Enrolled Agent University:

Business Tax Law

Certifyible.com

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CONTENTS

INTRODUCTION

Part two of the special enrollment examination consists of three domains which include the following:

- Domain 1: Business entities and consideration (30 questions)
- Domain 2: Business tax preparation (37 questions)
- Domain 3: Specialized returns for taxpayers (18 questions)

Part two of the Special Enrollment Examination will typically test heavily on Basis, Trust, Estates, Retirement and understanding the various aspects of the different types of entities and the requirements.

Please make sure you pay special attention to these points as these points are generally the hardest for most students.

Towards the end of this book we have an entire section of example basis scenarios you can practice. Ensure you understand how the basis was calculated for all of these types of scenarios.

If you need more support check out the Enrolled Agent University online course and weekly live instructor training at www.certifyible.com.

This book as well as the online course is structured to cover all three domains above.

From time to time we may make updates to this book throughout the year to make revisions or corrections.

If you have any questions we are here to help. Feel free to reach out to us at hello@certifyible.com.

BUSINESS ENTITIES

Overview

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

Sole Proprietorships

A sole proprietorship is an unincorporated business that is owned by one individual. It is the simplest form of business organization to start and maintain. The business has no existence apart from the owner.

Its liabilities are the personal liabilities, and the owner undertakes the risks of the business for all assets owned, whether or not used in the business.
The owner needs to Include the income and expenses of the business on SCH C of their 1040 tax return.

Forms Required To Be filed:

If you are liable for:	Then use Form:
Income Tax	1040, U.S. Individual Income Tax Return or 1040-SR, U.S. Tax Return for Seniors and Schedule C (Form 1040), Profit or Loss from Business
Self-employment tax	Schedule SE (Form 1040), Self-Employment Tax
Estimated tax	1040-ES, Estimated Tax for Individuals
Social security and Medicare taxes and income tax withholding	941, Employer's Quarterly Federal Tax Return 943, Employer's Annual Federal Tax Return for Agricultural Employees 944, Employer's Annual Federal Tax Return
Providing information on social security and Medicare taxes and income tax withholding	W-2, Wage and Tax Statement (to employee) and W-3, Transmittal of Wage and Tax Statements (to the Social Security Administration)
Federal unemployment (FUTA) tax	940, Employer's Annual Federal Unemployment (FUTA) Tax Return
Filing information returns for payments to nonemployees and transactions with other persons	See Information Returns
Excise Taxes	Refer to the Excise Tax Web page

Partnerships

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

A partnership must file an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, it "passes through" any profits or losses to its partners. Each partner includes his or her share of the partnership's income or loss on his or her own tax return.

Partners are not employees and should not be issued a Form W-2. The partnership must furnish copies of Schedule K-1 (Form 1065) to the partners by the date Form 1065 is required to be filed, including extensions.

Partners (individuals) in a partnership, will use some of the forms that may be required to file.

Chart 1 (Partnership)

If you are a partnership then you may be liable for...	Use Form...	Separate Instructions...
Annual return of income	1065,U.S. Return of Partnership Income	Instructions for Form 1065 U.S. Return of Partnership Income (PDF)
Employment taxes: Social security and Medicare taxes and income tax withholding, Federal unemployment (FUTA) tax, Depositing employment taxes	941, Employer's Quarterly Federal Tax Return and 943, Employer's Annual Federal Tax Return for Agricultural Employees (for farm employees), 940, Employer's Annual Federal Unemployment (FUTA) Tax Return	Instructions for Form 941 Employer's QUARTERLY Federal Tax Return (PDF), Instructions for Form 943 Employer's Annual Federal Tax Return for Agricultural Employees (PDF), Instructions for Form 940 Employer's Annual Federal Unemployment (FUTA) Tax Return (PDF)
Excise Taxes	Refer to the Excise Tax web page	

Chart 2 (Individual Partners in a Partnership)

If you are a partner (individual) in a partnership, then you may be liable for...	Use Form...	Separate Instructions...
Income Tax	1040, U.S. Individual Income Tax Return or 1040-SR, U.S. Tax Return for Seniors and Schedule E (Form 1040), Supplemental Income and Loss	Instructions for 1040 U.S. Individual Income Tax Return (PDF)Instructions for Schedule E (Form 1040) (PDF)
Self-employment tax	1040, U.S. Individual Income Tax Return or 1040-SR, U.S. Tax Return for Seniors and Schedule SE (Form 1040), Self-Employment Tax	Instructions for Schedule SE (Form 1040) (PDF
Estimated tax	1040-ES, Estimated Tax for Individuals	

Married Couple Businesses & Qualified Joint Venture

Partnerships

One of the advantages of operating a business is hiring family members. However, the employment tax requirements for family employees may vary from those that apply to other employees.

Facts When Working With Spouses

Both spouses carrying on the trade or business

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

Qualified joint venture

Spouses may elect treatment as a qualified joint venture instead of a partnership. A qualified joint venture conducts a trade or business where:

- The only members are a married couple who file a joint return,
- Both spouses materially participate in the trade or business, and
- Both spouses elect not to be treated as a partnership

Only businesses owned and operated by spouses as co-owners and not in the name of a state law entity, such as a limited partnership or limited liability company, are eligible for the qualified joint venture election.

Spouses electing qualified joint venture status are sole proprietors for federal tax purposes. Each spouse must file a separate Schedule C to report their share of profits and losses. They don't need an EIN unless their sole proprietorship must file excise, employment, alcohol, tobacco or firearms returns.

One spouse cannot continue to use the partnership's Employer Identification Number (EIN) for the qualified joint venture.

The EIN must stay with the partnership; it's used by the partnership for any year in which the business doesn't meet qualified joint venture requirements.

C Corporations

A corporation generally takes the same deductions as a sole proprietorship to figure its taxable income. A corporation conducts business, realizes net income or loss, pays taxes and distributes profits to shareholders.

For federal income tax purposes, a C corporation is recognized as a separate tax paying entity. The profit of a corporation is taxed to the corporation when earned, and then is taxed to the shareholders when distributed as dividends. This creates a double tax. The corporation does not get a tax deduction when it distributes dividends to shareholders. Shareholders cannot deduct any loss of the corporation.

C corporation or an S corporation may be liable for...	Use Form...	Separate Instructions...
Employment taxes Social security and Medicare taxes and income tax withholding Federal unemployment (FUTA) tax	941, Employer's Quarterly Federal Tax Return (PDF) or 943, Employer's Annual Federal Tax Return for Agricultural Employees (PDF) (for farm employees) 940, Employer's Annual Federal Unemployment (FUTA) Tax return (PDF)	Instructions for Form 941 (PDF) Instructions for Form 940 (PDF) Instructions for Form 943 (PDF)
Excise Taxes	Refer to the Excise Tax Web page	
Income Tax	1120, U.S. Corporation Income Tax Return (PDF)	Instructions for Form 1120 U.S. Corporation Income Tax Return (PDF)
Estimated tax	1120-W, Estimated Tax for Corporations (PDF)	Instructions for Form 1120-W (PDF)

S Corporation
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.

Qualification of S Corporation status:

- Be a domestic corporation
- Have only allowable shareholders
    - May be individuals, certain trusts, and estates and
    - May not be partnerships, corporations, or non-resident alien shareholders
- Have no more than 100 shareholders
- Have only one class of stock
- Not be an ineligible corporation (i.e., certain financial institutions, insurance companies, and domestic international sales corporations).

In order to become an S corporation, the corporation must submit Form 2553 Election by a Small Business Corporation signed by all the shareholders.

Filing Requirements: Chart 1 - S Corporation

S corporation may be liable for...	**Use Form...**	**Separate Instructions...**
Income Tax	1120S1120S (Sch. K-1)	Instructions for Form 1120S (PDF)Instructions for Form 1120S Sch. K-1 (PDF)
Estimated tax	1120-W (corporation only)	Instructions for Form 1120-W (PDF)
Employment taxes: Social security and Medicare taxes and income tax withholding	941 or 943 for farm employees) 940	Instructions for Form 941 Employer's QUARTERLY Federal Tax Return (PDF)
		Instructions for Form 943 Employer's Annual Federal Tax Return for Agricultural Employees (PDF)
Employment taxes: Federal unemployment (FUTA) tax Depositing employment taxes	941 or 943 for farm employees) 940	Instructions for Form 940 Employer's Annual Federal Unemployment (FUTA) Tax Return (PDF)
Excise Taxes	Refer to the Excise Tax webpage	

Chart 2 – S Corporation Shareholders

S corporation may be liable for...	Use Form...	Separate Instructions...
Income Tax	1040 or 1040-SR and Schedule E and other forms referenced on the shareholder's Schedule K-1	Instructions for Schedule E (Form 1040 and 1040-SR) Supplemental Income and Loss (PDF)
Estimated tax	1040-ES	

Limited Liability Companies (Llc)
A Limited Liability Company (LLC) is a business structure allowed by state statute. Owners of an LLC are called members. Most states do not restrict ownership, so members may include individuals, corporations, other LLC, and foreign entities. A few types of businesses generally cannot be LLCs, such as banks and insurance companies. Check your state's requirements and the federal tax regulations for further information, there are special rules for foreign LLCs.

Classifications

Depending on elections made by the LLC and the number of members, the IRS will treat an LLC as either:

- corporation
- partnership – a domestic LLC with at least two members (for Federal income tax purposes)
- unless it files Form 8832 and
- affirmatively elects to be treated as a corporation
- or as part of the LLC's owner's tax return (a "disregarded entity") - an LLC with only one member (For income tax purposes)

    - unless it files Form 8832 and
    - elects to be treated as a corporation
- separate entity - LLC with only one member (for employment tax and certain excise taxes)

Effective Date of Election

When an LLC does not want to accept its default federal tax classification or that wishes to change its classification, use Form 8832, Entity Classification Election. An election specifying an LLC's classification cannot take effect more than 75 days prior to the date the election is filed. It will take effect not later than 12 months after the date the election is filed**.** An LLC may be eligible for late election relief in certain circumstances

Tax Exempt Organization (Non-Profit)

Exempt Organization Types

- **Charitable Organizations**

1. Organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, educational, or other specified purposes and that meet certain other requirements are tax exempt under Internal Revenue Code Section 501(c)(3).

- **Churches and Religious Organizations**
    a. Churches and religious organizations, like many other charitable organizations, may qualify for exemption from federal income tax under Section 501(c)(3).
- **Private Foundations**
    a. Every organization that qualifies for tax-exempt status under Section 501(c)(3) is classified as a private foundation unless it meets one of the exceptions listed in Section 509(a). Private foundations typically have a single major source of funding (usually gifts from one family or corporation rather than funding from many sources) and most have as their primary activity the making of grants to other charitable organizations and

to individuals, rather than the direct operation of charitable programs.

- **Political Organizations**
    a. A political organization subject to Section 527 is a party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function.
- **Other Nonprofits**
    a. Organizations that meet specified requirements may qualify for exemption under subsections other than 501(c)(3). These include social welfare organizations, civic leagues, social clubs, labor organizations and business leagues.

Entity type default classifications and elections

An eligible entity uses Form 8832 to elect how it will be classified for federal tax purposes, as:

- A corporation
- A partnership
- An entity disregarded as separate from its owner

An eligible entity uses Form 2553**:**

- S corporation

Employment Identification Number (EIN)

An Employer Identification Number (EIN) is a nine-digit number that the IRS assigns in the following format: XX-XXXXXXX. It is used to identify the tax accounts of employers and certain others who have no employees. However, for employee plans, an alpha (for example, P) or the plan number (e.g., 003) may follow the EIN.

The IRS uses the number to identify taxpayers that are required to file various business tax returns. EINs are used by employers, sole proprietors, corporations, partnerships, non-profit associations, trusts, estates of decedents, government agencies, certain individuals, and other business entities.

Use your EIN on all of the items that you send to the IRS and the Social Security Administration (SSA).

New Ein Not Required

Under certain conditions the following business entities will not need a new EIN:

- Sole Proprietorship
- Corporation
- Partnership
- Estate
- Trust

<u>Sole Proprietorship</u>

Will Not Need A New Ein

- Change in the name of the business
- Change in the location or added locations (stores, plants, enterprises, or branches of the entity)
- Operating multiple businesses (including stores, plants, enterprises, or branches of the entity)
    - Sole proprietor who conducts business as a limited liability company (LLC), do not need a separate EIN for the LLC,
    - unless required to file employment or excise tax returns

Will Need A New Ein

- You are subject to a bankruptcy proceeding.
- You incorporate.
- You take in partners and operate as a partnership.
- You purchase or inherit an existing business that you operate as a sole proprietorship.

<u>Corporation</u>

Will Not Need A New Ein

- 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.
- The business name changes
- Change in the location or added locations (stores, plants, enterprises, or branches)
- Elect to be taxed as an S Corporation by filing Form 2553
- After a corporate reorganization, the owner only changes identity, form, or place of organization
- The corporation is sold, and the assets, liabilities and charters are obtained by the buyer

Will Need A New Ein

- A corporation receives a new charter from the secretary of state.
- You are a subsidiary of a corporation using the parent's EIN or you become a subsidiary of a corporation.
- You change to a partnership or a sole proprietorship.
- A new corporation is created after a statutory merger.

<u>Partnership</u>

Will Not Need A New Ein

- The partnership declares bankruptcy. However, if a liquidating trust is established for a partnership that is in bankruptcy, an EIN for that trust is required.
- The partnership name changes
- The location of the partnership changes or new locations are added.

- 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.

WILL NEED A NEW EIN

- You incorporate.
- Your partnership is taken over by one of the partners and is operated as a sole proprietorship.
- You end an old partnership and begin a new one.

Estate

Will Not Need A New Ein

- The administrator, personal representative, or executor changes his/her name or address.

Will Need A New Ein

- A trust is created with funds from the estate (not simply a continuation of the estate).
- You represent an estate that operates a business after the owner's death.

Trust

Will Not Need A New Ein

- The trustee changes
- The grantor or beneficiary changes his or her name or address.

Will Need A New Ein

- One person is the grantor/maker of many trusts. For example, if there is a trust for each grandchild, each trust must have a separate EIN and file a separate tax return. However, a single trust with several beneficiaries requires only one EIN.
- A trust changes to an estate.

- A living or intervivos trust changes to a testamentary trust.
- A living trust terminates by distributing its property to a residual trust.

Accounting periods

Every taxpayer (individuals, business entities, etc.) must figure taxable income for an annual accounting period called a tax year. The calendar year is the most common tax year. Other tax years include a fiscal year and a short tax year.

Each taxpayer must use a consistent accounting method, which is a set of rules for determining when to report income and expenses. The most commonly used accounting methods are the cash method and the accrual method.

Under the cash method, you generally report income in the tax year you receive it, and deduct expenses in the tax year in which you pay the expenses.

Under the accrual method, you generally report income in the tax year you earn it, regardless of when payment is received. You deduct expenses in the tax year you incur them, regardless of when payment is made.

Reporting requirements

Any person engaged in a trade or business, including a corporation, partnership, individual, estate, and trust, who makes reportable transactions during the calendar year, must file information returns to report those transactions to the IRS and furnish a copy of the information returns to recipients.

Form 1099-NEC, Nonemployee Compensation

By January 31st of the year following the tax year, file Form 1099-NEC, Nonemployee Compensation, when you're reporting non-employee compensation payments in box 1

Form 1099-MISC, Miscellaneous Income

By February 28th of the year following the tax year, file Form 1099-MISC, Miscellaneous Information, if you file on paper. By March 31st of the year following the tax year, file electronic Form 1099-MISC, Miscellaneous Information.

Every employer engaged in a trade or business who pays remuneration, including noncash payments of $600 or more for the year (all amounts if any income, social security, or Medicare tax was withheld) for services performed by an employee must file a Form W-2 for each employee (even if the employee is related to the employer) from whom:

- Income, Social Security, or Medicare tax was withheld.
- Income tax would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W-4, Employee's Withholding Allowance Certificate.

The due date for filing 2023 Forms W-2, W-2AS, W-2CM, W-2GU, W-2VI, W-3, and W-3SS with the SSA is January 31, 2024, whether you file using paper forms or electronically.

Business vs. Hobby

In general, taxpayers may deduct ordinary and necessary expenses for conducting a trade or business.

An ordinary expense is an expense that is common and accepted in the taxpayer's trade or business.

A necessary expense is one that is appropriate for the business.

Generally, an activity qualifies as a business if it is carried on with the reasonable expectation of earning a profit. In order to make this determination, taxpayers should consider the following factors:

- Does the time and effort put into the activity indicate an intention to make a profit?
- Does the taxpayer depend on income from the activity?

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

The IRS presumes that an activity is carried on for profit if it makes a profit during at least three of the last five tax years, including the current year — at least two of the last seven years for activities that consist primarily of breeding, showing, training or racing horses.

If an activity is not for profit, losses from that activity may not be used to offset other income. An activity produces a loss when related expenses exceed income. The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations. Deductions for hobby activities are claimed as itemized deductions on Schedule A (Form 1040). These deductions must be taken in the following order and only to the extent stated in each of three categories:

- Deductions that a taxpayer may take for personal as well as business activities, such as home mortgage interest and taxes, may be taken in full.
- Deductions that don't result in an adjustment to basis, such as advertising, insurance premiums and wages, may be taken next, to the extent gross income for the activity is more than the deductions from the first category.
- Business deductions that reduce the basis of property, such as depreciation and amortization, are taken last, but only to the extent gross income for the activity is more than the deductions taken in the first two categories.

POP QUIZ & ANSWER SHEET

BUSINESS ENTITIES

POP QUIZ

Test your knowledge on *Business Entities* by answering the questions below. The answer sheet may be found at the end of the Pop Quiz.

Q1: What schedule must you file to calculate self-employment tax?

A. Form 1040-SR
B. Form 1040-ES
C. Form 1040 Schedule C
D. Form 1040 Schedule SE

Q2: It is a corporation that elects to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes:

A. Sole Proprietorship
B. Partnership
C. C Corporations
D. S Corporations

Q3: Which of the following entities does not require an EIN?

A. C Corporations
B. S Corporations
C. Sole Proprietorship with no employees
D. Exempt Organization

Q4: It is the relationship existing between two or more persons who join to carry on a trade or business. Each person contributes money, property, labor, or skill, and expects to share in the profits and losses of the business.

A. Sole Proprietorship
B. Partnership
C. C Corporations
D. S Corporations

Q5: All of the following are true about S Corps, except:

A. Be a Domestic Corporation
B. May have 1000 shareholders
C. Have one class of stock
D. Not be a Financial Institution

Q6: It conducts business, realizes net income or loss, pays taxes, and distributes profits to shareholders.

A. Sole Proprietorship
B. Partnership
C. C Corporations
D. S Corporations

Q7: All are true about spouses and qualified joint ventures, except:

A. The only members are a married couple who file a joint return.
B. Both spouses materially participate in the trade or business.
C. The only members are a married couple who does not file a joint return.
D. Both spouses elect not to be treated as a partnership.

Q8: It is the simplest form of business organization to start and maintain.

A. Sole Proprietorship
B. Partnership
C. C Corporations
D. S Corporations

Q9: **What do you call owners of an LLC?**

A. CEO
B. President
C. Members
D. VIP

Q10: **What form must an LLC file if they do not want to accept its default federal tax classification and wishes to change to a corporation?**

A. Form 940
B. Form 2553
C. Form 2848
D. Form 8832

ANSWER SHEET

1. Answer is D – Form 1040 Schedule SE

2. Answer is D - S Corporations

3. Answer is C - Sole Proprietorship with no employees

4. Answer is B - Partnership

5. Answer is B - May have 1000 shareholders

6. Answer is C - C Corporations

7. Answer is C - The only members are a married couple who does not file a joint return.

8. Answer is A - Sole Proprietorship

9. Answer is C - Members

10. Answer is D - Form 8832

PARTNERSHIPS

The Nuts & Bolts Of A Partnership

In Publication 541, the Internal Revenue Service (IRS) defines a partnership as:

- 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 separate definition from the IRS website Tax Information for Partnerships defines a partnership a bit more clearly:
- A partnership is the relationship between two or more people in a trade or business. Each person contributes money, property, labor or skill, and shares in the profits and losses of the business.

Contrary to popular belief, merely having a business together does not make a partnership. The members of a partnership must be contributing something into the business (money, labor, property) and be entitled to a determined share of the profit and loss. In Publication 541, the IRS provides the following: Example to illustrate this requirement:

For example, co-ownership of property maintained and rented or leased is not a partnership unless the co-owners provide services to the tenants.

Self-Employment Income

Partners in a partnership (including certain members of a limited liability company (LLC)) are considered to be self-employed, not employees, when performing services for the partnership.

- If a taxpayer is a general partner of a partnership (or the equivalent in an LLC) that carries on a trade or business, their net earnings from self-employment include their distributive share of the income or loss from that trade or business. General partners must also include guaranteed payments as net earnings from self-employment.

- If a taxpayer is a limited partner of a partnership that carries on a trade or business, only guaranteed payments for services rendered to, or on behalf of, the partnership are net earnings from self-employment.
- Limited partners don't pay self-employment tax on their distributive share of partnership income, but do pay self-employment tax on guaranteed payments.

Partnership Income

Every partnership that engages in a trade or business or has gross income must file an information return on Form 1065 showing its income, deductions, and other required information. The partnership return must show the names and addresses of each partner and each partner's distributive share of taxable income. The return must be signed by a partner. If an LLC is treated as a partnership, it must file Form 1065 and one of its members must sign the return. 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 pays or incurs any expenses treated as deductions or credits for federal income tax purposes.

Partnership Expenses

Business expenses are the costs of carrying on a trade or business, and they are usually deductible if the business is operated to make a profit. Partnerships can take ordinary and necessary business expenses such as advertising, rent, utilities, wages, insurance and more.

Qualified Joint Venture Election

A "qualified joint venture," whose only members are spouses filing a joint return, can elect not to be treated as a partnership for federal tax purposes.

A qualified joint venture conducts a trade or business where the only members of the joint venture are spouses filing jointly; both spouses elect not to be treated as a partnership; both spouses materially participate in the trade or business; and the business is co-owned by both spouses and is not held in the name of a state law entity such as a partnership or an LLC.

Under this election, a qualified joint venture conducted by spouses who file a joint return is not treated as a partnership for federal tax purposes and therefore doesn't have a Form 1065 filing requirement. All items of income, gain, deduction, loss, and credit are divided between the spouses based on their respective interests in the venture. Each spouse takes into account their respective share of these items as a sole proprietor.

Each spouse would account for their respective share on the appropriate form, such as Schedule C (Form 1040).

For purposes of determining net earnings from self-employment, each spouse's share of income or loss from a qualified joint venture is taken into account just as it is for federal income tax purposes (that is, based on their respective interests in the venture).

If the spouses do not make the election to treat their respective interests in the joint venture as sole proprietorships, each spouse should carry their share of the partnership income or loss from Schedule K-1 (Form 1065) to their joint or separate Form(s) 1040.

Each spouse should include their respective share of self-employment income on a separate Schedule SE (Form 1040), Self-Employment Tax.

This generally doesn't increase the total tax on the return, but it does give each spouse credit for social security earnings on which retirement benefits are based. However, this may not be true if either spouse exceeds the social security tax limitation.

Contribution of Property

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

Basis of contributed property

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

For example
Laurette contributes an apartment building with a fair market value of \$200,000 and an adjusted basis of \$100,000. When Laurette contributes the apartment building to the partnership, her basis in the partnership will be \$100,000 the same as her adjusted basis. The partnership will have an adjusted basis of the property (inside basis) of \$100,000 as well. So if the partnership later sells the property that is what they will use (\$100k) to recognize any gain or loss.

Guaranteed Payments

Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership's income.

A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner. This treatment is for purposes of determining gross income and deductible business expenses only.

For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income. Guaranteed payments are not subject to income tax withholding.

The partnership generally deducts guaranteed payments on Form 1065, line 10, 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 (see Business start-up and organizational costs) Organizational expenses (if the election is not made) and syndication expenses paid to partners must be reported on the partners' Schedules K-1 as guaranteed payments.

IRS Example

Under a partnership agreement, Divya is to receive 30% of the partnership income, but not less than $8,000. The partnership has a net income of $20,000.

Divya's share, without regard to the minimum guarantee, is $6,000 (30% × $20,000).

The guaranteed payment that the partnership can deduct is $2,000 ($8,000 − $6,000).

Divya's income from the partnership is $8,000, and the remaining $12,000 of partnership income will be reported by the other partners in proportion to their shares under the partnership agreement.

If the partnership net income had been $30,000, there would have been no guaranteed payment because her share, without regard to the guarantee, would have been greater than the guarantee.

Partner's liabilities assumed by partnership

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

IRS Example.

Terry 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% (0.80) × $4,000).....$3,200
Basis of Ivan's partnership interest $4,800

In the above example we have to allocate to the remaining partners their portion of the debt that they are now going to assume. If you are going to be a partner in a partnership and you are contributing property that has a mortgage or other debt attached to it you are only going to be responsible for your percentage of partnership. In the above example Terry is obtaining 20% interest so Terry will assume 20% of the mortgage debt while the other partners collectively will assume the remaining 80%

Basis of Partner's Interest

The basis of a partnership interest is the money plus the adjusted basis of any property the partner contributed. If the partner must recognize gain as a result of the contribution, this gain is included in the basis of 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.

For example
Laura contributes $10,000 cash and a commercial building with a fair market value of $50,000 and an adjusted basis of $25,000 in exchange for 50% of the partnership. Her total basis in the partnership is

Cash $10,000 + $25,000 adjusted basis of commercial property = $35,000 basis in the partnership.

Disposition of Partner's Interest

A loss incurred from the abandonment or worthlessness of a partnership interest is an ordinary loss only if both of the following tests are met.
• The transaction is not a sale or exchange.
• The partner has not received an actual or deemed distribution from the partnership.

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

Sale, Exchange, or Other Transfer

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

IRS Example 1
Kumar became a limited partner in the ABC Partnership by contributing $10,000 in cash on the formation of the partnership. The adjusted basis of his partnership interest at the end of the current year is $20,000, which includes his $15,000 share of partnership liabilities. The partnership has no unrealized receivables or inventory items. Kumar sells his interest in the partnership for $10,000 in cash. He had been paid his share of the partnership income for the tax year. Kumar realizes $25,000 from the sale of his partnership interest ($10,000 cash payment + $15,000 liability relief). He reports $5,000 ($25,000 realized − $20,000 basis) as a capital gain.

IRS Example 2

The facts are the same as in Example 1, except that Kumar withdraws from the partnership when the adjusted basis of his interest in the partnership is zero. He is considered to have received a distribution of $15,000, his relief of liability. He reports a capital gain of $15,000.

Partnership Agreement

The partnership agreement includes the original agreement and any modifications. The modifications must be agreed to by all partners or adopted in any other manner provided by the partnership agreement.

The agreement or modifications can be oral or written.

Partners can modify the partnership agreement for a particular tax year after the close of the year but not later than the date for filing the partnership return for that year. This filing date doesn't include any extension of time.

If the partnership agreement or any modification is silent on any matter, the provisions of local law are treated as part of the agreement.

General Vs Limited Partnership

The difference between general and limited partnerships is a question of liability. A general partner is one who has unlimited liability related to the business, while a limited partner does not have a share of those liabilities.

A limited partnership must have both general and limited partners by law. Typically, the general partners assume the day-to-day management of the business while the limited partners might participate in major decisions but otherwise elect to remain uninvolved. A limited partner is primarily interested in the return on their investment rather than operating a business themselves. For this reason, their liability in the business is limited only to their own investment, while general partners have unlimited liability.

Liquidation at Partner's Retirement or Death Payments made by the partnership to a retiring partner or successor in interest of a deceased partner in return for the partner's entire interest in the partnership may have to be allocated between payments in liquidation of the partner's interest in partnership property and other payments. The partnership's payments include an assumption of the partner's share of partnership liabilities treated as a distribution of money. For income tax purposes, a retiring partner or successor in interest of a deceased partner is treated as a partner until their interest in the partnership has been completely liquidated.

Liquidating payments.

Payments made in liquidation of the interest of a retiring or deceased partner in exchange for their interest in partnership property are considered a distribution, not a distributive share or guaranteed payment that could give rise to a deduction (or its equivalent) for the partnership.

Partnership Filing Requirements

Partnerships file a Form 1065, U.S. Return of Partnership Income. This is an informational return, since partnerships are pass-through entities for business income tax. This means that the income passes through the entity to its partners individually.

Each partner will receive a supporting schedule of the Form 1065 called Schedule K-1, Partner’s Share of Credits, Deductions, Income, Etc. This form indicates how much of the partnership’s profits or losses are allocated to each individual. That amount is reported on their Form 1040 along with other income and deduction information.

Example:

Thomas and Theodore are best friends who happen to be brothers. They have started a business together providing demolition services in their community called T&T Demolition. Since they have started to acquire some new equipment for the business, they want to go ahead and establish a partnership for legal purposes. Their capital contributions at start-up were roughly the same, so they would like to establish the partnership with each of them owning 50% of the company.

Separately Stated Items

Separately stated items are specific transaction types that are broken out separately on the Schedule K-1 for each partner instead of being included in the gross profit/loss for the partnership.

Separately stated items can be things that other businesses would consider a normal part of their operating expenses, but instead are passed through to the partners to report on their individual income tax return with other itemized deductions. This means that the taxable income a partner reports from their Schedule K-1 could be much higher than the net income on the partnership's Profit & Loss Statement.

Each of the following items must be allocated separately from the ordinary business income reported on line 1 of the Schedule K-1:

- Net short-term capital gains and losses.
- Net long-term capital gains and losses.
- Section 1231 gains and losses,
- Charitable contributions.
- Dividends eligible for a dividends-received deduction.
- Taxes paid to a foreign country or to a U.S. possession.
- Any other items provided by the Regulations.

Role of Partnership Representative

Under the centralized partnership audit regime, partnerships are required to designate a partnership representative. 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. For more information, see the Instructions for Form 1065.

Electing Out of the Centralized Partnership Audit Regime

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, a C corporation, a foreign entity that would be treated as a C corporation if it were domestic, an S corporation, or an estate of a deceased partner.

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 TIN of each partner.
• The federal tax classification for each partner.

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, you are affirming that all of the partners in the partnership meet the eligibility requirements under section 6221(b)(1)(C) and you have provided all of the required information with the Form 1065.

Distribution of partner's debt.

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

The partner is treated as having satisfied the debt for its FMV. If the issue price (adjusted for any premium or discount) of the debt exceeds its FMV when distributed, the partner may have to include the excess amount in income as canceled debt.

Similarly, a deduction may be available to a corporate partner if the FMV of the debt at the time of distribution exceeds its adjusted issue price

Prohibited From Partnerships

The following types of organizations are prohibited from being classified as partnerships:

- A corporation (although a corporation can be a partner in a partnership)
- A joint-stock company or joint-stock association
- An insurance company
- Certain banks
- A government entity

- An organization required to be taxed as a corporation by the IRS
- Certain foreign organizations
- Any tax-exempt (non-profit) organization
- Any real estate investment trust (REIT)
- Any organization classified as a trust or estate
- Any other organization that elects to be classified as a corporation by filing Form 8832

POP QUIZ & ANSWER SHEET

PARTNERSHIPS

POP QUIZ

Test your knowledge on *Partnerships* by answering the questions below. The answer sheet may be found at the end of the Pop Quiz.

Q1: Which of the following is required to form a partnership as a legal entity?

A. Partnership Agreement
B. Articles of Incorporation
C. A Corporate Charter
D. Plenty of Money

Q2: A partner who has ___, has signature authority for the partnership.

A. The Most Seniority
B. The Most Money
C. Percentage of Partner Ownership
D. Both A & B

Q3: The difference between general and limited partnerships is a question of what?

A. The Number of Partners
B. Liability
C. Percentage of Partner Ownership
D. State Statute

Q4: Entities that elect to be taxed as a corporation, make the election by completing what form?

A. Form 2553
B. Form 8821
C. Form 8832
D. Form 3115

Q5: Which of the following is prohibited from forming a partnership?

A. A Government Entity
B. Certain Banks
C. Any Real Estate Investment Trust (REIT)
D. All of the Above

Q6: The tax return for a partnership is which of the following?

A. Form 1065
B. Form 1120
C. Form 1120-S
D. Form 1041

Q7: Each partner should receive a ___, Partner's Share of Credits, Deductions, Income, etc.

A. Schedule C
B. Schedule D
C. Schedule E
D. Schedule K-1

Q8: Distributions to a partner that are made without regard to the partnership's financial performance is referred to as what?

A. Guaranteed Payments
B. A Bonus
C. Dividends
D. Equity

Q9: Which of the following is classified as a separately stated item on a partnership Schedule K-1?

A. Section 1231 Gains and Losses
B. Taxes Paid to a Foreign Country or to a U.S. Possession
C. Charitable Contributions
D. All of the Above

Q10: The ___ restricts the amount of a loss that a partner can claim on their individual income tax return to the amount of their ___.

A. Partnership agreement, at risk basis.
B. At risk limitation, capital basis.
C. At risk limitation, at-risk basis.
D. All of the Above

Q11: There is usually not a gain, or a loss recognized by either the partnership or the partner for this.

A. Property Contributions
B. Financial Contributions
C. Charitable Contributions
D. All of the Above

Q12: Guaranteed payments are reported as ___ on the partner's individual income tax return.

A. Capital Gains
B. Ordinary Income
C. Exempt Income
D. Exempt Gains

Q13: The income or loss amount reported on the partner's Schedule K-1 is reported on the partner's ___.

A. Schedule D
B. Schedule A
C. Form 1040
D. Schedule B

Q14: Which of the following is not applicable to a limited partner?

A. Share of Profit or Loss
B. Participates in Daily Activities
C. Participates in Major Decisions
D. Liabilities Limited to Investment

C CORPORATIONS

What is a C-Corporation?

A corporation is a legal structure, in which the owners (known as shareholders), are taxed separate from the business.

By definition, a corporation is a separate entity. Owners are not their business, and their business is not them. An individual may be a shareholder, but he is not the business.

The following businesses are taxed as corporations.

- A business formed under a federal or state law that refers to it as a corporation, body corporate, or body politic.
- A business formed under a state law that refers to it as a joint-stock company or joint-stock association.
- An insurance company.
- Certain banks.
- A business wholly owned by a state or local government.

The federal income tax is a pay-as-you-go tax. A corporation must generally make estimated tax payments as it earns or receives income during its tax year. After the end of the year, the corporation must file an income tax return.

Income Tax Return

Unless exempt under section 501 of the Internal Revenue Code, all domestic corporations in existence for any part of a tax year (including corporations in bankruptcy) must file an income tax return whether or not they have taxable income.

The Corporate Income Tax Rate for 2023 is 21%. This means that corporations with net income will be taxed at a flat rate of 21%.

Which form to file.

A domestic entity electing to be classified as an association taxable as a corporation must generally 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, or may elect to, file special returns.

Electronic filing.

Corporations can generally electronically file (e-file) Form 1120 and certain related forms, schedules, and attachments. However, certain large corporations must e-file Form 1120.

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.

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's income tax return. The IRS will grant the extension if the corporation 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.

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

Late payment of tax. A corporation that does not pay the tax when due may be penalized half 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.

Reporting Dividends and Other Distributions

A corporate distribution to a shareholder is generally treated as a distribution of earnings and profits. Any part of a distribution from either current or accumulated earnings and profits is reported to the shareholder as a dividend.

Any part of a distribution that is not from earnings and profits is applied against and reduces the adjusted basis of the stock in the hands of the shareholder. To the extent the balance is more than the adjusted basis of the stock, the shareholder has a gain (usually a capital gain) from the sale or exchange of property.

Form 1099-DIV.

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

A corporation must generally send Forms 1099-DIV to the IRS with

Form 1096, Annual Summary and Transmittal of U.S. Information Returns, by February 28 (March 31 if filing electronically) of the year following the year of the distribution.

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

Constructive Distributions

The following transactions to shareholders can be considered a constructive distribution.

Below-market loans. If a corporation gives a shareholder a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate, the interest not charged may be treated as a distribution to the shareholder.

Corporation cancels shareholder's debt. If a corporation cancels a shareholder's debt without repayment by the shareholder, the amount canceled is treated as a distribution to the shareholder. Transfers of property to shareholders for less than FMV. A sale or exchange of property by a corporation to a shareholder may be treated as a distribution to the shareholder. For a shareholder who is not a corporation, if the FMV of the property on the date of the sale or exchange exceeds the price paid by the shareholder, the excess is treated as a distribution to the shareholder.

Unreasonable rents. If a corporation rents property from a shareholder and the rent is unreasonably more than the shareholder would charge to a stranger for use of the same property, the excessive part of the rent may be treated as a distribution to the shareholder.

Unreasonable salaries. If a corporation pays an employee who is also a shareholder a salary that is unreasonably high considering the services actually performed by the shareholder-employee, the excessive part of the salary may be treated as a distribution to the shareholder-employee.

Dividends-Received Deduction

A corporation can deduct a percentage of certain dividends received during its tax year. Corporations can be a shareholder or own stock in other corporations. If they do own stock in other corporations they may receive a dividend from the earnings and profits of that corporation. Well, depending on if the corporation that they received the dividends from is a foreign or domestic corporation and how much they own they can write off the dividend as a deduction on their 1120 schedule c. This is not to be confused with the sole proprietor schedule c. The deduction is figured on Form 1120, Schedule C, or the applicable schedule of your income tax return.

Dividends from foreign corporations.

Generally, 100% of the foreign-source portion of dividends (and items treated as dividends) from 10%-owned foreign corporations may be deducted. The stock with respect to which such dividends are received must meet a special 365-day holding period and does not include certain "hybrid" dividend payments

Dividends from domestic corporations.

A corporation can deduct, within certain limits, 50% of the dividends received if the corporation receiving the dividend owns less than 20% of the corporation distributing the dividend. If the corporation owns 20% or more of the distributing corporation's stock, it can, subject to certain limits, deduct 65% of the dividends received. Ownership. For these rules, ownership is based on the amount of voting power and value of the paying corporation's stock (other than certain preferred stock) that the receiving corporation owns.

Charitable Contributions

A corporation can claim a limited deduction for charitable contributions made in cash or other property. The contribution is deductible if made to, or for the use of, a qualified organization.

Liquidations

A corporation (or a farmers cooperative) must file Form 966 if it adopts a resolution or plan to dissolve the corporation or liquidate any of its stock.

File Form 966 within 30 days after the resolution or plan is adopted to dissolve the corporation or liquidate any of its stock.

A corporation must recognize gain or loss on the distribution of its assets in the complete liquidation of its stock. For purposes of determining gain or loss, the distributed assets are valued at fair market value.

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.

Estimated Tax

Generally, a corporation must make installment payments if it expects its estimated tax for the year to be $500 or more.

If the corporation does not pay the installments when they are due, it could be subject to an underpayment penalty.

When to pay estimated tax.

Installment payments are due by the 15th day of the 4th, 6th, 9th, and 12th months of the corporation's tax year.

Example 1. Big Johns corporation's tax year ends December 31. Installment payments are due on April 15, June 15, September 15, and December 15.

Example 2. Johnson & Johnson corporation's tax year ends June 30. Installment payments are due on October 15, December 15, March 15, and June 15. If any due date falls on a Saturday, Sunday, or legal holiday, the installment is due on the next business day.

IRC Section 351 Exchange

Property Exchanged for Stock If you transfer property (or money and property) to a corporation in exchange for stock in that corporation (other than nonqualified preferred stock), and immediately afterward you 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.
- You transfer the property in a bankruptcy or similar proceeding in exchange for stock used to pay creditors.
- The stock is received in exchange for the corporation's debt (other than a security) or for interest on the corporation's debt

(including a security) that accrued while you held the debt.

Basis of stock or other property received.

The basis of the stock you receive is generally the adjusted basis of the property you transfer. Increase this amount by any amount treated as a dividend, plus any gain recognized on the exchange.

Basis of property transferred. A corporation that receives property from you in exchange for its stock generally has the same basis you had in the property, increased by any gain you recognized on the exchange.

Basis. The corporation's basis of property contributed to capital by a shareholder is the same as the basis the shareholder had in the property, increased by any gain the shareholder recognized on the exchange. However, the increase for the gain recognized may be limited

Controlled Group
A control group relationship exists if the businesses have one of the following relationships:

- Parent-subsidiary,
- Brother-sister, and
- Combination of the above

A parent-subsidiary controlled group exists when one or more chains of corporations are connected through stock ownership with a common parent corporation; and

- 80 percent of the stock of each corporation, (except the common parent) is owned by one or more corporations in the group; and
- Parent Corporation must own 80 percent of at least one other corporation.

Example 1 Redwood Corporation owns:
90% of the stock of Bond Corporation,
80% of the stock of Greene Corporation, and
65% of the stock of Teller Corporation.

Unrelated persons own the percentage of stock not owned by Redwood Corporation. Redwood Corporation owns 80% or more of the stock of the Bond and Greene Corporations. Therefore, Redwood Corporation is the common parent of a parent-subsidiary group consisting of Redwood, Bond, and Greene. Teller Corporation is not a member of the group because Redwood Corporation's ownership is less than 80%.

Closely held corporations.

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

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

Schedule L. Balance Sheets per Books

The balance sheets should agree with the corporation's books and records. Corporations with total receipts and total assets at the end of the tax year less than $250,000 are not required to complete Schedules L, M-1, and M-2. Corporations with total assets non-consolidated (or consolidated for all corporations included within the consolidated tax group) of $10 million or more on the last day of the tax year must file Schedule M-3 (Form 1120) instead of Schedule M-1.

Schedule M-1. Reconciliation of Income (Loss) per Books with Income per Return

In completing Schedule M-1, the following apply.

Corporations with total receipts and total assets at the end of the tax year less than $250,000 are not required to complete Schedules L, M-1, and M-2.

Corporations with total assets non-consolidated (or consolidated for all corporations included within the consolidated tax group) of $10 million or more on the last day of the tax year must file Schedule M-3 (Form

1120) instead of Schedule M-1

POP QUIZ & ANSWER SHEET

C CORPORATIONS

POP QUIZ

Test your knowledge on *C Corporations* by answering the questions below. The answer sheet may be found at the end of the Pop Quiz.

Q1: A(n) ___ is a legal structure, in which the owners (known as shareholders), are taxed separately from the business?

A. Corporation
B. S Corporation
C. LLC
D. Sole Proprietorship

Q2: What are some characteristics of a C Corporation?

A. Perpetual Life
B. Double Taxation
C. Fringe Benefits
D. All of the Above

Q3: The benefits of perpetual life is mainly:

A. Stability
B. Business Continuity
C. Both B & C
D. None of the Above

Q4: The tax rate for a C Corporations is ___.

A. 21%
B. 30%
C. 32%
D. 35%

Q5: Which of the following is a type of stock that can be issued by a C Corporation?

A. Preferred

B. Common
C. Hybrid
D. Both A & B

Q6: These stockholders have voting rights.

A. Hybrid
B. Preferred
C. Common
D. Both B & C

Q7: ___ stockholders must receive dividends prior to ___ stockholders.
A. Hybrid, Preferred
B. Preferred Stock, Common Stock
C. Hybrid, Common Stock
D. Both B & C

Q8: Which of the following fringe benefits are not taxable to the employee?
A. Educational Assistance
B. Dependent Care Assistance
C. Achievement Awards
D. All of the Above

Q9: Some corporate formalities are:
A. File the Articles of Incorporation
B. Issue Stock
C. Obtain EIN from the IRS
D. All of the Above

Q10: Certain corporations with total assets of ___ or more that file at least ___ information returns are required to e-file the Form 1120.
A. $10 million, 250
B. $10 million, 100
C. $5 million, 250
D. $45 million, 100

Q11: Using corporate refunds for personal use could be interpreted as:

A. A Year-End Bonus
B. A Dividend
C. An Increase in Salary
D. Misappropriation of Funds

Q12: Relating to corporate amendments, you are generally required to inform your state for which of the following reasons?

A. A Change in Purpose
B. A Change in Corporation Type
C. A Change of Address
D. All of the Above

Q13: Which of the following is, or are taxed at lower capital gains at tax rates?

A. Share of Equity
B. Non-Qualified Dividends
C. Qualified Dividends
D. Wages

Q14: ___ is or taxed at normal (ordinary) income tax rates.

A. Non-Qualified Dividends
B. Qualified Dividends
C. Wages
D. Share of Equity

Q15: The ___ was enacted to discourage the accumulation of income (not paying out dividends) if the reason is to avoid paying taxes.

A. Alternative Minimum Tax (AMT)
B. Medicare Tax
C. Accumulated Earnings Tax (AET)
D. Double Taxation Rule

Q16: The termination of corporate activities, satisfaction of liabilities and distribution of the remaining assets, if any, is referred to as which of the following.

A. A Sell-Off
B. A Liquidation
C. A Merger
D. An Acquisition

Q17: A(n) ___ is a state law process of terminating an entity.

A. Absolution
B. Resolution
C. Distribution
D. Dissolution

Q18: When corporate activities are terminated, who gets paid first?

A. Preferred Stockholders
B. Common Stockholders
C. Bond and Debt Holders (people the corporation owes money to)
D. Both A & B

Q19: What must happen in order to dissolve the entity?

A. Shareholders must vote
B. A farewell party must be given
C. All assets need to be set aside for safekeeping
D. Both A & C

Q20: After filing the final return for a terminated corporation, what must be done?

A. Revise the Articles of Incorporation
B. File the Certificate of Dissolution with the Secretary of State
C. Destroy the Articles of Incorporation
D. Party like a RockStar

ANSWER SHEET

1. Answer is A - Corporation

2. Answer is D - All of the Above

3. Answer is B - Business Continuity

4. Answer is A - 21%

5. Answer is D - Both A & B

6. Answer is C - Common

7. Answer is B - Preferred Stock, Common Stock

8. Answer is D - All of the Above

9. Answer is D - All of the Above

10. Answer is A - $10 million, 250

11. Answer is B - A Dividend

12. Answer is D - All of the Above

13. Answer is C - Qualified Dividends

14. Answer is A - Non-Qualified Dividends

15. Answer is C - Accumulated Earnings Tax (AET)

16. Answer is B - A Liquidation

17. Answer is D - Dissolution

18. Answer is C - Bond and Debt Holders (people the corporation owes money to)

19. Answer is A - Shareholders must vote

20. Answer is B - File the Certificate of Dissolution with the Secretary of State

S CORPORATIONS

Overview

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.

To qualify for S corporation status, the corporation must meet the following requirements:

- Be a domestic corporation
- Have only allowable shareholders
- May be individuals, certain trusts, and estates and
- May not be partnerships, corporations or non-resident alien shareholders
- Have no more than 100 shareholders
- Have only one class of stock
- Not be an ineligible corporation (i.e. certain financial institutions, insurance companies, and domestic international sales corporations).

In order to become an S corporation, the corporation must submit Form 2553 Election by a Small Business Corporation signed by all the shareholders.

Filing Requirements

Generally, an S corporation must file Form 1120-S by the 15th day of the 3rd month after the end of its tax year. For calendar year corporations, the due date is March 15, 2023. A corporation that has dissolved must generally file by the 15th day of the 3rd month after the date it dissolved

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 ask for an extension of time to file. Generally, the corporation must file Form 7004 by the regular due date of the return.

Distributions, Dividends and Other Compensation as Wages

Courts have found shareholder-employees are subject to employment taxes even when shareholders take distributions, dividends or other forms of compensation instead of wages.

In 2001, in a Tax Court case against a Veterinary Clinic, the Tax Court ruled that an employer cannot avoid federal taxes by characterizing compensation paid to its sole director and shareholder as distributions of the corporation's net income rather than wages. Veterinary Surgical Consultants, P.C. vs. Commissioner, 117 T.C. 141 (2001).

The Sixth Circuit held that a shareholder-employee of a company used the company bank account for personal use. As such, the Court ruled the shareholder was an employee and owed employment tax. Joly v. Commissioner, T.C. Memo. 1998-361, aff'd by unpub. op., 211 F.3d 1269 (6th Cir. 2000).

In yet another similar case, the Tax Court held that an accountant was taking dividends and performing duties for the company. The Tax Court ruled the dividends were actually wages, subject to employment taxes. Joseph M. Grey Public Accountant, P.C. vs. Commissioner, 119 T.C. 121 (2002).

In the above listed cases the shareholders failed to report **any** wages from their S corporations. In a 2012 case the shareholder received wages of $24,000 per year and large distributions. Though there was no dispute that the shareholder was an employee, the issue dealt with the reasonableness of the wage amount. When challenged on the reasonableness of the wages, the taxpayer contended that the corporation only intended to pay wages of $24,000 and that its intent was controlling. The 8th Circuit disagreed and sustained the District Court which held that the test is whether the payments received by the shareholder were truly remuneration for services performed, thus the intent to limit wages is not a controlling factor. David E. Watson, PC vs. U.S., 668 F.3d 1008 (8th Cir. 2012). The Supreme Court held that it would not hear an appeal of the 8th Circuit decision.

Other decisions:

- Payments made by an S corporation to its president and sole shareholder were wages subject to employment taxes, not distributions or loan repayments. Prior transfers by the shareholder to the corporation were capital contributions and not loans. The court rejected the argument that the distributions would represent unreasonable compensation to its president. Glass Blocks Unlimited v. Comm'r, T.C. Memo. 2013-180.
- The corporation's payment of the shareholder's personal expenses for insurance and utilities were made with the intent to compensate the shareholder for services rendered. As such, the corporation was entitled to a deduction as additional compensation. The amounts when combined with small amounts of "management expenses" paid by the corporation were not unreasonable. Ghosn v. Comm'r, T.C. Memo. 1995-192.

- Purported “loans” from S corporation to its sole shareholder, officer, and director, were wages for purposes of FICA and FUTA taxes. The loans were unsecured demand notes bearing no interest, loans were made entirely at the discretion of shareholder, and the shareholder regularly performed substantial, valuable services for taxpayer. Repayment of loan was “simply a paper transaction” in which outstanding loan balance was credited against undistributed income and rental payments owed by the corporation to the shareholder. Gale W. Greenlee, Inc. v. U.S., 661 F. Supp. 642 (D. Colo. 1985).

If the shareholder received or had the right to receive cash or property, then the S corporation must determine and report an appropriate and reasonable salary for that shareholder.

Separately and Nonseparately Stated Items

All S corporation items of income, loss, deduction, or credit are passed through to the shareholders and reported on their individual returns. If the separate treatment of any item could affect a shareholder’s tax liability, that item must be passed through separately. These items are referred to as separately stated items. They are entered on lines 2 through 17 of Schedules K–1.

The list of items that must be separately

1) Net income or loss from rental real estate activities,
2) Net income or loss from other rental activities,
3) Portfolio income or loss
   - Interest Income
   - Dividend income
   - Royalty income
   - Short-term capital gain or loss
   - Long-term capital gain or loss

4) Section 1231 net gain or loss
5) Charitable contributions
6) Section 179 expense deduction
7) Expenses related to portfolio income or loss
8) Credits—

- Low-income housing credit,
- Qualified rehabilitation expenses, and
- Other credits,

9) Investment interest expense, and
10) Tax preference and adjustment items needed to figure shareholders' alternative minimum tax

Distributions from an S corporation

Generally will be a nontaxable return of the share holder's basis in the corporate stock. However, if the distributions are more than the shareholder's adjusted basis in the stock, the excess is taxable as a sale or exchange of property.

The S corporation's distributions may be in the form of cash or property.

Basis of stock or other property received. The basis of the stock you receive is generally the adjusted basis of the property you transfer.

Basis of property transferred. A corporation that receives property from you in exchange for its stock generally has the same basis you had in the property, increased by any gain you recognized on the exchange

For example, Jenna contributes a property with a fair market value of $50,000 and an adjusted basis of $20,000 to Genesis Market, LLC a supermarket taxed as an S Corp in exchange for 100 shares. Jenna's basis in the stock is now $20,000 which was her adjusted basis in the property she transferred.

Terminating S Corporation Status

The corporation's status as an S corporation can be terminated in any of the following ways:

1) By revoking the election.

2) By ceasing to qualify as an S corporation.

3) By violating the passive investment income restrictions on S corporations with pre-S corporation earnings and profits for three consecutive tax years.

Revoking S Corporation

An S corporation election can be revoked by the corporation for any tax year. It can be revoked only if shareholders who collectively own more than 50% of the outstanding shares in the S corporation's stock (including any nonvoting stock) consent to the revocation. The consenting shareholders must own their stock in the S corporation at the time the revocation is made.

Ceasing To Qualify

A corporation's status as an S corporation will be terminated if at any time the corporation ceases to qualify as an S corporation. Some of these include:

1. Having more than 100 shareholders (except for married persons)
2. Transferring stock in the S corporation to
    a. A Corporation
    b. A Partnership
    c. An ineligible trust
    d. A nonresident alien
3. Creating a second class of stock

4. Acquiring a subsidiary, other than certain non operating subsidiaries.

Effective date of termination. A termination of S corporation status will be effective as of the date the terminating event occurred.

Income from discharge of indebtedness.

Generally, S corporations must include in income amounts realized from the discharge of indebtedness. The debt is not included as income if the cancellation

1. Takes place in a title 11 bankruptcy case
2. Takes place when the corporation is insolvent and the amount excluded is not more than the amount by which the corporation is insolvent
3. Is a discharge of qualified farm indebtedness, or
4. Is a discharge of qualified real property Is a discharge of qualified real property

POP QUIZ & ANSWER SHEET

S CORPORATIONS

POP QUIZ

Test your knowledge on *S Corporations* by answering the questions below. The answer sheet may be found at the end of the Pop Quiz.

Q1: A ___ signed by all shareholders must be filed with the IRS when making an S-Corporation election?
A. Form 8332
B. Form 2553
C. Form 8821
D. Form 3315

Q2: The Form ___ must be filed within ___ of the date entered on Line E of the form.
A. 2553, 3 years and 75 days
B. 8832, 2 years and 75 days
C. 8821, 3 years and 50 days
D. 3315, 2 years and 50 days

Q3: An S Corporation must be:
A. A Domestic Corporation
B. A Non-Profit Organization
C. Registered in Multiple States
D. All of the Above

Q4: An S Corporation must not have more than ___ shareholders?
A. 40
B. 50
C. 75
D. 100

Q5: This is a qualified S Corporation subsidiary that has made an election to terminate its previous identity and be treated as part of its parent for tax purposes.

A. Sub-S
B. Sub-T
C. Q-Sub
D. None of the Above

Q6: What form is used to elect to treat a subsidiary as a qualified subchapter S subsidiary?

A. Form 8863
B. Form 8869
C. Form 1120
D. Form 1120-S

Q7: Which of the following cannot be a shareholder in an S Corporation?

A. C Corporations
B. Partnerships
C. Non-Resident Alien
D. All of the Above

Q8: Annually, what form does an S Corporation file to report the income, gains, losses, deductions, other credits as well as other pertinent information for the entity?

A. Form 1120
B. Form 1120-S
C. Schedule K-1
D. Schedule C

Q9: An S corporation uses the ___ to report each owner's share of profit or losses?

A. Schedule K-1
B. Form 1120
C. Form 1120-S
D. Form 1116

Q10: If the S Corporation estimates that it will owe taxes, it must use ___ to estimate this tax liability and figure the amount of estimated tax payments:

A. Form 1120
B. Form 1120-S
C. Form 1120-W
D. Form 1040

Q11: Income of an S Corporation is taxed at the ___ level regardless of whether it is distributed.

A. Entity
B. Shareholder
C. State Level
D. Both B & C

Q12: Which of the following is, or are considered, separately stated items for an S Corporation?

A. Net Rental Real Estate Income
B. IRC Section 1231 Gains and Losses
C. Dividend Income from other C Corps
D. All of the Above

Q13: An S Corp is a:

A. Separate Taxable Entity
B. Fake Corporation
C. Pass-Through Entity
D. Both B & C

Q14: For an S-Corporation, the excess net passive income tax applies if passive investment income is more than ___ of gross receipts for royalties, rents, dividends, interest, and annuities.

A. 25%
B. 50%
C. 75%
D. 80%

Q15: Health insurance premiums paid to more than ___ shareholders of the S Corporation must be included in wages for the shareholder.

A. 2%
B. 5%
C. 10%
D. 20%

Q16: A shareholder of an S Corporation can take the personal deduction for health insurance, dental insurance, and long-term care insurance premiums on ___.

A. Schedule C
B. Form 1120
C. Form 1120-S
D. Form 1040

Q17: An S Corporation can be revoked if a new shareholder owning more than ___ refuses consent.

A. 2%
B. 20%
C. 50%
D. 75%

Q18: An S Corporation must wait at least ___ years to request re-election unless there is a more than 50% change in ownership, or the revocation was not in the control of the corporation or its shareholders.

A. Three
B. Four
C. Five
D. Six

S Corporations
ANSWER SHEET

1. Answer is B - Form 2553

2. Answer is A - 2553, 3 years and 75 days

3. Answer is A - A Domestic Corporation

4. Answer is D - 100

5. Answer is C - Q-Sub

6. Answer is B - Form 8869

7. Answer is D - All of the Above

8. Answer is B - Form 1120-S

9. Answer is A - Schedule K-1

10. Answer is C - Form 1120-W

11. Answer is B - Shareholder

12. Answer is D - All of the Above

13. Answer is C - Pass-Through Entity

14. Answer is A - 25%

15. Answer is A - 2%

16. Answer is D - Form 1040

17. Answer is C - 50%

18. Answer is C – Five

BUSINESS INCOME

Overview

If there is a connection between any income you receive and your business, the income is business income. A connection exists if it is clear that the payment of income would not have been made if you did not have the business.

You can have business income even if you are not involved in the activity on a regular full-time basis. Income from work you do on the side in addition to your regular job can be business income. For example, you may be in the business of providing services for a ride-sharing business as a second job.

You report most business income, such as income from selling your products or services, on the appropriate business tax return (Sch C, 1065, 1120s, 1120). But you report the income from the sale of business assets, such as land and office buildings, on other forms.

Business income is a type of earned income and is classified as ordinary income for tax purposes. It encompasses any income realized as a result of an entity's operations. In its simplest form, business income is an entity's net profit or loss, which is calculated as its revenue from all sources minus the costs of doing business.

Cost of Goods Sold

If businesses make or buy goods to sell, they can deduct the cost of goods sold from their gross receipts. However, to determine these costs, they must value their inventory at the beginning and end of each tax year.

Cost of goods sold applies to businesses if they are a manufacturer, wholesaler, or retailer or if they are engaged in any business that makes, buys, or sells goods to produce income.

Cost of goods sold does not apply to a personal service business, such as the business of a doctor, lawyer, carpenter, or painter. However, if they work in a personal service business and also sell or charge for the materials and supplies normally used in their business, then the cost of goods sold does apply.

IRS Example

You are a calendar year taxpayer who uses an accrual method of accounting. In 2023, you contributed property from inventory to a church. It had a fair market value of $600. The closing inventory at the end of 2023 properly included $400 of costs due to the acquisition of the property, and in 2023, you properly deducted $50 of administrative and other expenses attributable to the property as business expenses. The charitable contribution allowed for 2023 is $400 ($600 − $200). The $200 is the amount that would be ordinary income if you had sold the contributed inventory at fair market value on the date of the gift. The cost of goods sold you use in determining gross income for 2023 must not include the $400. You remove that amount from opening inventory for 2023.

Accounting for Inventory

When the ending inventory is understated, The income statement for the current period will overstate (report too much) cost of goods sold.

For example

- Inventory Understated by $1000
- COGS was overstated by $2000

How would this affect the cogs at the end of the year?

In this question the COGS is already overstated by $2k so we will add the understated amount of $1k, making the total **overstated amount of $3,000**

Bartering for Property or Services

You must include in your gross receipts, at the time received, the fair market value of property or services you receive in exchange for something else. If you exchange services with another person and you both have agreed ahead of time on the value of the services, that value will be accepted as the fair market value unless the value can be shown to be otherwise.

Example 1. You are a self-employed lawyer. You perform legal services for a client, a small corporation. In payment for your services, you receive shares of stock in the corporation. You must include the fair market value of the shares in income.

Example 2. You are an artist and create a work of art to compensate your landlord for the rent-free use of your apartment. You must include the fair rental value of the apartment in your gross receipts. Your landlord must include the fair market value of the work of art in his or her rental income.

Hotels, boarding houses, and apartments.

Rental income you receive for the use or occupancy of hotels, boarding houses, or apartment houses is subject to SE tax if you provide services for the occupants.

Generally, you are considered to provide services for the occupants if the services are primarily for their convenience and are not services normally provided with the rental of rooms for occupancy only.

An example of a service that is not normally provided for the convenience of the occupants is maid service. However, providing heat and light, cleaning stairways and lobbies, and collecting trash are services normally provided for the occupants' convenience.

Prepaid rent.

Advance payments received under a lease that does not put any restriction on their use or enjoyment are income in the year you receive them. This is generally true no matter what accounting method or period you use.

Lease bonus.

A bonus you receive from a lessee for granting a lease is an addition to the rent. Include it in your gross receipts in the year received.

Lease cancellation payments.

Report payments you receive from your lessee for canceling a lease in your gross receipts in the year received.

Payments to third parties.

If your lessee makes payments to someone else under an agreement to pay your debts or obligations, include the payments in your gross receipts when the lessee makes the payments.

A common example of this kind of income is a lessee's payment of your property taxes on leased real property.

Settlement payments.

Payments you receive in settlement of a lessee's obligation to restore the leased property to its original condition are income in the amount that the payments exceed the adjusted basis of the leasehold improvements destroyed, damaged, removed, or disconnected by the lessee.

Personal Property Rents

If you are in the business of renting personal property (equipment, vehicles, formal wear, etc.), include the rental amount you receive in your gross receipts.

Interest and Dividend Income

Interest and dividends may be considered business income. Interest. Interest received on notes receivable that you have accepted in the ordinary course of business is business income. Interest received on loans is business income if you are in the business of lending money.

Canceled Debt

Generally, if a business's debt is canceled or forgiven, other than as a gift or bequest to, they must include the canceled amount in your gross income for tax purposes.

Net Operating Losses (NOLs)

If your deductions for the year are more than your income for the year, you may have an NOL. You can use an NOL by deducting it from your income in another year or years. Examples of typical losses that may produce an NOL include, but are not limited to, losses incurred from the following.

- Your trade or business.
- A casualty or theft resulting from a federally declared disaster.
- Moving expenses.
- Rental property.

A loss from operating a business is the most common reason for an NOL.

POP QUIZ & ANSWER SHEET

BUSINESS INCOME

POP QUIZ

Test your knowledge on *Business Income* by answering the questions below. The answer sheet may be found at the end of the Pop Quiz.

Q1: The following are payments received by a taxpayer as an advanced payment for services, except:
A. Payments with respect to warranty and guaranty contracts under which a third party is the primary obligor.
B. The guarantee or warranty contracts ancillary to an item or items.
C. The sale, lease, or license of computer software.
D. None of the Above

Q2: Choose an example of a passive activity that you materially participate in.
A. Trusts in which the Fiduciary Materially Participates
B. Rental Real Estate Activities (you are a qualified real estate professional)
C. Stocks & Bonds
D. Rental Activities

Q3: The most common material participation test is:
A. Involvement for more than 300 hours and no less than the participation of any other individual.
B. Working at least 500 hours in the business in the course of a year.
C. You participated in the activity for more than 500 hours during the tax year, and you participated at least as much as any other individual (including individuals who were not owners of interest in the activity) for the tax year.

D. You materially participated in the activity for any 2 of the prior 5 tax years (not necessarily consecutive).

Q4: What do you call the income that comes from interest payments, dividends, capital gains collected upon the sale of a security or other assets, and any other profit made through an investment vehicle of any kind?

A. Expenses Paid by a Tenant
B. Security Deposits
C. Investment Income
D. Advance Payments

Q5: What do you call the amounts paid before a good or service is received?

A. Expenses Paid by a Tenant
B. Security Deposits
C. Investment Income
D. Advance Payments

Q6: The amount of money collected by a landlord from a tenant or group of tenants for using a particular space?

A. Expenses Paid by a Tenant
B. Rental Income
C. Security Deposits
D. Investment Income

Business Income
ANSWER SHEET

1. Answer is A - Payments with respect to warranty and guaranty contracts under which a third party is the primary obligor.

2. Answer is D - Rental Activities

3. Answer is B - Working at least 500 hours in the business in the course of a year.

4. Answer is C - Investment Income

5. Answer is D - Advance Payments

6. Answer is B - Rental Income

Business Expenses, Deductions and Credits

Overview

You can deduct the costs of operating your business. These costs are known as business expenses. These are costs you do not have to capitalize or include in the cost of goods sold but can deduct in the current year.

To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your field of business. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

Employees' Pay

To be deductible, employees' pay must be an ordinary and necessary business expense and you must pay or incur it.

In addition, the pay must meet both of the following tests.

Test 1. It must be reasonable.
Test 2. It must be for services performed.

The form or method of figuring the pay doesn't affect its deductibility.

For example, bonuses and commissions based on sales or earnings, and paid under an agreement made before the services were performed, are both deductible.

Fringe Benefits

A fringe benefit is a form of pay for the performance of services. You can generally deduct the cost of fringe benefits. You may be able to exclude all or part of the value of some fringe benefits from your employees' pay. You also may not owe employment taxes on the value of the fringe benefits.

See Table 2-1 for the exclusion rules for the following fringe benefits:

- Accident and health benefits.
- Achievement awards.
- Adoption assistance.
- Athletic facilities.
- De minimis (minimal) benefits.
- Dependent care assistance.
- Educational assistance.
- Employee discounts.
- Employee stock options.
- Employer-provided cell phones.
- Group-term life insurance coverage, exempt up to $50,000
- HSAs.
- Lodging on your business premises.
- Meals.
- No-additional-cost services.
- Retirement planning services.
- Transportation (commuting) benefits.
- Tuition reduction.

- Working condition benefits

Table 2-1. Special Rules for Various Types of Fringe Benefits
(For more information, see the full discussion in this section.)

	Treatment Under Employment Taxes		
Type of Fringe Benefit	**Income Tax Withholding**	**Social Security and Medicare (including Additional Medicare Tax when wages are paid in excess of $200,000)[1]**	**Federal Unemployment (FUTA)**
Accident and health benefits	Exempt,[2] except for long-term care benefits provided through a flexible spending or similar arrangement.	Exempt, except for certain payments to S corporation employees who are 2% shareholders.	Exempt
Achievement awards	Exempt[2] up to $1,600 for qualified plan awards ($400 for nonqualified awards).		
Adoption assistance	Exempt[2,3]	Taxable	Taxable
Athletic facilities	Exempt if substantially all use during the calendar year is by employees, their spouses, and their dependent children, and the facility is operated by the employer on premises owned or leased by the employer.		
De minimis (minimal) benefits	Exempt	Exempt	Exempt
Dependent care assistance	Exempt[3] up to certain limits, $5,000 ($2,500 for married employee filing separate return).		
Educational assistance	Exempt up to $5,250 of benefits each year. (See Educational Assistance, later in this section.)		
Employee discounts	Exempt[3] up to certain limits. (See Employee Discounts, later in this section.)		
Employee stock options	See Employee Stock Options, later in this section.		
Employer-provided cell phones	Exempt if provided primarily for noncompensatory business purposes.		
Group-term life insurance coverage	Exempt	Exempt[2,4,6] up to cost of $50,000 of coverage. (Special rules apply to former employees.)	Exempt
Health savings accounts (HSAs)	Exempt for qualified individuals up to the HSA contribution limits. (See Health Savings Accounts, later in this section.)		
Lodging on your business premises	Exempt[2] if furnished on your business premises, for your convenience, and as a condition of employment.		
Meals	Exempt[2] if furnished on your business premises for your convenience.		
	Exempt if de minimis.		
No-additional-cost services	Exempt[3]	Exempt[3]	Exempt[3]
Retirement planning services	Exempt[5]	Exempt[5]	Exempt[5]
Transportation (commuting) benefits	Exempt[2] up to certain limits if for rides in a commuter highway vehicle and/or transit passes ($280) or qualified parking ($280). (See Transportation (Commuting) Benefits, later in this section.)		
	Exempt if de minimis.		
Tuition reduction	Exempt[3] if for undergraduate education (or graduate education if the employee performs teaching or research activities).		
Working condition benefits	Exempt	Exempt	Exempt

Statutory Employees

If workers are independent contractors under the common law rules, such workers may nevertheless be treated as employees by statute (statutory employees) for certain employment tax purposes if they fall within any one of the following four categories and meet the three conditions:

- 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.

Refer to the Salesperson section located in Publication 15-A, Employer's Supplemental Tax Guide for additional information. Categories under Social Security and Medicare taxes

- A driver who distributes beverages (other than milk), meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is an 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 who works at home on materials or goods that a business supplies and that must be returned to the business or to a specific person the business designates, if the business also furnishes specifications for the work to be done.
- A full-time traveling or city salesperson who works on a business's behalf and turns in orders to a business 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 a business must be the salesperson's principal business activity.

Statutory Non-Employees

Three categories:

1. direct sellers,
2. licensed real estate agents and
3. certain companion sitters.

Direct sellers and licensed real estate agents are treated as self-employed for all Federal tax purposes, including income and employment taxes, if:

a. Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked, and

b. Their services are performed under a written contract providing that they will not be treated as employees for Federal tax purposes.

Companion sitters who are not employees of a companion sitting placement service are generally treated as self-employed for all federal tax purposes.

Rent

Rent is any amount you pay for the use of property you do not own. In general, you can deduct rent as an expense only if the rent is for property you use in your trade or business. If you have or will receive equity in or title to the property, the rent is not deductible.

Unreasonable rent.

You can't take a rental deduction for unreasonable rent. Ordinarily, the issue of reasonableness arises only if you and the lessor are related. Rent paid to a related person is reasonable if it is the same amount you would pay to a stranger for use of the same property. Rent isn't unreasonable just because it is figured as a percentage of gross sales.

Rent on your home.

If you rent your home and use part of it as your place of business, you may be able to deduct the rent you pay for that part. You must meet the requirements for business use of your home

Depreciation

Depreciation is an annual income tax deduction that allows you to recover the cost or other basis of certain property over the time you use the property. It is an allowance for the wear and tear, deterioration, or obsolescence of the property.

What property can be depreciated?

You can depreciate most types of tangible property (except land), such as buildings, machinery, vehicles, furniture, and equipment. You can also depreciate certain intangible property, such as patents, copyrights, and computer software. To be depreciable, the property must meet all the following requirements.

- It must be property you own.
- It must be used in your business or income-producing activity.
- It must have a determinable useful life.
- It must be expected to last more than 1 year.

When does depreciation begin and end?
You begin to depreciate your property when you place it in service for use in your trade or business or for the production of income. You stop depreciating property either when you have fully recovered your cost or other basis or when you retire it from service, whichever happens first.

What method can you use to depreciate your property?
You must use the Modified Accelerated Cost Recovery System (MACRS) to depreciate most property.

Straight Line Method
This method lets you deduct the same amount of depreciation each year over the useful life of the property. To figure your deduction, first determine the adjusted basis, salvage value, and estimated useful life of your property. Subtract the salvage value, if any, from the adjusted basis. The balance is the total depreciation you can take over the useful life of the property. Divide the balance by the number of years in the useful life. This gives you your yearly depreciation deduction. Unless there is a big change in adjusted basis or useful life, this amount will stay the same throughout the time you depreciate the property. If, in the first year, you use the property for less than a full year, you must prorate your depreciation deduction for the number of months in use.

IRS Example.

In April, Frank bought a patent for $5,100 that is not a section 197 intangible. He depreciates the patent under the straight line method, using a 17-year useful life and no salvage value. He divides the $5,100 basis by 17 years to get his $300 yearly depreciation deduction. He only used the patent for 9 months during the first year, so he multiplies $300 by 9/12 to get his deduction of $225 for the first year. Next year, Frank can deduct $300 for the full year.

What is the basis of your depreciable property?

To figure your depreciation deduction, you must determine the basis of your property. To determine the basis, you need to know the cost or other basis of your property.

Cost as Basis

The basis of property you buy is its cost plus amounts you paid for items such as sales tax (see Exception below), freight charges, and installation and testing fees. The cost includes the amount you pay in cash, debt obligations, other property, or services.

Assumed debt.

If you buy property and assume (or buy subject to) an existing mortgage or other debt on the property, your basis includes the amount you pay for the property plus the amount of the assumed debt.

Example. You make a $20,000 down payment on property and assume the seller's mortgage of $120,000. Your total cost is $140,000, the cash you paid plus the mortgage you assumed.

Settlement costs.

The basis of real property also includes certain fees and charges you pay in addition to the purchase price. These are generally shown on your settlement statement and include the following.

- Legal and recording fees.
- Abstract fees.
- Survey charges.
- Owner's title insurance.
- Amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Other Basis

Other basis usually refers to a basis that is determined by the way you received the property.

For example, your basis is other than cost if you acquired the property in exchange for other property, as payment for services you performed, as a gift, or as an inheritance.

How do you treat repairs and improvements?

If you improve depreciable property, you must treat the improvement as separate depreciable property. Improvement means an addition to or partial replacement of property that is a betterment to the property, restores the property, or adapts it to a new or different use

Do you have to file Form 4562?

Use Form 4562 to figure your deduction for depreciation and amortization.

Attach Form 4562 to your tax return for the current tax year if you are claiming any of the following items.

- A section 179 deduction for the current year or a section 179 carryover from a prior year. See chapter 2 for information on the section 179 deduction.
- Depreciation for property placed in service during the current year.
- Depreciation on any vehicle or other listed property, regardless of when it was placed in service. See chapter 5 for information on listed property.
- A deduction for any vehicle if the deduction is reported on a form other than Schedule C (Form 1040).
- Amortization of costs if the current year is the first year of the amortization period.
- Depreciation or amortization on any asset on a corporate income tax return (other than Form 1120-S, U.S. Income Tax Return for an S Corporation) regardless of when it was placed

in service. You must submit a separate Form 4562 for each business or activity on your return for which a Form 4562 is required.

How do you correct depreciation deductions?

If you deducted an incorrect amount of depreciation in any year, you may be able to make a correction by filing an amended return for that year

Electing the Section 179 Deduction

You can elect to recover all or part of the cost of certain qualifying property, up to a limit, by deducting it in the year you place the property in service. This is the section 179 deduction. You can elect the section 179 deduction instead of recovering the cost by taking depreciation deductions.

Eligible Property

To qualify for the section 179 deduction, your property must be one of the following types of depreciable property.

1. Tangible personal property.
2. Other tangible property (except buildings and their structural components) used as: a. An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services;
b. A research facility used in connection with any of the activities in (a) above; or
c. A facility used in connection with any of the activities in (a) for the bulk storage of fungible commodities.
3. Single-purpose agricultural (livestock) or horticultural structures.
4. Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum.
5. Off-the-shelf computer software.
6. Qualified section 179 real property

Tangible personal property.

Tangible personal property is any tangible property that is not real property. It includes the following property.
• Machinery and equipment.
• Property contained in or attached to a building (other than structural components), such as refrigerators, grocery store counters, office equipment, printing presses, testing equipment, and signs.
• Gasoline storage tanks and pumps at retail service stations.
• Livestock, including horses, cattle, hogs, sheep, goats, and mink and other furbearing animals.
• Portable air conditioners or heaters placed in service by you in tax years beginning after 2015.
• Certain property used predominantly to furnish lodging or in connection with the furnishing of lodging (except as provided in section 50(b)(2)).

The treatment of property as tangible personal property for the section 179 deduction is not controlled by its treatment under local law.

For example, property may not be tangible personal property for the deduction even if treated so under local law, and some property (such as fixtures) may be tangible personal property for the deduction even if treated as real property under local law.

Depletion is the using up of natural resources extracted from a mineral property by mining, drilling, quarrying stone, or cutting timber. The depletion deduction allows an owner or operator to account for the reduction of the mineral property's value or basis as a result of the extraction of the natural resource. There are two ways of figuring depletion: cost depletion and percentage depletion.

Temporary 100 percent expensing for certain business assets (first-year bonus depreciation)

The new law increases the bonus depreciation percentage from 50 percent to 100 percent for qualified property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023. The bonus depreciation percentage for qualified property that a taxpayer acquired before Sept. 28, 2017, and placed in service before Jan. 1, 2018, remains at 50 percent. Special rules apply for longer production period property and certain aircraft.

The definition of property eligible for 100 percent bonus depreciation was expanded to include used qualified property acquired and placed in service after Sept. 27, 2017, if all the following factors apply:

- The taxpayer or its predecessor didn't use the property at any time before acquiring it.
- The taxpayer didn't acquire the property from a related party.
- The taxpayer didn't acquire the property from a component member of a controlled group of corporations.
- The taxpayer's basis of the used property is not figured in whole or in part by reference to the adjusted basis of the property in the hands of the seller or transferor.
- The taxpayer's basis of the used property is not figured under the provision for deciding basis of property acquired from a decedent.
- Also, the cost of the used property eligible for bonus depreciation doesn't include the basis of property determined by reference to the basis of other property held at any time by the taxpayer (for example, in a like-kind exchange or involuntary conversion).

The new law added qualified film, television and live theatrical productions as types of qualified property that may be eligible for 100 percent bonus depreciation.

Business Bad Debts

You have a bad debt if you cannot collect money owed to you. A bad debt is either a business bad debt or a nonbusiness bad debt. This chapter discusses only business bad debts. Generally, a business bad debt is one that comes from operating your trade or business. You can deduct business bad debts on Schedule C (Form 1040) or your applicable business income tax return. All other bad debts are nonbusiness bad debts and are deductible only as short-term capital losses.

A business bad debt is a loss from the worthlessness of a debt that was either:

• Created or acquired in your trade or business, or

• Closely related to your trade or business when it became partly or totally worthless.

A debt is closely related to your trade or business if your primary motive for incurring the debt is business related. Bad debts of a corporation (other than an S corporation) are always business bad debts.

Temporary deduction of 100% business meals. A 100% deduction is allowed for certain business meals paid or incurred after 2020 and before 2023

Standard mileage rate. For 2023, the standard mileage rate for the cost of operating your car for business use is 65.5 cents per mile.

Section 179 deduction. The maximum amount you can elect to deduct for most section 179 property (including cars, trucks, and vans) you placed in service in tax years beginning in 2023 is $1,160,000. This limit is reduced by the amount by which the cost of section 179 property placed in service during the tax year exceeds $2,890,000

Travel

If you temporarily travel away from your tax home.

Travel expenses defined.

For tax purposes, travel expenses are the ordinary and necessary expenses of traveling away from home for your business, profession, or job. An ordinary expense is one that is common and accepted in your trade or business. A necessary expense is one that is helpful and appropriate for your business. An expense doesn't have to be required to be considered necessary.

Gifts

If you give gifts in the course of your trade or business, you may be able to deduct all or part of the cost.

You can deduct no more than $25 for business gifts you give directly or indirectly to each person during your tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift.

If you give a gift to a member of a customer's family, the gift is generally considered to be an indirect gift to the customer. This rule doesn’t apply if you have a bona fide, independent business connection with that family member and the gift isn’t intended for the customer's eventual use. If you and your spouse both give gifts, both of you are treated as one taxpayer.

It doesn’t matter whether you have separate businesses, are separately employed, or whether each of you has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

Example. Bob Jones sells products to Local Company. He and his wife Jan gave Local Company three gourmet gift baskets to thank them for their business. They paid $80 for each gift basket, or $240 total. Three of Local Company's executives took the gift baskets home for their families' use. Bob and Jan have no independent business relationship with any of the executives' other family members. They can deduct a total of $75 ($25 limit × 3) for the gift baskets.

Business use of a car

If individuals use their car exclusively in their business, they can deduct car expenses. If they use the car for both business and personal purposes, they must divide the expenses based on actual mileage. Generally, commuting expenses between their home and their business location, within the area of their tax home, are not deductible.

Individuals can deduct actual car expenses, which include depreciation (or lease payments), gas and oil, tires, repairs, tune-ups, insurance, and registration fees. Or, instead of figuring the business part of these actual expenses, they may be able to use the standard mileage rate to figure their deduction.

Business interest expense is an amount charged for the use of money you borrowed for business activities

The rules for deducting interest vary, depending on whether the loan proceeds are used for business, personal, or investment activities. If you use the proceeds of a loan for more than one type of expense, you must allocate the interest based on the use of the loan's proceeds. Allocate your interest expense to the following categories.
• Nonpassive trade or business activity interest.
• Passive trade or business activity interest.
• Investment interest.
• Portfolio interest.
• Personal interest.

In general, you allocate interest on a loan the same way you allocate the loan proceeds. You allocate loan proceeds by tracing disbursements to specific uses.

Insurance Expenses

Individuals generally can deduct the ordinary and necessary cost of insurance as a business expense if it is for their trade, business, or profession. However, they may have to capitalize certain insurance costs under the uniform capitalization rules.

Deductible Premiums

Individuals generally can deduct premiums they pay for the following kinds of insurance related to their trade or business.

1. Insurance that covers fire, storm, theft, accident, or similar losses.
2. Credit insurance that covers losses from business bad debts.
3. Group hospitalization and medical insurance for employees, including long-term care insurance.
    - If a partnership pays accident and health insurance premiums for its partners, it generally can deduct them as guaranteed payments to partners.
    - If an S corporation pays accident and health insurance premiums for its more-than-2% shareholder-employees, it generally can deduct them, but also must include them in the shareholder's wages subject to federal income tax withholding.
4. Liability insurance

5. Malpractice insurance that covers the personal liability for professional negligence resulting in injury or damage to patients or clients.
6. Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in the business, regardless of fault.
    - If a partnership pays workers' compensation premiums for its partners, it generally can deduct them as guaranteed payments to partners.
    - If an S corporation pays workers' compensation premiums for its more-than-2% shareholder-employees, it generally can deduct them, but also must include them in the shareholder's wages.
7. Contributions to a state unemployment insurance fund are deductible as taxes if they are considered taxes under state law.
8. Overhead insurance that pays for business overhead expenses individuals have during long periods of disability caused by an injury or sickness.
9. Car and other vehicle insurance that covers vehicles used in the business for liability, damages, and other losses. If an individual operates a vehicle partly for personal use, he needs to deduct only the part of the insurance premium that applies to the business use of the vehicle. If he uses the standard mileage rate to figure out the car expenses, he can’t deduct any car insurance premiums.
10. Life insurance covers the officers and employees if an individual is not directly or indirectly a beneficiary under the contract.
11. Business interruption insurance that pays for lost profits if the business is shut down due to a fire or other cause.

Nondeductible Premiums

Individuals can’t deduct premiums on the following kinds of insurance.

1. Self-insurance reserve funds. They can’t deduct amounts credited to a reserve set up for self-insurance. This applies even if they can’t get business insurance coverage for certain business risks. However, the actual losses may be deductible.
2. Loss of earnings. They can’t deduct premiums for a policy that pays for lost earnings due to sickness or disability. However, see

the discussion on overhead insurance, item (8), under Deductible Premiums, earlier.

3. Certain life insurance and annuities.
    - For contracts issued after June 8, 1997, individuals generally can't deduct the premiums on any life insurance policy, endowment contract, or annuity contract if they are directly or indirectly a beneficiary. The disallowance applies without regard to whom the policy covers.
    - Partners. If, as partners in a partnership, individuals take out an insurance policy on their own life and name their partners as beneficiaries to induce them to retain their investments in the partnership, they are considered a beneficiary. they can't deduct the insurance premiums.
4. Insurance to secure a loan. If individuals take out a policy on their life or on the life of another person with a financial interest in their business to get or protect a business loan, they can't deduct the premiums as a business expense. Nor can they deduct the premiums as interest on business loans or as an expense of financing loans. In the event of death, the proceeds of the policy are generally not taxed as income even if they are used to liquidate the debt.

Taxes

You can deduct various federal, state, local, and foreign taxes directly attributable to your trade or business as business expenses. You cannot deduct federal income taxes, estate and gift taxes, or state inheritance, legacy, and succession taxes.

Generally, you can only deduct taxes in the year you pay them. This applies whether you use the cash method or an accrual method of accounting.

Real Estate Taxes

Deductible real estate taxes are any state or local taxes, including taxes imposed by U.S. possessions, on real estate levied for the general public welfare. The taxing authority must base the taxes on the assessed value of the real estate and charge them uniformly against all property under its jurisdiction. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of the property

Example. To improve downtown commercial business, Waterfront City converted a downtown business area street into an enclosed pedestrian mall. The city assessed the full cost of construction, financed with 10-year bonds, against the affected properties. The city is paying the principal and interest with the annual payments made by the property owners. The assessments for construction costs are not deductible as taxes or as business expenses, but are depreciable capital expenses. The part of the payments used to pay the interest charges on the bonds is deductible as taxes.

Employment Taxes If you have employees, you must withhold various taxes from your employees' pay. Most employers must withhold their employees' share of social security, Medicare taxes, and Additional Medicare Tax (if applicable), along with state and federal income taxes.

You may also need to pay certain employment taxes from your own funds. These include your share of social security and Medicare taxes as an employer, along with unemployment taxes. Your deduction for wages paid is not reduced by the social security and Medicare taxes, Additional Medicare Tax, and income taxes you withhold from your employees. You can deduct the employment taxes you must pay from your own funds as taxes.

Example. You pay your employee $18,000 a year. However, after you withhold various taxes, your employee receives $14,500. You also pay an additional $1,500 in employment taxes. You should deduct the full $18,000 as wages. You can deduct the $1,500 you pay from your own funds as taxes.

Additional Medicare Tax. You must withhold a 0.9% Additional Medicare Tax from wages you pay to an employee in excess of $200,000 in a calendar year. The Additional Medicare Tax is only imposed on the employee. There is no employer share of Additional Medicare Tax.

Deduction for qualified business income

For tax years beginning after 2017, business owners may be entitled to take a deduction of up to 20% of their qualified business income from their qualified trade or business, plus 20% of the aggregate amount of qualified real estate investment trust (REIT), and qualified publicly traded partnership income.

The deduction is subject to various limitations, such as limitations based on the type of their trade or business, the taxable income, the amount of W-2 wages paid with respect to the qualified trade or business, and the unadjusted basis of qualified property held by their trade or business.

Individuals will claim this deduction on Form 1040 or 1040-SR, not on Schedule C. Unlike other deductions, this deduction can be taken in addition to the standard or itemized deductions.

Business Start Up Organizational Costs

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

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.

How to make the election

Business owners elect to deduct the start-up or organizational costs by claiming the deduction on their income tax return (filed by the due date including extensions) for the tax year in which the active trade or business begins. For costs paid or incurred, they are not required to attach a statement to their return to elect to deduct such costs. Business owners need to file the amended return at the same address they filed the original return. The election applies when figuring taxable income for the current tax year and all subsequent years. Once made, the election is irrevocable.

Failed Business Purchases And Failed Start-Ups

If the attempt to go into business is unsuccessful

If the business owner is an individual whose attempt to go into business is not successful, the expenses he has in trying to establish himself in business fall into two categories.

- The costs the individual has before making a decision to acquire or begin a specific business. These costs are personal and non-deductible. They include any costs incurred during a general search for, or preliminary investigation of, a business or investment possibility.
- The costs the individual has in the attempt to acquire or begin a specific business. These costs are capital expenses, and they can be deducted as a capital loss.

If the business is a corporation and the attempt to go into a new trade or business is not successful, the owner may be able to deduct all investigatory costs as a loss.

The costs of any assets acquired during the unsuccessful attempt to go into business are a part of the basis in the assets. The individual cannot take a deduction for these costs. He will recover the costs of these assets when he disposes of them.

Qualifying Organizational Costs

Organizational costs

These are any costs involved in the actual formation of a corporation, partnership or LLC. (The accountant or tax lawyer might also refer to these as "incorporation" or "partnership" costs.) Typical qualifying organizational costs include:

- Incorporation fees
- Partnership filing fees

- Legal fees for services incident to the organization of the corporation or partnership, such as negotiation and preparation of the partnership agreement
- Accounting fees for services incident to the organization of the partnership
- The cost of organizational meetings
- The cost of temporary directors

General Business Credit

Form 3800 needs to be filed to claim any of the general business credits. The credit is limited to tax liability. Unused credits can be carried back 1 year, forward 20 years

Credit Ordering Rule

General business credits reported on Form 3800 are treated as used on a first-in, first-out basis by offsetting the earliest-earned credits first. Therefore, the order in which the credits are used in any tax year is:

- Carry forwards to that year, the earliest ones first;
- The general business credit earned in that year; and
- The carryback to that year.

Investment Credit

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

The investment credit consists of the rehabilitation, energy, qualifying advanced coal project, qualifying gasification project, and qualifying advanced energy project credits.

This is reported on Form 3468.

Work Opportunity Credit

Work Opportunity Credit is authorized until December 31, 2025. It is available to employers for hiring individuals from certain targeted groups who have consistently faced significant barriers to employment:

- Qualified IV-A recipient
- Qualified veteran
- Qualified ex-felon
- Designated community resident
- Vocational rehabilitation referral
- Recipient of SNAP benefits (food stamps)
- Supplemental Security Income (SSI) recipient
- Long-term family assistance recipient
- Qualified Long-term unemployment recipient.

The credit is limited to the amount of the business income tax liability or social security tax owed for qualified wages.

Individuals need to complete Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Credit, on or before the day the individual is offered a job and receives the certification before he claims the credit. The credit needs to be reported on Form 5884.

Disabled Access Credit

A non-refundable credit for small businesses that incur expenditures for the purpose of providing access to persons with disabilities. Needs to be reported on Form 8826.

An eligible small business is one that earned $1 million or less or had no more than 30 full time employees in the previous year; they may take the credit each and every year they incur access expenditures.

Eligible expenditures:

- To remove barriers that prevent a business from being accessible to or usable by individuals with disabilities
- To provide qualified interpreters or other methods of making audio materials available to hearing- impaired individuals

- To provide qualified readers, taped texts, and other methods of making visual materials available to individuals with visual impairments
- To acquire or modify equipment or devices for individuals with disabilities
-

Credit For Employer Social Security & Medicare Taxes On Employee Tips

Certain food and beverage establishments can claim a credit for social security and Medicare taxes paid or incurred by the employer on certain employees' tips.

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, $5.15 an hour. It is reported on Form 8846

Employer Credit For Paid Family & Medical Leave

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. It is effective for wages paid in taxable years of the employer beginning after December 31, 2017.

Employers must have a written policy in place that meets certain requirements, including providing:

- 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
- The paid leave is not less than 50 percent of the wages normally paid to the employee.

The employer credit for paid family and medical leave must be reported on Form 8994

Small Business Healthcare Tax Credit

Small Business Healthcare Tax Credit is a refundable credit for employers that:

- Have fewer than 25 full-time equivalent employees
- Pay average wages of less than $56,000 a year per full-time equivalent
- 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 amount of the credit received works on a sliding scale. The smaller the employer, the bigger the credit. The credit can be carried back or forward. It must be reported on Form 8941

Other Business Credits

- Credit for Increasing Research Activities
- Low-Income Housing Credit
- Indian Employment Credit
- Empowerment Zone and Renewal Community Employment Credit
- New Markets Credit
- Distilled Spirits Credit
- Alternative Motor Vehicle Credit

Net Operating Losses

If the deductions for the year are more than the income for the year, individuals may have a net operating loss (NOL).

For Individuals—they may have an NOL if AGI less the standard deduction/ itemized deduction = a negative amount.

If they have an NOL for tax year ending in 2023, individuals must carry the loss forward to future years. They may carry the losses forward indefinitely.

Home Office Deduction

If an individual uses a part of his home regularly and exclusively for business purposes, he may be able to deduct a part of the operating expenses and depreciation of the home.

He can claim this deduction for the business use of a part of his home only if he uses that part of the home regularly and exclusively:

- As a principal place of business for any trade or business;
- As a place to meet or deal with patients, clients, or customers in the normal course of the trade or business; or
- In the case of a separate structure not attached to the home, in connection with the trade or business.
- The regular and exclusive business use must be for the convenience of the employer and not just appropriate and helpful in his job.

POP QUIZ & ANSWER SHEET

Business Expenses, Deductions and Credits

POP QUIZ

Test your knowledge on *Business Expenses, Deductions and Credits* by answering the questions below. The answer sheet may be found at the end of the Pop Quiz.

Q1: Capital expenses are considered assets in your business. What are the three types of costs?
A. Personal Expenses, Business Start-up Cost, Business
B. Expenses used to figure the Cost of Goods Sold, and Personal Expenses
C. Personal Expenses, Business Assets, Improvements
D. Business Start-up Cost, Business Assets, Improvements

Q2: Taxpayers use this method to determine the amount of deductible expenses attributable to certain business use of a residence during the tax year. This method is an alternative to the calculation, allocation, and substantiation of actual expenses.
A. Accrual Method
B. Accrual of Contested Income Method
C. Optional Safe Harbor Method
D. Loan & Capital Contribution Method

Q3: This kind of cost includes 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.
A. Organizational
B. Start-Up Cost
C. Direct Cost
D. Variable

Q4: If you use this method of accounting, you can deduct the taxes as additional rent for the tax year in which you can determine all the following: that you have a liability for taxes on the leased property, how much the liability is, that economic performance occurred, the liability and amount of taxes are deter- mined by state or local law and the lease agreement, economic performance occurs as you use the property.

A. Accrual Method
B. Accrual of Contested Income Method
C. Optional Safe Harbor Method
D. Loan & Capital Contribution Method

Q5: What kind of expense is an amount charged for the use of money borrowed for business activities?

A. Personal Expense
B. Business Interest Expense
C. Capital Expense
D. Car Expense

Q6: You can generally deduct only the interest you actually paid during the tax year. You cannot deduct a promissory note you gave as payment because it is a promise to pay and not an actual payment.

A. Discounted Loan
B. Refunds of Interest
C. Prepaid Interest
D. None of the Above

Q7: An amount you pay for the use of property you do not own.

A. Deduction S
B. Rent
C. Income
D. Expense

Q8: This type of transaction may not be considered leases. It generally involves three parties: a lessor, a lessee, and a lender to the lessor. Usually, the lease term covers a large part of the useful life of the leased property, and the lessee's payments to the lessor are enough to cover the lessor's payments to the lender.

A. Leveraged Leases
B. Operating Leases
C. Regular Leases
D. Financing Leases

Q9: An annual deduction to recover the cost or basis of property used in business over a certain number of years, is referred to as:

A. Amortization
B. Cost Valuation
C. Depreciation
D. Capitalization

Q10: What method is used to deduct the cost or basis of an intangible asset over its estimated life?

A. Depreciation
B. Amortization
C. Capitalization
D. Valuation

Q11: When does the depreciable period begin?

A. When you first place the property in use for business or production of
income.
B. When you purchase the property.
C. 3 years before the sale of the property.
D. None of the above

Q12: The depreciable period ends when?

A. The property is no longer being used for business or income producing purposes.
B. You have recovered all cost or basis of the property.
C. You start using the property for personal use.
D. All the above

Q13: Which of the following is an untrue statement relating to the depreciation rules?

A. Must be property that you own.

B. Property can have an indeterminable useful life.

C. Property must be used for business or income producing activity.

D. The property must be expected to last more than a year.

Q14: What IRS form is used to report depreciation and amortization?

A. Form 2106

B. Form 1116

C. Form 4562

D. Form 2555

Q15: Business A purchased a business truck with a useful life of 5 years for $85,000 on May 15, 2023. Business A placed the truck in service June 1, 2023. They take the following depreciation:

Year 1: $8500

Year 2: $17,000

Based upon the depreciation transactions taken, which depreciation method is Business A using?

A. Double Declining balance method

B. Straight line depreciation

C. Units of production

D. Sum of years digits

Q17: All of the following are depreciable assets, except:

A. Raw Land

B. Property used for business use

C. Computer server for a business

D. Commercial property

Q18: Non-residential real property has a useful life of how many years?

A. 10 years
B. 20 years
C. 27.5 years
D. 39 years

Q19: In 2023, businesses can expense up to how much in qualified asset purchases under section 179?

A. $500,000
B. $1 million
C. $1,160,000
D. $2 million

Q20: Which of the following is the current method of accelerated asset depreciation required by the Tax Code?

A. Accelerated Cost Recovery System (ACRS)
B. Modified Accelerated Cost Recovery System (MACRS)
C. Straight Line
D. None of the Above

Q21: Which of the following forms is used to request a change of accounting method of depreciation?

A. Form 1040X
B. Form 8821
C. Form 3115
D. Form 4562

Q22: Relating to Section 179 depreciation, which of the following is considered qualifying property?

A. Cellular Telephones
B. Heating and A/C Units
C. Property used to Furnish Lodging
D. All of the Above

Q23: Relating to Bonus Depreciation, how much is first year depreciation?
A. 50%
B. 75%
C. 100%
D. 125%

Q24: When the same amount is deducted each year over the useful life of property, this is referred to as:
A. Straight-Line Depreciation
B. ACRS
C. MACRS
D. Hybrid Depreciation

Q25: Leasehold improvements include which of the following?
A. Built-In Cabinetry
B. Carpeting and Tiles
C. Interior Walls and Ceilings
D. All the Above

Q26: What method of depreciation is used for oil mining?
A. Percentage Depletion
B. Cost Depletion
C. Straight Line
D. None of the Above

Q27: What is a net operating loss?
A. The amount by which the total deductions attributable to all of the trades
for a business reported on the Federal tax return.
B. The loss incurred if the deductions for the year are more than the income
for the year.
C. Net amount of qualified items of income, gain, deduction and loss from any qualified trade or business
D. None of the above

Q28: Who is not eligible for a qualified business income deduction?

A. Sole Proprietorship
B. Partnership
C. S Corporation
D. C Corporation

Q29: The following are the requirements needed by taxpayers to qualify for the safe harbor rule, except?

A. Separate books and records are maintained to reflect income and expenses
for each rental real estate enterprise.
B. At least 250 hours of rental services are performed per year by owners,
employees, contractors, or agents for the enterprise.
C. Combined books and records are maintained to reflect the income and
expenses of the entire enterprise.
D. The taxpayer or RPE attaches a statement to the return filed for the tax
year(s) the safe harbor is relied upon.

Q30: Which of the following is not true about REIT/PTP Income?

A. This component of the deduction equals 20 percent of qualified REIT dividends and qualified PTP income.
B. It is not limited by W-2 wages or the UBIA of qualified property.
C. Depending on the taxpayer's taxable income, the amount of PTP income that qualifies may be limited depending on the PTP's trade or business.
D. None of the above

Q31: What is the maximum credit for the disabled access credit?

A. $10,000
B. $7,500
C. $5,000
D. $15,000

Q32: Alamo Farming Inc, reported a $55,000 profit for tax year 2023. For tax year 2024 Alamo Farming reported a $75,000 loss. Alamo files an amendment for 2023 to carry back the NOL from 2023. How much of the profit will Alamo Farming Inc be able to adjust on their 2021 tax return?

A. $75,000
B. $55,000
C. $20,000
D. $0

Q33: Corporations may apply for a refund by filing which form?

A. Form 1139, Corporation Application for Tentative Refund
B. Form 1040x, Amended U.S. Individual Income Tax Return
C. Form 1120, U.S. Corporation Income Tax Return
D. Form 843, Claim for Refund and Request for Abatement.

Q34: Businesses can apply for the Work Opportunity Tax Credit when hiring all of the following individuals, except:

A. Ex-Felons
B. Food stamp recipients
C. Disabled Veterans
D. Recently laid off worker due to covid

Q35: Various business credits are claimed on their respective separate forms, and then aggregated on which form?

A. Form 3468, Investment Credit
B. Form 5884, Work Opportunity Credit
C. Form 3800, General Business Credit
D. Form 8844, Empowerment Zone Employment Credit

Business Expenses, Deductions and Credits
Answer Sheet

1. Answer is D - Business Start-up Cost, Business Assets, Improvements

2. Answer is C - Optional Safe Harbor Method

3. Answer is B - Start-Up Cost

4. Answer is A - Accrual Method

5. Answer is B - Business Interest Expense

6. Answer is D - Prepaid Interest

7. Answer is B - Rent

8. Answer is A - Leveraged Leases

9. Answer is C - Depreciation

10. Answer is B - Amortization

11. Answer is A - When you first place the property in use for business or production of income.

12. Answer is D - All the above

13. Answer is B - Property can have an indeterminable useful life.

14. Answer is C - Form 4562

15. Answer is B - Straight line depreciation

16. Answer is A - Raw Land

17. Answer is D - 39 years

18. Answer is C - $1,160,000

19. Answer is B - Modified Accelerated Cost Recovery System (MACRS)

20. Answer is C - Form 3115

21. Answer is D - All of the Above

22. Answer is C - 100%

23. Answer is A - Straight-Line Depreciation

24. Answer is D - All the Above

25. Answer is B - Cost Depletion

26. Answer is B - The loss incurred if the deductions for the year are more than the income for the year.

27. Answer is D - C Corporation

28. Answer is C - Combined books and records are maintained to reflect the income and expenses of the entire enterprise

29. Answer is D - None of the above

30. Answer is C - $5,000

31. Answer is B - $55,000

32. Answer is A - Form 1139, Corporation Application for Tentative Refund

33. Answer is D - Recently laid off worker due to covid

34. Answer is C - Form 3800, General Business Credit

BUSINESS ASSETS

Overview

Basis is the amount of the investment in property for tax purposes. Individuals need to use the basis of property to figure depreciation, amortization, depletion, and casualty losses. Also, it can be used to figure gain or loss on the sale or other disposition of property.

This training is divided into the following sections.

- Cost Basis
- Adjusted Basis
- Basis Other Than Cost

The basis of property an individual buys is usually its cost. He may also have to capitalize (add to basis) certain other costs related to buying or producing the property.

The original basis in property is adjusted (increased or decreased) by certain events. If an individual makes improvements to the property, he needs to increase the basis. If he takes deductions for depreciation or casualty losses, he needs to reduce the basis.

Individuals can't determine the basis in some assets by cost. This includes property received as a gift or inheritance. It also applies to property received in an involuntary conversion and certain other circumstances.

If an individual purchases property to use in his business, his basis is usually its actual cost. If an individual constructs, creates, or otherwise produces property, he must capitalize the costs as his basis. In certain circumstances, he may be subject to the uniform capitalization rules.

Basis is generally the amount of the capital investment in property for tax purposes. Use the basis to figure depreciation, amortization, depletion, casualty losses, and any gain or loss on the sale, exchange, or other disposition of the property.

In most situations, the basis of an asset is its cost. The cost is the amount paid for it in cash, debt obligations, and other property or services. Cost includes sales tax and other expenses connected with the purchase. The basis in some assets isn't determined by the cost.

If an individual acquires property other than through a purchase (such as a gift or an inheritance), he needs to refer to Publication 551, Basis of Assets for more information.

If an individual buys stocks or bonds, the basis is the purchase price plus any additional costs such as commissions and recording or transfer fees. If he has stocks or bonds that he didn't purchase, he may have to determine the basis by the fair market value of the stocks and bonds on the date of transfer or the basis of the previous owner.

Before figuring gain or loss on a sale, exchange, or other disposition of property, or before figuring allowable depreciation, the individual must determine the adjusted basis in that property. Certain events that occur during the period of the ownership may increase or decrease the basis, resulting in an "adjusted basis." The basis can be increased by items such as the cost of improvements that add to the value of the property and decreased by items such as allowable depreciation and insurance reimbursements for casualty and theft losses.

The Basis Of Real Property

Real property, also called real estate, is land and generally anything built on or attached to it. If an individual buys real property, certain fees and other expenses become part of the cost basis in the property.

Real Estate Taxes

If an individual pays real estate taxes the seller owed on real property, and the seller didn't reimburse those taxes, those taxes need to be treated as part of the basis. Individuals can't deduct them as taxes.

If an individual reimburses the seller for taxes the seller paid him, he can usually deduct that amount as an expense in the year of purchase.

That amount needs to be added to the basis of the property. If the individual didn't reimburse the seller, he must reduce the basis by the amount of those taxes.

Settlement Cost

The basis includes the settlement fees and closing costs for buying property. Individuals can't include in their basis the fees and costs for getting a loan on property. A fee for buying property is a cost that must be paid even if the property is bought for cash.

The following items are some of the settlement fees or closing costs that can be included in the basis of the property.

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including title search and preparation of the sales contract and deed).
- Recording fees.
- Surveys.
- Transfer taxes.
- Owner's title insurance.
- Any amounts the seller owes that the individual agrees to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement costs don't include amounts placed in escrow for the future payment of items such as taxes and insurance.

The following items are some settlement fees and closing costs that can't be included in the basis of the property.

- Casualty insurance premiums.
- Rent for occupancy of the property before closing.
- Charges for utilities or other services related to occupancy of the property before closing.
- Charges connected with getting a loan

The following are examples of charges with getting a loan.

1. Points (discount points, loan origination fees).
2. Mortgage insurance premiums.

3. Loan assumption fees.
4. Cost of a credit report.
5. Fees for an appraisal required by a lender.
6. Fees for refinancing a mortgage.

If these costs relate to business property, items (1) through (3) are deductible as business expenses. Items (4) and (5) must be capitalized as costs of getting a loan and can be deducted over the period of the loan.

Points

If an individual pays points to obtain a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), he doesn't need to add the points to the basis of the related property. Generally, he can deduct the points over the term of the loan. For more information on how to deduct points, see Points in chapter 4 of Pub. 535.

Points on home mortgage. Special rules may apply to points the buyer and the seller pay when the buyer obtains a mortgage to purchase his main home. If certain requirements are met, he can deduct the points in full for the year in which they're paid. He can reduce the basis of his home by any seller-paid points. For more information, see Points in Pub. 936, Home Mortgage Interest Deduction.

Assumption of mortgage. If an individual buys property and assumes (or buys subject to) an existing mortgage on the property, his basis includes the amount paid for the property plus the amount to be paid on the mortgage.

Example:

If Maria buys a building for $20,000 cash and assumes a mortgage of $80,000 on it, her basis is $100,000.

Construction Assets

If an individual builds property or has assets built, his expenses for this construction are part of the basis. Some of these expenses include the following costs.

- Land
- Labor and materials
- Architect's fees
- Building permit charges
- Payments to contractors
- Payments for rental equipment
- Inspection fees

In addition, if an individual owns a business and uses his employees, material, and equipment to build an asset, he can't deduct the following expenses. He must include them in the asset's basis.

- Employee wages paid for the construction work, reduced by any employment credits allowed.
- Depreciation on equipment owned while it's used in the construction.
- Operating and maintenance costs for equipment used in the construction.
- The cost of business supplies and materials used in the construction.

Repairs Vs. Improvements

The basis of property can be increased by assessments for items such as paving roads and building ditches that increase the value of the property assessed. These expenses cannot be deducted as taxes. However, individuals can deduct as taxes charges for maintenance, repairs, or interest charges related to the improvements.

Example:

Mike's city changes the street in front of his store into an enclosed pedestrian mall and assesses him and other affected landowners for the cost of the conversion. Mike needs to add the assessment to his property's basis. In this example, the assessment is a depreciable asset.

Deducting vs. Capitalizing Costs

Costs that can be deducted as current expenses are not added to the basis. For example, amounts paid for incidental repairs or maintenance that are deductible as business expenses can't be added to the basis. However, individuals can choose either to deduct or to capitalize certain other costs. If they capitalize these costs, they need to be included in the basis. If they deduct them, they don't need to include them in the basis. See Uniform Capitalization Rules, earlier.

A regulatory framework for analyzing whether expenditures are for deductible repairs or capital improvements.

Have the final tangibles regulations changed the rules for determining whether an expenditure is a deductible repair or a capital improvement?

The final tangibles regulations synthesize existing case law and prior administrative rules into a framework to help determine whether a cost is deductible as a repair and maintenance expense or must be capitalized because it's an improvement. If the amounts are not paid or incurred for an improvement to tangible property as determined under the final tangibles regulations, then the amounts generally are deductible as repairs and maintenance. Of course, whether a cost is for repair or an improvement will always require reviewing facts and circumstances, as required under prior rules. This facts and circumstances analysis is described in more detail below. The final regulations do not eliminate the requirements of section 263A, which generally provide that individuals must capitalize the direct and allocable indirect costs of producing real or tangible personal property and acquiring property for resale.

In addition, the final tangibles regulations provide several simplifying safe harbors and elections (simplifying alternatives) to ease the compliance with these rules. See Safe Harbor Election for Small Taxpayers, Safe Harbor for Routine Maintenance, and Election to Capitalize Repair and Maintenance Costs.

What is the facts and circumstances analysis for distinguishing capital improvements from deductible repairs?

Step 1 – What is the unit of property to which individuals should apply the improvement rules?

For buildings – The unit of property is generally the entire building including its structural components. However, under the final tangibles regulations and for these purposes only, the improvement analysis applies to the building structure and each of the key building systems. The key building systems are the plumbing system, electrical system, HVAC system, elevator system, escalator system, fire protection and alarm system, gas distribution system, and the security system. Lessees of portions of buildings apply the analysis to the portion of the building structure and portion of each building system subject to the lease. Lessors of an entire building apply the improvement rules to the entire building structure and each of the key building systems.

What is the facts and circumstances analysis for distinguishing capital improvements from deductible repairs?

For non-buildings – The unit of property is, and the analysis applies to, all components that are functionally interdependent. Components of property are functionally interdependent if you cannot place in service one component of property without placing in service another component of property.

For plant property, e.g., manufacturing plant, generation plant, etc. – The unit of property is, and the analysis applies to, each component or group of components within the plant that performs a discrete and major function or operation.

For network assets, e.g., railroad track, oil and gas pipelines, etc. – Your particular facts and circumstances or industry guidance from the Treasury Department and the IRS determines the unit of property and the application of the improvement analysis.

There are two additional rules, based on depreciation conformity, that determine when a component or group of components of a unit of property must be treated as a separate unit of property. These are as follows:

- For the Year Placed in Service - This rule, only for non-building property, is triggered at the time you initially placed the unit of property into service. If at the time the unit of property is first placed in service, you properly treat the component of the unit of property as being within a different MACRS class than the MACRS class for the unit of property of which the component is a part, or you properly depreciate the component using a different depreciation method than the depreciation method used for the unit of property of which the component is a part, then you must treat the component as a separate unit of property.

- Subsequent Change in Classification - This rule, for both building and non-building property, is triggered when you make a subsequent change in your classification of the property for MACRS. In any taxable year after the unit of property is initially placed in service, if you or the IRS changes the treatment of that property to a proper MACRS class or a proper depreciation method (for example, as a result of a cost segregation study or a change in the use of the property), then you must change the unit of property determination for that property under this rule to be consistent with your change in treatment for depreciation purposes.

Step 2 – Is there an improvement to the unit of property, or in the case of a building, the building structure, or any key building system, identified in Step 1?

A unit of tangible property is improved only if the amounts paid are

- For a betterment to the unit of property; or
- To restore the unit of property; or
- To adapt the unit of property to a new or different use.

What is a betterment?

Betterment is amounts paid to fix a material condition or material defect that existed before the acquisition or arose during production of the unit of property; or amounts paid for a material addition, including a physical enlargement, expansion, extension, or addition of a major component, to the property or a material increase in capacity, including additional cubic or linear space, of the unit of property; or Amounts paid that are reasonably expected to materially increase productivity, efficiency, strength, quality, or output of the unit of property where applicable.

The term "material" is not defined in the final tangibles regulations. Although the final tangible regulations include examples that refer to percentage increases, these examples are provided to assist people in understanding the rules. These percentages are not intended to set a standard, for example, a particular percentage increase in square footage or capacity, for determining whether the amount paid is a "material" betterment. In determining whether a betterment is "material", individuals should use common sense and reasonable judgment as applied to their own facts and circumstances.

What are amounts to restore a unit of property?

Replacement of a major component or substantial structural part – Amounts paid for the replacement of a part or combination of parts that make up a major component or a substantial structural part of the unit of property; or

Recognition of gains or losses and basis adjustments - Individuals have taken into account or adjusted the basis of the unit of property or component of the unit of property, including:

- Deducted Loss – Amounts paid for the replacement of a component of the unit of property and individuals have properly deducted a loss for that component, other than a casualty loss; or
- Sale or exchange – Amounts paid for the replacement of a component of the unit of property and individuals have properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component; or
- Casualty loss or event – Amounts paid for the restoration of damage to the unit of property for which individuals are required to take a basis adjustment because of a casualty loss under section 165, or relating to a casualty event described in section 165, but limited to the basis in the unit of property; or
- Deterioration to state of disrepair – Amount paid to return the unit of property to its ordinarily efficient operating condition, if the unit of property has deteriorated to a state of disrepair and is no longer functional for its intended use; or

- Rebuilding to like-new condition – Amounts paid for the rebuilding of the unit of property to a like-new condition after the end of its class life.

What adapts the unit of property to a new or different use?

An amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the ordinary use of the unit of property at the time an individual originally placed it in service.

Election to Capitalize 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 individuals to follow financial accounting policies for federal tax purposes, the final tangibles regulations include an election to capitalize repair and maintenance expenses as improvements, if such costs are treated as capital expenditures for financial accounting purposes.

Individuals may elect to treat repair and maintenance costs paid during the taxable year as amounts paid to improve property if thy:

- Pay these amounts in carrying on a trade or business; and
- Treat these amounts as capital expenditures on their books and records regularly used in computing their income.
- Make the election to capitalize for each taxable year in which qualifying amounts are incurred by attaching a statement to their timely filed original federal tax return including extensions for the taxable year that the amounts are paid.

If an individual makes the election to capitalize repair and maintenance expenses, he must apply the election to all amounts paid for repair and maintenance that he treats as capital expenditures on his books and records in that taxable year. For more information see When and how do you make an election provided under the final tangibles regulations?

An annual election is not a change in method of accounting. Therefore, individuals shouldn't 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.

Irs Tangible Property Regulation

Section 162 of the Internal Revenue Code (IRC) allows individuals to deduct all the ordinary and necessary expenses they incur during the taxable year in carrying on their trade or business, including the costs of certain materials, supplies, repairs, and maintenance. However, section 263(a) of the IRC requires individuals to capitalize the costs of acquiring, producing, and improving tangible property, regardless of the size or the cost incurred. The tax law has long required people to determine whether expenditures related to tangible property are currently deductible business expenses or non-deductible capital expenditures. Before the issuance of the final tangible property regulations on Sept. 17, 2013, [Treasury Decision 9636 ("final tangibles regulations")], the decisions were guided by decades of often conflicting case law, as well as administrative rulings on specific factual situations.

The final tangibles regulations combine the case law and other authorities into a framework to help individuals determine whether certain costs are currently deductible or must be capitalized. The final tangibles regulations also contain several simplifying provisions that are elective and prospective in application (for example, the election to apply the de minimis safe harbor, the election to utilize the safe harbor for small taxpayers, and the election to capitalize repair and maintenance costs in accordance with books and records).

How do these final tangibles regulations coordinate with other provisions of the IRC?

Nothing in the final tangibles regulations under section 263(a) changes the treatment of any amount that is specifically provided for under any provision of the IRC or the Treasury regulations other than section 162(a) or section 212. For example, the final tangibles regulations do not eliminate the requirements of section 263A, which generally provides that people must capitalize the direct and allocable indirect costs of producing real or tangible personal property and acquiring property for resale.

When and how do individuals apply the final tangibles regulations? What is the effective date?

Generally, the final tangibles regulations apply to taxable years beginning on or after 1-1-2014, or in certain circumstances, apply to costs paid or incurred in taxable years beginning on or after 1-1-2014.

When and how do people make an election provided under the final tangible regulations?

The final tangibles regulations add certain annual elections that individuals can choose to make 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, individuals 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 name, address, Taxpayer Identification Number, and a statement describing the election. For some elections, individuals will need to include a description of the property to which the election is applied. For example, if they qualify and desire to use the de minimis safe harbor election for qualifying amounts paid during the annual taxable year beginning 1-1-2023, they must file a statement with their timely filed original federal tax return for 2023. They must also file a statement with their timely filed original tax return for each subsequent taxable year for which they intend to make such an election.

An annual election is not a change in method of accounting. Therefore, individuals shouldn't file Form 3115, Application for Change in Method of Accounting, to make these elections or to stop applying for safe harbor or other election in a subsequent year.

When and how do people change a method of accounting to use the final tangibles regulations?

General Procedures

Under the IRS, a change in method of accounting includes a change in the treatment of an item affecting the timing for including the item in income or taking the item as a deduction. For example, if a person is changing the method of accounting if he has been capitalizing certain amounts that he characterized as improvements and would like to currently deduct the amounts as repairs and maintenance costs pursuant to the final tangibles regulations.

Individuals must get the IRS Commissioner's consent to change a current accounting method to a new accounting method. The Treasury Department and the IRS provides automatic consent procedures for those who want to change to a method of accounting permitted under the final tangibles regulations.

Generally, individuals receive automatic consent to change a method of accounting by completing and filing Form 3115, Application for Change in Accounting Method (Rev. Dec. 2015), and including it with the timely filed original federal tax return for the year of change. They also mail a duplicate copy of the Form 3115 to Covington, KY. The Form 3115 will identify the taxpayer; people need to describe the methods that are being changed, identify the type of property involved in the change, and include a section 481(a) adjustment, if applicable. There is no fee for filing an automatic consent to change a method of accounting.

Individuals cannot file an amended return to make the change in method of accounting. The only exception is a limited late filing provision found in section 6.03(4) of Revenue Procedure 2015-13. These provisions grant, for a taxpayer who has timely filed (including any extension) its original federal income tax return for the year of change, an automatic extension of 6 months from the due date (excluding any extension) of the federal income tax return for the year of change to file an amended return in a manner that is consistent with the taxpayer's changed method of accounting and includes the original Form 3115. The return must also have a statement attached to the Form 3115 that the application is being filed pursuant to Treas. Reg. §

301.9100-2(b) of the Procedure and Administration Regulations. A copy needs to be filed with Covington, KY.

Safe Harbor Rules

Safe Harbor for Routine Maintenance

Individuals are not required to capitalize as an improvement, and therefore may deduct, amounts that meet all of the following criteria:

- Amounts paid for recurring activities that they expect to perform;
- As a result of their use of the property in their trade or business;
- To keep the property in its ordinarily efficient operating condition; and

Individuals reasonably expect, at the time the property is placed in service, to perform the activities:

- For building structures and building systems, more than once during the 10-year period beginning when placed in service, or
- For property other than buildings, more than once during the class life of the unit of property.

If the amount doesn't meet all of the requirements for the routine maintenance safe harbor, individuals may still deduct the amount if the amount is not for an improvement under the facts and circumstances analysis.

What are the most important exceptions from and inclusions in the routine maintenance safe harbor?

The routine maintenance safe harbor doesn't apply to amounts paid for betterments. The routine maintenance safe harbor does apply to certain restorations that would otherwise be improvements, including when individuals pay amounts to replace a major component or substantial structural part of a unit of property.

What must individuals do to apply the safe harbor for routine maintenance to amounts paid for repairs and maintenance?

Because these final tangibles regulations are based primarily on prior law, if they were previously in compliance with the rules they generally will be in compliance with the final tangibles regulations and generally no action was required. If they are not in compliance or otherwise want to change their method of accounting to use the safe harbor for routine maintenance, they should file Form 3115, Application for Change in Accounting Method, and compute a section 481(a) adjustment. For more information, including simplified accounting method change rules for certain small business taxpayers, see When and how do you change a method of accounting to use the final tangibles regulations?

A de minimis safe harbor election

Note: Effective for taxable years beginning on or after January 1, 2016, the Internal Revenue Service in Notice 2015-82 increased the de minimis safe harbor threshold from $500 to $2500 per invoice or item for taxpayers without applicable financial statements. In addition, the IRS will provide audit protection to eligible businesses by not challenging the use of the $2,500 threshold for tax years ending before January 1, 2016 if the taxpayer otherwise satisfies the requirements of Treasury Regulation § 1.263(a)-1(f)(1)(ii).

What is the de minimis safe harbor election?

Under the final tangibles regulations, individuals may elect to apply a de minimis safe harbor to amounts paid to acquire or produce tangible property to the extent such amounts are deducted by them for financial accounting purposes or in keeping their books and records. If they have an applicable financial statement (AFS), they may use this safe harbor to deduct amounts paid for tangible property up to $5,000 per invoice or item (as substantiated by invoice). If they don't have an AFS, they may use the safe harbor to deduct amounts up to $2,500 ($500 prior to 1-1-2016) per invoice or item (as substantiated by invoice).

These limitations are for purposes of determining whether particular expenses qualify under the safe harbor; they aren't intended as a ceiling on the amount individuals can deduct as business expenses under the IRS.

The de minimis safe harbor election does not include amounts paid for inventory and land. Additionally, it does not apply to rotable, temporary, and standby emergency spare parts that the taxpayer elects to capitalize and depreciate under § 1.162-3(d). It does not apply to rotable and temporary spare parts that the taxpayer accounts for under the optional method of accounting under § 1.162-3(e).

Neither the IRS nor prior regulations included a de minimis safe harbor exception to capitalization; individuals were required to determine whether each expenditure for tangible property, regardless of amount, was required to be capitalized. The de minimis safe harbor election eliminates the burden of determining whether every small-dollar expenditure for the acquisition or production of property is properly deductible or capitalizable. If they elect to use the de minimis safe harbor, they don't have to capitalize the cost of qualifying de minimis acquisitions or improvements. However, de minimis amounts paid for tangible property may be subject to capitalization under §263A, if the amounts include the direct or allocable indirect costs of other property produced or acquired for resale. For example, individuals must capitalize all the direct and allocable indirect costs of constructing a new building.

If a person uses the de minimis safe harbor, does he have to capitalize all expenses that exceed the $2,500 ($500 prior to 1-1-2016) or $5,000 limitations?

No. Amounts paid for the acquisition or production of tangible property that exceed the safe harbor limitations aren't subject to the de minimis safe harbor election. Therefore, the safe harbor doesn't require him to capitalize all amounts paid for tangible property in excess of the applicable limitation. If an amount doesn't qualify under the de minimis safe harbor, he should treat the amount under the normal rules that apply, i.e., currently deductible if paid for incidental materials and supplies or for repair and maintenance. This treatment is proper regardless of whether the amount exceeds the applicable de minimis safe harbor limitation. The de minimis safe harbor is simply an administrative convenience that generally allows him to elect to deduct small-dollar expenditures for the acquisition or production of property that otherwise must be capitalized under the general rules.

How do people elect to use the de minimis safe harbor?

Individuals should attach a statement titled "Section 1.263(a)-1(f) de minimis safe harbor election" to the timely filed original federal tax return including extensions for the taxable year in which the de minimis amounts are paid. The statement should include name, address, and Taxpayer Identification Number, as well as a statement that the person is making the de minimis safe harbor election. Under the election, he must apply the de minimis safe harbor to all expenditures meeting the criteria for the election in the taxable year. For more information, see When and how do you make an election provided under the final tangibles regulations?

An annual election is not a change in method of accounting. Therefore, individuals should not file Form 3115, Application for Change in Method of Accounting, to use the de minimis safe harbor for a particular tax year, and they should not file a Form 3115 to change the amount they deduct under the book policy. Similarly, they should not file a Form 3115 to stop applying the de minimis safe harbor for a subsequent tax year.

How does the de minimis safe harbor affect the deductions that are typically taken for materials and supplies or repairs and maintenance?

In general, when individuals elect the de minimis safe harbor, materials and supplies that also qualify under the de minimis safe harbor are treated as de minimis costs and are not treated as materials and supplies. However, the de minimis safe harbor doesn't change the ability to deduct costs for materials and supplies, incidental or non-incidental, that don't qualify under the de minimis safe harbor.

Similarly, the de minimis safe harbor doesn't change the ability to deduct repair and maintenance costs that don't qualify under the de minimis safe harbor, for example, costs that exceed the safe harbor threshold. Therefore, for costs that don't qualify under the de minimis safe harbor, individuals apply the general rules for identifying and deducting repair and maintenance costs, incidental supplies, and non-incidental materials and supplies.

Inventory that individuals are accounting for as non-incidental materials and supplies under Revenue Procedure 2001-10 or Revenue Procedure 2002-28 are still characterized as inventory and not subject to the de minimis safe harbor election. These two revenue procedures allow qualifying small business taxpayers to remain on the cash method even though they have inventory and to account for their inventory as non-incidental materials and supplies.

Other Additions To Basis Of Business Property

In most situations, the basis of an asset is its cost. The cost is the amount paid for it in cash, debt obligations, and other property or services. Cost includes sales tax and other expenses connected with the purchase. The basis in some assets isn't determined by the cost. If an individual acquires a property other than through a purchase (such as a gift or an inheritance), he needs to refer to Publication 551, Basis of Assets for more information. If he acquired the property from an individual who died in 2010, special rules may apply to the calculation of basis. Review Publication 4895, Tax Treatment of Property Acquired From a Decedent Dying in 2010 (PDF) for more information.

Casualty & Theft Losses Of Business Property

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. A sudden event is one that is swift, not gradual or progressive. An unexpected event is one that is ordinarily unanticipated and unintended. An unusual event is one that isn’t a day-to-day occurrence and that isn’t typical of the activity in which the individual was engaged.

Casualty losses are deductible during the tax year that the loss is sustained. This generally is the tax year that the loss occurred. However, a casualty loss may be sustained in a year after the casualty occurred.

Three types of casualty losses are described in this publication.

- Federal casualty losses,
- Disaster losses, and
- Qualified disaster losses

All three types of losses refer to federally declared disasters, but the requirements for each loss vary. A federally declared disaster is a disaster determined by the President of the United States to warrant assistance by the federal government under the Stafford Act. A federally declared disaster includes (a) a major disaster declaration or (b) an emergency declaration under the Stafford Act.

Federal Casualty Loss

A federal casualty loss is an individual's casualty or theft loss of personal-use property that is attributable to a federally declared disaster. The casualty loss must occur in a state receiving a federal disaster declaration. If individuals suffered a federal casualty loss, they are eligible to claim a casualty loss deduction. If they suffered a casualty or theft loss of personal-use property that wasn't attributable to a federally declared disaster, it isn't a federal casualty loss, and they may not claim a casualty loss deduction unless the exception applies. See the Caution under Deductible losses, later.

Disaster Loss

A disaster loss is a loss that is attributable to a federally declared disaster and that occurs in an area eligible for assistance pursuant to the Presidential declaration.

The disaster loss must occur in a county eligible for public or individual assistance (or both). Disaster losses aren't limited to individual personal-use property and may be claimed for individual business or income-producing property and by corporations, S corporations, and partnerships. If individuals suffered a disaster loss, they are eligible to claim a casualty loss deduction and to elect to claim the loss in the preceding tax year. See Disaster Area Losses, later.

Qualified Disaster Loss

A qualified disaster loss is an individual's casualty or theft loss of personal-use property that is attributable to a major disaster declared by the President under section 401 of the Stafford Act in 2016, as well as from Hurricane Harvey, Tropical Storm Harvey, Hurricanes Irma and Maria, or the California wildfires. If individuals suffered a qualified disaster loss, they are eligible to claim a casualty loss deduction, to elect to claim the loss in the preceding tax year, and to deduct the loss without itemizing other deductions on Schedule A (Form 1040). See Qualified disaster losses, later.

A theft is 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. Individuals don't need to show a conviction for theft. Theft includes the taking of money or property by the following means.

- Blackmail.
- Burglary.
- Embezzlement.
- Extortion.
- Kidnapping for ransom.
- Larceny.
- Robbery.

The taking of money or property through fraud or misrepresentation is theft if it is illegal under state or local law.

Theft Loss Deduction Limited

For tax years 2018 through 2025, for individuals, casualty and theft losses of personal-use property are deductible only if the losses are attributable to a federally declared disaster (federal casualty loss).

Basis Of Security

Stocks and Bonds

The basis of stocks or bonds individuals buy is generally the purchase price plus any costs of purchase, such as commissions and recording or transfer fees. If they get stocks or bonds other than by purchase, the basis is usually determined by the fair market value (FMV) or the previous owner's adjusted basis of the stock. Individuals must adjust the basis of stocks for certain events that occur after purchase. See Stocks and Bonds in chapter 4 of Pub. 550 for more information on the basis of stock.

Identifying stock or bonds sold. If individuals can adequately identify the shares of stock or the bonds sold, their basis is the cost or other basis of the particular shares of stock or bonds.

If individuals buy and sell securities at various times in varying quantities and they can't adequately identify the shares they sell, the basis of the securities they sell is the basis of the securities they acquired first. For more information about identifying securities sold, see Stocks and Bonds under Basis of Investment Property in chapter 4 of Pub. 550.

Mutual Fund Shares

If individuals sell mutual fund shares acquired at different times and prices, they can choose to use an average basis. For more information, see Pub. 550.

Basis Other Than Cost

There are many times when individuals can't use cost as a basis. In these cases, the fair market value or the adjusted basis of property may be used.

Fair Market Value (FMV).

FMV is the price at which property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property on or about the same date may be helpful in figuring the property's FMV.

POP QUIZ & ANSWER SHEET

BUSINESS ASSETS

POP QUIZ

Test your knowledge on *Business Assets* by answering the questions below. The answer sheet may be found at the end of the Pop Quiz.

Q1: Taxpayer A bought a building for $20,000 cash and assumed a mortgage of $80,000. How much is Taxpayer's A basis?

A. $20,000
B. $60,000
C. $80,000
D. $100,000

Q2: Business A has the following costs on an asset purchased:

Business equipment $25,000
Installation fees $8,000
Sales tax: $2300

How much is Business A's basis??

A. $27,300
B. $35,300
C. $25,000
D. $10,300

Q3: Which of the following can be deducted as a business expense?

A. Theft losses in the year the business discovers the property stolen
B. Rent for occupancy of the property before closing
C. Charges for utilities or other services related to occupancy of the property
before closing
D. Charges connected with getting a loan

Q4: **Business A with non qualifying financial statements has the following repairs and improvements to a rental property placed in service in 2023.**

$18000 New Roof
$1800 Kitchen counter replacement
$250 Bathroom tile
$5000 Furnace replacement

How much should be added to the property's basis?

A. $7,050
B. $18,000
C. $23,000
D. $25,050

Q5: **Business A with applicable financial statements had repairs totaling $4800. How much can Business A claim as a deduction if any?**

A. 50% deduction of $2,400
B. 100% deduction of $4,800
C. 75% deduction of $3,600
D. 25% deduction of $1,200

Q6: **Business A has a property with the following transactions:**

Purchase price: $250,000
Roof $15,000
Depreciation $23,000
Attorney fees to defend title $8000

What is Business A's basis in the property?

A. $225,000
B. $250,000
C. $200,000
D. $175,000

Q7: Which costs will not be included in the basis?

A. Sales tax
B. Installation costs
C. Loan assumption fees
D. Recording fee

Q8: Effective for taxable years beginning on or after January 1, 2016, the Internal Revenue Service in Notice 2015-82 increased the de minimis safe harbor threshold from $500 to ___ per invoice or item for taxpayers without applicable financial statements.

A. $1,000
B. $1,500
C. $2,000
D. $2,500

Q9: Business A has the following transactions:

Demolition $20,000
Architect fees: $15,000
New build construction of a commercial building $900,000
Employee wages for construction work of $300,000
Empowerment zone credit: $500,000

What is Business A's basis?

A. $1,235,000
B. $900,000
C. $735,000
D. $1,200,000

Q10: What price will a buyer and a seller both having reasonable knowledge of all necessary facts use for a barter transaction to report taxable income?

A. FMV
B. FIFO
C. LIFO
D. SMV

ANSWER SHEET

1. Answer is D - $100,000

2. Answer is B - $35,300

3. Answer is A - Theft losses in the year the business discovers the property stolen

4. Answer is C - $23,000

5. Answer is B - 100% deduction of $4,800

6. Answer is B - $250,000

7. Answer is C - Loan assumption fees

8. Answer is D - $2,500

9. Answer is C - $735,000
Explanation:
Demolishing $20,000 (adds to basis)
Architect fees: $15,000 (adds to basis)
New build construction of a commercial building $900,000 (adds to basis)
Employee wages for construction work of $300,000 (adds to basis)
Empowerment zone credit: $500,000 (decreases basis)
Equation:
$20,000 + $15,000 + $900,000+ $300,000 -$500,000= $735,000

10. Answer is A - FMV

Analysis of Financial Records

Overview

Everyone in business must keep records. Good records will help you do the following.

Monitor the progress of your business. You need good records to monitor the progress of your business. Records can show whether your business is improving, which items are selling, or what changes you need to make. Good records can increase the likelihood of business success.

Prepare your financial statements. You need good records to prepare accurate financial statements. These include income (profit and loss) statements and balance sheets. These statements can help you in dealing with your bank or creditors and help you manage your business.

1. An income statement shows the income and expenses of the business for a given period of time.
2. A balance sheet shows the assets, liabilities, and your equity in the business on a given date.

Identify source of receipts. You will receive money or property from many sources. Your records can identify the source of your receipts. You need this information to separate business from nonbusiness receipts and taxable from nontaxable income.

Keep track of deductible expenses. You may forget expenses when you prepare your tax return unless you record them when they occur.

Prepare your tax returns. You need good records to prepare your tax returns. These records must support the income, expenses, and credits you report.

Generally, these are the same records you use to monitor your business and prepare your financial statements.

Support items reported on tax returns. You must keep your business records available at all times for inspection by the IRS. If the IRS examines any of your tax returns, you may be asked to explain the items reported. A complete set of records will speed up the examination.

Supporting Documents

Purchases, sales, payroll, and other transactions you have in your business generate supporting documents.

Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks.

These documents contain information you need to record in your books. It is important to keep these documents because they support the entries in your books and on your tax return. Keep them in an orderly fashion and in a safe place.

For instance, organize them by year and type of income or expense.

Gross receipts. Gross receipts are the income you receive from your business. You should keep supporting documents that show the amounts and sources of your gross receipts. Documents that show gross receipts include the following.

- Cash register tapes.
- Bank deposit slips.
- Receipt books.
- Invoices.
- Credit card charge slips.
- Forms 1099-MISC.
- Forms 1099-NEC.

Inventory. Inventory is any item you buy and resell to customers. If you are a manufacturer or producer, this includes the cost of all raw materials or parts purchased for manufacture into finished products. Your supporting documents should show the amount paid and that the amount was for inventory.

- Documents reporting the cost of inventory include the following.
- Canceled checks.
- Cash register tape receipts.
- Credit card sales slips.
- Invoices.

These records will help you determine the value of your inventory at the end of the year.

Expenses. Expenses are the costs you incur (other than the cost of inventory) to carry on your business. Your supporting documents should show the amount paid and that the amount was for a business expense. Documents for expenses include the following.

- Canceled checks.
- Cash register tapes.
- Account statements.
- Credit card sales slips.
- Invoices.
- Petty cash slips for small cash payments.

Assets. Assets are the property, such as machinery and furniture you own and use in your business. You must keep records to verify certain information about your business assets. You need records to figure the annual depreciation and the gain or loss when you sell the assets. Your records should show the following information.

• When and how you acquired the asset.

• Purchase price.

• Cost of any improvements.

• Section 179 deduction taken.

• Deductions taken for depreciation.

• Deductions taken for casualty losses, such as losses resulting from fires or storms.

• How you used the asset.

• When and how you disposed of the asset.

• Selling price.

• Expenses of sale.

The following documents may show this information.

• Purchase and sales invoices.

• Real estate closing statements.

• Canceled checks.

What if I don't have a canceled check? If you do not have a canceled check, you may be able to prove payment with certain financial account statements prepared by financial institutions. These include account statements prepared for the financial institution by a third party. These account statements must be highly legible. The following table lists acceptable account statements.

How Long To Keep Records

You must keep your records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep records that support an item of income or deduction on a return until the period of limitations for that return runs out.

Form 8300

Generally, if you're in a trade or business and receive more than $10,000 in cash in a single transaction or in related transactions, you must file Form 8300.

The Form 8300, Report of Cash Payments Over $10,000 in a Trade or Business, provides valuable information to the Internal Revenue Service and the Financial Crimes Enforcement Network (FinCEN) in their efforts to combat money laundering. Money is "laundered" to conceal illegal activity, including the crimes that generate the money itself, such as drug trafficking, tax evasion and terrorist financing.

Who Must File

A "person" who must file Form 8300 includes an individual, company, corporation, partnership, association, trust or estate.

You must file Form 8300 with the IRS if any part of the transaction occurs within any of the 50 states, 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).

When to File

You must file Form 8300 by the 15th day after the date the cash transaction occurred.

Besides filing Form 8300, you also need to provide a written statement to each party whose name you included on the Form 8300 by January 31 of the year following the reportable transaction. This statement must include the name, address, contact person and telephone number of your business and the aggregate amount of reportable cash. The statement must also indicate that you provided this information to the IRS.

Civil and criminal penalties may apply if you fail to file Form 8300 and provide a written statement to each person named on Form 8300. Penalty amounts are adjusted annually for inflation.

How to File

Electronic filing. E-filing is a free, quick, and secure method for filing Forms 8300. You may electronically file Forms 8300 using FinCEN's BSA E-Filing System.

International Information Returns

Per the Bank Secrecy Act, every year you must report certain foreign financial accounts, such as bank accounts, brokerage accounts and mutual funds, to the Treasury Department and keep certain records of those accounts. You report the accounts by filing a Report of Foreign Bank and Financial Accounts (FBAR) on Financial Crimes Enforcement Network (FinCEN) Form 114.

Who Must File

A U.S. person, including a citizen, resident, corporation, partnership, limited liability company, trust and estate, must file an FBAR to report:

1. a financial interest in or signature or other authority over at least one financial account located outside the United States if
2. the aggregate value of those foreign financial accounts exceeded $10,000 at any time during the calendar year reported.

Payments and deposit obligations

Depositing Employment Taxes

In general, you must deposit federal income tax withheld as well as both the employer and employee social security and Medicare taxes.

There are two deposit schedules, monthly and semi-weekly. Before the beginning of each calendar year, you must determine which of the two deposit schedules you are required to use. To determine your payment schedule,

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.

You **must** use electronic funds transfer (EFTPS) to make all federal tax deposits.

If you fail to make a timely deposit, then you may be subject to a failure-to-deposit penalty of up to 15 percent.

Reporting Employment Taxes

Generally, employers must report wages, tips and other compensation paid to an employee by filing the required form(s) to the IRS. You must also report taxes you deposit by filing Forms 941, 943, 944, 945, and 940 on paper or through e-file.

Federal Income Tax and Social Security and Medicare Tax

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

File Form 943, Employer's Annual Federal Tax Return for Agricultural Employees, if you are filing to report agricultural wages.

File Form 944, Employer's Annual Federal Tax Return, if you have received written notification about the Form 944 program.

File Form 945, Annual Return of Withheld Federal Income Tax, if you are filing to report backup withholding.

Federal Unemployment Tax Act (FUTA)

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

Preparing and Filing Form W-2

At the end of the year, the employer must complete Form W-2, Wage and Tax Statement, to report wages, tips and other compensation paid to an employee. File Copy A of all paper and electronic Forms W-2 with Form W-3, Transmittal of Wage and Tax Statements, to the Social Security Administration (SSA). File Copy 1 to an employee's state or local tax department

Choosing an Accounting Method

An accounting method is a set of rules used to determine when and how income and expenses are reported. You choose an accounting method for your business when you file your first income tax return. There are two basic accounting methods.

1. Cash method. Under the cash method, you report income in the tax year you receive it. You usually deduct or capitalize expenses in the tax year you pay them.

2. Accrual method. Under an accrual method, you generally report income in the tax year you earn it, even though you may receive payment in a later year. You deduct or capitalize expenses in the tax year you incur them, whether or not you pay them that year.

If an inventory is necessary to account for your income, you must generally use an accrual method of accounting for purchases and sales. Inventories include goods held for sale in the normal course of business. They also include raw materials and supplies that will physically become a part of merchandise intended for sale

Commingling

Businesses should keep their personal and business expenses and income in separate accounts. Business should avoid commingling funds (using personal and business in the same bank account). Consider the following:

- You would include the money used to pay personal expenses in your business income when your business earned it.
- You wouldn't write off these expenses as business expenses because they're not ordinary and necessary costs of carrying on your trade or business.
- Personal, living, or family expenses are generally not deductible.
- It's a good idea to keep separate business and personal accounts as this makes it easier to keep records.

Worker Classification

Employers must withhold Social Security and income taxes from employee paychecks. Conversely, independent contractors are responsible for reporting and paying their own Social Security and income taxes.

Businesses use several factors to determine how to classify its workers, including the degree of control the business has over its workers.

Generally, the more control the business has over a worker, the more likely it is that the worker is an employee rather than an independent contractor.

Categories:

Behavioral control

Relates to whether the business has a right to direct and control how the worker performs the task for which they are hired. In general, anyone who performs services for you is your employee if you can control what will be done and how it will be done. This is so even when you give the employee freedom of action. What matters is that the employer has the right to control the details of how the services are performed. Such details include:

- When and where to do the work
- What tools or equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow

Financial control

- Look at whether a worker has the ability to affect financial decisions.
- Does the worker have a significant investment in assets or tools?
- Are there unreimbursed expenses that the worker has to bear themselves?
- Are the worker's services available to the public?
- What is the method of payment; do they get paid whether the work is done or not or do they get paid only if they finish the job?
- Independent contractors can realize a profit or loss on a job.
- Can the worker make business decisions that affect his bottom line?

Relationship of the parties

- Look at whether or not there is a contract between the worker and the business and how it is worded.
- whether the worker gets any type of benefits – vacation and sick pay, pension plan, and health or life insurance; and
- the permanency of the relationship such as continuing indefinitely or only for a specific project or period.
- Also, does the worker have his own business, which he markets to others?
- If you want the IRS to determine whether a specific individual is an independent contractor or an employee, file Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

Affordable Care Act For Employers (Aca)

Under the Affordable Care Act, the federal government, state governments, insurers, employers, and individuals share responsibility for improving the quality and availability of health insurance coverage in the United States.

The Affordable Care Act, or health care law, contains benefits and responsibilities for employers. The size and structure of the workforce determines what applies to the particular employer. An employer's size is determined by the number of its full-time employees, including full-time equivalents.

Some of the provisions of the Affordable Care Act, or health care law, apply only to small employers, generally those with fewer than 50 full-time employees, including full-time equivalent employees.
Here are the responsibilities and benefits for small employers under the health care law:

Coverage	Reporting	Payments & Credits
You can purchase insurance through the Small Business Health Organization Program (SHOP). Learn more at HealthCare.gov.	You must withhold and report an additional 0.9 % on employee wages or compensation that exceeds $200,000.	You may be eligible for the Small Business Health Care Tax Credit if you cover at least 50 percent of your full time employee's premium costs and you have fewer than 25 full time equivalent employees.
	You may be required to report the value of the health insurance coverage you provided to each employee on his/ her Form W-2.	If you self-insure, you may be required to pay a fee to help fund the Patient-Centered Outcomes Research Trust Fund.
	If you provide self-insured health coverage to your employees, you must file an annual return reporting certain information for each employee you cover.	

Some of the provisions of the Affordable Care Act, or health care law, apply only to applicable large employers, generally those with 50 or more full-time employees, including full-time equivalent employees.

For example, applicable large employers have annual reporting responsibilities concerning whether and what health insurance they offer to their full-time employees (and their dependents).

Coverage

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

Reporting

The employer must withhold and report an additional 0.9 percent on employee wages or compensation that exceeds $200,000.

The employer may be required to report the value of the health insurance coverage provided to each employee on his or her Form W-2.

The employer must file an annual return reporting whether and what health insurance he offered his employees.
If an employer provides self-insured health coverage to his employees, he must file an annual return reporting certain information for each employee he covers.

Payment & Provisions

The employer must either offer affordable minimum essential coverage that provides minimum value to his full-time employees (and offer coverage to the full-time employees' dependents), or potentially owe an employer shared responsibility payment. If he self-insures, he may be required to pay a fee to help fund the Patient- Centered Outcomes Research Trust Fund.

Minimum Essential Coverage

Under the ACA, minimum essential coverage is a health care plan or arrangement specifically identified in the law as minimum essential coverage, including:

- Specified government-sponsored programs (for example, Medicare Part A, Medicare Advantage, most Medicaid programs, CHIP, most TRICARE programs, and comprehensive health care coverage of veterans)
- Employer-sponsored coverage under a group health plan (including self-insured plans)
- Individual market coverage (for example, a qualified health plan purchased through the Marketplace or individual health coverage purchased directly from an insurance company)
    - Grandfathered health plans (in general, certain plans that existed before the ACA and have not changed since the ACA was passed)
    - Other plans or programs that the Department of Health and Human Services recognizes as minimum essential coverage for purposes of the ACA

IRS.gov/aca has a chart that shows these and other types of coverage that qualify as minimum essential coverage and some that do not.

Form 1040 will not have the "Full-year health care coverage or exempt" box and individuals will no longer report health care coverage when they file.

For corporations filing taxes, Schedule L refers to the balance sheets that should match the corporation's books and records. Corporations with total receipts and total assets below $250,000 are not required to complete Schedules L, M-1, and M-2 if certain conditions are met. Corporations with total assets of $10 million or more must file Schedule M-3 instead of Schedule M-1. Instructions for Schedule M-3 also impact Schedule L, and more details can be found in the separate Instructions for Schedule M-3 (Form 1120).

M1 Reconciliation.

M1 reconciliation focuses on reconciling the net income reported for tax purposes with the net income reported in the books. It involves identifying and explaining the differences between the taxable income calculated based on tax laws and regulations and the income reported in the financial statements prepared under generally accepted accounting principles (GAAP). This reconciliation typically includes adjustments such as non-deductible expenses for tax purposes or non-taxable income items.

M2 Reconciliation:
M2 reconciliation expands on the M1 reconciliation and includes additional adjustments. It aims to reconcile the equity or shareholders' equity reported for tax purposes with the equity reported in the financial statements. The M2 reconciliation often involves adjustments related to differences in tax basis and book basis for assets and liabilities, deferred tax assets and liabilities, and other tax-related adjustments that affect the equity section of the financial statements.

M3 Reconciliation:
M3 reconciliation is the most comprehensive reconciliation and includes all the adjustments made in the M1 and M2 reconciliations. It involves reconciling the total assets and liabilities reported for tax purposes with those reported in the financial statements. The M3 reconciliation typically includes adjustments related to the recognition of deferred taxes, changes in tax rates, tax credits, and other significant items affecting the balance sheet.

The purpose of these reconciliations is to provide transparency and clarity regarding the differences between tax reporting and financial reporting, ensuring compliance with both tax regulations and accounting standards. They help organizations accurately reflect their financial position, income, and equity in both their tax returns and financial statements, enabling stakeholders to understand the tax implications and the financial performance of the business.

Here are some examples of adjustments that might be included in each of the M1, M2, and M3 reconciliations:

M1 Reconciliation:
1. Non-deductible expenses: Certain expenses, such as fines and penalties, may be deductible for financial reporting purposes but not for tax purposes. The M1 reconciliation would involve adding back these non-deductible expenses to the net income reported on the tax return.

2. Non-taxable income: Income items that are excluded from taxable income, such as tax-exempt interest or certain capital gains, would be subtracted from the net income reported on the tax return during the M1 reconciliation.
3. Timing differences: Timing differences occur when income or expenses are recognized in different periods for tax purposes and financial reporting. For example, accelerated depreciation methods used for tax purposes may differ from straight-line depreciation used for financial reporting, resulting in timing differences that need to be reconciled.

M2 Reconciliation:
1. Depreciation differences: Tax laws often prescribe different depreciation methods and useful lives compared to financial reporting standards. Adjustments would be made to reconcile the differences between the tax basis and the book basis of assets, such as buildings, machinery, or vehicles.
2. Deferred tax assets and liabilities: Differences in the recognition of temporary differences between tax and book accounting, such as timing differences in revenue recognition or deductible expenses, would result in the creation of deferred tax assets or liabilities. The M2 reconciliation would involve recognizing and adjusting these deferred tax items.
3. Changes in tax rates: If there have been changes in tax rates between the time the financial statements were prepared and the tax return was filed, adjustments would be made to reflect the impact of these changes on the tax provision and deferred tax balances.

M3 Reconciliation:
1. Revaluation of assets: If certain assets are revalued for financial reporting purposes but not for tax purposes, the M3 reconciliation would involve adjusting the carrying amounts of these assets on the balance sheet to their tax basis.
2. Tax credits: Certain tax credits, such as research and development credits or investment tax credits, may be recognized for tax purposes but not for financial reporting. The M3 reconciliation would involve adjusting the tax provision and deferred tax balances to account for these credits.
3. Changes in tax laws: If there have been changes in tax laws that impact the recognition or measurement of certain items, adjustments

would be made in the M3 reconciliation to ensure compliance with the revised tax regulations.

These examples illustrate the types of adjustments that may be necessary during the reconciliation process to align the tax books with the financial books. It's important to note that the specific adjustments will vary depending on the jurisdiction, industry, and individual circumstances of each organization.

Trust & Estate Income Tax

A **simple trust** must distribute all its income currently. Generally, it cannot accumulate income, distribute out of corpus, or pay money for charitable purposes. If a trust distributes corpus during a year, as in the year it terminates, the trust becomes a complex trust for that year. Whether a trust is simple or complex determines the amount of the personal exemption

The **corpus of a trust** is the sum of money or property that is set aside to produce income for a named beneficiary.

In the law of estates, the corpus of an estate is the amount of property left when an individual dies.

A **complex trust** is 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) of the Code.

If the grantor retains the ability to revoke the trust and revest the trust assets in the grantor, the trust is revocable and the income is taxable to the grantor under the grantor trust rules.

Assets in a revocable trust are included in the grantor's gross estate for federal estate tax purposes.

Revocable trusts, also called living trusts, are one of the more frequently misunderstood trust concepts. They are used primarily as a will substitute.

Assets in trust avoid the cost, time, expense, and publicity of probate. Because a revocable trust may be a will substitute, it may provide for direct gifts to charity as well as establishing a split interest trust, a charitable remainder trust, or a charitable lead trust.

For example, a revocable trust may establish a charitable remainder trust upon the grantor's death to benefit a surviving spouse or child.

The non charitable beneficiary can receive an income payment for life, or for a term of years. The remainder will pass to charity at the death of the noncharitable income recipient or the end of the term. Similarly, a grantor may use a will or a revocable trust to establish a charitable lead trust, with an interest for charity during a term of years or for the life of certain individuals, and the remainder to the grantor's spouse, child or other heir.

Irrevocable Trust

An irrevocable trust is one that, by its terms, cannot be revoked.

International Tax Gap Series

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.

Caution: A specialized industry of offshore scheme promoters has developed to assist U.S. taxpayers in circumventing the current payment of income tax through the use of foreign trusts and other offshore entities. The promoters of offshore schemes often advance technical arguments which purport to show that their scheme is legal or compliant with the Internal Revenue Code. These arguments are used to induce their clients to enter into an abusive scheme, which usually involves concealing the true ownership and control of assets and income.

To help prevent the use of foreign trusts and other offshore entities for tax avoidance or improper deferral of income, the Internal Revenue Code has provisions that address this abuse. Some of these provisions trigger immediate recognition of gains that would otherwise be deferred, while others require annual information reporting and impose significant penalties for failing to comply on a timely basis.

For more information about offshore tax schemes, refer to Abusive Foreign Trust Schemes.

Distributable net income

Distributable net income (figured on Form 1041, Schedule B) is the estate's taxable income,

Example: Estate A had the following:

- Interest income of $1000
- Attorney fees of $800

The distributable net income or DNI of the estate is: $200

Abusive Domestic Trust Schemes

Domestic trusts are trusts created in the U.S. Here are some common abusive estate domestic trust schemes:

Business Trust

This involves the transfer of an ongoing business to a trust. Also called an unincorporated business organization, a pure trust or a constitutional trust, it gives the appearance that the taxpayer has given up control of his or her business. In reality, through trustees or other entities controlled by the taxpayer, he or she still runs the day-to-day activities and controls the business's income stream. Such arrangements provide no tax relief. The courts have held that the business income is taxable to the taxpayer under a variety of legal concepts, including lack of economic substance (sham theory), assignment of income, or that the arrangement is a grantor trust. In some circumstances, the trust could be taxed as a partnership.

Equipment or Service Trust

This trust is formed to hold equipment that is rented or leased to the business trust, often at inflated rates. The business trust reduces its income by claiming deductions for payments to the equipment trust. This type of arrangement has the same pitfalls as the business trust, and it will result in no tax reduction.

Family Residence Trust

Taxpayers transfer family residences and furnishings to a trust, which sometimes rents the residence back to the taxpayer. The trust deducts depreciation and the expenses of maintaining and operating the residence including gardening, pool service and utilities. The courts have consistently collapsed these types of trusts, taxing income to the taxpayer and disallowing personal expenses.

Charitable Trust

Taxpayers transfer assets or income to a trust claiming to be a charitable organization. The trust or organization pays for personal, education or recreation expenses on behalf of the taxpayer or family members. The trust then claims the payments as charitable deductions on its tax returns. These alleged charitable organizations often are not qualified and have no IRS exemption letter; hence, contributions are not deductible. Charitable deductions are not allowed when the donor receives personal benefit from the alleged gift.

Asset Protection Trust

These trusts are promoted as a means of avoiding liability for judgments against an individual or business. 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.

Personal Representative Or Executor

The term "executor" includes the executor, personal representative, or administrator of the decedent's estate. If none of these is appointed, qualified, and acting in the United States, every person in actual or constructive possession of any property of the decedent is considered an executor and must file a return.

Executors must provide documentation proving their status. Documentation will vary but may include documents such as a certified copy of the will or a court order designating the executor(s). A statement by the executor attesting to their status is insufficient.

Final Income Tax Return (Form 1040)

In general, the final individual income tax return of a decedent is prepared and filed in the same manner as when they were alive. All income up to the date of death must be reported and all credits and deductions to which the decedent is entitled may be claimed. File the return using Form 1040 or 1040-SR or, if the decedent qualifies, one of the simpler forms in the 1040 series (Forms 1040 or 1040- SR, A).

Income In Respect Of A Decedent (Ird)

The method of accounting used by the decedent at the time of death determines the income to include and the deductions to take on the final return. Most individuals use the cash receipts and disbursements method. Under this method, the final individual return should show only the items of income the decedent actually or constructively received, that were credited to his or her account, or that were made available to him or her without restriction before death.

Generally, the final individual return can claim deductions for expenses the decedent paid before death.

The Estate Tax Return (Form 706)

Purpose of Form 706

The executor of a decedent's estate uses Form 706 to figure the estate tax imposed by Chapter 11 of the Internal Revenue Code. This tax is levied on the entire taxable estate and not just on the share received by a particular beneficiary.

Form 706 is also used to figure the generation-skipping transfer (GST) tax imposed by Chapter 13 on direct skips (transfers to skip persons of interests in property included in the decedent's gross estate).

Which Estates Must File

For decedents who died in 2023, 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 $12.92 million; or
- Whose executor elects to transfer the DSUE amount to the surviving spouse, regardless of the size of the decedent's gross estate.

When to File

Taxpayers must file Form 706 to report estate and/or GST tax within 9 months after the date of the decedent's death. If they are unable to file Form 706 by the due date, they may receive an extension of time to file. Use Form 4768, Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes, to apply for an automatic 6-month extension of time to file.

Portability Election

An executor can only elect to transfer the DSUE amount to the surviving spouse if the Form 706 is filed timely; that is, within 9 months of the decedent's date of death or, if the taxpayer has received an extension of time to file, before the 6-month extension period ends.

Form 1041, Annual Tax Returnfor Estates & Trusts

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. See Schedule G, Part I, line 5, and the Instructions for Form 8960.

The Estate Tax

The estate tax is a tax on the individuals' right to transfer property at their death. The fair market value of these items is used, not necessarily what the individuals paid for them or what their values were when they acquired them. It consists of an accounting of everything the individuals own or have certain interests in at the date of death refer to form 706.

The total of all of these items is the individuals' "gross estate." the includible property may consist of cash and securities, real estate, insurance, trusts, annuities, business interests and other assets.

The Gross Estate

The gross estate includes all property in which the decedent had an interest (including real property outside the United States). It also includes:

- Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth,
- Annuities,
- The includible portion of joint estates with right of survivorship (see the instructions for Schedule E), The includible portion of tenancies by the entirety (see the instructions for Schedule E),
- Certain life insurance proceeds (even though payable to beneficiaries other than the estate) (see the instructions for Schedule D),

- Property over which the decedent possessed a general power of appointment, Dower or curtesy (or statutory estate) of the surviving spouse, and
- Community property to the extent of the decedent's interest as defined by applicable law.

Deductions From The Gross Estate

Marital Deduction

One of the primary deductions for married decedents is the Marital Deduction. All property that is included in the gross estate and passes to the surviving spouse is eligible for the marital deduction. The property must pass "outright." In some cases, certain life estates also qualify for the marital deduction.

Charitable Deduction

- If the decedent leaves property to a qualifying charity, it is deductible from the gross estate.
- Mortgages and Debt.
- Administration expenses of the estate.
- Losses during estate administration.

Special Rule For Medical Expenses

Medical expenses paid before death by the decedent are deductible, subject to limits, on the final income tax return if deductions are itemized. This includes expenses for the decedent, as well as for the decedent's spouse and dependents.

Election for decedent's expenses. Medical expenses not paid before death are liabilities of the estate and are shown on the federal estate tax return (Form 706). However, if medical expenses for the decedent are paid out of the estate during the 1-year period beginning with the day after death, individuals can elect to treat all or part of the expenses as paid by the decedent at the time they were incurred.

The Marital Deduction

The marital deduction is authorized by section 2056 for certain property interests that pass from the decedent to the surviving spouse. Taxpayers may claim the deduction only for property interests that are included in the decedent's gross estate (Schedules A through I).

Note. The marital deduction generally is not allowed if the surviving spouse is not a U.S. citizen.

Item **numbe r**	**Description of property interests passing to surviving spouse. For securities, give the CUSIP number. If trust, partnership, or closely held entity, give EIN**	**Amou nt**
B1	All other property: One-half the value of a house and lot, 256 South West Street, held by decedent and surviving spouse as joint tenants with right of survivorship under deed dated July 15, 1975 (Schedule E, Part I, item 1) .	$182,50 0
B2	Proceeds of Metropolitan Life Insurance Company Policy No. 104729, payable in one sum to surviving spouse (Schedule D, item 3)	200,000
B3	Cash bequest under Paragraph Six of will	100,000

Deceased Spousal Unused Exclusion (Dsue)

Section 303 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 authorized estates of decedents dying after December 31, 2010, to elect to transfer any unused exclusion to the surviving spouse. The amount received by the surviving spouse is called the deceased spousal unused exclusion, or DSUE, amount. If the executor of the decedent’s estate elects transfer, or portability, of the DSUE amount, the surviving spouse can apply the DSUE amount received from the estate of his or her last deceased

spouse (defined later) against any tax liability arising from subsequent lifetime gifts and transfers at death.
A timely filed and complete Form 706 is required to elect portability of the DSUE amount to a surviving spouse.

Inheritances

Property received as a gift, bequest, or inheritance isn't included in the income. However, if the received property in this manner later produces income, such as interest, dividends, or rents, that income is taxable to the taxpayer.

The income from property donated to a trust that is paid, credited, or distributed to the taxpayer is taxable income. If the gift, bequest, or inheritance is the income from property, that income is taxable.

The Basis Of Estate Property

The basis of property inherited from a decedent is generally one of the following:

- The FMV of the property on the date of the individual's death.
- The FMV on the alternate valuation date (discussed in the Instructions for Form 706) if elected by the personal representative.
- The value under the special-use valuation method for real property used in farming or other closely held business (see Special-use valuation, later), if elected by the personal representative.
- 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 (discussed in the Instructions for Form 706).

The Gift Tax

The gift tax applies to lifetime transfers of property from one person (the donor) to another person (the donee). A gift is made if tangible or intangible property (including money), the use of property, or the right to receive income from property is given without expecting to receive something of at least equal value in return. If something is sold for less than its full value or if a loan is made without interest or with reduced (less than market rate) interest, a gift may have been made.

The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule.

POP QUIZ & ANSWER SHEET

Trust & Estate Income Tax

POP QUIZ

Test your knowledge on *Trusts & Estate Income Tax* Income by answering the questions below. The answer sheet may be found at the end of the Pop Quiz.

Q1: These trusts are promoted as a means of avoiding liability for judgments against an individual or business.

A. Asset Protection Trust
B. Charitable Trust
C. Family Residence Trust
D. Business Trust

Q2: ___ deductions are not allowed when the donor receives personal benefit from the alleged gift.

A. Business
B. Retirement
C. Charitable
D. Dependent

Q3: This trust deducts depreciation and the expenses of maintaining and operating the residence including gardening, pool service and utilities.

A. Asset Protection Trust
B. Charitable Trust
C. Family Residence Trust
D. Equipment or Service Trust

Q4: This trust is also called an unincorporated business organization, a pure trust or a constitutional trust, it gives the appearance that the taxpayer has given up control of his or her business.

A. Asset Protection Trust
B. Charitable Trust
C. Family Residence Trust
D. Business Trust

Q5: These are some common abusive domestic trust schemes:

A. Charitable Trust, Business Trust, Constructive Trust, Special Needs Trust, Family Residence Trust
B. Charitable Trust, Business Trust, Asset Protection Trust, Revocable Trust, Family Residence Trust
C. Charitable Trust, Business Trust, Irrevocable Trust, Special Needs Trust, Family Residence Trust
D. Charitable Trust, Asset Protection Trust, Family Residence Trust, Equipment or Service Trust, Business Trust

Q6: This trust is formed to hold equipment that is rented or leased to
the business trust, often at inflated rates.

A. Asset Protection Trust
B. Charitable Trust
C. Family Residence Trust
D. Equipment or Service Trust

Q7: The gross estate includes all property in which the decedent had an interest (including real property outside the United States). It does not include:

A. Property over which the decedent does not possess a general power of appointment.
B. Dower or courtesy (or statutory estate) of the surviving spouse.
C. Community property to the extent of the decedent's interest as defined by applicable law.
D. Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth.

Q8: What is not a deduction from the Gross Estate?

A. Mortgages & Debt
B. Administration Expenses of the Estate
C. Losses During Estate Administration
D. Annuities

Q9: All are basis of property inherited from a decedent, except:

A. The FMV of the property on the date of the individual's death.
B. The adjusted basis of real estate, vehicles, and stocks.
C. The value under the special-use valuation method for real property used in farming or other closely held business, if elected by the personal representative.
D. The FMV on the alternate valuation date if elected by the personal representative.

Q10: A ___ is a person who belongs to a generation that is two or more generations below the generation of the donor.

A. Boomers
B. Gen Z
C. Skip Person
D. Lost Person

Trust & Estate Income Tax

ANSWER SHEET

1. Answer is A - Asset Protection Trust

2. Answer is C - Charitable

3. Answer is C - Family Residence Trust

4. Answer is D - Business Trust

5. Answer is D - Charitable Trust, Asset Protection Trust, Family Residence Trust,
Equipment or Service Trust, Business Trust

6. Answer is D - Equipment or Service Trust

7. Answer is A - Property over which the decedent does not possess a general power of appointment.

8. Answer is D - Annuities

9. Answer is B - The adjusted basis of real estate, vehicles, and stocks.

10. Answer is C - Skip Person

EXEMPT ORGANIZATIONS

Exempt Entities

Organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, educational, or other specified purposes and that meet certain other requirements are tax exempt under Internal Revenue Code Section 501(c)(3).

Applying For Tax Exempt Status

Form 1023, Application for Recognition of Exemption. Individuals need to file Form 1023 if they are seeking recognition of exemption under section:

- 501(c)(3) Corporations, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports, or prevention of cruelty for children or animals,
- 501(e) Cooperative hospital service organization,
- 501(f) Cooperative service organization of operating educational organizations,
- 501(k) Certain organizations providing child care,
- 501(n) Charitable risk pools, and
- 501(q) Credit counseling organizations.

Applications for exempt status on a Form 1023 must be electronically submitted through Pay.gov. For a limited time period, paper submissions will still be accepted.

Other Section 501(C) Organizations

Organizations that meet specified requirements may qualify for exemption under subsections other than 501(c)(3). These include social welfare organizations, civic leagues, social clubs, labor organizations and business leagues.

Public Charity Or Private Foundation

It is important that the owner determines if the organization is a private foundation. Most organizations exempt from income tax (as organizations described in section 501(c)(3)) are presumed to be private foundations unless they notify the IRS within a specified period of time that they meet the requirements of section 509(a) to be treated as other than a private foundation. This notice requirement applies to most section 501(c)(3) organizations regardless of when they were formed.

Exempt Entity Filing Requirements

An organization that normally has $50,000 or more in gross receipts and that is required to file an exempt organization information return must file either Form 990 PDF, Return of Organization Exempt from Income Tax, or Form 990-EZ PDF, Short Form Return of Organization Exempt from Income Tax.

The return is due on the 15th day of the 5th month after the end of the organization's fiscal year.

The due date may be extended for six months, without showing cause, by filing Form 8868 PDF before the due date. An organization will only be allowed an extension of 6 months for a return for a tax year.

Small organizations -- those whose annual gross receipts are normally less than the threshold- are not required to file an annual return, but may be required to file an annual electronic notice - e-Postcard.

Penalties For Non-Filing

If an organization fails to file a required return by the due date (including any extensions of time), it must pay a penalty of $20 a day for each day the return is late. The same penalty applies if the organization does not give all the information required on the return or does not give the correct information.

In 2018, the IRS began sending back incomplete or incorrect Form 990-series returns to the filing organization with Letter 2694C, 2695C or 2696C. Organizations receiving one of these letters should follow the directions in the letter. Individuals need to return a complete and accurate return within 10 days of the date of the letter to avoid penalties. The date the IRS receives a complete and accurate return is the date they consider the return filed.

In general, the maximum penalty for any return is the lesser of $10,000 or 5 percent of the organization's gross receipts for the year. For an organization that has gross receipts of over $1 million for the year, the penalty is $100 a day up to a maximum of $50,000.

If the organization is subject to this penalty, the IRS may specify a date by which the return of correct information must be filed. If the return is not filed by that date, an individual within the organization who fails to comply may be charged a penalty of $10 a day. The maximum penalty on all individuals for failures with respect to a return shall not exceed $5,000. Penalties for failure to file may be abated if the organization has reasonable cause for the failure to file timely, completely, or accurately.

Automatic revocation occurs when an exempt organization that is required to file an annual return (e.g., Form 990, 990-EZ or 990-PF) or submit an annual electronic notice (Form 990-N, or e-Postcard) does not do so for three consecutive years. Under the law, the organization automatically loses its federal tax exemption.

Exempt Entity Filing Requirements

Most exempt organizations (including private foundations) must file various returns and reports at some time during (or following the close of) their accounting period.

- Annual information returns
- Unrelated business income tax return
- Employment tax returns
- Political organization income tax return
- Reporting requirements for a political organization
- Donee information return
- Information provided to donors
- Report of cash received

- Public inspection of exemption applications, annual returns, and political organizations reporting forms
- Required disclosures

Unrelated Business Income Tax (Ubit)

Even though the organization is recognized as tax exempt, it still may be liable for tax on its unrelated business income. Unrelated business income is income from a trade or business, regularly carried on, that isn't substantially related to the charitable, educational, or other purpose that is the basis for the organization's exemption.

If the organization has $1,000 or more of unrelated business income, Form 990-T must be filed in addition to the required annual information return or notice.

POP QUIZ & ANSWER SHEET

EXEMPT ORGANIZATIONS

POP QUIZ

Test your knowledge on *Exempt Organizations* by answering the questions below. The answer sheet may be found at the end of the Pop Quiz.

Q1: Non-profit organizations are ___ both in sales tax and property tax.
A. Tax Exempt
B. Not Tax Exempt
C. Partial Exempt
D. None of the Above

Q2: Churches and religious organizations, like many other charitable organizations, may ___ for exemption from federal income tax under Section 501(c)(3).
A. Qualify
B. Not Qualify
C. Partially Qualify
D. None of the Above

Q3: Every organization that qualifies for tax-exempt status under Section 501(c)(3) is classified as a ___ foundation unless it meets one of the exceptions listed in Section 509(a).
A. Public
B. Private
C. Foreign
D. None of the Above

Q4: A ___ subject to Section 527 is a party, committee, association, fund or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function.

A. Public Organization
B. Political Organization
C. Private Organization
D. None of the Above

Q5: Organizations described in section 501(c)(3) are commonly referred to as ___ organizations.

A. Political
B. Public
C. Charitable
D. None of the Above

Q6: To qualify for a group exemption, the central organization and its subordinates must have a defined relationship. Subordinates must be:

A. Affiliated with the Central Organization
B. Subject to the Central Organization's General Supervision or Control
C. Both A & B
D. None of the Above

Q7: If an organization has had its tax-exempt status automatically revoked and wishes to have that status reinstated, it ___ files an application for exemption and pays the appropriate user fee even if it was not required to apply for exempt status initially.

A. Must
B. Must Not
C. Could
D. None of the Above

Q8: In most cases, the effective date of reinstated exemption will be the ___ that the organization's exemption application was submitted to the IRS.

A. The same day
B. A month after
C. A year after
E. None of the Above

Q9: ___ is a relationship in which one person holds title to property, subject to an obligation to keep or use the property for the benefit of another.

A. Liability
B. Trust
C. Ownership
D. None of the Above

Q10: Organizations must electronically file this form to apply for recognition of exemption from federal income tax under section 501(c)(3)

A. Form 501(c)3
B. Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code
C. Form 1024, Application for Recognition of Exemption Under Section 501(a) or Section 521 of the Internal Revenue Code
D. Form 990, Return of Organization Exempt from Income Tax

Q11: All are not considered unrelated business income, except:

A. Volunteer Labor contributed with a FMV of $125,000
B. School cafeteria that charges $7 per lunch
C. Ecommerce store that generates $500/month and is unrelated to the organizations mission
D. Selling Donated Merchandise totaling $150,000

Q12: Organizations whose annual gross receipts are normally less than ___ are not required to file an annual return but may be required to file an annual electronic notice - e-Postcard.

A. $25,000
B. $50,000
C. $75,000
D. None of the Above

Q13: What form should you use if Gross receipts are over $50,000?

A. Form 990 postcard
B. Form 990-PF
C. Form 990-N
D. None of the Above

Q14: States associations of ___ offer summaries of the filing requirements that apply in their states.

A. Profit Organizations
B. Non-Profit Organizations
C. Private Organizations
D. None of the Above

Q15: Tax-exempt organizations have important responsibilities as employers while operating and managing their activities. Before an organization becomes an employer and hires employees, it needs a ______?

A. Employee Inter-Company Number
B. Employer Identification Number
C. Employee Identity Number
D. None of the Above

Q16: ___ are members of the governing board - are defined by statute as non-employees.

A. Directors of a Corporation
B. Executive Managers
C. Tenured Employees
D. None of the Above

Q17: ___ is the income from a trade or business regularly conducted by an exempt organization and not substantially related to the performance by the organization of its exempt purpose or function.

A. Taxable Business Income

B. Unrelated Business Income

C. Direct Business Financing

D. None of the Above

Exempt Organizations

ANSWER SHEET

1. Answer is A - Tax Exempt

2. Answer is A - Qualify

3. Answer is B - Private

4. Answer is B - Political Organization

5. Answer is C - Charitable

6. Answer is C- Both A & B

7. Answer is A - Must

8. Answer is A - The same day

9. Answer is B - Trust

10. Answer is B- Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code

11. Answer is C - Ecommerce store that generates $500/month and is unrelated to the organization's mission will be considered unrelated business income.

12. Answer is B - $50,000

13. Answer is C - Form 990-N

14. Answer is B - Non-Profit Organizations

15. Answer is B - Employer Identification Number

16. Answer is A - Directors of a Corporation

17. Answer is B - Unrelated Business Income

RETIREMENT PLANS

OVERVIEW

- To retire comfortably, individuals may need up to 80% of their current annual income.
- The average monthly Social Security benefit is $1,565.
- Retirement can last 30 years or more.
- Allows individuals to invest now for financial security when they retire
- Individuals get significant tax benefits for saving

Retirement Plans For Businesses: Benefits

- Employer contributions are tax deductible.
- Assets in the plan grow tax free.
- Plan options are flexible.
- Credits available to help with plan startup costs for the first 3 years. (up to $500/yr.)
- Attracts & helps keep better employees
- Employee contributions can reduce taxable W2 income.
- Contributions and investment gains are not taxed until distributed.

Retirement Plans For Businesses: Types

No annual IRS filing requirements:

- SEP IRA (Simplified Employee Pension IRA)
- SIMPLE IRA (Savings Incentive Match Plan for Employees)

IRS Annual Filing Requirement: Form 5500

- 401 (k) Plans
- Individual 401(k) [aka Solo 401(k)] – Form 5500 EZ
- Profit Sharing Plans

Sole Proprietorship: (Sep-Ira) Plans

- A SEP-IRA is a common choice for sole proprietors.
- A SEP-IRA is NOT a ROTH IRA. (Individuals can get tax benefits now! Individuals pay taxes when they withdraw)
- To establish the plan, file IRS Form 5305-SEP.
- There is no IRS annual filing requirement.

Sep-Ira: Contributions

- Individuals can contribute up to 25% of the Schedule C income or $66,000 max for 2023 whichever is lesser.
- If (aside from the owner) there are employees, who are:
    - Over the age of 21
    - And have performed services for the sole proprietor in the last 3 of the past 5 years.
    - Sole proprietors MUST also contribute to the employee's plan too!!
- They do not have to contribute to the plan every year. But if they do, all eligible employees must participate. (In other words they have to treat everyone equally).

Example:

During 2023 John has 0 eligible employees. His Schedule C shows net income from his business of $100,000. John has Self Employment Tax of $15,300 (15.3%). 50% of this SE Tax is deductible. ($7,650). After the SE Tax Deduction that leaves $92,350 of taxable income.

If John chooses to contribute the 25% max to the plan, he will be allowed to contribute $18,470 (25%/125% x $92,350). In other words, after his SEP contribution, John's taxable income goes from $92,350 to $73,880 (92,350 - 18,470). $73,880 x 25% = $18,470

Sep-Ira: Cons

What are the cons?

Employee contributions are NOT allowed. Only the employer may contribute. If the individual decides to contribute 25% for the year, he

MUST also contribute 25% to his other eligible employees as well. In other words, if a sole proprietor paid his employee Sarah $25,000, He will need to contribute $6,250 to Sarah's SEP-IRA.
Mislabeling an employee as a contractor could be opened up to liability. Contractors could argue they were employees and sue for the employer contribution they did not receive. In other words, employees make the plan more complicated.

SIMPLE IRA: OVERVIEW

File IRS Form 5304-SIMPLE or 5305-SIMPLE to establish the plan.	No IRS Annual Filing Requirements.	Employee contributions ARE allowed!	Company must have 100 or fewer employees.
$15,500 max Employee (EE) contribution each year (Applies to 2023)	Employers may match an employee's contribution but only up to 3% of the employee's salary. (e.g. $3k for employee making $100k)	Must be offered to ALL employees who: • Make more than $5,000 annually (in any prior two years) • Reasonably expected to make $5,000 in the current year. • NO age requirement	Loans are NOT permitted.

SIMPLE 401(K): OVERVIEW

Annual Filing Requirement: Form 5500	Employee contributions ARE allowed!	Company must have 100 or fewer employees.	$22,500 max Employee (EE) contribution each year (Applies to 2023)
Employers may match an employee's contribution but only up to 3% of the employee's salary. (e.g. $3k for employee making $100k)	Employers may reduce the match to as low as 1% but not for more than 2 out of 5 calendar years.	Must be offered to ALL employees who: • Make more than $5,000 annually (in any prior two years) • Reasonably expected to make $5,000 in the current year. • NO age requirement	Loans ARE permitted.

Simple Plan: Rules

- Each year during the election period, employees can change their contribution levels. Employers must give their employees a window of at least 60-days to elect their contribution percentage.
- Election period required: November 2 thru December 31 (A plan can have more election periods each year in addition to this 60-day election period).

- Auto Enrollment: Is a plan feature that allows an employer to automatically deduct a fixed percentage from an employee's wages.
- Auto Enrollment: The employee MUST be given the option to OPT-OUT.
- Auto Enrollment: Is easier to manage.

Simple Plan: Employer Match

- If an employer normally matches 3% of his employee's contributions, he must notify employees of any reduction.
- Employers must notify employees within a reasonable period of time before the 60-day election period for the year.

Simple Plans: Alternative to the 3% match

If the employer does not want to match the employee's contribution up to 3%. There is another option. It is called a "2% Non-elective Contribution"

This allows an employer to contribute 2% of each eligible employee's pay regardless of whether or how much the employee deferred (contributed).

Simple Ira: Termination

Step 1:
The employer needs to notify the employees within a reasonable time BEFORE November 2nd that he will discontinue the plan effective the following January

Step 2:
The employer needs to notify his SIMPLE IRA plan's financial institution & payroll provider that he won't be making SIMPLE IRA contributions for the next calendar year.

Step 3:
The employer needs to keep records of his notifications. IRS notification is not required.

Simple 401(K): Termination

1. **Amend** - The employer needs to amend the plan to establish a termination date, cease plan contributions, to provide full vesting to all affected employees, authorize a plan to distribute all benefits as soon as possible after the termination date.
2. **Notify** - The employer needs to notify all plan participants & beneficiaries
3. **Provide** - The employer needs to provide roll over notice to participants & beneficiaries
4. **Distribute** - The employer needs to distribute plan assets: Within 12 months after termination date.
5. **File** - The employer needs to file a FINAL form 5500
6. **Coordinate** - The employer needs to coordinate with his financial institution.

RETIREMENT ACCOUNTS: ADDITIONAL OPTIONS

Plan Type:	**Profit Sharing**	**Safe Harbor 401(k)**	**Auto Enrollmen t 401(k)**	**Traditional 401(k)**
Key Advantag e:	ER can make large contributio ns for EE.	High level of EE salary deferrals.	High level of EE salary deferrals.	High level of EE salary deferrals.
Eligibility :	Any employer with 1 or more EE.	Any employer with 1 or more EE.	Any employer with 1 or more EE.	Any employer with 1 or more EE.
Role:	Must file annual Form 5500	Must file annual Form 5500	Must file annual Form 5500	Must file annual Form 5500
Contribut ors:	ER contributio n is discretionar y.	EE & ER can contribute	EE & ER can contribute	EE & ER can contribute

Maximums:	ER Max: 25% of EE compensation or $66k (2023)	EE: $22,500 (2023) EE+ER Max: 25% of EE compensation or $66k	EE: $22,500 (2023) EE+ER Max: 25% of EE compensation or $66k	EE: $22,500 (2023) EE+ER Max: 25% of EE compensation or $66k
Options:	ER contributions: Set by plan	EE: Elects deferral %/$ ER: 3% match	EE: Elects deferral %/$ ER: Set by plan terms	EE: Elects deferral %/$ ER: Set by plan terms
Draws/Loans:	Loan/Hardship permitted. Subject to tax.	Loan/Hardship permitted. Subject to tax.	Loan/Hardship permitted. Subject to tax.	Loan/Hardship permitted. Subject to tax.

Defined Contribution Plans

- Defined-contribution (DC) retirement plans allow employees to invest pre-tax dollars in the capital markets where they can grow tax-deferred until retirement.
- 401(k) and 403(b) are two popular defined-contribution plans commonly used by companies and organizations to encourage their employees to save for retirement.
- DC plans can be contrasted with defined-benefit (DB) pensions, in which retirement income is guaranteed by an employer. With a DC plan, there are no guarantees, and participation is both voluntary and self-directed.
- Employees can contribute up to $20,500 to their 401(k) plans, 403(b)plans, and 457 plans.
- Additional catch-up contribution of $6500 is allowed for participants age 50 and over
- Employers can contribute

- Limit of $66,000 on combined employer and employee contributions for 2023.
- Employer contributions to these plans are limited to 25% of the employee's total compensation.
- Common defined contribution plan is a traditional 401(k) plan.

Defined Benefit Plans

- Often called a Traditional Pension Plan
- Promises a specified benefit amount or annuity after retirement.
- Very costly to administer so most private companies do not offer a pension vs. most states and governments do
- Businesses must make contributions to the pension
- Vesting occurs over time according to the terms of the plan
- The plan must file a yearly information return Form 5500
- Allow for significantly larger contributions than other retirements accounts
- For self-employed persons: limited to 100% of compensation
- Limitation to the annual benefit plan is the lower of $245,000 or The average compensation of the employee in the three highest years
- Usually, defined benefits plans are funded by the employer and generally do not require employee contributions
- Defined benefits plans are not limited to 25% of compensation like defined contributions plans are.

Prohibited Transactions

Generally, a prohibited transaction in an IRA is any improper use of an IRA account or annuity by the IRA owner, his or her beneficiary or any disqualified person.

Disqualified persons include the IRA owner's fiduciary and members of his or her family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

The following are examples of possible prohibited transactions with an IRA.

- Borrowing money from it

- Selling property to it
- Using it as security for a loan
- Buying property for personal use (present or future) with IRA funds

15% tax is applied on the amount involved in a prohibited transaction for each year or part of a year in a taxable period.

If not corrected within the taxable period an additional tax of 100% of the amount involved is imposed.

If the prohibited transaction is not corrected during the taxable period, the taxpayer usually has an additional 90 days after the day the IRS mails a notice of deficiency to correct the transaction.

Protection From Creditors: Qualified Accounts

Qualified Retirement Plan
- Meets ERISA/IRC Guidelines
- Qualify for tax benefits
- Government protection: Some protection is offered under Title 11, Chapter 5, Subchapter II, Section 522 of the US Bankruptcy Code.

Non-Qualified Retirement Plan
- Does not meet all ERISA rules
- Used for highly compensated employees.

Where To Open Accounts?

From IRS Publication 560: "Generally, unless individuals write their own plan, the financial institution that provided the plan will take the continuing responsibility for meeting qualification rules that are later changed."
- Merrill Lynch (A Bank of America Company)
- TD Ameritrade
- Charles Schwab
- Wells Fargo
- Chase

- Fidelity
- Morgan Stanley

POP QUIZ & ANSWER SHEET

RETIREMENT PLANS

POP QUIZ

Test your knowledge on *Retirement Plans* by answering the questions below. The answer sheet may be found at the end of the Pop Quiz.

Q1: To retire comfortably, you may need up to ___ of your current annual income?

A. 50%
B. 60%
C. 70%
D. 80%

Q2: A ___ does not have an IRS annual filing requirement.

A. A 401(k) Plan
B. A Profit-sharing Plan
C. A SEP IRA
D. A Solo 401(k) Plan

Q3: Which of the following plans does have an IRS annual filing requirement?

A. A Profit-Sharing Plan
B. A 401(k) Plan
C. A Solo 401(k) Plan
D. All of the Above

Q4: **A sole proprietor can contribute up to ___ of his or her Schedule C income to a SEP-IRA.**

A. 25%
B. 35%
C. 50%
D. 65%

Q5: **For SIMPLE plans, the employer must give employees a window of at least ___ days to elect their contribution percentage?**

A. 30
B. 60
C. 90
D. 120

Q6: **Relating to SIMPLE plans, which of the following is a true statement about auto enrollment in the plan?**

A. This is a feature that allows an employer to automatically deduct a fixed percentage from an employee's wages
B. It is easier to manage
C. The employee MUST be given the option to opt-out
D. All of the above

Q7: **Relating to the SIMPLE Plan, when reducing the employer match (up to 3%) of the employee's contribution, the employer must notify the employees within a reasonable period of time before the ___ day election period for the year:**

A. 20
B. 40
C. 60
D. 90

Q8: Relating to the SIMPLE plan, if the employer does not want to match an employee's contributions (up to 3%), there is another option. What is that option?

A. A 2% Charitable Contribution
B. A 2% Non-Elective Contribution
C. A 2% Mandatory Contribution
D. Both A & C

Q9: A loan/hardship, which is subject to tax is permitted with what plan or plans?

A. A Safe Harbor 401(k)
B. A Profit-Sharing Plan
C. A Traditional 401(k)
D. All of the Above

Q10: For a ___ plan, the employer can make large contributions for the employee.

A. Profit-Sharing Plan
B. An Auto Enrollment 4019 (k)
C. A Traditional 401(k)
D. A Safe Harbor 401(k)

Q11: Both the employee and the employer can contribute to what plan or plans?

A. A Safe Harbor 401(k)
B. An Auto Enrollment 401(k)
C. A Traditional 401(k)
D. All of the Above

Q12: For this plan, the maximum employer contribution is 25% of employee compensation or $66k for TY 2023.

A. A Traditional 401(k)
B. A Safe Harbor 401(k)
C. The Profit-Sharing Plan
D. An Auto Enrollment 401(k)

Q13: The Form 5500 is required to be filed annually by which plan or plans?

A. Auto Enrollment 401(k)
B. The Profit-Sharing Plan
C. The Traditional 401(k)
D. All of the Above

Q14: The ___ has a maximum employer matching amount of 3%.

A. The Safe Harbor 401(k)
B. The Traditional 401(k)
C. A Profit-Sharing Plan
D. All of the Above

Q15: Which of the following plans allow employers with one or more employees to participate?

A. A Traditional 401(k)
B. A Safe Harbor 401(k)
C. An Auto Enrollment 401(k)
D. All of the Above

Q16: This type of retirement plan does not meet all ERISA rules.

A. Disqualified
B. Qualified
C. Non-Qualified
D. Suspended

Q17: A ___ retirement plan does meet ERISA/IRC guidelines.

A. Qualified
B. Non-Qualified
C. Vested
D. State Formed

Q18: A ___ does not have an annual IRS filing requirement.

A. A SEP IRA
B. A SIMPLE IRA
C. A 401(k) Plan
D. Both A & B

Q19: For a SIMPLE IRA plan, the company must have ___ or fewer employees.

A. 100
B. 75
C. 50
D. 25

Q20: For a SIMPLE 401(k) plan, which of the following statements is not true.

A. The company must have 100 or fewer employees
B. Employee contributions are allowed
C. Loans are not permitted
D. There is an annual filing requirement using the Form 5500

ANSWER SHEET

1. Answer is D - 80%

2. Answer is C - A SEP IRA

3. Answer is D - All of the Above

4. Answer is A - 25%

5. Answer is B - 60

6. Answer is D - All of the above

7. Answer is C - 60

8. Answer is B - A 2% Non-Elective Contribution

9. Answer is D - All of the Above

10. Answer is A - Profit-Sharing Plan

11. Answer is D - All of the Above

12. Answer is C - The Profit-Sharing Plan

13. Answer is D - All of the Above

14. Answer is A - The Safe Harbor 401(k)

15. Answer is D - All of the Above

16. Answer is C - Non-Qualified

17. Answer is A - Qualified

18. Answer is D - Both A & B

19. Answer is A - 100

20. Answer is C - Loans are not permitted

Farmers

Overview

Individuals are considered in the business of farming if they cultivate, operate, or manage a farm for profit, either as an owner or a tenant.

A farm includes livestock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards.

A fish farm is an area where fish and other marine animals are grown or raised and artificially fed, protected, etc. It doesn't include an area where they are merely caught or harvested.

A plant nursery is a farm for purposes of deducting soil and water conservation expenses.

The Office of Professional Responsibility (OPR) is responsible for all matters related to practitioner misconduct, discipline and practice, including instituting disciplinary proceedings and pursuing sanctions.

The Office of Professional Responsibility (OPR) supports the Internal Revenue Service's (IRS's) strategy to enhance enforcement of the tax laws by ensuring that tax professionals adhere to practice standards and follow the Internal Revenue Code, Treasury regulations, and other laws as they apply to an individual's qualifications, competency, and ethical and professional fitness to practice before the IRS.

Not Classified As Farming Businesses

Individuals are not considered in the business of farming if they cultivate or operate a farm for recreation or pleasure, rather than for profit.

Individuals are not farming if they are engaged only in forestry or the growing of timber.

If an individual owns a farm and receives farm rental payments based on farm production, either in cash or crop shares, he is in the business of farming. If he gets cash rental for a farm he owns that is not used in farm production, he can't deduct soil and water conservation expenses for that farm.

If an individual receives a fixed rental payment that is not based on farm production, he is in the business of farming only if he materially participates in operating or managing the farm.

Example:

Jordan owns a farm in Iowa and lives in California. He rents the farm for $250 in cash per acre and doesn't materially participate in producing or managing production of the crops grown on the farm. He can't deduct his soil conservation expenses for this farm. He must capitalize the expenses and add them to the basis of the land.

If an individual doesn't carry on his farming activity, or other activity he engages or invests in, to make a profit, he can report the income from the activity on Schedule 1 (Form 1040 or 1040–SR), line 8. He can no longer deduct expenses of carrying on the activity, even if he itemizes the deductions on Schedule A (Form 1040 or 1040–SR).

In determining whether a person is carrying on the farming activity for profit, all the facts are taken into account. No one factor alone is decisive. Among the factors to consider are whether:

- The individual operates his farm in a business-like manner;
- The time and effort spend on farming indicate the intend to make it profitable;
- The individual depends on income from farming for his livelihood;
- The losses are due to circumstances beyond the control or are normal in the start-up phase of farming;
- The individual changes his methods of operation in an attempt to improve profitability;
- The individual , or his advisors, have the knowledge needed to carry on the farming activity as a successful business;

- The individual was successful in making a profit in similar activities in the past;
- The individual makes a profit from farming in some years and the amount of profit made; and
- The individual can expect to make a future profit from the appreciation of the assets used in the farming activity.

Farming Rents

The rent received for the use of the farmland by another person or entity is generally rental income, not farm income. However, the rent is farm income if:

1. The arrangement with the tenant provides that the individual will materially participate in the production or management of production of the farm products on the land, and
2. The individual materially participates

Pasture income and rental - If the individual pastures someone else's livestock and takes care of them for a fee, the income is from the farming business. He must enter it as Other income on Schedule F. If he simply rents his pasture or other farm real estate for a flat cash amount without providing services, the income needs to be reported as rent on Schedule E (Form 1040 or 1040-SR), Part I.

Estimated Taxes For Farmers

Estimated tax is the method used to pay tax on income that is not subject to withholding. If an individual is a qualified farmer, defined below, he is subject to the special rules covered in this chapter for paying estimated tax.

Special rules apply to the payment of estimated tax by individuals who are qualified farmers.

An individual is a qualified farmer for 2023 or 2024 if at least two-thirds of his or her gross income from all sources for 2023 or 2024 was from farming.

The following special estimated tax rules apply for qualified farmers for 2023.

- Individuals do not have to pay estimated tax if they file the 2023 tax return and pay all the tax due by March 1, 2024.
- Individuals do not have to pay estimated tax if their 2023 income tax withholding (including any amount applied to the 2023 estimated tax from the 2021 return) will be at least 662/3% (0.6667) of the total tax shown on the 2020 tax return or 100% of the total tax shown on the 2021 return.
- If the individuals must pay estimated tax, they are required to make only one estimated tax payment (the required annual payment) by January 17, 2023, using special rules to figure the amount of the payment. See Required Annual Payment next for details.

Accounting Methods For Farming

An accounting method is a set of rules used to determine when and how the income and expenses are reported on the tax return. The accounting method includes not only the overall method of accounting, but also the accounting treatment used for any material item.

Generally, individuals can use any of the following accounting methods.

- Cash method.
- Accrual method.
- Special methods of accounting for certain items of income and expenses.
- Combination (hybrid) method using elements of two or more of the above methods.

1. Cash Method

Most farmers use the cash method because they find it easier to keep records using the cash method. Certain farm corporations and partnerships and all tax shelters are generally required to use an accrual method of accounting. Farm corporations or partnerships that have average annual gross receipts of $26 million or less for the 3 preceding tax years and are not tax shelters can use the cash method instead of the accrual method.

2. Accrual Method

Under an accrual method of accounting, individuals generally report income in the year earned and deduct or capitalize expenses in the year incurred. The purpose of an accrual method of accounting is to correctly match income and expenses. Certain large farm businesses must use an accrual method of accounting for its farm activities and for sales and purchases of inventory items.

3. Special Methods of Accounting

There are special methods of accounting for certain items of income and expense.

- Crop method. If the individual does not harvest and dispose of the crop in the same tax year as its plant, he can, with IRS approval, use the crop method of accounting. He cannot use the crop method for any tax return, including the first tax return, unless he receives approval from the IRS. Under this method, he deducts the entire cost of producing the crop, including the expense of seed or young plants, in the year he realizes income from the crop.
- Other special methods of accounting apply to the following items.
    - Casualties
    - Condemnations
    - Depletion
    - Depreciation
    - Farm business expenses
    - Farm income
    - Installment sales
    - Soil and water conservation expenses
    - Thefts

4. Combination Method

Individuals can use any combination of cash, accrual, and special methods of accounting if the combination clearly shows the income and expenses and it's used consistently. However, the following restrictions apply.

- If an individual uses the cash method for figuring his income, he must use the cash method for reporting his expenses.
- If an individual uses an accrual method for reporting the expenses, he must use an accrual method for figuring the income.

Farming Inventory

If an individual is required to keep an inventory, he should keep a complete record of the inventory as part of the farm records. This record should show the actual count or measurement of the inventory. It also should show all factors that enter into its valuation, including quality and weight, if applicable. Below are some items that could be included in inventory.

- Hatchery business - If the individual is in the hatchery business, and uses an accrual method of accounting, he must include in inventory eggs in the process of incubation.
- Products held for sale - All harvested and purchased farm products held for sale or for feed or seed, such as grain, hay, silage, concentrates, cotton, tobacco, etc., must be included in inventory.
- Supplies - Supplies acquired for sale or that become a physical part of items held for sale must be included in inventory. Deduct the cost of supplies in the year used or consumed in operations. Do not include incidental supplies in inventory as these are deductible in the year of purchase.
- Livestock - Livestock held primarily for sale must be included in inventory. Livestock held for draft, breeding, or dairy purposes can either be depreciated or included in inventory. If an individual is in the business of breeding and raising chinchillas, mink, foxes, or other fur-bearing animals, these animals are livestock for inventory purposes.
- Growing crops - Generally, growing crops are not required to be included in inventory. However, if the crop has a preproductive period of more than 2 years, the costs associated with the crop may have to be capitalized (or included in the inventory).

The inventory should include all items held for sale, or for use as feed, seed, etc., whether raised or purchased, that are unsold at the end of the year.

Unicap For Farmers

Under the uniform capitalization rules, individuals must include certain direct and indirect costs in the basis of property they produce or in their inventory costs, rather than claim them as a current deduction.

These costs can be recovered through depreciation, amortization, or cost of goods sold when used, sold, or otherwise disposed of the property.

Generally, individuals are subject to the uniform capitalization rules if they do any of the following:

- Produce real or tangible personal property, or
- Acquire property for resale. However, this rule does not apply to personal property if the average annual gross receipts for the 3-tax-year period ending with the year preceding the current tax year are $10 million or less.

Individuals can produce property if they construct, build, install, manufacture, develop, improve, or create the property.

In a farming business, individuals produce property if they raise or grow any agricultural or horticultural commodity, including plants and animals.

Sale Of Farm Products & Farm Assets

Amounts received from the sales of products raised on a farm for sale (or bought for resale), such as livestock, produce, or grains, are reported on Schedule F. This includes money and the fair market value of any property or services received.

When an individual sells farm products bought for resale, the profit or loss is the difference between the selling price (money plus the fair market value of any property) and the basis in the item (usually the cost). Individuals need to generally report these amounts on Schedule F for the year they receive payment.

Example:

In 2023, George bought 20 feeder calves for $27,000 for resale. He sold them in 2024 for $35,000. He reports the $35,000 sales price on Schedule F, line 1a, subtract his $27,000 basis on line 1b, and reports the resulting $8,000 profit on line 1c.

Sales of livestock held for draft, breeding, sport, or dairy purposes may result in ordinary or capital gains or losses, depending on the circumstances. In either case, individuals should not report these sales on Schedule F. Instead, these sales need to be reported on Form 4797. Animals that are not held primarily for sale are considered business assets of the farm.

Depreciation Of Farm Assets

If a property acquired for use in a farm business is expected to last more than 1 year, the owner generally can't deduct the entire cost in the year acquired.

The owner must recover the cost over more than 1 year and deduct part of it each year on Schedule F as depreciation or amortization. However, he can choose to deduct part or all of the cost of certain qualifying property, up to a limit, as a section 179 deduction in the year he places it in service.

Disposition Of Farm Assets

When an individual disposes of property used in a farm business, the taxable gain or loss is usually treated as ordinary income or capital gain (under the rules for section 1231 transactions). Ordinary income is taxed at the same rate as wages and interest. Capital gain is generally taxed at lower rates.

When an individual disposes of depreciable property (section 1245 property or section 1250 property) at a gain, he may have to recognize all or part of the gain as ordinary income under the depreciation recapture rules. Any gain remaining after applying the depreciation recapture rules is a section 1231 gain, which may be taxed as a capital gain. Similar rules apply to the sale of property on which soil and water conservation expenses have been deducted or government cost-sharing payments have been received.

Gains and losses from property used in farming are reported on Form 4797, Sales of Business Property.

Postponing Gain Due To Weather Condition

To postpone gain, individuals can attach a statement to the tax return for the year of the sale. The statement must include name and address and give the following information for each class of livestock for which the individual is postponing gain.

- A statement that he is postponing gain under section 451(e).
- Evidence of the weather-related conditions that forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the federal government because of weather-related conditions.
- A statement explaining the relationship of the area affected by the weather-related condition to the early sale or exchange of the livestock.
- The number of animals sold in each of the 3 preceding years.
- The number of animals he would have sold in the tax year had he followed the normal business practice in the absence of weather-related conditions.
- The total number of animals sold and the number sold because of weather-related conditions during the tax year.
- A computation, as described above, of the income to be postponed for each class of livestock.

Generally, individuals must file the statement and the return by the due date of the return, including extensions. However, for sales or exchanges treated as an involuntary conversion from weather-related sales of livestock in an area eligible for federal assistance, individuals can file this statement at any time during the replacement period. For other sales or exchanges, if they timely filed the return for the year without postponing gain, they can still postpone gain by filing an amended return within 6 months of the due date of the return (excluding extensions).

Attach the statement to the amended return and write "Filed pursuant to section 301.9100-2" at the top of the amended return. The amended return needs to be filed at the same address the original return is filed . Once the individual has filed the statement, he can cancel the postponement of gain only with the approval of the IRS.

Crop Insurance & Government Payments

Individuals must include in income any crop insurance proceeds received as the result of physical crop damage or reduction of crop revenue, or both. They generally include them in the year that they receive them. Treated as crop insurance proceeds, the crop disaster payments received from the federal government as the result of destruction or damage to crops, or the inability to plant crops, because of drought, flood, or any other natural disaster.

Individuals must include in income most government payments, such as those for approved conservation practices, livestock indemnity payments, or livestock forage disaster payments whether they receive them in cash, materials, services, or commodity certificates. However, they can exclude from income some payments they receive under certain cost-sharing conservation programs.

Individuals need to report the agricultural program payment on the appropriate line of Schedule F, Part I. They need to report the full amount even if they return a government check for cancellation, refund any of the payment they receive, or the government collects all or part of the payment from them by reducing the amount of some other payment or Commodity Credit Corporation (CCC) loan. However, they can deduct the amount they refund or return or that reduces some other payment or loan to them. Claim the deduction on Schedule F, Part II, for the year of repayment or reduction.

Other Unique Tax Rules For Farmers

Truck and Car Expenses - Individuals can deduct the actual cost of operating a truck or car in their farm business. Only expenses for business use are deductible. These include such items as gasoline, oil, repairs, license tags, insurance, and depreciation (subject to certain limits).

Soil and Water Conservation - If an individual is in the business of farming, he can choose to deduct certain expenses for soil or water conservation, prevention of erosion of land used in farming, or endangered species recovery. The deduction for conservation expenses cannot be more than 25% of the gross income from farming.

Net Operating Losses are limited for 2023.

For the years 2021 through 2028, there are limits on the amount of losses that noncorporate taxpayers can claim for their business. If you have more losses than allowed, you can carry them over to future years. The calculation of excess business losses no longer takes into account certain deductions or income related to performing services as an employee. Additionally, you can't deduct losses that exceed a certain threshold in the current year.

In 2023, excess means the total amount of business deductions minus the total gross business income plus $289,000 ($578,000 for joint returns). Any excess is considered a net operating loss (NOL) that you can carry forward to future years (or carry back for farmer's excess business losses). However, when you use these carryforwards, they can only offset 80% of your taxable income in those future years.

While the limit on excess business losses applies to calculate the deduction as an NOL in the year you incur the loss, the deduction itself is not limited to 80% of your modified adjusted gross income from previous years. So, you can use your full modified adjusted gross income from previous years to absorb the loss.

Fuel Excise Tax Credits and Refunds - An individual may be eligible to claim a credit on his income tax return for the federal excise tax on certain fuels. He may also be eligible to claim a quarterly refund of the fuel taxes during the year, instead of waiting to claim a credit on the income tax return.

Income Averaging for Farmers - If an individual is engaged in a farming business, he may be able to average all or some of the farm income by using income tax rates from the 3 prior years (base years) to calculate the tax on that income. Income averaging may lower the income tax liability in a year where farm income and taxable income are higher compared to one or more of the 3 prior years.

Net Operating Losses For Farmers

If the deductions for the year are more than the income for the year, individuals may have a net operating loss (NOL). An NOL year is the year in which an NOL occurs. Individuals can use that NOL by deducting it from the income in another year or years.

The deduction for soil and water conservation expenses, after applying the 25% limit, is included when figuring an NOL for the year.

If the NOL is carried to another year, the soil and water conservation deduction included in the NOL is not subject to the 25% limit in the year to which it is carried.

POP QUIZ & ANSWER SHEET

FARMERS

POP QUIZ

Test your knowledge on *Farmers* by answering the questions below. The answer sheet may be found at the end of the Pop Quiz.

Q1: Which of the following is not classified as a farming business?

A. Cultivating, operating, or managing a farm for profit, either as an owner or a tenant.
B. Cultivating or operating a farm for recreation or pleasure.
C. Owning a farm and receiving farm rental payments based on farm production.
D. None of the above

Q2: Claire owns land in Iowa and rents it for $150 in cash per acre. She does not materially participate in producing or managing production of the crops grown on the farm. What can't she do with the soil conservation expenses?

A. Deduct the soil and conservation expenses.
B. Capitalize the soil and conservation expenses.
C. Add the soil and conservation expenses to the basis of the land.
D. All of the above

Q3: An individual is a qualified farmer for 2023 if at least ___ of his or her gross income from all sources for 2022 or 2023 was from farming.

A. One-half
B. One-fourth
C. One-thirds
D. Two-thirds

Q4: What accounting method can generally be used by farm corporations or partnerships that have average annual gross receipts of $26 million or less for the 3 preceding tax years and are not tax shelters?

A. Cash Method
B. Accrual Method
C. Special Method of Accounting
D. Combination Method

Q5: If the crop has a pre-productive period of more than ___ the farmer may have to capitalize (or include in inventory) costs associated with the crop.

A. 2 years
B. 3 years
C. 4 years
D. 5 years

Q6: In 2022, Tom bought 20 feeder calves for $27,000 for resale. He sold them in 2023 for $35,000. How would you report this on Schedule F?

A. You report the $27,000 sales price on Schedule F, line 1a, add $8,000 basis on line 1b, and report the resulting $35,000 profit on line 1c.

B. You report the $8,000 sales price on Schedule F, line 1a, add $27,000 basis on line 1b, and report the resulting $35,000 profit on line 1c.

C. You report the $35,000 sales price on Schedule F, line 1a, subtract $27,000 basis on line 1b, and report the resulting $8,000 profit on line 1c.

D. You report the $35,000 sales price on Schedule F, line 1a, subtract $27,000 basis on line 1c, and report the resulting $8,000 profit on line 1b.

Q7: Which form should be used to report gains and losses from property used in farming?

A. Form 3115

B. Form 4797

C. Form 8826

D. Form 9645

ANSWER SHEET

1. Answer is B - Cultivating or operating a farm for recreation or pleasure.

2. Answer is A - Deduct the soil and conservation expenses.

3. Answer is D - Two-thirds

4. Answer is A - Cash Method

5. Answer is A - 2 years

6. Answer is C - You report the $35,000 sales price on Schedule F, line 1a, subtract your $27,000 basis on line 1b, and report the resulting $8,000 profit on line 1c.

7. Answer is B - Form 4797

Depending on the "participation" of a taxpayer would depend on if they have "passive" income.

Passive business activities:
Taxpayer does not materially participate during the years.
Generally, losses from passive activities that exceed the income from passive activities are disallowed for the current year. You can carry forward disallowed passive losses to the next taxable year subject to the same passive loss rules and limitations. Must use form 8582 Passive Activity Loss Limitations
There are two kinds of passive activities.

- Trade or business activities in which you don't materially participate during the year.
- Rental activities, even if you do materially participate in them, unless you're a real estate professional.

Passive activity rules apply to individuals, estates, trusts, personal service corporation and closely held corporations. Same rules apply to owners of grantor trusts, partners in a partnership, and shareholders of an S Corporation (but not to the entities themselves)

Special $25,000 allowance
If you or your spouse actively participated in a passive rental real estate activity, the amount of the passive activity loss that's disallowed is decreased and you therefore can deduct up to $25,000 of loss from the activity from your nonpassive income.

Example
Kate, 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).

Active participation isn't the same as material participation. Active participation is a less stringent standard than material participation. For example, you may be treated as actively participating if you make management decisions in a significant and bona fide sense. Management decisions that count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

Example

Mike, a single taxpayer, had the following income and loss during the tax year.

- Salary $42,300
- Dividends $300
- Interest $1,400
- Rental loss $(4,000)

The rental loss came from a house Mike owned. He advertised and rented the house to the current tenant himself. He also collected the rents and did the repairs or hired someone to do them. Even though the rental loss is a loss from a passive activity, Mike can use the entire $4,000 loss to offset his other income because he actively participated.

Phase Out 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 your modified adjusted gross income that's more than $100,000 ($50,000 if you're married filing separately). If your modified adjusted gross income is $150,000 or more ($75,000 or more if you're married filing separately), you 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.

Example

During 2023, John was unmarried and wasn't a real estate professional. For 2023, he had $120,000 in salary and a $31,000 loss from his rental real estate activities in which he actively participated. His modified adjusted gross income is $120,000. When he files his 2023 return, he can deduct only $15,000 of his passive activity loss. He must carry over the remaining $16,000 passive activity loss to 2023. He figures his deduction and carryover as follows.

- Adjusted gross income, modified as required $120,000
- Minus amount not subject to phase out –$100,000
- Amount subject to phase out rule $20,000
- Multiply by 50% × 50%
- Required reduction to special allowance $10,000
- Maximum special allowance $25,000
- Minus required reduction (see above) –10,000
- Adjusted special allowance $15,000
- Passive loss from rental real estate $31,000
- Deduction allowable/Adjusted special allowance (see above) – 15,000

Amount that must be carried forward $16,000

Commercial rentals versus residential rentals

Rental income you receive for the use or occupancy of hotels, boarding houses, or apartment houses is subject to SE tax if you provide services for the occupants.

Generally, you are considered to provide services for the occupants if the services are primarily for their convenience and are not services normally provided with the rental of rooms for occupancy only.

An example of a service that is not normally provided for the convenience of the occupants is maid service. However, providing heat and light, cleaning stairways and lobbies, and collecting trash are services normally provided for the occupants' convenience.

Material participation must meet one of the following tests:

- 500 hours during the year
- Participation was substantially all the participation in the activity of all individuals for the tax year
- Participation in the activity for more than 100 hours during the tax year and participated no less than any other individual
- Significant participation for more than 500 hours
- Materially participated for 5 of the preceding 10 taxable years
- The activity is a personal service activity

Prepaid rent.
Advance payments received under a lease
that does not put any restriction on their use or enjoyment are income in the year you receive them. This is generally true no matter what accounting method or period you use.

Lease bonus.
A bonus you receive from a lessee for
granting a lease is an addition to the rent. Include it in your gross receipts in the year received.
Lease cancellation payments.
Report payments you receive from your lessee for canceling a lease in your gross receipts in the year received.
Not for Profit Rental Income is when you do not rent your property to make a profit.
If you do not rent your property to make a profit, you can deduct your rental expenses only up to the amount of your rental income. You cannot deduct a loss or carry forward to the next year any rental expenses that are more than your rental income for the year. For more information about the rules for an activity not engaged in for profit, see Not-for-Profit Activities in chapter 1 of Pub. 535.
You can report your not-for-profit rental income on Form 1040, line 8
Rental expenses and deductions
if a taxpayer has any personal use of a dwelling that they rent, they must divide their expenses between rental use and personal use. they must divide expenses even if the dwelling doesn't meet the definition of a residence. they may deduct only rental expenses on schedule e (form 1040). they may be able to deduct some of their personal expenses on schedule a (form 1040) if they itemize deductions.
furthermore, the amount of rental expenses that a taxpayer can deduct may be limited if the dwelling is considered a residence.

Basis Scenarios Review Section

Understanding how to properly calculate basis is widely tested on the Special Enrollment Examination. This section will cover various sections with answers.

Try to answer the question and then review the answer on the next page.

Question 1:

Jean inherited stock from her late Grandmother Beth. She received the following:

- 20 Apple shares with a FMV $120,000 and a basis of $68,880
- 20 Amazon shares with a FMV of $220,000 and a basis of $80,050
- 25 Alphabet shares with a FMV of $150,000 and a basis of $90,900

Jean had to pay a $2500 stock ownership transfer fee to the brokerage firm.

What is Jean's basis in the stock?

Question 1 Answer:

Jean inherited stock from her late Grandmother Beth. She received the following:

- 20 Apple shares with a FMV $120,000 and a basis of $68,880
- 20 Amazon shares with a FMV of $220,000 and a basis of $80,050
- 25 Alphabet shares with a FMV of $150,000 and a basis of $90,900

Jean had to pay a $2500 stock ownership transfer fee to the brokerage firm.

What is Jean's basis in the stock?

$490,000+$2500 fee=$492,500 total basis in stock

New basis (add all by $833.33 which is $2500/3):

- **Apple: $120,833.33**
- **Amazon: $220833.33**
- **Alphabet: $150,833.33**

Question 2:

Ike is a partner at the Science of Living. His adjusted basis in the partnership is $280,000. Ike receives a distribution of $25,000 cash and property that has an adjusted basis of $50,000 and a FMV of $250,000.

What is Ikes basis in the partnership after this transaction and what are the tax implications of this distribution if any?

Question 2 Answer

Ike is a partner in the Science of Living. His adjusted basis in the partnership is $280,000. Ike receives a distribution of $25,000 cash and property that has an adjusted basis of $50,000 and a FMV of $250,000.

What is Ikes basis in the partnership after this transaction and what are the tax implications of this distribution if any?

$280,000 Ike's starting basis

-$25,000 cash distribution

= $255,000 remaining basis after cash

-$50,000 property distribution (partnership basis)

=$205,000 Ike's remaining partnership basis

There are no tax implications of this transaction. When Ike sells the property he will realize his gain or loss then.

Question 3:

Joel and Victoria start a partnership called Lakewood Ventures. Joel contributes cash of $250,000, and property with a FMV of $890,000 and a basis of $610,000. Victoria contributes cash of $800,000 cash and property with a basis of $60,000 and a FMV of $150,000.

What is Joel's and Victoria's basis in the partnership?

Question 3 Answer:

Joel and Victoria start a partnership called Lakewood Ventures. Joel contributes cash of $250,000, and property with a FMV of $890,000 with a basis of $610,000. Victoria contributes cash of $800,000 cash and property with a basis of $60,000 and a FMV of $150,000.

What is Joel's and Victoria's basis in the partnership?

Joel:

$250,000 cash

+ $610,000 basis in property

=$860,000 Joel's basis

Victoria:

$800,000 cash

+$60,000 basis in property

=$860,000 Victoria's basis

Question 4:

Maria acquired a 25% interest in

a partnership by contributing property that had a FMV of $990,000 an adjusted basis to her of $800,000 and a $475,000 mortgage. The partnership assumed payment of the mortgage.

What is the basis of Maria's interest in the partnership?

Question 4 Answer:

Maria acquired a 25% interest ina partnership by contributing property that had

an adjusted basis to her of $800,000 and a $475,000 mortgage. The partnership assumed payment of the mortgage. What is the basis of Maria's interest in the partnership?

Adjusted basis of contributed property $800,000

Minus: Part of mortgage assumed by other partners (75% (0.75) × $475,000).......$356,250

Basis of Maria's partnership interest $443,750

Question 5:

David contributes to his partnership, property that has an adjusted basis of $275,000

and an FMV of $300,000. His partner Tori contributes $275,000 cash.

What is each partner's basis in the partnership?

Question 5 Answer:

David contributes to his partnership, property that has an adjusted basis of $275,000

and an FMV of $300,000. His partner Tori contributes $275,000 cash.

What is each partner's basis in the partnership?

David $275,000 basis (the adjusted basis he had in the property)

Tori: $275,000 (cash contributed)

Question 6:

Kelly acquired a 33.33% interest in a partnership by contributing property that had a FMV of $150,000 and an adjusted basis to her of $100,000 and a $55,000 mortgage. The partnership assumed payment of the mortgage.

What is the basis of Kelly's interest in the partnership?

Question 6 Answer:

Kelly acquired a 33.33% interest in a partnership by contributing property that had a FMV of $150,000 and an adjusted basis to her of $100,000 and a $55,000 mortgage. The partnership assumed payment of the mortgage.

What is the basis of Kelly's interest in the partnership?

Adjusted basis of contributed property $100,000

Minus: Part of mortgage assumed by other

partners (66.67% ×$55,000) $36,668.50

Basis of Kelly's partnership interest $63,331.50

Question 7:

Tyler purchased a new Air BnB in 2020 and had the following transactions:

- $275,000 purchase price
- $500 title insurance
- $2500 points
- $8000 heating and cooling
- $ 10,000 Lawn & Grounds
- $8500 Wall to wall carpeting
- $18,333 Depreciation expense

What is Tyler's basis in the property?

Question 7 Answer:

Tyler purchased a new Air BnB in 2020 and had the following transactions:

- **ADD: $275,000 purchase price**
- **ADD: $500 title insurance**
- N/A: $2500 points **(needs to be amortized over the life of the loan)**
- **ADD: $8000 heating and cooling**
- **ADD: $ 10,000 Lawn & Grounds**
- **ADD: $8500 Wall to wall carpeting**
- **SUBTRACT:** $18,333 Depreciation expense (deduct from basis)

What is Tyler's basis in the property?

Tyler's basis is: $283,667

QUESTION 8:

Devon purchased a commercial building for $560,000 in 2015 and had the following transactions:

- Title insurance 2015: $560
- New heating and cooling units 2016: $9000
- Seller's delinquent taxes 2015: $23,000
- Depreciation 2015-2021: $130,667
- Attorney's fees to defend title 2016: $8000
- New Roof 2018: $18,000

What is Devon's basis in the commercial building?

QUESTION 8 ANSWER:

Devon purchased a commercial building for ADD $560,000 in 2015 and had the following transactions:

- ADD: Title insurance 2015: $560
- ADD: New heating and cooling units 2016: $9000
- ADD: Seller's delinquent taxes 2015: $23,000
- SUBTRACT: Depreciation 2015-2021: $130,667
- ADD: Attorney's fees to defend title 2016: $8000
- ADD: New Roof 2018: $18,000

What is Devon's basis in the commercial building?

Devon’s basis is $487,893

QUESTION 9:

Maria purchases a delivery van for $55,000 and has the following transactions:

- Sales tax: $1,500
- Delivery fee: $500

What is Maria's basis in the delivery van?

QUESTION 9 ANSWER:

Maria purchases a delivery van for $55,000 and has the following transactions:

- Sales tax: $1,500
- Delivery fee: $500

What is Maria's basis in the delivery van?

$55,000 PURCHASE PRICE + $1500 SALES TAX + $500 DELIVERY FEE

MARIA'S BASIS IN THE DELIVERY VAN IS: $57,000

QUESTION 10:

Charles, Dionna, and Carmen form a partnership with each having a third interest. The following contributions occured:

Charles contributed

- Real estate he purchased in 2023 with a FMV of $50,000 and a basis of $25,000
- Equipment he purchased in 1999 with a FMV of $20,000 and a basis of $15,000, and
- Cash of $60,000.

Dionna contributed

- Stock she acquired in 2008 with a fmv of $100,000 and basis of $50,000,
- Bitcoin she acquired in 2005 with a FMV of $50,000 and basis of $10,000, and
- Cash of $40,000

Carmen contributed

- NFT she purchased in 2023 with a fmv of $200,000 and a basis of $40,000,
- Work van she owned since 2005 with a basis of $50,000 and a FMV of $70,000,
- Cash of $10,000

What is each Partner's Basis?

QUESTION 10 ANSWER:

Charles, Dionna, and Carmen form a partnership with each having a third interest. The following contributions occured:

Charles contributed

- **Real estate they purchased in 2023 with a FMV of $50,000 and a basis of $25,000**
- **Equipment they purchased in 1999 with a FMV of $20,000 and a basis of $15,000, and**
- **Cash of $100,000.**

Charles's basis is: $100,000

Dionna B contributed

- **Stock they acquired in 2008 with a fmv of $100,000 and basis of $50,000,**
- **Bitcoin they acquired in 2005 with a FMV of $50,000 and basis of $10,000, and**
- **Cash of $40,000**

Dionna's basis is: $100,000

Carmen contributed

- **NFT they purchased in 2023 with a fmv of $200,000 and a basis of $40,000,**
- **Work van they purchased in 2023 with a basis of $50,000 and a FMV of $50,000,**
- **Cash of $10,000**

Carmen's basis is: $100,000

Advising The Business Taxpayer

Review Scenarios

Jonathan starts a landscaping business January 1, 2023. The below details apply:

- Purchased a Sitting Mower: $5000
- Purchased a Handheld blower: $1500
- Neighborhood Research to figure which zipcode to advertise to: $500
- Advertising flyers: $1000
- F150 pickup w/trailer: $65,000 financed with $2500 down payment and taxes and with a monthly payment of $500
- Jon got his first client March 1, 2023.
- Jon makes $28,000 in 2023
- Jon has a goal to grow his business to $100,000 per year and hire one additional worker to help. He wants to consistently bring home about $60,000 per year to support his family.
- He comes to you to get his taxes prepared.

Analysis:

- What business entity would you recommend for Jon?
- What tax form would need to be filed for this business entity?
- When would this tax return be due for this business entity?
- What is Jon's total taxable income if any?
- How much tax would Jon be subject to if any?

<u>Answer Sheet:</u>

Jon never incorporated so he is operating as a Sole Proprietor. We will file Sch C to report all of his income and expenses. His tax return will be due the 15th day of the fourth month or April 15, 2023. His income should be reported as follows:

- **Total Income: $28,000**
- **Total expenses: $5000 allowable start-up costs**
- **The remaining $3000 to be amortized over 180 months**
- **2023 depreciation expense: $166.67**

(remaining depreciation amount: $2833.33)

- **$67,500 basis depreciated over 5 years:**
- **2023 depreciation expense: $11,250**

(remaining depreciation amount: $56,250)

$11,583.33 total taxable income ($28,000-$5000-166.67-$11,250)

x 92.3% amount subject to SE tax

= $10691.41 amount subject to SE tax

x 15.3% (SE tax rate)

=$1635.79 SE tax

Jonetta starts a restaurant with Shane on April 1, 2023 selling vegan soul food. They:

- Verbally agree to split the expenses and profits 50/50. The following details apply:
- Jonetta contributes $25,000 cash, and a commercial building downtown Atlanta that has an adjusted basis of $375,000 and a FMV of $490,000.
- Shane contributes $10,000 cash, and equipment that has an adjusted basis of $195,000 and a FMV of $230,000
- They open doors on July 15, 2023 and generates $180,000 for the year
- Total food cost was: $90,000
- Wages: 25,000
- Guaranteed payment to Jonetta for $20000

Analysis:

- What business entity would you recommend for Jonetta & Shane?
- What tax form would need to be filed for this business entity?
- When would this tax return be due for this business entity?
- What is Jonetta's and Shane's basis if any?
- What is Jonetta's and Shane's total taxable income if any?
- How much tax would Jonetta and Shane owe if any?

Answer Sheet:

Two members' default classification would be a Partnership.

Jonetta and Shane will need to file Form 1065 by the 15th day of the third month or March 15, 2023.

- Jonetta's basis is: $400,000
- Shane's basis is: $205,000
- Partnership income: $180,000
- Partnership total expenses: $135,000
- Total net income of Partnership: $45,000
- Jonetta K-1 totals: $42,500
- Shane's K-1 totals: $22,500
- Jonetta: 42,500 x 92.3% = $39,227.50 subject to se tax x 15.3% =$6001,80 total tax
- Shane: $22,500 x 92.3% = $20767.50 subject to se tax x 15.3% =$3177.43 total tax

Karena is in the process of starting her own tax and accounting firm.

She incorporated as a Limited Liability Company with the state of Florida on August 30, 2023.

She wants greater liability protection due to the nature of her work. She purchases $250,000 in professional liability and errors and omissions insurance with The Hartford.

She plans on growing her firm to around $150,000 per year, and hire 2-3 staff to help with the tax and bookkeeping. She hopes to take home around $85,000 as a salary each year. She has no other growth plans for the firm.

<u>Analysis:</u>

- What business entity would you recommend for Karena?
- How would you elect this business entity if required?
- What tax form would need to be filed for this business entity?
- When would this tax return be due for this business entity?

Answer Sheet:

Because Karena wants greater protection we would generally recommend a S Corp or C Corp.

- However because she doesn't have any future growth plans and she wants to pay herself a salary of
- $85,000 I would recommend a S Corp. This way she avoids double taxation as a small business.
- We will file form 2553 to elect S Corp status
- We will file Form 1120 S
- Her S Corp return will be due by the 15th day of the third month or March 15, 2023

Jack and Jill, a tax exempt entity with a mission to provide educational support to high schools in underserved communities, received $1.2 million in contributions. The non-profit also had the following:

- Volunteer baked sale and earned $75,000
- Senior Bingo night and earned $5000
- Shopify store selling Jack and Jill T-shirts, mugs, and coffee: $175,000
- Provided day care services to its members and earned $8000

Analysis:

- What business entity would you recommend for Jack & Jill?
- How would you elect this business entity if they were just starting?
- What tax form would need to be filed for this business entity?
- When would this tax return be due for this business entity?
- What is the entity's total revenue?
- What is the entity's tax if any?

Answer Sheet

- **Jack and Jill is a non-profit therefore they should file**
- **990 (full version because they have gross revenue over $50k)**
- **We would use Form 1023 application for recognition of exemption**
- **to elect their 501(c)3 status**
- **Their form 990 would need to be filed by the 15th day of the 5th month, or May 15, 2023.**
- **Total revenue: $1,463,000 of which $175,000 would be Unrelated business income and subject to 21% flat tax.**
- **Their tax would be $36,750 (175k x 21%)**

Timothy and Terrill start a tech company that allows users to easily send money to friends, family and pay for services. They both have plans on raising $2 million in venture funding so that they can build the app and scale quickly. They incorporated as a Limited Liability Company (LLC) with the state of Delaware on January 1, 2023. Their goal is to grow the company to millions of dollars in revenue and eventually go public.

Analysis:

- What business entity would you recommend for Timothy and Terrill?
- How would you elect this business entity if required?
- What tax form would need to be filed for this business entity?
- When would this tax return be due for this business entity?
- What is the entity's tax rate if any?

Answer Sheet

- **We would recommend electing a C Corp as their Federal tax entity.**
- **We would file form 8832, entity classification election to make this election.**
- **They would need to file form 1120 and it is due the 15th day of the fourth month or April 15, 2023**
- **The tax rate for a C Corp is 21%**

Ascend Media an LLC formed in the state of California has been operating since 2023 and generates $85,000 in net revenue and has the following shareholders:

- Katrina a US citizen living in California
- Rita a Us citizen living in Maryland
- Asina a Canadian Citizen living in Toronto
- Hollis & Hollis a C Corporation in Delaware
- Zorski & Associates LLP

Analysis:

- What entity is Ascend Media?
- Why?

Answer Sheet:

Ascend media is a C Corporation because S Corps can not have foreign persons, corporations or partnerships as a shareholder.

Team Retro a calendar year corporation has the following:

- Generated $500,000 in gross revenue
- Expenses & Wages of $405,000
- Retained earnings: $90,000
- $315,000 in total assets

Team Retro needs to file their 2023 tax return.

Analysis:

- What form should Team Retro file?
- What Schedules would be required with this form?

Answer Sheet:

Team retro should file form 1120 and we will complete

- **Sch L (balance sheet because revenue or assets were over $250k)**
- **Sch M1 (because revenue and assets were over $250k)**
- **Sch M2 (because retained earnings)**

***Not M3 because assets were not over $10 million**

Since 2018 Farmer Joe has lived in Waco Texas. He has the following transactions occur for tax year 2023:

- He receives $150,000 crop insurance proceeds for drought
- He receives $500,000 government payment for livestock indemnity payment but refunds $75,000 back in overage
- He receives $85,000 flat fee for renting out his 25,000 sq. ft. chicken barnyard
- He receives $1,150,000 from Purdue Farms for rental of his crops and livestock located in Oklahoma
- He has property and equipment depreciation expense of $120,000
- He sells a tractor trailer for $100,000 with an adjusted basis of $35,000 and a FMV of $100,000
- He has a small nursery in Florida that he earns $18,000 for the year with $5500 in expenses

<u>Analysis:</u>

1. What form(s) must Farmer Joe file to report these transactions?

2. What is the total amount of income that is taxable if any for Self-Employment?

3. What is the total tax from SE tax if any?

Answer Sheet:

- **Forms F to report farming income and all other income from assistance received.**
- **Form 4835, for the income received from renting his farm to Purdue**
- **Sch E, to report the income from rental of his chicken barnyard**
- **Form 4797 to report the sell of the tractor**
- **Form 4562 to report depreciation**
- **Total income subject to SE: $587,500**
- **Total taxable income for SE: $542,262.50**
- **Total tax from SE: $82,966**