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SMALL BUSINESS TAXES 2021

For 2020 returns and year-round planning

#1 Small business income tax guide for 25 years

Includes tax changes from the SECURE Act and the CARES Act

Your Complete Guide to a Better Bottom Line

BARBARA WELTMAN

"The Guru of Small Business Taxes"—*The Wall Street Journal*

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Your Complete Guide to a Better Bottom Line

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WILEY

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data is available:

ISBN 978-1-119-74005-6 (paper)
ISBN 978-1-119-74006-3 (ePDF)
ISBN 978-1-119-74007-0 (ePub)

Cover design: Wiley

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Contents

Preface

The COVID-19 pandemic has changed everything. Many businesses struggled throughout 2020 and some have gone under because sales suffered following government-ordered social distancing and other rules designed to curtail the spread of the virus. It's an unprecedented disaster. In response to this situation, there have been various new tax rules created to directly and indirectly help small businesses weather the storm and be able to survive and reestablish business as usual.

More specifically, the Families First Coronavirus Response (FFCRA) Act was signed into law on March 20, 2020, and the Coronavirus Aid, Relief, and Economic Security (CARES) Act was signed into law on March 27, 2020. Both of these measures make some dramatic changes impacting small business taxes for 2020, as well as certain prior years. But this isn't all. At the end of 2019, the Further Consolidated Appropriations Act 2020 (which includes the Setting Every Community Up for Retirement Enhancement [SECURE] Act) was enacted; it was signed into law on December 20, 2019. This law impacts not only 2020 taxes, but also 2018 and 2019 years, as well as years beyond 2020. All of this is a lot to take in. It means small businesses can't rely on the tax rules they've become accustomed to. They need to become familiar with new rules to minimize 2020 taxes, figure estimated taxes for 2021, and obtain tax refunds from certain prior years.

The book also provides information about future changes scheduled to take effect in order to help you with business tax planning. Most importantly, it addresses the many tax questions I have received from readers as well as visitors to my website, www.BigIdeasForSmallBusiness.com.

This book focuses primarily on federal income taxes. Businesses may be required to pay and report many other taxes, including state income taxes, employment taxes, sales and use taxes, and excise taxes. Some information about these taxes is included in this book to alert you to your possible obligations so that you can then obtain further assistance if necessary. The book takes a holistic approach to taxes, showing you where applicable the ramifications that tax decisions can have on your business activities and your bottom line. Statistics, resources, and other materials are provided to help you better run your business by making good tax decisions and implementing sound business practices.

It is important to stay alert to future tax changes. Be sure to check on any final action before you take any steps that could be affected by these changes.

For a free supplement on tax developments after October 1, 2020, affecting small businesses (available in February 2021), go to www.jklasser.com or www.BigIdeasForSmallBusiness.com.

How to Use This Book

The purpose of this book is to make you acutely aware of how your actions in business can affect your bottom line from a tax perspective. The way you organize your business, the accounting method you select, and the types of payments you make all have an impact on when you report income and the extent to which you can take deductions. This book is not designed to make you a tax expert. It is strongly suggested that you consult with a tax adviser before making certain important decisions that will affect your ability to minimize your taxes (and Chapter 33 tells you how to work with a tax professional). I hope that the insight you gain from this book will allow you to ask your adviser key questions to benefit your business.

In Part 1, you will find topics of interest to all businesses. First, there is an overview of the various forms of business organization and an explanation of how these forms of organization affect personal liability for an owner as well as reporting of income and claiming tax deductions. Part 1 also explains tax years and accounting methods that businesses can select.

And it covers important recordkeeping requirements and suggestions to help you audit-proof your return to the extent possible and protect your deductions and tax credits. In the course of business you may incur certain expenses, but unless you have specific proof of those expenses, you may not be able to claim a deduction or credit. Learn how to keep the necessary records to back up your write-offs in the event your return is questioned by the IRS.

Part 2 details how to report various types of income your business may receive. Directions for reporting income in this part of the book as well as directions for reporting deductions and credits throughout the rest of the book for small business owners of pass-through entities are geared to Form 1040, *U.S. Individual Income Tax Return.* The same rules apply to Form 1040-SR, *U.S. Tax Return for Seniors*. In addition to fees and sales receipts—the bread-and-butter of your business—you may receive other types of ordinary income such as interest income, royalties, and rents. You may have capital gain transactions as well as sales of business assets. But you may also have losses—from operations or the sale of assets. Special rules govern the tax treatment of these losses. The first part of each topic in a chapter discusses the types of income or loss to report and special rules that affect them. Then scan the second part of each topic in a chapter, which explains where on the tax return to report the income or claim the loss.

Part 3 focuses on specific deductions and tax credits. It provides you with guidance on the various types of deductions you can use to reduce your business income, including the qualified business income (QBI) deduction for owners of pass-through entities. In the first part of each topic in a chapter, you will learn what the write-off is all about and any dollar limits or other special requirements that may apply. As with the income chapters, the second part of each topic chapter explains where on the tax return you can claim the write-off based on your form of business organization. The portion of the appropriate tax form or schedule is highlighted in certain instances. As a practical matter, returns prepared on a computer automatically populate the appropriate form or schedule, but it's helpful to see where your write-offs end up on the return. For your convenience, key tax forms for claiming these deductions have been included. While the forms and schedules are designed for the 2020 returns, they serve as an example for future years. Also, in Chapter 22, Miscellaneous Business Deductions, you will find checklists that serve as handy reference guides on all business deductions. The checklists are organized according to your status: self-employed, employee, or small corporation. You will also find a checklist of business expenses that are not deductible.

Part 4 contains planning ideas for your business. You will learn about strategies for deferring income, boosting deductions, starting up or winding down a business, running a sideline business, running multiple businesses, taking distributions, and avoiding audits. It also highlights the most common mistakes that business owners make in their returns, so by avoiding them you will not lose out on tax-saving opportunities. You will also find links to resources for tax assistance and planning purposes. And you will find information about other taxes on your business, including state income taxes, employment taxes, sales and use taxes, and excise taxes. Finally, you will see how to work with a tax professional and what to do if you are audited.

In Appendix A, you will find a listing of information returns you may be required to file with the IRS or other government agencies in conjunction with your tax obligations. These returns enable the federal government to crosscheck tax reporting and other financial information. Appendix B covers tax penalties that can apply if you fail to do something you were supposed to do, or if you do it wrong or do it late. Appendix C contains a checklist of tax-related corporate resolutions to help you keep your corporate minutes book up to date. Appendix D is a list of dollar limits and amounts in certain tax rules that are adjusted annually for inflation to help you plan ahead. Appendix E is a list of refund opportunities to which you may be entitled.

Several forms and schedules as well as excerpts from them have been included throughout the book to illustrate reporting rules. These forms are not to be used to file your return. (In many cases, the appropriate forms were not available when this book was published, and older or draft versions of the forms were included.) If you do not use software or a paid preparer to complete your return, you can obtain the forms you need from the IRS's website at https://www.irs.gov or where otherwise indicated.

Another way to stay abreast of tax and other small business developments that can affect your business throughout the year is by subscribing to *Barbara Weltman's Big Ideas for Small Business*®, a free online newsletter geared for small business owners and their professional advisers, and my "Idea of the Day®" (via e-mail) at www.BigIdeasForSmallBusiness.com. The Supplement to this book, which covers developments after October 1, 2020, can be found at www.jklasser.com and my website www.BigIdeasForSmallBusiness.com.

This book has been in print for more than 25 years and has tracked dramatic changes in tax law and business operations. For those who are using it for the first time, the book is a resource guide for handling taxes effectively as well as for making financial decisions and using business practices to increase your bottom line. For those who are perennial readers, you will see that while much in the book is unchanged, it has been updated and expanded to reflect changes from new laws, court decisions, and IRS pronouncements as well as my additional comments on tax strategies and business practices. For tax practitioners, I recognize that there are no citations, and that there are some issues that are unsettled. I invite your comments on any areas in which you disagree with my presentation and for ways to make improvements in future editions (send comments to Barbara@BigIdeasForSmallBusiness.com). I also recognize that more small businesses are going global and have to contend with foreign taxes and the implications on their U.S. returns, but the subject of foreign taxes is not fully addressed in this book.

I would like to thank Sidney Kess, Esq. and CPA, for his valuable suggestions in the preparation of the original tax deduction book and Elliott Eiss, Esq., for his expertise and constant assistance with this and other projects.

Barbara Weltman
October 2020

Introduction

Small businesses are vital to the U.S. economy. They account for 99.9% of all firms, employ nearly half of the country's private sector workforce, and contribute more than half of the nation's gross national product. Small businesses created 64.9% of all new jobs between 2000 and 2018 (the latest statistics).

Before the pandemic, there were more than 30 million pass-through entities—sole proprietorships, limited liability companies, partnerships, S corporations, and even C corporations. It's too early to know how many of these small businesses have closed for good, how many will re-open only to close in the next year or so, and how many new businesses will launch in the wake of COVID-19. But it's certain that interest in entrepreneurship won't be stopped. It's likely that the gig economy will expand and small businesses will continue to be present on Main Street, farms, homes, and anywhere else that a business can be found.

Small businesses fall under the purview of the Internal Revenue Service's (IRS) Small Business and Self-Employed Division (SB/SE). This division services approximately 57 million tax filers, including 47 million individuals filing Schedules C, E, or F, as well as (3.8 million partnerships and 6.8 million corporations with assets of $10 million or less), more than 41 million of whom are full-time or partially self-employed, and about 7 million filers of employment, excise, and certain other returns. The SB/SE division accounts for about 40% of the total federal tax revenues collected. The goal of this IRS division is customer assistance to help small businesses comply with the tax laws.

There is also an IRS Small Business and Self-Employed Tax Center at https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed where you'll find find special information for your industry—agriculture, automotive, child care, construction, entertainment, gaming, manufacturing, real estate, restaurants, retailers, veterinarians, and even tax professionals are already covered, and additional industries are set to follow. You can see the hot tax issues for your industry, find special audit guides that explain what the IRS looks for in your industry when examining returns, and links to other tax information.

As a small business owner, you work, try to grow your business, and hope to make a profit. What you can keep from that profit depends in part on the income tax you pay. The income tax applies to your net income rather than to your gross income or gross receipts. You are not taxed on all the income you bring in by way of sales, fees, commissions, or other payments. Instead, you are essentially taxed on what you keep after paying off the expenses of providing the services or making the sales that are the crux of your business. Deductions for these expenses operate to fix the amount of income that will be subject to tax. So deductions, in effect, help to determine the tax you pay and the profits you keep. And tax credits, the number of which has been expanded in recent years, can offset your tax to reduce the amount you ultimately pay.

Special Rules for Small Businesses

Sometimes it pays to be small. The tax laws contain a number of special rules exclusively for small businesses. But what is a small business? The average size of a small business in the United States is one with fewer than 20 employees with annual revenue under $2 million. The SBA usually defines small business by the number of employees—size standards range from 500 employees to 1,500 employees, depending on the industry or the SBA program. The SBA also uses revenue for certain business size standards (e.g., average annual gross receipts for many nonmanufacturing industries). Size matters because only "small businesses" can qualify for SBA-guaranteed loans and for special consideration with federal contracting.

Amazon said back in 2018 it had more than one million small business vendors, which it defined as having $7.5 million or less in annual revenue. Various employment law rules enforced by the U.S. Department of Labor base the definition of small employers on the number of employees. And banks use their own definition of "small business" for their loans and other offerings.

The bottom line is the fact there's no single definition of a small business. For federal tax purposes, the answer varies from rule to rule, as explained throughout this book. Sometimes, it depends on your revenues, the number of employees, or total assets. In Table I.1 are nearly 3 dozen definitions from the Internal Revenue Code on what constitutes a small business in 2020. You may be a small business for some tax rules but not for others.

TABLE I.1 Examples of Tax Definitions of Small Business

Tax Rule	Definition
Accrual method exception for small businesses (Chapter 2)	Average annual gross receipts of no more than $26 million in the 3 prior years (or number of years in business, if less)
Archer medical savings accounts (Chapter 19)	Fewer than 50 employees
Bad debts deducted on the nonaccrual-experience method (Chapter 11)	Average annual gross receipts for the 3 prior years of no more than $5 million
Building improvements safe harbor (Chapter 10)	Average annual gross receipts for the 3 prior years of no more than $10 million *and* building's unadjusted basis no greater than $1 million
Centralized audit regime for partnerships–election out (Chapter 33)	100 or fewer partners
Disabled access credit (Chapter 10)	Gross receipts of no more than $1 million in the preceding year or no more than 30 full-time employees
Employer mandate exemption from providing affordable health coverage	Fewer than 50 full-time/full-time equivalent employees
Estimated tax for C corporations based on prior year's return (Chapter 30)	Taxable income of less than $1 million in any of the 3 preceding years
Employer differential wage payments credit (Chapter 7)	Fewer than 50 employees
First-year expensing election (Chapter 14)	Qualified property for 2020 of no more than $3.63 million
Golden parachute payments exemption (Chapter 7)	100 or fewer shareholders
Independent contractor versus employee determination—shifting burden of proof to IRS (Chapter 7)	Net worth of business does not exceed $7 million
Interest deduction limit exemption (Chapter 13)	Average annual gross receipts of $26 million or less in the 3 prior years
Late filing penalty for failure to file information return—cap (Appendix B)	Average annual gross receipts of no more than $5 million for a 3-year period
Mandated paid family leave (Chapter 7)	Fewer than 500 employees
Mandated paid sick leave (Chapter 7)	Fewer than 500 employees
Qualified small employer health reimbursement arrangement (Chapter 19)	Fewer than 50 full time and full-time equivalent employees

TABLE I.1 *(Continued)*

Tax Rule	Definition
Reasonable compensation—shifting the burden of proof to the IRS (Chapter 7)	Net worth of business not in excess of $7 million
Recovery of legal fees from the government	Net worth less than $5 million and fewer than 500 employees at the time the action is filed
Repair regulations—deduction under safe harbor for items up to $2,500 per item or invoice (Chapter 10)	No applicable financial statement (SEC filing; audited financial statement)
Repair regulations—safe harbor not to capitalize improvements to buildings (Chapter 10)	Average annual gross receipts under $10 million and building has unadjusted basis under $1 million
Research credit–offset to AMT(Chapter 23)	Businesses with average annual gross receipts in the 3 prior years of $50 million or less
Research credit—offset to employer's Social Security taxes (Chapter 23)	Corporation or partnership with gross receipts of no more than $5 million for current year and no gross receipts during the 5-year period ending with the current year (similar for sole proprietors)
Retirement plan start-up credit (Chapter 16)	No more than 100 employees with compensation over $5,000 in the preceding year
Savings Incentive Match Plans for Employees (SIMPLE) plans (Chapter 16)	Self-employed or businesses with 100 or fewer employees who received at least $5,000 in compensation in the preceding year
Section 1244 losses (Chapter 5)	Equity of no more than $1 million at the time stock is issued
Simple cafeteria plans (Chapter 7)	100 or fewer employees on business days during either of the 2 preceding years
Simplified change in accounting for repair safe harbors (Chapter 10)	Total assets less than $10 million or average annual gross receipts in 3 prior years less than $10 million
Small business/self-employed (SB/SE) division of IRS	Self-employed individuals, plus corporations and partnerships with assets under $10 million
Small employer automatic enrollment credit (Chapter 16)	No more than 100 employees with compensation over $5,000 in the preceding year
Small employer health care credit (Chapter 19)	No more than 25 full-time equivalent employees
Small business stock—exclusion of gain on sale (Chapter 5)	Gross assets of no more than $50 million when the stock is issued and immediately after
UNICAP small reseller exception (Chapter 2)	Average annual gross receipts of no more than $26 million for a 3-year period
UNICAP simplified dollar value last-in, first-out (LIFO) method (Chapter 2)	Average annual gross receipts of no more than $5 million for a 3-year period

Reporting Income

Generally, all of the income your business receives is taxable unless there is a specific tax rule that allows you to exclude the income permanently or defer it to a future time.

When you report income depends on your method of accounting. *How* and *where* you report income depends on the nature of the income and your type of business organization.

The IRS reported a “tax gap” (the spread between revenues that should be collected and what actually is collected) of $441 billion a year and that a great portion of this can be traced to entrepreneurs who underreport or don’t report their income, overstate their deductions, or fail to pay self-employment tax where warranted. While audit rates have recently been at historic lows and budgetary concerns make this unlikely to change any time soon, the IRS continues to look carefully at self-employed individuals in an attempt to detect intentional or unintentional reporting errors.

Claiming Deductions

You pay tax only on your profits, not on what you take in (gross receipts). In order to arrive at your profits, you are allowed to subtract certain expenses from your income. These expenses are called “deductions.”

The law says what you can and cannot deduct (see below). Within this framework, the nature and amount of the deductions you have often vary with the size of your business, the industry you are in, where you are based in the country, and other factors. The most common deductions for businesses include car and truck expenses, utilities, supplies, legal and professional services, insurance, depreciation, taxes, meals, advertising, repairs, travel, rent for business property and equipment, and in many cases, a home office.

What Is the Legal Authority for Claiming Deductions?

Deductions are a legal way to reduce the amount of your business income subject to tax. But there is no constitutional right to tax deductions. Instead, deductions are a matter of legislative grace; if Congress chooses to allow a particular deduction, so be it. Therefore, deductions are carefully spelled out in the Internal Revenue Code (the Code).

The language of the Code in many instances is rather general. It may describe a category of deductions without getting into specifics. For example, the Code contains a general deduction for all *ordinary and necessary* business expenses, without explaining what constitutes these expenses. Over the years, the IRS and the courts have worked to flesh out what business expenses are ordinary and necessary. “Ordinary” means common or accepted in business and “necessary” means appropriate and helpful in developing and maintaining a business; it does not mean essential. The IRS and the courts often reach different conclusions about whether an item meets this definition and is deductible, leaving the taxpayer in a somewhat difficult position. If the taxpayer uses a more favorable court position to claim a deduction, the IRS may very well attack the deduction in the event that the return is examined. This puts the taxpayer in the position of having to incur legal expenses to bring the matter to court. However, if the taxpayer simply follows the IRS approach, a good opportunity to reduce business income by means of a deduction will have been missed. Throughout this book, whenever unresolved questions remain about a particular deduction, both sides have been explained. The choice is up to you and your tax adviser.

Sometimes, the Code is very specific about a deduction, such as an employer's right to deduct employment taxes. Still, even where the Code is specific and there is less need for clarification, disputes about applicability or terminology may still arise. Again, the IRS and the courts may differ on the proper conclusion. It will remain for you and your tax adviser to review the different authorities for the positions stated and to reach your own conclusions based on the strength of the different positions and the amount of tax savings at stake.

A word about authorities for the deductions discussed in this book: There are a number of sources for these write-offs in addition to the Internal Revenue Code. These sources include court decisions from the U.S. Tax Court, the U.S. district courts and courts of appeal, the U.S. Court of Federal Claims, and the U.S. Supreme Court. There are also regulations issued by the Treasury Department to explain sections of the Internal Revenue Code. The IRS issues a number of pronouncements, including Revenue Rulings and Revenue Procedures, which are official IRS positions, was well as Notices, Announcements, and News Releases, which carry less weight. The IRS also issues private letter rulings, determination letters, field service advice, and technical advice memoranda. While these private types of pronouncements cannot be cited as authority by a taxpayer other than the one for whom the pronouncement was made, they are important nonetheless. They serve as an indication of IRS thinking on a particular topic, and it is often the case that private letter rulings on topics of general interest later get restated in revenue rulings. And sometimes the IRS simply posts information on its website, in the form of Frequently Asked Questions (FAQs) or other pronouncement, that is helpful in understanding the IRS position on a matter.

What Is a Tax Deduction Worth to You?

The answer depends on your tax bracket. The tax bracket is dependent on the way you organize your business. If you are self-employed and in the top tax bracket of 37% in 2020, then each $100 deduction will save you $37. Had you not claimed this deduction, you would have had to pay $37 of tax on that $100 of income that was offset by the deduction. For C corporations, there is a flat rate of 21%. This means that the corporation is in the 21% tax bracket. Thus, each $100 deduction claimed saves $21 of tax on the corporation's income. Deductions are even more valuable if your business is in a state that imposes income tax. The details of state income taxes are not discussed in this book. However, you should explore the tax rules in your state and ascertain their impact on your business income.

When Do You Claim Deductions?

Like the timing of income, the timing of deductions—when to claim them—is determined by your tax year and method of accounting. Your form of business organization affects your choice of tax year and your accounting method.

Even when expenses are deductible, there may be limits on the timing of those deductions. Most common expenses are currently deductible in full. However, some expenses must be capitalized or amortized, or you must choose between current deductibility and capitalization. Capitalization generally means that costs can be written off ratably as amortized expenses or depreciated over a period of time. (Capitalized costs, such as for the purchase of machinery and equipment, are added to the balance sheet as company assets.) Amortized expenses include, for example, fees to incorporate a business and expenses to organize a new business. Certain capitalized costs may not be deductible at all, but are treated as an additional cost of an asset (*basis*).

Some expenses, even though related to business and not incurred but for business, are not deductible. The tax law specifically bars deductions for certain expenses (e.g., entertainment costs, transportation fringe benefits). And no deduction is allowed for personal expenses that are business-related, such as commuting costs. These nondeductible expenses are pointed out throughout the book.

Credits versus Deductions

Not all write-offs of business expenses are treated as deductions. Some can be claimed as tax credits. A tax credit is worth more than a deduction since it reduces your taxes dollar for dollar. Like deductions, tax credits are available only to the extent that Congress allows. In a couple of instances, you have a choice between treating certain expenses as a deduction or a credit. In most cases, however, tax credits can be claimed for certain expenses for which no tax deduction is provided. Most business tax credits are offsets for income taxes, but some reduce employment taxes.

Tax Responsibilities

As a small business owner, your obligations taxwise are broad. Not only do you have to pay income taxes and file income tax returns, but you must also manage payroll taxes if you have any employees. You may also have to collect and report on state and local sales taxes. Some businesses, such as farms, may have excise tax responsibilities. Finally, you may have to notify the IRS of certain activities on information returns.

It is very helpful to keep an eye on the tax calendar so you will not miss out on any payment or filing deadlines, which can result in interest and penalties. You might want to view the IRS's *Tax Calendar for Businesses and Self-Employed* (go to https://www.irs.gov/businesses/small-businesses-self-employed/irs-tax-calendar-for-businesses-and-self-employed).

Should you need them, you can obtain most federal tax forms online at https://www.irs.gov. Nonscannable forms, which cannot be downloaded from the IRS, can be ordered by calling toll free at 800-829-4933 during normal business hours.

PART 1

Organization

CHAPTER 1

Business Organization

If you have a great idea for a product or a business and are eager to get started, do not let your enthusiasm be the reason you get off on the wrong foot. Take awhile to consider how you will organize your business. The form of organization your business takes controls how income and deductions are reported to the government on a tax return. Sometimes you have a choice of the type of business organization; other times, circumstances limit your choice. If you have not yet set up your business and do have a choice, this discussion will influence your decision on business organization. If you have already set up your business, you may want to consider changing to another form of organization.

According to the Tax Foundation, 92% of all businesses in the United States are organized as sole proprietorships, partnerships, limited liability companies (LLCs), or S corporations, all of which are "pass-through" entities. This means that the owners, rather than the businesses, pay tax on business income. Nearly 50% of the private sector workforce is employed by these pass-through entities.

The way in which you set up your business impacts the effective tax rate you pay on your profits. Taxes, however, are only one factor in deciding what type of entity to use for your business.

As you organize your business, consider which type of entity to use after factoring in taxes (federal and state) and other consequences. This is especially important in light of tax changes in the Tax Cuts and Jobs Act. Also consider whether to change from your current form of business entity to a new one and what it means from a tax perspective, which is discussed later in this chapter. Finally, be sure to obtain your business's federal tax identification number or a new one when making certain entity changes (explained in Chapter 25).

Sole Proprietorships

If you go into business for yourself and do not have any partners (with the exception of a spouse, as explained shortly), you are considered a *sole proprietor*, and your business is called a *sole proprietorship*. You may think that the term *proprietor* connotes a storekeeper. For purposes of tax treatment, however, proprietor means any unincorporated business owned entirely by one person. Thus, the category includes individuals in professional practice, such as doctors, lawyers, accountants, and architects. Those who are experts in an area, such as engineering, public relations, or computers, may set up their own consulting businesses and fall under the category of sole proprietor. The designation also applies to independent contractors. Other terms used for sole proprietors include freelancers, solopreneurs, and consultants. And it includes "dependent contractors": self-employed individuals who provide all (or substantially all) of their services for one company (often someone laid off or retired from a corporate job who is then engaged to provide nonemployee services for the same corporation). Further, it includes those working in the gig economy through such online platforms as Uber, Lyft, HopSkipDrive, TaskRabbit, Takl, and Upwork (although some workers for these companies are claiming to be employees and courts are reviewing their worker status as well as state laws, such as California's ABC test, treating these workers as employees).

Sole proprietorships are the most common form of business. The IRS reports that one in 6 Form 1040 or 1040-SR contains a Schedule C (the forms used by sole proprietorships). Most sideline businesses are run as sole proprietorships, and many start-ups commence in this business form.

There are no formalities required to become a sole proprietor; you simply conduct business. You may have to register your business with your city, town, or county government by filing a simple form stating that you are doing business as the "Quality Dry Cleaners" or some other business name other than your own (a fictitious business name, or FBN). This is sometimes referred to as a DBA, which stands for "doing business as."

From a legal standpoint, as a sole proprietor, you are personally liable for any debts your business incurs. For example, if you borrow money and default on a loan, the lender can look not only to your business equipment and other business property but also to your personal stocks, bonds, and other property. Some states may give your house homestead protection; state or federal law may protect your pensions and even Individual Retirement Accounts (IRAs). Your only protection for your other personal assets is adequate insurance against accidents for your business and other liabilities and paying your debts in full.

Simplicity is the advantage to this form of business. This form of business is commonly used for sideline ventures, as evidenced by the fact that half of all sole proprietors earn salaries and wages along with their business income. For 2017 (the most recent year for statistics), more than 26.4 million taxpayers filed returns as sole proprietors.

Independent Contractors

One type of sole proprietor is the *independent contractor*. To illustrate, suppose you used to work for Corporation X. You have retired, but X gives you a consulting contract under which you provide occasional services to X. In your retirement, you decide to provide consulting services not only to X, but to other customers as well. You are now a consultant. You are an independent contractor to each of the companies for which you provide services. Similarly, you have a full-time job but earn extra money by doing graphic design work through Fiverr. Here too you are an independent contractor.

More precisely, an independent contractor or freelancer is an individual who provides services to others outside an employment context. The provision of services becomes a business, an independent calling. In terms of claiming business deductions, classification as an independent contractor is generally more favorable than classification as an employee. (See "Tax Treatment of Income and Deductions in General," later in this chapter.) Therefore, many individuals whose employment status is not clear may wish to claim independent contractor status. Also, from the employer's perspective, hiring independent contractors is more favorable because the employer is not liable for employment taxes and need not provide employee benefits. (It costs about 30% more for an employee than an independent contractor after factoring in employment taxes, workers' compensation and other insurance, and benefits.) Federal employment taxes include Social Security and Medicare taxes under the Federal Insurance Contribution Act (FICA) as well as unemployment taxes under the Federal Unemployment Tax Act (FUTA).

You should be aware that the Internal Revenue Service (IRS) aggressively tries to reclassify workers as employees in order to collect employment taxes from employers. And states do so as well to see that workers are covered by unemployment insurance and workers' compensation. A discussion about worker classification can be found in Chapter 7.

There is a distinction that needs to be made between the classification of a worker for income tax purposes and the classification of a worker for employment tax purposes. By statute, certain employees are treated as independent contractors for employment taxes even though they continue to be treated as employees for income taxes. Other employees are treated as employees for employment taxes even though they are independent contractors for income taxes.

There are 2 categories of employees that are, by statute, treated as non-employees for purposes of federal employment taxes. These 2 categories are real estate salespersons and direct sellers of consumer goods. These employees are considered independent contractors (the ramifications of which are discussed later in this chapter). Such workers are deemed independent contractors if at least 90% of the employees' compensation is determined by their output. In other words, they are independent contractors if they are paid by commission and not a fixed salary. They must also perform their services under a written contract that specifies they will not be treated as employees for federal employment tax purposes.

Statutory Employees

Some individuals who consider themselves to be in business for themselves—reporting their income and expenses as sole proprietors—may still be treated as employees for purposes of employment taxes. As such, Social Security and Medicare taxes are withheld from their compensation. These individuals include:

- Corporate officers
- Agent-drivers or commission-drivers engaged in the distribution of meat products, bakery products, produce, beverages other than milk, laundry, or dry-cleaning services
- Full-time life insurance salespersons
- Homeworkers who personally perform services according to specifications provided by the service recipient
- Traveling or city salespersons engaged on a full-time basis in the solicitation of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar businesses

Full-time life insurance salespersons, homeworkers, and traveling or city salespersons are exempt from FICA if they have made a substantial investment in the facilities used in connection with the performance of services. But they'll have to pay Social Security and Medicare taxes through self-employment tax on their net earnings.

Day Traders

Traders in securities may be viewed as being engaged in a trade or business in securities if they seek profit from daily market movements in the prices of securities (rather than from dividends, interest, and long-term appreciation) and these activities are substantial, continuous, and regular. Calling yourself a day trader does not make it so; your activities must speak for themselves.

Being a trader means you report your trading expenses on Schedule C, such as subscriptions to publications and online services used in this securities business. Investment interest can be reported on Schedule C (it is not subject to the net investment income limitation that otherwise applies to individuals).

Being a trader means income is reported in a unique way—income from trading is *not* reported on Schedule C. Gains and losses are reported on Schedule D unless you make a mark-to-market election. If so, then income and losses are reported on Form 4797. The mark-to-market election is explained in Chapter 2.

Gains and losses from trading activities are not subject to self-employment tax (with or without the mark-to-market election).

Spousal Joint Ventures

Usually when 2 or more people co-own a business, they are in partnership. However, spouses who co-own a business and file jointly and conduct a joint venture can opt *not* to be treated as a partnership, which requires filing a partnership return (Form 1065) and reporting 2 Schedule K-1s (as explained later in this chapter). Instead, these "couplepreneurs" each report their share of income on 2 Schedule Cs attached to the couple's Form 1040 or 1040-SR. To qualify for this election, each must materially participate in the business (neither can be a silent partner), and there can be no other co-owners. Making this election simplifies reporting while ensuring that each spouse receives credit for paying Social Security and Medicare taxes.

One-Member Limited Liability Companies

Every state allows a single owner to form a limited liability company (LLC) under state law. From a legal standpoint, an LLC gives the owner protection from personal liability (only business assets are at risk from the claims of creditors) as explained later in this chapter. But from a tax standpoint, a single-member LLC is treated as a "disregarded entity." If the owner is an individual (and not a corporation), all of the income and expenses of the LLC are reported on Schedule C of the owner's Form 1040 or 1040-SR. In other words, for federal income tax purposes, the LLC is treated just like a sole proprietorship.

SCHEDULE C (Form 1040) Department of the Treasury Internal Revenue Service (99)	**Profit or Loss From Business** (Sole Proprietorship) ► Go to *www.irs.gov/ScheduleC* for instructions and the latest information. ► Attach to Form 1040, 1040-SR, 1040-NR, or 1041; partnerships generally must file Form 1065.	OMB No. 1545-0074 2020 Attachment Sequence No. 09

Name of proprietor | **Social security number (SSN)**

A Principal business or profession, including product or service (see instructions) | **B Enter code from instructions** ►

C Business name. If no separate business name, leave blank. | **D Employer ID number (EIN)** (see instr.)

E Business address (including suite or room no.) ►

City, town or post office, state, and ZIP code

F Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ►

G Did you "materially participate" in the operation of this business during 2020? If "No," see instructions for limit on losses . ☐ Yes ☐ No

H If you started or acquired this business during 2020, check here . . . . ► ☐

I Did you make any payments in 2020 that would require you to file Form(s) 1099? See instructions . . . ☐ Yes ☐ No

J If "Yes," did you or will you file required Form(s) 1099? . . . ☐ Yes ☐ No

Part I Income

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked . . . ► ☐	1	
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	
4	Cost of goods sold (from line 42)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7	**Gross income.** Add lines 5 and 6 . . . ►	7	

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8		18	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	
				20	Rent or lease (see instructions):		
10	Commissions and fees	10		a	Vehicles, machinery, and equipment	20a	
11	Contract labor (see instructions)	11		b	Other business property	20b	
12	Depletion	12		21	Repairs and maintenance	21	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13		22	Supplies (not included in Part III)	22	
				23	Taxes and licenses	23	
				24	Travel and meals:		
14	Employee benefit programs (other than on line 19)	14		a	Travel	24a	
15	Insurance (other than health)	15		b	Deductible meals (see instructions)	24b	
16	Interest (see instructions):			25	Utilities	25	
a	Mortgage (paid to banks, etc.)	16a		26	Wages (less employment credits)	26	
b	Other	16b		27a	Other expenses (from line 48)	27a	
17	Legal and professional services	17		b	**Reserved for future use**	27b	

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27a . . . ►	28	
29	Tentative profit or (loss). Subtract line 28 from line 7	29	
30	Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method. See instructions. **Simplified method filers only:** Enter the total square footage of (a) your home: ______ and (b) the part of your home used for business: ______ . Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Schedule 1 (Form 1040), line 3,** and on **Schedule SE, line 2**. (If you checked the box on line 1, see instructions). Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32.	31	
32	If you have a loss, check the box that describes your investment in this activity. See instructions. • If you checked 32a, enter the loss on both **Schedule 1 (Form 1040), line 3**, and on **Schedule SE, line 2.** (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on **Form 1041, line 3.** • If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.	32a ☐ All investment is at risk. 32b ☐ Some investment is not at risk.	

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11334P **Schedule C (Form 1040) 2020**

FIGURE 1.1 Schedule C, Profit or Loss From Business

The owner can elect to have the LLC taxed as a corporation, but this is not typical. An election made to be taxed as a corporation can be followed by an S election, so that the owner can make tax payments through wage withholding rather than making estimated tax payments, as well as minimize Social Security and Medicare taxes.

Schedule C (Form 1040) 2020 Page 2

Part III **Cost of Goods Sold** (see instructions)

33	Method(s) used to value closing inventory: **a** ☐ Cost **b** ☐ Lower of cost or market **c** ☐ Other (attach explanation)		
34	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation . . . ☐ **Yes** ☐ **No**		
35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation . . .	35	
36	Purchases less cost of items withdrawn for personal use . . .	36	
37	Cost of labor. Do not include any amounts paid to yourself . . .	37	
38	Materials and supplies . . .	38	
39	Other costs . . .	39	
40	Add lines 35 through 39 . . .	40	
41	Inventory at end of year . . .	41	
42	**Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on line 4 . . .	42	

Part IV **Information on Your Vehicle.** Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month/day/year) ▶ / /

44 Of the total number of miles you drove your vehicle during 2020, enter the number of miles you used your vehicle for:

a Business ______ **b** Commuting (see instructions) ______ **c** Other ______

45 Was your vehicle available for personal use during off-duty hours? . . . ☐ **Yes** ☐ **No**

46 Do you (or your spouse) have another vehicle available for personal use? . . . ☐ **Yes** ☐ **No**

47a Do you have evidence to support your deduction? . . . ☐ **Yes** ☐ **No**

b If "Yes," is the evidence written? . . . ☐ **Yes** ☐ **No**

Part V **Other Expenses.** List below business expenses not included on lines 8–26 or line 30.

48 **Total other expenses.** Enter here and on line 27a . . .	48	

Schedule C (Form 1040) 2020

FIGURE 1.1 *(Continued)*

Tax Treatment of Income and Deductions in General

Sole proprietors, including independent contractors and statutory employees, report their income and deductions on Schedule C, see *Profit or Loss From Business* (Figure 1.1). The net amount (profit or loss after offsetting income with deductions) is then reported on Schedule 1 of Form 1040 or 1040-SR.

In the past, some individuals were able to use a simplified form for reporting business income and deductions: Schedule C-EZ, *Net Profit From Business*, but this form is no longer in use. Individuals engaged in farming activities report business income and deductions on Schedule F, *Profit or Loss from Farming*, the net amount of which is then reported on Schedule 1 of Form 1040 or 1040-SR. Individuals who are considered employees cannot use Schedule C to report their income and claim deductions. See page 31 for the tax treatment of income and deductions by employees.

In effect, a sole proprietor pays tax on business profits using tax rates for individuals; there is no separate tax rate for a sole proprietorship. The top rate for an individual in 2020 is 37%, although the sole proprietor may be able to claim a 20% qualified business income deduction on his or her personal return to reduce the effective tax rate on their profits (see Chapter 21).

Partnerships and Limited Liability Companies

If you go into business with others, then you cannot be a sole proprietor (with the exception of a spousal joint venture, explained earlier). You are automatically in a *partnership* if you join together with one or more people to share the profits of the business, even if you take no formal action. Owners of a partnership are called *partners*.

There are 2 types of partnerships: *general partnerships* and *limited partnerships*. In general partnerships, all of the partners are personally liable for the debts of the business. Creditors can go after the personal assets of any and all of the partners to satisfy partnership debts. In limited partnerships (LPs), only the general partners are personally liable for the debts of the business. Limited partners are liable only to the extent of their investments in the business plus their share of recourse debts and obligations to make future investments. Some states allow LPs to become limited liability limited partnerships (LLLPs) to give general partners personal liability protection with respect to the debts of the partnership.

Example

If a partnership incurs debts of $10,000 (none of which are recourse), a general partner is liable for the full $10,000. A limited partner who initially contributed $1,000 to the limited partnership is liable only to that extent. He or she can lose the $1,000 investment, but creditors cannot go after personal assets.

General partners are jointly and severally liable for the business's debts. This means that a creditor can go after any one partner for the full amount of the debt. That partner can seek to recoup a proportional share of the debt from other partner(s).

Partnerships can be informal agreements to share profits and losses of a business venture. More typically, however, they are organized with formal partnership agreements. These agreements detail how income, deductions, gains, losses, and credits are to be split (if there are any special allocations to be made) and what happens on the retirement, disability, bankruptcy, or death of a partner. A limited partnership must have a partnership agreement that complies with state law requirements.

Another form of organization that can be used by those joining together for business is a limited liability company (LLC). This type of business organization is formed under state law in which all owners are given limited liability. Owners of LLCs are called *members*. Every state has LLC statutes to permit the formation of an LLC within its boundaries. Most states also permit limited liability partnerships (LLPs)—LLCs for accountants, attorneys, doctors, and other professionals—which are easily established by existing partnerships filing an LLP election with the state. A partner in an LLP has personal liability protection with respect to the firm's debts, but remains personally liable for his or her professional actions.

Alabama, Delaware, District of Columbia, Illinois, Indiana, Iowa, Kansas, Missouri, Montana, Nebraska, Nevada, North Dakota, Oklahoma, Tennessee, Texas, Utah, Virginia (as of 2020), Wisconsin (to a limited extent), and Wyoming permit multiple LLCs to operate under a single LLC umbrella called a "series LLC" (each LLC is called a "cell"). (California and some other states don't allow the formation of a series LLC but permit one formed in another state to register and do business in the state.) The rules are not uniform in all of these states. If you are in a state that does not have a law for series LLC, in most but not all states you can form the series in Delaware, for example, and then register to do business in your state. The debts and liabilities of each LLC remain separate from those of the other LLCs, something that is ideal for those owning several pieces of real estate—each can be owned by a separate LLC under the master LLC as long as each LLC maintains separate bank accounts and financial records. At present, state law is evolving to determine the treatment of LLCs formed in one state but doing business in another.

As the name suggests, the creditors of LLCs can look only to the assets of the company to satisfy debts; creditors cannot go after members and hope to recover their personal assets.

Tax Treatment of Income and Deductions in General

Partnerships are *pass-through* entities. They are not separate taxpaying entities; instead, they pass income, deductions, gains, losses, and tax credits through to their owners. (Partnerships only become taxpayers if they are

NOTE

K-1s can be distributed to partners electronically if the partnership has the partners' consent. Obtain consent by sending instructions to partners on how to obtain, complete, and submit a consent form to the partnership.

audited under the Bipartisan Budget Act regime explained in Chapter 33 and don't opt to push out tax resulting from the audit to partners.) Nearly 4 million partnership returns were filed in the government's 2019 fiscal year. Of these, more than two-thirds were limited liability companies, representing the most prevalent type of entity filing a partnership return; more common than general partnerships or limited partnerships. The owners report these amounts on their individual returns. Owners may be able to claim a 20% qualified business income deduction on their personal returns to reduce the effective rate levied on business profits. While the entity does not pay taxes (except to the extent of certain adjustments following an audit as explained in Chapter 33), it must file an information return with IRS Form 1065, *U.S. Return of Partnership Income*, to report the total pass-through amounts. Even though the return is called a *partnership return*, it is the same return filed by LLCs with 2 or more owners who do not elect to be taxed as a corporation. The entity also completes Schedule K-1 of Form 1065, see Figure 1.2, a copy of which is given to each owner to allocate the share of partnership/LLC amounts. Like W-2 forms used by the IRS to match employees' reporting of their compensation, the IRS employs computer matching of Schedules K-1 to ensure that owners are properly reporting their share of their business's income.

For federal income tax purposes, LLCs are treated like partnerships unless the members elect to have the LLCs taxed as corporations. This is done on IRS Form 8832, *Entity Classification Election*. See Figure 1.3. For purposes of our discussion throughout this book, it will be assumed that LLCs have not chosen corporate tax treatment and so are taxed the same way as partnerships.

A single-member LLC is treated for tax purposes like a sole proprietor if it is owned by an individual who reports the company's income and expenses on his or her Schedule C. Under regulations proposed in 2010, for federal tax purposes a series LLC is treated as an entity formed under local law, whether or not local law treats the series as a separate legal entity. The tax treatment of the series is then governed by the check-the-box rules.

There are 2 types of items that pass through to an owner: trade or business income or loss and separately stated items. A partner's or member's share is called the *distributive share*. Trade or business income or loss takes into account most ordinary deductions of the business—compensation to employees (non-partners), rent, taxes, interest, and so forth. Guaranteed payments to an owner are also taken into account when determining ordinary income or loss. From an owner's perspective, deductions net out against income from the business, and the owner's allocable share of the net amount is then reported on the

651119

☐ Final K-1 ☐ Amended K-1

OMB No. 1545-0123

Schedule K-1 (Form 1065) **2020**

Department of the Treasury
Internal Revenue Service

For calendar year 2020, or tax year

beginning / / 2020 ending / /

Partner's Share of Income, Deductions, Credits, etc. ► See separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number

B Partnership's name, address, city, state, and ZIP code

C IRS Center where partnership filed return ►

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.

G ☐ General partner or LLC member-manager ☐ Limited partner or other LLC member

H1 ☐ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:

TIN ______ Name ______

I1 What type of entity is this partner? ______

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

Check if decrease is due to sale or exchange of partnership interest . . ☐

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . .	$	$
Qualified nonrecourse financing . . .	$	$
Recourse . . .	$	$

☐ Check this box if Item K includes liability amounts from lower tier partnerships.

L **Partner's Capital Account Analysis**

Beginning capital account . . . $______
Capital contributed during the year . . $______
Current year net income (loss) . . . $______
Other increase (decrease) (attach explanation) $______
Withdrawals & distributions . . . $ ( )
Ending capital account . . . . $______

M Did the partner contribute property with a built-in gain or loss?
☐ **Yes** ☐ **No** If "Yes," attach statement. See instructions.

N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**
Beginning . . . . $______
Ending . . . . $______

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1 Ordinary business income (loss)
2 Net rental real estate income (loss)
3 Other net rental income (loss)
4a Guaranteed payments for services
4b Guaranteed payments for capital
4c Total guaranteed payments
5 Interest income
6a Ordinary dividends
6b Qualified dividends
6c Dividend equivalents
7 Royalties
8 Net short-term capital gain (loss)
9a Net long-term capital gain (loss)
9b Collectibles (28%) gain (loss)
9c Unrecaptured section 1250 gain
10 Net section 1231 gain (loss)
11 Other income (loss)
12 Section 179 deduction
13 Other deductions
14 Self-employment earnings (loss)
15 Credits
16 Foreign transactions
17 Alternative minimum tax (AMT) items
18 Tax-exempt income and nondeductible expenses
19 Distributions
20 Other information

21 ☐ More than one activity for at-risk purposes*
22 ☐ More than one activity for passive activity purposes*

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R **Schedule K-1 (Form 1065) 2020**

FIGURE 1.2 Schedule K-1, Partner's Share of Income, Deductions, Credits, etc.

Form **8832**
(Rev. December 2013)
Department of the Treasury
Internal Revenue Service

Entity Classification Election

► Information about Form 8832 and its instructions is at *www.irs.gov/form8832*.

OMB No. 1545-1516

Type or Print	Name of eligible entity making election	**Employer identification number**
	Number, street, and room or suite no. If a P.O. box, see instructions.	
	City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code.	

► Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41
☐ Relief for a late change of entity classification election sought under Revenue Procedure 2010-32

Part I **Election Information**

1 **Type of election** (see instructions):

a ☐ Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
b ☐ Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

☐ **Yes.** Go to line 2b.
☐ **No.** Skip line 2b and go to line 3.

2b Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

☐ **Yes.** Go to line 3.
☐ **No.** Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?

☐ **Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
☐ **No.** You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:

a Name of owner ► ....
b Identifying number of owner ► ....

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

a Name of parent corporation ► ....
b Employer identification number ► ....

For Paperwork Reduction Act Notice, see instructions. Cat. No. 22598R Form **8832** (Rev. 12-2013)

FIGURE 1.3 Form 8832, Entity Classification Election

Form 8832 (Rev. 12-2013) Page 2

Part I **Election Information** (Continued)

6 **Type of entity** (see instructions):

a ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.
b ☐ A domestic eligible entity electing to be classified as a partnership.
c ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
d ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
e ☐ A foreign eligible entity electing to be classified as a partnership.
f ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ▶

8 Election is to be effective beginning (month, day, year) (see instructions) . . . . ▶

9 Name and title of contact person whom the IRS may call for more information

10 Contact person's telephone number

Consent Statement and Signature(s) (see instructions)

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

Signature(s)	Date	Title

Form 8832 (Rev. 12-2013)

FIGURE 1.3 *(Continued)*

SCHEDULE E (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)
▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041.
▶ Go to *www.irs.gov/ScheduleE* for instructions and the latest information.

OMB No. 1545-0074
2020
Attachment Sequence No. 13

Name(s) shown on return | **Your social security number**

Part I **Income or Loss From Rental Real Estate and Royalties** **Note:** If you are in the business of renting personal property, use **Schedule C.** See instructions. If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2020 that would require you to file Form(s) 1099? See instructions . . . . . ☐ **Yes** ☐ **No**
B If "Yes," did you or will you file required Form(s) 1099? . . . . ☐ **Yes** ☐ **No**

1a	Physical address of each property (street, city, state, ZIP code)
A	
B	
C	

1b	Type of Property (from list below)	**2** For each rental real estate property listed above, report the number of fair rental and personal use days. Check the **QJV** box only if you meet the requirements to file as a qualified joint venture. See instructions.		**Fair Rental Days**	**Personal Use Days**	**QJV**
A			**A**			☐
B			**B**			☐
C			**C**			☐

Type of Property:
1 Single Family Residence
2 Multi-Family Residence
3 Vacation/Short-Term Rental
4 Commercial
5 Land
6 Royalties
7 Self-Rental
8 Other (describe)

Income:	**Properties:**		**A**	**B**	**C**
3	Rents received	**3**			
4	Royalties received	**4**			
Expenses:					
5	Advertising	**5**			
6	Auto and travel (see instructions)	**6**			
7	Cleaning and maintenance	**7**			
8	Commissions.	**8**			
9	Insurance	**9**			
10	Legal and other professional fees	**10**			
11	Management fees	**11**			
12	Mortgage interest paid to banks, etc. (see instructions)	**12**			
13	Other interest.	**13**			
14	Repairs.	**14**			
15	Supplies	**15**			
16	Taxes	**16**			
17	Utilities.	**17**			
18	Depreciation expense or depletion	**18**			
19	Other (list) ▶	**19**			
20	Total expenses. Add lines 5 through 19	**20**			
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file **Form 6198**	**21**			
22	Deductible rental real estate loss after limitation, if any, on **Form 8582** (see instructions)	**22**	( )	( )	( )

23a	Total of all amounts reported on line 3 for all rental properties	**23a**	
b	Total of all amounts reported on line 4 for all royalty properties	**23b**	
c	Total of all amounts reported on line 12 for all properties	**23c**	
d	Total of all amounts reported on line 18 for all properties	**23d**	
e	Total of all amounts reported on line 20 for all properties	**23e**	
24	**Income.** Add positive amounts shown on line 21. **Do not** include any losses	**24**	
25	**Losses.** Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here .	**25**	( )
26	**Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 2 .	**26**	

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11344L **Schedule E (Form 1040) 2020**

FIGURE 1.4 Schedule E

Schedule E (Form 1040) 2020 Attachment Sequence No. 13 Page 2

Name(s) shown on return. Do not enter name and social security number if shown on other side. | Your social security number

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II **Income or Loss From Partnerships and S Corporations** – **Note:** If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column **(e)** on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column **(f)** on line 28 and attach **Form 6198.** See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section . . . . . ☐ **Yes** ☐ **No**

28	**(a)** Name	**(b)** Enter **P** for partnership; **S** for S corporation	**(c)** Check if foreign partnership	**(d)** Employer identification number	**(e)** Check if basis computation is required	**(f)** Check if any amount is not at risk
A			☐		☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

	Passive Income and Loss		Nonpassive Income and Loss		
	(g) Passive loss allowed (attach **Form 8582** if required)	**(h)** Passive income from **Schedule K-1**	**(i)** Nonpassive loss allowed (see **Schedule K-1**)	**(j)** Section 179 expense deduction from **Form 4562**	**(k)** Nonpassive income from **Schedule K-1**
A					
B					
C					
D					
29a Totals					
b Totals					

30	Add columns (h) and (k) of line 29a	30	
31	Add columns (g), (i), and (j) of line 29b	31	( )
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31	32	

Part III **Income or Loss From Estates and Trusts**

33	**(a)** Name	**(b)** Employer identification number
A		
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach **Form 8582** if required)	**(d)** Passive income from **Schedule K-1**	**(e)** Deduction or loss from **Schedule K-1**	**(f)** Other income from **Schedule K-1**
A				
B				
34a Totals				
b Totals				

35	Add columns (d) and (f) of line 34a	35	
36	Add columns (c) and (e) of line 34b	36	( )
37	**Total estate and trust income or (loss).** Combine lines 35 and 36	37	

Part IV **Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder**

38 (a) Name	**(b)** Employer identification number	**(c)** Excess inclusion from **Schedules Q,** line 2c (see instructions)	**(d)** Taxable income (net loss) from **Schedules Q,** line 1b	**(e)** Income from **Schedules Q,** line 3b

39	Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below	39	

Part V **Summary**

40	Net farm rental income or (loss) from **Form 4835.** Also, complete line 42 below	40	
41	**Total income or (loss).** Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Schedule 1 (Form 1040), line 5 ▶	41	
42	**Reconciliation of farming and fishing income.** Enter your **gross** farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120-S), box 17, code AD; and Schedule K-1 (Form 1041), box 14, code F. See instructions . .	42	
43	**Reconciliation for real estate professionals.** If you were a real estate professional (see instructions), enter the net income or (loss) you reported anywhere on Form 1040, Form 1040-SR, or Form 1040-NR from all rental real estate activities in which you materially participated under the passive activity loss rules	43	

Schedule E (Form 1040) 2020

FIGURE 1.4 ***(Continued)***

owner's Schedule E of Form 1040 or 1040-SR. Figure 1.4 shows Schedule E on which a partner's or member's distributive share is reported.

Separately stated items are stand-alone items that pass through to owners apart from the net amount of trade or business income. These are items that are subject to limitations on an individual's tax return and must be segregated from the net amount of trade or business income. They are reported along with similar items on the owner's own tax return.

Example

A charitable contribution deduction made by a partnership passes through separately as a charitable contribution. The partner adds the amount of the pass-through charitable contribution to his or her other charitable contributions. Since an individual's cash contributions in 2020 are deductible only to the extent of 100% of adjusted gross income (after reduction for all other charitable donations), the partner's allocable share of the partnership's charitable contribution is subject to his or her individual adjusted gross income limit.

Other items that pass through separately to owners include capital gains and losses, Section 179 (first-year expensing) deductions, investment interest deductions, and tax credits.

When a partnership or LLC has substantial expenses that exceed its operating income, a loss is passed through to the owner. A number of different rules operate to limit a loss deduction. The owner may not be able to claim the entire loss. The loss is limited by the owner's *basis*, or the amount of cash and property contributed to the partnership, in the interest in the partnership.

Example

You contributed $12,000 to the AB Partnership. In 2020, the partnership had sizable expenses and only a small amount of revenue. Your allocable share of partnership loss is $13,000. You may deduct only $12,000 in 2029, which is the amount of your basis in your partnership interest. You may deduct that additional $1,000 of loss when you have additional basis to offset it.

There may be additional limits on your write-offs from partnerships and LLCs. If you are a passive investor—a silent partner—in these businesses, your loss deduction is further limited by the passive activity loss rules. In general, these rules limit a current deduction for losses from passive activities to the extent of income from passive activities. Additionally, losses are limited by the individual's economic risk in the business. This limit is called the *at-risk rule*. The passive activity loss and at-risk rules are discussed in Chapter 4. For a further discussion of the passive activity loss rules, see IRS Publication 925, *Passive Activity and At-Risk Rules*.

S Corporations and Their Shareholder-Employees

There were nearly 5.2 million S corporations in the government's 2019 fiscal year, making these entities the most prevalent type of corporation. Nearly 79% of all corporations file a Form 1120-S, the return for S corporations. The vast majority of S corporations have only 1, 2, or 3 shareholders.

S corporations are like regular corporations (called *C corporations*) for business law purposes. They are separate entities in the eyes of the law and exist independently from their owners. For example, if an owner dies, the S corporation's existence continues. S corporations are formed under state law in the same way as other corporations. The only difference between S corporations and other corporations is their tax treatment for federal income tax purposes.

NOTE

State laws vary on the tax treatment of S corporations for state income tax purposes. Be sure to check the laws of any state in which you do business.

For the most part, S corporations are treated as pass-through entities for federal income tax purposes. This means that, as with partnerships and LLCs, the income and loss pass through to owners, and their allocable share is reported by S corporation shareholders on their individual income tax returns. The tax treatment of S corporations is discussed more fully later in this chapter.

S corporation status is not automatic. A corporation must elect S status in a timely manner. This election is made on Form 2553, *Election by Small Business Corporations to Tax Corporate Income Directly to Shareholders*. It must be filed with the IRS no later than the fifteenth day of the third month of the corporation's tax year.

Example

A corporation (on a calendar year) that has been in existence for a number of years wants to elect S status. It had to file an election no later than March 15, 2020, to be effective for its 2020 tax year. If a corporation is formed on August 1, 2020, and wants an S election to be effective for its first tax year, the S election must be filed no later than November 15, 2020.

If an S election is filed after the deadline, it is automatically effective for the following year. A corporation can simply decide to make a prospective election by filing at any time during the year prior to that for which the election is to be effective. However, if you want the election to be effective now but missed the deadline, you may qualify for relief under Rev. Proc. 2013–30 (see the instructions to Form 2553 for making a late election).

Example

A corporation (on a calendar year) that has been in existence for a number of years wants to elect S status for its 2021 tax year. It can file an election at any time during 2020.

To be eligible for an S election, the corporation must meet certain shareholder requirements. There can be no more than 100 shareholders. For this purpose, all family members (up to 6 generations) are treated as a single shareholder. Only certain types of trusts are permitted to be shareholders. There can be no nonresident alien shareholders as direct shareholders; nonresidents can be indirect shareholders if they become beneficiaries of Electing Small Business Trusts (ESBTs). A complete discussion of ESBTs and their taxation is beyond the scope of this book.

An election cannot be made before the corporation is formed. The board of directors of the corporation must agree to the election and should indicate this assent in the minutes of a board of directors meeting.

Once the election is made, it remains in effect until it is revoked or is terminated because the corporation fails to meet S corporation requirements (e.g., more than 100 shareholders own the stock, a nonresident alien becomes a direct shareholder, or the corporation creates a second class of stock). If an election is revoked, a new one cannot be made for 5 years unless the IRS agrees to it.

Remember, if state law also allows S status, a separate election may have to be filed with the state. Check with all state law requirements.

Tax Treatment of Income and Deductions in General

For the most part, S corporations, like partnerships and LLCs, are pass-through entities. They are generally not separate taxpaying entities. Instead, they pass through to their shareholders' income, deductions, gains, losses, and tax credits. The shareholders report these amounts on their individual returns. This means owners pay tax on their business profits using individual tax rates. They may be able to claim a 20% qualified business income deduction on their personal return (see Chapter 21). The S corporation files a return with the IRS—Form 1120-S, *U.S. Income Tax Return for an S Corporation*—to report the total pass-through amounts. The S corporation also completes Schedule K-1 of Form 1120-S, a copy of which is given to each shareholder. The K-1 tells the shareholder his or her allocable share of S corporation amounts. The K-1 for S corporation shareholders is similar to the K-1 for partners and LLC members (as shown in Figure 1.2).

S corporations may become taxpayers if they have certain types of income. There are only 3 types of income that result in a tax on the S corporation. These 3 items cannot be reduced by any deductions:

1. *Built-in gains.* These are gains related to appreciation of assets held by a C corporation that converts to S status. Thus, if a corporation is formed and immediately elects S status, there will never be any built-in gains to worry about. The built-in gains tax ends once the S corporation has held the appreciated assets for more than 5 years.
2. *Passive investment income.* This is income of a corporation that has earnings and profits from a time when it was a C corporation. A tax on the S corporation results only when this passive investment income exceeds 25% of gross receipts. Again, if a corporation is formed and immediately elects S status, or if a corporation that converted to S status does not have any earnings and profits at the time of conversion, then there will never be any tax from this source.
3. *LIFO recapture.* When a C corporation using last-in, first-out or LIFO to report inventory converts to S status, there may be recapture income that is taken into account, partly on the C corporation's final return, but also on the S corporation's return. Again, if a corporation is formed and immediately elects S status, there will not be any recapture income on which the S corporation must pay tax.

To sum up, if a corporation is formed and immediately elects S status, the corporation will always be solely a pass-through entity and there will never be any tax at the corporate level. If the S corporation was, at one time (other than momentarily), a C corporation, there may be some tax at the corporate level.

C Corporations and Their Shareholder-Employees

A *C corporation* is an entity separate and apart from its owners; it has its own legal existence. Though formed under state law, it need not be formed in the state in which the business operates. Many corporations, for example, are formed in Delaware or Nevada because the laws in these states favor the corporation, as opposed to the investors (shareholders). However, state law for the state in which the business operates may still require the corporation to make some formal notification of doing business in the state. The corporation may also be subject to tax on income generated in that state.

Until now, C corporations primarily were used by big businesses, even though there was nothing technically barring even a one-person company from being a C corporation. According to IRS data for its 2019 fiscal year, there were more than 2.1 million C corporations, that vast majority of which were small or midsize companies (with assets of $10 million or less). But with the corporate tax rate at 21%, there is some interest in C corporations by small businesses. Changing your form of business is discussed later in this chapter.

For federal tax purposes, a C corporation is a separate taxpaying entity. It files its own return (Form 1120, *U.S. Corporation Income Tax Return*) to report its income or losses. Shareholders do not report their share of the corporation's income. The tax treatment of C corporations is explained more fully later in this chapter.

Personal Service Corporations

Professionals who incorporate their practices are a special type of C corporation called **personal service corporations (PSCs)**.

Personal service corporation (PSC) **A C corporation that performs personal services in the fields of health, law, accounting, engineering, architecture, actuarial science, performing arts, or consulting and meets certain ownership and service tests.**

Personal service corporations are subject to special rules in the tax law. Some of these rules are beneficial; others are not. Personal service corporations:

- Are generally required to use the same tax year as that of their owners. Typically, individuals report their income on a calendar year basis (explained more fully in Chapter 2), so their PSCs must also use a calendar year. However, there is a special election that can be made to use a fiscal year.
- Can use the cash method of accounting. Other C corporations cannot use the cash method and instead must use the accrual method unless they meet a gross receipts test (explained more fully in Chapter 2).
- Are subject to the passive loss limitation rules (explained in Chapter 4).
- Can have their income and deductions reallocated by the IRS between the corporation and the shareholders if it more correctly reflects the economics of the situation.

- Have a smaller exemption from the accumulated earnings penalty than other C corporations. This penalty imposes an additional tax on corporations that accumulate their income above and beyond the reasonable needs of the business instead of distributing income to shareholders.

Tax Treatment of Income and Deductions in General

The C corporation reports its own income and claims its own deductions on Form 1120, *U.S. Corporation Income Tax Return*. Shareholders in C corporations do not have to report any income of the corporation (and cannot claim any deductions of the corporation). Figure 1.5 shows a sample copy of page 1 of Form 1120.

C corporations have a flat corporate tax rate of 21%. Thus, a small business that operates as a C corporation and a multinational corporation pay the same tax rate on their profits.

Distributions from the C corporation to its shareholders are personal items for the shareholders. For example, if a shareholder works for his or her C corporation and receives a salary, the corporation deducts that salary against corporate income. The shareholder reports the salary as income on his or her individual income tax return. If the corporation distributes a dividend to the shareholder, again, the shareholder reports the dividend as income on his or her individual income tax return. In the case of dividends, however, the corporation cannot claim a deduction. This, then, creates a 2-tier tax system, commonly referred to as *double taxation*. First, earnings are taxed at the corporate level. Then, when they are distributed to shareholders as dividends, they are taxed again, this time at the shareholder level. There has been sentiment in Congress over the years to eliminate the double taxation, but as of yet there has been no legislation to accomplish this end other than the relief provided by capping the rate on dividends (zero for individuals with taxable income below a threshold amount; 20% for those with taxable income above a threshold amount; and 15% for those with taxable income above the lower threshold but below the upper threshold).

Other Tax Issues for C Corporations

In view of the favorable corporate rate tax structure (compared with the individual tax rates), certain tax penalties prevent businesses from using this form of business organization to optimum advantage.

- *Personal holding company penalty.* Corporations that function as a shareholder investment portfolio rather than as an operating company may fall subject to the personal holding corporation (PHC) penalty tax of 20% on

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2020 or tax year beginning ________, 2020, ending ________, 20 ____
▶ Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123
2020

A Check if:
1a Consolidated return (attach Form 851) . ☐
b Life/nonlife consolidated return . . . ☐
2 Personal holding co. (attach Sch. PH) . ☐
3 Personal service corp. (see instructions) . ☐
4 Schedule M-3 attached ☐

TYPE OR PRINT
Name
Number, street, and room or suite no. If a P.O. box, see instructions.
City or town, state or province, country, and ZIP or foreign postal code

B Employer identification number
C Date incorporated
D Total assets (see instructions) $

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

Income	1a	Gross receipts or sales	1a	
	b	Returns and allowances	1b	
	c	Balance. Subtract line 1b from line 1a	1c	
	2	Cost of goods sold (attach Form 1125-A)	2	
	3	Gross profit. Subtract line 2 from line 1c	3	
	4	Dividends and inclusions (Schedule C, line 23)	4	
	5	Interest	5	
	6	Gross rents	6	
	7	Gross royalties	7	
	8	Capital gain net income (attach Schedule D (Form 1120))	8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)	9	
	10	Other income (see instructions—attach statement)	10	
	11	**Total income.** Add lines 3 through 10 ▶	11	
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ▶	12	
	13	Salaries and wages (less employment credits)	13	
	14	Repairs and maintenance	14	
	15	Bad debts	15	
	16	Rents	16	
	17	Taxes and licenses	17	
	18	Interest (see instructions)	18	
	19	Charitable contributions	19	
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)	20	
	21	Depletion	21	
	22	Advertising	22	
	23	Pension, profit-sharing, etc., plans	23	
	24	Employee benefit programs	24	
	25	Reserved for future use	25	
	26	Other deductions (attach statement)	26	
	27	**Total deductions.** Add lines 12 through 26 ▶	27	
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11	28	
	29a	Net operating loss deduction (see instructions)	29a	
	b	Special deductions (Schedule C, line 24)	29b	
	c	Add lines 29a and 29b	29c	
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28. See instructions	30	
	31	Total tax (Schedule J, Part I, line 11)	31	
	32	2020 net 965 tax liability paid (Schedule J, Part II, line 12)	32	
	33	Total payments, credits, and section 965 net tax liability (Schedule J, Part III, line 23)	33	
	34	Estimated tax penalty. See instructions. Check if Form 2220 is attached ▶ ☐	34	
	35	**Amount owed.** If line 33 is smaller than the total of lines 31, 32, and 34, enter amount owed	35	
	36	**Overpayment.** If line 33 is larger than the total of lines 31, 32, and 34, enter amount overpaid	36	
	37	Enter amount from line 36 you want: **Credited to 2021 estimated tax** ▶ **Refunded** ▶	37	

Sign Here
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer | Date | Title

May the IRS discuss this return with the preparer shown below? See instructions. ☐ **Yes** ☐ **No**

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2020)

FIGURE 1.5 Form 1120, U.S. Corporation Income Tax Return

Form 1120 (2020) Page 2

Schedule C	Dividends, Inclusions, and Special Deductions (see instructions)	(a) Dividends and inclusions	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)		50	
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		65	
3	Dividends on certain debt-financed stock of domestic and foreign corporations		See instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		23.3	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		26.7	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		50	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		65	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Subtotal.** Add lines 1 through 8. See instructions for limitations		See instructions	
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Foreign-source portion of dividends received from a specified 10%-owned foreign corporation (excluding hybrid dividends) (see instructions)		100	
14	Dividends from foreign corporations not included on line 3, 6, 7, 8, 11, 12, or 13 (including any hybrid dividends)			
15	Section 965(a) inclusion		See instructions	
16a	Subpart F inclusions derived from the sale by a controlled foreign corporation (CFC) of the stock of a lower-tier foreign corporation treated as a dividend (attach Form(s) 5471) (see instructions)		100	
b	Subpart F inclusions derived from hybrid dividends of tiered corporations (attach Form(s) 5471) (see instructions)			
c	Other inclusions from CFCs under subpart F not included on line 15, 16a, 16b, or 17 (attach Form(s) 5471) (see instructions)			
17	Global Intangible Low-Taxed Income (GILTI) (attach Form(s) 5471 and Form 8992)			
18	Gross-up for foreign taxes deemed paid			
19	IC-DISC and former DISC dividends not included on line 1, 2, or 3			
20	Other dividends			
21	Deduction for dividends paid on certain preferred stock of public utilities			
22	Section 250 deduction (attach Form 8993)			
23	**Total dividends and inclusions.** Add column (a), lines 9 through 20. Enter here and on page 1, line 4			
24	**Total special deductions.** Add column (c), lines 9 through 22. Enter here and on page 1, line 29b			

Form 1120 (2020)

FIGURE 1.5 ***(Continued)***

Form 1120 (2020) Page 3

Schedule J Tax Computation and Payment (see instructions)

Part I—Tax Computation

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)). See instructions ▶ ☐			
2	Income tax. See instructions		2	
3	Base erosion minimum tax amount (attach Form 8991)		3	
4	Add lines 2 and 3		4	
5a	Foreign tax credit (attach Form 1118)	5a		
b	Credit from Form 8834 (see instructions)	5b		
c	General business credit (attach Form 3800)	5c		
d	Credit for prior year minimum tax (attach Form 8827)	5d		
e	Bond credits from Form 8912	5e		
6	**Total credits.** Add lines 5a through 5e		6	
7	Subtract line 6 from line 4		7	
8	Personal holding company tax (attach Schedule PH (Form 1120))		8	
9a	Recapture of investment credit (attach Form 4255)	9a		
b	Recapture of low-income housing credit (attach Form 8611)	9b		
c	Interest due under the look-back method—completed long-term contracts (attach Form 8697)	9c		
d	Interest due under the look-back method—income forecast method (attach Form 8866)	9d		
e	Alternative tax on qualifying shipping activities (attach Form 8902)	9e		
f	Interest/tax due under Section 453A(c) and/or Section 453(l)	9f		
g	Other (see instructions—attach statement)	9g		
10	**Total.** Add lines 9a through 9g		10	
11	**Total tax.** Add lines 7, 8, and 10. Enter here and on page 1, line 31		11	

Part II—Section 965 Payments (see instructions)

12	2020 net 965 tax liability paid from Form 965-B, Part II, column (k), line 4. Enter here and on page 1, line 32	12	

Part III—Payments, Refundable Credits, and Section 965 Net Tax Liability

13	2019 overpayment credited to 2020		13	
14	2020 estimated tax payments		14	
15	2020 refund applied for on Form 4466		15	( )
16	Combine lines 13, 14, and 15		16	
17	Tax deposited with Form 7004		17	
18	Withholding (see instructions)		18	
19	**Total payments.** Add lines 16, 17, and 18		19	
20	Refundable credits from:			
a	Form 2439	20a		
b	Form 4136	20b		
c	Reserved for future use	20c		
d	Other (attach statement—see instructions)	20d		
21	**Total credits.** Add lines 20a through 20d		21	
22	2020 net 965 tax liability from Form 965-B, Part I, column (d), line 4. See instructions		22	
23	**Total payments, credits, and section 965 net tax liability.** Add lines 19, 21, and 22. Enter here and on page 1, line 33		23	

Form **1120** (2020)

FIGURE 1.5 ***(Continued)***

Form 1120 (2020) Page 4

Schedule K **Other Information** (see instructions)

		Yes	No
1	Check accounting method: **a** ☐ Cash **b** ☐ Accrual **c** ☐ Other (specify) ▶		
2	See the instructions and enter the:		
a	Business activity code no. ▶		
b	Business activity ▶		
c	Product or service ▶		
3	Is the corporation a subsidiary in an affiliated group or a parent–subsidiary controlled group? . . . . If "Yes," enter name and EIN of the parent corporation ▶		
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G) .		
5	At the end of the tax year, did the corporation:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on **Form 851,** Affiliations Schedule? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below.		

(i) Name of Corporation	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Incorporation	**(iv)** Percentage Owned in Voting Stock

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below.		

(i) Name of Entity	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Organization	**(iv)** Maximum Percentage Owned in Profit, Loss, or Capital

		Yes	No
6	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? See sections 301 and 316 . . . . If "Yes," file **Form 5452,** Corporate Report of Nondividend Distributions. See the instructions for Form 5452. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.		
7	At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of the total voting power of all classes of the corporation's stock entitled to vote or at least 25% of the total value of all classes of the corporation's stock? . For rules of attribution, see section 318. If "Yes," enter: **(a)** Percentage owned ▶ ________ and **(b)** Owner's country ▶ ________ **(c)** The corporation may have to file **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ▶		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount . . . . ▶ ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
9	Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶		
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here (see instructions) ▶ ☐ If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.		
12	Enter the available NOL carryover from prior tax years (do not reduce it by any deduction reported on page 1, line 29a.) . . . . ▶ $		

Form **1120** (2020)

FIGURE 1.5 ***(Continued)***

Form 1120 (2020) Page 5

Schedule K **Other Information** *(continued from page 4)*

		Yes	No
13	Are the corporation's total receipts (page 1, line 1a, plus lines 4 through 10) for the tax year **and** its total assets at the end of the tax year less than $250,000?		
	If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year ▶ $		
14	Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement? See instructions		
	If "Yes," complete and attach Schedule UTP.		
15a	Did the corporation make any payments in 2020 that would require it to file Form(s) 1099?		
b	If "Yes," did or will the corporation file required Form(s) 1099?		
16	During this tax year, did the corporation have an 80%-or-more change in ownership, including a change due to redemption of its own stock?		
17	During or subsequent to this tax year, but before the filing of this return, did the corporation dispose of more than 65% (by value) of its assets in a taxable, non-taxable, or tax deferred transaction?		
18	Did the corporation receive assets in a section 351 transfer in which any of the transferred assets had a fair market basis or fair market value of more than $1 million?		
19	During the corporation's tax year, did the corporation make any payments that would require it to file Forms 1042 and 1042-S under chapter 3 (sections 1441 through 1464) or chapter 4 (sections 1471 through 1474) of the Code?		
20	Is the corporation operating on a cooperative basis?		
21	During the tax year, did the corporation pay or accrue any interest or royalty for which the deduction is not allowed under section 267A? See instructions		
	If "Yes," enter the total amount of the disallowed deductions ▶ $		
22	Does the corporation have gross receipts of at least $500 million in any of the 3 preceding tax years? (See sections 59A(e)(2) and (3))		
	If "Yes," complete and attach Form 8991.		
23	Did the corporation have an election under section 163(j) for any real property trade or business or any farming business in effect during the tax year? See instructions		
24	Does the corporation satisfy one or more of the following? See instructions		
a	The corporation owns a pass-through entity with current, or prior year carryover, excess business interest expense.		
b	The corporation's aggregate average annual gross receipts (determined under section 448(c)) for the 3 tax years preceding the current tax year are more than $26 million and the corporation has business interest expense.		
c	The corporation is a tax shelter and the corporation has business interest expense.		
	If "Yes," complete and attach Form 8990.		
25	Is the corporation attaching Form 8996 to certify as a Qualified Opportunity Fund?		
	If "Yes," enter amount from Form 8996, line 15 ▶ $		
26	Since December 22, 2017, did a foreign corporation directly or indirectly acquire substantially all of the properties held directly or indirectly by the corporation, and was the ownership percentage (by vote or value) for purposes of section 7874 greater than 50% (for example, the shareholders held more than 50% of the stock of the foreign corporation)? If "Yes," list the ownership percentage by vote and by value. See instructions		
	Percentage: By Vote By Value		

Form **1120** (2020)

FIGURE 1.5 ***(Continued)***

Form 1120 (2020) Page 6

Schedule L Balance Sheets per Books

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash				
2a Trade notes and accounts receivable				
b Less allowance for bad debts	( )		( )	
3 Inventories				
4 U.S. government obligations				
5 Tax-exempt securities (see instructions)				
6 Other current assets (attach statement)				
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach statement)				
10a Buildings and other depreciable assets				
b Less accumulated depreciation	( )		( )	
11a Depletable assets				
b Less accumulated depletion	( )		( )	
12 Land (net of any amortization)				
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
14 Other assets (attach statement)				
15 Total assets				
Liabilities and Shareholders' Equity				
16 Accounts payable				
17 Mortgages, notes, bonds payable in less than 1 year				
18 Other current liabilities (attach statement)				
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more				
21 Other liabilities (attach statement)				
22 Capital stock: a Preferred stock				
b Common stock				
23 Additional paid-in capital				
24 Retained earnings—Appropriated (attach statement)				
25 Retained earnings—Unappropriated				
26 Adjustments to shareholders' equity (attach statement)				
27 Less cost of treasury stock		( )		( )
28 Total liabilities and shareholders' equity				

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

Note: The corporation may be required to file Schedule M-3. See instructions.

1 Net income (loss) per books		7 Income recorded on books this year not included on this return (itemize): Tax-exempt interest $	
2 Federal income tax per books			
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize):			
5 Expenses recorded on books this year not deducted on this return (itemize):		8 Deductions on this return not charged against book income this year (itemize):	
a Depreciation $		a Depreciation $	
b Charitable contributions $		b Charitable contributions $	
c Travel and entertainment $			
		9 Add lines 7 and 8	
6 Add lines 1 through 5		10 Income (page 1, line 28)—line 6 less line 9	

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Schedule L, Line 25)

1 Balance at beginning of year		5 Distributions: a Cash	
2 Net income (loss) per books		b Stock	
3 Other increases (itemize):		c Property	
		6 Other decreases (itemize):	
		7 Add lines 5 and 6	
4 Add lines 1, 2, and 3		8 Balance at end of year (line 4 less line 7)	

Form **1120** (2020)

FIGURE 1.5 *(Continued)*

certain undistributed corporate income. The tax rules strictly define a PHC according to stock ownership and adjusted gross income. The penalty may be avoided by *not* triggering the definition of PHC or by paying out certain dividends.

- *Accumulated earnings tax.* Corporations may seek to keep money in corporate accounts rather than distribute it as dividends to shareholders with the view that an eventual sale of the business will enable shareholders to extract those funds at capital gain rates. Unfortunately, the tax law imposes a penalty on excess accumulations at 20%. Excess accumulations are those above an exemption amount ($250,000 for most businesses, but only $150,000 for PSCs) *plus* amounts for the reasonable needs of the business. Thus, for example, amounts retained to finance planned construction costs, to pay for a possible legal liability, or to buy out a retiring owner are reasonable needs not subject to penalty regardless of amount.

Benefit Corporations

As of February 2020, 36 states and the District of Columbia permitted benefit corporations in their jurisdictions, and 5 states were considering it. Benefit corporations are for for-profit companies committed to having a positive impact on employees, the environment, the community, and society; officers and directors must consider these stakeholders in their business decisions. Companies incorporate as benefit corporations, which protects officers and directors from certain investor lawsuits and tells the public that they're committed to societal benefit programs. The key attributes of a benefit corporation are:

- Public benefit programs to create a material impact on society and the environment
- Transparency and reporting to provide an annual review of its conduct. When no audit is required, performance is measured against a third-party standard to assess their creation of a general public benefit.
- Benefit enforcement to entitle shareholders to sue in order to hold the corporation accountable for its public purpose.

Benefit corporations do not have any special tax treatment. Thus, they may be an S corporation or a C corporation, with the tax treatment that follows these entities. There are state filing fees for becoming a benefit corporation.

Instead of "inc," "corp," or "ltd," a benefit corporation uses the designation PBC (public benefit corporation). They can be public or privately held; there's no asset or revenue limits or requirements. An of a well-known PBCs is Kickstarter (www.kickstarter.com/blog/kickstarter-is-now-a-benefit-corporation).

Do not confuse benefit corporations with B corporations. B corporations are corporations certified by B Lab, a non-profit organization, to show they meet standards for social and environmental performance, accountability, and transparency. The "b" stands for benefits. This certification can be used by a corporation in any state, whether or not it incorporated as a benefit corporation.

Some states (e.g., Delaware, Illinois, Maryland, Oregon, Pennsylvania, and Utah) allow for benefit LLCs, which are limited liability companies obtaining the same opportunities that the state's benefit corporations enjoy.

Employees

Whether or not you own any interest in a business, if you are employed by one, you still have income and business expenses. Your salary or other compensation is reported as wages on page 1 of your Form 1040 or 1040-SR.

Generally, your business expenses are not deductible. In 2018 through 2025, employees cannot deduct their unreimbursed employee business expenses. In the past they were able to deduct them as miscellaneous itemized deductions on Schedule A of Form 1040 or 1040-SR.

Example

You are the owner-employee of an S corporation. You drive your personal car on company business. You cannot take any deduction in 2020 for this business driving on your personal return. (There is a better way to handle this expense, as explained in Chapter 9).

Factors in Choosing Your Form of Business Organization

Throughout this chapter, the differences of how income and deductions are reported have been explained for different entities, but these differences are not the only reasons for choosing a form of business organization. When you are deciding on which form of business organization to choose, tax, financial, and many other factors come into play, including:

- Personal liability
- Access to capital
- Lack of profitability
- Fringe benefits
- Nature and number of owners
- Tax rates

- Social Security and Medicare taxes
- Restrictions on accounting periods and account methods
- Owner's payment of company expenses
- Multistate operations
- Audit chances
- Filing deadlines and extensions
- Exit strategy

Each of these factors is discussed below.

Personal Liability

If your business owes money to another party, are your personal assets—home, car, investments—at risk? The answer depends on your form of business organization. You have personal liability—your personal assets are at risk—if you are a sole proprietor or a general partner in a partnership. In all other cases, you do not have personal liability. Thus, for example, if you are a shareholder in an S corporation, you do not have personal liability for the debts of your corporation.

Of course, you can protect yourself against personal liability for some types of occurrences by having adequate insurance coverage. For example, if you are a sole proprietor who runs a store, be sure that you have adequate liability coverage in the event someone is injured on your premises and sues you.

Even if your form of business organization provides personal liability protection, you can become personally liable if you agree to it in a contract. For example, some banks may not be willing to lend money to a small corporation unless you, as a principal shareholder, agree to guarantee the corporation's debt. For instance, SBA loans usually require the personal guarantee of any owner with a 20% or more ownership interest in the business. In this case, you are personally liable to the extent of the loan to the corporation. If the corporation does not or cannot repay the loan, then the bank can look to you, and your personal assets, for repayment.

There is another instance in which corporate or LLC status will not provide you with personal protection. Even if you have a corporation or LLC, you can be personally liable for failing to withhold and deposit payroll taxes, which are called trust fund taxes (employees' income tax withholding and their share of FICA taxes, which are held in trust for them) to the IRS. This liability is explained in Chapter 29.

Access to Capital

Most small businesses start up using an owner's personal resources or by turning to family and friends. However, some businesses need outside capital—equity and/or debt—to get started properly. A C corporation may make it easier to raise money, especially now. For example, access to equity crowdfunding, which allows businesses to raise small amounts from numerous investors, is effectively limited to C corporations (S corporations cannot have more than 100 investors unless Congress changes the law; partnerships and LLCs would have difficulty in divvying up ownership among an ever-changing number of owners). Equity crowdfunding for accredited investors (net worth more than $1 million, excluding a principal residence or income exceeding $300,000) obviously works best for C corporations.

For non-accredited investors (those who do not qualify as accredited investors because they don't have annual income of $200,000, or $300,000 with a spouse), equity crowdfunding investments are capped at up to 10% of annual income for those with income over $100,000, or up to $2,000 or 5% of annual income, whichever is greater, for investors with annual income under $100,000.

Lack of Profitability

All businesses hope to make money. But many sustain losses, especially in the start-up years and during tough economic times. The way in which a business is organized affects how losses are treated.

Pass-through entities allow owners to deduct their share of the company's losses on their personal returns (subject to limits discussed in Chapter 4). If a business is set up as a C corporation, only the corporation can deduct losses. Thus, when losses are anticipated, for example, in the start-up phase, a pass-through entity generally is a preferable form of business organization. However, once the business becomes profitable, the tables turn. In that situation, C corporations can offer more tax opportunities, such as a lower tax rate and fringe benefits. Companies that suffer severe losses may be forced into bankruptcy. The bankruptcy rules for corporations (C or S) are very different from the rules for other entities (see Chapter 25).

Fringe Benefits

The tax law gives employees of corporations the opportunity to enjoy special fringe benefits on a tax-free basis. They can receive employer-provided group term life insurance up to $50,000, health insurance coverage, dependent care assistance up to $5,000, education assistance up to $5,250, adoption assistance, and more. They can also be covered by certain medical reimbursement plans. This same opportunity is not extended to sole proprietors. Remember that sole proprietors are not employees, so they cannot get the benefits given only to employees. Similarly, partners, LLC members, and even S corporation shareholders who own more than 2% of the stock in their corporations (and are not considered employees) are not eligible for fringe benefits.

If the business can afford to provide these benefits, the form of business becomes important. All forms of business can offer tax-favored retirement plans. Corporations make it possible to give ownership opportunities to employees. Corporations—both C and S—can offer employee stock ownership plans (ESOPs) in which employees receive ownership interests through a plan that is much like a qualified retirement plan (see Chapter 16). Certain C corporations can offer employees an income tax exclusion opportunity for stock they buy or receive as compensation. For 2020, 50%, 75%, or 100% of the gain on the sale of qualified small business stock (explained in Chapter 5) is excludable from gross income, depending on when the stock was acquired, as long as the stock has been held for more than 5 years. C corporations can also offer incentive stock option (ISO) plans and nonqualified stock option (NSO) plans (see Chapter 7). The tax law does not bar S corporations from offering stock option plans, but because of the 100-shareholder limit (discussed earlier in this chapter), it becomes difficult to do so.

Nature and Number of Owners

With whom you go into business affects your choice of business organization. For example, foreign individuals are not permitted to own S corporation stock directly (resident aliens are permitted to own S corporation stock). But a nonresident alien can be a potential current income beneficiary of an electing small business trust (ESBT). An S corporation also cannot be used if investors are partnerships or corporations. In other words, in order to use an S corporation, all shareholders must be individuals who are not nonresident aliens (there are exceptions for estates, certain trusts, and certain exempt organizations).

The number of owners also presents limits on your choice of business organization. If you are the only owner, then your choices are limited to a sole proprietorship or a corporation (either C or S). All states allow single-member LLCs. If you have more than one owner, you can set up the business in just about any way you choose. S corporations cannot have more than 100 shareholders, but this number provides great leeway for small businesses.

If you have a business already formed as a C corporation and want to start another corporation, you must take into consideration the impact of special tax rules for multiple corporations. These rules apply regardless of the size of the business, the number of employees you have, and the profit the businesses make. Multiple corporations are corporations under common control, meaning they are essentially owned by the same parties. The rules for multiple corporations are explained in Chapter 27. If you want to avoid restrictions on multiple corporations, you may want to look to LLCs or some other form of business organization.

Tax Rates

If a business is highly profitable, tax rates may become a consideration in entity choice. C corporations pay a flat 21% rate on their profits. Owners of pass-through entities may pay up to a 37% tax rate on their share of profits. While there is a 20% qualified business income (QBI) deduction for owners of pass-through entities designed to lower the effective tax rate on business profits, there are various limitations that may restrict or bar the use of this write-off. For example, an accountant or attorney with taxable income in 2020 over $426,600 on a joint return, or $213,300 for any other filing status cannot claim this deduction. The 20% QBI deduction is explained in Chapter 21.

But remember, even though the C corporation has a lower tax rate, there is a 2-tier tax structure with which to contend if earnings are paid out to you as dividends—tax at the corporate level and again at the shareholder level.

While the so-called double taxation for C corporations is lessened by having a lower tax rate on dividends for individuals, there is still some double tax because dividends remain nondeductible at the corporate level. The rate on qualified dividends for most taxpayers is 15% (it may be zero or 20%, depending upon taxable income).

The tax rates on capital gains also differ between C corporations and other taxpayers. This is because capital gains of C corporations are not subject to special tax rates (they are taxed the same as ordinary business income), while owners of other types of businesses may pay tax on the business's capital gains at no more than zero, 15%, or 20%, depending on taxable income). Of course, tax rates alone should not be the determining factor in selecting your form of business organization.

Social Security and Medicare Taxes

Owners of businesses organized any way other than as a corporation (C or S) are not employees of their businesses. As such, they are personally responsible for paying Social Security and Medicare taxes (called *self-employment* taxes for owners of unincorporated businesses). This tax is made up of the employer and employee shares of Social Security and Medicare taxes. The deduction for one-half of self-employment taxes is explained in Chapter 13.

However, owners of corporations have these taxes applied only against their salary and taxable benefits. Owners of unincorporated businesses pay self-employment tax on net earnings from self-employment. This essentially means profits, whether they are distributed to the owners or reinvested in the business. The result: Owners of unincorporated businesses can wind up paying higher Social Security and Medicare taxes than comparable owners who work for their corporations. On the other hand, in unprofitable businesses, owners of unincorporated businesses may not be able to earn any Social Security credits, while corporate owners can have salary paid to them on which Social Security credits can be generated.

There have been proposals to treat certain S corporation owner-employees like partners for purposes of self-employment tax. To date, these proposals have failed, but could be revived in the future.

The additional Medicare surtaxes on earned income and net investment income (NII) are yet another factor to consider. The 0.9% surtax on earned income applies to taxable compensation (e.g., wages, bonuses, commissions, and taxable fringe benefits) of shareholders in S or C corporations; it applies to all net earnings from self-employment for sole proprietors, partners, and limited liability company members. The 3.8% NII tax applies to business income passed through from an entity in which the owner does not materially participate (i.e., one in which the owner is effectively a silent investor).

Restrictions on Accounting Periods and Accounting Methods

As you will see in Chapter 2, the tax law limits the use of fiscal years and the cash method of accounting for certain types of business organizations. For example, partnerships and S corporations in general are required to use a calendar year to report income.

Also, C corporations generally are required to use the accrual method of accounting to report income. There are exceptions to both of these rules. However, as you can see, accounting periods and accounting methods are considerations in choosing your form of business organization.

Owner's Payment of Company Expenses

In small businesses it is common practice for owners to pay certain business expenses out of their own pockets—either as a matter of convenience or because the company is short of cash. The type of entity dictates where owners can deduct these payments.

A partner who is not reimbursed for paying partnership expenses can deduct his or her payments of these expenses as an above-the-line deduction (on a separate line on Schedule E of the partner's Form 1040 or 1040-SR, which should be marked as "UPE"), as long as the partnership agreement requires the partner to pay specified expenses personally and includes language that no reimbursement will be made.

A shareholder in a corporation (S or C) is an employee, so that unreimbursed expenses paid on behalf of the corporation cannot be deducted in 2018 through 2025 because the deduction for itemized miscellaneous expenses has been suspended. However, shareholders can avoid this deduction problem by having the corporation adopt an accountable plan to reimburse their out-of-pocket business expenses. An accountable plan allows the corporation to deduct the expenses, while the shareholders do not report income from the reimbursement (see Chapter 8).

Multistate Operations

Each state has its own way of taxing businesses subject to its jurisdiction. The way in which a business is organized for federal income tax purposes may not necessarily control for state income tax purposes. For example, some states do not recognize S corporation elections and tax such entities as regular corporations.

A company must file a return in each state in which it does business and pay income tax on the portion of its profits earned in that state. Income tax liability is based on having a *nexus*, or connection, to a state. This is not always an easy matter to settle. Where there is a physical presence—for example, a company maintains an office—then there is a clear nexus. But when a company merely makes sales to customers within a state or offers goods for sale from a website, there is generally no nexus. (However, a growing number of states are liberalizing the definition of nexus in order to get more businesses to pay state taxes so they can increase revenue; some states are moving toward "a significant economic presence," meaning taking advantage of a state's economy to produce income, as a basis for taxation.)

Assuming that a company does conduct multistate business, then its form of organization becomes important. Most multistate businesses are C corporations because only one corporate income tax return needs to be filed in each state where they do business. Doing business as a pass-through entity means that each owner would have to file a tax return in each state the company does business.

Audit Chances

Each year, the IRS publishes statistics on the number and type of audits it conducts. The rates for the government's fiscal year 2019, the most recent year for which statistics are available, show a very low overall audit activity of business returns.

The chances of being audited vary with the type of business organization, the amount of income generated by the business, and the geographic location of the business. While the chance of an audit is not a significant reason for choosing one form of business organization over another, it is helpful to keep these statistics in mind.

Table 1.1 sheds some light on your chances of being audited, based on the most recently available statistics.

Many tax experts agree that your location can impact your audit chances. Some IRS offices are better staffed than others. There have been no recent statistics identifying these high-audit locations.

TABLE 1.1 Percentage of Returns Audited

	FY 2018*	FY 2019*
Sole proprietors (Schedule C) (based on gross receipts)		
Under $25,000	0.9%	0.6%
$25,000 to under $100,000	0.9	0.8
$100,000 to under $200,000	2.4	1.6
$200,000 or more	1.9	1.4
Farming (Schedule F) (based on gross receipts)		
All farm returns	0.3	0.2
Partnerships	0.2	0.07
S corporations	0.2	0.1
C corporations (based on assets)		
Under $250,000	0.4	0.16
$250,000 to under $1 million	0.9	0.48
$1 million to under $5 million	0.8	0.57
$5 million to under $10 million	1.1	0.63

*Fiscal year from October 1 to September 30.
Source: IRS Data Book.

Past audit rates are no guarantee of the likelihood of future IRS examinations. The $441 billion gross tax gap for 2011–2013 (the most recent statistics), which represents the spread between what the government is owed and what it collects, has been blamed in large part on those sole proprietors/independent contractors who underreport income, overstate deductions, or fail to pay self-employment tax. While the IRS has indicated that it would increase audits of certain sole proprietors and other small businesses, due to budgetary constraints, the number of audits is still very low.

Filing Deadlines and Extensions

How your business is organized dictates when its tax return must be filed, the form to use, and the additional time that can be obtained for filing the return. Pass-throughs (partnerships and S corporations) reporting on a calendar year must file by March 15; they can obtain a 6-month filing extension. Calendar year C corporations don't have to file until April 15 (the same deadline for individuals, including Schedule C filers); they too have an extended due date of October 15. The September 15 extended due date gives S corporations, limited liability companies, and partnerships time to provide a Schedule K-1 to owners so they can file their personal returns by their extended due date of October 15.

Table 1.2 lists the filing deadlines for calendar-year businesses, the available automatic extensions, and the forms to use in filing the return or requesting a filing extension. Note that these dates are extended to the next business day when a deadline falls on a Saturday, Sunday, or legal holiday.

TABLE 1.2 Filing Deadlines, Extensions, and Forms for 2020 Returns

Type of Entity	Return Due Date	Income Tax Return	Automatic Filing Extension	Form to Request Filing Extension
Sole proprietorship	April 15	Schedule C of Form 1040 or 1040-SR	October 15	Form 4868
Partnership/LLC	March 15	Form 1065	September 15	Form 7004
S corporation	March 15	Form 1120-S	September 15	Form 7004
C corporation	April 15	Form 1120	October 15	Form 7004

Exit Strategy

The tax treatment on the termination of a business is another factor to consider. While the choice of entity is made when the business starts out, you cannot ignore the tax consequences that this choice will have when the business terminates, is sold, or goes public. The liquidation of a C corporation usually produces a double tax—at the entity and owner levels. The liquidation of an S corporation produces a double tax *only* if there is a built-in gains tax issue—created by having appreciated assets in the business when an S election is made. However, the built-in gains tax problem disappears a certain number of years after the S election, so termination after that time does not result in a double tax.

If you plan to sell the business some time in the future, again your choice of entity may have an impact on the tax consequences of the sale. The sale of a sole proprietorship is viewed as a sale of the underlying assets of the business; some may produce ordinary income while others trigger capital gains. In contrast, the sale of qualified small business stock, which is stock in a C corporation, may result in tax-free treatment under certain conditions. Sales of business interests are discussed in Chapter 5.

Another exit strategy is using an Employee Stock Ownership Plan (ESOP) to have a trust–a ready marketplace for privately held stock–acquire the owner's stock; the employees who participate in the ESOP effectively becomes owners. Obviously, because ESOPs are based on stock, only C and S corporations can use them. ESOPs are discussed in greater detail in Chapter 31.

If the termination of the business results in a loss, different tax rules come into play. Losses from partnerships and LLCs are treated as capital losses (explained in Chapter 5). A shareholder's losses from the termination of a C or S corporation may qualify as a Section 1244 loss—treated as an ordinary loss within limits (explained in Chapter 5).

If the business goes bankrupt, the entity type influences the type of bankruptcy filing to be used and whether the owners can escape personal liability for the debts of the business. Bankruptcy is discussed in Chapter 25.

Forms of Business Organization Compared

So far, you have learned about the various forms of business organization. Which form is right for your business? The answer is really a judgment call based on all the factors previously discussed. You can, of course, use different forms of business organization for your different business activities. For example, you may have a C corporation and personally own the building in which it operates—directly or through an LLC. Or you may be in partnership for your professional activities, while running a sideline business as an S corporation.

Table 1.3 summarizes 2 important considerations: how the type of business organization is formed and what effect the form of business organization has on where income and deductions are reported.

Changing Your Form of Business

The lowering of the corporate tax rate to 21% has sparked discussion about whether other entities should now become C corporations. But tax rates aren't the only reason for making a change in entity choice.

Suppose you have a business that you have been running as a sole proprietorship. Now you want to make a change. Your new choice of business organization is dictated by the reason for the change. If you are taking in a partner, you would consider these alternatives: partnership, LLC, S corporation, or C corporation. If you are not taking in a partner, but want to obtain limited personal liability, you would consider an LLC (if your state permits a one-person LLC), an S corporation, or a C corporation. If you are looking to take advantage of certain fringe benefits, such as certain medical reimbursement plans, you would consider only a C corporation.

If you project that the tax rate on your business profits would be greatly reduced by becoming a C corporation, then you'd need to revoke an S election or incorporate an unincorporated business. Keep in mind that if you revoke an S election, a new one cannot be made for 5 years. Also, if an S corporation revoked its election and became a C corporation, any adjustment to income resulting from a change in accounting method attributable to the conversion during the 2-year period beginning December 22, 2017, is taken into account ratably over a 6-year period beginning with the year of the change. This means some of the adjustment is reported on a 2020 return. This rule applies if the business was an S corporation on December 21, 2017, made the revocation by December 22,

TABLE 1.3 Comparison of Forms of Business Organization

Type of Business	How It Is Formed	Where Income and Deductions Are Reported
Sole proprietorship	No special requirements	On owner's Schedule C (Schedule F for farming)
Partnership	No special requirements	Some items taken into account in figuring trade or business income directly on Form 1065 (allocable amount claimed on partner's Schedule E); separately stated items are passed through to partners and claimed in various places on partner's tax return.
Limited special partnership	Some items taken into account in figuring partnership under state law	Trade or business income directly on Form 1065 (allocable amount claimed on partner's Schedule E); separately stated items passed through to partners and claimed in various places on partner's tax return
Limited liability company	Organized as such under state law	Some items taken into account in figuring trade or business income directly on Form 1065 (allocable amount claimed on member's Schedule E); separately stated items passed through to members and claimed in various places on member's tax return
Limited liability partnership	Organized as such under state law	Some items taken into account in figuring trade or business income directly on Form 1065 (allocable amount claimed on member's Schedule E); separately stated items passed through to members and claimed in various places on member's tax return
S corporation	Formed as corporation under state law; tax status elected by filing with IRS	Some items taken into account in figuring trade or business income directly on Form 1120-S (allocable amount claimed on shareholder's Schedule E); separately stated items passed through to shareholders and claimed in various places on shareholder's tax return
C corporation	Formed under state law	Claimed by corporation in figuring its trade or business income on Form 1120
Employee	No ownership interest	Income reported as wages; no deduction for unreimbursed employee business expenses
Independent contractor	No ownership interest in a business	Claimed on individual's Schedule C

2019, and it had the same shareholders on December 22, 2017, and on the day of revocation.

Whatever your reason, changing from a sole proprietorship to another type of business organization generally does not entail tax costs on making the changeover. You can set up a partnership or corporation, transfer your business assets to it, obtain an ownership interest in the new entity, and do all this on a tax-free basis. You may, however, have some tax consequences if you transfer your business liabilities to the new entity.

But what if you now have a corporation or partnership and want to change your form of business organization? This change may not be so simple. Suppose you have an S corporation or a C corporation. If you liquidate the corporation to change to another form of business organization, you may have to report gains on the liquidation. In fact, gains may have to be reported both by the business and by you as owner.

Partnerships can become corporations and elect S corporation status for their first taxable year without having any intervening short taxable year as a C corporation if corporate formation is made under a state law formless conversion statute or under the check-the-box regulations mentioned earlier in this chapter.

Before changing your form of business organization, it is important to review your particular situation with a tax professional. In making any change in business, consider the legal and accounting costs involved.

Tax Identification Number

For individuals on personal returns, the federal tax identification number is the taxpayer's Social Security number. For businesses, the federal tax identification number is the employer identification number (EIN). The EIN is a 9-digit number assigned to each business. Usually, the federal EIN is used for state income tax purposes. Depending on the state, there may be a separate state tax identification number.

If you are just starting your business and do not have an EIN, you can obtain one instantaneously online using an interview-style application at www.irs.gov (search "EIN online") or by filing Form SS-4, *Application for Employer Identification Number*, with the IRS service center in the area in which your business is located. You must provide your own Social Security number in order to obtain an EIN for the business (it's part of a security measure). Application by mail takes several weeks. An SS-4 can be obtained from the IRS website at www.irs.gov or by calling a special business phone number (800-829-4933) or the special Tele-TIN phone number. The number for your service center is listed in the instructions to Form SS-4. If you call for a number, it is assigned immediately, after which you must send or fax a signed SS-4 within 24 hours.

If you change your business entity (e.g., from a sole proprietorship to an S corporation), you usually need to obtain a new EIN. You can determine whether you need a new EIN at www.irs.gov (search "do you need a new EIN?").

SPECIAL RULES FOR SOLE PROPRIETORS

Because sole proprietors report their business income and expenses on their personal returns, they may not be required to use an EIN. Instead, they simply use their Social Security number for federal income tax reporting.

A sole proprietor *must* use an EIN if the business has any employees or maintains a qualified retirement plan. A sole proprietor *may* need an EIN to open a business bank account (it depends on the institution). An EIN can also be used in place of a Social Security number by an independent contractor for purposes of Form 1099-NEC reporting (a consideration today with concerns about identity theft). A sole proprietor *should* use an EIN as a way in which to build a business credit profile in order to qualify for credit without relying entirely on the owner's credit history and personal guarantee.

A single-member limited liability company, which is a disregarded entity taxed as a sole proprietorship (unless an election is made to be taxed as a corporation) for income tax purposes, must obtain an employer identification number and use the number issued to the entity (and not the EIN issued to the owner's name).

CHAPTER 2

Tax Year and Accounting Methods

Once you select your form of business organization, you must decide how you will report your income. There are 2 key decisions you must make: What is the time frame for calculating your income and deductions (called the tax year or accounting period), and what are the rules that you will follow to calculate your income and deductions (called the accounting method). In some cases, as you will see, your form of business organization restricts you to an accounting period or accounting method. In other cases, however, you can choose which method is best for your business. Depending upon circumstances, you may want to need to change your accounting method. Sometimes making a change is easy, with automatic procedures; other situations require IRS consent, as you will see later in this chapter.

For a further discussion on tax years and accounting methods, see IRS Publication 538, *Accounting Periods and Methods*. Inventory rules are discussed in Chapter 4.

Accounting Periods

You account for your income and expenses on an annual basis. This period is called your *tax year*. There are 2 methods for fixing your tax year: *calendar* and *fiscal*. Under the calendar year, you use a 12-month period ending on

December 31. Under the fiscal year, you use a 12-month period ending at the end of any month other than December.

When you start your business and don't select a fiscal year, you automatically have a calendar year. You don't need to file any form or obtain IRS approval. If you commence your business in the middle of the tax year you have selected, your first tax year will be short.

Example

You start your S corporation in May 2020. It uses a calendar year to report expenses. The corporation will have a short tax year ending December 31, 2010, for its first tax year. Then, for 2021, it will have a full 12-month tax year.

A short tax year may occur in the final year of business.

Example

If you closed the doors to your business on May 31, 2020, even though you operated on a calendar year, your final tax year is a short year because it is only 5 months.

You do not have to apportion or prorate deductions for this short year merely because the business was not in existence for the entire year. Different rules apply if a short year results from a change in accounting period.

Seasonal Businesses

Seasonal businesses should use special care when selecting their tax year. It is often advisable to select a tax year that will include both the period in which most of the expenses as well as most of the income is realized. For example, if a business expects to sell its products primarily in the spring and incurs most of its expenses for these sales in the preceding fall, it may be best to select a fiscal year ending just after the selling season, such as July or August. In this way, the expenses and the income that are related to each other will be reported on the same return.

Limits on Use of the Fiscal Year

C corporations, other than personal service corporations (PSCs), can choose a calendar year or a fiscal year, whichever is more advantageous. Other entities, however, cannot simply choose a fiscal year, even though it offers tax advantages to its owners. In general, partnerships, limited liability companies (LLCs), S corporations, and PSCs must use a **required year**. Since individuals typically use a calendar year, their partnership or LLC must also use a calendar year.

Required year **For S corporations, this is a calendar year; for partnerships and LLCs, it is the same year as the tax year of the entity's owners. When owners have different tax years, special rules determine which owner's tax year governs.**

Business Purpose for Fiscal Year

The entity can use a fiscal year even though its owners use a calendar year if it can be established to the satisfaction of the IRS that there is a business purpose for the fiscal year. The fact that the use of a fiscal year defers income for its owners is not considered to be a valid **business purpose** warranting a tax year other than a required tax year.

Business purpose **This is shown if the fiscal year is the natural business year of the entity. For a PSC, for example, a fiscal year is treated as a natural business year if 25% or more of its gross receipts for the 12-month period ending on the last month of the requested tax year are received within the last 2 months of that year.**

While the vast majority of small businesses use a calendar year, some companies may use a fiscal year because it is the natural year of the type of business they are in. The end of the fiscal year coincides with the close of the business cycle. For example, a ski shop may close out its year on June 30 after running end-of-season sales. They do not have to use this fiscal year, however, and many such businesses use a calendar year.

Section 444 Election for Fiscal Year

If an entity wants to use a fiscal year that is not its natural business year, it can do so by making a Section 444 election. The only acceptable tax years under this election are those ending September 30, October 31, and November 30. Use of these fiscal years means that at most there can be a 3-month deferral for the owners. The election is made by filing Form 8716, *Election to Have a Tax Year Other Than a Required Tax Year*, by the earlier of the due date of the return for the new tax year (without regard to extensions) or the fifteenth day of the sixth month of the tax year for which the election will be effective.

If the election is made, then partnerships, LLCs, and S corporations must make certain *required payments*. These essentially are designed to give to the federal government the tax that has been deferred by reason of the special tax year. This payment can be thought of as simply a deposit, since it does not serve to increase the tax that is otherwise due. The payment is calculated using the highest individual income tax rate plus one percentage point. Therefore, the rate for 2020 is 38%. The required payment is made by filing Form 8752, *Required Payment or Refund Under Section 7519 for Partnerships and S Corporations*, by May 15 of the calendar year following the calendar year in which the election begins. For example, if the election begins on October 1, 2020, the required payment must be made no later than May 15, 2021. In view of the high required payment and the complications involved in making and maintaining a Section 444 election, most of these entities use a calendar year.

Personal service corporations that make a Section 444 election need not make a required payment. Instead, these corporations must make *required distributions*. They must distribute certain amounts of compensation to employee-owners by December 31 of each year for which an election is in effect. The reason for the required elections is to ensure that amounts will be taxed to owner-employees as soon as possible and will not be deferred simply because the corporation uses a fiscal year. Required distributions are figured on Part I of Schedule H of Form 1120, *Section 280H Limitations for a Personal Service Corporation*.

Pass-Through Business on a Fiscal Year

Owners in pass-through entities who are on a calendar year report their share of the business's income, deductions, gains, losses, and credits from the entity's tax year that ends in the owners' tax year.

Example

You are in a partnership that uses a fiscal year ending October 31. The partnership's items for its 2020 fiscal year ending October 31, 2020, are reported on your 2020 return. The portion of the partnership's income and deductions from the period November 1, 2020, through December 31, 2020, are part of its 2021 fiscal year, which will be reported on your 2021 return.

Short Tax Years

You may have a year that is less than a full tax year. This results most commonly in the year you start or end a business.

Example

You start an LLC on August 1, 2020, and use a calendar year to report your income and expenses. The LLC's first tax year is a short tax year, running from August 1, 2020, through December 31, 2020.

A short tax year can also result when a C corporation that had been reporting on a fiscal year elects S status and adopts a calendar year. The tax year of the C corporation ends on the date the S election becomes effective.

Alternatively, if an S election is terminated within the year or there is a substantial change in ownership (50% or more), then the corporation can have 2 short tax years in this case.

Example

A C corporation with a fiscal year ending on June 30 elects to become an S corporation and adopts a calendar year. The election is effective on January 1, 2021. The C corporation has a short tax year starting on July 1, 2020, and ending on December 31, 2020.

Example

An S corporation reporting on a calendar year has its election involuntarily terminated on July 31, 2020, when another corporation becomes a shareholder. The corporation has 2 short tax years: the S tax year running from January 1, 2020, through July 31, 2020, and the C tax year running from August 1, 2020, through December 31, 2020.

The IRS says that an unincorporated entity converting to a corporation under a state law formless conversion statute or check-the-box rules and which is eligible for S corporation status as of the first day of its first year does *not* have any short tax year for the momentary period it was a C corporation.

Change in Tax Year

If your business has been using a particular tax year and you want to change to a different one, you must obtain IRS approval to do so. Depending on the reason for the change, approval may be automatic or discretionary. You can request a change in your tax year by filing Form 1128, *Application to Adopt, Change,* *or Retain a Tax Year*. There is a user fee (an amount set by the IRS) for this request.

Accounting Methods

An accounting method is a set of rules used to determine when and how to record income and expenses on your books and for tax-reporting purposes. In some cases, how items are treated may differ for tax reporting purposes and financial accounting purposes. What is included in this chapter are the accounting method rules for tax reporting purposes.

There are 2 overall methods of accounting: *cash basis* and *accrual basis*. Use of a particular method determines when income is reported and a deduction can be claimed. However, restrictions apply for both methods of accounting. Also, the form of business organization may preclude the use of the cash method of accounting even though it may be the method of choice.

Cash Method

Cash method is the simpler overall accounting method. Income is reported when it is actually or constructively received, and a deduction for an allowable deductible expense can be claimed when and to the extent the expense is paid.

Example

You are a consultant. You perform services and send a bill. You report the income when you receive payment. Similarly, you buy business cards and stationery. You can deduct this expense when you pay for the supplies.

Actual receipt is the time when income is in your hands. Constructive receipt occurs when you have control over the income and can reduce it to an actual receipt.

Example

You earn a fee for services rendered but ask your customer not to pay you immediately. Since the customer was ready and able to pay immediately, you are in constructive receipt of the fee at that time.

Payments received by check are income when the check is received even though you may deposit it some time later. However, if the check bounces, then no income results at the time the check was received. You report income only when the check is later honored.

Sole proprietors and independent contractors on the cash method (and reporting on a calendar year basis) can run into a problem with respect to Form 1099-NEC for year-end payments. A company may send a payment late in December 2020 and include it on Form 1099-NEC for 2020; the contractor may receive the payment in January 2021. While this income is not taxable to the contractor until 2021, he or she must report the income on the return as it is reported by the company (because of IRS computer matching of information returns with income reported by recipients on their returns) and then make a subtraction to eliminate this amount from income. The payment is then included in income in 2021 even though it is not reflected on a Form 1099-NEC for 2021.

Expenses are usually fully deductible when paid. Payments by a general credit card, such as Mastercard or Visa, are deductible in the year they are charged, even if you pay the credit card bill in the following year. Payments using "pay by phone" with your bank are deductible when the bank sends the payment (check your bank account statement). There has been no IRS guidance on deductibility when using PayPal, Amazon Payments, or other electronic payment methods, but it appears that payments are deductible when you instruct PayPal or other provider to make them because that is when the funds are taken from your account. Bitcoin and other digital currencies are not treated by the IRS as currency (they're treated as property), so this complicates the deduction process.

You may not be able to deduct all expenses when they are paid because there are some limitations that come into play. Generally, you cannot deduct advance payments (so-called prepaid expenses) that relate to periods beyond the current tax year. However, under a 12-month rule, you can deduct amounts paid for a benefit that does not extend beyond the earlier of 12 months after the benefit begins or the end of the tax year after the tax year in which payment is made.

Example

You pay a $10,000 insurance policy on July 1, 2020, that is effective for one year. Because you meet the 12-month rule, you can deduct the full $10,000 in 2020. You take out a 3-year subscription to a business journal and pay the 3-year subscription price this year. Because the 12-month rule does not apply, you can deduct only ⅓ of the payment—the amount that relates to the current year. You can deduct another ⅓ next year, and the final ⅓ the following year.

Prepayments may occur for a number of expenses. You may prepay rent, insurance premiums, or subscriptions. Generally, prepayments that do not extend beyond 12 months are currently deductible.

In the case of interest, no deduction is allowed for prepayments by businesses. For example, if you are required to pay points to obtain a mortgage on your office building, these points are considered to be prepaid interest. You must deduct the points ratably over the term of the loan.

Example

If the mortgage on the office building runs for 30 years (or 360 months) and you pay the points on July 1, you can deduct 6/360 of the points in the first year. In each succeeding year you would deduct 12/360 of the points. In the final year, you would again deduct 6/360.

Deposits you make, such as an extra month's rent, may be called advances. If they are refundable, then they cannot be deducted when paid. If they are nonrefundable, they can be deducted when made.

If you pay off the mortgage before the end of the term (you sell the property or refinance the loan), you can then write off any points you still have not deducted.

RESTRICTIONS ON THE USE OF THE CASH METHOD

The tax law requires the use of the accrual method of accounting for certain taxpayers. Generally, a business must be on an accrual basis for its overall accounting method if it maintains inventory, is a large farming corporation, or if it is a C corporation, a partnership with a C corporation as a partner, or a tax shelter. However, key exceptions listed below permit small businesses to use the cash method of accounting.

Small Business Exception. Businesses can use the cash method of accounting if they are considered to be *small businesses*. A small business for this purpose in 2020 is one that has average annual **gross receipts** of $26 million or less for the 3-year period ending in the prior year in at least one of 3 prior taxable years. This is referred to as the gross receipts test.

Gross receipts **All the income taken in by the business without offsets for expenses. For example, if a consultant receives fees of $25,000 for the year and has expenses of $10,000, gross receipts are $25,000.**

In figuring gross receipts, noncorporate taxpayers—owners of pass-through entities—must aggregate gross receipts from the all the businesses they own.

Farming Corporations Exception. Farming corporations and farming partnerships in which a corporation is a partner usually must use the accrual method. However, the farming business is exempt from this rule if it meets the $26 million gross receipts test. A farming business includes any business that operates a nursery or sod farm or that raises or harvests trees bearing fruit, nuts, or other crops and ornamental trees.

PSC Exception. A **qualified personal service corporation** (PSC) can use the cash method of accounting without regard to gross receipts.

Qualified personal service corporation **A corporation (other than an S corporation) with a substantial number of activities involving the performance of personal services in the fields of medicine, law, accounting, architecture, actuarial sciences, performing arts, or consulting by someone who owns stock in the corporation (or who is retired or the executor of the estate of a deceased former employee).**

NOTE

If you use the small business exception or small inventory-based business exception, you account for inventoriable items as non-incidental materials and supplies (see Chapter 4).

Small Inventory-Based Business Exception. Even though you have inventory, you are permitted to use the cash method if you meet the $26 million gross receipts test.

You can use the cash method of accounting even though you use the accrual method for financial accounting purposes (for example, on profit and loss statements). However, you do not qualify for this exception if your principal business activity is retailing, wholesaling, manufacturing (other than custom manufacturing), mining, publishing, or sound recording. (Principal business activity is based on the largest percentage of your gross receipts using the North American Industry Classification System [NAICS], published by the U.S. Department of Commerce and which can be found in instructions to Schedule C of Form 1040 or 1040-SR.) NAICS codes are also used for government contracting purposes, so be sure that you use the correct code if you want to work with the government. You can get help determining which NAICS code is most appropriate for your business by using an online tool at www.naics.com/search.htm. Alternatively, you can contact the U.S. Census Bureau for help by calling 888-75NAICS.

Accrual Method of Accounting

Under the accrual method, you report income when it is earned rather than when it is received, and you deduct expenses when they are incurred rather than when they are paid. There are 2 tests to determine whether there is a fixed right to receive income so that it must be accrued and whether an expense is treated as having been incurred for tax purposes.

ALL EVENTS TEST

All events that fix the income and set the liability must have occurred. Also, you must be able to determine the amount of the income or expense with reasonable accuracy.

ECONOMIC PERFORMANCE TEST

In order to report income or deduct an expense, economic performance must occur. In most cases, this is rather obvious. If you provide goods and services, economic performance occurs when you provide the goods or services. By the same token, if goods or services are provided to you, economic performance occurs when the goods or services are provided to you. Thus, for example, if you buy office supplies, economic performance occurs when the purchase is made and the bill is tendered. You can accrue the expense at that date even though you do not pay the bill until a later date.

If you sell gift cards to customers, do not report the income until the cards are redeemed.

Example

If you sell a gift card to a customer in December 2020, and the customer gives the card to a friend who redeems it in January 2021, under the all-events test, the income from the sale of the gift card is deferred until 2021.

If you give gift cards to customers in exchange for returns of merchandise, you can treat the card as a payment of a cash refund and a sale of a gift card, allowing you to defer the income to be received through the gift cards. This is treated as a change in accounting method for which automatic consent is provided, but you must file for a change in accounting method as explained later in this chapter.

Advance payments. When a business receives advance payments, the revenue can only be deferred to the year after the year of receipt, and only if the deferral is consistent with the business's financial statement. This rule does not apply to long-term contracts and installment sale reporting explained later in this chapter. But there is a special rule explained earlier for gift cards.

Recurring items. There is an exception to the economic performance test for certain recurring items (items that are repeated on a regular basis). A deduction for these items can be accrued even though economic performance has not occurred.

Real estate taxes. There is a special rule for real estate taxes. An election can be made to ratably accrue real property taxes that are related to a definite period of time over that period of time.

Example

You own a building in which you conduct your business. Real property taxes for the property tax year ending June 30 are $12,000. You are an accrual method taxpayer on a calendar year of reporting. You can elect to ratably accrue the taxes. If the election is made, you deduct $6,000 in the current year, the amount of taxes that relates to the period for your tax year. The balance of the taxes is deductible next year.

Any real property taxes that would normally be deductible for the tax year that apply to periods prior to your election are deductible in the year of the election.

The election must be made for the first tax year in which real property taxes are incurred. It is made simply by attaching a statement to the return for that tax year. The return must be filed on time (including any extensions) in order for the election to be valid. Include on the statement the businesses to which the election applies and their methods of accounting, the period of time to which the taxes relate, and the computation of the real property tax deduction for the first year of the election.

Once you make this election, it continues indefinitely unless you revoke it. To revoke your election, you must obtain the consent of the IRS. However, there is an automatic procedure rule that allows you to elect or revoke an election by attaching a statement to your return. Under this method, you may assume you have IRS consent; you do not have to request it and wait for a reply.

If you have been accruing real property taxes under the general rule for accrual, you must file for a change in accounting method, which is explained later in this chapter.

You can make an election to ratably accrue real property taxes over the period to which they relate for each separate business you own.

TWO-AND-A-HALF-MONTH RULE

If you pay salary, interest, or other expenses to an unrelated party, you can accrue the expense only if it is paid within 2½ months after the close of the tax year.

Example

You declare a year-end bonus for your manager (who is not related to you under the rules discussed). You are on the calendar year. You can accrue the bonus in the year in which you declare it if you actually pay it no later than March 15.

Related Parties. If expenses are paid to related parties, a special rule applies. This rule, in effect, puts an accrual taxpayer on the cash basis so that payments are not deductible until actually paid. Related parties include:

- Members of an immediate family (spouses, children, brothers and sisters of whole or half blood, grandchildren, and grandparents).
- An individual and a C corporation (other than a PSC) in which he or she owns more than 50% of the corporation's outstanding stock (based on the stock's value). Stock ownership may be *direct* or *indirect*. Direct means that the individual holds the stock in his or her name. Indirect ownership means the stock is owned by a member of the individual's immediate family (listed above) or by a corporation, partnership, estate, or trust owned in full or in part by the individual. If the individual has only a partial ownership interest, that same proportion of stock owned by the entity is treated as owned by the individual. Thus, if an individual owns 75% of stock in Corporation X and X owns 100% of the stock in Corporation Y, the individual is treated as owning 75% of the stock in Y for purposes of this accrual method limitation.
- An individual and an S corporation in which he or she owns any of the corporation's outstanding stock. The Tax Court has said that this includes employees who are participants in an S corporation's ESOP and an appellate court has agreed.
- A PSC and any owner-employee (regardless of the amount of stock ownership). Thus, if an individual owns 10% of the stock in Corporation X (a PSC), and X owns 100% of the stock in Y, the individual is treated as owning 100% of the stock in Y.
- Other categories of related parties (e.g., 2 corporations that are members of a controlled group—they have certain owners in common).

If you fall under this related party rule, you cannot deduct the expense until payment is actually made and the related party includes the payment in his or her income.

Example

You have an accrual business in which your child is an employee. Your business is on the calendar year. On December 31, 2020, you declare a year-end bonus of $5,000 for your child. You may not accrue the bonus until you pay the $5,000 to your child and your child includes the payment as income. Therefore, if you write a check on January 15, 2021, for the bonus and your child cashes it that day, you can accrue the expense in 2021.

Accounting Methods for Long-Term Contracts

For businesses involved in building, constructing, installing, or manufacturing property where the work cannot be completed within one year, special accounting rules exist. These rules do not affect the amount of income or expenses to be reported—they merely dictate the timing of the income or expenses.

Generally, you must use the percentage-of-completion method to report income and expenses from these long-term contracts. Under this method, you must estimate your income and expenses while the contract is in progress and report a percentage of these items relative to the portion of the contract that has been completed. However, income and expenses are not fully accounted for until the earlier of either the completion of the job and acceptance of the work or the buyer starts to use the item and 5% or less of the total contract costs remain to be completed.

You may also have to use a *look-back method* (discussed later) to compensate for any inaccuracies in your estimates for income or expenses.

EXCEPTIONS FROM THE PERCENTAGE-OF-COMPLETION METHOD

Under this method you account for your income and expenses when, as the name implies, the contract has been completed. You can account for income and expenses using the completed-contract method if:

1. The contracts are small construction contracts that will be completed within 2 years and average annual gross receipts for the 3 preceding years from the start of the contract do not exceed $26 million.
2. The contracts are for the construction of homes containing 4 or fewer dwelling units. Eighty percent or more of the estimated total costs of the contract must be for these homes plus any related land improvements.

3. The contracts are for the construction of residential apartments (80% or more of the total contract costs are attributable to these buildings).

You can account for your income and expenses using the completed-contract method if you meet either of the first 2 exceptions. If you meet the third exception, you account for your income and expenses under a special method called the percentage-of-completion/capitalized-cost method. Under this hybrid method, 70% of income and expenses are reported under the percentage-of-completion method while 30% of income and expenses are reported under the completed-contract method.

Manufacturing contracts are treated as long-term contracts only if they involve the manufacture of unique items that cannot be completed within a 12-month period. Thus, income and expenses relating to most manufacturing contracts are reported under the company's usual method of accounting.

LOOK-BACK METHOD

At the end of the contract period, you must look back to each year that the contract was in progress and recalculate the income using the correct contract price and costs. These revised numbers determine whether the business owes additional interest on the taxes it should have paid or it is entitled to receive interest on the taxes already paid. Interest for this purpose is hypothetical interest on the overpayment and underpayment for each of the years in issue. This interest is calculated on Form 8697, *Interest Computation Under the Look-Back Method for Completed Long-Term Contracts*.

Small business owners, however, may escape the application of the look-back method. This method is *not* required if the contract is completed within a 2-year period and the contract's gross sale price does not exceed the lesser of $1 million or 1% of the business' average annual gross receipts for the 3 years preceding the tax year in which the contract is completed. The gross receipts test used for construction contracts in general does not apply for the exception to the look-back method.

Even if the exception for small businesses cannot be met, it is still possible to avoid the look-back method and its complications. You can elect not to use the look-back method if the estimated income and expenses are within 10% of the actual income and expenses. Once this election is made, it applies to all future contracts. In order to make the election, you must make the recalculations of the actual income and expenses for the prior years to see if the 10% threshold has been satisfied.

Other Accounting Methods

The cash and accrual methods of accounting are the most commonly used methods. There are, however, other accounting methods.