	No, as it is classified in asset classes.	Yes — Section 179 election is made on property-by-property basis.	No — Bonus depreciation is mandatory; must elect out and election out is for each class of property, not each individual property.
Election revocable	Does not apply.	Yes, until statute of limitations on return has passed.	Election out of bonus depreciation must be made by the due date, including extensions, of he tax return.
Subject to luxury auto limitations under Section 280F	Yes — for cars placed in service for which no bonus depreciation deduction applies: - $12,400 for the year it was placed in service; - $19,800 for the second tax year, - $11,900 for the third tax year; and - $7,160 for each succeeding year.	Yes — if electing out of bonus depreciation, subject to first-year maximum deduction of $12,400 (for 2024). If not electing out of bonus depreciation, will be eligible for additional $8,000 first-year depreciation.	Yes — luxury autos acquired after September 27, 2017, qualify for a bonus depreciation of $20,400 for the year they are placed in service, plus: - $19,800 for the second tax year; - $11,900 for the third tax year; and - $7,160 for each succeeding year.

ACA Compliance

The Affordable Care Act (ACA) has various complex requirements that must be met by businesses, and many keep on wondering on the level of preparedness in terms of compliance with the ACA. The ACA requires employers to ensure that employees' health, social security and other aspects affecting the relationship between the employers and the employees are well followed and that those businesses that fail to comply are well punished. The best form of punishment for non-compliance is through the use of penalties.

If a business taxpayer has at least 50 full-time equivalent employees and is an Applicable Large Employer (ALE), they are to issue Form 1095-C to them until March 31 (a two-month extension from the original due date, January 31,2025). If the taxpayer's business sponsors self-insured group plans, then they must use Form 1095-B to report coverage. These are to be filed with the IRS by February 28, 2025 if filing on paper or March 31, 2025, if filing electronically.

ALEs are required to offer health insurance that is comprehensive (i.e., providing minimum value) and affordable. If they fail to do so, they may be subject to an employer mandate penalty, as their employees could be eligible for premium subsidies in the health insurance exchange.

To be affordable, the employee's share of the premiums must not exceed a certain percentage of their household income. For 2024, the rate is of 8.39%. This is only based on the cost of the employee's premium; it does not take into account the cost to add dependents.

For employers to confirm that the coverage offered by them is affordable, they may use safe harbor methods, such as the federal poverty level safe harbor method: In this manner, the employer may determine the maximum amount an employee would pay for their own coverage by calculating 8.39% of the poverty level, for 2024, and then dividing that number by 12. Hence, an employee would not be forced to pay more than $101.94 (($14,580 x 8.39%) / 12) per month for coverage in 2024.

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Adjusted Employer Mandate Penalties

If an Applicable Large Employer (ALE) does not offer coverage to at least 95% of their full-time workers, or said coverage is not affordable or provides minimum value, they are subject to a penalty by the IRS. There are different penalty calculations for those two scenarios, but both are based on numbers that are indexed each year.

If an ALE does not offer any coverage, they are subject to a penalty of $2,970 in 2024, per full-time employee (minus the first 30 employees). The calculation includes, however, employees working full-time that have minimum essential coverage whether under the employer's plan or from another source.

On the other hand, if an ALE does offer minimum essential coverage, but it is not affordable, did not provide minimum value or the employee did not belong to the 95% that were offered minimum essential coverage, then the ALE is subject to a $4,460 penalty, for 2024.

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REVIEW QUESTIONS

1. For the tax year 2024, which is the maximum amount an employee must pay for health insurance coverage, for the employer to comply with the ACA?

A. $103.28
B. $101.94
C. $103.15
D. $96.08

Answer: B

For employers to confirm that the coverage offered by them is affordable, they may use safe harbor methods, such as the federal poverty level safe harbor method: In this manner, the employer may determine the maximum amount an employee would pay for their own coverage by calculating 8.39% of the poverty level, for 2024, and then dividing that number by 12. Hence, an employee would not be forced to pay more than $101.94 per month for coverage in 2024.

2. Regarding ACA compliance, for an Applicable Large Employer to offer a health insurance that is comprehensive and affordable, which should be the maximum rate of the employee's share of the premiums for 2024?

A. 9.61%.
B. 8.86%.
C. 9.12%.
D. 8.39%.

Answer: D

Applicable Large Employers (ALEs) are required to offer health insurance that is comprehensive (i.e., providing minimum value) and affordable. To be affordable, the employee's share of the premiums must not exceed a certain percentage of their household income. For 2024, the rate is of 8.39%.

3. Which of the following applies to contractors?

A. They provide name, address, Social Security number, tax filing status, and number of exemptions on a W-4.
B. They provide name, address, TIN, and certification about back up withholding on a W-9.
C. A and B.
D. None of the above.

Answer: B

A contractor must provide their name, address, TIN, and certification about back up withholding on a W-9. All others apply to employees instead.

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4. Who does not qualify as an employee?

A. Seasonal employees.

B. An independent contractor.

C. Homeworkers.

D. A and B.

Answer: B

An employee is anyone who has agreed to be employed, under a contract of service, to work for some form of payment. This can include wages, salary, commission, and piece rates. People who can be classified as an employee are:

- *Homeworkers.*
- *People who have been offered and have accepted a job.*
- *Fixed-term employees.*
- *Seasonal employees.*
- *Casual and part-time employees.*
- *Employees on probationary and trial periods.*

An employee is not:

- *A self-employed or independent contractor.*
- *A real estate agent whose agreement says they are an independent contractor.*
- *A volunteer who does not receive a reward for working.*
- *In some cases, a person who is engaged in film production.*

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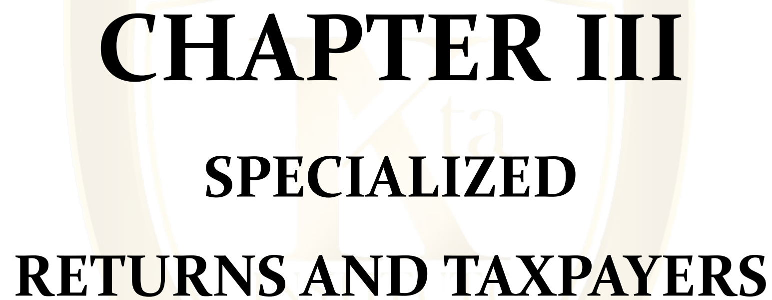

CHAPTER III

SPECIALIZED

RETURNS AND TAXPAYERS

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Module: Trust and Estate Income Tax

Estates and trusts are different legal entities, defined by the assets they hold. When a taxpayer dies, an estate is created. Both estates and trusts (except for revocable grantor trusts) need to obtain an EIN, just like any other entity.

Estates and trusts typically terminated when they have distributed all assets and income and paid all liabilities. Should the existence of a trust or estate be unduly extended, the IRS might step in to terminated it once sufficient time has been allowed for the final administrative duties.

If a trust or estate experiences a loss during its final tax year, this loss can be carried over to the beneficiaries, potentially offering them deductions on their personal tax returns. However, losses from a trust or estate cannot be carried over in a year other than the termination year.

Trust

A trust is an entity created and governed under the state law in which it was formed. A trust involves the creation of a fiduciary relationship between a grantor, a trustee, and a beneficiary for a stated purpose. A trust may be created by any of the following methods:

- A declaration by the owner of property that the owner holds the property as trustee;
- A transfer of property by the owner during the owner's lifetime to another person as trustee;
- A transfer of property by the owner, by will or by other instrument taking effect upon the death of the owner, in trust, to another person as trustee, or
- An exercise of a power of appointment to another person as trustee or an enforceable promise to create a trust

Estate

An estate is recognized as a distinct legal entity that is established when a taxpayer dies. U.S. citizens face estate taxation on their global assets.

At the time of the decedent's demise, all properties are incorporated in the gross estate at their FMV. However, the IRS notes that there can be an alternative where an assessment date can be used, which is six months after the death of the decedent.

The total property owned by the decedent at their time of death constitutes the gross estate for the purposes of estate tax. Typically, beneficiaries who inherit property directly from an estate are not taxed on the transfer. Rather, the estate itself is tasked with settling any relevant taxes before distributing the property. However, if the estate distributes assets to the beneficiaries before taxes are settled, those beneficiaries may be held responsible for the tax obligations, limited to the value of the assets they received.

Important Terms of a Trust

- **Grantor:** The grantor (also known as trustor, settlor, or creator) is the creator of the trust relationship and is generally the owner of the assets initially contributed to the trust. The grantor generally establishes in the trust instrument the terms and provisions of the trust relationship between the grantor, the trustee, and the beneficiary. These will usually include the following:

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  - The rights, duties, and powers of the trustee;
  - Distribution provisions;
  - Ability of the grantor to amend, modify, revoke, or terminate the trust agreement;
  - The designation and selection of a trustee or successor trustees; and
  - The designation of the state under which the terms and provisions of the trust agreement are to be governed.
- **Trustee/Fiduciary:** The trustee/fiduciary obtains legal title to the trust assets and is required to administer the trust on behalf of the beneficiaries according to the express terms and provisions of the trust agreement. A fiduciary is an individual or organization charged with the duty to act for the benefit of another. A trustee is a fiduciary.
- **Beneficiary:** The beneficiaries are those entitled to receive benefits from the trust.

Responsibilities of an Estate Administrator

When a person dies, a probate proceeding may be opened. Depending on state law, probate will generally open 30 to 90 days after the date of death. One of the probate court's first actions is to appoint an estate administrator.

An estate administrator is the appointed legal representative of the deceased. The legal representative may be a surviving spouse, other family member, executor named in the will or an attorney.

In general, the estate administrator:

- Collects all the assets of the deceased.
- Pays creditors.
- Distributes the remaining assets to heirs or other beneficiaries.

Executors are designated when a decedent has a will, and administrators are appointed in cases where the decedent passes away without a will. Proceedings involving a will are often referred to as testamentary probate proceedings. Conversely, if an individual dies without a will, it is stated that they have died intestate. Both executors and administrators are granted legal authority to represent and manage the estate.

To inform the IRS of a fiduciary relationship involving an estate or trust, IRS Form 56, the Notice Concerning Fiduciary Relationship, must be used. The executor must file this form to establish their authority to act on behalf of the estate. This form should be submitted as soon as the estate's EIN is obtained, ensuring that the executor receives all necessary notices from the IRS.

Additionally, Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, must be used for claiming a refund owed to a deceased taxpayer, when the claimant is not the surviving spouse.

Probate Court

The first responsibility of the estate administrator is to provide the probate court with an accounting of the assets and debts of the deceased. Probate means the court-supervised process of administering an estate.

The administrator will need to:

- Have all assets appraised to determine their value.
- Verify all debts.

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- Contact the IRS to file a proof of claim.

The probate court will issue Letters of Testamentary or a similar document, authorizing the estate administrator to act on behalf of the deceased. The estate administrator will need Letters of Testamentary to handle their tax and other matters.

Net Investment Income Tax (NIIT)

The Net Investment Income Tax is imposed by section 1411 of the Internal Revenue Code. The NIIT applies at a rate of 3.8% to certain net investment income of individuals, estates and trusts that have income above the statutory threshold amounts.

Estates and trusts are subject to the Net Investment Income Tax if they have undistributed Net Investment Income and also have adjusted gross income over $15,200.

In general, investment income includes, but is not limited to, interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities and passive activity income.

The following trusts are not subject to the Net Investment Income Tax:

- Charitable trusts and qualified retirement plan trusts, and Charitable Remainder Trusts.
- A trust or decedent's estate in which all of the unexpired interests are devoted to one or more of the purposes described in section 170(c)(2)(B).
- Trusts that are classified as "grantor trusts".
- Real Estate Investment Trusts and Common Trust Funds.
- Electing Alaska Native Settlement Trusts.
- Perpetual Care (Cemetery) Trusts.

The estate or trust must file Form 8960, Net Investment Income Tax; Individuals, Estates, and Trusts, to compute their Net Investment Income Tax.

Trust Types

While trusts can vary widely in type and purpose, they share several basic elements. Every trust includes a grantor (also known as a settlor or trustor), a trustee, and one or more beneficiaries. The grantor is the individual who owns the property to be transferred into the trust. The trustee holds a fiduciary duty to manage and eventually distribute the trust assets according to the trust document's terms and in the beneficiaries' best interests.

For tax purposes, there are two main categories of trusts: Grantor Trusts and Non-Grantor Trusts.

Grantor Trusts

In a Grantor Trust, the trust creator (or grantor) retains certain powers over the trust, causing the trust to be disregarded as a separate tax entity. As a result, the trust's net income is taxed to the grantor on their personal tax return. These retained powers may also lead to the inclusion of the trust property in the grantor's gross estate upon death.

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- **Revocable Trust:** Also known as a "living trust" or "intervivos", the grantor retains full control over the trust property during their lifetime, with the power to revoke or amend the trust. This type of trust is often used to manage the grantor's financial assets if they become disabled or upon death. The main advantage is the avoidance of probate, thereby preventing delays in distributions to beneficiaries and legal fees. Upon the grantor's death, the trust becomes irrevocable, and the trust assets are included in the grantor's gross estate, receiving a step-up in basis.

  Example: Luciana is experiencing significant health issues and decides to transfer her assets into a trust. She requests her attorney to establish the trust and manage the assets. The trust is set up to cover Luciana's living expenses, with the remaining assets passing to her granddaughter after her death. During Luciana's lifetime, the trust is revocable, allowing her to maintain control over the assets. Upon her death, the trust automatically becomes irrevocable. In this example, Luciana is the grantor, the lawyer is the trustee, and both Luciana and her granddaughter are the beneficiaries.

Non-Grantor Trusts

In a Non-Grantor Trust, the grantor retains no control over the trust property. This type of trust is considered a separate tax entity responsible for paying its taxes. Generally, the trust assets are not included in the grantor's gross estate.

- **Simple trust:** This trust is not a grantor trust or required to be treated as a grantor trust, is required to distribute all income annually, and does not distribute the corpus of the trust or make charitable contributions.
- **Complex trust:** Any trust that is not defined as a simple trust or a grantor trust. Complex trusts may accumulate income, distribute amounts other than current income and make deductible payments for charitable purposes.
- **Irrevocable trust:** This trust may not be altered, changed, modified or revoked after its creation. Once a property is transferred to this trust, no one, including the person who established the trust, may take the property out of the trust.
- **Charitable Contributions Trust:** This trust is for qualified charitable contributions purposes. It allows a taxpayer to leave some of their estate to a qualifying charitable organization of their choice. This trust is not subject to NUT and is considered irrevocable.
- **Qualified Disability Trust (QDT):** Is any non-grantor trust thar is established solely for the benefit of an individual under 65 years of age who is disabled. For tax year 2024, a qualified disability trust can claim an exemption of up to $5,000 (instead of $100 for all complex trusts). This amount is not subject to phaseout.

Foreign Trusts

U.S. persons and their tax return preparers should be aware that U.S. persons who create a foreign trust, or have transactions with a foreign trust, can have both U.S. income tax consequences, as well as information reporting requirements. Failure to satisfy the information reporting requirements can result in significant penalties, as well as an extended time to assess any tax imposed with respect to the period to which the information relates.

A U.S. person includes a citizen or resident of the United States, a domestic partnership, a domestic corporation, any estate other than a foreign estate, and any trust if a court within the United States exercises primary supervision

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over the administration of the trust and if one or more U.S. persons have the authority to control all substantial decisions of the trust.

Tax consequences apply to U.S. persons who are treated as owners of a foreign trust under the grantor trust rules of Internal Revenue Code (IRC) sections 671-679, and may apply to U.S. persons treated as beneficiaries of a foreign trust and to the foreign trust itself. Both income tax and transfer tax consequences should be considered.

In addition to tax consequences, there a number of information reporting rules that can apply to a U.S. person who enters into a transaction with a foreign trust, is treated as an owner of a foreign trust under the grantor trust rules, or receives distributions from a foreign trust, including information reporting on Forms 3520 and 3520-A; on Form 8938, Statement of Specified Foreign Financial Assets; and on FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR).

Distributable Net Income and Accounting Income

Distributable net income is the limit on the amount of the deduction of a domestic trust or estate for distributions to beneficiaries in any taxable year. It is the taxable income, with the following modifications:

- Distributions to beneficiaries are not deducted.
- The deduction for estate tax attributable to Income in Respect of a Decedent (IRD) is not allowed.
- Capital gains ordinarily are not included in distributable net income. However, they are included if:
  - The gain is allocated to income in the accounts of the estate or to notice to the beneficiaries, under the terms of the will or by local law.
  - The gain is allocated to the corpus or principal of the estate or by notice to the beneficiaries, under the terms of the will or by local law.
  - The gain is used, under either the terms of the will or the practice of the personal representative, to determine the amount that is distributed or required to be distributed; or
  - Charitable contributions are made out of capital gains.
- Capital losses are excluded in figuring distributable net income unless they enter into the computation of any capital gain that is distributed or must be distributed during the year.
- Tax-exempt interest, including exempt interest dividends, though excluded from the estate's gross income, is included in the distributable net income, but is reduced by:
  - The expenses that were not allowed in computing the estate's taxable income because they were attributable to tax-exempt interest.
  - The part of the tax-exempt interest deemed to have been used to make a charitable contribution.
- The distribution deduction includes any amount of income that under the terms of the decedent's will or by reason of local law must be distributed currently. This also includes amounts that may be paid out of income or corpus (such as an annuity) to the extent they are paid out of income for the tax year. The deduction is allowed to the estate even if the personal representative does not make the distribution until a later year or makes no distribution until the final settlement and termination of the estate.

NOTE: For tax years beginning after August 5, 1997, the personal representative can elect to treat distributions paid or credited within 65 days after the close of the estate's first tax year as though the distribution was paid or credited on the last day of that tax year (Section 663(b) election).

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Accounting Income

Similar to businesses, trusts have both “book income" and taxable income. The book income of a trust is referred to as Trust Accounting Income (TAI), also known as Fiduciary Accounting Income (FAI), and must be calculated in accordance with the terms of the trust agreement and state law. The purpose of calculating TAI is to recognize the difference between whether a particular receipt of income or payment of expense is intended for the current income beneficiary or to be retained for future distribution to remainder beneficiaries. The TAI is, then, the income available to distribute to the income beneficiary of a trust. In order to calculate the TAI, the operating instrument, such as a will or trust agreement, is key, and as such, tax professionals working on trust returns must be capable of knowing how to apply the documents to a TAI calculation.

Exclusions, Exemptions and Deductions

There is an exemption amount on a Form 1041 of:

- $600 for a decedent's estate,
- $300 for a trust that is required to distribute all income currently,
- $5,000 for a Qualified Disability Trust, and
- $100 for all other trusts.

Charitable contributions

An estate qualifies for a deduction for amounts of gross income paid or permanently set aside for qualified charitable organizations.

- Adjusted gross income limitations for individuals do not apply.
- However, to be deductible by an estate, a specific provision for the contribution must be in the decedent’s will. If there is no will, or if the will makes no provision for the charitable contribution payment, then a deduction will not be allowed even though all of the beneficiaries may agree to the gift.

Deductions

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.

Fraudulent Trusts

Filings of trust returns (in Form 1041) are now the third most frequently filed income tax return behind individual and corporate returns. Although the vast majority of these transfers are legal, there is widespread potential for fraud.

Preparers should be aware of abusive trusts. In the last few years, the IRS has detected a proliferation of abusive trust tax evasion schemes. These promotions are targeted towards wealthy individuals, small business owners, and professionals such as doctors and lawyers.

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The courts generally describe “sham trusts" as abusive trusts that serve no legitimate purpose and lack economic substance. Sham trusts are disregarded for tax purposes, and all income and expenses are assigned to the true owner of the activity.

Promises of abusive trust arrangements typically include:

- Reduction or elimination of taxable income.
- Deductions for personal expenses paid by the trust.
- Depreciation deductions of an owner’s personal expenses paid by the trust.
- Depreciation deductions of an owner's personal residence and furnishings.
- A stepped-up basis for property transferred to the trust.
- The reduction or elimination of self-employment taxes.
- The reduction or elimination of gift and estate taxes.

Abusive foreign trusts are often formed in foreign countries that impose little or no tax on trusts and also provide financial secrecy. These are usually "tax haven" countries, supposedly outside the jurisdiction of the U.S. Typically, abusive foreign trust arrangements enable taxable funds to flow through several trusts or entities until the funds ultimately are distributed or made available to the original owner, purportedly tax-free. In actuality, the income from these arrangements is fully taxable.

These arrangements frequently involve more than one trust, each holding different assets of the taxpayer (the taxpayer’s business, equipment, home, automobile, etc.), as well as interests in other trusts.

The trusts are vertically layered, with each trust distributing income to the next layer (known as “upstreaming”). Funds may flow from one trust to another trust by way of rental agreements, fees for services, purchase and sale agreements, and distributions. The goal is to use inflated or non-existent deductions to reduce taxable income to nominal amounts.

Although the individual abusive promotions vary, two basic schemes have been identified:

- The domestic package, and
- The foreign package.

These schemes are often promoted by a network of promoters and sub-promoters who have charged $5,000 to $70,000 for their packages. This fee enables taxpayers to have trust documents prepared, to utilize foreign and domestic trustees as offered by promoters, and to use foreign bank accounts and corporations. In some instances, tax return preparer services are also made available.

Foreign packages often begin with an Asset Management Company, a business trust, and then distribution of income to several trust layers. These schemes also involve offshore bank accounts and International Business Corporations (IBCs). A typical abusive foreign trust scheme has the following steps:

- **Asset Management Company:** In many promotions, taxpayers are advised to create asset management companies (AMCs). The AMC, which lists the taxpayer as the director, is formed as a domestic trust. An individual on the promoter's staff is usually the trustee of the AMC, but the taxpayer quickly replaces this individual. The purpose of the AMC is to give the appearance that the taxpayer is not managing his or her business and to start the layering process.

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- **Business Trust:** The next step is to form a business trust, again very similar to the domestic scheme.
- **Foreign Trust One:** Next, a foreign trust is formed in a tax haven country and the income from the business trust is distributed to this trust. We will refer to this foreign trust as "foreign trust one". In many cases, the AMC will be the trustee of foreign trust one. Because the source of income is U.S.-based and there is a U.S. trustee, this foreign trust has filing requirements.
- **Foreign Trust Two:** The next step is to form a second foreign trust or "foreign trust two". All income of foreign trust one is distributed to foreign trust two. Either foreign trust one or a foreign member of the promoter's staff becomes the trustee of foreign trust two. If the trustee is foreign trust one, the taxpayer still controls foreign trust two by the fact that he/she is in control of foreign trust one's trustee, by the directorship of the AMC. If a foreigner is the trustee of foreign trust two, the taxpayer is empowered by the promoter to overrule any decisions by this trustee. In either case, the taxpayer is in control of foreign trust two.
- Promoters will claim that since the trustee and the sources of income are now foreign, there are no U.S. filing requirements. Promoters also advise taxpayers that since the trusts are formed in tax haven countries it is impossible for the IRS to determine who is in control of the trusts. In actuality, the taxpayer has never relinquished control of their business, but has set up, with the assistance of a promoter, an elaborate scheme to subvert and evade U.S. tax laws.
- **Asset Protection Trust:** Either as part of the second foreign trust or as a separate trust, an asset protection trust is formed. The taxpayer supposedly transfers all of his assets to it including his home and other assets actually located within the United States. According to the promoter, this will make the taxpayer judgment proof. In actuality, the courts look at the economic substance of the transaction and, if the taxpayer continues to reside in his home and control his assets, those assets may be seized and sold in satisfaction of his liabilities. This definition of an asset protection trust is not meant to imply that all are formed as part of an abusive tax scheme. However, beware of any asset protection trust marketed as part of a package to reduce federal income or employment taxes. The courts can ignore such trusts and order the taxpayer's property sold to satisfy the outstanding liabilities.

Abusive trust arrangements will not produce the tax benefits advertised by their promoters. The IRS constantly examines these types of trust arrangements. Furthermore, in appropriate circumstances, taxpayers and/or the promoters of these trust arrangements may be subject to civil and/or criminal penalties.

Income

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 their 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.

Allocations

Income passes to the beneficiary in the same ratio as it's earned by the trust or estate. So, if a trust earns 40% of its income as interest, 30% as dividends, and 30% as rental, the numbers shown on Schedule K-1 will reflect those percentages.

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The one exception to this rule concerns capital gains. Except in the last year of the trust or estate, capital gains remain trapped at the trust or estate level, which pays all the income taxes due on them. However, if the taxpayer, as the fiduciary, determine to distribute to a beneficiary the value of certain property, they may elect to have the beneficiary pay the tax on the capital gain generated by the sale.

The taxpayer arrives at each individual number by dividing the total for each type of income into the total for all types of income includible on Schedule K-1, and then multiplying the result by the amount of the Income Distribution Deduction (IDD) (Form 1041, Schedule B, line 15). Allocations are made across all classes of income, whether taxable or nontaxable.

Corpus Vs. Income

The principal of an estate or trust is the amount originally received, plus capital gains and less debts, expenses, and capital losses. The principal is sometimes called the "corpus" (or body) of the estate or trust The income is the interest, dividends, and other income earned by the principal.

Separately Stated Items

Businesses that have trusts or estates as owners need to be mindful of how depreciation expense is presented on a Schedule K-1 that is reported to the estate or trust as an owner.

Depreciation can affect the tax liabilities of a trust or estate because of the rules peculiar to calculating an estate's or trust's taxable income. Specifically, a trust or estate claims a deduction for amounts distributed to a beneficiary, and the beneficiary then reports an amount of taxable income equal to the deduction claimed by the trust or estate (per sections 651 and 661).

As part of this process, however, any depreciation or depletion deduction allowed to the estate or trust is likewise shifted to the beneficiary and is reported separately by the trust to the beneficiary [Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc., line 9, code A or BJ. Unlike the majority of other items of income and expense, which are shifted from the fiduciary to the beneficiary based on a proportion and measured as a distribution to the beneficiary as a percentage of the distributable net income, depreciation is allocated based on the ratio of the distribution compared with the trust's or estate's Trust Accounting Income (TAI).

Example: A trust has only one beneficiary who can receive distributions from it, but the trust is not required to make distributions. The trust earns $1,100 of rental income, incurs trustee fees of $200 and depreciation expense of $300, and pays the beneficiary a distribution of $400.

A practitioner who is unaware of the unique rules for depreciation might conclude that the trust has net income of $600 ($1,100, less $200 and $300) while the beneficiary receives a distribution of $400. If so, they would issue a Schedule K-1 to the beneficiary for $400 of net rental income, leaving $200 taxable to the trust The correct method would be to separately state the depreciation and independently allocate it between the fiduciary and the beneficiary, based on the proportion of the distribution ($400) to the TAI ($1,000).

TAI is calculated differently than taxable income and is computed in Example as rental income ($1,100) less one-half of the $200 trustee fee (or $100). Therefore, the $300 of depreciation expense would be allocated 40% (or $120) to the beneficiary, while the trust itself would be allowed to claim a deduction for the remaining $180 of depreciation.

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Ultimately, the beneficiary would receive a Schedule K-1 showing $400 of taxable income (because of the $400 distribution) and a depreciation deduction of $120.

Thus, the net taxable income to the beneficiary would be $280, rather than the $400 in Example.

Meanwhile, the trust itself would have net taxable income of $320 (computed as $1,100 of interest, less $200 of trustee fees, less a $400 distribution deduction and $180 of depreciation). Overall, a total of $600 is taxable in both calculations, but instead of the improper allocation of $400 to the beneficiary and $200 to the trust, the proper treatment is $280 to the beneficiary and $320 to the trust It is clear, based on this example, that separately stating deprecation can significantly affect the taxation of both a trust and its beneficiary, and that it would be incorrect for a partnership or S corporation that has an estate or trust as an owner to include depreciation in the calculation of a single net number for ordinary business income.

Although this difference in taxation occurs only if the trust or estate makes a distribution to the beneficiary, tax practitioners who are preparing tax returns for businesses that have estates and trusts as owners should err on the side of caution and always separately state the depreciation or depletion expense for an estate or trust.

Filing Requirements, Tax Years and Penalties

- **Income Tax Returns of the Deceased - Form 1040**

The estate administrator must file income tax returns for the deceased on Forms 1040, U.S. Individual Tax Return or 1040-SR, U.S. Tax Return for Seniors. The estate administrator is required to file a return for the year of death, and for any preceding years for which a return was not filed, if their income for those years was above the filing requirement.

- **Income Tax Returns of the Estate or Trust - Form 1041**

The fiduciary of a domestic decedent's estate, trust, or bankruptcy estate uses Form 1041

to report:

- 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; and
- Net Investment Income Tax (NIIT).

For calendar year estates and trusts, it must be filed Form 1041 and Schedule(s) K-1 by April 15, 2025. For fiscal year estates and trusts, it must be filed 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, 2025, must file Form 1041 by October 15, 2025.

If more time is needed to file the estate or trust return, it must be used Form 7004, Application for automatic extension of time to file certain business income tax, information, and other returns, to apply for an automatic 5 1A month extension of time to file, due September 30 for a calendar-year entity.

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If the return is for a fiscal year or a short tax year (less than 12 months), it must be filled in the tax year space at the top of the form.

The fiduciary (or one of the joint fiduciaries) must file Form 1041 for a domestic estate that has:

1. Gross income for the tax year of $600 or more;
2. A beneficiary who is a nonresident alien; or
3. Held a qualified investment in a qualified opportunity fund (QOF) at any time during the year, and must file the return with Form 8997 attached.

The fiduciary (or one of the joint fiduciaries) must file Form 1041 for a domestic trust taxable under section 641 that has:

1. Any taxable income for the tax year;
2. Gross income of $600 or more (regardless of taxable income);
3. A beneficiary who is a nonresident alien; or
4. Held a qualified investment in a qualified opportunity fund (QOF) at any time during the year, and must file the return with Form 8997 attached.

For 2024, these are the tax rates for Estates and Trusts:

If the taxable income is		Tax is	PLUS	Of the amount over
Over	But not over			
$0	$3,100	$0.00	10%	$0
$3,100	$11,150	$310	24%	$3,100
$11,150	$15,200	$2,424	35%	$11,150
$15,200	AND OVER	$3,659.5	37%	$15,200

- **Estate Tax Return - Form 706**

The estate administrator must file an estate tax return on Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. Estate tax is a tax on the transfer of assets from the deceased to their heirs and beneficiaries.

Form 706 must be filed to report estate and/or GST tax within 9 months after the date of the decedent's death. If the estate administrator is unable to file Form 706 by the due date, he or she may receive an extension of time to file. The estate administrator is to 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.

For decedents who died in 2024, 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 $13,610,000; or
- Whose executor elects to transfer the DSUE amount to the surviving spouse, regardless of the size of the decedent's gross estate.

Penalties

Form 1041

Failure to File: The law provides a penalty of 5% of the tax due for each month, or part of a month, for which a return isn't 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%

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if the failure to file is fraudulent). If the return is more than 60 days late, the minimum penalty is the smaller of $510 or the tax due. The penalty won't be imposed if the administrator or the fiduciary can show that the failure to file on time was due to reasonable cause.

Failure to Pay: Generally, the penalty for not paying tax when due is 1/2 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 administrator or fiduciary must provide Schedule K-1 (Form 1041), on or before the day they are required to file Form 1041, to each beneficiary who receives a distribution of property or an allocation of an item of the estate. 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 $330 penalty may be imposed with regard to each Schedule K-1 for which a failure occurs. The maximum penalty is $3,987,000 for all such failures during a calendar year. If the requirement to report information is intentionally disregarded, each $330 penalty is increased to $630 or, if greater, 10% of the aggregate amount of items required to be reported, and no maximum penalty applies.

Form 706

Failure to File: The penalty is 5% of the unpaid taxes for each month or part of a month that the return is late, up to a maximum of 25% of the unpaid taxes. If the return is more than 60 days late, the minimum penalty is either $510 (for returns due in 2024) or 100% of the tax required to be shown on the return, whichever is less.

Failure to Pay: The penalty is 0.5% of the unpaid taxes for each month or part of a month that the tax is not paid, up to a maximum of 25% of the unpaid taxes. If both the failure to file and the failure to pay penalties apply in the same month, the failure to file penalty is reduced by the amount of the failure to pay penalty for that month.

Valuation understatement: Section 6662 provides a 20% penalty for the underpayment of estate tax that exceeds $5,000 when the underpayment is attributable to valuation understatements. A valuation understatement occurs when the value of property reported on Form 706 is 65% or less of the actual value of the property. This penalty increases to 40% if there is a gross valuation understatement. A gross valuation understatement occurs if any property on the return is valued at 40% or less of the value determined to be correct. Penalties also apply to late filing, late payment, and underpayment of GST taxes.

Return preparer: Estate tax return preparers who prepare any return or claim for refund which reflects an understatement of tax liability due to an unreasonable position are subject to a penalty equal to the greater of $1,000 or 50% of the income earned (or to be earned) for the preparation of each such return.

Estate tax return preparers who prepare a return or claim for refund which reflects an understatement of tax liability due to willful or reckless conduct are subject to a penalty of $5,000 or 75% of the income earned (or income to be earned), whichever is greater, for the preparation of each such return.

Foreign Trust

The most notable penalty for failing to comply with tax laws in the U.S. is the penalty involving a foreign trust. If an arrangement involves a foreign trust, taxpayers should be aware that a number of special provisions apply to foreign trusts with U.S. grantors or U.S. beneficiaries.

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If a U.S. taxpayer fails to report a transfer of property to a foreign trust or the receipt of a distribution from a foreign trust, they are subject to a tax penalty equal to 35% of the gross value of the transaction. Other examples of these provisions are the application of U.S. withholding taxes on payments to foreign trusts and the application of U.S. excise taxes to transfers of appreciated property to foreign trusts.

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REVIEW QUESTIONS

1. Which of these is not a type of trust?

A. Grantor trust
B. Revocable trust.
C. Foreign trust
D. All the above are types of trust

Answer: D

Types of trust

- *Simple trust.*
- *Complex trust.*
- *Grantor trust.*
- *Revocable trust.*
- *Irrevocable trust*
- *Foreign trust.*
- *Charitable trust*

2. M trust is required to distribute all its income currently and cannot pay money for charitable purpose, whereas "N" trust does make deductible payments for charitable purposes under Section 642(c). Which of them is considered a complex trust?

A. M trust
B. N trust
C. Both of them
D. Neither of them

Answer: B

Simple trust: *This type of trust must distribute all its income currently, as it cannot accumulate income, distribute out of corpus, or pay money for charitable purposes.*

Complex trust*: Any trust that does not meet the requirements for a simple trust. Complex trusts may accumulate income, distribute amounts other than current income, and make deductible payments for charitable purposes under Section 642(c).*

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3. Trusts have taxable income and:

A. Book income.
B. Accountable income.
C. Foreign income.
D. None of the above.

Answer: A

Similar to businesses, trusts have both "book income" and taxable income. The book income of a trust is referred to as Trust Accounting Income (TAI), also known as Fiduciary Accounting Income (FAI) and must be calculated in accordance with the terms of the trust agreement and state law. The purpose of calculating TAI is to recognize the difference between whether a particular receipt of income or payment of expense is intended for the current income beneficiary or to be retained for future distribution to remainder beneficiaries. The TAI is, then, the income available to distribute to the income beneficiary of a trust.

4. Which is the exemption deduction allowed for a decedent's estate?

A. $1,200

B. $600

C. $100

D. $300

Answer: B

There is an exemption amount on a Form 1041 of $600 for a decedent's estate, $300 for a trust that is required to distribute all income currently, $100 for all other trusts and $5,000 for a Qualified Disability Trust.

5. "S" is a simple trust What is the exclusion amount MS" is entitled to on Form 1041?

A. $600

B. $300

C. $150

D. $100

Answer: B

As "S" is a simple trust, it is required to distribute all income currently. The exemption amount on a Form 1041 fora trust that is required to distribute all income currently is $300.

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6. For the 2024 tax year, which is the tax bracket for an estate with a taxable income of $10,000?

A. 35%.

B. 10%.

C. 37%.

D. 24%.

Answer: D

For 2024, if an estate or a trust has a taxable income over $3,100, but not over $11,150, the tax rate that will apply is 24%. In this case, the amount of $10,000 falls under this bracket.

7. MC" trust has a taxable income of $2,000. Which is the tax amount to be imposed on "C"?

A. $200
B. $260
C. $300
D. $400

Answer: A

As C's taxable income falls under the bracket of $0 through $3,100, the tax to be imposed on C is $0 plus 10% of the amount over $0; that is to say, 10% of $2,000, which is $200.

8. Which of these qualifies as promises of abusive trust arrangements?

A. Depreciation deductions of an owner's personal expenses paid by the trust.
B. Income distribution deduction for distributions to beneficiaries.
C. Deductions for amounts of gross income paid to qualified charitable organizations.
D. All of the above qualify.

Answer: A

Promises of abusive trust arrangements typically include:

- *Reduction or elimination of taxable income.*
- *Deductions for personal expenses paid by the trust.*
- *Depreciation deductions of an owner's personal expenses paid by the trust.*
- *Depreciation deductions of an owner's personal residence and furnishings.*
- *A stepped-up basis for property transferred to the trust.*
- *The reduction or elimination of self-employment taxes.*

Abusive trust arrangements often use trusts to hide the true ownership of assets and income or to disguise the substance of transactions.

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9. Armando and Manuel are both beneficiaries for a domestic trust taxable under Section 641. Armando's trust had a gross income of $700, whereas Manuel's trust had a gross income of $900 for the 2024 tax year. Which of them is required to file Form 1041?

A. Carlos
B. Manuel
C. Both of them
D. Neither of them

Answer: C

The fiduciary must file Form 1041 for a domestic trust taxable that has:

- *Any taxable income for the tax year,*
- *Gross income of $600 or more (regardless of taxable income), or*
- *A beneficiary who is a non-resident alien.*

10. If the taxpayer does not report a transfer of property to a foreign trust, or the receipt of a distribution from a foreign trust, they are subject to a tax penalty equal to:

A. 20% of the gross value of the transaction.
B. 50% of the gross value of the transaction.
C. 75% of the gross value of the transaction.
D. 35% of the gross value of the transaction.

Answer: D

If a U.S. taxpayer fails to report a transfer of property to a foreign trust or the receipt of a distribution from a foreign trust, they are subject to a tax penalty equal to 35% of the gross value of the transaction.

11. Carla passed away the previous year. During the current year, her estate received interest income of $2,500, dividend income of $5,000 and long-term capital gain of $2,500. Pursuant to her will, 50% of all income was to be distributed to a specific qualifying charitable organization. The executor complied with the provision in a timely manner. Assuming all income was accumulated, what is the estate's taxable income?

A. $10,000
B. $2,500
C. $5,000
D. $4,400

Answer: C

An estate qualifies for a deduction for amounts of gross income paid or permanently set aside for qualified charitable organizations. Adjusted gross income limitations for individuals do not apply. However, to be deductible by an estate, a specific provision for the contribution must be in the decedent's will. If there is no will, or if the will makes no provision for the charitable contribution payment, then a deduction will not be allowed even though all of the beneficiaries may agree to the gift. After distributing 50% of the income received in Carla's estate ($5,000), the estate's taxable income after applying the deduction is $5,000.

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Module: Exempt Organizations

There are all kinds of "non-profit" groups that are established by a desire to achieve a mission, rather than to make a profit. The term "non-profit," by itself, does not indicate any specific type of legal structure. If a non-profit group incorporates, it is a non-profit corporation. If the group does not incorporate, it is an unincorporated non-profit association.

Non-profit corporations

A non-profit corporation is an organization that has a mission to serve the public interest and has filed incorporation papers with the state. Because the corporation works for the public good, it receives exemptions from state and federal taxes it would otherwise have to pay. Hence, to a certain extent, these groups are publicly subsidized.

Non-Governmental Organizations (NGOs)

Although the "mission driven" nature of non-profits sets them apart from traditional private businesses, they are not part of the government. Sometimes they are referred to as non-governmental organizations or NGOs.

Corporations are incorporated at state level using "Articles of Incorporation"

To create any type of corporation, for-profit or non-profit, paperwork must be filed with the state government, usually the secretary of state's office. This initial filing document to create a corporation, typically called "Articles of Incorporation", must be filed with the respective state. Once this document is filed, the organization has been incorporated and a separate legal entity has been established as a corporation.

- In the simplest terms, a corporation, whether non-profit or for-profit, is a type of business structure.
- Other types of business structures include sole proprietorships, partnerships, and Limited Liability Companies (LLCs).
- Some states also recognize associations of groups of individuals who work together for some common goal but have not taken steps to create a specific legal entity (i.e., to incorporate).

Federal tax law provides tax benefits to non-profit organizations recognized as exempt from federal income tax under various IRC sections, most notably, Section 501.

This section offers tax exempt status to a wide range of organizations. Here are a few of the many different types of organizations that may be granted tax exempt status:

- Charitable groups.
- Civic leagues.
- Trade associations.
- Black lung benefit trusts.
- Veterans organizations.
- Cemetery companies.

Qualifying for and Maintaining Tax-Exempt Status

Organizations that qualified to be exempted for taxation under the U.S. law fall under Section 501(c)(3) of the IRC. These organizations include churches, public charities, educational entities, hospitals, and private foundations.

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Despite this classification, it is easy for an organization to lose its tax-exempt status just as easy as it is to maintain it. These organizations need to observe the rules and regulations set out in the following six areas:

1. **Activities of a political campaign:** Organizations under this section should be non-partisan to any political activity at any level (federal, state or local) whether in support or opposition to an individual running for public office.
2. **Obligations of annual reporting:** The exemption form tax does not mean these organizations are not to file annual reports with the government. Although these organizations enjoy tax exemption, they are required by law to make an annual report of certain information. This involves completion of one of the Form 990 series of returns. These forms are a verification that the organization is still entitled to tax exemption and gives the public a view if the organization's operations and programs. This requirement is further compounded by the Pension Protection Act of 2006 that makes exercises an automatic revocation of tax exemption for organizations that fail to file the annual information return for three years in a row.
3. **Lobbying:** Organizations under this section are otherwise allowed to participate in lobbying. However, their lobbying activities should not form a substantial part of their overall activities but rather should be insignificant in comparison to their key mandate. If an organization is to contravene this provision, then it risks being removed from the 'umbrella' of tax exemption.
4. **Unrelated business income:** An organization under this section risks losing their tax-exempt status if they operate a substantial amount of income generating business that is not related to its core function.
5. **Private benefit:** The mandate of the firm should be directed towards an exempt activity and should not be focused on providing private benefit to any individual or to serve a substantial private interest. Furthermore, the income from the organization should not benefit insiders, such as board of directors. Benefits to insiders is eligible to reverting the status of the organization form a tax-exempt organization.
6. **Operation in line with stated tax-exempt purpose:** The purpose stated by the organization as a tax-exempt activity should form the core mandate of the organization and any deviation form said activity should be disclosed to the IRS to prevent sanctions or dismissal from the tax-exempt bracket. Maintaining a nonprofit's tax-exempt status under IRC Section 501(c)(3) requires the taxpayer to constantly keep up with a number of routine tasks including, but not limited to:
    - Establishing a corporate board.
    - Having a purpose.
    - Documenting any donations received.
    - Adhering to an approval process for contracts and other agreements.
    - Understanding lobbying laws.
    - Avoiding all political campaign activities.
    - Paying taxes on unrelated business income.
    - Filing annual information returns.

Applying for IRS Tax-Exempt Status

Organizations looking to be considered under the tax-exempt category are supposed to be informed of the fees charged, the necessary files to submit, the filing deadlines and the necessary procedures to be followed.

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- **Form SS-4:** Required for all organizations, irrespective of the presence of employees, is the Employer Identification Number which is used as the account number by the IRS. This number is acquired by completing Form SS-4, Application for employer Identification number, through calling a toll-free number or an online submission at the IRS website. The form can be obtained from social security offices or at the IRS website. Worthy of noting is that an organization should never file for EIN unless it is already legally formed as filing for Form SS-4 triggers an internal control at IRS systems that an entity has already been formed and as such requirements for filing are required.
- **Form 1023:** This is mandatory for all applicants. The user fee (usually $600) stated must be paid for the application to be processed.
- **Form 1023-EZ:** Small organizations with an income of less than $50,000 may file this form instead of the one above and ensure the processing fee is paid. This form must however be filed electronically.
- **Form 1024:** Organizations use Form 1024 to apply for recognition of exemption under Section 501(a) or to receive a determination letter of IRS recognition of their Section 501(c) status.
- **Forms 2848 and 8821:** The former is filed if the organization will appoint a different party other than the directors or principal officers to represent it in matters pertaining application. The latter is filed to authorize the IRS to submit the application information to the principal officers or directors.

These forms are supposed to be filed before the 27th of the month after they are formed legally. For a firm, it is considered lawfully functional at the point which all the articles of incorporation have been completed by the state. Unincorporated firms become lawfully established with the adoption of its documents is signed by at least two individuals. For a trust, all charitable interest must expire or when it is funded, for a non-charitable fund.

In the case of a firm which does not fall under any category, application filing is not needed unless it has annual gross receipts in excess of $5,000. Such an entity has to file its application before the lapse 90 to the end of the tax year when the threshold is exceeded. For instance, a firm which was lawfully formed on March 1st, 2024, and surpasses that total receipt inception, has to place its submission on or before June 30, 2024.

Filing before the deadline means that the IRS would recognize the organization as tax exempt from the day of legal formation. Filing after the deadline however means that the IRS would recognize the organization as being tax exempt from the day of application.

Filing Requirements

Organizations under the tax exemption section of the IRS are required to file annual information return, together with other schedules that may be required for these particular organizations. The information return forms include Form 990, Form 990-EZ, Form 990-N and Form 990-PF. Organizations such as churches are exempt from filing Form 990 and Form 990-EZ.

Form 990 must be filed by the 15th day of the 5th month after the organization's accounting period ends (May 15th, 2025 for a calendar-year filer). If the due date falls on a Saturday, Sunday, or legal holiday, file on the next business day. A business day is any day that isn't a Saturday, Sunday, or legal holiday.

If the organization is liquidated, dissolved, or terminated, file the return by the 15th day of the 5th month after liquidation, dissolution, or termination.

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If the return isn't filed by the due date (including any extension granted), provide a reasonable-cause explanation giving the reasons for not filing on time.

For 2024, Form 990 must be filed electronically.

Organizations under the tax-exempt section may also be expected to file an annual electronic notice. In order to fulfill their requirements for annual filing, any organization that has a gross receipt amount of $50,000 or below may choose to file electronically by attaching Form 990-N. This form is an e-postcard for all organizations that are tax exempt and are not needed to file Form 990 or 990 EZ. The electronic notice has no paper format and as such, has to be filed electronically.

Preparing Form 1023

Preparation of Form 1023 has been substantially revised increasing the information requested in the approval process. Specific changes to Form 1023 include:

- Incorporating Form 8718, User fee for exempt organization determination letter request, into Part X of Form 1023.
- Organizations must have an Employer Identification Number prior to filing Form 1023.
- Limited liability companies (LLCs) have been added as a type of organization eligible to apply for tax exempt status under IRC Section 501(c)(3).

Some organizations are not required to file Form 1023, these ones include:

- Churches, interchurch organizations of local units of a church, conventions of associations of churches, or integrated auxiliaries of a church, such as a men's or women's organization, religious school, mission society, or youth group.
- Any organization (other than a private foundation) normally having annual gross receipts of not more than $5,000.

Gross Receipts Test

An organization is considered to have gross receipts of less than $5,000 if:

1. During the first tax year, the organization received gross receipts of $7,500 or less.
2. During its first 2 years, the organization had a total of $12,000 or less in gross receipts.
3. In the case of an organization that has been in existence for at least 3 years, the total gross receipts received by the organization during the immediately preceding 2 years, plus the current year, are $15,000 or less.

An organization with gross receipts in excess of the amounts in the gross income tests, unless otherwise exempt from filing Form 1023, must file that form within 90 days after the end of the period in which the amounts are exceeded.

Tax Reports and Returns

Most tax-exempt organizations must file an annual tax-exempt organization return in the Form 990 series. Return of organization exempt from income tax.

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- All private foundations and most non-exempt charitable trusts must file Form 990-PF, Return of private foundation.
- Section 501(c)(3) organizations also generally file Schedule A and Schedule B, Schedule of Contributions, of Form 990.

Form 990-EZ filing amounts: Form 990-EZ, Short form return of organization exempt from income tax, can be filed by most organizations with gross receipts and total assets below certain amounts. Most organizations with annual gross receipts less than $200,000 and total assets less than $500,000 at the end of the tax year can choose to file Form 990 or 990-EZ.

Filing Penalties for 990 Series Forms

$20 per day penalty

If a return is not filed, the IRS may assess penalties on the organization of $20 per day until it is filed.

- This penalty also applies when the filer fails to include required information or to show correct information.
- The penalty for a return may not exceed the lesser of $12,500 for 2024, or 5% of the organization's gross receipts.

Failure-to-file penalty

Organizations with annual gross receipts exceeding $1,274,000 are subject to a penalty of $125 for each day failure continues (with a maximum penalty of $63,500) for 2024 tax year. The penalty applies on each day after the due date that the return isn't filed.

Tax-exempt organizations that are required to file electronically but don't are deemed to have failed to file the return. The penalty can also be charged if the organization files an incomplete return, such as by failing to complete a required line item or a required part of a schedule. To avoid penalties and having to supply missing information later:

- Complete ail applicable line items;
- Unless instructed to skip a line, each question on the return must be answered;
- Make an entry (including a zero when appropriate) on all lines requiring an amount or other information to be reported; and
- Provide required explanations as instructed.

Also, this penalty can be imposed if the organization's return contains incorrect information. For example, an organization that reports contributions net of related fundraising expenses may be subject to this penalty.

Automatic revocation for not filing for three consecutive years

The law requires most tax-exempt organizations, other than churches, to file an annual Form 990, 990-EZ, or 990-PF, or to submit a Form 990-N e-Postcard to the IRS.

Unrelated Business Taxable Income

Besides the filing of the above forms with the IRS, there is another requirement by law for organizations under the tax exemption section of the IRC. These organizations must file Form 990-T if the organization has acquired $1,000 or more in terms of gross income from other business transactions that are unrelated to the core mandate registered

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with the IRS within the year. The organization is also required by law to remit quarterly payments of a tax estimation on unrelated business income when the organization anticipates its tax liability to be $500 or more for the year. In this case, a firm wishes to use Form 990-W to assist in the calculation and estimation of the amount of payment required. The tax is basically charged on income that does contribute to the organization's main mandate, the tax-exempt purpose. The income may be from a trade that is normally carried on by the organization but is not core to its mandate.

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REVIEW QUESTIONS

1. Which of the following are not a type of exempt organization?

A. Estates.
B. Non-governmental organizations.
C. Non-profit corporations.
D. All of the above.

Answer: A

The following organizations are tax-exempt type:

- *Non-profit corporations.*
- *Non-Governmental Organizations (NGOs).*

2. Which of these forms may be required to request exempt status?

A. Forms 1023, 1065 and 2555.
B. Forms 1023, 1024 and 8821.
C. Forms 1023 and 1025.
D. Forms 8976 and 1024.

Answer: B

Most organizations seeking recognition of exemption from federal income tax must use specific forms prescribed by the IRS. Forms currently required by the IRS based on the requirements of the applicant are:

- *Form 1023*
- *Form 1023-EZ*
- *Form 1024*
- *Form 2848 and 8821*

3. Which of the following organizations are required to file Form 1023?

A. Churches.
B. Integrated auxiliaries of a church.
C. Organizations that are not a private foundation that have annual gross receipts of not more than $5,000.
D. None of the above.

Answer: D

Organizations not required to file Form 1023 include:

- *Churches, interchurch organizations of local units of a church, conventions of associations of churches, or integrated auxiliaries of a church, such as a men's or women's organization, religious school, mission society, or youth group.*
- *Any organization (other than a private foundation) normally having annual gross receipts of not more than $5,000.*

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4. What organizations can choose to file Form 990 or 990-EZ?

A. Organizations with annual gross receipts less than $600,000 and total assets less than $1,000,000.
B. Organizations with annual gross receipts less than $300,000 and total assets less than $600,000.
C. Organizations with annual gross receipts less than $200,000 and total assets less than $500,000.
D. Organizations with annual gross receipts less than $100,000 and total assets less than $500,000.

Answer: C

Form 990-EZ, Short form return of organization exempt from income tax, can be filed by most organizations with gross receipts and total assets below certain amounts. Most organizations with annual gross receipts less than $200,000 and total assets less than $500,000 at the end of the tax year can choose to file Form 990 or 990-EZ.

5. Which of the following tax-exempt organizations can submit Form 990-N Electronic Notice (e-Postcard) instead of filing Form 990 or Form 990-EZ?

A. “Christ for us" church, with annual gross receipts of $100,000.
B. “Cookies and Fun” boy scouts’ organization, with annual gross receipts of $46,000.
C. “Free Apprenticeships for Everybody” educational non-profit organization, with annual gross receipts of $72,000.
D. None of the above.

Answer: B

In order to fulfill their requirements for annual filing, organizations that have a gross receipt amount of $50,000 or below, have the option of filing their annual electronic notice by attaching Form 990 N. This form is an e-postcard for all organizations that are tax exempt and are not needed to file Form 990 or 990 EZ. The electronic notice has no paper format and, as such, has to be filed electronically.

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Module: Retirement Plans

Regarding the contribution in retirement plans, the IRS defines it as the specific amount that each individual employee remits according to the terms of the plan, into the retirement plans.

This includes persons who are in self-employment. Normally, the plan will have a ceiling point for the amount which an individual is required to contribute. Individuals are required not to remit funds above this limit Said limitation will vary depending on the type of plan in question.

Employer and Employee Contributions

An employer contribution to an employee's retirement plan gives the employee an additional incentive to stay with the same company. Generally, employees are limited as to how much they can contribute to a retirement plan each year. However, an employer can contribute even more on that person's behalf, further enriching the employee's workspace. The following are the types of contributions the employer may make:

Employer matching contributions

If the plan document allows it, the employer may make matching contributions for an employee who contributes elective deferrals (for example, 50 cents for each dollar deferred). Employer matching contributions can be discretionary (contributed in some years and not in others, depending on the company's decision) or mandatory, as in SIMPLE plans and 401(k) plans.

Example: Anita's employee, Jose Rico, earned $25,000 and chose to defer 5% of his salary. Anita's net earnings from self-employment are $40,000, and she chooses to contribute 10% of her earnings to her SIMPLE IRA. Anita makes 3% matching contributions. The total contributions made for Jose is $2,000, figured as follows:

Salary reduction contributions ($25,000 x .05)	$1,250
Employer matching contribution ($25,000 x .03)	$750
Total contributions	$2,000

The total contribution Anita makes for herself is $5,200, figured as follows:

Salary reduction contributions ($40,000 x .10)	$4,000
Employer matching contribution ($40,000 x .03)	$1,200
Total contributions	$5,200

Employer discretionary or non-elective contributions

If the plan document allows it, the employer can make contributions other than matching contributions for participants. These contributions are made on behalf of all employees who are plan participants, including participants who choose not to contribute elective deferrals.

If the employer chooses this 2% contribution formula, he is required to notify their employees within a reasonable period of time before the 6O-day election period for the calendar year.

Example: In 2024, Gabriel's employee, Julia Rosas, earned $36,000 and chose to have him contribute 10% of her salary. Gabriel's net earnings from self-employment are $50,000, and he chooses to contribute 10% of his earnings

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to his SIMPLE IRA. Gabriel makes a 2% non-elective contribution. Both Gabriel and Julia are under age 50. The total contribution made for Julia is $4,320, figured as follows:

Salary reduction contributions ($36,000 x .10)	$3,600
2% non-elective contributions ($36,000 x .02)	$720
Total contributions	$4,320

The total contribution Gabriel made for himself is $6,000, figured as follows:

Salary reduction contributions ($50,000 x .10)	$5,000
2% non-elective contributions ($50,000 x .02)	$1,000
Total contributions	$6,000

Employees, on the other hand, can make these types of contributions:

- **Salary reduction/elective deferral contributions:** These pre-tax employee contributions are generally a percentage of the employee's compensation. Some plans allow the employee to contribute a specific dollar amount each pay period.

401(k), 403(b) or SIMPLE IRA plans may permit elective deferral contributions.

- **Designated Roth contributions:** This is a type of elective contribution that, unlike pre-tax elective contributions, is currently includible in gross income but tax-free when distributed. 401 (k), 403(b) and governmental 457(b) plans can allow it. If a plan permits designated Roth contributions, it must also offer pre-tax elective deferral contributions.

- **After-tax contributions:** These are contributions from compensation (other than Roth contributions) that an employee must include in income on their tax return. If a plan allows after-tax contributions, they are not excluded from income and an employee cannot deduct them on their tax return.

- **Catch-up contributions:** If permitted by a 401(k), 403(b), governmental 457(b) or SIMPLE IRA plan, participants who are age 50 or over at the end of the calendar year can also make catch-up elective deferral contributions beyond the basic limit on elective deferrals.

Reporting Requirements

Administrators or sponsors of retirement plans are generally required by law to report certain information with the IRS, the Department of Labor, and the Pension Benefit Guarantee Corporation, and disclosure to affected parties depending on the plans* type, size, and circumstances.

Some of the forms used to report retirements plans are:

- Form 5500, Annual return/report of employee benefit plan.
- Form 5500-SF, Short form annual return/report of small employee benefit plan.
- Form 5500-EZ, Annual return of one-participant (owners/partners and their spouses) retirement plan or a foreign plan.
- Form 8955-SSA, Annual registration statement identifying separated participants with deferred vested benefits.
- Form 5558, Application for extension of time to file certain employee plan returns.

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- Form 1099-R, Distributions from pensions, annuities, retirement or profit-sharing plans, IRAs, insurance contracts, etc.
- Form 1098-Q, Qualifying longevity annuity contract information.
- Form 5330, Return of excise taxes related to employee benefit plans.
- Form 8886-T, Disclosure by tax-exempt entity regarding prohibited tax shelter transaction.
- Form 5308, Request for change in plan/trust year.

Form 5500 series must be filed by the last day of the 7th calendar month after end of the plan (due July 31 for calendar year plan. A plan may obtain a one-time extension of time to file a Form 5500 Annual Return/Report (up to 27a months) by filing IRS Form 5558, Application for Extension of Time To File Certain Employee Plan Returns, on or before the normal due date (not including any extensions) of the return/report.

Plans for Self-Employed Persons

Simplified Employee Pension (SEP) Plans

These plans provide a simplified method for the taxpayer to make contributions to a retirement plan for himself and his employees. Instead of setting up a profit-sharing or money purchase plan with a trust, a taxpayer may 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 himself or herself and each eligible employee. This SEP plan is also available for self-employed taxpayers. Only employers (in the case of a small business) are able to contribute. The contributions to a SEP-IRA cannot exceed the lesser of:

- 25% of compensation (compensation is generally limited to $345,000 in 2024),
  or
- $69,000 for 2024.

In order to establish a SEP plan, the taxpayer will first need to choose a financial institution to serve as trustee of the SEP-IRAs that will hold each employee's retirement plan assets. These accounts will receive the contributions the taxpayer makes to the plan.

To establish a SEP, the taxpayer must:

1. Complete Form 5305-SEP, or an IRS-approved "prototype SEP plan", offered by many mutual funds, banks and other financial institutions, and by plan administration companies.
2. Open a SEP-IRA through a bank or other financial institution.

SIMPLE Plans

Defined as a Savings Incentive Match Plan for Employees (SIMPLE) plan, if a taxpayer had 100 or fewer employees who received at least $5,000 in compensation last year, they may 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.

Additionally, they will contribute matching or non-elective contributions. The two types of SIMPLE plans are the SIMPLE IRA plan and the SIMPLE 401 (k) plan. Both are applicable to a self-employed taxpayer.

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For SIMPLE IRA plans, self-employed taxpayers are allowed to put all of their net earnings from self-employment in the plan, up to $16,000 in 2024, plus an additional $3,500 if 50 or older, plus either a 2% fixed contribution or a 3% matching contribution.

To establish the plan, the taxpayer must follow these steps:

1. Complete either Form 5305-SIMPLE, Form 5304-SIMPLE or an IRS-approved "prototype SIMPLE IRA plan", offered by many mutual funds, banks and other financial institutions, and by plan administration companies, and
2. Open a SIMPLE IRA through a bank or another financial institution.
   a. The SIMPLE IRA plan must be set up at any time between January 1st and October 1st.
   b. If the taxpayer becomes self-employed after October 1st, they may set up a SIMPLE IRA plan for the year as soon as it is administratively feasible to do so after their business starts.

For a 401(k) plan, self-employed taxpayers may:

- Make annual salary deferrals up to $23,000 in 2024, plus an additional $7,500 if they are 50 or older either on a pre-tax basis or as designated Roth contributions.
- Contribute up to 20 % of their adjusted net earnings from self-employment for total contributions of $69,000 for 2024, including salary deferrals.
- Tailor their plan to allow access to their account balance through loans and hardship distributions.

Prohibited Transactions

Prohibited transactions are certain transactions made between a retirement plan and a disqualified individual. If an individual is a disqualified person that participates in prohibited transactions, they are to pay tax payments. Prohibited transactions in a qualified plan include:

Disqualified persons include the IRA owner's fiduciary and members of their family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

- A disqualified individual's transfer of plan income, assets or use of them to their advantage.
- Any act of a fiduciary in which plan assets or income are used for their interest.
- The receipt of consideration by a fiduciary for their own account from any party dealing with the plan in a transaction involving plan income or assets.
- Sale, exchange or lease of property between a plan and a disqualified individual.
- Lending money of extending credit between a plan and a disqualified individual.
- Furnishing goods, services or facilities between a plan and a disqualified individual.

Regarding an IRA, a prohibited transaction is one where there is an improper use of this account or annuity by the owner, their beneficiary or other disqualified individuals.

Disqualified individuals in this context include the IRA owner's fiduciary, as well as the members of their family. Some of the prohibited transactions under an IRA account include:

- Borrowing money from the IRA.
- Selling property to the IRA.
- Using the IRA as a collateral in order to secure a loan.

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- Buying property for personal use with funds (present or future) from the IRA account.

Who is Fiduciary?

An IRA fiduciary includes anyone who does any of the following:

- Exercises any discretionary authority or discretionary control in managing the IRA or exercises any authority or control in managing or disposing of its assets.
- Provides investment advice to the IRA for a fee or has any authority or responsibility to do so.
- Has any discretionary authority or discretionary responsibility in administering the IRA.

Qualified and Non-Qualified Plans

The Employee Retirement Income Security Act (ERISA) establishes differences between qualified and non-qualified plans. Qualified plans aim at creating a situation where the person making the remittances gets more benefits, especially regarding tax benefits, over and above the normal retirement benefits. It is achieved by allowing the employer to make the right amount of deductions before taxation on the employee's salary. These deductions are allowed to accumulate without taxation until the time of withdrawing.

A qualified plan, however, has more requirements. It requires that the documents that relate to the plan should be available for inspection any time in which the participants need them. The plan must also cover a specified number of the employees, if not all. Any employee who is qualified for the plan must also be allowed to participate with non-discrimination. The plan must also be established in such a way that after some years, the benefits of the plan become a benefit inherent and unalienable on every employee.

For non-qualified plans, the employees do not enjoy the delay in taxation on their remittances. The deductions on the salary are made by the employer during the salary payment This means that the deductions in term of taxations are also made at this time.

Defined Contribution Plan

A defined contribution plan is a retirement plan in which the employee and/or the employer contribute to the employee’s individual account under the plan. The amount in the account at distribution includes the contributions and investment gains or losses, minus any investment and administrative fees. Generally, the contributions and earnings are not taxed until distribution. The value of the account will change based on contributions and the value and performance of the investments. Examples of defined contribution plans include 401 (k) plans, 403(b) plans, employee stock ownership plans and profit-sharing plans.

Non-Discrimination Rules

This rule states that all employees of a company must be eligible for the same benefits, no matter their position within the company. In this way, the plans will not be discriminatory towards neither company executives nor employees that are not highly compensated alike.

In order to ensure that there will not be any kind of discrimination, there are a number of annual tests required. The company must pass these tests, and if it fails, it must then take the appropriate remedial actions. These are as follows:

- Actual Deferral Percentage (ADP) test.

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- Actual Contribution Percentage (ACP) test.
- Top Heavy test.

These tests take into account the following definitions:

- **Highly Compensated Employee (HCE):** The IRS defines it as an employee that either owned more than 5% of the interest in the business at any time during the year or the preceding one, regardless of how much compensation they received, or received compensation from the business of more than $155,000 (if the preceding year is 2023).
- **Non-Highly Compensated Employee (NHCE):** It is defined as any employee that does not fit the description for an HCE. Newly hired employees that would traditionally qualify as HCE will be treated as NHCEs until the year after they surpass the $155,000 limit.
- **Key Employees:** A key employee is one who in 2024 tax year met one or more of the following criteria:
  - An officer of the company earning $220,000 or more annually;
  - A 1 % owner with a salary of $150,000 or more; and,
  - A 5% (or more) owner regardless of salary.

Tests

- Actual Deferral Percentage (ADP) test

The actual deferral percentage test or ADP test is the first non-discrimination test. This test compares average NHCE salary deferral percentages to the average for the HCEs, and as such, it involves the calculation of these numbers.

The steps for this test are:

1. **Calculate the Annual HCE Deferral rate:** This is done by dividing the salary referral by the total compensation and displaying it as a percentage.
2. **Calculate the Annual NHCE Deferral rate:** Divide the salary referral by the total compensation and display it as a percentage.
3. **Compare and make determinations:** The taxpayer is to make sure that they fall within the acceptable ranges.

The annual maximum HCE deferral rate is based off the contribution rates of the NHCEs.

The maximum HCE rates are determined as follows:

NHCE Percentage	Maximum HCE Percentage
2% or less	NHCE% x 2
2-8%	NHCE% + 2
More than 8%	NHCE% x 1.25

- **Actual Contribution Percentage (ACP) Test**

This includes employer matching contributions and after-tax contributions made by employees. The procedure is similar to that of the ADP test:

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1. **Calculate the Annual HCE Contribution rate:** This is calculated by adding the salary referrals, the employer contributions and the after-tax contributions. Afterwards, this sum is divided by the total compensation. The result is displayed as a percentage.
2. **Calculate the Annual NHCE Contribution rate:** Same procedure as above.
3. **Compare and make the determination:** The taxpayer must make sure that these fall within the acceptable ranges.

- **Top-Heavy Test**

This takes the key employees into account. For this test the taxpayer must:

1. **Gather key employee account balances:** Total the account balances of the key employees participant in the retirement plan.
2. **Determine the percentage of account balance contributed by key employees:** Divide the total key employee account balance by the total account plan balance, and express the result as a percentage.
3. **Check the result:** If the result of the above calculation exceeds 60%, the plan is top-heavy and steps must be taken accordingly.

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REVIEW QUESTIONS

1. Which of the following are contributions that employees can make?

A. Non-elective contributions.

B. Matching contributions.

C. Catch-up contributions.

D. All of the above.

Answer: C

Employees can make these types of contributions:

- *Salary reduction / elective deferral contributions*
- *Designated Roth contributions*
- *After-tax contributions*
- *Catch-up contributions*
- *Employers, in the other hand, can make these types of contributions:*
  - *Employer matching contributions.*
  - *Employer discretionary or non-elective contributions.*

2. For 2024, the contributions for a SEP IRA cannot exceed the lesser of:

A. 25% of compensation, or $61,000.

B. 50% of compensation, or $75,000.

C. 25% of compensation, or $69,000.

D. 30% of compensation, or $60,000.

Answer: C

The contributions to a SEP IRA cannot exceed the lesser of 25% of compensation or $69,000 for 2024.

3. Which of these are conditions that will allow a taxpayer to set up a SIMPLE IRA plan?

A. That the taxpayer had more than 100 employees.

B. C and D.

C. That the taxpayer's employees received at least $5,000 in compensation last year.

D. That the taxpayer had 100 employees or less.

Answer: B

If a taxpayer had 100 or fewer employees who received at least $5,000 in compensation last year, they may set up a SIMPLE IRA plan.

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4. Which of the following are activities that a self-employed taxpayer may do under a 401(k) plan?

A. Contribute up to an additional 25% of their net earnings from self-employment for total contributions of $69,000 for 2024, Including salary deferrals.
B. Make annual salary deferrals up to $23,000 in 2024, plus an additional $7,500 if they are 50 or older either on a pre-tax basis or as designated Roth contributions.
C. Tailor their plan to allow access to their account balance through loans and hardship distributions.
D. All of the above.

Answer: D

For a 401(k) plan, self-employed taxpayers may:

- *Make annual salary deferrals up to $23,000 in 2024, plus an additional $7,500 if they are 50 or older either on a pre-tax basis or as designated Roth contributions.*
- *Contribute up to 20 % of their adjusted net earnings from self-employment for total contributions of $69,000 for 2024, including salary deferrals.*
- *Tailor their plan to allow access to their account balance through loans and hardship distributions.*

5. With respect to the annual tests required under the nondiscrimination standards, which of the following qualify for key employees?

A. A 1% owner with a salary of $150,000 or more.
B. An officer of the company earning $220,000 or more annually.
C. A and B.
D. An employee earning less than $220,000 in 2024.

Answer: C

A key employee is one who in 2024 tax year met one or more of the following criteria:

- *An officer of the company earning $220,000 or more annually;*
- *A 1% owner with a salary of $150,000 or more; and,*
- *A 5% (or more) owner regardless of salary*

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Module: Farmers

A taxpayer is in the business of farming if they cultivate, operate or manage a farm for profit, either as an owner or a tenant. A farm may include livestock, poultry, fruit, fish, dairy and truck farms, as well as ranches, ranges, plantations, orchards and groves.

Farm Income

Farming is one of the economic activities that are undertaken in the U.S. Those who engage in the farming activities usually generate income from different sources, such as sales of their crops, dividend and other sources. Income generated from farming activities is taxable, and therefore, farmers must comply with a number of IRS rules while filing their tax returns forms.

A farmer can receive income from different sources. However, it is a legal requirement under IRS rules that income generated from different farming sources must be reported on the tax return for a particular tax year, unless the income under consideration is excluded through the law. The way the income is reported in the tax return forms is largely dependent on the source. It is critical to understand that the cash method be applied when accounting for farmers' income for tax return filing purposes. Legally, trusts, partnerships and individuals are supposed to report their farm income on Schedule F, Form 1040. One of the sources of income on a farm is the sale of products produced from farming activities. The income generated from this source is supposed to be recorded in Schedule F, on the basis of the FMV of the sale of the items in question.

Additionally, the income generated from the sales of livestock that is held for breeding purposes should be reported on Form 4797, as this results in either capital losses or gains. Also, sales made by an agent on a farmer's behalf should be recorded in Schedule F, as net sales proceed after deducting the commission payable to the agent.

Furthermore, sales of farm products, such as livestock, caused by changes in weather condition, when reporting income gained from the sales, any income generated from sales that exceed the normal annual sales made by the farmer can be deferred to the next tax period. Nonetheless, the sale should be done by a person engaged in farming in an area designated as eligible for federal government aid as a result of the unfavorable changes in weather conditions.

The income generated from rents on farmland and crop share is not considered as farm income, but rent income, unless the individual who rented the land also participated in the farming operations on the land. The income from crop share in situations where the taxpayer does not participate in land operations should be recorded on Form 4835.

Crop Insurance Proceeds

Any crop insurance payments received as the result of physical crop damage or reduction of crop revenue (or both) must be included as income in the year received. The taxpayer may elect to postpone reporting some or all crop insurance proceeds as income until the year following the year in which the physical damage was incurred, provided that they fulfill the following requirements:

- Taxpayer uses the cash method of accounting.
- Taxpayer receives the crop insurance proceeds in the same tax year the crops are damaged.

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- Taxpayer can demonstrate that under their normal business practice, they would have included income from the damaged crops in any tax year following the year the damage occurred.

Subsidies

Several government program payments must be included in farming income, regardless of whether they are received in cash, materials, services or commodity certificates.

Commodity Credit Corporation (CCC) Loans

Loans are not generally reported as income, but if the taxpayer pledges part or all of their production in order to secure a loan, then the loan may be treated as if it were a sale of the crop, and report the loan proceeds as income in the year that they were received. Approval of the IRS to report these CCC loans is not required. To elect to report a CCC loan as income, the taxpayer is to include the proceeds as income on Schedule F in the year received.

Conservation Reserve Program (CRP)

If a taxpayer owns or operates land that is highly erodible, they may enter into a long contract with the U.S. Department of Agriculture (USDA), and agree to convert the land to a use that is less intensive. The taxpayer must report on Schedule F the annual rental payments, as well as any one-time incentive payment received.

Feed assistance and payments

If the Secretary of Agriculture determines that there is a livestock emergency because of a natural disaster, programs can then provide feed assistance, reimbursement payments and other benefits to livestock producers that qualify, according to the Disaster Assistance Act of 1988. The taxpayer is to include in their income the following:

- The market value of donated feed.
- The difference between the market value and the price the taxpayer paid for feed bought at below-market prices.
- Any cost reimbursement received.

Cost-sharing exclusion

A taxpayer is allowed to exclude from their income part or all of the payments received under certain federal or state cost-sharing conservation, reclamation and restoration programs. The exclusion applies to that part of the payment that fulfills all of the following tests:

- Payment was for a capital expense.
- Payment does not increase substantially the taxpayer's annual income from the property for which it was made.
- Payment was certified by the Secretary of Agriculture to have been primarily made for the conservation of soil and water resources, the protection or restoration of the environment, the improvement of forests or the provision of habitat for wildlife.

Patronage Dividends

If farm supplies are bought through a cooperative, the taxpayer may receive income from the cooperative, in the form of patronage dividends, or refunds. On the other hand, if a taxpayer sells their farm products through a cooperative,

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they may receive either patronage dividends or a per-unit retain certificate. The cooperative is required to report the income to the taxpayer using Form 1099-PATR, and sending it to the IRS. If a taxpayer has the duty to file Form 6251, there is an alternative minimum tax adjustment on Form 1099-PATR that must be included in the required form.

The dividends must be reported, in general, as income on Schedule F in the year that they were received, including:

- Money paid as a patronage dividend, including cash advances received.
- The stated dollar value of qualified written notices of allocation.
- The FMV of other property.

Dividends received from non-deductible expenses, such as buying personal or family items, capital assets or depreciable property, must not be reported.

Farm Inventory

If a taxpayer participates in farming activities, and it is a requirement to keep some inventories, then it is crucial to keep a record on all inventories kept as a component of the farm records. The records help in showing the true count of the stock held at the farm. In a scenario where one is engaged in the hatchery business, it is critical to keep a record of egg inventory using the accrual approach.

Also, inventory records should be kept for farm items that are held for purposes of selling them, such as tobacco, cotton and others. These are some of the items that should be included in the inventory:

- Hatchery business.
- Products held for sale.
- Supplies.
- Livestock.
- Growing crops.

Supplies that are purchased for purposes of reselling them should also be included as part of the farm inventory. Other items that should be included in the farm inventory include livestock that is held for purposes of sale, crops grown and that have a reproductive time of that exceed two years. For purposes of taxation, the inventory should be valued on the basis of cost, farm-price approach, unit-livestock-price approach and lower market cost.

The following methods are the ones most commonly used to value inventory, and the method used should conform to generally accepted accounting principles, as well as reflect the taxpayer's income clearly:

- **Farm-price method:** Under this method, each item, whether raised or purchased, is valued at its market price less the direct cost of disposition. Market price is the current price at the nearest market in the quantities usually sold. Cost of disposition includes broker's commissions, freight, hauling to market, and other marketing costs. If a taxpayer chooses this method, then it must be used for the entire inventory, except livestock, which may be inventoried under the unit-livestock-price method.
- **Unit-livestock-price method:** A taxpayer groups or classifies livestock according to type and age, and uses a standard unit price for each animal belonging to a class or group. As a standard rule, the unit price assigned should be close to the normal costs that are normally incurred when producing the animals in each class, and both prices and classifications are subject to the IRS approval in the evaluation of the taxpayer's return. The prices must also be adjusted annually so that they reflect increases or decreases.

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- **Crop method:** If a taxpayer does not harvest and dispose of their crop in the same tax year that they plant it, with the approval of the IRS, the taxpayer is allowed to use the crop method of accounting. This method cannot be used for any tax return, including the taxpayer's first tax return, unless they receive approval from the IRS to do so. Under this method, the cost of producing the crop is deducted in its entirety, including the expense of seed or young plants, in the year the taxpayer realizes income from the crop.

Depreciation for Farmers

When reporting tax returns in a given tax period, if as a farmer, the taxpayer purchased or made improvements to the existing farm property, for example, buying farm machinery, livestock or equipment, then they are allowed to apply depreciation for tax deduction purposes. However, the depreciation cannot be used in one year only; the cost should be spread over the asset's useful life.

There are various assets that can be included in the farm depreciation for purposes of tax deductions. First, the lease of an item aimed at being used for a number of years can be included in the tax report as depreciated. Second, tangible assets purchased for farming purposes should be reported for depreciation deduction purposes.

Buildings and Structural Components

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. The depreciation approach that is recommended for farm items under IRS is mainly the Straight-Line (SL) method.

Example: Rita uses the SL method, owns a farm and a car that is valued at $100,000 and is used for farm activities and has a life of 10 years. In Rita's tax return, she is expected to claim depreciation expenses of $10,000 regarding the car.

Depreciation Claimed on Other Property

Depreciation and amortization include the amounts claimed on the Section 1245 property, as well as the following depreciation and amortization amounts:

- Amounts claimed on property the taxpayer exchanged for, or converted to, their section 1245 property in a like-kind exchange or involuntary conversion.
- Amounts a previous owner of the section 1245 property claimed, if the taxpayer's basis is determined with reference to that person's adjusted basis (for example, the donor's depreciation deductions on property received as a gift and part of the transfer is a sale or exchange).

Example: Andres paid $120,000 for a tractor in 2023. On February 23, 2024, he traded it for a chopper and paid an additional $30,000. To figure his depreciation deduction on the chopper for the current year, Andres continues to use the basis of the tractor as he would have before the trade. Andres can also depreciate the additional $30,000 for the chopper.

Disaster-Area Provisions

There are special rules that apply if a farmer taxpayer incurred federally declared disaster area losses. In the case of a disaster, a farmer is allowed to deduct the losses incurred in certain scenarios:

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- If the losses incurred are more than the amount insured for, the farmer is allowed to make a tax deduction of the exceeding amount. For example, if the losses incurred by a farmer exceed the insurance amount by $50,000, the tax deduction on disaster losses will be included as $50,000.
- If a taxpayer claimed a deduction for a disaster loss in the disaster year and they wish to deduct the loss in the preceding year, an amended return must be filed in order to remove the previously deducted loss on or before the return or amended return is filed for the preceding year that includes the disaster loss deduction.

Theft losses, as long as they are not family related, are allowed for tax deductions. However, if the losses incurred are covered by the insurance, then the farmer cannot benefit from disaster provisions on loss deductions.

Qualified disaster relief payments

Qualified disaster relief payments are not included in the income of taxpayers, 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, and no withholding applies to these payments. Qualified disaster relief payments include payments received for the following expenses:

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 owned by the taxpayer).
- Reasonable and necessary expenses incurred for the repair or replacement of the contents of a personal residence due to a federally declared disaster.

Drought, Flood and Weather-related Conditions

Farmers and ranchers who were forced to sell livestock due to drought may have an additional year to replace the livestock and defer tax on any gains from the forced sales, according to the Internal Revenue Service. The farmer or rancher must be in an applicable region. This is a county designated as eligible for federal assistance plus counties contiguous to that county. The relief generally applies to capital gains realized by eligible farmers and ranchers on sales of livestock held for draft, dairy or breeding purposes. Sales of other livestock, such as those raised for slaughter or held for sporting purposes, or poultry, are not eligible.

To qualify, the sales must be solely due to drought, flooding or other severe weather causing the region to be designated as eligible for federal assistance. Livestock generally must be replaced within a four-year period, instead of the usual two-year period. The IRS is also authorized to further extend this replacement period if the drought continues.

Farm Rental

When a farm sells an asset held for farming activity, a capital gain or loss can be incurred. The farmer is supposed to report the capital gain or loss in their tax return forms, particularly in Schedule F. The income generated from the sale of assets is taxable. For instance, in the case of a farmer selling an asset that he purchased at the price of $100,000, at the price of $150,000, the capital gain in this case would be $50,000. The farmer would be required to report a capital gain on the sale of the asset as $50,000 on Schedule F.

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Landowners and sub-lessors that do not materially participate in the operation or management of the farm (for self-employment tax purposes), file the Form 4835 to report farm rental income based on crops or livestock produced by the tenant.

Farm Tax Computations

In Schedule F, one is supposed to include all the income generated from farming activities, and in Schedule SE, farming expenses should be included. The total deductions in Schedules F and SE help in getting the taxable income of the farmer.

For example, if the gross income of the farmer is $100,000 and the farm expenses and deductions are $60,000, then the taxable income would be $40,000.

It is evident that when reporting for income generated from farm activities, there are certain rules from the IRS that should be followed. It is critical to ensure that when accounting for farm activities while filing for tax returns, everything is recorded accurately in line with the legal requirements of IRS.

Schedule SE is to be filed to figure and report the SE tax on farm earnings.

Schedule J

This schedule may be used to elect to figure a taxpayer's income tax by averaging, over the previous 3 years (base years), all or part of their taxable income from the taxpayer's trade or business of farming or fishing. This election may give the taxpayer a lower tax if their income from farming or fishing last year is high and the taxable income for one or more of the 3 prior years was low.

Estimated Tax

Special rules apply to the payment of estimated tax by individuals who are qualified farmers. A qualified farmer, according to the IRS, has 2/3 of their gross income from all sources for 2024 or 2025 originate from farming activity. The special rules are the following:

- A taxpayer does not have to pay estimated tax if they file their 2024 tax return and pay all the tax due by March 3, 2025.
- A taxpayer does not have to pay estimated tax if the 2024 income tax withholding (including any amount applied to the taxpayer's 2024 estimated tax from their 2023 return) will be at least 66%% (.6667) of the total tax shown on their 2024 tax return or 100% of the total tax shown on the taxpayer's 2023 return.
- If a taxpayer must pay estimated tax, they are required to make only one estimated tax payment (the required annual payment) by January 15, 2025, using special rules to figure the amount of the payment.

The following flow chart shows whether a farmer taxpayer will need to pay estimated tax.

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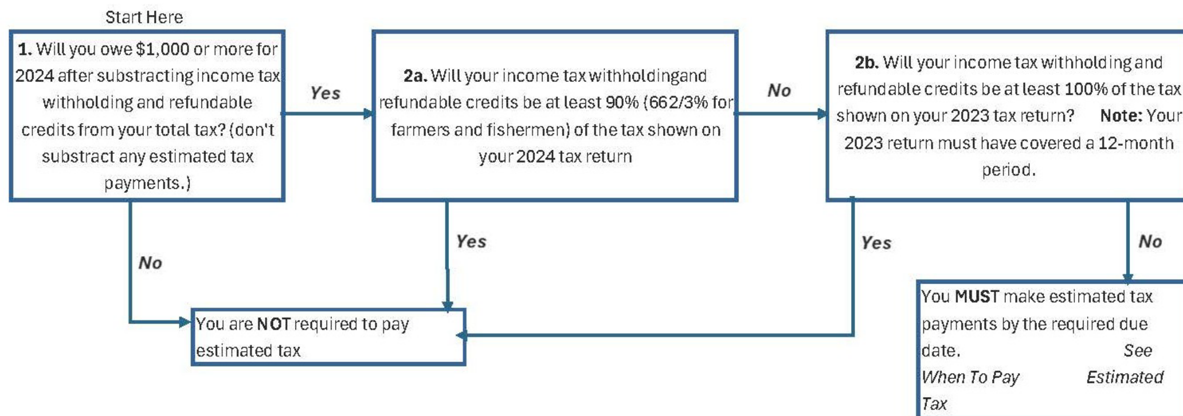
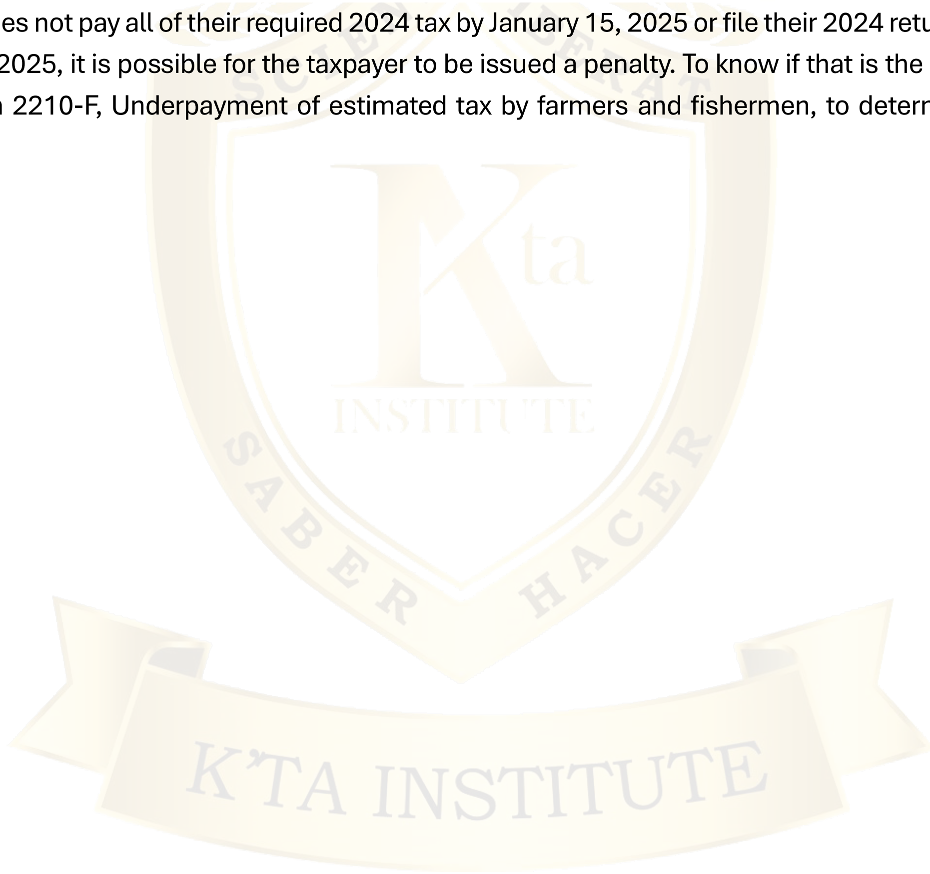
Estimated Tax Test





If the taxpayer does not pay all of their required 2024 tax by January 15, 2025 or file their 2024 return and pay any tax due by March 3, 2025, it is possible for the taxpayer to be issued a penalty. To know if that is the case, the taxpayer should use Form 2210-F, Underpayment of estimated tax by farmers and fishermen, to determine if they owe a penalty.

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REVIEW QUESTIONS

1. Which of the following items must not be reported on Schedule F?

A. Depreciable farm equipment
B. Land.
C. Livestock held for draft, breeding, sport, or dairy purposes.
D. None of the above.

Answer: D

Do not report on Schedule F any gains or losses from sales or other dispositions of following farm assets:

- *Land.*
- *Depreciable farm equipment.*
- *Buildings and structures.*
- *Livestock held for draft, breeding, sport, or dairy purposes.*

2. Where should trusts, partnerships and individuals report their farm income?

A. Schedule F.
B. Schedule C.
C. Schedule D.
D. Schedule 3.

Answer: A

The way the income is reported in the tax return forms is largely dependent on the source. It is critical to understand the cash method to be applied when accounting for farmers' income for tax return filing purposes. Legally, trusts, partnerships and individuals are supposed to report their farm income on Schedule F, Form 1040.

3. Under which of the following circumstances may a taxpayer elect to postpone reporting some or all crop insurance proceeds?

A. Taxpayer uses the accrual method of accounting.
B. Taxpayer receives the crop insurance proceeds in the same tax year the crops are damaged.
C. A and B.
D. None of the above.

Answer: B

The taxpayer may elect to postpone reporting some or all crop insurance proceeds as income until the year following the year in which the physical damage was incurred, provided that they fulfill the following requirements:

- *The taxpayer uses the cash method of accounting.*
- *The taxpayer receives the crop insurance proceeds in the same tax year the crops are damaged.*
- *The taxpayer can demonstrate that under their normal business practice, they would have included income from the damaged crops in any tax year following the year the damage occurred.*

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4. What should not be included as part of the farm inventory?

A. Supplies.
B. Growing crops.
C. Products held for personal use.
D. Products held for sale.

Answer: C

These are some of the items that should be included in the farm inventory:

- *Hatchery business.*
- *Products held for sale.*
- *Supplies.*
- *Livestock.*
- *Growing crops.*

Supplies that are purchased for purposes of reselling them should also be included as part of the farm inventory.

5. How long should depreciation be used regarding farm property?

A. Over the useful life of the asset to be depreciated.
B. For one year.
C. All property must be depreciated over 39 years.
D. All property must be depreciated over 25 years.

Answer: A

When reporting tax returns in a given tax period, if as a farmer, the taxpayer purchased or made improvements to the existing farm property, for example, buying farm machinery, livestock, equipment, then they are allowed to apply depreciation for tax deduction purposes. However, the depreciation cannot be used in one year only; the cost should be spread over the asset's useful life.

6. If Pablo is going to sell an asset purchased at $300,000 for $400,000, which would be the capital gain to be acquired?

A. $100,000.

B. $200,000.

C. $50,000.

D. $75,000.

Answer: A

When a farmer taxpayer sells an asset held for farming activity, a capital gain or loss can be incurred. The farmer is supposed to report the capital gain or loss in their tax return forms, particularly in Schedule F. The income generated from the sale of assets is taxable.

In this case, Pablo will obtain a capital gain of $100,000, and he must report it on Schedule F.

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7. If a farmer taxpayer must pay estimated tax, when are they required to make the required annual payment?

A. April 15, 2025.

B. March 3, 2025.

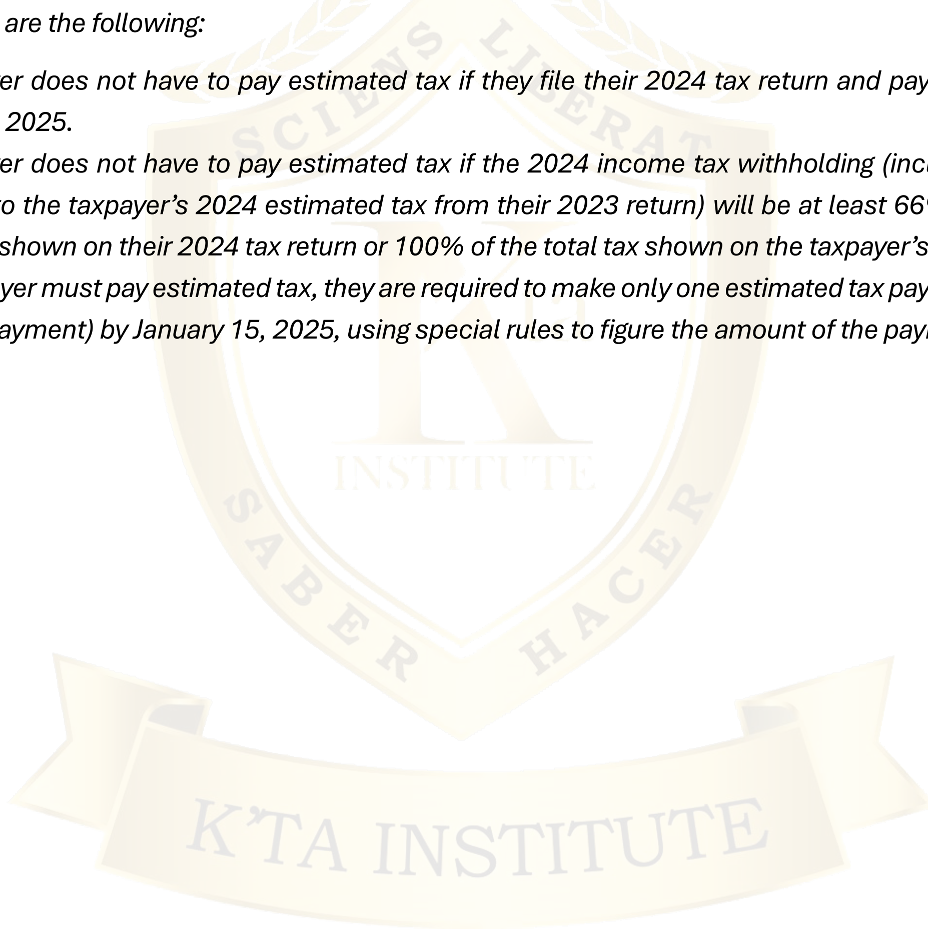
C. January 15, 2025.

D. March 31, 2025.

Answer: C

Special rules apply to the payment of estimated tax by individuals who are qualified farmers. A qualified farmer, according to the IRS, has 2/3 of their gross income from all sources for 2024 or 2025 originate from farming activity. The special rules are the following:

- *A taxpayer does not have to pay estimated tax if they file their 2024 tax return and pay all the tax due by March 3, 2025.*
- *A taxpayer does not have to pay estimated tax if the 2024 income tax withholding (including any amount applied to the taxpayer's 2024 estimated tax from their 2023 return) will be at least 66%% (.6667) of the total tax shown on their 2024 tax return or 100% of the total tax shown on the taxpayer's 2023 return.*
- *If a taxpayer must pay estimated tax, they are required to make only one estimated tax payment (the required annual payment) by January 15, 2025, using special rules to figure the amount of the payment.*



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Module: Rental Property

Real Estate Professional Qualifications

Real Estate Professional

Generally, rental activities are passive activities even if the taxpayer materially participated in them. However, if the taxpayer qualified as a real estate professional, rental real estate activities in which they materially participated aren't passive activities.

For this purpose, each interest the taxpayer has in a rental real estate activity is a separate activity, unless the taxpayer chooses to treat all interests in rental real estate activities as one activity.

If the taxpayer qualified as a real estate professional for 2024, report income or losses from rental real estate activities in which they materially participated as nonpassive income or losses, and complete line 43 of Schedule E (Form 1040).

Qualifications

The taxpayer qualified as a real estate professional for the year if they met both of the following requirements.

- More than half of the personal services performed by the taxpayer in all trades or businesses during the tax year were performed in real property trades or businesses in which the taxpayer materially participated.
- The taxpayer performed more than 750 hours of services during the tax year in real property trades or businesses in which they materially participated.

Don't count personal services performed by the taxpayer as an employee in real property trades or businesses unless the taxpayer was a 5% owner of their employer. The taxpayer was a 5% owner if they owned (or are considered to have owned) more than 5% of the employer's outstanding stock, outstanding voting stock, or capital or profits interest.

If the taxpayer files a joint return, don't count taxpayer's spouse's personal services to determine whether the taxpayer met the preceding requirements. However, the taxpayer can count their spouse's participation in an activity in determining if they materially participated.

Real property trades or businesses

A real property trade or business is a trade or business that does any of the following with real property.

- Develops or redevelops it
- Constructs or reconstructs it.
- Acquires it
- Converts it.
- Rents or leases it
- Operates or manages it.
- Brokers it.

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Closely held corporations

A closely held corporation can qualify as a real estate professional if more than 50% of the gross receipts for its tax year came from real property trades or businesses in which it materially participated.

Commercial Rentals vs. Residential Rentals

In regards with rental property, there are two common types of residential rental activities, namely commercial rentals and residential rentals. The determination behind whether taxpayer's rental activity is considered commercial or residential depends on whether the taxpayer own as second home that rents out all the time, or a vacation home that rents out when the taxpayer or their family are not using it.

If it turns out that the taxpayer rents their property all the time at a fair rental price, defined later in this module, then the taxpayer is considered to have a commercial rental, and a rental income thereof, that must be reported.

In most cases, it must be included in taxpayer's gross income all amounts received as rent. Rental income is any payment received by the taxpayer for the use or occupation of property. It isn't limited to amounts the taxpayer receives as normal rental payments.

If the taxpayer rents temporarily a vacation home they have, when the taxpayer is not using it, then the taxpayer may be considered to have a residential rental, namely a dwelling unit More detailed information on these considerations is available in the next subchapter.

Mixed Used Property/Vacation Home

If the taxpayer has any personal use of a dwelling unit (including a vacation home) that they rent, it must be divided taxpayer's expenses between rental use and personal use.

In general, taxpayer's rental expenses will be no more than their 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 taxpayer's rental expenses may be deducted on Schedule E (Form 1040). Some of taxpayer's personal expenses may be deductible on Schedule A (Form 1040) if the taxpayer itemizes their 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 rented it for less than 15 days during the year.

Dwelling Unit

A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property. It also includes all structures or other property belonging to the dwelling unit. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities.

A dwelling unit doesn't include property (or part of the property) used solely as a hotel, motel, inn, or similar establishment. Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and isn't used by an owner as a home during the year.

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Example: The taxpayer rents a room in their home that is always available for short-term occupancy by paying customers. The taxpayer doesn't use the room for him/her and allows only paying customers to use the room. This room is used solely as a hotel, motel, inn, or similar establishment and isn't a dwelling unit.

Dividing Expenses

If a taxpayer uses a dwelling unit for both rental and personal purposes, divide taxpayer's expenses between the rental use and the personal use based on the number of days used for each purpose. When dividing taxpayer's expenses, follow these rules.

- Any day that the unit is rented at a fair rental price is a day of rental use even if the taxpayer used the unit for personal purposes that day. (This rule doesn't apply when determining whether the taxpayer used the unit as a home.)
- Any day that the unit is available for rent but not actually rented isn't a day of rental use.

Fair Rental Price

A fair rental price for taxpayer's property is generally the amount of rent that a person who isn't related to the taxpayer would be willing to pay. The rent the taxpayer charges isn't a fair rental price if it is substantially less than the rents charged for other properties that are similar to taxpayer's property in their area.

Example: Bernarda's beach cottage was available for rent from June 1st through August 31 (92 days). Except for the first week in August (7 days), when she was unable to find a renter, she rented the cottage at a fair rental price during that time. The person who rented the cottage for July allowed Bernarda to use it over the weekend (2 days) without any reduction in or refund of rent. Bernarda's family also used the cottage during the last 2 weeks of May (14 days). The cottage wasn't used at all before May 17 or after August 31.

Figure the part of Bernarda's cottage expenses to treat as rental expenses as follows:

- The cottage was used for rental a total of 85 days (92 — 7). The days it was available for rent but not rented (7 days) aren't days of rental use. The July weekend (2 days) she used it is rental use because she received a fair rental price for the weekend.
- She used the cottage for personal purposes for 14 days (the last 2 weeks in May).
- The total use of the cottage was 99 days (14 days personal use + 85 days rental use).
- Bernarda's rental expenses are 85/99 (86%) of the cottage expenses.

NOTE: When determining whether Bernarda used the cottage as a home, the July weekend (2 days) she used it is considered personal use even though she received a fair rental price for the weekend. Therefore, Bernarda had 16 days of personal use and 83 days of rental use for this purpose. Because she used the cottage for personal purposes more than 14 days and more than 10% of the days of rental use (8 days), she used it as a home. If Bernarda has a net loss, she may not be able to deduct all of the rental expenses.

Dwelling Unit Used as a Home

If the taxpayer uses a dwelling unit for both rental and personal purposes, the tax treatment of the rental expenses figured earlier under Dividing expenses and rental income, depends on whether the taxpayer is considered to be using the dwelling unit as a home.

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A taxpayer uses a dwelling unit as a home during the tax year if they use it for personal purposes more than the greater of:

1. 14 days, or
2. 10% of the total days it is rented to others at a fair rental price.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price (discussed earlier), don't count that day as a day of rental use in applying (2) above.

Instead, count it as a day of personal use in applying both (1) and (2) above.

Passive Loss Limitation

Generally, the passive activity loss for the tax year isn't allowed. However, there is a special allowance under which some or all of taxpayer's passive activity loss may be allowed.

Definition of Passive Activity Loss

Generally, taxpayer's passive activity loss for the tax year is the excess of taxpayer's passive activity deductions over their passive activity gross income.

For a closely held corporation, the passive activity loss is the excess of passive activity deductions over the sum of passive activity gross income and net active income.

Special $25,000 Allowance

If the taxpayer or their spouse actively participated in a passive rental real estate activity, the amount of the passive activity loss that's disallowed is decreased and the taxpayer therefore can deduct up to $25,000 of loss from the activity from their 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 their spouse for the entire tax year, the taxpayer's special allowance can't be more than $12,500. If the taxpayer lived with their spouse at any time during the year and are filing a separate return, the taxpayer can't use the special allowance to reduce their nonpassive income or tax on nonpassive income.

The maximum special allowance is reduced if taxpayer's modified adjusted gross income exceeds certain amounts. See Phaseout rule, below.

Example: Katrina, 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 isn't 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 the remaining $11,000 rental real estate loss to offset $11,000 of her nonpassive income (wages).

Phaseout Rule

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 taxpayer's Modified Adjusted Gross Income (MAGI)

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that's more than $100,000 ($50,000 if the taxpayer is married filing separately). If taxpayer's modified adjusted gross income is $150,000 or more ($75,000 or more if the taxpayer is married filing separately), the taxpayer generally can't 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.

The MAGI for this purpose is the taxpayer's adjusted gross income figured without the following:

- Taxable Social Security and Tier 1 Railroad Retirement benefits.
- Deductible contributions to Individual Retirement Accounts (IRAs) and Section 501(c)(18) pension plans.
- The exclusion from income of interest from qualified U.S. savings bonds used to pay qualified higher education expenses.
- The exclusion from income of amounts received from an employer's adoption assistance program.
- Passive activity income or loss included on Form 8582.
- Any rental real estate loss allowed because the taxpayer materially participated in the rental activity as a real estate professional.
- Any overall loss from a publicly traded partnership (see Publicly Traded Partnerships (PTPs) in the instructions for Form 8582).
- The deduction allowed for the deductible part of self-employment tax.
- Foreign-derived intangible income and global intangible low-taxed income.
- The deduction allowed for interest on student loans.
- The deduction for qualified tuition and related expenses.

Rental Income

A taxpayer generally must include in gross income all amounts received as rent. Rental income is any payment received for the use or occupation of property. In addition to amounts received as normal rent payments, there are other amounts that may be rental income.

- **Advance rent:** Advance rent is included in rental income in the year received regardless of the period covered or the method of accounting used.

  Example: Jim signed a 10-year lease to rent his property. In the first year, he receives $5,000 as rent for the first year of the lease and $5,000 as rent for the last year of lease. Jim must include $10,000 in his income in the first year.

- **Security deposits:** A security deposit is not included in income when it is received if it is to be returned to the tenant at the end of the lease. But if the taxpayer keeps part or all of the security deposit during the year because the tenant did not live up to the terms of the lease, that amount is included in income.

- **Payment for canceling a lease:** If a tenant pays to cancel a lease, the amount received is rent. Include the payment in income for the year received, regardless of the method of accounting.

- **Expenses paid by tenant:** If a tenant pays any of the expenses and deducts them from their rent paid to the lessor, the expense payments are rental income to the lessor. The expenses may be deducted by the lessor if they are deductible rental expenses.

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- **Not for Profit Rental Income:** Is when the taxpayer does not rent their property to make a profit. If the taxpayer does not rent their property to make a profit, they can deduct their rental expenses only up to the amount of their rental income.

Rental Expenses

The costs of repairs to the rental property may be deducted. However, the cost of improvements cannot be deducted.

The cost of improvements is recovered by taking depreciation. (Section 179 deductions cannot be claimed for property held to produce rental income).

Example: While Jim is out of town, the furnace in his rental property stops working. His tenant pays for the necessary repairs and deducts the repair bill from the rent payment.

Based on the facts in each example, Jim shall include as rental income both the net amount of the rent payment and the amount the tenant paid for the utility bills and the repairs. He can deduct the cost of the utility bills and repairs as a rental expense.

Depreciation of residential rental property

Residential rental property is, by definition, 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 derives from dwelling units. The MACRS recovery period for residential rental property (buildings) is 27.5 years.

The mid-month convention is used for residential rental property under which all property placed in service or disposed of during a month is considered to be placed in service or disposed of at the midpoint of the month.

Home office depreciation: A part of the home used for business may be depreciated over 39 years as non-residential real property.

Repairs vs. Improvements

A repair keeps the property in good operating condition. It does not materially add to the value of the property or substantially prolong its life. Repainting the property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

NOTE: If the repairs are made as part of an extensive remodeling or restoration of the property, the whole job is an improvement and must be capitalized.

Other expenses

Other expenses that can be deducted from rental income include advertising, cleaning and maintenance services, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation.

Vacant rental property

If a taxpayer holds property for rental purposes, the taxpayer may be able to deduct the ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant.

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REVIEW QUESTIONS

1. SpcX and CRN are both closely held corporations and had gross receipts of $400,000. For SpcX and CRN, $270,000 and $198,000 respectively of their gross receipts came from real property trades. Which of them qualifies as a real estate professional?

A. SpcX.

B. CRN.

G Both of them.

D. Neither of them.

Answer: A

A closely held corporation can qualify as a real estate professional if more than 50% of the gross receipts for its tax year came from real property trades or businesses in which it materially participated. In this case, the $270,000 amount of SpcX which came from real property trades means more than the half of its gross receipts, $400,000.

2. In which of the following schedules may a taxpayer who has a personal use of a dwelling unit they rent, deduct their rental expenses?

A. Schedule A

B. Schedule C

C. Schedule E

D. Schedule B

Answer: C

If the taxpayer has any personal use of a dwelling unit (including a vacation home) that they rent, the taxpayer's expenses must be divided between rental use and personal use.

Only the taxpayer's rental expenses may be deducted on Schedule E (Form 1040). Some of the taxpayer's personal expenses may be deductible on Schedule A (Form 1040) if the taxpayer itemizes their deductions.

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*************** **END OF SECTION** *****************

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What is being an Enrolled Agent?

An Enrolled Agent (EA) is a tax professional authorized by the U.S. Department of the Treasury to represent taxpayers before the Internal Revenue Service (IRS). Holding the EA designation signifies deep expertise in U.S. tax laws, along with a strong commitment to ethics and professional responsibility, enabling EAs to effectively guide taxpayers through the complexities of taxation.

This book is an essential resource for aspiring Enrolled Agents, meticulously designed to prepare candidates for Part II (Business) of the Special Enrollment Examination (SEE). It comprehensively covers all necessary aspects of corporate entity taxation, detailing tax obligations and requirements for various business structures, including corporations, partnerships, and limited liability companies. Topics such as entity formation, tax filing procedures, and dissolution processes are clearly explained, providing a practical understanding for future professionals.

Additionally, the book delves into critical IRS regulations concerning deductions, credits, and effective management of business assets and liabilities. Readers will also gain valuable insights into strategies for maintaining compliance and maximizing efficiency within their tax practice.

With this book that includes theory and practice, the preparer will have everything needed to prepare for and take the second part of the SEE.

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