Quickfinder®

Small Business Quickfinder® Handbook (2019 Tax Year)

Updates for December 2019 Legislation and Other Recent Guidance

Instructions: This packet contains "marked up" changes to the pages in the *Small Business Quickfinder® Handbook* that were affected by December 2019 legislation, which was enacted after the *Handbook* was published. Additionally, changes were made based on other guidance issued after the *Handbook* was published. To update your *Handbook*, you can make the same changes in your *Handbook* or print the revised page and paste over the original page.

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Where to File: Business Returns Filing Addresses—2019 Returns

Note: At the time of publication, the IRS had not released the 2019 filing addresses for business returns. This information will be posted to the *Handbook Updates* section of **tax.thomsonreuters.com/quickfinder** when available.

Principal Business Activity Codes—Forms 1065, 1120, and 1120S

Note: At the time of publication, the IRS had not released the 2019 principal business activity codes for business returns. This information will be posted to the *Handbook Updates* section of **tax.thomsonreuters.com/quickfinder** when available.

Business Quick Facts Data Sheet[1]

	2020	2019	2018	2017	2016
FICA/SE Taxes					
Maximum earnings subject to tax:					
Social Security tax	$ 137,700	$ 132,900	$ 128,400	$ 127,200	$ 118,500
Medicare tax	No Limit	No Limit	No Limit	No Limit	No Limit
Maximum tax paid by:					
Employee—Social Security	$ 8,537.40	$ 8,239.80	$ 7,960.80	$ 7,886.40	$ 7,347.00
SE—Social Security	17,074.80	16,479.60	15,921.60	15,772.80	14,694.00
Employee or SE—Medicare	No Limit	No Limit	No Limit	No Limit	No Limit
Business Deductions					
Section 179 deduction—limit	$ 1,040,000	$ 1,020,000	$ 1,000,000	$ 510,000	$ 500,000
Section 179 deduction—SUV limit (per vehicle)	25,900	25,500	25,000	25,000	25,000
Section 179 deduction—qualifying property phase-out threshold	2,590,000	2,550,000	2,500,000	2,030,000	2,010,000
Depreciation limit—autos (1st year with special depreciation)	[2]	18,100	18,000	11,160	11,160
Depreciation limit—autos (1st year with no special depreciation)	[2]	10,100	10,000	3,160	3,160
Depreciation limit—trucks and vans (1st year with special depreciation)	[2]	18,100	18,000	11,560	11,560
Depreciation limit—trucks and vans (1st year with no special depreciation)	[2]	10,100	10,000	3,560	3,560
Retirement Plans					
SIMPLE IRA plan elective deferral limits:					
Under age 50 at year end	$ 13,500	$ 13,000	$ 12,500	$ 12,500	$ 12,500
Age 50 or older at year end	16,500	16,000	15,500	15,500	15,500
401(k), 403(b), 457, and SARSEP elective deferral limits:					
Under age 50 at year end	19,500	$ 19,000	$ 18,500	$ 18,000	$ 18,000
Age 50 or older at year end	26,000	25,000	24,500	24,000	24,000
Profit-sharing plan/SEP contribution limits	57,000	56,000	55,000	54,000	53,000
Compensation limit (for employer contributions to profit-sharing plans)	285,000	280,000	275,000	270,000	265,000
Defined benefit plans—annual benefit limit	230,000	225,000	220,000	215,000	210,000
Key employee compensation threshold	185,000	180,000	175,000	175,000	170,000
Highly compensated threshold	130,000	125,000	120,000	120,000	120,000
Estate and Gift Taxes					
Estate tax exclusion	$11,580,000[3]	$ 11,400,000[3]	$11,180,000[3]	$ 5,490,000[3]	$5,450,000[3]
Gift tax exclusion	11,580,000[3]	11,400,000[3]	11,180,000[3]	5,490,000[3]	5,450,000[3]
GST tax exemption	11,580,000	11,400,000	11,180,000	5,490,000	5,450,000
Gift tax annual exclusion	15,000	15,000	15,000	14,000	14,000

[1] See Tab 3 in the *1040 Quickfinder® Handbook* for an expanded *Quick Facts Data Sheet.*
[2] Amount not released by IRS at publication time; will be posted to the *Handbook Updates* section of **tax.thomsonreuters.com/quickfinder** when available.
[3] Plus the amount of any deceased spousal unused exclusion and/or any restored exclusion related to lifetime gifts to a same-sex spouse—see Tab H.

Tax Info for Partnership, Corporation, LLC, and LLP Returns (Cont.)

(Page 2 of 3)

Answer the following questions for all returns (1065, 1120, and 1120S):

Provide details for any item answered yes.

☐ Yes ☐ No 1) Was there any change in determining quantities, cost, or valuations between opening and closing inventory?

☐ Yes ☐ No 2) At any time during the year, did this business have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank, securities or other financial account)?

☐ Yes ☐ No 3) Does this business have any foreign partners, members or shareholders? If yes, provide details.

☐ Yes ☐ No 4) Did this business pay any taxes to a foreign government during the tax year?

☐ Yes ☐ No 5) Did this business have any debt canceled or forgiven or have terms of any debt modified?

☐ Yes ☐ No 6) Has this business filed, or is it required to file, a return under IRC Sec. 6111 on any reportable transaction?

☐ Yes ☐ No 7) Did this business have a Section 163(j) election for a real property or farming business in effect during the tax year?

☐ Yes ☐ No 8) Did this business conduct any activity or have any expenditure during the tax year that may entitle it to any of the following general business credits? If so, please indicate which ones on the list below:

- ☐ Yes a) Pay differential wages?
- ☐ Yes b) Provide access to the disabled?
- ☐ Yes c) Pay FICA on tips above minimum wage?
- ☐ Yes d) Provide child care and related services to employees?
- ☐ Yes e) Business located in an empowerment zone or renewal community?
- ☐ Yes f) Pay wages/health insurance for Indian tribe members/spouses?
- ☐ Yes g) Own any residential rental building providing qualified low-income housing?
- ☐ Yes h) Start new pension plan for business with less than 100 employees?
- ☐ Yes i) Conduct research and experimental projects?
- ☐ Yes j) Pay at least 50% of a qualified health arrangement for employees (if a small employer)?
- ☐ Yes k) Employ specifically targeted groups of individuals?
- ☐ Yes l) Invest in qualifying rehabilitation of historical structures?
- ☐ Yes m) Invest in property qualifying for ~~the~~ certain energy credits including: fuel cell vehicles (Form 8910), plug-in electric drive motor vehicles ~~credit~~ (Form 8936), and alternative fuel vehicle refueling property (Form 8911)?

Answer the following questions for all partnerships, and LLCs and LLPs filing Form 1065:

☐ Yes ☐ No 1) Is any partner/member in this partnership/LLC/LLP also a disregarded entity, partnership (or entity taxed thereas), S corporation, trust, estate or nominee (or similar person)?

☐ Yes ☐ No 2) Did this partnership/LLC/LLP own an interest in another partnership or a foreign disregarded entity?

☐ Yes ☐ No 3) Is this entity a publicly traded partnership as defined in IRC Sec. 469(k)(2)?

☐ Yes ☐ No 4) At any time during the calendar year, did the entity have an interest in or a signature or other authority over a financial account in a country outside the U.S.?

☐ Yes ☐ No 5) During the tax year, did the entity receive a distribution from, or was it grantor of or transferor to, a foreign trust?

☐ Yes ☐ No 6) Was there a distribution of property or transfer (by sale or death) of a partnership interest, etc. during tax year? If yes, provide details.

☐ Yes ☐ No 7) Has the entity previously made (and not revoked) a Section 754 election?

☐ Yes ☐ No 8) At tax year end, did any individual, estate, foreign or domestic corporation, partnership, trust, tax exempt organization or foreign government own (directly or indirectly) 50% or more in the profit, loss or capital of the entity? If yes, provide details.

☐ Yes ☐ No 9) At tax year end, did the entity own directly 20% or more, or own directly or indirectly 50% or more of total voting stock or profit/loss/capital of any foreign or domestic corporation, partnership or beneficial interest of a trust? If yes, provide details.

☐ Yes ☐ No 10) Did the entity, at any time during the current or prior tax year, distribute (or contribute to another entity) any property received in a like-kind exchange?

☐ Yes ☐ No 11) Did the entity, at any time during the tax year, distribute to any owner a tenancy-in-common or other undivided interest in entity property?

Corporations

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Basics of Corporations

Form 1120; see also IRS Pub. 542

Filing Requirements

Every corporation (except exempt—although exempt organizations that are corporations could be required to file other forms such as 990 and 990-T) must file regardless of the amount of income or loss. A corporation must continue to file until it is dissolved.

Filing deadline. For most C corporations, by the 15th day of the fourth month following the close of the tax year.

Note: For tax years beginning in 2016 or later, C corporation returns are due April 15 (or the 15th day of the fourth month following the close of a fiscal year). For tax years beginning before 2016, the deadline was the 15th day of the third month following the close of the tax year. For corporations with a June 30 year end, the due date change will be effective for tax years beginning after 2025.

Electronic filing of Form 1120 is required for C corporations that have $10 million or more in assets and annually file 250 or more returns of any type (including information returns such as Forms W-2 and 1099). However, these corporations can request a waiver of the electronic filing requirements (Notice 2010-13).

Extension deadline and form number. Form 7004 extends the deadline (1) six months for calendar year C corporations, (2) seven months for June 30 year end C corporations or (3) six months for other fiscal year C corporations (Reg. 1.6081-3). An extension to file does not extend the time for paying tax.

Penalties:

- Estimated tax underpayment: see *Estimated Tax* on Page C-2.
- Failure to make tax payments utilizing authorized methods: see *Tax Payments* on Page C-2.

- Late filing penalty: 5% of the unpaid balance per month or part of a month, up to a maximum of 25% (plus any underpayment and/or late payment penalties and interest) [IRC Sec. 6651(a)(1)].
- Minimum penalty for late filing in 2020 (including 2019 tax year returns due in 2020): if a return is more than 60 days late (including extensions), lesser of $435 or 100% of the amount of tax required to be shown on the return [IRC Sec. 6651(a)].

  Note: The statutory penalty amount is indexed by a cost-of-living adjustment (COLA).

- Late payment penalty: tax not paid by due date of a return is subject to a penalty of one half of one percent per month or part of a month, up to a maximum of 25% [IRC Sec. 6651(a)(2)].

If the corporation is assessed a penalty for late payment of tax for the same period in which a late filing penalty applies, the penalty for late filing is reduced by the amount of penalty for late payment, but not below the amount of the minimum penalty for late filing discussed earlier. Penalties for late filing and late payment will not be imposed if the corporation can show the failure was due to reasonable cause. A statement explaining the reasonable cause should be attached to the tax return. For reasonable cause exceptions, see Section 20.1.1.3—Criteria for Relief from Penalties, of the Internal Revenue Manual (available at **www.irs.gov/irm**).

Tax Rates on Taxable Income

The Tax Cuts and Jobs Act of 2017 (TCJA) changed the corporate tax rate to a flat 21%. This rate also applies to personal service corporations (PSCs) [see *Personal Service Corporation (PSC)* on Page F-12]. Prior to January 1, 2018, graduated tax rates applied, with a top rate of 35% if taxable income exceeded $10 million. PSCs were taxed at a flat rate of 35%.

Tax rate exceptions. Personal holding companies (PHCs) are subject to a 20% tax on undistributed PHC income [see *Personal Holding Company (PHC)* on Page F-14]. C corporations may also be subject to a 20% accumulated earnings tax on accumulated taxable income (see *Accumulated Earnings Tax* on Page C-12).

Corporation Defined

For federal tax purposes, corporations include the following:

1) Businesses organized under a federal or state law that identifies the entity as a corporation.
2) Joint stock companies.
3) Insurance companies.
4) Certain banks.
5) Business entities wholly owned by a state or any political subdivision thereof.
6) Certain foreign business entities.

Other entities, such as publicly traded partnerships, may be treated as corporations by other Code sections.

***Check-the-box* rules.** Noncorporate entities, such as sole proprietorships and partnerships, may elect to be taxed as corporations by filing Form 8832 (Entity Classification Election).

Note: Corporations cannot elect out of corporate tax treatment. If an entity is classified as a corporation under IRS regulations, the entity must file as a corporation.

Caution: Some states have rules that classify entities for tax purposes. Not all states recognize reclassification of an entity under check the box rules.

See *Check-the-Box Rules—Entity Classification Election (Form 8832)* on Page F-2 for more information.

Limited Liability

A corporation formed under state law shields owners from liability for the corporation's actions. A shareholder's risk of loss is limited to the amount invested in stock. This is in contrast to sole proprietors or general partners in partnerships, who are personally liable for debts of the business.

State laws determine an entity's liability status. A proprietor or partnership cannot receive limited liability status simply by electing to be taxed as a corporation under the check the box rules.

owns 30% (by vote and value) of the payor corporation's stock, the basic deduction amount is 65% of any dividend received, limited to an amount not exceeding 65% of the recipient's taxable income.

The preceding limits are figured without regard to NOL, qualified business income or dividends-received deductions; nontaxable portion of an extraordinary dividend or capital loss carrybacks.

When a corporation sustains an NOL, the above 65% or 50% limitation of taxable income does not apply.

Example #1: BNG Corporation sustains a $43,500 loss from operations. It received $90,000 in dividends from a 20%-owned corporation. Its taxable income is $46,500 ($90,000 – $43,500) before the deduction for dividends received.

By claiming the full dividends-received deduction of $58,500 ($90,000 × 65%), BNG Corporation calculates its NOL as follows:

Operating losses	($ 43,500)
Dividend income	90,000
Dividends-received deduction	(58,500)
NOL	($ 12,000)

Since BNG has an NOL, the 65% of taxable income limitation does not apply and it is entitled to a full dividends-received deduction of $58,500.

Example #2: Assume the same facts as Example #1, except BNG loses $10,000 from operations instead of $43,500. Taxable income before the dividends-received deduction is $80,000 ($90,000 – $10,000). After claiming a dividends-received deduction of $58,500 ($90,000 × 65%), the corporation has net income of $21,500 ($80,000 – $58,500).

Since in this example there is no NOL after a full dividends-received deduction, the allowable dividends-received deduction is limited to 65% of taxable income, or $52,000 ($80,000 × 65%). BNG calculates income as follows:

Operating losses	($ 10,000)
Dividend income	90,000
Dividends-received deduction (DRD) (limited to 65% of taxable income before DRD)	(52,000)
Taxable income	$ 28,000

Foreign dividends received. For distributions after 2017, a 100% deduction is provided for the foreign-source portion of dividends received from certain 10%-or-more-owned foreign corporations (IRC Sec. 245A). No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a dividend that qualifies for the deduction. The deduction is available only to C corporations and does not apply to RICs or REITs.

Business Interest Expense Limitation

The TCJA added a business interest expense deduction limitation [IRC Sec. 163(j)]. Business interest expense is limited to the sum of a taxpayer's (1) business interest income, (2) 30% of adjusted taxable income (if a positive amount), and (3) floor plan financing interest of vehicle dealers. Generally, taxpayers (other than tax shelters) with annual gross receipts for the three-year-tax period ending with the prior tax year of $25 million or less (as adjusted for inflation—$26 million or less in 2019) are not subject to this limitation. See *Business Interest Expense Limitation* on Page B-6 for additional information and applicable elections that are available.

Charitable Contributions

C corporations are allowed to deduct charitable contributions as a business expense. The deduction is limited to 10% of the corporation's taxable income [IRC Sec. 170(b)(2) and (c)].

Disaster Relief Alert: The 10% of taxable income limit does not apply to qualified contributions for relief efforts in qualified disaster areas. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019* on Page Q-1.

Taxable income for limitation purposes is calculated without regard to the deductions for [IRC Sec. 170(b)(2)(D)]:

- Charitable contributions.
- Dividends received.
- Premium on repurchase of convertible debt.
- Foreign-derived intangible income and global intangible low-taxed income.
- Dividends paid on certain public utility preferred stock.
- Net operating loss carrybacks.
- Capital loss carrybacks.
- Income attributable to domestic production activities of specified agricultural or horticultural cooperatives.

Unused contributions from this limitation can be carried forward for five years. No carryback is allowed [IRC Sec. 170(d)(2)].

State and local tax credits. The IRS clarified that payments made by business taxpayers to charities or government entities in exchange for credits against their state and local taxes are generally deductible as business expenses (IR-2018-178).

Research property. An exception to the contribution limit applies to contributions of scientific equipment for use in experimentation or for certain research training. This exception is only available for C corporations other than PHCs or service organizations as described in IRC Sec. 414(m)(3) [IRC Sec. 170(e)(4)]. These contributions are subject to the special computation rules discussed at *Charitable Contributions of Inventory* on Page C-14.

Intellectual property. In addition to the initial deduction, a taxpayer who has donated qualified intellectual property may claim a subsequent charitable contribution based on a percentage of the net income received by the charity (other than certain private foundations) from the property [IRC Sec. 170(m)].

Substantiation requirements. Strict rules exist for substantiating charitable contributions. For all monetary contributions, the corporation must maintain a bank record or a receipt, letter or other written communication from the donee organization indicating the organization's name, the date of the contribution, and the amount [IRC Sec. 170(f)(17)]. There is no *de minimis* exception. For contributions of $250 or more of either cash or property, the taxpayer must have a contemporaneous written acknowledgement from the donee (a canceled check will not suffice) [Reg. 1.170A-13(f)].

Charitable contributions of property over $5,000. C corporations are required to obtain a qualified appraisal for donated property if the claimed deduction exceeds $5,000. If the claimed deduction of property other than cash, inventory or publicly traded securities exceeds $500,000, a qualified appraisal must be attached to the donor's tax return.

Conservation easements. A deduction is available for qualified donations. See *Conservation easements* on Page N-15.

Charitable Contributions of Inventory

The deduction for a charitable contribution of inventory or other ordinary income producing property is generally limited to the adjusted basis of the property.

A provision in the Code allows a C corporation (not an S corporation) to donate inventory to charity and deduct up to one-half of FMV above cost as a charitable contribution [IRC Sec. 170(e)(3) and Reg. 1.170A-4A]. For purposes of this provision, depreciable property under IRC Sec. 1221(a)(2) also qualifies for the deduction.

The following rules must be met [IRC Sec. 170(e)(3)]:

1) The charity must be a Section 501(c)(3) organization;
2) The charity must use the donated property solely for the care of the ill, the needy or infants;
3) The charity cannot exchange the donated property for money, other property or services;
4) The corporation must be given a written statement from the charity that says it will follow rules 2 and 3;
5) If the property is subject to the Federal Food, Drug, and Cosmetic Act regulations, all such regulations must be satisfied; and

S Corporations

Tab D Topics

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Basics of S Corporations

Form 1120S

Filing Requirements

Every S corporation must file a return, regardless of the amount of income or loss (IRC Sec. 6037). It must file even if it stops conducting business. Filing ends when totally dissolved.

Filing deadline. By the 15th day of the third month following the close of its tax year or date of dissolution (March 15 for calendar year S corporations).

Electronic filing of Form 1120S is normally required for S corporations that have $10 million or more in assets and annually file 250 or more returns of any type (including information returns such as Forms W-2 and 1099) (Reg. 301.6037-2). See Notice 2010-13 for the requirements to request a waiver.

Extension deadline and form number. A six-month extension of time to file may be obtained by filing Form 7004 (Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns).

Penalties. The statutory penalty amount for failure to file an S corporation return is indexed by a cost-of-living adjustment (COLA). The COLA adjusted penalty amount for failure to file a return in 2019 is $200 ($205 for 2020) per month or part of a month per shareholder up to 12 months (IRC Sec. 6699; Rev. Procs. 2017-58 and 2018-57). The penalty is assessed against the corporation.

If S corporation taxes are due, a late filing penalty may be imposed equal to 5% of tax owed per month, up to 25%. If the return is more than 60 days late (including extensions) a minimum penalty of the lesser of $210 for returns required to be filed in 2019 (annually indexed for inflation) or the amount of unpaid tax applies. A late payment of tax penalty may also be imposed equal to one-half of one percent per month, up to 25% (IRC Sec. 6651).

Law Change Alert: For returns required to be filed after 2019, the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act, enacted December 20, 2019) increased the failure to file penalty to $435 (indexed for inflation for returns required to be filed in calendar years beginning after 2020).

In an IRS Program Manager Technical Advice (PMTA 2013-15) the IRS concluded that an untimely S corporation return should not be subject to both the general failure to file penalty under IRC Sec. 6651(a)(1) (which does not apply unless the S corporation owes tax) and the failure to file an S corporation return penalty under IRC Sec. 6699(a)(1) at the same time.

Additional information regarding penalties is found at *Penalties:* on Page C-1 and in the table *Taxpayer First Act of 2019* on Page Q-4.

Schedule K-1 deadline. S corporations must furnish a Schedule K-1 to each shareholder by the due date, including extensions, of the corporation tax return (Form 1120S). This penalty is annually adjusted for inflation. A $270 penalty for Schedules K-1 required to be furnished in 2020 (2019 tax year filings) is imposed with respect to each Schedule K-1 for which a failure occurs. This penalty applies for failure to furnish Schedule K-1 when due, failure to include all required information, or for including incorrect information (Rev. Proc. 2018-57). The $270 penalty may be reduced to $50 or $110 per failure, depending on when and whether the failure is corrected (IRC Sec. 6722). Higher penalties apply if the failure is due to intentional disregard of the law. See IRC Sec. 6722 for details.

Reasonable cause exception. The penalties discussed here will not be imposed if the failure was due to reasonable cause (IRC Secs. 6651, 6699, and 6724).

Estimated tax requirements. Shareholders pay estimated tax for their individual returns. The S corporation pays estimated tax only if corporate-level taxes apply [IRC Sec. 6655(g)(4)].

C Corporation vs. S Corporation

An eligible domestic corporation can elect to be taxed as an S corporation. An S corporation generally does not pay federal income tax—its profits and losses pass through directly to shareholders. This avoids the C corporation double tax, and allows shareholders to deduct corporate losses on their individual returns.

	C Corporation	S Corporation
Taxation	Double taxation of profits. Income is taxed at the corporate level; profits distributed as dividends are taxed at the individual level.	Profits are passed through directly to shareholders, escaping corporate-level tax. Qualified business income (QBI) from a taxpayer's qualified businesses is eligible for a QBI deduction. See *Qualified Business Income (QBI) Deduction* on Page D-1.
Dividends	Dividends paid by a C corporation are generally taxed to the individual at the same rate as long-term capital gains (0%, 15% or 20%).	S corporation earnings passed through to a shareholder are taxed as ordinary income.
Ordinary Losses	C corporation losses are not passed through to shareholders. Losses can be deducted only at the corporate level as NOL carrybacks (for certain entities) and carryforwards.	Losses are passed through directly to shareholders. Current-year losses are deductible up to the shareholder's basis in S corporation stock and loans to the S corporation.
Capital Gains	Taxed at the same rate as ordinary income.	Pass through to shareholders and are eligible for favorable capital gain tax rates for individuals.
Capital Losses	Allowed only to the extent of capital gains. Net capital losses are carried back three years and forward five years.	Pass through to shareholders. Capital losses are deductible subject to limitations on the shareholder's return.

For tax purposes, S corporations are treated similar to partnerships. Many rules governing S corporations are intended to subject S corporation shareholders to the same tax treatment as partners.

An S election can be useful in a corporation's early years, since losses pass through to shareholders.

Qualified Business Income (QBI) Deduction

The TCJA added IRC Sec. 199A, which applies to tax years 2018–2025. Under this new provision, individuals, estates and trusts may deduct up to 20% of their QBI from sole proprietorships (including farms) and pass-through entities.

Observation: IRC Sec. 199A is intended to provide tax relief to businesses not benefitting from the reduction in the top corporate rate from 35% to 21%. Thus, pass-through businesses (S corpo-

Private Operating Foundations

Private operating foundations engage in charitable activities (for example, museums, nursing homes, libraries, and sites preserved for historical reasons). Donations to private operating foundations fall under the more liberal deductibility laws of public charities.

- Donors may deduct cash contributions up to 50%-of-AGI [IRC Sec. 170(b)(1)(A) and (F)].
- Donors may deduct the full FMV of appreciated long-term capital gain property up to 30% of AGI [IRC Sec. 170(e)(1)]. For example, a donor establishes a private operating foundation to donate a family library that will lend the collection to other libraries. The donor may deduct full FMV of the library up to 30%-of-AGI.

Caution: Donating tangible personal property not related to the exempt purpose of the foundation limits the donor to a deduction of basis only.

Guidelines for a private operating foundation require that it spend at least 85% of the lesser of adjusted net income or minimum investment return directly on the active conduct of its exempt activities (the income test). It must also qualify under one of the following: the asset test, the endowment test or the support test.

Form 990-PF

All private foundations are required to file an annual return on Form 990-PF (Return of Private Foundation).

Restrictions and requirements on private foundations:

1) Restrictions on self-dealing between private foundations and their substantial contributors and other disqualified persons.
2) Requirements that the foundation annually distribute income for charitable purposes.
3) Limits in their holdings in private businesses.
4) Provisions that investments must not jeopardize the carrying out of exempt purposes.
5) Provisions to assure expenditures further exempt purposes.

Violating these provisions results in taxes and penalties against the private foundation and, in some cases, its managers, substantial contributors and certain related persons.

Disclosure. A private foundation must make its annual returns and exemption application available for public inspection. See *Disclosure Requirements* on Page E-6 for a discussion of the penalties for failure to disclose. Unlike other tax-exempt organizations, a private foundation is required to disclose the names and addresses of its contributors.

Caution: Do not report personal information about grantees or others that is not required and could be used for identity theft (for example, social security number or bank account information).

Excise Taxes

Private foundations are subject to excise taxes on (1) net investment income, (2) self-dealing, (3) failure to distribute income, (4) excess business holdings, (5) investments that jeopardize exempt status, and (6) expenditures that do not further the exempt purpose.

Note: Item 1 is reported on Form 990-PF, and items 2–6 are reported on Form 4720 (Return of Certain Excise Taxes Under Chapter 41 and 42 of the IRC).

Net investment income. IRC Sec. 4940 imposes a 2% (1.39% for tax years beginning after December 20, 2019) excise tax on the net investment income (interest, dividends, rents, royalties, securities loan payments, and income from similar sources) and capital gain net income of private foundations.

Self-dealing. IRC Sec. 4941 imposes on the disqualified person (not the foundation) an excise tax equal to 10% of the self-dealing amount, plus an additional 200% tax if the action is not corrected. Managers of the foundation may also be subject to a 5% tax if they knowingly allow the self-dealing to take place. The maximum amount of tax imposed on the foundation manager with respect to any one act of self-dealing shall not exceed $20,000.

Failure to distribute income. Private foundations must annually distribute to charity the greater of their net investment income or 5% of net investment assets. IRC Sec. 4942 imposes a 30% tax on undistributed amounts. If corrective action is not taken in a timely manner, a second tier tax of 100% of the undistributed income may be imposed. **Note:** This does not apply to private operating foundations.

Excess business holdings. Combined holdings of a private foundation and its disqualified persons are not permitted to exceed 20% of a corporation's voting stock, 20% of the profits interest in a partnership, or 20% beneficial interest in other entities. A 10% initial excise tax is imposed on the excess business holdings. A second-tier tax equal to 200% of the excess holdings is imposed if corrective action is not taken in a timely manner (IRC Sec. 4943).

For tax years beginning after 2017, certain businesses contributing all profits to charity and wholly owned by a private foundation are not subject to the excess business holdings tax [IRC Sec. 4943(g)].

Disqualified persons generally include a substantial contributor (including family members), a manager or a more-than-20% owner of a substantial contributor (including family members) to the private foundation. See IRC Sec. 4946(a) for more details.

The excess business holdings tax applies to donor advised funds.

Terminations. A private foundation generally must give notice and pay an excise tax under IRC Sec. 507(c) to terminate its status. To avoid tax, it can distribute all its assets to a qualifying Section 509(a)(1) organization that has been in continuous existence for at least 60 months prior to the distribution (Rev. Rul. 2003-13).

Becoming an Exempt Organization

Application Procedure

Organizations seeking exempt status from federal income tax must file a written application with the IRS. An organization applying under IRC Sec. 501(c)(3) submits Form 1023 [Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code] or if they qualify, Form 1023-EZ [Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code]. (See *Form 1023-EZ* on Page E-5 for a discussion on who qualifies to file the shorter Form 1023-EZ.) Other organizations submit Form 1024 [Application for Recognition of Exemption Under Section 501(a)]. Certain organizations filing for tax exempt status under IRC Sec. 501(c)(4), use Form 1024-A [Application for Recognition of Exemption Under Section 501(c)(4) of the Internal Revenue Code]. See the Organization Reference Chart in IRS Pub. 557 for the proper form.

The following organizations may be considered tax-exempt under IRC Sec. 501(c)(3) even if they do not file Form 1023:

- Churches and integrated auxiliaries of churches, and conventions or associations of churches.
- Any organization that is not a private foundation and has gross receipts in each tax year of normally not more than $5,000.

Even if not required to file to be tax-exempt, organizations may choose to file Form 1023 to receive a determination letter that recognizes their 501(c)(3) status and specifies whether contributions to them are tax deductible.

Note: An interactive version of Form 1023 is available at **www.irs.gov** by searching for "interactive application."

Expedited process. The IRS will expedite applications if there is a compelling reason to process the case ahead of others. Compelling reasons include: (1) a pending grant that is needed to secure the organization's ability to continue operating, (2) a newly created organization providing disaster relief to victims of emergencies such as floods and hurricanes or (3) IRS errors causing undue

exchange for the contribution, even if no such goods or services were provided (*Durden*, TC Memo 2012-140).

Note: Volunteers may deduct unreimbursed out-of-pocket expenses incurred for qualified charities if properly substantiated [*Van Dusen*, 136 TC 515 (2011)].

Sale of Donated Property

Disposing of donated property within three years of receiving it requires the organization to file Form 8282 (Donee Information Return) within 125 days of the disposition. A copy must be given to the original donor (IRC Sec. 6050L). Form 8282 is not required if the property is valued at $500 or less or is consumed or distributed for charitable purposes.

Property covered by this rule is any property for which the organization signed an appraisal summary as donee (thus, it does not include cash or publicly traded securities). The original appraisal summary for value exceeding $5,000 is attached to the donor's income tax return on Form 8283 (Noncash Charitable Contributions).

The information required by Form 8282 helps the IRS determine whether the donor might have claimed a deduction for more than the FMV of the property. In addition, the information will indicate whether the organization used the property for an exempt purpose. A donor's deduction is limited to his tax basis in tangible personal property, rather than FMV, if it is not used for the donee organization's exempt purpose.

Nondeductible Contributions or Dues

Organizations receiving donations that are not deductible by the donor must state this in their solicitations for contributions.

Membership dues used for lobbying expenses may not be deductible. See *Proxy Tax* on Page E-6 for more information.

Unrelated Business Income Tax (Form 990-T)

See also IRS Pub. 598

Filing Requirements

If an exempt organization has unrelated business income (UBI) of $1,000 or more, it is required to file Form 990-T. Gross income for this purpose is gross receipts or sales (net of returns and allowances) less costs of goods sold. This form is in addition to other annual filing requirements, such as Form 990, 990-EZ, 990-N or 990-PF. The filing of Form 990-T also applies to organizations that may not be required to file Form 990 (for example, a church or a school).

Disallowed Fringe Benefits Create UBI

The TCJA provided that a tax-exempt organization must increase its unrelated business taxable income (UBTI) by any disallowed fringe benefit expenses for amounts paid or incurred after December 31, 2017 [former IRC Sec. 512(a)(7)]. Specifically, the costs of providing qualified transportation (such as parking) were to be included in UBI. This provision could have caused a Form 990-T filing requirement for organizations that have never had this requirement.

Law Change Alert: Section 302 of the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (enacted December 20, 2019) repealed IRC Sec. 512(a)(7), effective for amounts paid or incurred after December 31, 2017. Thus, the TCJA provision discussed in the preceding paragraph does not apply.

Disclosure Requirements

Section 501(c)(3) organizations must make their Forms 990-T available for public inspection.

Unrelated Business Income Tax (UBIT)

Tax is levied on unrelated business income (UBI). Without a tax, taxable organizations would be placed at a disadvantage when trying to compete with exempt organizations. UBIT is intended to neutralize the tax differences. The unrelated trade or business could result in the loss of exempt status if the activity is determined to be the primary purpose of the organization.

Exempt organizations with UBI are subject to corporate tax rates, with the exception of charitable trusts that are subject to the tax rates for estates and trusts (IRC Sec. 511). Organizations with UBI are also subject to estimated tax rules for corporations and trusts.

Unrelated Trade or Business

Three factors must be present for activities to be considered an unrelated trade or business (IRC Secs. 512 and 513):

1) Organization conducts a trade or business.
2) Trade or business is not substantially related to the exempt purpose of the organization.
3) Trade or business is regularly carried on by the organization.

Trade or business. Includes any activity conducted for the production of income from selling goods or performing services. The activity does not need to produce a profit. Income from an unrelated trade or business used exclusively for carrying on the exempt organization's purpose is still considered UBI.

Note: For tax years beginning after 2017, the TCJA provides that unrelated business taxable income is to be calculated separately for each trade or business, and a loss from one business cannot offset income from another business [IRC Sec. 512(a)(6)].

Example: Historic Ltd., an exempt organization, restores historic buildings to their original condition. Historic Ltd. charges admission to tour its buildings. Admission fees do not cover all of the restoration costs, so Historic Ltd. runs a motel for tourists to stay in while visiting. The income generated by the motel is UBI.

Not substantially related to the exempt purpose. Not only must the trade or business contribute to the accomplishment of the tax-exempt purpose, but there must be a substantial causal relationship between the activity and the achievement of the organization's exempt purpose.

Example: Young Act, an exempt organization, operates a training school for young children in the performing arts. A vital part of the children's training is performing for the general public. The children are paid minimum wage, and Young Act generates income through admission fees. The income is not UBI because the performances contribute importantly to the exempt purpose.

Regularly carried on. Specific business activities of an exempt organization are deemed to be *regularly carried on* if they are pursued in a manner similar to comparable commercial activities.

Factors determining if an activity is regularly carried on:

- Frequency of the activity.
- Continuity of the activity.
- Manner in which the activity is conducted.

Example #1: An exempt organization owns an office building and adjacent parking lot. During the week, the employees park in the lot. On the weekends, the exempt organization rents spaces in the parking lot to individuals who are shopping or visiting the area. Since the activity is regularly carried on (every weekend), the income from the parking lot rentals is UBI.

~~**Note:** For years beginning after 2017, the employer's cost associated with provided parking is a qualified transportation fringe benefit included in UBTI. See *Disallowed Fringe Benefits Create UBI Disallowed Fringe Benefits Create UBI* on Page E-11 for more information~~.

Example #2: A church owns land located next to the state fairgrounds. During the 10 days of the fair, the parking lot is used for fair parking, and fees are charged for parking (no services are provided). This activity is not considered to be regularly carried on, therefore, it is not UBI.

Exceptions to unrelated trade or business classification:

- *Volunteer labor.* Substantially all (generally 85% or more) the work of the trade or business is performed by volunteers. For example, retail store run by an orphanage and staffed with unpaid volunteers.
- *Donated goods.* Trade or business consists of merchandise sales, and substantially all of the merchandise has been received as gifts or contributions. For example, thrift shop run by an organization.
- *Convenience of members.* For Section 501(c)(3) organizations and governmental colleges or universities, the trade or business is conducted primarily for the convenience of the organization's members, students, patients, officers or employees. For example, a laundry operated by the college for laundering linens and students' clothing.
- Other special exceptions are provided for in IRC Sec. 513, including public entertainment events at fairs and trade shows (for example, agricultural event at a state fair designed to promote the breeding of animals), bingo games, hospital services, pole rentals, distribution of low-cost articles (see *Token Benefits—Distribution of Low-Cost Articles* on Page E-12), and sponsorship payments (see *Qualified Sponsorship Payments* on Page E-12).

Dues

Agricultural and horticultural organizations that require members to pay annual dues of $169 or less for 2019 (Rev. Proc. 2018-57) are not required to include the dues revenue as UBI [IRC Sec. 512(d)].

Gaming

Gaming includes, but is not limited to, bingo, pull-tabs, Texas Hold-em poker and other card games, raffles, video games, 21, punch boards and lotteries. Income from regularly conducted gaming activities is treated as UBI and may result in loss of exempt status. (See IRS Pub. 3079.)

Volunteer labor exception. If substantially all (generally 85% or more) of the work is performed by unpaid volunteers (including tips), the activity will not be considered UBI.

Gaming is not UBI for:

- Section 501(c)(3) or (4) organizations if gaming is not regularly carried on.
- Section 501(c)(5) or (6) organizations if the gaming activities are considered to further the exempt organization's purpose.
- Section 501(c)(7), (8), (10) or (19) organizations if the gaming activities provide social or recreational activities for members only.

A qualified bingo game is not considered an unrelated trade or business if three requirements are satisfied [IRC Sec. 513(f)]:

1) The bingo game is legal under both state and local law,
2) Commercial bingo games (conducted for profit) ordinarily are not permitted in the area and
3) Wagers are placed, winners determined and prizes distributed in the presence of all persons wagering in the game.

Caution: Even though tax-exempt organizations may be exempt from paying income taxes, they may be subject to withholding, occupation and wagering excise taxes.

Example: Church, a tax-exempt organization, volunteers conduct weekly bingo games in order to raise money for Church's missions ministry. State and local laws provide that bingo games may be conducted by tax-exempt organizations. In addition, bingo games are not conducted by any for-profit businesses in the area. Church's bingo games are not considered unrelated business income.

Token Benefits—Distribution of Low-Cost Articles

If an exempt organization distributes low-cost items [$11.10 or less for 2019 (Rev. Proc. 2018-57)] and the distributions are incidental to the solicitation, these distributions may not be considered an unrelated trade or business.

Incidental means:

- Person receiving item did not request it.
- Person receiving item receives it without his/her consent.
- Item is accompanied by a request for a charitable contribution.
- Contribution request includes a statement that the person may keep it even if no contribution is made.

Qualified Sponsorship Payments

Qualified sponsorship payments (QSPs) are not subject to UBIT. A QSP is a payment by a business for which it will receive no substantial benefit other than the use of its name, logo or product lines by the nonprofit. Reg. 1.513-4 provides guidance and examples on QSPs, including the tax treatment of any payment (or portion of a payment) that is not a QSP.

Advertising or Charitable Donation

Tax-exempt organizations can publicly acknowledge donors for their contributions. However, if the exempt organization conducts advertising for the donor, the donation would be considered taxable income to the exempt organization [IRC Sec. 513(i)].

Donations to tax-exempt organizations are taxable income if the organization, in return, provides a valuable benefit or service to the donor. Mere recognition of a contributor as a benefactor (value-neutral acknowledgement) is incidental to the contribution.

Tax-exempt organizations that go beyond recognition and promote the donor are engaging in advertising, which is unrelated to the mission of tax-exempt organizations. In these cases, exempt organizations must pay UBIT on the payment received in exchange for advertising services provided.

All the facts and circumstances of the relationship between the sponsor and the exempt organization must be considered. Items to consider include the value of the service provided in exchange for the payment and the terms under which payments and services are rendered (Ann. 92-15).

Example #1: A symphony maintains a website that contains performance schedules. Corporate sponsors help fund the performances. In appreciation, the symphony lists the sponsors and web addresses but it does not promote or advertise their merchandise. However, users may hyperlink (jump) to the sponsors' websites. This is not considered advertising and payments for sponsorships are not UBI (Ltr. Rul. 200303062).

Example #2: The same facts as above, except the user hyperlinks to a corporate sponsor to find an endorsement of the sponsor's product by the exempt organization. The endorsement is advertising and the payment for sponsorship is UBI.

Fiduciary Tax Returns (Form 1041)

Tab G Topics

Fiduciary Return Facts .... Page G-1
Trust and Estate Terminology .... Page G-2
Overview of Income Taxation of Trusts and Estates .. Page G-3
Qualified Business Income (QBI) Deduction .... Page G-8
Grantor Trusts .... Page G-9
Grantor Trusts—Tax Returns and Reporting Requirements .... Page G-9
Simple Trust—Detailed Example .... Page G-11
Complex Trust—Detailed Example .... Page G-12
Form 1041, Schedule K-1 Codes .... Page G-16

Fiduciary Tax Rate Schedules

2019 rates—See *Form 1041* on the front cover

Related Information

- Decedent's final Form 1040; Estate's Form 706—Tab H
- Estate planning—Tab 15, *1040 Quickfinder® Handbook*; Tab 15, *Tax Planning for Individuals Quickfinder® Handbook*
- Worksheet to reconcile income reported on final Form 1040 and Form 1041—Tab A
- IRS Pub. 559 (Survivors, Executors, and Administrators)

Fiduciary Return Facts

Filing requirements:

- *Estates.* Gross income of $600 or more, or a nonresident alien beneficiary.
- *Trusts.* Any taxable income, gross income of $600 or more, or a nonresident alien beneficiary.
- *Grantor Trusts.* See the chart *Grantor Trusts—Tax Returns and Reporting Requirements* on Page G-9.

Tax year:

- *Estates.* Day after death is the beginning of the first tax year. The first year can cover any period of 12 months or less that ends on the last day of a month. The executor chooses a tax year when the first fiduciary return is filed.
- *Trusts.* Calendar year. *Exception:* A grantor trust that files Form 1041 uses the same tax year as the grantor.

Filing deadlines:

- Calendar year 2019: April 15, 2020.
- Fiscal year: The 15th day of the fourth month following the close of the tax year.

File a 2019 Form 1041 for:

- Calendar year 2019.
- Fiscal year beginning in 2019 and ending in 2019 or 2020.
- Fiscal year beginning in 2020 if the 2020 form is not available by the due date for the return. Use 2020 tax rates and incorporate any law changes.

Beneficiary's year. Beneficiaries report income in the tax year in which the trust or estate year ends. For example, the estate of a decedent who died on February 17, 2019, closes its first year on January 31, 2020. The estate files a 2019 Form 1041 for the first year. A calendar-year beneficiary reports any items from the Schedule K-1 on his or her year 2020 Form 1040 even though the items are reported on a 2019 Schedule K-1.

Estimated tax requirements (Form 1041-ES):

- *Estates.* Estimated payments are only required for tax years ending two or more years after the decedent's death [IRC Sec. 6654(l)]. (This rule also applies to a decedent's grantor trust that will receive the residue of the estate under the decedent's will or, if no will is probated, to the trust primarily responsible for paying the decedent's debts, taxes and administration expenses.)
- *Trusts* (and estate tax years ending two or more years after the decedent's death). Estimated payments are required if tax after subtracting withholding and credits is $1,000 or more, and withholding and credits is less than the smaller of [IRC Sec. 6654(d)]:
  1) 90% of the tax for the current year or
  2) 100% of the tax from the previous year.

  However, if a return was not filed in the previous year, or the previous year's return did not cover a full 12 months, then item 2 does not apply. If adjusted gross income (AGI) in the previous year was more than $150,000, and less than two-thirds of gross income is from farming or fishing, the safe harbor is 110% (not 100%) of the previous year's tax.

A domestic estate or trust that had a full 12-month prior tax year with no tax liability for that year is not required to make ES payments the next year.

Estimated tax allocated to beneficiaries. A trust (or an estate in its final year) may allocate all or any portion of its estimated tax payments to beneficiaries under IRC Sec. 643(g) by filing Form 1041-T by the 65th day after the close of the tax year (March 6, 2020 for calendar year 2019). Form 1041-T can be filed with Form 1041 or filed separately. If filed separately, Form 1041-T should not be attached to Form 1041. The estimated tax allocated to beneficiaries should be reported on line 13 (Code A) of their Schedules K-1.

Estimated tax—special rules:

- Individuals calculate estimated tax payments using income for months ending before the due date of the installment. For example, the June 15 payment is based on income through May 31. For trusts and estates, the period ends one month earlier [IRC Sec. 6654(l)(4)]. Estimated payments are based on income through February 28 (April 15 payment), April 30 (June 15 payment), July 31 (September 15 payment) and November 30 (January 15 payment).
- Estates and trusts are subject to the 3.8% net investment income tax (NIIT), and the calculation of estimates should include the liability for this tax. See *Net Investment Income Tax* on Page G-7.
- A beneficiary is not required to include income distributed during the first 65 days of the following year in annualized income for the January 15 payment when a trust or estate elects to treat such income as if it were paid during the current year (Rev. Rul. 78-158).

Tax withholding. Backup withholding reported to an estate or trust on Form 1099 (for interest income, dividends or other income) is reported on line 11, Schedule G of Form 1041. Backup withholding distributed to the beneficiaries is reported on Schedule K-1, box 13 (Code B). Other than backup withholding, withheld income tax cannot be passed through to beneficiaries on Form 1041-T or Schedule K-1.

Employer identification number (EIN). Any estate or trust required to file Form 1041 must obtain an EIN. See inside front cover.

Exemptions	
Estates	$ 600
Trusts required to distribute all income currently	300
Trusts permitted to accumulate income	100

Extensions. Form 7004 is used for an automatic extension of 5½ months for Form 1041. Thus, for calendar-year trusts and estates, the extended due date will be September 30.

Penalties. Late filing penalty of 5% of tax per month up to 25%, plus late payment penalties and interest. If a return is more than 60 days late, the minimum late filing penalty is the smaller of $435 [for tax returns required to be filed in 2020 per IRC Sec. 6651(a)] or the tax due. The penalty may be waived if an explanation showing reasonable cause for the delay is attached to the return.

Income and Expense Chart for a Decedent (Continued)

—Cash Method of Accounting—

Category	*Where to Report*	*Explanation*
Medical Expenses	Final Form 1040, Schedule A	Medical expenses paid before death. Can elect to deduct medical expenses incurred before death but paid from the estate within one year of the day following death [Reg. 1.213-1(d)]. Election does not apply to medical expenses for a decedent's dependents. To elect, attach a statement to Form 1040 stating the estate has waived the right to claim medical expense for estate tax. With the election, deduction is taken on Form 1040, Schedule A in year costs were incurred (a Form 1040X may be needed). Amounts not allowed due to 7.5%-of-AGI threshold cannot be claimed on Form 706.
	Form 706, Schedule K	Unpaid medical expenses at death are reported on Form 706 as a claim against the estate, unless an election is made to report on decedent's final Form 1040. Amounts deducted on Form 706 are not subject to the 7.5%-of-AGI deduction threshold. If deduction taken on Form 1040, amount not allowed due to 7.5%-of-AGI threshold cannot be claimed on Form 706.
	Form 1041	Any insurance reimbursements after death of amounts previously deducted on Form 1040. Report as IRD.
Miscellaneous Itemized Deductions	Final Form 1040, Schedule A	Miscellaneous itemized deductions that would not have been subject to the 2%-of-AGI limit that are paid before death. Generally, most miscellaneous deductions are not deductible.
	Form 706, Schedule J or Form 1041	Unpaid miscellaneous itemized deductions at date of death are reported on Form 706. When paid, if the item would not have been subject to the former 2%-of-AGI limitation, deduct on Form 1041 as DRD.
	Form 1041	Incurred, paid after death, and would not be subject to the former 2%-of-AGI limit. See *Deductions* on Page G-5.
Net Investment Income Tax	Form 8960	Estates are subject to the 3.8% net investment income tax. See Tab G for additional discussion.
Partnership Income (Loss)	Final Form 1040, Schedule E	Income (or loss) up to date of death using any reasonable method of allocating income (loss). Allocation is often based on pro rata amount for year or interim closing of books.
	Form 1041 (or beneficiary's return)	Income (or loss) after death not included on final Form 1040.
Passive Losses	Final Form 1040	Losses are allowed to extent of passive income, plus accumulated unused losses to extent they exceed any increase in basis allocated to the activity. For example, if a passive activity's basis is increased $6,000 upon taxpayer's death, and unused passive activity losses as of date of death are $8,000, decedent's deduction is $2,000 ($8,000 – $6,000).
	Form 1041	Estates are subject to the same passive loss limitation rules as individuals. The fiduciary's level of participation determines the classification. If decedent actively participated in a rental real estate activity before death, the estate will be allowed the special $25,000 rental real estate exemption for up to two years after decedent's death.
Personal Residence	Form 1041	The Section 121 exclusion of gain from sale of personal residence does not apply to estates. If personal residence is a capital asset to the estate (either held for investment or rental purposes), estate can deduct loss on sale. If property is used by estate beneficiaries for personal purposes, loss on sale is not deductible. If home was not subject to probate and passed directly to heirs, sale of home is reported on beneficiaries' Form 1040.
Real Estate, State and Local Income Taxes	Final Form 1040, Schedule A	Paid before death, subject to $10,000 limitation ($5,000 if MFS). General sales taxes deductible if state and local income taxes not deducted [IRC Sec. 164(b)(5)]. The total deduction for state and local real property, personal property, income and general sales taxes is generally limited to $10,000. Exceptions apply for taxes paid in carrying on a trade or business or for the production of income.
	Form 706, Schedule K and Form 1041 (or beneficiary's return)	Real estate taxes accrued before death but paid after death. **Note:** The $10,000 limit for deducting taxes mentioned previously applies to Form 1041 as well unless the property is held for the production of income.
	Form 1041 (or beneficiary's return)	Accrued and paid after death. **Note:** The $10,000 limit for deducting taxes mentioned previously applies to Form 1041 as well unless the property is held for the production of income
Rental Income and Expenses	Final Form 1040, Schedule E	Income and expenses received or paid before death.
	Form 706 and Form 1041 (or beneficiary's return)	Income and expenses accrued before death but not actually received or paid until after death (IRD and DRD). Passive activity loss rules apply to estates (for Form 1041 reporting).
	Form 1041 (use Schedule E of Form 1040)	Income and expenses accrued and received or paid after death. Passive loss rules apply to estates.
S Corporation Income (Loss)	Final Form 1040, Schedule E	Pro rata share of income (or loss) up to death. Generally, amount of income (or loss) is computed as follows: S corporation income or loss for the year, divided by number of days in S corporation's year, multiplied by number of days shareholder was alive. Can elect under Section 1377(a)(2) to close S corporation books on day of death.
	Form 1041 (or beneficiary's return)	Income (or loss) after date of death and not included on final Form 1040.
Savings Bond Interest *(Decedent did not elect to report interest annually)*	Final Form 1040 or Form 1041	Two options (Rev. Rul. 68-145): 1) Executor elects to report interest accrued before death on final Form 1040. Interest accrued after death is reported on Form 1041 (or beneficiary's return) in year bond is redeemed or matures. 2) All interest (both before and after death) is reported on Form 1041 (or beneficiary's return) in year bond is redeemed, matures or an election is made to report income. Interest accrued before death is IRD. Alternatively, recipient of an inherited bond can elect to report interest annually (Rev. Rul. 64-104).
	Form 706, Schedule B	FMV of bonds, including interest accrued up to date of death, which may be IRD.
Savings Bond Interest *(Decedent elected to report interest annually)*	Final Form 1040	Interest accrued up to date of death.
	Form 1041 (or beneficiary's return)	Interest accrued after death. Note that the last Series E bonds matured in 2010 and the last Series H bonds matured in 2009. These bonds stopped paying interest at that time and any deferred interest should have been recognized on the 1040 in the year the bond matured.
	Form 706, Schedule B	FMV of bonds as of date of death. No IRD.
Social Security	Final Form 1040	Payments cease at death; therefore, subject to reporting on final Form 1040.
Standard Deduction	Final Form 1040	Full amount allowed. No proration required.
Wages	Final Form 1040	Wages received before death.
	Form 706, Schedule F and Form 1041 (or beneficiary's return)	Wages earned before death but received after death (IRD).

quarters should check the box on line 18 of Form 941 every quarter the form is filed. Generally, the IRS will not inquire about unfiled returns if at least one taxable return is filed each year.

Deposit threshold. If the tax liability for the quarter is less than $2,500, it may be paid with Form 941. Otherwise, the withheld taxes must be deposited on either a semiweekly or monthly basis. See *Deposit Deadlines (Forms 941, 944, and 945)* on Page I-2.

Filing deadlines:

Quarter Ending	Due Date
March 31	April 30
June 30	July 31
September 30	October 31
December 31	January 31

Extensions. If all taxes were timely deposited for the quarter, the due dates are extended 10 days. There is no additional extension for filing Form 941.

Paper and computer-generated substitute Forms 941, W-2, and W-3. See Rev. Procs. 2016-20, 2018-24, and 2018-37 for the rules.

Penalties:

- The penalty for filing a tax return late is 5% of the tax due for each whole or part month the return is not filed when required. The maximum penalty is 25% of the unpaid tax. If the return is over 60 days late, the minimum penalty is the lesser of $435 or the tax due [IRC Sec. 6651(a)(1)].
- The penalty for paying the tax late is 0.5% of the tax due for each whole or part month the tax is not paid when required. The maximum penalty is 25% of the unpaid tax. The IRS can also charge interest on the balance due [IRC Sec. 6651(a)(2)].
- If both penalties apply in any month, the failure to file penalty is reduced by the amount of the failure to pay penalty.
- If the employer fails to withhold and pay over the tax, a responsible person can be held liable for 100% of the tax in place of the employer. See *Trust Fund Recovery Penalty* on Page I-11.

Credits for increasing research activities. A credit may be claimed on Forms 941, 943, or 944 from Forms 8974 (Qualified Small Business Payroll Tax Credit for Increasing Research Activities) and 6765 (Credit for Increasing Research Activities) to accommodate the R&D credit against payroll taxes. This permits taxpayers with annual gross receipts of less than $5 million to offset the employer portion of social security taxes with up to $250,000 of qualified research expenses [IRC Sec. 41(h)]. See Notice 2017-23 for interim guidance on claiming the credit and IRS internal legal advice AM 2017-003 regarding timing issues. Clarifying procedures for claiming the credit on Form 943 or 944 have been posted at **www.irs.gov** (search "research payroll credit").

Employer's Annual Federal Tax Return (Form 944)

Employers with a total annual tax (social security, Medicare, and FITW) liability of $1,000 or less may be eligible to file Form 944 (Employer's ANNUAL Federal Tax Return) once a year instead of Form 941 quarterly.

Caution: Employers that were previously notified by the IRS to file Form 944 must continue filing Form 944 until opting out of the program or being notified by the IRS that Forms 941 must be filed. Employers may request to opt out of filing Form 944 by calling (800-829-4933) or writing the IRS at the addresses specified in the Form 944 instructions before the applicable due date. See Rev. Proc. 2009-51 for guidance.

Annual Return of Withheld Federal Income Tax (Form 945)

Form 945 is used to report federal income tax withheld for nonpayroll items, which may include backup withholding, withholding for pensions, annuities, IRAs, and gambling winnings. Generally, separate deposits must be made via EFTPS. However, exceptions exist to this rule (for example, if net taxes in full for the year are less than $2,500 and the amount is being paid in full with the timely filed return, Form 945-V (Payment Voucher) may be used). Do not combine this deposit with Form 941 or other payroll tax deposits.

Nonpayroll income tax withholding reported on Form 1099 or Form W-2G must be reported on Form 945. All income tax withholding reported on Form W-2 must be reported on Form 941 or 943 (for agricultural employees) or 944 (for small employers—see above), Schedule H (Form 1040) for household employees, or Form CT-1 (for railroad employees).

Backup withholding. If a taxpayer fails to provide a payer with a current taxpayer identification number (TIN), the payer must withhold federal taxes at a 24% rate for 2019 (IRC Sec. 3406). Rev. Proc. 2014-43 provides procedures for validating TINs to prevent or stop back-up withholding. See also IRS Pub. 1281.

Employer's Federal Unemployment Tax Return (Form 940)

Used by employers to report annual federal unemployment tax (imposed on the employer, not the employee).

Filing requirements. Employers who were not household or agricultural employers must file Form 940 if they paid a total of $1,500 or more in wages in any calendar quarter (of the current or prior year), or had one or more employees for some part of a day in any 20 different weeks during the current or prior year. Count all regular, temporary, and part-time employees. A partnership should not count its partners. Form 940 can be filed electronically through the IRS's e-file Program (Rev. Proc. 2007-40).

Note: If the employer receives a preprinted Form 940 and is not liable for FUTA tax because no payments to employees were made during the year, check box c. on page 1, sign and return it to the IRS.

Agricultural employers pay FUTA tax and file Form 940 if, during the current or preceding calendar year, they meet either of two tests regarding agricultural laborers [IRC Sec. 3306(a)(2)]:

1) Pay them wages ≥ $20,000 during any calendar quarter or
2) Employ ≥ 10 of them for some part of a day (whether or not at the same time) during any 20 or more different weeks.

Wages paid for agricultural labor performed by aliens lawfully admitted to the U.S. on a temporary basis to work peak seasons are not subject to FUTA tax. However, the services performed by such aliens are still counted in determining whether an agricultural employer meets either of the two preceding tests.

Household employees. Wages paid to household employees are subject to FUTA tax if they total $1,000 or more during any calendar quarter of the current or preceding calendar year [IRC Sec. 3306(a)(3)]. Household employers use Schedule H of Form 1040 to report and pay FUTA taxes for their household employees. However, if a household employee's wages are reported on Forms 941, 943, or 944, the employer must deposit the tax and use Form 940 to report FUTA tax.

Filing deadline. Form 940 is due by January 31, 2020.

Extensions. If all tax is deposited when due, the deadline is extended 10 days. There is no additional extension for Form 940.

Penalties:

- Late filing penalty of 5% of tax per month up to 25%.
- Late payment penalty of 0.5% of tax per month up to 25%.

Partial Table of Class Lives and Recovery Periods—IRS Pub. 946, Appendix B (Continued)

Asset Class	*Description of assets included:*	*Class Life (in years)*	*GDS Life (MACRS)*	*ADS*
01.21	**Cattle, breeding or dairy**	7	5	7
01.221	**Any breeding or work horse 12 years old or less** at the time it is placed in service[2]	10	7	10
01.222	**Any breeding or work horse more than 12 years old** at the time it is placed in service[2]	10	3	10
01.223	**Any race horse more than two years old** at the time it is placed in service[2]	[3]	3	12
01.224	**Any horse more than 12 years old** at the time it is placed in service that is neither a race horse nor a horse described in Class 01.222[2]	[3]	3	12
01.225	**Any horse not described in Classes 01.221, 01.222, 01.223, or 01.224**[2]	[3]	7	12
01.23	**Hogs, breeding**	3	3	3
01.24	**Sheep and goats, breeding**	5	5	5
01.3	**Farm buildings** except structures included in Class 01.4	25	20	25
01.4	**Single-purpose agricultural or horticultural structures** [within the meaning of IRC Sec. 168(i)(13)]	15	10[4]	15
10.0	**Mining.** Includes assets used in the mining and quarrying of metallic and nonmetallic minerals (including sand, gravel, stone, and clay) and the milling, beneficiation and other primary preparation of such materials	10	7	10
13.1	**Drilling of oil and gas wells.** Includes assets used in the drilling of onshore oil and gas wells and the provision of geophysical and other exploration services; and the provision of such oil and gas field services as chemical treatment, plugging and abandoning of wells, and cementing or perforating well casings.	6	5	6
13.2	**Exploration for and production of petroleum and natural gas deposits.** Includes assets used by petroleum and natural gas producers for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related storage facilities.	14	7	14
15.0	**Construction.** Includes assets used in construction by general building, special trade, heavy and marine construction contractors, operative and investment builders, real estate subdividers and developers, and others, except railroads	6	5	6
23.0	**Manufacturing of apparel and other finished products.** Includes assets used in the production of clothing and fabricated textile products; does not include apparel from rubber and leather	9	5	9
24.1	**Timber cutting equipment**	6	5	6
24.4	**Assets used in the manufacturing of wood products and furniture**	10	7	10
27.0	**Printing, publishing and allied industries.** Includes assets used in printing by one or more processes, such as letter-press, lithography, gravure or screen; the performance of services for the printing trade, such as bookbinding, typesetting, engraving, photo-engraving and electrotyping; and the publication of newspapers, books, and periodicals	11	7	11
39.0	**Manufacture of athletic, jewelry, and other goods.** Includes assets used in the production of: jewelry; musical instruments; toys and sporting goods; motion picture and television films and tapes; and pens, pencils, office and art supplies, brooms, brushes, caskets, etc.	12	7	12
57.0	**Distributive trades and services.** Includes assets used in wholesale and retail trade, and personal and professional services. Includes Section 1245 assets used in marketing petroleum and petroleum products	9	5	9[5]
79.0	**Recreation.** Assets used in the provision of entertainment services for a fee or admission charge, such as bowling alleys, pool halls, theaters, concert halls, and miniature golf courses. Does not include amusement and theme parks and specialized land improvements such as golf courses, sports stadiums, race tracks, ski slopes, and buildings	10	7	10
	Personal property with no class life		7	12
	Section 1245 real property with no class life		7	40
	Residential rental real property		27.5	30
	Nonresidential real property. Includes office buildings, warehouses, and qualified *office-in-home*		39	40

[1] 5 years if the asset's original use began with the taxpayer after 12/31/17 (new assets); 7 years otherwise (used assets).

[2] Race horses placed in service after 2008 and before 2021, regardless of age, are three-year property. Outside of that date range, race horses more than two years old when placed in service are three-year property, and race horses two years old or younger are seven-year property. A horse is more than two (or 12) years old after the day that is 24 (or 144) months after its actual birthdate.

[3] Properties described in asset classes 01.223, 01.224, and 01.225 are assigned recovery periods but have no class lives.

[4] Seven years if property was placed in service before 1989.

[5] High technology medical equipment is assigned a five-year recovery period for alternate MACRS method (ADS).

GDS *General Depreciation System.* 200% declining-balance (DB) depreciation method for three-year, five-year, seven-year and 10-year property; 150% DB for farm placed in service before 2018, 15-year and 20-year property; straight-line (SL) depreciation method for 27.5- and 39-year property; and recovery years for alternative minimum tax (AMT) depreciation for assets placed in service after 1998.

ADS *Alternative Depreciation System.* Recovery years for AMT depreciation for assets placed in service prior to 1999, C corporation *book* depreciation and exempt organizations. Can be elected for *tax* depreciation.

Note: Use this table for assets placed in service after 1986. See IRS Pub. 946 for a list of all asset recovery periods.

2019 Employer and Self-Employed Retirement Plan Chart

	SEP IRA (Self-Employed)	SEP IRA (Employee)	SIMPLE IRA
Who can establish?	Anyone (regardless of age) with self-employment (SE) income.[1]	Any employer.	Employers with 100 or fewer employees (including self-employed individuals) that do not maintain another retirement plan.
Eligible employees[2]	N/A. But, if contributions are made for self-employed, they must also be made for eligible employees.	Employees at least age 21 who worked for the employer during at least three of the last five years and received at least $600 in compensation from employer in 2019.	Employees who have earned at least $5,000 from employer in any prior two years, and are reasonably expected to do so in the current year.
Maximum Contributions Allowed	20% of net SE income after SE tax deduction up to a maximum contribution of $56,000. SARSEPs established before 1997 follow 401(k) contribution limit rules.	25% of wages up to maximum contribution of $56,000. SARSEPs established before 1997 follow 401(k) contribution limit rules.	Employee elective deferrals limited to $13,000 (additional $3,000 if age 50 or older at end of the year). The employer can either: 1) Match employee elective deferrals dollar for dollar up to 3% of wages (can be reduced to as low as 1% in any two out of five years) or 2) Contribute 2% of wages (up to $280,000) for *all* employees (including nonparticipants).
Penalties for Early Withdrawal (Before Age 59½)	10% of distribution. (See *Exceptions to 10% Withdrawal Penalty Before Age 59½* on Page K-5.)		10% of distribution, or 25% if withdrawn within two years from the date first participated in plan. (See *Exceptions to 10% Withdrawal Penalty Before Age 59½* on Page K-5.)
When Withdrawals Must Begin	By April 1 of the year following the year the account owner turns age 70½. **Note:** Contributions can still be made to the account after age 70½ if the individual has earned income.		
Date to Establish Plan and Make Contributions	Return due date, including extensions, for the year the plan is to be effective.		• Establish plan by October 1, 2019 for new plans first in effect for 2019.[3] • Make employer contributions by the return due date, including extensions.[4]
Employer Contributions Required?	No	No	Yes
Borrowing Permitted?	No	No	No
Rollover Allowed?	Yes	Yes	Yes
Penalty for Excess Contributions?[5]	6% excise tax for both self-employed individuals and employees if excess contribution (plus earnings) is not withdrawn by return due date (including extensions). Employers are subject to a 10% excise tax on nondeductible (excess) contributions, unless an exception applies.		

[1] A SEP is established at the employer level. For a partner, the partnership establishes and contributes to the SEP.
[2] Plans can set less restrictive participation requirements, but not more restrictive ones.
[3] New employers that come into existence after October 1 may establish a plan as soon as administratively possible.
[4] Employee and self-employed elective deferrals must be deposited as soon as reasonably possible, but no later than 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash. A self-employed taxpayer's elective deferral must be deposited by January 30 of the following year (January 30, 2020 for 2019 amounts).
[5] Excess contribution penalties are cumulative each year until corrected. The penalty is reported on IRS Form 5330 (Return of Excise Taxes Related to Employee Benefit Plans).

Advantages to Employer and Self-Employed Plans

Qualified plans, SEPs, and SIMPLEs:
- Contributions are generally tax deductible by the contributor and tax deferred for the plan participant. Earnings on contributions are tax deferred until withdrawn.
- Maximum contributions (including SEPs and SIMPLEs) are generally greater than IRAs.
- Deductible contributions allowed after age 70½.

SEPs and SIMPLEs:
- Easy to set up and maintain.
- Allow plan participant to choose how funds are invested as opposed to a plan administrator through employer.
- Participant is always 100% vested in the plan.

SEPs:
- No annual reporting requirements; easy to administer.
- Do not require recurring contributions.

SIMPLEs: Similar to 401(k) employee elective deferral and employer matching, without complex nondiscrimination and "top-heavy" rules.

401(k) and 403(b) plans:
- Employers allowed to match employee contributions; employee is generally fully vested sooner than with other qualified plans.
- Plan is managed by professionals.
- Easy for employees—contributions through payroll reductions.
- Certain tax-free borrowing from plan is permitted.

<table>
<tr><th colspan="4">2019 Employer and Self-Employed Retirement Plan Chart</th></tr>
<tr><th>Defined-Benefit</th><th>Defined-Contribution (Profit-Sharing)</th><th>401(k)</th><th>403(b)</th></tr>
<tr><td colspan="3">Any employer.</td><td>Tax-exempt religious, charitable, or educational organizations.</td></tr>
<tr><td colspan="3">Employees at least age 21 with one year of service (1,000 hours).</td><td>Employees[6] who work 20 or more hours per week, do not participate in another 401(k), 457 or 403(b) plan and will contribute more than $200 per year.</td></tr>
<tr><td>Actuarially determined contribution. Maximum benefit payout limited to 100% of average compensation for the three consecutive years of highest compensation (limited to $280,000), but not to exceed $225,000.[7]</td><td>Contributions per participant up to lesser of 100% of compensation or $56,000. Employer deduction limited to 25% of aggregate compensation (limited to $280,000 per employee) for all participants (20% of net SE income after SE tax deduction for self-employed).[7]</td><td>Employee elective deferrals limited to $19,000 (additional $6,000 if age 50 or older at end of the year). Employer deduction limited to 25% of combined wages of all employees (elective deferrals do not reduce wages for the 25% limit). Combined employer contributions and employee elective deferrals per employee limited to lesser of 100% of wages or $56,000 (additional $6,000 for employees age 50 or older by year-end).[7]</td><td>Employee elective deferrals limited to $19,000 (additional $6,000 if age 50 or older at end of the year). Special formula applies to additional employer contributions based on years of service. Combined employer contributions and employee elective deferrals per employee limited to lesser of 100% of wages or $56,000 (additional $6,000 for employees age 50 or older by year-end).[7]</td></tr>
<tr><td colspan="4">10% of distribution. (See Exceptions to 10% Withdrawal Penalty Before Age 59½ on Page K-5.)</td></tr>
<tr><td colspan="4">For self-employed and >5% owners, by April 1 of the year following the year the account owner turns age 70½. For all other employees, April 1 of the year following the year the account owner turns age 70½ or retires, whichever is later.</td></tr>
<tr><td colspan="2">December 31, to establish plan. Return due date, including extensions for profit-sharing plan contributions. 8½ months after year-end for defined benefit plan contributions.</td><td colspan="2">December 31 to establish plan. For employer contributions, return due date including extensions.[8]</td></tr>
<tr><td>Yes</td><td>No</td><td colspan="2">Generally no.</td></tr>
<tr><td colspan="4">Yes, if plan permits. Must pay back in five years (unless used to buy a principal residence).</td></tr>
<tr><td>Yes</td><td>Yes</td><td>Yes</td><td>Yes</td></tr>
<tr><td colspan="2">Employers are subject to a 10% excise tax on nondeductible (excess) contributions, unless an exception applies.</td><td colspan="2">Employee's elective deferral: No penalty or tax if 2019 excess is withdrawn by April 15, 2020 (but allocable earnings are taxable in year withdrawn). If not withdrawn by April 15, 2020, excess is taxed twice—once in the year of excess contribution and again when distributed because no cost basis is allowed for excess contribution.
Employer's contribution: 10% penalty on excess contributions (resulting from plan failing average deferral percentage test) unless distributed (with earnings) to highly compensated employee(s) within 2½ months after the close of the plan year (taxable to employee in year of deferral). Failure to distribute excess within 12 months after close of plan year results in plan failing to qualify for that plan year and all subsequent plan years for which the excess contributions remain uncorrected.</td></tr>
</table>

[6] Includes self-employed ministers.
[7] Nondiscrimination rules may affect contributions/deferrals for certain employees.
[8] The Tax Code does not specify when the employer is required to deposit employee elective deferrals into the employee's account. However, under ERISA regulations, employee elective deferrals must be contributed to the employee's 401(k) plan account as soon as reasonably can be segregated from the employer's general assets, but not later than the 15th business day of the month immediately after the month in which the contributions either were withheld or received by the employer.

Disaster Relief Alert: Special rules apply for distributions and loans to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019* on Page Q-1.

Exceptions to 10% Withdrawal Penalty Before Age 59½

Note: Distributions treated as a return of nondeductible contributions, distributions of excess contributions or deferrals and distributions of excess aggregate contributions to meet nondiscrimination requirements are not subject to the 10% penalty.

Form 5329 Number	Applies to distributions from:	Exception
01	Qualified plan	Distribution made to an employee after separating from service in or after the year he reaches age 55 (age 50 for qualified public safety employees).
02	Qualified plan or IRA	Distribution is part of a series of substantially equal periodic payments made over the life expectancy of the participant or joint lives of participant and his beneficiary.
03	Qualified plan or IRA	Distribution made due to total and permanent disability.
04	Qualified plan or IRA	Distribution made due to death.
05	Qualified plan or IRA	Distribution to the extent the individual's unreimbursed medical expenses exceed 7.5% of his AGI.
06	Qualified plan	Distribution made to an alternate payee pursuant to a qualified domestic relations order (QDRO).
07	IRA	Distribution to pay for health insurance premiums for certain unemployed individuals.
08	IRA	Distribution to the extent of the qualified higher education expenses for the year of the taxpayer, spouse, child or grandchild.
09	IRA	Distribution for first-time home purchases (no home ownership in prior two years). Exception limited to $10,000 (lifetime).
10	Qualified plan or IRA	Distribution due to an IRS levy on the qualified plan or IRA. The exception will not apply if funds are withdrawn to avoid a levy or to satisfy a levy on other property.
11	Qualified plan or IRA	Distribution to reservists while serving on active duty for at least 180 days.
12	—	Various other exceptions. See Form 5329 instructions and IRS Pubs. 575 and 721 for more information.

Determining the car's FMV. If the employer bought the car in an arm's-length transaction, its cost (including applicable sales tax, title fee, and other transaction costs) can be used as FMV.

If the employer leases the auto, the manufacturer's suggested retail price (including applicable sales tax, title fees, and other transaction costs) less 8% can be used as the safe-harbor FMV figure. Or, a leased auto's FMV can be determined by reference to the retail value of the auto as reported by a nationally recognized pricing source. Finally, for leased autos, the employer can use the manufacturer's invoice price (including applicable options) plus 4% as the auto's FMV (Notice 89-110).

Commuting Value Method

In rather limited circumstances, an employee's personal use of a company car can be valued at $3 per round-trip to and from work ($1.50 per one-way commute) [Reg. 1.61-21(f)]. If multiple employees commute in the same vehicle, the imputed personal use income for each is $3 per round trip/$1.50 per one-way commute.

Requirements for Commuting Value Method	
Requirement	*Description*
Employee required to commute in the employer provided vehicle	For valid business reasons, the employee is required to commute to work in the vehicle (for example, a job requires 24-hour on-call availability).
Personal use prohibited	The employer has an enforced, written policy that prevents the employee (and/or anyone whose use would be taxable to the employee, such as a spouse) from using the car for personal reasons other than commuting to and from work.[1]
No personal use occurs	The employee does not actually use the car for personal use other than commuting.[1]
Employee is not a control employee	A control employee is: • Officer with compensation ≥ $110,000 (for 2019);[2] • Director; • Employee with compensation ≥ $225,000 (for 2019) or[2] • Owner of 1% or more of the employer's equity, capital or profits.

[1] *De minimis* personal use (such as a trip to the grocery store on the way home from work) is allowed.
[2] Notice 2018-83.

Safety Requirement for Commuting

The TCJA specifically allows the employer to take an income tax deduction for expenses incurred or paid for providing transportation, or any payment or reimbursement, to an employee for travel between the employee's residence and place of employment when necessary for ensuring the safety of the employee [IRC Sec. 274(l)(1)]. Other expenses for such travel are specifically disallowed. At the time of this publication, the IRS had not provided guidance on how to determine what expenses are considered necessary to ensure the safety of an employee. Practitioners should be alert for additional information.

Cents-per-Mile Method

Sometimes, the standard business mileage rate (58¢ for 2019) can be used to value an employee's personal use of a company car [Reg. 1.61-21(e); Rev. Proc. 2010-51; Notice 2019-2]. If the employer does not provide or pay for fuel, the cents-per-mile rate can be reduced by up to 5.5¢ per mile.

Requirements for Cents-per-Mile Method	
Requirement	*Description*
Period of Use OR Required Mileage	The employer must expect that the car will be used regularly for business for the entire year (or, if less, the time the employer owns the car) OR The car must be driven (primarily by employees) at least 10,000 miles (pro-rated if not owned the entire year) during the calendar year.
Cap on FMV	The car's FMV must be less than $50,400 (2019 amounts per Notice 2019-34).

In general, the employer must adopt the cents-per-mile method for an auto by the first day an employee uses it for personal purposes. Once the cents-per-mile method is used for an auto, it must be used as long as that auto is eligible for it. But, if an auto later qualifies for the commuting value method, that method can be used even though the cents-per-mile method was used earlier.

Recordkeeping Requirements

An employee may not exclude from income any portion of the value of an employer-provided automobile unless the use is substantiated by records.

The records should contain (Temp. Reg. 1.274-5T):

- Date of each use.
- Mileage per trip.
- Business purpose of the trip.
- Description of destination, business purpose, benefit derived, etc. (for travel outside tax home area).
- Total mileage for the year.

Records must be kept at or near the time of the use. If there are no written records, the employee may provide a statement containing information related to the automobile's use or may provide other corroborative evidence sufficient to establish use. However, without written records, the IRS may disallow the exclusion from income.

Reporting Employee Personal Use on Business Tax Return

When the personal use of a company car is included in an employee's wages as taxable compensation, the employer recovers the cost of the car as if it were used entirely for business purposes. Section A in Part V of Form 4562 on the employer's tax return would then show business-use percentage as 100%.

Qualified Retirement Plans

A qualified retirement plan is one of the best tax-saving tools available, since the plan contributions are deductible by the employer and tax deferred to the employee. The rules governing retirement plans are lengthy and complex. Some of the general rules are covered below. For more coverage see the *IRA and Retirement Plan Quickfinder® Handbook*.

Disaster Relief Alert: Special rules apply for distributions and loans to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019* on Page Q-1.

Qualified retirement plans fall into two basic categories:

- Defined-contribution plans.
- Defined-benefit plans.

1) *Defined-contribution plans* provide benefits based on the amount contributed to an employee's individual account plus any income, expenses, gains, losses, and forfeitures of other employees that are allocated to the account [IRC Sec. 414(i)].

Continued on the next page

Other Employer Retirement Plans

Disaster Relief Alert: Special rules apply for distributions and loans to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019* on Page Q-1.

SIMPLEs

Savings incentive match plans for employees. Qualified employers (including self-employed individuals) may establish Section 408(p) SIMPLE retirement plans. A SIMPLE is a written salary reduction arrangement that allows eligible employees to defer compensation tax free and employers to make either matching contributions for employees who elect to participate, or nonelective contributions for all eligible employees (including those who do not elect to participate).

SIMPLEs do not fall under the complicated 401(k)-type rules that require a certain level of employee participation. A SIMPLE can operate as an IRA with an individual account set up for each employee (SIMPLE IRA) or in a 401(k) format with contributions made to a trust or annuity contract [SIMPLE 401(k)]. Both types of plans have many common requirements (differences are noted):

Qualified employers/employees:

1) The employer must have 100 or fewer employees who earned $5,000 or more during the preceding calendar year,
2) The employer cannot currently maintain another qualified plan (except for certain union employees),
3) Employees must receive at least $5,000 in compensation from the employer during any two preceding years (not necessarily the immediately preceding two years), and be reasonably expected to receive at least $5,000 in the current year, and
4) Eligible employees may participate in another employer's qualified plan, but are subject to the combined elective deferral limitations of $19,000 for 2019—Notice 2018-83) for all plans. An employee who is age 50 or older can contribute an additional $6,000 for a total of $25,000 for 2019).

Contributions:

1) Employer contributions must either:
   - Match employee contributions dollar for dollar up to 3% of employee compensation,
   - Match employee contributions up to a reduced percentage of employee compensation, not less than 1% of compensation and not for more than two out of any five years [this employer election is not available for SIMPLE 401(k) plans] or
   - Be nonelective contributions equal to 2% of compensation for all eligible employees.
2) Employee elective deferrals cannot exceed the lesser of $13,000 for 2019 ($16,000 if age 50 or over—$13,000 plus $3,000 catch-up limit) or total compensation for the year.
3) Compensation limit for qualified plans ($280,000 for 2019) does not apply to the 3% matching contributions to SIMPLE IRAs. The compensation limit does apply to the 2% nonelective contributions, and to any matching contributions to SIMPLE 401(k) plans.
4) Employer contributions are excluded from employee wages for both income and employment tax purposes (FICA and FUTA). Contributions made by employees and self-employed individuals are subject to employment taxes (SE, FICA, and FUTA). (Notice 98-4, Q&A I-1)
5) A self-employed individual's compensation for purposes of employee deferrals and employer matching is defined as the amount entered on line 4, Section A or line 6, Section B of Schedule SE (Form 1040), before subtracting any contributions made to a SIMPLE IRA on behalf of the self-employed individual.

Example: In 2019, Nell's share of partnership profits (box 1, Part III of Schedule K-1, Form 1065) equals $15,000, which is reported on Schedule E and line 2 of Schedule SE, Form 1040. Nell contributes $10,000 to a SIMPLE as an employee deferral. Compensation for purposes of the employer's match is $13,853 ($15,000 × .9235, line 4 of Schedule SE). The employer's 3% match equals $416 ($15,000 × .9235 × 3%). Nell's Schedule K-1 reports $10,416 in box 13, Code R as total contributions to her SIMPLE. Nell deducts $10,416 on Schedule 1, Form 1040. A similar calculation is made for Schedules C and F filers.

Distributions are taxed like IRAs (except the 10% early withdrawal penalty is increased to 25% if made within first two years of participation) [IRC Sec. 72(t)(6)].

Disaster Relief Alert: Generally, Section 72(t) will not apply to qualified distributions and certain loans from qualified plans to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019* on Page Q-1.

Other requirements (Notice 98-4):

1) The employer and employee contributions must be 100% vested at all times.
2) The employer (or self-employed person) must deposit employee (or his own) elective deferrals as soon as reasonably possible, but no later than 30 days after the end of the month during which the contributions were withheld from wages.
3) The employer contribution must be made by the due date of the employer's income tax return, including extensions.

Simplified Employee Pensions (SEPs)

See the *2019 Employer and Self-Employed Retirement Plan Chart* on Page K-4.

Deemed (Payroll Deduction) IRAs

Employers can set up separate accounts or annuities (payroll deduction IRAs) for employees [IRC Sec. 408(q)]. These are treated as IRAs (deemed IRAs) rather than part of a qualified plan. Employees may make voluntary contributions via payroll deduction into traditional or Roth IRA accounts. Employee contributions are included in the employee's income, but the employee may deduct such amounts under the rules that normally apply to traditional IRA deductions (Roth IRA contributions are nondeductible). Employees may adjust their federal income tax withholding (via their Form W-4) for deductible contributions to traditional IRAs in order to receive a more immediate tax benefit from their contributions.

Form 5500

The Form 5500 series of returns is used by qualified plans to report information concerning the plan to the IRS and Department of Labor (DOL). Simplified forms in the 5500 series are filed for one-participant, certain foreign and fewer-than-100 participant plans. See *Form 5500 Reporting Requirements* on Page K-20 for a summary of which plans are eligible to file which forms. Information on Form 5500 filing requirements is available at **www.efast.dol.gov**. The "Form 5500 Version Selection Tool," accessible by searching "5500 Selection Instructions" at **www.dol.gov**, can be used to determine which version to use when filing or amending prior years' 5500 series forms.

Due date. Form 5500, 5500-SF, or 5500-EZ is normally due by the last day of the seventh month after the plan year ends (for a calendar year plan, July 31 of the following year). A 2½ month filing extension may be obtained by filing Form 5558 (Application for Extension of Time To File Certain Employee Plan Returns) on or before the normal return due date. If the employer maintains more than one plan, a separate Form 5558 must be filed for each plan requesting an extension.

An accrual-basis taxpayer can take a deduction (or add a cost to its basis in property) in the year of payment if it reasonably expects the property or services to be provided within 3½ months of payment [Reg. 1.461-4(d)(6)(ii)].

Economic performance typically occurs as services or property are provided to, or ratably as property is used by, the taxpayer unless the recurring item exception applies. Accrual method taxpayers are required to recognize lease liabilities ratably over the lease period unless the liability was immaterial or early expense recognition results in a better matching of expenses and income (Rev. Rul. 2012-1).

Effective for tax years ending on or after July 30, 2015, the IRS has issued guidance for accrual method taxpayers to treat economic performance as occurring ratably on contracts that provide services on a regular basis. Under this safe harbor, a taxpayer can ratably expense the cost of regular and routine services as provided. The guidance defines a *Ratable Service Contract* and provides examples of what will and will not satisfy the definition. Examples of services that may qualify include contracts for regular janitorial and landscape maintenance. Contracts that provide for a single deliverable (for example, an environmental impact study) will not qualify (Rev. Proc. 2015-39).

Hybrid method. Here, two or more accounting methods are combined. The most common hybrid method is used by taxpayers with inventory, accounting for purchases and sales of inventory using the accrual method, and accounting for service income and related expenses using the cash method. The combination of methods must clearly reflect income and be consistently used. For example, if the accrual method is used to report income, it must also be used to report related expenses.

If a combination of methods includes the cash method, the accounting method is treated as the cash method for purposes of limitations on use of the cash method.

Limitations on Use of Cash Method

Pre-2018. Before enactment of the Tax Cuts and Jobs Act (TCJA), the cash method was available to (1) taxpayers with average annual gross receipts of $1 million or less; (2) certain farming C corporations and partnerships with C corporation partners with annual gross receipts for each prior year of $1 million or less; (3) C corporations and partnerships with C corporation partners, but not certain farming C corporations or partnerships, with $5 million or less in average annual gross receipts; (4) individuals, S corporations and individually owned partnerships engaged in service activities when average annual gross receipts were $10 million or less; (5) certain family farm corporations with annual gross receipts for each prior year of $25 million or less; and (6) qualified personal service corporations (PSCs).

Post-2017. For tax years beginning in 2018, the TCJA significantly expanded the availability of the cash method by replacing more limited exceptions to the accrual method available under prior law with a $25 million gross receipts test [IRC Sec. 448(c)(1)]. The $25 million ($26 million for 2019) gross receipts test applies regardless of whether the purchase, production, or sale of merchandise is an income-producing factor.

Gross receipts test. A corporation or partnership satisfies the $25 million ($26 million for 2019) gross receipts test for any tax year the taxpayer seeks to use the cash method if average annual gross receipts for the three-year period preceding the current tax year does not exceed $25 million ($26 million for 2019). Taxpayers are no longer required to have satisfied the three-year average test for all prior years as was necessary under prior law.

Other excepted businesses. Both farming businesses and qualified PSCs are eligible to use the cash method without having to satisfy the $25 million ($26 million for 2019) gross receipts test.

1) *Farming businesses* (including the operation of a nursery or sod farm and the raising, harvesting, or growing of trees bearing fruits, nuts, or other crops, or ornamental trees). An evergreen tree more than six years old at the time severed from the roots shall not be treated as an ornamental tree [IRC Sec. 448(d)(1)].
2) *Qualified PSCs* in which substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, and substantially all of the stock of which (by value) is held by employees, retired employees or their estates [IRC Sec. 448(d)(2)].

Tax shelters, including partnerships and other entities (but not C corporations) where more than 35% of losses are allocated to limited partners or limited entrepreneurs {persons who have an interest in an enterprise other than as a limited partner and do not actively participate in management [IRC Sec. 461(k)(4)]}, are prohibited from using the cash method [IRC Secs. 448(d)(3), 461(i)(3), and 1256(e)(3)].

Gross receipts includes all receipts recognized under the method of accounting used by the taxpayer for that tax year [Temp. Reg. 1.448-1T(f)(2)(iv)]. It includes sales (net of returns and allowances), credit card payments and amounts received from services, bartering, interest, dividends, rents, royalties, and annuities. Failure to include payments reported on Form 1099-K (Payment Card and Third Party Network Transactions) could raise questions with the IRS.

Automatic accounting method change. Taxpayers (other than tax shelters) that meet the $25 million ($26 million for 2019) gross receipts test (*small business taxpayers*) and wish to make any of the following accounting method changes must use the automatic change procedures in Rev. Procs. 2015-13 and 2018-31 (or any successors such as Rev. Proc. 2019-43): (1) from the overall accrual method to the overall cash method; (2) from capitalizing costs under IRC Sec. 263A to no longer capitalizing such costs; (3) from a Section 471 method of accounting for inventory items to (a) treating inventory as non-incidental materials and supplies or (b) conforming to the taxpayer's method of accounting reflected in its applicable financial statements or books and records; and (4) for (a) exempt long-term construction contracts, from the percentage-of-completion method to an exempt contract method or (b) home construction contracts, from capitalizing costs under IRC Sec. 263A to not capitalizing such costs. In addition, the IRS has waived the five-year restriction on eligibility for making automatic changes for a taxpayer's first, second or third year beginning after 2017 (Rev. Proc. 2018-40).

Accounting Methods for Inventory

Also see *Inventories* on Page L-7.

Under the general rule, taxpayers are required to use the accrual method for purchases and sales of inventory, even if ending inventory is always zero [Reg. 1.446-1(c)(2)(i)]. A taxpayer with inventory may use the overall accrual method or a hybrid method using accrual for purchases and sales of inventory, and cash for other income and expenses.

Beginning in 2018, taxpayers that meet the $25 million ($26 million for 2019) gross receipts test may use an accounting method for inventories that either treats inventories as non-incidental materials and supplies or conforms to the taxpayer's financial accounting treatment of inventories [IRC Sec. 471(c)].

- *Other construction contracts.* Exempt if the work will be completed within two years from the commencement of the contract date and meets the $25 million ($26 million for 2019) gross receipts test for the tax year in which the contract is entered into. See *Gross receipts test* on Page L-2.

Note: Exempt long-term contracts may use the completed contract method—the taxpayer reports all income and expenses from the contract in the year of completion.

Look-back rules. Since the percentage-of-completion method computes yearly income based on estimated costs, when the contract is complete, the taxpayer must look back to compare the estimates with the actual final costs (Reg. 1.460-6). The purpose of the look-back rules is to compute interest on either (1) underpayment of tax (estimated costs exceed actual costs) or (2) overpayment of tax (actual costs exceed estimates), resulting in either an amount owed to the IRS or a refund due the taxpayer.

***De minimis* rule (look-back).** If estimated costs reported in a look-back year are within 10% of actual costs (both on a cumulative basis), the taxpayer can elect not to apply the look-back rules [IRC Sec. 460(b)(6)]. The exception still applies if additional costs are incurred after the project is completed.

Example: In the final year of a contract, a taxpayer using the percentage-of-completion method looks back to what income would have been if actual costs had been used:
Year 1 .... $20,000 Year 2 .... $24,000 Year 3 .... $26,000
The taxpayer may elect not to apply the look-back rules if cumulative income reported, based on estimates, was:
Year 1 .... Between $18,000 and $22,000.
Year 2 .... Between $39,600 and $48,400.
By making the election, the taxpayer does not pay or receive interest on the underpayment or overpayment of tax.

Prepaid Expenses

A prepaid expense is deductible only in the year to which it applies unless it qualifies under the so-called *12-month rule*.

12-month rule. Prepaid expenses are deductible when paid if the rights or benefits to the taxpayer do not extend beyond the earlier of the following [Reg. 1.263(a)-4(f)(1)]:
- 12 months after the right to the benefit begins or
- The end of the tax year after the tax year the payment is made.

Example: On December 1, 2019, ZAP Corp. prepays a $10,000 insurance premium for a property insurance policy with a one-year term beginning February 1, 2020. Because the right or benefit attributable to the $10,000 payment extends beyond the end of the tax year following the tax year in which the payment is made, the 12-month rule does not apply. ZAP must capitalize the $10,000 payment and deduct it over the term of the policy.

Variation: Assume the same facts, except that the policy's one-year term begins December 15, 2019. Now, the 12-month rule applies because the right or benefit attributable to the payment neither extends more than 12 months beyond December 15, 2019 (the first date the benefit is realized), nor beyond the end of the tax year following the tax year in which the payment is made. Accordingly, ZAP can deduct the $10,000 when paid.

The IRS gives automatic consent to taxpayers that want to change their accounting method to use the 12-month rule for prepaid expenses. See Rev. Procs. 2006-12 and 2006-37 for guidance. Taxpayers must follow the automatic change procedures of Rev. Proc. 2015-13 (see discussion that follows). Also see *Intangible Assets* on Page O-15 for more information.

Change in Accounting Method

To change an accounting method, a taxpayer generally must receive IRS consent. Under certain circumstances, automatic consent is available. Form 3115 (Application for Change in Accounting Method) is used to request a change in method.

User fees. If the change is not automatic, a user fee of $10,800 applies for all requests received by the IRS after February 1, 2019 (Rev. Proc. 2019-1). Reduced user fees of $7,600 and $2,800 are available for businesses with gross income of less than $1 million or $250,000 respectively. See Rev. Proc. 2019-1, Appendix A, for more information about user fees (the IRS updates and issues a new Rev. Proc. each year). There is no fee for filing Form 3115 if the change in accounting method is eligible for automatic consent.

Note: All user fee payments must be made through **www.pay.gov** (Rev. Proc. 2019-1).

Consent required to change accounting method. Rev. Proc. 2015-13 sets forth procedures for obtaining a nonautomatic change in accounting method.

Automatic consent to change accounting method. Rev. Proc. 2015-13 also sets forth procedures for obtaining automatic consent for a change in accounting method. Highlights of the procedure include:
- One copy of Form 3115 (signed and dated) is filed with the IRS [address is listed in Form 3115 instructions and in Section 9.05(2) of Rev. Proc. 2019-1] and the original is attached to the income tax return for the year of change. The return must be filed by the due date (including extensions), and the copy filed with the IRS must be filed no later than the tax return. Neither copy may be filed before the first day of the tax year of change.
- Provisions exist for limited relief for late filing of the application on an amended return within six months of the original due date.
- The application must clearly identify the method to be changed by including the designated automatic accounting method change number (from Rev. Proc. 2018-31, as modified through the date of this publication by Rev. Procs. 2018-35, 2018-40, 2018-44, 2018-49, 2018-56, 2018-60, 2019-8, and 2019-10, or any successor such as Rev. Proc. 2019-43) on the appropriate line of the Form 3115.

Many automatic accounting method changes are contained in Rev. Proc. 2018-31, as modified through the date of this publication by Rev. Procs. 2018-35, 2018-40, 2018-44, 2018-49, 2018-56, 2018-60, 2019-8, and 2019-10, or any successor such as Rev. Proc. 2019-43, including (but not limited to):
- Changing to an overall cash method for farmers.
- Deducting accrued bonus and vacation pay in the year the all events test has been met to establish the liability and the pay is received by the employee by the 15th day of the third month following year end.
- Changing from cash to accrual method for specific items.
- Advance payments, including certain gift cards.
- California franchise tax deductions.
- Change in connection with whether the recurring-item exception to the economic performance rules of an accrual method taxpayer applies with respect to the prepayment of lease or service contract extending over two years (Rev. Rul. 2012-1).
- Changes in connection with the tangible property regulations related to accounting methods for amounts paid to acquire, produce or improve tangible property (Rev. Proc. 2014-16).
- Changes in connection with the tangible property regulations related to dispositions of tangible depreciable property (Rev. Procs. 2014-17 and 2014-54).
- Changes by a taxpayer using the retail inventory method to comply with regulations under Reg. 1.471-8 clarifying a taxpayer's treatment of certain sales-based vendor allowances, margin protection payments, permanent markups and markdowns, and temporary markups and markdowns when determining the cost complement (Rev. Proc. 2014-48).

- Change from applying the Section 263A UNICAP rules to certain citrus replanting costs to instead deducting such costs (Rev. Proc. 2018-35).
- Changes specified in Rev. Proc. 2018-40 as discussed at *Automatic accounting method change* on Page L-2.
- Change to an overall accrual method by an eligible terminated S corporation for which the resulting positive or negative Section 481(a) adjustment is taken into account over a six-tax year period beginning with the year of change [IRC Sec. 481(d); Rev. Proc. 2018-44].
- Changes for adopters or early adopters of the FASB "New Standards" for identifying performance obligations, allocating transaction price to performance obligations, and/or considering performance obligations satisfied (see discussion below) (Rev. Procs. 2018-29, 2018-31 or any successor such as Rev. Proc. 2019-43, and 2018-49).
- Changes to comply with Section 451(b) as discussed at *Accrual method income* on Page L-1 (Rev. Proc. 2018-60). Also see CCA 201852019.

Section 481 adjustment. When a business changes its accounting method, an income adjustment is required under IRC Sec. 481 to make sure income and expenses are not duplicated or omitted. A positive adjustment resulting from an automatic consent to change of accounting method is generally recognized over four years. Under a *de minimis* rule set forth in Rev. Proc. 2015-13, a positive adjustment of less than $50,000 may be recognized in the year of change. A negative adjustment (in favor of the taxpayer) is fully recognized in the year of change. Guidance for a Section 481(a) adjustment for a nonautomatic method change and for an automatic method change is provided by Rev. Proc. 2015-13, Section 7.03.

Example: Don owns Goodware Sales as a sole proprietor. Gross receipts for all past tax years have been less than $1 million. Don has been using the hybrid method of accounting—accrual for purchases and sales of merchandise and cash for other income and expenses.

In 2019, Don decides to change to the cash method of accounting under Rev. Proc. 2018-31. Balance sheet items include the following:

Accounts receivable	$ 100,000
Accounts payable	(40,000)
Negative 481 adjustment	$ 60,000

By switching to the cash method of accounting, Don deducts a Section 481 adjustment of $60,000 for tax year 2019.

In computing the net Section 481(a) adjustment, consider all relevant accounts. For example, the Section 481(a) adjustment for a change in the proper time for deducting salary bonuses under IRC Sec. 461 should reflect any necessary adjustments for amounts of salary bonuses capitalized to inventory under IRC Sec. 263A (Rev. Proc. 2015-13, Sec. 3.15).

A small business taxpayer changing to the cash method for a trade or business must include open accounts receivable in income. An *open accounts receivable* is any receivable that is due in full in 120 days or less and not subject to the mark to market rules for dealers in securities under IRC Sec. 475 [Rev Proc. 2018-40, Sec. 3.02(1)].

A partnership or corporation reports a Section 481 adjustment on the "Other income" line of the tax return.

Guidance on financial revenue recognition standards. In Rev. Procs. 2018-29 and 2018-49, the IRS provides procedures for taxpayers to obtain automatic consent to change a method of accounting used to recognize income for federal tax purposes to a method in which the taxpayer uses the new financial accounting standards for income recognition [FASB's Revenue From Contracts With Customers (Topic 606)] to (1) identify performance obligations, (2) allocate transaction price to performance obligations and/or (3) consider performance obligations satisfied.

Tax Year

The tax year is the period for which taxable income will be computed and reported.

An entity adopts a tax year when it files its first tax return. The tax year can be a calendar or fiscal year. Once a tax year is adopted, IRS approval is generally required to change it, even if changing from an improper tax year. See *Changing a Tax Year* on Page L-6.

Calendar Tax Year

Generally, any entity can adopt a calendar tax year. A calendar year *must* be used if a taxpayer [IRC Sec. 441(g)]:

1) Does not keep adequate records,
2) Has no annual accounting period,
3) Has an accounting period that does not qualify as a fiscal tax year, or
4) Is required to use a calendar year by a provision of the Code or Regulations.

Fiscal Tax Year

A fiscal year is either [IRC Sec. 441(e)]:

1) A 12-month period ending on the last day of any month except December or
2) A 52–53 week tax year.

52–53 week tax year. A 52–53 week tax year always ends on the same day of the week, and must end either on the date that day last falls in a particular calendar month, or the date that day falls nearest to the last day of a particular calendar month.

Example #1: ZAP Corporation elects a 52–53 week tax year that will end on the last Friday in October. In 2019, ZAP's tax year ends on Friday, October 25.

Example #2: TAB Corporation elects a 52–53 week tax year that will end on the Friday closest to the last day of November. In 2019, TAB's tax year ends on Friday, November 29.

When computing depreciation or amortization, a 52-53 week tax year is generally considered a 12-month tax year.

To elect a 52–53 week tax year, attach a statement to the tax return showing [Reg. 1.441-2(b)(1)]:

1) The day of the week on which the tax year will always end,
2) Whether it will end on the last such day of the week in the calendar month or on the date such day of the week occurs nearest the end of the month, and
3) The month in which (or with reference to which) the tax year will end.

C corporations and estates generally can elect a fiscal tax year without any special restrictions. The fiscal year is chosen when the first tax return is filed.

Trusts must use a calendar tax year (but see *Tax year* on Page G-1 for a limited exception).

S corporations, PSCs and partnerships must use a "required tax year." See *Required Tax Year* on Page L-6.

Short Tax Year

A short tax year is a tax year of less than 12 months [IRC Sec. 443(a)].

The two situations that result in a short tax year are:

1) Entity is not in existence for an entire tax year such as the first or last tax return of a partnership or corporation.
2) Entity changes its accounting period.

Entity not in existence for an entire year. If the entity was not in existence for an entire year, the filing requirements and the tax computation generally are the same as if the return was for a full 12 months ending on the last day of the short tax year.

Simplified methods:

1) *Simplified production method without historic absorption ratio election* [Reg. 1.263A-2(b)(3)].
   - If the taxpayer uses FIFO for direct costs, indirect costs allocated to inventory at the end of the year are determined by multiplying the total direct costs of inventory remaining on hand at the end of the year by an *absorption ratio*, which equals the *additional 263A costs* incurred during the year divided by the direct costs of inventory incurred during the year.
   - Taxpayers using LIFO multiply the absorption ratio by their *LIFO increment* for the year [see Reg. 1.263A-2(b)(3)(iii), which also covers allocating costs if there is a *LIFO decrement*].
   - *Additional 263A costs* generally are those costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the Section 263A effective date, but that are required to be capitalized under IRC Sec. 263A.
2) *Simplified production method with historic absorption ratio election* [Reg. 1.263A-2(b)(4)]. *A historic absorption ratio election* lets a taxpayer compute its absorption ratio based on its Section 263A costs in the three tax years prior to the election year. The resulting ratio is used for five years, then tested for accuracy and changed if necessary.
3) *Simplified resale method* [Reg. 1.263A-3(d)], either with or without a historic absorption ratio election.
4) *Simplified service cost method* for determining the capitalizable amount of *mixed service costs* [costs partially allocable to production or resale activities and partially allocable to other activities—see Reg. 1.263A-1(e)(4)]. This method may be used in connection with either a facts-and-circumstances or a simplified method [Reg. 1.263A-1(f) and (h)].

Capitalization of Interest

Generally, interest is deducted in the year paid or accrued on debt that is related to a trade or business activity. However, under UNICAP certain interest payments must be added to the cost basis of property that is produced and generally recovered when the property is sold or through depreciation, amortization, etc. Interest paid or incurred during the production period of qualified property must be capitalized.

For this purpose, qualified property is [IRC Sec. 263A(f)(1); Reg. 1.263A-8]:

1) Real property,
2) Personal property with class life of 20 years or more,
3) Personal property with an estimated production period of more than two years, or
4) Personal property with an estimated production period of more than one year if the estimated cost of production is more than $1 million.

Property is considered produced if it is constructed, built, installed, manufactured, developed, improved, created, raised, or grown.

For real property, the production period begins when physical activity is first performed on the property. For all other property, the production period begins when production costs equal or exceed 5% of the total estimated production costs that will be incurred on the property (Reg. 1.263A-12).

***De minimis* rule.** Interest is not required to be capitalized if the [Reg. 1.263A-8(b)(4)]:

- Production period does not exceed 90 days and
- Total production expenditures do not exceed $1 million divided by the number of days in the production period.

Capitalized interest is recovered through COGS, an adjustment to basis, depreciation, amortization or other methods.

Note: The interest deduction limitation rules under IRC Sec. 163(j) are applied after the interest capitalization rules of IRC Sec. 263A.

Capitalization of Pre-Production Costs

Direct and indirect expenses allocable to property that is held for future production must be capitalized [Reg. 1.263A-2(a)(3)(ii)]. For example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are committed to production. In addition, a real estate developer must capitalize property taxes incurred on property held for future development.

Farmers. Special exceptions to the UNICAP rules apply to farming businesses [IRC Sec. 263A(d)]. See IRS Pub. 225 (Farmer's Tax Guide) for how to apply the UNICAP rules to farming businesses.

Authors, photographers, artists. Reg. 1.263A-5 has been reserved for creative expenses incurred by free-lance authors, photographers, and artists.

Adopting/Changing UNICAP Methods

The rules on adopting/changing UNICAP accounting methods are included in Rev. Proc. 2018-31 (Section 12) as modified by Rev. Procs. 2018-35 and 2018-40, or in any successor to Rev. Proc. 2018-31 such as Rev. Proc. 2019-43.

Bookkeeping Basics

Supporting Documents

Bookkeeping is the detailed recording and summarizing of economic activity, business transactions, and events. It starts with supporting documents that are generated when there are transactions such as purchases, sales, and payroll. Supporting documents contain information about the transactions evidencing that they took place and provide support for the entries in the books and on the tax return. Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, canceled checks, and signed agreements.

- *Sales documents.* Documents supporting sales should show the amount and sources of the sale. Sales documents include cash register tapes, bank deposit slips, receipt books, sales invoices, and credit card charge slips.
- *Purchase documents.* Documents supporting purchases of items bought for resale or for use in the manufacturing process should show the amount paid and the nature of the purchase. Purchase documents include canceled checks, cash register tape receipts, purchase invoices, and credit card slips.
- *Expense documents.* Documents supporting costs incurred (other than purchases) to carry on the business, such as salaries and wages, rent, utilities, etc., should show the amount paid and nature of the expense item. Expense documents include canceled checks, cash register receipts, invoices, credit card slips, vendor statements, and petty cash slips for small cash payments.
- *Asset documents.* Documents supporting property used in the business, such as land, buildings, machinery, equipment, and furniture, should provide information used to determine (1) the cost basis to capitalize, (2) depreciation, and (3) the gain or loss if the assets are sold. Asset supporting documents include purchase invoices, canceled checks, vendor statements, real estate closing documents, etc.

Recording Business Transactions

Once business transactions are determined based on the supporting documents that the transactions generate, the supporting

- Gains from the disposition of a commercial building depreciated under the prescribed accelerated cost recovery system (ACRS) percentages (including an office in the home) are ordinary income to the extent of total depreciation claimed.
- Gains from the disposition of residential rental property depreciated under the prescribed ACRS percentages are ordinary income to the extent of the excess over SL depreciation claimed.
- Depreciation of commercial and residential rental property under modified ACRS (MACRS) is described as only SL depreciation.

For corporations, IRC Sec. 291(a)(1) provides that 20% of the excess (if any) of (1) ordinary income that would have resulted if the property was Section 1245 property over (2) the amount treated as ordinary income under IRC Sec. 1250, is treated as gain that is ordinary income under IRC Sec. 1250.

Involuntary Conversions

An involuntary conversion occurs when property is destroyed, stolen, condemned, or disposed of under the threat of condemnation, and the taxpayer receives other property or money in payment, such as insurance or a condemnation award.

Gain from an involuntary conversion may be postponed to the extent that the taxpayer purchases replacement property that is similar to the old property or related in service or use (or like-kind in the case of condemned real estate). Replacement property held for the same function as the converted property can be excluded from gain recognition [*Gaynor News*, 22 TC 1172 (1954), *acq*. 1955-2 CB 6]. In order to postpone the entire amount of the gain, the cost of replacement property must be at least as much as the amount realized on the conversion. Gain must be recognized, however, to the extent that the taxpayer receives unlike property as reimbursement. The new property's basis equals the adjusted basis of the old property.

Example #1: A retail store is located beside a highway that is to be converted into a wider freeway. Under threat of condemnation, the store sells its property (needed for freeway lanes) to the highway department. Using the cash proceeds from the sale, the store relocates across town. The new store is similar to the old store. The sale of the old store is an involuntary conversion. The gain from the sale is postponed, and the basis of the new store is the basis of the old store plus the cost of sale.

Example #2: An auto repair shop has some tools and equipment stolen. The tools and equipment were expensed in prior years so that their adjusted basis is zero. The auto repair shop received $12,000 in insurance proceeds from the theft. The proceeds were used to purchase new tools and equipment. This qualifies as an involuntary conversion; the insurance reimbursement is not taxable, and the purchase of the new tools and equipment is not deductible. The basis of the new tools and equipment is zero.

IRS Ruling: The IRS ruled that gain realized from insurance proceeds for hurricane damage to an apartment complex could be deferred to the extent that such proceeds were used to repair damaged buildings, clubhouses, and landscaping; demolish destroyed buildings; or reinvest in qualified replacement property. In addition, the IRS allowed the taxpayer to defer gain realized from the sale of what remained of the apartment complex, but only if the insurance proceeds were reinvested in replacement property in a transaction that otherwise qualified under IRC Sec. 1033 (Ltr. Rul. 200743010).

Court Case: A manufacturer processed trees at lumber and paper mills. Before the trees were fully mature and ready for harvest, they were damaged by storms, fire, and insects. Instead of selling the damaged trees as is, the taxpayer processed the trees and sold the products manufactured from the damaged trees. The taxpayer claimed involuntary conversion and deferred the portion of the gain attributable to the difference between the basis in the trees and their FMV prior to salvage of the trees began.

The IRS argued the taxpayer had processed the trees into end products in the ordinary course of business and was not entitled to involuntary conversion treatment. The Court disagreed and allowed the taxpayer to defer a portion of the gain because the conversion was involuntary and the trees were not available for their original intended business use [*Willamette*, 118 TC 126 (2002)].

Replacement period. To postpone the gain, the property must be replaced within a specified period of time [IRC Sec. 1033(a)].

Replacement period begins on the earlier of:
1) Date on which the condemned property was disposed of or
2) Date on which the threat of condemnation began.

Replacement period ends two years after the close of the first tax year in which any part of the gain on the conversion is realized. *Exception:* Three-year replacement period for real property used in a trade or business or for investment.

Property acquired from related parties. Certain taxpayers must recognize gain on involuntary conversions if the replacement property is acquired from a related party, including [IRC Sec. 1033(i)]:
1) C corporations,
2) Partnerships in which C corporations own more than 50% of the capital or profits interest, and
3) Any other taxpayer, including individuals, if the realized gain is greater than $100,000.

Exception: Recognition of gain under these rules will not apply if the related party acquired the replacement property from an unrelated party during the replacement period. For definitions of related parties, see IRC Secs. 267(b) and 707(b)(1).

Electing to defer gain. A taxpayer is not required to defer recognition of gain on an involuntary conversion, but rather is allowed to elect to either defer recognizing the gain or recognize it in the current year. The election to defer the gain from income in the current year is made by excluding the deferred gain from income and attaching a statement to the return reporting all details of the conversion [Reg. 1.1033(a)-2]. Including the gain in income in the year of sale is an election to recognize the gain in that year.

See Tab 9 of the *Depreciation Quickfinder® Handbook* for more information on involuntary conversions.

Casualties

Disaster Relief Alert: Special rules apply to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019* on Page Q-1.

For 2018–2025, personal casualty losses in excess of personal casualty gains are deductible only if attributable to a federally declared disaster and are subject to AGI and dollar thresholds. Casualty losses on business property (other than employee property) and income-producing property are not subject to these limits. See Tab 5 in the *1040 Quickfinder® Handbook* for discussion of personal casualty losses and Tab 4 in the *Individuals—Special Tax Situations Quickfinder® Handbook* for an expanded discussion of disaster victims.

Federally declared disaster. A casualty loss occurring in, and attributable to, a federally declared disaster can be deducted in the year the disaster occurred or in the year preceding the loss [IRC Sec. 165(i)]. The election must be made on or before the date that is six months after the original due date for the taxpayer's federal tax return for the disaster year (without extensions). The taxpayer need not request a filing extension for the disaster year to benefit from this due date. The taxpayer makes the election to deduct the loss in the preceding tax year by deducting the loss on an original (if not yet filed) or amended return for the preceding year and attaching a specified election statement to the return. The election can be revoked within 90 days of its due date (Temp. Reg. 1.165-11T; Rev. Proc. 2016-53).

See IRS Pubs. 547 (Casualties, Disasters, and Thefts) and 976 (Disaster Relief) for additional discussion.

For purposes of the involuntary conversion rules, a special allowance applies to property destroyed in a federally declared disaster area [IRC Sec. 1033(h)]. If business or income-producing property is destroyed in such an area, any tangible replacement property acquired for use in a business qualifies as "similar or related in service or use." This relaxed definition for replacement property allows business owners to postpone gain when starting a new

Depletion. See Tab J.

Depreciation. See Tab J.

Development costs. Costs of developing a mine or other natural deposit (other than an oil or gas well) may be deducted. The costs must be paid after the discovery of ores or minerals in commercially marketable quantities [IRC Sec. 616(a)]. An election can be made to treat the costs as deferred expenses deducted ratably as the ores/minerals are sold [IRC Sec. 616(b) or to amortize the costs over ten years [IRC Sec. 59(e)].

Disaster losses. For 2018–2025, personal casualty losses are limited to federally declared disaster areas and are subject to AGI and dollar thresholds. Casualty losses on business property (other than employee property) and income-producing property are not subject to these limits. Per IRC Sec. 165(i), any loss occurring in a disaster area and attributable to a federally declared disaster may, at the election of the taxpayer, be taken into account for the tax year immediately preceding the tax year in which the disaster occurred (not just business losses).

See *Tax Relief for Disaster Victims* on Page Q-1.

Disaster Relief Alert: Special rules apply to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019* on Page Q-1.

Donations of patents, etc. A deduction for a contribution of a patent or certain other items of intellectual property to charity is limited to the lesser of (1) the taxpayer's basis in the property or (2) the FMV. Taxpayers may deduct certain additional amounts in later years, based on a specified percentage of qualified income received by the charitable organization from the contributed property. No deduction is permitted for income received by the charity after the expiration of the legal life of the patent or other intellectual property [IRC Sec. 170(e) and (m)].

Education expenses. An employer can deduct the following employee education expenses:

- *Educational Assistance Program.* Up to $5,250 of qualified educational assistance can be excluded from an employee's income (IRC Sec. 127). See Tab K for more information about educational assistance programs.
- *Working Condition Fringe Benefit* [IRC Sec. 132(d)]. Employer-provided education is excludable from an employee's income if the expense would have been deductible as a business expense if paid out of the employee's pocket. An individual is generally not allowed to deduct education expenses if (1) the education is required to meet minimum requirements of the individual's employment or trade, or (2) the education will qualify the individual for a new trade or business. See *Work-Related Education Costs* in Tab 5 of the *1040 Quickfinder® Handbook* for more information about deducting education expenses for individuals.

Employee awards. See *Awards and bonuses* on Page O-1.

Employee benefit programs. See Tab K.

Entertainment. Before 2018, the expense of providing entertainment to a client, customer, or employee could qualify as an ordinary and necessary business expense provided it directly related to or was associated with the active conduct of the trade or business. Entertainment activities included the cost of meals (food, beverage, tax, tip).

The TCJA provides that no deduction is allowed for any entertainment expenses paid or incurred after 2017, except for certain meal expenses associated with operating a trade or business. See *Meals* on Page O-3.

Entertainment expenses included in W-2 wages. Entertainment expenses are completely nondeductible [unless one of the exceptions in IRC Sec. 274(e) applies]. IRC Sec. 274(e) was not changed by the TCJA. This includes expenses for goods, services, and facilities that are treated as compensation to an employee on the employer's income tax return and as wages to the employee for withholding purposes. When an employer adds the personal value of a benefit to a *specified individual's* taxable W-2 wages, the employer's deduction is limited to the lesser of the actual cost of the benefit or the amount included in the employee's taxable wages. This rule applies to expenses for activities generally considered to be entertainment, amusement, or recreation and facilities used in connection with such activities, such as a company airplane. *Specified individuals* generally include officers, directors, and 10% or greater owners [IRC Sec. 274(a) and (e)(2)(B)].

Environmental clean-up costs. Rev. Rul. 94-38 held that costs incurred to construct groundwater treatment facilities were capital expenses. Other costs incurred to clean up land and to treat groundwater contaminated with hazardous waste resulting from business operations were deductible as business expenses. Otherwise deductible costs incurred by a manufacturing operation must be included in inventory under the uniform capitalization rules of IRC Sec. 263A (Rev. Rul. 2004-18).

Taxpayers must capitalize amounts paid to ameliorate (make better or more tolerable) a material condition or defect that existed prior to a taxpayer's acquisition of property, whether or not the taxpayer was aware of the defect at the time of acquisition [Reg. 1.263(a)-3(j)]. Therefore, if a taxpayer purchases land contaminated prior to acquisition, the clean-up cost is capitalized.

The IRS has privately applied rules similar to those for soil remediation costs to a taxpayer removing mold from a building. A deduction was allowed for the cost of removing mold from a nursing home where the facility was not contaminated at acquisition and the mold removal did not prolong the building's life or increase its value (Ltr. Rul. 200607003).

Environmental remediation costs incurred to clean up land contaminated with a taxpayer's hazardous waste during operation of the taxpayer's manufacturing activities are allocable to the inventory produced under IRC Sec. 263A during the year costs are incurred (Rev. Rul. 2005-42).

Fines. See *Penalties and Fines* on Page O-18.

Franchise. See *Intangible Assets* on Page O-15.

Fringe benefits. See Tab K.

Gifts. See *Awards and bonuses* on Page O-1.

Goodwill. See *Intangible Assets* on Page O-15.

Impact fees on real estate development. Impact fees are one-time charges imposed by a state or local government for offsite capital improvements necessitated by a new or expanded development. The IRS has ruled that impact fees are capital expenses that are added to the basis of buildings. This allows developers to depreciate impact fees over the life of constructed buildings, rather than adding the fees to the basis of nondepreciable land. Impact fees may also be considered for purposes of computing the low-income housing credit (Rev. Rul. 2002-9).

Impairment losses. See *Impairment Losses* on Page O-14.

Improvements and repairs. Taxpayers may deduct amounts paid for repairs or maintenance of tangible property provided the amounts are not otherwise required to be capitalized (Reg. 1.162-4).

Insurance. See *Insurance* on Page O-14.

Intangible assets. See *Intangible Assets* on Page O-15.

Intangible drilling costs. See *Intangible Drilling Costs* on Page O-15.

Interest. See also *Interest Expenses* on Page O-16.

The TCJA added IRC Sec. 163(j), which limits the annual deduction of business interest expense to the sum of a taxpayer's: (1) business interest income, (2) 30% of adjusted taxable income (if a positive amount), and (3) floor plan financing interest of vehicle dealers. *Adjusted taxable income* is taxable income computed without regard to any item not properly allocable to a trade or business; business interest income or expense; any net operating loss deduction under IRC Sec. 172; deductions for depreciation, amortization, or depletion (for tax years beginning before January 1, 2022); or the Section 199A deduction. However, taxpayers (other

Reimbursed employee expenses. See *Accountable plan* on Page O-1.

Rent. See *Lease and Rental Expenses* on Page O-17.

Repairs. See *Improvements and repairs* on Page O-2.

Research and development costs. See *Research and Development Costs* on Page O-19.

Restaurant or tavern smallwares (Rev. Proc. 2002-12, as modified by Rev. Proc. 2018-31 or any successor such as Rev. Proc. 2019-43). Costs of replacing smallwares such as glassware, dinnerware, pots and pans, tabletop items, kitchen utensils, and food storage supplies are deducted in the year they are available for use at a taxpayer's restaurant. An automatic change in accounting method is available subject to limitations set forth in the revenue procedure.

Note: The deduction is for replacement items only. Costs of opening a restaurant with an inclusive package of smallwares purchased as part of a business acquisition must be deducted and/or amortized or capitalized as start-up costs.

Retirement plans. See Tab K.

Rotable, temporary, and standby emergency spare parts. Rotable spare parts are materials and supplies that are acquired for installation on a unit of property, removable from that unit of property, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation. Temporary spare parts are materials and supplies that are used temporarily until a new or repaired part can be installed, at which time they are removed and stored for later (emergency or temporary) installation [Reg. 1.162-3(c)(2)]. Standby emergency spare parts are also treated as materials and supplies [Reg. 1.162-3(c)(3)]. The costs are generally deducted when the parts are disposed of [Reg. 1.162-3(a)(3)]. Alternatively, taxpayers can elect to capitalize and depreciate the costs [Reg. 1.162-3(d)] or, if eligible, deduct the costs under the *de minimis* safe harbor [Reg. 1.162-3(f)]. (See *Capital Improvements vs. Deductible Repairs* on Page J-8 for more information.) An optional method of accounting for rotable or temporary spare parts is also available—see Reg. 1.162-3(e).

Start-up costs. See *Organizational and Start-Up Costs* on Page M-6.

Taxes. See *Taxes* on Page O-21.

Tools. The cost of tools with a useful life of less than one year is generally deductible when purchased, unless the *Uniform Capitalization Rules* on Page L-8 apply. Tools with a useful life of more than one year are depreciated. Tab J covers depreciation.

Trademark and trade names. See *Intangible Assets* on Page O-15.

Travel. Costs for transportation, lodging, and meals are generally deductible if the expenses are reasonable and necessary, and if the trip is primarily for business. See *Lodging* on Page O-3 and *Meals* on Page O-3. See Tab 9 in the *1040 Quickfinder® Handbook* for more information.

Truck and trailer tires. Under the original tire capitalization method (OTCM), the cost of original tires is depreciated as part of the vehicle and the cost of replacement tires is deducted as a current expense. A taxpayer must use the OTCM consistently for all its vehicles. (Rev. Proc. 2002-27)

Wages. See *Salaries and Wages* on Page O-19.

Qualified Business Income (QBI) Deduction

IRC Sec. 199A

The TCJA added IRC Sec. 199A, which applies to tax years 2018–2025. Under this new provision, individuals, estates and trusts may deduct up to 20% of their QBI from sole proprietorships (including farms) and pass-through entities.

Observation: Section 199A is intended to provide tax relief to businesses not benefitting from the reduction in the top corporate rate from 35% to 21%. The rules are complex and subject to phase-outs and limits. In conjunction with the enactment of Section 199A, former Section 199, which provided a 9% deduction for qualified production activities income, was repealed.

Understanding the mechanics of the QBI deduction is essential to effective planning to maximize its tax benefit. See *Qualified Business Income (QBI) Deduction* on Page B-7, as it relates partnerships and partners; *Qualified Business Income (QBI) Deduction* on Page D-1, as it relates to S corporations and shareholders; *Qualified Business Income (QBI) Deduction* on Page F-4 for more detailed coverage of the deduction; and *Qualified Business Income (QBI) Deduction* on Page G-8, as it relates to estates and trusts.

Tax Credits

Unlike deductions—which reduce a taxpayer's tax liability by the marginal tax rate times the deduction amount (cents on the dollar)—tax credits reduce the tax liability on a dollar for dollar basis.

See the table *Selected General Business Tax Credits* on Page O-7 for more information on the component credits of the general business credit.

General Business Credit

A taxpayer must file Form 3800 (General Business Credit) to claim any of the general business component credits.

Compute each component credit separately on its applicable form. After each component credit is separately computed on its applicable form, it is then carried to Form 3800, where the component credits are separately listed and then combined into one general business credit (GBC). The combined credit is subject to a limitation based on tax liability. Follow the line-by-line steps of Part II of Form 3800 to figure the limitation. Attach to the return Form 3800 and the separate forms for each credit claimed.

Exception: Taxpayers whose only source of credits listed on Form 3800, Part III, is from pass-through entities may not be required to complete and file separate credit forms to claim the general business credit—see the Form 3800 instructions. If a credit is being reported from a pass-through entity, that entity's employer identification number must be entered in Part III.

Form 3800, Part III includes several check boxes for the specific categories of GBC being reported. A taxpayer must complete a separate Part III for each box checked, and an additional consolidated Part III if certain conditions are met. See the Form 3800 instructions for details.

Carryback/carryforward of unused credits. The passive activity limit and carryover amounts for all GBCs are also reported on Form 3800. The general business credit is limited to net income tax reduced by the greater of [IRC Sec. 38(c)(1)]:

- Tentative minimum tax or
- 25% of the amount by which the net regular tax liability exceeds $25,000.

If the full general business credit may not be claimed because of the limitation, unused credits are carried back one year and forward 20 years (IRC Sec. 39). However, no part of any unused current year business credit attributable to a component credit may be carried back to tax years before the first tax year that the component credit was allowable.

Unused credits. Credits as defined in IRC Sec. 196(c) that remain unused after the 20-year carryforward period may be taken as a deduction in the first tax year following the expiration of the 20-year period. Unused credits may also be taken as a deduction if a taxpayer dies or goes out of business. See the instructions for Form 3800 for more information about deducting carryovers.

Other Tax Credits for Businesses

In addition to the various components of the general business credit, several other tax credits are available to business taxpayers, including those shown in the following table.

Other Tax Credits for Business Taxpayers Summary		
Tax Credit	IRC Sec.	Tax Forms
Federal Fuels Tax	Various	4136
Foreign and U.S. Possessions Tax	901	1116 1118
Prior-Year Minimum Tax/Refundable Minimum Tax	53	8801 8827
Undistributed Capital Gains of REITs and RICs	852(b)(3)(D) 857(b)(3)(D)	2439

Federal fuels tax. Taxpayers may be eligible to claim a refund or credit for federal and state excise taxes paid for motor fuels for vehicles and equipment. These excise taxes are collected for highway and road construction and maintenance. Therefore, if the equipment or vehicle is used off-road, typically in a trade or business, the excise taxes are refundable.

Refundable Minimum Tax. For tax years beginning in 2018–2021, a C corporation's minimum tax credit limitation is increased by the AMT refundable credit amount. The portion of the credit treated as refundable is 50% (100% for a tax year beginning in 2021) of the excess of minimum tax credits available over the regular tax liability. A corporation with a short tax year must prorate the refundable credit based on the number of days in the tax year.

Qualified Opportunity Zones

To encourage economic growth and investments in distressed areas, Congress often uses tax legislation to spur the growth. The TCJA created qualified opportunity zones (QO Zones). These are certain low-income communities that meet the requirements of IRC Sec. 1400Z-1. Investing in QO Zones can result in three major tax breaks (IRC Sec. 1400Z-2):

- Temporary deferral of capital gains reinvested in a qualified opportunity fund (QO Fund),
- Permanent exclusion of post-acquisition capital gains from the sale or exchange of an investment in a QO Fund held for at least 10 years, and
- The "building" of basis in deferred gain (10% or 15%, based on holding period).

Taxpayers continue to be allowed to recognize losses associated with investments in QO Funds.

Designation of QO Zones. A QO Zone is a population census tract that is a low-income community. In addition, the IRS must certify and designate the community as a QO Zone [IRC Sec. 1400Z-1(a)]. The term *low-income community* is borrowed from the Section 45D new markets tax credit [IRC Sec. 1400Z-1(c)(1)]. It includes any population census tract with a poverty rate of at least 20%. It also includes a tract whose median family income does not exceed 80% of statewide median family income. For tracts located within a metropolitan area, the standard is 80% of the greater of :

- Statewide median family income or
- The metropolitan area median family income.

The IRS has published a complete list of all population census tracts that the Dept. of Treasury has designated as QO Zones (See Notice 2018-40).

Definition of a QO Fund. A QO Fund is any investment vehicle that:

1) Is organized as a corporation or partnership for investing in QO zone property and
2) Holds at least 90% of its assets in QO Zone property [IRC Sec. 1400Z-2(d)].

The 90% test looks to the average percentage of QO Zone property held by the fund on the last day of the first half of the tax year and the last day of the tax year. Note that a QO Fund cannot be organized for the purpose of investing in other QO Funds.

Caution: A QO Fund that fails the 90% test is subject to a penalty for each month of noncompliance [IRC Sec. 1400Z-2(f)]. The penalty amount is calculated under the following formula:

(90% of aggregate assets − aggregate amount of QO zone property) × Section 6621(a)(2) underpayment rate for the month

No penalty is imposed if the failure is due to reasonable cause [IRC Sec. 1400Z-2(f)(3)].

The IRS released Form 8996 (Qualified Opportunity Fund), which is filed annually by corporations or partnerships that are organized and operated as a QO Fund.

Selected Energy Tax Incentives for Businesses

Alternative Motor Vehicle Credit

See also Form 8910; IRC Sec. 30B

For vehicles purchased after 2011, the credit is available only for qualified fuel cell motor vehicles.

~~**Expired Provision Alert:** The alternative motor vehicle credit has expired for vehicles acquired after 2017. The following discussion is included in the event the credit is extended.~~

Qualified fuel cell vehicle credit. Qualified fuel cell motor vehicles include, for example, vehicles that run on hydrogen power cells. Only new vehicles placed in service after 2005 and purchased before 2021 qualify for the credit.

The IRS will certify the credit amount for qualifying vehicles. Taxpayers can rely on this certification (Notice 2008-33).

Reporting. Form 8910 (Alternative Motor Vehicle Credit) is used to claim the alternative motor vehicle credit. The business/investment-use percentage of the credit is then transferred to Form 3800.

The personal-use portion of the credit is transferred to the "Nonrefundable Credits" line 6 of Schedule 3, Form 1040 (check box c and write "8910" in the space next to that box). Any part of the personal-use portion of the credit that can't be used in the current year is lost. It cannot be carried over to other years.

Recapture. The IRS has been instructed to issue regulations on the rules for recapturing the credits for vehicles that cease to qualify for the credits [IRC Sec. 30B(h)(8)], except that no recapture will be required if the vehicle ceases to qualify because it is converted to a qualified plug-in electric drive motor vehicle. As of the date of this publication, no regulations have been issued.

Vehicle Refueling Property Credit

See also Form 8911; IRC Sec. 30C

~~**Expired Provision Alert:** This credit is not available after 2017 unless legislation is enacted that extends the provision. This section is included in the event the rules for the credit are extended~~.

Taxpayers may claim a 30% credit for the cost of installing clean-fuel vehicle refueling property to be used in a trade or business or installed at the taxpayer's principal residence. The credit generally applies to property placed in service after 2005 and before 2021.

The maximum allowable credit is:

- $30,000 for business property.
- $1,000 for property installed at a principal residence.

Qualified alternative fuel vehicle refueling (QAFVR) property is any property, not including a building and its structural components, whose original use begins with the taxpayer, that is depreciable (not required for the $1,000 credit) and that:

1) Stores or dispenses a clean-burning fuel into the fuel tank of a vehicle propelled by that fuel, but only if the storage or dispensing of the fuel is at the point where the fuel is delivered into the fuel tank of the vehicle or

2) Recharges vehicles propelled by electricity, but only if the property is located at the point where the vehicles are recharged.

Clean-burning fuels include:

- Any fuel at least 85% of which consists of one or a mixture of ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, or hydrogen.
- Any fuel that is a mixture of diesel fuel and biodiesel determined without regard to any use of kerosene and containing at least 20% biodiesel.
- Electricity.

The tax basis of QAFVR property is reduced by the portion of the property's cost allowed as a credit. Notice 2007-43 provides interim guidance on the credit pending issuance of regulations.

Plug-In Electric Drive Motor Vehicle Credit

See also Form 8936; IRC Sec. 30D

Taxpayers can claim a credit for each new qualifying vehicle purchased for use or for lease, but not for resale. The credit amount ranges from $2,500 to $7,500. The portion of the credit attributable to the vehicle's business-use percentage is treated as part of the taxpayer's general business credit. The remainder is a nonrefundable personal credit that can offset both regular tax and AMT (IRC Sec. 30D).

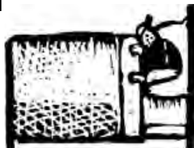
Qualifying vehicles. These are new four-wheeled plug-in electric vehicles manufactured primarily for use on public streets, roads, and highways that meet certain technical requirements.

However, the following do not qualify:

1) Vehicles manufactured primarily for off-road use (such as golf carts).
2) Vehicles weighing 14,000 pounds or more.
3) Low-speed vehicles (four-wheeled vehicles that can obtain a speed of 20 but not more than 25 miles per hour and a gross vehicle weight rating of less than 3,000 pounds).

An Index to Manufacturers of qualified vehicles can be found at **www.irs.gov** by searching for "Plug-in electric drive motor vehicle."

Manufacturer's certification. The IRS will acknowledge a manufacturer's (or in the case of a foreign vehicle manufacturer, its domestic distributor's) certifications that a vehicle meets the standards to qualify for the credit. Taxpayers may rely on such a certification (Notice 2009-89).



The credit begins to phase out for a manufacturer's vehicles when at least 200,000 qualifying vehicles manufactured by that manufacturer have been sold for use in the U.S. (determined cumulatively for sales after 2009). For General Motors, LLC and Tesla, Inc. the phaseout period begins in 2019. For the latest on the phase out amounts, see the IRS website at **www.irs.gov/businesses/irc-30d-new-qualified-plug-in-electric-drive-motor-vehicle-credit**.

Note: A vehicle is considered acquired on the date when title to that vehicle passes under state law (Notice 2009-89).

Two-Wheeled Electric Vehicles

See also Form 8936; IRC Sec. 30D(g)

~~**Expired Provision Alert:** This credit is not available after 2017 unless legislation is enacted that extends the provision. This section is included in the event the rules for the credit are extended~~.

A credit for purchasing qualified two-wheeled plug-in electric vehicles is available for vehicles purchased in 2015–2020. Among other criteria, the vehicle must be (1) capable of achieving a speed of 45 miles per hour or greater and (2) manufactured for use on public roads. The credit equals 10% of the vehicle's cost (limited to $2,500) [IRC Sec. 30D(g)].

Recapture. The IRS has been instructed to issue regulations on the rules for recapturing the credits for plug-in vehicles that cease to qualify for the credits [IRC Sec. 30D(f)(5)]. As of the date of this publication, no regulations have been issued.

Energy Efficient Home Builders Credit

See also Form 8908; IRC Sec. 45L

~~**Expired Provision Alert:** This credit is not available after 2017 unless legislation is enacted that extends the provision. This section is included in the event the rules for the credit are extended.~~

Contractors (including producers of manufactured homes) that build new energy-efficient homes in the U.S. are eligible for a credit of $2,000 per dwelling unit (IRC Sec. 45L). The credit is reported on Form 8908 (Energy Efficient Home Credit). Partnerships and S corporations transfer the amount to Schedule K. All others carry it to Form 3800 (General Business Credit).

- To qualify, the dwelling unit must be certified to have annual energy consumption for heating and cooling that is at least 50% less than comparable units and meet certain other requirements.
- The credit can also apply to a substantial reconstruction and rehabilitation of an existing dwelling unit.
- A manufactured home that meets a 30% reduced energy consumption standard can generate a $1,000 credit.
- These credits only apply to homes sold by contractors for use as personal residences.
- The contractor's tax basis in the home is reduced by the amount of the credit.
- Construction must be substantially completed after August 8, 2005, and the home must be purchased after 2005 and before 2021.

Certification. The IRS issued guidance on the certification process that builders must complete to qualify for the credit. The notices also provide a public list of software programs that may be used in calculating energy consumption for obtaining a certification. See Notice 2008-35 for standard homes rules. Notice 2008-36 covers manufactured homes.

Energy-Efficient Commercial Building Deduction

~~**Expired Provision Alert:** This deduction is not available after 2017 unless legislation is enacted that extends the provision. This section is included in the event the rules for the deduction are extended.~~

IRC Sec. 179D allows businesses to deduct, rather than capitalize and depreciate, all or part of the cost of energy efficient commercial building property. The deduction is allowed for new and existing buildings but only for qualifying property placed in service in 2006 through 2020.

Continued on Page O-8

Selected General Business Tax Credits[1]

Credit Name	IRC Sec.	For	Rate	Tax Forms
Employment Credits				
Differential Wage Payment	45P	Small business employers paying differential wages to qualified employees that are active duty uniformed service members.	20% of eligible differential wage payments; $20,000 maximum wages/year/employee.	8932
Disabled Access	44	Expenses to make business accessible to/usable by disabled.	50%; $5,000 maximum credit.	8826
Employer-Paid FICA on Tips	45B	Amount paid on tips (not service charges) above minimum wage.	100% of eligible amounts.	8846
Employer-Provided Child Care	45F	Employers who provide child care and related services to employees.	25% of qualified child care facility plus 10% of resource and referral costs.	8882
Empowerment Zone Employment~~[2]~~	1396	Wages paid to employees working in selected geographic areas.	20% of wages up to $15,000.	8844
Family and Medical Leave	45S	Eligible employers that pay wages to qualifying employees while they are on family and medical leave. ~~Note: This provision expires December 31, 2019.~~	12.5% of wages paid to employees on leave, increased (but not above 25%) by .25 % pts. for each % pt. by which payment exceeds 50%.	8994
Indian Employment~~[2]~~	45A	Wages and health insurance costs paid to members of an Indian tribe or spouse for services performed on a reservation.	20% of increase over amount paid in 1993.	8845
Small Employer Pension Plan Start-Up Costs	45E	Credit for start-up costs of new employer retirement plans. Employer cannot have more than 100 employees.	50% of eligible costs up to a maximum credit of $500, for first 3 years of plan.	8881
Small Employer Health Insurance Premiums	45R	Qualified small employers that pay at least 50% of a qualified health arrangement for their employees.	Up to 50% (35% for tax-exempt organizations) of the lesser of: (1) the amount contributed or (2) the small business benchmark premium.	8941 990-T
Work Opportunity	51	Effective for work begun by certain targeted groups through 2020.	Rates vary for certain targeted groups.	5884 8850
Other Credits				
Biodiesel and Renewable Diesel Fuels~~[2]~~	40A	Use in the production of biodiesel mixture; use of biodiesel in a trade or business or sale at retail; production of qualified agri-biodiesel. For biodiesel mixture and biodiesel components, $1 rate applies if agri-biodiesel or renewable diesel (may include certain aviation fuel) is used.	Biodiesel mixture: $1 per gallon used. Biodiesel: $1 per gallon used or sold at retail. Agri-biodiesel: 10¢ for each gallon produced.	8864
Biofuel Producer~~[2]~~	40(b)(6)	Producers of second generation biofuel.	Generally, $1.01 for each gallon produced.	6478
Distilled Spirits	5011	Wholesalers and warehousers of distilled spirits.	15.878¢/case of distilled spirits purchased or stored.	8906
Energy Credits~~[2]~~	Var.	See *Selected Energy Tax Incentives for Businesses* on Page O-5.	Varies	Var.
Investment Credit:				
• Rehabilitation Property	47	• Certified historic structures.	• 20%, taken ratably over five years.	3468
• Energy Credit	48	• Equipment that uses solar energy to generate electricity, heat or cool a structure (or provide hot water for use in), provide solar process heat or illuminate the inside of a structure using fiber-optic distributed sunlight. Also, equipment (1) used to produce, distribute or use energy derived from a geothermal deposit; (2) that is a qualified fuel cell or microturbine, combined heat and power system or qualified small wind energy property; or (3) that uses the ground or ground water as a thermal energy source to heat or cool a structure.	• 10%; 30% for solar energy property and property using fiber-optic distributed sunlight under construction before 2022, and qualified fuel cell, or small wind energy property. **Note:** The 30% rate is reduced to 26% for property that begins construction after December 31, 2019.	
• Qualifying Advanced Coal	48A	• Investment in qualifying advanced coal project.	• 15%, 20% or 30% of qualified investment (QI).	
• Qualifying Gasification	48B	• Investment in qualifying gasification project.	• 20% or 30% of QI.	
• Qualifying Advanced Energy	48C	• Investment in qualifying advanced energy project.	• Up to 30% of QI.	
Low-Income Housing	42	Owners of residential rental buildings providing qualified low-income housing.	70% (or 30%) of qualified building basis over 10 years.	8586 8609-A
New Markets	45D	Investment in community development entities.	5% – 6% per year over seven years.	8874
Orphan Drug	45C	Expenses in testing certain drugs for rare diseases or conditions.	25% of qualified clinical testing costs.	8820
Research Activities	41	Business research and experimental expenditures.	20% of expenses over base amount.	6765
Qualified Opportunity Zones and Qualified Opportunity Funds	1400Z-1- and 1400Z-2	Investment in low-income communities as designated as a QO Zone by the Dept. of Treasury.	Temporary deferral of gain from the sale of the property and permanent exclusion of post-acquisition capital gains on disposition when held for 10 years.	8996

[1] See the current version of Form 3800, the other referenced forms and their instructions for details of these credits.

~~[2] This credit is not available after 2017 unless legislation is enacted that extends the provision. The credit is included in this table in the event the credit is extended.~~

	Accounting for Bookkeeping	Accounting for Income Tax
Capital Gains and Losses	**GAAP** Realized gains and losses on the sale of securities classified as *held to maturity* are included in income. For nonpublic entities with years beginning on or before December 15, 2018: Securities classified as *trading* are adjusted to FV on the balance sheet and the unrealized gain or loss is included in earnings. Securities classified as *available for sale* are adjusted to FV on the balance sheet; however, the unrealized gain or loss is reported as other comprehensive income. The net change in value is reported as a separate equity account until gain or loss is realized, at which time gain or loss is included in income. For years beginning after December 15, 2018: Investments in debt securities classified as *trading securities* and equity securities are adjusted to FV on the balance sheet and the unrealized gain or loss is included in earnings. Debt securities classified as *available for sale* are adjusted to FV on the balance sheet and the unrealized gain or loss is reported as other comprehensive income. The net change in value is reported as a separate equity account until gain or loss is realized, at which time gain or loss is included in income **E&P** If capital losses exceed capital gains, the excess is fully deductible except to the extent the wash sale rules apply to a loss [Reg. 1.312-7(b)(1)].	**TAX** **Individuals including partners and S corporation shareholders.** Current-year deduction for net capital loss is limited to $3,000 ($1,500 MFS). Excess over $3,000/$1,500 is carried forward to the next tax year [IRC Sec. 1211(b)]. **Corporations.** Current-year deduction for capital loss is allowed only to the extent of capital gains [IRC Sec. 1211(a)]. Net capital loss is carried back three years and forward five years [IRC Sec. 1212(a)(1)]. **Banks and other financial institutions.** Gain or loss from the sale of Fannie Mae or Freddie Mac preferred stock is treated as an ordinary rather than a capital gain or loss if the taxpayer held the stock on September 6, 2008 (Rev. Proc. 2008-64). **AMT** If AMT adjustments that affect basis were made in the current year or prior years, gain or loss is recomputed using the AMT adjusted basis. A common example is the AMT depreciation adjustment.
Charitable Contributions	**GAAP** Generally expensed as incurred and recorded at FV. An unconditional promise to give cash should be recorded at the time it is promised by increasing a liability and recording contribution expense. **E&P** Fully deductible. No adjusted gross income (AGI) or taxable income limitation.	**TAX** **Individuals (including partners and S corporation shareholders)** can deduct charitable contributions on Schedule A of Form 1040. The deduction is generally limited to 50% of AGI (100%, 60%, 30% and 20% limits apply to certain contributions) [IRC Sec. 170(b)(1)]. Excess contributions are carried forward for five years. **C corporations** can deduct charitable contributions as a business expense. The deduction is generally limited to 10% of the corporation's taxable income before considering the charitable contribution [IRC Sec. 170(b)(2)]. Contributions that exceed the 10% limit are carried forward for five years [IRC Sec. 170(d)(2)(A)].
Circulation Expenses	**GAAP** Generally expensed as incurred. **E&P** Capitalized and written off as part of basis if the asset has a reasonably determinable useful life [IRC Sec. 312(n)(3)].	**TAX** The cost to establish, maintain or increase circulation of a newspaper, magazine or other periodical is currently deductible, or may be capitalized and amortized as a deferred expense (IRC Sec. 173). **AMT** For noncorporate taxpayers, expenses are amortized over three years [IRC Sec. 56(b)(2)].

Table continued on the next page

Notes

Solution. For years beginning after 2017, the cash method of accounting under IRC Sec. 448(c) is available to taxpayers (other than tax shelters) that satisfy a $25 million ($26 million for 2019) gross receipts test, regardless of whether the purchase, production or sale of merchandise is an income-producing factor. In addition, such taxpayers are not required to maintain inventories under IRC Sec. 471 or apply the Section 263A UNICAP rules. Instead, taxpayers may treat inventories as nonincidental materials and supplies or conform to their financial accounting treatment of inventories.

The gross receipts test is based on the three-tax-year period before the testing year; however, it doesn't have to be met for all prior tax years. If a taxpayer hasn't been in existence for three years, the test period includes the number of years the taxpayer has existed. Finally, gross receipts for short tax years must be annualized [IRC Sec. 448(c)(3)].

Small Contractor Exemption from Percentage of Completion Method (PCM)

The small contractor exemption from the PCM has been greatly expanded by the TCJA to apply to contractors with up to $25 million ($26 million for 2019) in gross receipts.

Problem. Prior to enactment of the TCJA, income from small construction contracts didn't have to be computed using the PCM. However, this exception applied only if all of the following conditions were met:

1) The contract was a construction contract.
2) At the time the contract was entered into, the taxpayer expected the project to be completed within two years.
3) The taxpayer's average annual gross receipts for the three tax years preceding the year the contract was entered into didn't exceed $10 million.

Solution. For contracts entered into after 2017, small construction contractors are no longer required to use the percentage of completion method (PCM) if their gross receipts do not exceed $25 million ($26 million for 2019) and the contract is expected to be completed within two years [IRC Sec. 460(e)].

Applying for the Method Changes

To take advantage of these TCJA changes, Form 3115 (Application for Change in Accounting Method) is required to be filed. The IRS has issued automatic consent procedures for taxpayers seeking to change to one or more of these methods. If eligible, taxpayers must use the procedures in Rev. Procs. 2015-13 and 2018-31 (or any successors such as Rev. Proc. 2019-43) as modified by Rev. Proc. 2018-40.

For more information on applying for these automatic accounting method changes see *Change in Accounting Method* on Page L-4.

Hiring Dependents

Problem. Combined income and payroll tax can devour half the profit of a self-employed individual. It may be possible to shift income to a dependent child who will pay tax at a lower rate, or no tax.

Applicable rules:

1) Wages are exempt from FICA for a child under 18 employed in a parent's unincorporated business (sole proprietorship), a partnership in which each partner is a parent of the child, or a single-member LLC (SMLLC) [IRC Sec. 3121(b)(3); Reg. 31.3121(b)(3)-1(c) and (d)].
2) A dependent's standard deduction ($12,200 maximum in 2019), can be used to shelter up to $350 of the child's unearned income plus the child's earned income up to the $12,200 limit [IRC Sec. 63(c)(5)].
3) A child may qualify to contribute up to $6,000 to a traditional or Roth IRA for 2019 [IRC Sec. 219(b)].
4) Wages paid by a parent to a child are deductible by the parent's business if the work is done by the child in connection with the parent's trade or business.

Solution. An employer-parent can shield self-employment (SE) income from taxation by hiring his child. In addition, this could help reduce or avoid the 0.9% additional Medicare tax for the employer-parent. See *Additional Medicare tax* on Page I-2 for more information.

Note: Wages paid to a child must be reasonable in relation to the services rendered [IRC Sec. 162(a)]. The business owner should keep detailed records of the child's employment, including payroll records, in case federal or state taxing authorities or labor departments seek verification. See information about child labor laws under *Fair Labor Standards Act* on Page M-8.

Example: Marshall is a self-employed rocket scientist, operating as a sole proprietor. His marginal federal tax rate is 24% and his state tax rate is 8%. Marshall has a 16-year-old son named Junior. Marshall hires Junior as a ray gun tester at the current market rate of $24 per hour. Junior works 40 hours per week through the summer and 5 hours a week on Saturdays the remainder of the year, earning total wages of $16,320 for the year.

Marshall may deduct $16,320 as wage expense from his business income. The wages are exempt from FICA, and Junior pays $0 income tax. Junior's Form 1040 for tax year 2019 reports the following:

Wages	$ 16,320
IRA deduction	(6,000)
Standard deduction	(12,200)
Taxable income	$ 0
Total tax	$ 0

Ignoring for simplicity the SE and state tax deductions, Marshall would have paid $7,529 in total tax on the $16,320 of income at his rate [SE tax $2,306 ($16,320 × 92.35% × 15.3%) + federal income tax $3,917 ($16,320 × 24%) + state income tax $1,306 ($16,320 × 8%)].

Note: It may be possible to increase the retirement plan deduction by contributing to an employer's savings incentive match plan for employees (SIMPLE) IRA. See *SIMPLEs* on Page K-19 for more information.

Note: This strategy may be helpful in increasing the QBI deduction for a taxpayer subject to the phaseout range. However, a reduction of QBI (and the related deduction) occurs when wages are paid to family member employees.

Qualified Business Income (QBI) Deduction

Problem. The flat 21% C corporation tax rate under the TCJA could make proprietorships and pass-through entities less attractive.

Solution. For tax years 2018–2025, the TCJA enacted the complex QBI deduction under IRC Sec. 199A available to individuals, estates and trusts that is intended to create some parity with the 21% flat rate applicable to C corporations. Individual owners of S corporations, partnerships, LLCs, and sole proprietorships (including farmers) are eligible for the QBI deduction. In addition, a qualified rental real estate enterprise will qualify for the QBI deduction (Rev. Proc. 2019-38). In general, these taxpayers compute a deductible amount for each of their trades or businesses. The deductible amount is 20% of the individual's share of the business's QBI, limited to an amount based on the business's W-2 wages or a combination of its W-2 wages and its investment in qualified property (the *wage/investment limitation*) when the individual's taxable income exceeds certain threshold amounts. The rules are complex and the deduction is subject to phase-outs and limits. [For definitions, thresholds and calculation guidance, see *Qualified Business Income (QBI) Deduction* on Page F-4.]

Preferred returns may mitigate the business interest expense limit. Unless an exception applies, IRC Sec. 163(j) limits a taxpayer's business interest expense deduction to 30% of adjusted taxable income (ATI) plus any business interest income and any floor plan financing interest paid by motor vehicle dealers. The limit applies at the partnership level, and any deduction for allowable business interest expense is considered in determining the nonseparately stated taxable income or loss of the partnership [IRC Sec. 163(j)(4)]. Regulations proposed by the IRS in November 2018 adopt a broad definition of the term *interest*. For example, guaranteed payments for the use of capital under IRC Sec. 707(c) are treated as interest subject to IRC Sec. 163(j) [Prop. Reg. 1.163(j)-1(b)(20)(iii)(I)]. However, preferred returns aren't specifically mentioned in the proposed regulations. This leads to the question of whether partnerships should abandon guaranteed payments for the use of capital in favor of preferred returns.

Observation: A major advantage of preferred returns is their potential to boost a partner's QBI deduction under IRC Sec. 199A. However, partnership agreements should be carefully drafted to make sure preferred returns won't be reclassified as guaranteed payments or disguised payments for service.

Kiddie Tax

Problem. Under the Section 1(j)(4) kiddie tax, for years 2018–2019, the taxable income of a child attributable to earned income is taxed under the rates for single individuals and taxable income of a child attributable to net unearned income is taxed according to the brackets applicable to trusts and estates. For the kiddie tax to apply, the child must:

1) Have at least one living parent, at tax year-end;
2) Not file a joint return for the tax year; and either
3) Be under age 18 at tax year-end; or
4) Be age 18, or a full-time student age 19 through 23, at tax year-end with earned income of 50% or less than the amount of his support (without regard to certain scholarship income).

Note: Under the kiddie tax rules as modified by the TCJA, a portion of a child's (or young adult's) net unearned income can be taxed at the federal income tax rates paid by trusts and estates. The trust and estate rate structure is unfavorable because the rate brackets are compressed compared to the brackets for a single individual. There is no longer a connection between the kiddie tax and the parents' return, unless the parents elect to report the child's income on their return.

Solution 1: Generate earned income. Paying wages to an age-18 or older child can potentially eliminate the kiddie tax liability if the wages cause the child's earned income to exceed 50% of his support. Of course, if the child's after-tax wages are actually used to provide for his support (as opposed to being saved or invested), the parent's ability to claim the child as a dependent may be in jeopardy.

If the child is in college, his college costs are usually the largest part of his support. Certain scholarships are not considered support. By increasing the amount of a child's scholarship to cover his education costs, using the child's own funds for support and/or choosing a less expensive school, the child can more easily meet the more than 50% support test to avoid the kiddie tax. For the years that a student is 19 to 23 years old, the rule is purely mechanical. There is no requirement for the child to actually spend any of the earned income on his own support.

Solution 2: Pick the right investments. A family should try to push investment income that would have been earned in an earlier year and taxed at the higher trust rates into a year that the investment income would be taxed at the child's lower rate. This can be accomplished by buying and retaining any of the following investments until the child is no longer subject to kiddie tax:

- Capital growth securities and mutual funds that produce little or no current income.
- Vacant land that is expected to appreciate in value.
- Stock in a closely held family business that is expected to appreciate as the business expands, but which pays little or no dividends.
- Tax-exempt municipal bonds and bond funds.
- U.S. Series EE bonds because recognition of income can be deferred until the bonds mature, are cashed in, or an election to recognize income annually is made.
- Annuities and/or cash-value life insurance policies.
- Market discount bonds.

Also, if the child is the beneficiary of a trust, coordinate trust income with the child's income. The first $2,600 (for 2019) of trust income is taxed at the 10% rate. In certain cases, a trust instrument may allow the trustee to allocate realized capital gains to income in whole or in part. [Reg. 1.643(a)-3(b)]

Solution 3: Transfer parents' money. Another strategy is to transfer the parents' money to qualified tuition plans (529 plans) or education savings accounts. (See *Qualified Tuition Programs* and *Education Savings Accounts* in Tab 13 of the *1040 Quickfinder® Handbook*.)

Lodging and Meals for Shareholder-Employees

Problem. In certain situations an employer must pay for employee meals and lodging in order to conduct business. The value of the meals and lodging will be considered taxable income to the employee unless certain factors are present. IRC Sec. 119 sets forth rules determining if employer-paid expenses for meals and lodging are eligible for exclusion from the employee's income.

Applicable rules. To be excluded from the employee's income, expenses for meals and lodging must first pass the *"convenience of the employer"* test. If the employer furnishes meals to employees for a substantial, noncompensatory business reason, they are furnished for its convenience (Reg. 1.119-1).

1) *Meals.* To exclude employer-provided meals from income, they must be provided on the business premises.
2) *Lodging.* To exclude lodging from income, the employee must accept the lodging as a condition of employment and the lodging is furnished on the business premises of the employer.

Note: Under the TCJA, an employer's deduction for the cost of business meals is limited to 50% for amounts paid or incurred from January 1, 2018–December 31, 2025 [IRC Sec. 274(n)]. No deduction is allowed after 2025 [IRC Sec. 274(o)].

Also see *Meals and Lodging* on Page K-10 for more information.

Example #1: Farmer Jones is the sole shareholder in Dell Farms, a C corporation, and is the corporation's only employee. Dell owns and operates a livestock farm where it requires Jones to live in a corporate-owned residence to be available for emergencies, day or night. All criteria are met to exclude meals and lodging from Jones' wages, and to deduct the corporation's expenses. In 2019, the cost of providing the meals and lodging for Farmer Jones amounts to $9,600 for the year. The corporation deducts $4,800 and Jones receives the meals and lodging tax free.

What's New

Tab Q Topics

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Inflation-Adjusted Amounts

For a summary of inflation-adjusted amounts for 2019 (plus 2020 and 2018 and prior years) see the *Business Quick Facts Data Sheet* on Page A-1.

Tax Legislation

December 2019 Legislation

Taxpayer Certainty and Disaster Tax Relief Act of 2019. Enacted on December 20, 2019, the Act retroactively extends certain expired provisions, generally through 2020. This means that taxpayers can apply many of these provisions to both 2019 and already-filed 2018 tax returns. The Act also provides relief for taxpayers affected by qualified disasters occurring from January 1, 2018 through January 19, 2020. In addition, the Act includes other provisions not related to expired provisions or disasters.

Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act). Enacted on December 20, 2019, the Act expands opportunities for individuals to increase their savings, and makes administrative simplifications to the retirement system.

Quickfinder tax act summaries. See the *Handbook Updates* section of the Quickfinder website (**tax.thomsonreuters.com/quickfinder**) for tables summarizing key provisions of the December 2019 legislation.

Taxpayer First Act of 2019

The Taxpayer First Act (TFA) was enacted on July 1, 2019. The key purpose of this legislation is to alter the management and oversight of the IRS with the aim of improving customer service and the appeals process. The TFA also provides new confidentiality safeguards as taxpayers interact with the IRS. An important provision of the TFA requires the Treasury Department to submit to Congress by September 30, 2020 a comprehensive written plan to redesign the IRS. The plan must (1) streamline the structure of the agency, including minimizing the duplication of services and responsibilities; (2) best position the IRS to combat cybersecurity and other threats to the agency; and (3) address whether the IRS's Criminal Division should report directly to the Commissioner. Beginning one year after the plan is submitted, the IRS's current structure, which features operating units that serve particular groups of taxpayers with similar needs, will cease to apply. For a summary of the key provisions of the TFA, see *Taxpayer First Act of 2019* on Page Q-4.

Tax Relief for Disaster Victims

Disaster Relief Alert: See *December 2019 Legislation* on Page Q-1 regarding legislative relief for taxpayers affected by certain qualified disasters.

The Internal Revenue Code provides a number of special tax relief provisions available to victims of a federally declared disaster. For purposes of these provisions, the term *federally declared disaster* means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, and the term *disaster area* means the area so determined to warrant such assistance [IRC Sec. 165(i)(5)]. A *federally declared disaster* includes a major declaration or an emergency declaration under the Act (Rev. Rul. 2003-29; IRS Pub. 547).

Help for Disaster Victims—Quick Summary

For taxpayers impacted by a disaster, the Code may provide necessary relief. The Code permits the IRS to grant taxpayers affected by a federally declared disaster additional time to perform certain time-sensitive acts, including filing returns and paying taxes when the original or extended due date of the return or payment falls within the disaster period. In addition, affected individual and business taxpayers in a federally declared disaster area can more quickly obtain a refund by claiming losses related to the disaster on the tax return for the previous year, usually by filing an amended return. See *Federally declared disaster* on Page N-14. See Tab 5 of the *1040 Quickfinder® Handbook* for discussion of personal casualty losses and Tab 4 of the *Individuals—Special Tax Situations Quickfinder® Handbook* for an expanded discussion of disaster victims.

The IRS website has information on the most recent tax relief provisions for taxpayers affected by disaster situations. Search for "Disaster Assistance and Emergency Relief for Individuals and Businesses" at **www.irs.gov** for a listing of covered disaster areas and tax relief provided in response to a federally declared disaster. Information on prior tax relief provided by the IRS in disaster situations, based on Federal Emergency Management Agency (FEMA) declarations of individual assistance, is also available. Helpful IRS materials include Pubs. 547 (Casualties, Disasters, and Thefts) and 2194 (Disaster Resource Guide for Individuals and Businesses). For an additional resource, see the table *2019 Federally Declared Disasters* in Tab 4 of the *Individuals—Special Tax Situations Quickfinder® Handbook*.

Affected taxpayer. A taxpayer does not have to be located in a federally declared disaster area to be an *affected taxpayer*. Taxpayers are *affected* if records necessary to meet a filing or payment deadline postponed during the relief period are located in a covered disaster area.

An affected taxpayer can be:

- An individual (includes relief workers).
- Any business entity or sole proprietor.
- Any partner or shareholder in an affected partnership or S corporation.

Note: See *Deadlines postponed* on Page Q-2 for a list of taxpayer acts that may be postponed in response to a federally declared disaster.

Affected tax preparer. Disaster relief applies to tax preparers who are unable to file returns or make payments on behalf of their clients because of the disaster. A taxpayer outside of the disaster area may qualify for relief if:

- His preparer is located in the disaster area, and
- The preparer is unable to file or pay on the taxpayer's behalf.

To get the postponement for filing or payment, a taxpayer should:

- Call the Disaster Assistance Hotline at (866) 562-5227.
- Explain that the necessary records are located in a covered disaster area.
- Provide the FEMA Disaster Number of the county where the tax preparer is located.

Casualty losses. Affected taxpayers have the option of claiming casualty losses attributable to federally declared disasters on their federal income tax return for either the current tax year or the previous tax year. Claiming the loss on an original or amended return

for the prior year will allow the taxpayer to receive a refund earlier, but waiting to claim the loss on the current year's return could result in a greater tax saving, depending on other income factors.

If claiming the disaster loss on the previous year's tax return, put the disaster designation in red ink at the top of the form so that the IRS can expedite the processing of the refund.

Other relief. The IRS will waive the usual fees and expedite requests for copies of previously filed tax returns for affected taxpayers who need them to apply for benefits or to file amended returns claiming casualty losses. Form 4506 (Request for Copy of Tax Return) should be filed with the assigned disaster designation in red ink at the top and submitted to the IRS.

Affected taxpayers who are contacted by the IRS on a collection or examination matter should provide an explanation of how they were impacted by the disaster so that the IRS can provide appropriate consideration to their case.

Drought-stricken farmers. Farmers and ranchers who were forced to sell livestock due to drought may have an additional year to replace the livestock and defer tax on any gains from the forced sales. To qualify for relief, the farmer or rancher must be in an applicable region. This is a county designated as eligible for federal assistance plus counties contiguous to that county. The relief generally applies to capital gains realized by eligible farmers and ranchers on sales of livestock held for draft, dairy, or breeding purposes. Sales of other livestock, such as those raised for slaughter or held for sporting purposes, or poultry, are not eligible.

The sales must be solely due to drought, flooding, or other severe weather causing the region to be designated as eligible for federal assistance. Livestock generally must be replaced within a four-year period, instead of the usual two-year period. The IRS is also authorized to further extend this replacement period if the drought continues.

The one-year extension gives eligible farmers and ranchers until the end of the tax year after the first drought-free year to replace the sold livestock. The IRS provides this extension to farmers and ranchers located in the applicable region who qualified for the four-year replacement period if any county that is included in the applicable region is listed as suffering exceptional, extreme, or severe drought conditions during any week between September 1, 2018 and August 31, 2019. This determination is made by the National Drought Mitigation Center. All or part of 32 states, plus Guam, the U.S. Virgin Islands, Puerto Rico, and the Northern Mariana Islands, are eligible. See Notice 2019-54.

Qualified farmers and ranchers whose drought-sale replacement period was scheduled to expire at the end of this tax year, December 31, 2019 in most cases, now have until the end of the next tax year. Because the normal drought-sale replacement period is four years, this extension immediately impacts drought sales that occurred during 2015. The replacement periods for some drought sales before 2015 are also affected due to previous drought-related extensions affecting some of these localities.

See Tab 6 of the *Individuals—Special Tax Situations Quickfinder® Handbook* for further discussion of this and other weather-related tax provisions that may benefit farmers and ranchers.

FEMA Disaster Declarations

According to FEMA, there are two types of disaster declarations provided for in the Stafford Act: emergency declarations and major disaster declarations. Both declaration types authorize the President to provide supplemental federal disaster assistance. However, the events related to the two different types of declaration, and the scope and amount of assistance, differ.

Emergency declarations. The President can declare an emergency for any occasion or instance when he determines federal assistance is needed. Emergency declarations supplement state and local or Indian tribal government efforts in providing emergency services, such as the protection of lives, property, public health and safety, or to lessen or avert the threat of a catastrophe in any part of the U.S. The total amount of assistance provided for in a single emergency may not exceed $5 million. Federal assistance available under emergency declarations may include limited types of public assistance and/or individual assistance.

Major disaster declarations. The President can declare a major disaster for any natural event, including any hurricane, tornado, storm, high water, wind-driven water, tidal wave, tsunami, earthquake, volcanic eruption, landslide, mudslide, snowstorm, or drought, or, regardless of cause, fire, flood, or explosion, that he determines has caused damage of such severity that it is beyond the combined capabilities of state and local governments to respond. A major disaster declaration provides a wide range of federal assistance programs for individuals and public infrastructure, including funds for both emergency and permanent work. Not all federal assistance programs are activated for every major disaster. FEMA disaster assistance programs that may apply to a specific major disaster include several different types of individual assistance, public assistance, and hazard mitigation assistance.

For more information on the FEMA disaster declaration process, see **www.fema.gov/disaster-declaration-process**.

IRS Disaster Filing and Payment Relief

The Code and regulations authorize the IRS to postpone certain tax-related deadlines for up to one year (IRC Sec. 7508A; Reg. 301.7508A-1). The IRS usually limits this relief to major disaster areas eligible for federal individual assistance or individual and public assistance.

Covered disaster area. The regulations and the IRS refer to an area for which deadlines have been postponed as a *covered disaster area*.

Deadlines postponed. The tax deadlines the IRS may postpone include those for filing income, excise, and employment tax returns; paying income, excise, and employment taxes; and making contributions to a traditional or Roth IRA. If any tax deadline is postponed, the IRS will publicize the postponement in the impacted area and publish a news release and, where necessary, a revenue ruling, revenue procedure, notice, announcement, or other guidance. Specifically, deadlines for performing the following acts are extended:

- Filing any return of income, estate, gift, generation-skipping transfer, excise, or employment tax.
- Paying any income, estate, gift, generation-skipping transfer, excise, or employment tax, including making estimated tax payments.
- Making certain contributions or distributions, recharacterizing contributions, or making a rollover to or from a qualified retirement plan.
- Filing certain petitions with the Tax Court.
- Filing a claim for credit or refund of any tax.
- Bringing suit upon a claim for credit or refund.
- Certain other acts described in Rev. Proc. 2018-58.

Penalty and interest abatement. The IRS may abate the interest and penalties on any underpaid income, estate, gift, employment, or excise tax for the length of any postponement of tax deadlines.

Eligible taxpayers. If the IRS postpones a tax deadline, the following taxpayers are eligible for the postponement:

- Any individual whose main home is located in a covered disaster area.
- Any business entity or sole proprietor whose principal place of business is located in a covered disaster area.
- Any individual who is a relief worker affiliated with a recognized government or philanthropic organization and who is assisting in a covered disaster area.

- Any individual, business entity, or sole proprietorship whose records are needed to meet a postponed tax deadline, provided those records are maintained in a covered disaster area (the main home or principal place of business does not have to be located in the covered disaster area).
- Any estate or trust that has tax records necessary to meet a postponed tax deadline, provided those records are maintained in a covered disaster area.
- The spouse on a joint return with a taxpayer who is eligible for postponements.
- Any individual, business entity, or sole proprietorship not located in a covered disaster area, but whose records necessary to meet a postponed tax deadline are located in the covered disaster area.
- Any individual visiting the covered disaster area who was killed or injured as a result of the disaster.
- Any other person determined by the IRS to be affected by a federally declared disaster.

Additional Code Disaster Relief Provisions

These relief provisions are automatically available to victims of a federally declared disaster (emergency or major). They provide special rules for the tax treatment of:

- Qualified disaster relief and mitigation payments (IRC Sec. 139).
- Casualty losses (IRC Sec. 165).
- Involuntary conversions (IRC Sec. 1033).

Legislative Relief Provisions

These are provisions that are not part of the automatically available Code relief provisions. They may be enacted by Congress, typically only for the most serious disasters, and apply to taxpayers and areas as specifically defined in the legislation. Such legislation may provide different types of tax relief for different areas, and may be enacted as Code sections or as separate laws that are not incorporated into the Code. Examples of such relief legislation are the Disaster Tax Relief and Airport and Airway Extension Act of 2017, which provided temporary tax relief for certain 2017 hurricane victims, and the Bipartisan Budget Act of 2018, which extended this relief to certain California wildfire victims. In December 2019, Congress enacted the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (see *December 2019 Legislation* on Page Q-1).

Notes

Taxpayer First Act of 2019 (Continued)

Item	IRC Sec.	Effective Date	New Law	Before Law Change
Other Provisions				
Volunteer Income Tax Assistance (VITA) Program	7526A	N/A	Unless otherwise provided by specific appropriation, the IRS may allocate up to $30 million per year in matching grants to qualified entities for the development, expansion, or continuation of qualified tax return preparation programs. The IRS may use mass communications and other means to promote the VITA program.	Through its VITA program, the IRS partnered with volunteer organizations to provide free tax return filing assistance to low-income populations, persons with disabilities, taxpayers with limited English proficiency, and other underserved communities.
Low Income Taxpayer Clinics	7526	7/1/19	IRS personnel may advise taxpayers of the availability of, and eligibility requirements for receiving, advice and assistance from qualified low-income taxpayer clinics. They also can provide location and contact information for the clinics.	The IRS could provide up to $6 million per year in matching grants to low-income taxpayer clinics. However, IRS personnel were generally prohibited from referring taxpayers to clinics for advice and assistance.
Whistleblower Reforms	6103(k) and 7623(d)	7/1/19	The IRS may exchange information with whistleblowers, but only if such information would further the investigation. Also, the IRS must notify whistleblowers of the status of their claims at certain points in the review process. Under penalty of law, whistleblowers are prohibited from disclosing information received from the IRS. Whistleblowers receive anti-retaliation protection similar to that provided by the False Claims Act and the Sarbanes-Oxley Act.	Individuals who submitted information leading to the detection of a tax underpayment (or the detection, trial, and punishment of violators of internal revenue laws) could file a claim for an award.
Feasibility of Return-Free Tax System	N/A	7/1/19	These requirements are repealed.	The RRA required the IRS to study the feasibility of, and develop procedures for, the implementation of a return-free tax system for appropriate individuals. The IRS was required to report annually on the development of the system.
Failure to File Penalty	6651	1/1/20	For returns required to be filed on or after the effective date, the $205 penalty amount described in the Before Law Change column is increased to $330 (adjusted for inflation for returns required to be filed in a calendar year beginning after 2020). **Note:** Subsequently, the SECURE Act (enacted 12/20/19) increased the $330 amount to $435.	Absent reasonable cause, if a return was filed more than 60 days after its due date, the failure to file penalty was the lesser of $205 or 100% of the tax amount required to be shown on the return. The $205 amount was subject to an inflation adjustment ($215 for 2019).

— End of Tab Q—