



EnrolledAgent.com®

TESTING WINDOW JULY 1, 2026 – FEBRUARY 28, 2027 • BASED ON 2025 TAX LAW

EA Exam Part 2: Businesses

The Plain-English Study Guide for the IRS Special
Enrollment Examination

Kenneth Omoruyi, M. Tax, EA, CPA

An EnrolledAgent.com Study Guide

EA Exam Part 2: Businesses — The Plain-English Study Guide for the IRS Special Enrollment Examination

First edition, for the July 1, 2026 – February 28, 2027 testing window.

Copyright © 2026 EnrolledAgent.com. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher, except for brief quotations in reviews.

Published by EnrolledAgent.com. Inquiries: info@enrolledagent.com.

Tax-law basis. The IRS states that for examinations taken between July 1, 2026 and February 28, 2027, all references are to the Internal Revenue Code, regulations, IRS forms, instructions, and publications as amended through December 31, 2025, and that unless a question says otherwise, “current tax year” means calendar year 2025. This guide follows that basis. Where a 2026 change exists, it is flagged in a separate “Not on your exam” note so you never mix years.

Important notices. This guide is an independent study aid. It is not affiliated with, endorsed by, or sponsored by the Internal Revenue Service, the U.S. Department of the Treasury, or PSI Services LLC. “Special Enrollment Examination” and the content outlines are the property of their respective owners. All practice questions in this book are original questions written for study purposes; they are not actual or retired exam questions. This publication provides general educational information about federal tax law and does not constitute tax, legal, or accounting advice for any specific taxpayer. Figures are drawn from official IRS sources listed in Appendix D; readers should confirm current figures before relying on them in practice.

Contents

About the Author	vii
How to Use This Guide	viii
The Exam at a Glance	x
A Six-Week Study Plan	xii
Chapter 1. Business Entities and Considerations	2
1.1 The five forms of business, side by side	2
1.2 Sole proprietorships and qualified joint ventures	3
1.3 Partnerships and LLCs	4
1.4 C corporations	5
1.5 S corporations	5
1.6 Tax-exempt entities and associations	6
1.7 Default classification and the check-the-box election	6
1.8 Employer identification numbers	7
1.9 Accounting periods	8
1.10 Reporting requirements: Forms W-4, W-2, and the 1099 series	9
1.11 Hobby or business, and the order of loss limitations	11
Quick Check: Chapter 1	12
Chapter 2. Partnerships	15
2.1 Forming the partnership: contributions of property	15
2.2 Partnership income and separately stated items	16
2.3 Guaranteed payments and dealings with the partnership	17
2.4 Family partnerships	18
2.5 Basis of a partner's interest	18
2.6 Distributions	19
2.7 Sale of a partnership interest and the death of a partner	20
2.8 Termination of a partnership	21
2.9 Filing requirements, due dates, and penalties	21
2.10 Cancellation of partnership debt	22
2.11 The centralized partnership audit regime	23
Quick Check: Chapter 2	24
Chapter 3. C Corporations	27
3.1 Forming the corporation: section 351	27
3.2 Section 1244 stock and qualified small business stock	29
3.3 Computing corporate taxable income	29
3.4 Filing, estimated taxes, and penalties	31
3.5 Earnings and profits	32
3.6 Distributions to shareholders	32
3.7 Stock redemptions	34
3.8 Liquidations	35
3.9 Penalty taxes on undistributed income	35
3.10 Controlled groups, consolidated returns, and closely held corporations	36
Quick Check: Chapter 3	37

Chapter 4. S Corporations	40
4.1 Eligibility and the election	40
4.2 Income, deductions, and separately stated items	41
4.3 Entity-level taxes	42
4.4 Shareholder basis: stock and debt	43
4.5 Distributions	19
4.6 Revocation, termination, and reinstatement	45
4.7 Debt discharge	46
4.8 Partnerships and S corporations side by side	46
Quick Check: Chapter 4	47
Chapter 5. Business Income, Expenses, Depreciation, and Credits	50
5.1 Gross receipts and other business income	50
5.2 Cost of goods sold and inventory	51
5.3 Loss limits and cancellation of business debt	52
5.4 Compensation, fringe benefits, and family employment	52
5.5 Rent and self-rentals	54
5.6 Depreciation, section 179, bonus, amortization, and depletion	54
5.7 Bad debts	58
5.8 Travel, meals, entertainment, and gifts	59
5.9 Vehicle expenses	60
5.10 Interest, insurance, and taxes	61
5.11 Casualties, thefts, and condemnations	62
5.12 Employment taxes	63
5.13 The qualified business income deduction	65
5.14 General business credits	67
5.15 Net operating losses	31
5.16 The home office deduction	69
Quick Check: Chapter 5	70
Chapter 6. Business Assets, Financial Records, and Advising the Business Taxpayer	74
6.1 Basis of business assets	74
6.2 Dispositions of business property: sections 1231, 1245, and 1250	75
6.3 Like-kind exchanges	77
6.4 The capitalization and repair regulations	78
6.5 Reading the business's financial records	79
6.6 Accounting methods and Form 3115	79
6.7 Depreciation recapture under section 280F and pass-through items	80
6.8 Reconciling books to the return: Schedules M-1, M-2, and M-3	81
6.9 Related parties and loans to and from owners	81
6.10 Reporting, filing, and payment obligations	82
6.11 Advising the owner	84
Quick Check: Chapter 6	88
Chapter 7. Specialized Returns and Taxpayers	92
7.1 Trusts and estates: who files, when, and at what rates	92
7.2 Accounting income, distributable net income, and the distribution deduction	94
7.3 Exempt organizations	96
7.4 Retirement plans	100
7.5 Farmers	103
7.6 Rental property	106
Quick Check: Chapter 7	108
Part III. Practice Exam	112

Appendix A. 2025 Numbers at a Glance 127

 Entities and filing 127

 Depreciation, vehicles, and asset expensing 128

 Payroll and self-employment 129

 QBI, credits, and other limits 129

 Trusts, estates, and exempt organizations 130

 Retirement plans 100

 Farmers and rentals 132

Appendix B. Forms Directory 133

Appendix C. Glossary 137

Appendix D. Sources and Authorities 141

Appendix E. Changes That Take Effect in 2026 and Are Not on Your Exam 144

PART I

Getting Ready

How this guide works, what the exam tests, and a six-week plan to pass.

About the Author

Kenneth Omoruyi, M. Tax, EA, CPA, is the Managing Partner of CKO CPAs & Advisors, a Texas accounting and advisory firm, and the founder of EnrolledAgent.com, the online platform that connects taxpayers with IRS-licensed Enrolled Agents.

He earned a Bachelor of Science in Accounting from the University of Benin and a Master of Science in Business Taxation from the University of Southern California's Leventhal School of Accounting, and holds a Public Leadership Credential from the Harvard Kennedy School. Before founding his firm he served as a Senior Tax and Financial Analyst at Schlumberger, where he received multiple "Be Outstanding" awards for process improvement and leadership development.

Kenneth is both an Enrolled Agent and a Certified Public Accountant. He teaches as an Adjunct Professor of Accounting at Lone Star College, and in 2025 he was appointed by Texas Governor Greg Abbott to the Texas State Board of Public Accountancy, with Senate confirmation for a six-year term. His recognitions include the AICPA Outstanding Young CPA Award, the AICPA Black CPA 40 Under 40 Award, and the Top 40 Under 40 in the Accounting Profession Award.

He wrote this guide the way he teaches: one rule at a time, with the smallest example that proves the point.

How to Use This Guide

Part 2 is the longest and most feared part of the Enrolled Agent exam, and most study materials make it worse by presenting partnerships, C corporations, and S corporations as three unrelated bodies of law. They are not. They are three answers to the same five questions: how does property get in, how is income taxed, how does money come out, what happens to the owner's basis, and how does the entity end. This guide asks those five questions of every entity in the same order, so by Chapter 4 you are recognizing patterns rather than memorizing lists. Every topic on the official Part 2 content outline is taught the same way:

Feature	What it does for you
The rule	The law restated in one or two plain sentences, with the numbers that matter for 2025.
At a glance	A compact comparison table whenever the exam likes to test two or more things that look alike, especially partnership versus S corporation treatment.
Worked example	A small, round-number scenario that proves the rule. One idea per example. If the math takes more than four lines, the example is too big.
Memory cue	A short phrase or pattern to hold the rule in place under exam pressure.
Exam trap	The specific way the test writers try to make you choose the wrong answer.
New for 2025	A change from the One Big Beautiful Bill Act (Public Law 119-21, enacted July 4, 2025) that applies to the 2025 tax year tested on your exam. Business taxpayers were affected more than any other group.
Not on your exam	A rule that changes in 2026 or later. You need to know it does not apply to 2025 so you are not tempted by an answer choice built on it.
Quick check	Short practice at the end of every chapter with full explanations, followed by a 50-question practice exam in Part III.

The businesses you will get to know. The examples follow the Lopez family of Houston, Texas, and the businesses around them. Maria Lopez runs Panadería Lopez, a bakery, as a sole proprietorship that becomes an S corporation. Her husband David and his brother Carlos own Lopez Brothers Landscaping, LLC, taxed as a partnership. David and their neighbor Priya own Bayou Fabrication, Inc., a C corporation. Priya also runs a consulting practice. Maria's mother Rosa owns a rental duplex, Rosa's brother Tomás farms near La Grange, and Maria is treasurer of Houston Reading Alliance, a 501(c)(3). Using the same people and businesses throughout lets you focus on the one rule that changes from example to example.

Recommended path.

1. Read “The Exam at a Glance” so you know exactly what is scored and how.
2. Work through Chapters 1 to 7 in order. Chapters 1 to 4 cover Domain 1 (entities), Chapters 5 and 6 cover Domain 2 (business tax preparation), and Chapter 7 covers Domain 3 (specialized returns). Later chapters assume earlier ones.
3. Do the Quick Check at the end of each chapter before moving on. Read every explanation, including the ones you got right.
4. Take the practice exam in Part III under timed conditions: 50 questions in 105 minutes mirrors the pace of the real 100-question, 3.5-hour exam.
5. Use Appendix A, “2025 Numbers at a Glance,” as your final-week review sheet.

The Exam at a Glance

What Part 2 is. The Special Enrollment Examination (SEE) has three parts. Part 2 covers business taxation: entities, business income and deductions, and specialized returns such as trusts, exempt organizations, retirement plans, farms, and rentals. Each part has 100 multiple-choice questions, of which 85 are scored and 15 are unscored experimental questions you cannot identify. You have 3.5 hours of testing time. Results are converted to a scaled score from 200 to 800, and the IRS has set the passing score at 500; a passing report shows only “pass,” while a failing report shows the scaled score and diagnostic information by domain. You may take the three parts in any order, up to four attempts per part in each testing window, and you have three years from the date you pass a part to pass the other two. PSI Services LLC administers the exam for the IRS at U.S. test centers and by remote proctoring.

What law is tested. For exams taken July 1, 2026 through February 28, 2027, the exam uses the law as amended through December 31, 2025. Unless a question says otherwise, every amount, threshold, and deadline refers to calendar year 2025. Do not apply any legislation, court decision, or penalty amount that took effect after December 31, 2025.

How the 85 scored questions are distributed.

Domain	Scored questions	Share	Chapters
1. Business Entities and Considerations	30	35%	1, 2, 3, 4
2. Business Tax Preparation	37	44%	5, 6
3. Specialized Returns and Taxpayers	18	21%	7
Total	85	100%	

Three habits that raise scores.

- Ask which entity is speaking. The same word means different things in different entities: a “distribution” from a partnership is usually tax-free to the extent of basis, from an S corporation it follows the AAA ordering rules, and from a C corporation it is a dividend to the extent of earnings and profits. Before you answer, name the entity.
- Track basis in every example. More Part 2 questions turn on an owner’s basis than on any other single concept. Know what raises it, what lowers it, and the order in which the adjustments are made.
- Eliminate the 2026 answer. Because the exam tests 2025 law while you are studying in 2026, the most tempting wrong answer is often the 2026 rule. Every “Not on your exam” note in this guide exists to protect you from that trap.

Registering and sitting for the exam. Obtain a Preparer Tax Identification Number (PTIN), create your account through the PSI link on the IRS “Become an Enrolled Agent” page, and schedule each part separately. The fee is \$317 per part, paid when you schedule. Your name must match your unexpired government-issued photo ID exactly. You may reschedule or cancel without forfeiting the fee with at least 48 hours’ notice; inside 48 hours the

fee is forfeited. Testing is not offered in March and April while the exam is updated. After passing all three parts, apply for enrollment on Form 23 and pay the \$140 enrollment fee. Passing the exam does not by itself make you an Enrolled Agent.

A Six-Week Study Plan

This plan assumes about eight to ten hours per week. If you have more time, spread the same sequence across eight weeks and add a second pass through the Quick Checks.

Week	Focus	Target
1	Front matter, Chapter 1 (Entities and considerations), Chapter 2 (Partnerships)	Entity classification and default rules. Partner basis, guaranteed payments, and the distribution rules cold.
2	Chapters 3 and 4 (C corporations; S corporations)	Section 351, E&P and dividends, the DRD. S election mechanics, shareholder basis, the AAA ordering rules. Side-by-side comparison of all three entities.
3	Chapter 5, first half (Business income, COGS, expenses, depreciation)	Section 179 versus bonus, the auto limits, meals and travel, start-up costs.
4	Chapter 5, second half (Employment taxes, QBI, credits, NOL, home office)	Deposit schedules. QBI thresholds and the SSTB rule. Which credits are general business credits.
5	Chapter 6 (Assets, records, accounting methods, advising)	Sections 1231, 1245, and 1250. Like-kind exchanges. Form 3115. Worker classification.
6	Chapter 7 (Specialized returns), practice exam, Appendix A review	Trust DNI, Form 990 thresholds, SEP and SIMPLE limits, farm rules, the \$25,000 rental allowance. Timed 50-question exam. Review misses.

PART II

The Three Domains

Chapters 1 through 7 follow the official Part 2 content outline in order: four chapters on business entities, two on business tax preparation, and one on specialized returns. Each chapter opens with its share of the exam and closes with a Quick Check.

Chapter 1. Business Entities and Considerations

Domain 1 • 30 scored questions (35%) • Chapters 1 through 4

What the outline tests in this chapter: sole proprietorships; partnerships and qualified joint ventures; corporations; S corporations; LLCs; tax-exempt entities and associations; default entity classifications and elections; employer identification numbers; accounting periods; reporting requirements (Forms W-2, W-4, and the 1099 series); and the hobby-versus-business determination with its loss limitations. Chapters 2, 3, and 4 then take partnerships, C corporations, and S corporations one at a time.

Every business question on Part 2 starts with the same silent step: identify the entity. The tax treatment of a dollar of income, a distribution, or a loss depends on whether it belongs to a sole proprietor, a partnership, a C corporation, or an S corporation. This chapter gives you the map. It also covers the housekeeping rules the exam loves because they have clean, testable answers: how an entity gets its EIN, which tax year it may use, and which information returns it must file.

1.1 The five forms of business, side by side

The rule. Federal tax law recognizes four ways to tax a business: as part of its owner (sole proprietorship or disregarded entity), as a partnership, as a C corporation, or as an S corporation. A limited liability company is a state-law entity, not a federal tax classification; an LLC is taxed as one of the four depending on how many owners it has and what it elects.

	Sole proprietorship	Partnership	C corporation	S corporation
Return	Schedule C (Form 1040)	Form 1065 with Schedule K-1	Form 1120	Form 1120-S with Schedule K-1
2025 due date (calendar year)	April 15	March 15	April 15	March 15
Extension	6 months (Form 4868)	6 months (Form 7004)	6 months (Form 7004)	6 months (Form 7004)
Who pays the income tax	Owner	Partners	Corporation, at a flat 21%	Shareholders (with narrow entity-level exceptions)
Owner's share of profit subject to self-employment tax	Yes, all of it	General partners: yes; limited partners: only guaranteed payments for services	No; owner-employees receive wages	No; shareholder-employees must be paid reasonable wages

	Sole proprietorship	Partnership	C corporation	S corporation
Liability of owners for business debts (state law)	Unlimited	General partners unlimited; limited partners and LLC members limited	Limited	Limited
Number and type of owners	One	Two or more, any type	Unlimited, any type	100 or fewer; individuals, estates, certain trusts, and exempt organizations; no nonresident alien shareholders; one class of stock
Losses flow to owners	Yes	Yes, limited by basis, at-risk, and passive rules	No; losses stay in the corporation as NOLs	Yes, limited by stock and debt basis, at-risk, and passive rules
Distributions of cash	Not a taxable event	Tax-free to the extent of basis	Dividend to the extent of earnings and profits	Tax-free to the extent of stock basis (if no E&P)
Fringe benefits for owners	Generally taxable	Generally taxable (guaranteed payments)	Excludable like any employee	Taxable to more-than-2% shareholders

Memory cue. “Pass-throughs file in March, taxpayers file in April.” Partnerships and S corporations must get K-1s to their owners before the owners’ own returns are due, so their returns are due one month earlier.

Exam trap. A C corporation with a fiscal year ending June 30 files by the 15th day of the third month after year end (September 15) and receives a seven-month extension. Every other C corporation files by the 15th day of the fourth month and receives six months. The June 30 rule is a favorite because it breaks the pattern.

1.2 Sole proprietorships and qualified joint ventures

The rule. A sole proprietor reports business income and expenses on Schedule C, pays income tax on the net profit at individual rates, and pays self-employment tax on 92.35% of net profit at 15.3% (12.4% Social Security up to the \$176,100 wage base for 2025, plus 2.9% Medicare on all of it). Half of the self-employment tax is an adjustment to income. A single-member LLC that has made no election is a disregarded entity and is reported the same way.

A married couple who jointly own and operate an unincorporated business would ordinarily be a partnership. Two escape hatches exist:

Option	Requirements	Effect
Qualified joint venture (QJV)	Married couple filing jointly; both materially participate; both elect; the only owners are the spouses; not a state-law entity such as an LLC (except that the IRS allows a spouse-owned LLC in a community property state to be treated as a disregarded entity)	Each spouse files a separate Schedule C and Schedule SE for his or her share. No Form 1065. Each spouse earns Social Security credit.
Spouse as employee	One spouse owns the business and the other works in it under the owner's control	Owner files one Schedule C and issues a Form W-2 to the employee-spouse. Wages are subject to income and FICA withholding but not FUTA.

Worked example. Maria Lopez owns Panadería Lopez, a bakery, as a sole proprietor. In 2025 its net profit is \$80,000. Net earnings from self-employment are $\$80,000 \times 92.35\% = \$73,880$. Self-employment tax is $\$73,880 \times 15.3\% = \$11,304$ (rounded). Maria deducts half, \$5,652, as an adjustment to income. The \$80,000 is also qualified business income for the QBI deduction (Chapter 5).

Exam trap. A sole proprietor's child under 18 who works in the business is exempt from Social Security and Medicare taxes, and a child under 21 is exempt from FUTA. These exemptions apply only to a parent's sole proprietorship or a partnership in which each partner is a parent of the child. They never apply to a corporation, even one wholly owned by the parent.

1.3 Partnerships and LLCs

The rule. A partnership is any unincorporated organization with two or more owners that carries on a business for profit and has not elected to be taxed as a corporation. It files Form 1065 to report, but not pay, income tax. Each partner receives a Schedule K-1 and reports his or her distributive share whether or not any cash was distributed. Multi-member LLCs are partnerships by default.

The three varieties the outline names:

Form	Owners	Liability	Self-employment tax on distributive share
General partnership	General partners only	Unlimited for all	Yes
Limited partnership	At least one general and one limited partner	General unlimited; limited partners limited to investment	General partners yes; limited partners no, except guaranteed payments for services

Form	Owners	Liability	Self-employment tax on distributive share
LLC taxed as a partnership	Members	Limited for all	Members who are active in the business are treated like general partners; passive investor-members may be treated like limited partners

Chapter 2 covers everything else about partnerships: formation, basis, distributions, and liquidation.

1.4 C corporations

The rule. A C corporation is a taxpayer in its own right. It pays tax on its taxable income at a flat 21%, and when it distributes its after-tax earnings as dividends, the shareholders are taxed again at their own rates. This “double tax” is the central disadvantage; the central advantages are unlimited owners, retained earnings taxed at a flat rate, and tax-free fringe benefits for owner-employees.

Two special corporations appear on the outline:

- **Personal service corporation (PSC).** A C corporation whose principal activity is services in health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, substantially performed by employee-owners. A PSC pays the same 21% rate as any other corporation, must generally use a calendar year, and has a lower accumulated earnings credit (\$150,000 instead of \$250,000).
- **Closely held corporation.** More than 50% of the stock is owned, directly or indirectly, by five or fewer individuals during the last half of the year. Closely held corporations are subject to the at-risk rules and, unless they are PSCs, a modified passive activity rule that lets passive losses offset active business income but not portfolio income.

Chapter 3 covers formation, earnings and profits, distributions, redemptions, and liquidation.

1.5 S corporations

The rule. An S corporation is a corporation (or an LLC that elects to be taxed as one) that has filed Form 2553 and meets the eligibility rules. It files Form 1120-S, generally pays no entity-level tax, and passes income, deductions, and credits through to shareholders on Schedule K-1 in proportion to stock ownership for each day of the year.

The eligibility rules, which you must know cold:

Requirement	Detail
Domestic corporation	Formed under U.S. or state law

Requirement	Detail
100 or fewer shareholders	Spouses and their estates count as one; all members of a family (six generations from a common ancestor) may elect to count as one
Eligible shareholders only	Individuals who are U.S. citizens or residents, estates, certain trusts (grantor, testamentary for two years, voting, QSST, ESBT), and 501(c)(3) and other exempt organizations. Not allowed: partnerships, corporations, nonresident aliens, IRAs (with a narrow bank exception)
One class of stock	All shares have identical rights to distributions and liquidation proceeds; differences in voting rights are permitted
Not an ineligible corporation	Certain financial institutions, insurance companies, and domestic international sales corporations

Chapter 4 covers the election, income, basis, distributions, and termination.

1.6 Tax-exempt entities and associations

The rule. An organization formed and operated exclusively for exempt purposes under section 501(c) pays no income tax on income related to those purposes. Most must apply for recognition (Form 1023 or 1023-EZ for 501(c)(3) charities; Form 1024 or 1024-A for most others) and file an annual information return in the Form 990 series. Income from an unrelated trade or business is taxed at the corporate rate.

Homeowners' associations and similar membership groups may elect on Form 1120-H to be taxed only on their nonexempt-function income (such as interest) at a flat 30%, with a \$100 specific deduction, if at least 60% of gross income is exempt-function income and at least 90% of expenses go to the association's purpose. Chapter 7 covers exempt organizations in depth.

1.7 Default classification and the check-the-box election

The rule. Under the entity classification regulations, a domestic business entity that is not organized as a corporation under state law is classified by default: one owner means a disregarded entity, two or more owners means a partnership. An eligible entity may elect a different classification on Form 8832. A state-law corporation is always a corporation for tax purposes and cannot use Form 8832; its only choice is between C and S status.

Entity	Default	Available elections
Single-member LLC	Disregarded (Schedule C, E, or F of the owner)	Corporation (Form 8832), then S corporation (Form 2553)

Entity	Default	Available elections
Multi-member LLC	Partnership	Corporation (Form 8832), then S corporation (Form 2553)
State-law corporation	C corporation	S corporation (Form 2553)
Limited partnership	Partnership	Corporation (Form 8832)

Mechanics worth memorizing:

- The Form 8832 election may take effect up to **75 days before** or **12 months after** the date filed. Late-election relief is available under Rev. Proc. 2009-41 for up to three years and 75 days if there was reasonable cause.
- Once an entity elects to change its classification, it generally cannot elect again for **60 months**. The limitation does not apply to a newly formed entity's first election.
- An LLC that wants to be an S corporation files **only Form 2553**. A timely Form 2553 is treated as a deemed election to be classified as a corporation; Form 8832 is unnecessary.
- A disregarded entity is still a separate entity for **employment tax** and certain **excise tax** purposes, so it uses its own EIN for payroll.

Worked example. David and Carlos Lopez form Lopez Brothers Landscaping, LLC, in Texas on March 1, 2025, each owning 50%. They file nothing with the IRS about classification. The LLC is a partnership by default and must file Form 1065 for 2025 by March 16, 2026 (March 15 is a Sunday). If they had wanted S corporation treatment from the start, they would have filed Form 2553 by May 15, 2025, two months and 15 days after formation.

Exam trap. Changing an LLC from partnership to corporation classification is a tax event: the partnership is treated as contributing its assets to a new corporation in exchange for stock and liquidating. Changing from disregarded to corporation is treated as the owner contributing the assets under section 351. These deemed transactions can trigger gain when liabilities exceed basis.

1.8 Employer identification numbers

The rule. An employer identification number (EIN) is the business equivalent of a Social Security number. It is obtained free on Form SS-4 or, for most applicants, instantly online. A business needs an EIN if it has employees, operates as a corporation or partnership, files employment, excise, or alcohol, tobacco, and firearms returns, withholds tax on payments to nonresident aliens, has a Keogh or other qualified plan, or is a trust, estate, or nonprofit. A sole proprietor with no employees and no plan may use a Social Security number but may still obtain an EIN.

When a **new EIN** is required and when it is not:

New EIN required	No new EIN
Sole proprietor incorporates, takes on partners, or files for bankruptcy	Sole proprietor changes the business name or location, or operates several businesses
Partnership incorporates, is taken over by one partner and operated as a sole proprietorship, or terminates and a new partnership begins	Partnership changes its name or location, or 50% or more of ownership changes within 12 months
Corporation receives a new charter, is a subsidiary using the parent's EIN, or changes to a partnership or sole proprietorship	Corporation changes its name or location, elects S status, is a surviving corporation in a merger, or reorganizes without changing its charter
Estate operates a business after the owner's death	Grantor trust becomes irrevocable at the grantor's death (the trust itself now needs its own EIN; the point is the business does not)

Online applications are limited to **one EIN per responsible party per day**, and the responsible party must be an individual, not an entity, unless the applicant is a government entity. Changes in responsible party are reported on **Form 8822-B** within 60 days.

Memory cue. “New owner structure, new number. New name or address, same number.”

1.9 Accounting periods

The rule. A tax year is the annual accounting period for which a return is filed. It is a calendar year or a fiscal year (12 consecutive months ending on the last day of a month other than December, or a 52–53 week year). A new taxpayer adopts a tax year by filing its first return. Changing a tax year generally requires IRS approval on Form 1128 unless an automatic procedure applies.

Pass-through entities and personal service corporations are restricted because the owners are usually calendar-year individuals and a fiscal year would let them defer income:

Entity	Required tax year
Partnership	In this order: (1) the tax year of the partners owning a majority interest (more than 50%); (2) if none, the tax year of all principal partners (5% or more); (3) if none, the year producing the least aggregate deferral of income to the partners
S corporation	Calendar year
Personal service corporation	Calendar year
C corporation (other than PSC)	Any calendar or fiscal year
Sole proprietor	The owner's year, which is almost always the calendar year

Entity	Required tax year
Trust	Calendar year (estates may use a fiscal year)

Two exceptions let a partnership, S corporation, or PSC keep a fiscal year:

- **Business purpose.** A natural business year, such as one in which 25% or more of gross receipts fall in the last two months for three consecutive years.
- **Section 444 election.** The entity may elect a year with a deferral period of no more than **three months** (for example, a September 30 year end). The price is a “required payment” on **Form 8752**, roughly the tax the owners would have paid on the deferred income, held by the IRS without interest. A PSC making the election must instead meet minimum distribution requirements.

A **short tax year** arises when a business begins or ends mid-year or changes its accounting period. When the short year results from a change in period, taxable income must be **annualized** so the entity does not benefit from lower brackets twice; a short first or last year is not annualized.

Worked example. Bayou Fabrication, Inc., a C corporation, is incorporated and begins business on September 10, 2025, and adopts a calendar year by filing its first Form 1120 for the period September 10 to December 31, 2025. The return is due April 15, 2026. Because the short year is the corporation’s first year rather than a change in accounting period, income is not annualized.

Exam trap. A partnership whose partners are two calendar-year individuals and one fiscal-year corporation owning 60% must use the corporation’s fiscal year under the majority-interest rule. Candidates who jump straight to “partnerships use a calendar year” miss this. Work the three-step test every time.

1.10 Reporting requirements: Forms W-4, W-2, and the 1099 series

The rule. Employers collect Form W-4 from each employee to compute income tax withholding and report wages on Form W-2, furnished to employees and filed with the Social Security Administration (with transmittal Form W-3) by **January 31**. Payers report payments to nonemployees and other recipients on the Form 1099 series, generally when payments in the calendar year reach **\$600**, and must file electronically if they file **10 or more** information returns of all types combined.

Form	Reports	Threshold for 2025 payments	To recipient	To IRS
W-2	Wages, tips, withholding	Any amount	Jan. 31	Jan. 31 (SSA)

Form	Reports	Threshold for 2025 payments	To recipient	To IRS
1099-NEC	Nonemployee compensation (independent contractors, attorney fees for services)	\$600	Jan. 31	Jan. 31
1099-MISC	Rents, prizes and awards, other income, medical payments, gross proceeds to attorneys (\$600); royalties (\$10)	\$600 / \$10	Jan. 31	Feb. 28 paper, Mar. 31 electronic
1099-INT	Interest	\$10 (\$600 in the course of a trade or business)	Jan. 31	Feb. 28 / Mar. 31
1099-DIV	Dividends	\$10	Jan. 31	Feb. 28 / Mar. 31
1099-K	Payment card and third-party network transactions	Payment cards: any amount; third-party networks: more than \$20,000 and more than 200 transactions	Jan. 31	Feb. 28 / Mar. 31
1099-R	Pension, IRA, and annuity distributions	\$10	Jan. 31	Feb. 28 / Mar. 31
1098	Mortgage interest received	\$600	Jan. 31	Feb. 28 / Mar. 31
8300	Cash of more than \$10,000 received in one transaction or related transactions	\$10,000	Written statement by Jan. 31 of following year	Within 15 days of receipt

Supporting rules the exam tests:

- **Form W-9** is how a payer obtains a payee's taxpayer identification number. If the payee fails to furnish a TIN, or the IRS notifies the payer that the TIN is wrong, the payer must apply **backup withholding at 24%**.
- Payments to **corporations** are generally exempt from Form 1099-NEC and 1099-MISC reporting, except payments for medical and health care services and payments to attorneys.
- A new employee's W-4 that claims exemption from withholding expires **February 15** of the following year.
- **Form 945** reports backup withholding and withholding on nonpayroll payments. **Form 941** reports quarterly payroll withholding and FICA; **Form 944** replaces it for the smallest employers (annual liability of \$1,000 or less) who are notified by the IRS; **Form 943** is for agricultural employers; **Form 940** reports annual FUTA.
- **Form 8300** applies to any person in a trade or business, must be filed electronically by businesses required to e-file their information returns, and treats cashier's checks, money orders, and traveler's checks of \$10,000 or less as "cash" when received in a designated reporting transaction.

New for 2025. The One Big Beautiful Bill Act retroactively restored the Form 1099-K threshold to more than \$20,000 **and** more than 200 transactions, undoing the \$600 threshold that had been scheduled to phase in. For 2025, a seller who received \$8,000 through a payment app in 30 transactions should not receive a 1099-K, although the income is still taxable.

Not on your exam. For payments made after December 31, 2025, the reporting threshold for Forms 1099-NEC and 1099-MISC rises from \$600 to \$2,000 and will be indexed for inflation. On a 2025 question, \$600 is the number.

Worked example. In 2025 Lopez Brothers Landscaping paid an unincorporated subcontractor \$4,200 for labor, paid \$9,000 of rent to an individual landlord, and paid \$7,500 to a law firm organized as a corporation. The partnership must issue a 1099-NEC to the subcontractor and a 1099-MISC to the landlord. The law firm also receives a 1099-NEC despite being a corporation, because the attorney exception overrides the corporate exemption.

1.11 Hobby or business, and the order of loss limitations

The rule. An activity is a business if it is carried on with a genuine intent to make a profit, judged by all the facts and circumstances using the nine factors in the regulations. An activity is **presumed** to be for profit if it shows a profit in **three of five consecutive years** (two of seven for horse breeding, training, showing, or racing). If an activity is a hobby, all of its gross income is reported as other income on Schedule 1, and none of its expenses are deductible for 2025, because miscellaneous itemized deductions remain suspended.

The nine factors: the businesslike manner in which the activity is conducted; the expertise of the taxpayer and advisers; the time and effort expended; the expectation that assets will appreciate; the taxpayer's success in similar activities; the history of income and losses; the amount of occasional profits; the taxpayer's financial status; and elements of personal pleasure. No single factor controls. A taxpayer may elect on **Form 5213** to postpone the determination until the fourth (or sixth) year, which also extends the statute of limitations for those years.

Even when an activity is a business, a loss must pass through four gates, in this order, before it reduces other income:

Gate	Limit	Suspended losses
1. Basis	A partner or S shareholder may deduct losses only up to basis in the interest (stock plus debt for S corporations)	Carried forward until basis is restored

Gate	Limit	Suspended losses
2. At-risk (section 465)	Losses limited to amounts the taxpayer could actually lose: cash and basis of property contributed, recourse debt, and qualified nonrecourse real estate financing	Carried forward until at-risk amount increases (Form 6198)
3. Passive activity (section 469)	Losses from activities without material participation offset only passive income	Carried forward; released in full on a taxable disposition of the entire activity (Form 8582)
4. Excess business loss (section 461(l))	Aggregate business losses of a noncorporate taxpayer above \$313,000 (\$626,000 joint) for 2025 are disallowed	Treated as a net operating loss carryforward to the next year (Form 461)

Worked example. Carlos is a limited partner in a real estate partnership and materially participates in nothing. His 2025 K-1 shows a \$12,000 loss; his basis is \$20,000, all of it at risk. Gates 1 and 2 are cleared. At gate 3 the loss is passive, and Carlos has no passive income, so the entire \$12,000 is suspended on Form 8582 and carries forward. Gate 4 is never reached.

Memory cue. “BAPE”: Basis, At-risk, Passive, Excess. The gates are always applied in that order, and a loss stopped at an earlier gate never reaches a later one.

New for 2025. The excess business loss limitation, which had been scheduled to expire after 2028, was made permanent by the One Big Beautiful Bill Act. The 2025 thresholds are \$313,000 and \$626,000.

Exam trap. Hobby income is fully taxable, but the “cost of goods sold” of a hobby that sells products may still be subtracted in arriving at gross income, because COGS is not a deduction. Hobby **expenses** other than COGS get nothing for 2025.

Quick Check: Chapter 1

1. Priya forms a single-member LLC for her consulting practice in 2025 and files no election. For federal tax purposes the LLC is:

- A. A partnership, because it is an LLC.
- B. A C corporation, because it provides limited liability.
- C. A disregarded entity reported on Priya’s Schedule C.
- D. An S corporation by default.

2. Lopez Brothers Landscaping, LLC, a calendar-year partnership, wants to be taxed as an S corporation beginning January 1, 2027. The latest date it may file Form 2553 for a timely election, absent late-election relief, is:

- A. December 31, 2026
- B. January 31, 2027
- C. March 15, 2027
- D. April 15, 2027

3. A C corporation's tax year ends June 30, 2025. Without an extension, its Form 1120 is due:

- A. September 15, 2025
- B. October 15, 2025
- C. November 15, 2025
- D. December 15, 2025

4. Which event requires a sole proprietor to obtain a new EIN?

- A. Moving the business to a new city
- B. Changing the business's trade name
- C. Taking in a partner
- D. Opening a second location under the same ownership

5. A new partnership has three partners: two calendar-year individuals who each own 30%, and a corporation with a March 31 fiscal year that owns 40%. Which tax year must the partnership use?

- A. Calendar year, because a majority of the partners are calendar-year taxpayers.
- B. The March 31 fiscal year, because the corporation is the largest partner.
- C. Calendar year, because it is the tax year of all principal partners.
- D. The year that produces the least aggregate deferral, because no majority interest or principal-partner year exists.

6. During 2025, Panadería Lopez paid \$750 to an unincorporated graphic designer, \$450 to an unincorporated window washer, and \$2,000 of rent to a corporate landlord. Which Forms 1099 must Maria issue for 2025?

- A. 1099-NEC to the designer only
- B. 1099-NEC to the designer and the window washer
- C. 1099-NEC to the designer and 1099-MISC to the landlord
- D. No forms, because all payments are under \$2,000

7. Rosa breeds and shows dogs. The activity has produced a profit in two of the last five years. Which statement is correct?

- A. The activity is presumed to be a hobby because it did not profit in three of five years.
- B. The activity is presumed to be a business because dog breeding is treated like horse activities.
- C. The activity has no presumption either way; profit motive is determined from all the facts and circumstances.
- D. The activity is automatically a business if Rosa files Form 5213.

8. Carlos's share of a partnership loss is \$40,000. His basis is \$25,000, his at-risk amount is \$25,000, and he materially participates. The partnership is his only business activity. How much of the loss may he deduct in 2025?

- A. \$40,000
- B. \$25,000
- C. \$15,000
- D. \$0

Answers.

1. C. A single-member LLC that makes no election is disregarded as separate from its owner, so Priya reports it on Schedule C. Partnership status requires at least two owners; corporate status requires an election on Form 8832 (or Form 2553 for S status).

2. C. An election for a tax year beginning January 1 must be made by the 15th day of the third month of that year, March 15, 2027, or at any time during the preceding year. An election filed after March 15, 2027 would take effect for 2028 unless late-election relief is granted.

3. A. A C corporation with a June 30 year end files by the 15th day of the third month after year end, September 15. It receives a seven-month extension. All other C corporations file by the 15th day of the fourth month.

4. C. Taking in a partner converts the sole proprietorship to a partnership, a new entity that needs its own EIN. Name changes, moves, and additional locations under the same ownership do not require a new number.

5. D. The corporation owns 40%, not a majority, so the majority-interest test produces no answer. All three partners own 5% or more and are therefore principal partners, but they do not share a tax year, so the principal-partner test also produces no answer. The partnership must therefore use the year that produces the least aggregate deferral of income to the partners. Being the largest single partner (answer B) is not a test.

6. A. The designer received \$600 or more in nonemployee compensation and gets a 1099-NEC. The window washer received less than \$600. Rent paid to a corporation is exempt from 1099-MISC reporting. The \$2,000 threshold applies only to payments made after 2025.

7. C. The three-of-five-year presumption (two of seven for horses) is a safe harbor that helps the taxpayer; failing it does not create a presumption of hobby status. The nine-factor facts-and-circumstances test then decides. Form 5213 only postpones the determination; it does not make the activity a business.

8. B. The basis gate limits the deduction to \$25,000; the at-risk gate allows the same amount; the passive gate does not apply because he materially participates; and \$25,000 is well under the \$313,000 excess business loss threshold. The remaining \$15,000 is suspended until his basis increases.

Chapter 2. Partnerships

Domain 1, continued • Partnerships

What the outline tests: partnership income, expenses, distributions, and flow-through (including self-employment income); family partnerships; a partner's dealings with the partnership (exchanges of property, guaranteed payments); contributions of property and services (the partnership's basis, property subject to debt); basis of a partner's interest; disposition of an interest; formation (the agreement, general versus limited partners, capital contributions); dissolution (sale, death of a partner); filing requirements, due dates, penalties, and audit notice rules; partnership cancellation of debt; and the partnership-level audit regime and the opt-out election.

A partnership is a conduit. It computes income but does not pay tax on it; the partners do, whether or not cash is distributed. Almost everything the exam asks about partnerships is a consequence of that one fact and of the running tally that tracks each partner's investment: the partner's basis in the partnership interest, called **outside basis**. Learn how outside basis is built, raised, and lowered, and most distribution and disposition questions become arithmetic.

2.1 Forming the partnership: contributions of property

The rule. Under section 721, neither the partner nor the partnership recognizes gain or loss when property is contributed in exchange for a partnership interest. The partner's outside basis equals the adjusted basis of the property contributed plus cash contributed. The partnership's basis in the property (**inside basis**) is the same carryover basis, and the partnership's holding period includes the partner's.

Item	Treatment
Cash contributed	Increases outside basis dollar for dollar
Property contributed	Carryover basis to both partner (outside) and partnership (inside); holding period tacks
Built-in gain or loss at contribution	Must later be allocated to the contributing partner under section 704(c) when the partnership sells the property
Liabilities on contributed property assumed by the partnership	Contributing partner's basis is reduced by the share of debt shifted to other partners and increased by the partner's share of all partnership debt
Services contributed for a capital interest	Ordinary income to the partner equal to the fair market value of the interest; partnership deducts or capitalizes the same amount; partner's basis equals the amount included

Item	Treatment
Services contributed for a profits interest only	Generally not taxable on receipt (Rev. Proc. 93-27)

Every partner's outside basis also includes the partner's **share of partnership liabilities**, because a partner is treated as having contributed cash equal to any increase in his or her share of debt (and as having received a cash distribution equal to any decrease). Recourse debt is shared by the partners who bear the economic risk of loss, generally the general partners. Nonrecourse debt is shared according to the partners' profit-sharing ratios.

Worked example. David contributes a truck with an adjusted basis of \$14,000 and a fair market value of \$30,000 to Lopez Brothers Landscaping, LLC, for a 50% interest. Carlos contributes \$30,000 cash. Neither brother recognizes gain. David's outside basis is \$14,000; Carlos's is \$30,000. The LLC's inside basis in the truck is \$14,000. If the LLC later sells the truck for \$30,000, the \$16,000 of built-in gain is allocated entirely to David under section 704(c).

Worked example (property subject to debt). Suppose instead that David's truck carried a \$20,000 loan that the LLC assumes, and the LLC has no other debt. David's basis starts at \$14,000. The LLC assumed \$20,000 of debt, of which Carlos's 50% share, \$10,000, is treated as a cash distribution to David. David's basis would be $\$14,000 - \$10,000 = \$4,000$. Had the shifted debt exceeded his basis, the excess would have been taxable gain, because a deemed cash distribution in excess of basis is always gain.

Exam trap. Section 721 has no control requirement. Section 351 (corporations) requires the contributors to own 80% after the exchange. A partner who contributes appreciated property for a 5% interest is still tax-free; a shareholder who does the same with a corporation is not.

2.2 Partnership income and separately stated items

The rule. The partnership computes **ordinary business income or loss** from its trade or business on page 1 of Form 1065 and lists every item that could be treated differently by different partners as a **separately stated item** on Schedule K. Each partner's share of both appears on Schedule K-1 and is reported on the partner's own return, in the partner's tax year that includes the partnership's year end, whether or not any cash was distributed.

Items that must be separately stated include: net short-term and long-term capital gains and losses; section 1231 gains and losses; charitable contributions; dividends and interest; rental real estate income or loss; section 179 expense; foreign taxes paid; investment interest expense; tax-exempt income; nondeductible expenses; guaranteed payments; and credits. The reason is always the same: a limit or rate that applies at the partner level (the \$3,000 capital loss limit, the charitable percentage limits, the section 179 ceiling) would be defeated if these items were buried in ordinary income.

Most **elections** are made by the partnership, not the partners: accounting method, depreciation methods, section 179, inventory method, and the installment method. Three elections belong to the partners individually: the choice to deduct or credit foreign taxes, the treatment of discharged debt under section 108, and the deduction or capitalization of mining exploration costs.

Memory cue. “The partnership chooses how to count; the partner chooses foreign taxes, forgiven debt, and mines.”

Self-employment income

Partner	Subject to self-employment tax
General partner (and an LLC member who is active in the business)	Distributive share of trade or business income plus guaranteed payments
Limited partner	Guaranteed payments for services only
Any partner	Not rental income, dividends, interest, or capital gains passed through

2.3 Guaranteed payments and dealings with the partnership

The rule. A **guaranteed payment** is a payment to a partner for services or for the use of capital that is determined without regard to partnership income. The partnership deducts it (or capitalizes it, if the services are capital in nature) in computing ordinary income, and the partner reports it as ordinary income in the partner’s tax year that includes the end of the partnership’s year in which it was deducted. Guaranteed payments are not wages: no Form W-2, no withholding, and they are subject to self-employment tax.

When a partner deals with the partnership as an outsider (section 707(a)), for example by leasing a building to it or lending it money, the transaction is treated as between unrelated parties. Two related-party limits apply when the partner owns, directly or indirectly, **more than 50%** of capital or profits:

- A **loss** on a sale or exchange between the partner and the partnership is **disallowed**. The partnership may later offset gain on resale by the disallowed loss.
- A **gain** on a sale is **ordinary** if the property is not a capital asset in the hands of the buyer (for example, land sold to a partnership that holds it as inventory).

Worked example. The Lopez Brothers Landscaping agreement pays David \$3,000 per month for managing crews, regardless of profit. For 2025 the LLC has \$120,000 of income before the payments. It deducts \$36,000, leaving \$84,000 of ordinary income split \$42,000 each. David reports $\$42,000 + \$36,000 = \$78,000$ of self-employment income from the LLC. Carlos reports \$42,000.

Exam trap. A payment that is a percentage of partnership profits is a distributive share, not a guaranteed payment, even if the agreement calls it a salary. A payment determined without regard to income is a guaranteed payment even if the partnership has a loss. The label in the agreement does not control; the formula does.

2.4 Family partnerships

The rule. A family member is recognized as a partner if either (1) capital is a material income-producing factor in the business and the family member actually owns the capital interest, even if it was received by gift, or (2) capital is not a material factor but the family member contributes substantial services. When an interest is received by gift, the donor must first be allocated **reasonable compensation** for services, and the remaining income must be allocated in proportion to capital so the donee's share is not disproportionately large.

Capital is a material income-producing factor when a substantial portion of gross income comes from the use of capital, as in a business with significant inventory or equipment. It is not material in a business of personal services such as accounting or law. A minor child's interest is recognized only if the child is competent to manage the property or the interest is held by a fiduciary.

Worked example. David gives Mateo, 16, a 20% interest in Lopez Brothers Landscaping, held by a trustee. The LLC's equipment makes capital a material income-producing factor, so Mateo can be a partner. If the LLC earns \$100,000 and the value of David's services is \$40,000, David is first allocated \$40,000; the remaining \$60,000 is divided by capital, giving Mateo $20\% \times \$60,000 = \$12,000$, not $20\% \times \$100,000$.

2.5 Basis of a partner's interest

The rule. A partner's outside basis is a running balance. It **increases** for additional contributions, the partner's share of taxable and tax-exempt income, and increases in the partner's share of partnership liabilities. It **decreases** (but never below zero) for distributions, the partner's share of losses and nondeductible expenses, and decreases in the partner's share of liabilities. Within a year, the adjustments are applied in a fixed order: increases first, then distributions, then losses.

Step	Adjustment
Start	Basis at beginning of year
+	Contributions of cash and property; increase in share of liabilities
+	Share of ordinary income, separately stated income, and tax-exempt income

Step	Adjustment
–	Cash distributed and basis of property distributed; decrease in share of liabilities
–	Share of nondeductible, noncapital expenses
–	Share of losses (ordinary and separately stated), limited to remaining basis
End	Basis at end of year, never below zero

Losses that exceed basis are suspended and carried forward until basis is restored (gate 1 in Chapter 1). Because liabilities are part of basis, a partner who personally guarantees a partnership loan or whose partnership borrows on a recourse basis increases basis and may deduct more loss.

Worked example. Carlos begins 2025 with an outside basis of \$30,000. During the year the LLC allocates him \$42,000 of ordinary income, \$1,000 of tax-exempt interest, and \$500 of nondeductible meal expense, distributes \$50,000 cash to him, and his share of LLC debt rises from \$10,000 to \$16,000. Ending basis: $\$30,000 + \$42,000 + \$1,000 + \$6,000 - \$50,000 - \$500 = \$28,500$.

Memory cue. “Income up, money out, losses last.” Apply income before distributions so a distribution is less likely to exceed basis, and losses last so you know exactly how much room is left.

2.6 Distributions

The rule. A distribution is generally not taxable to the partner or the partnership. A partner recognizes gain only when **cash** (including marketable securities and relief of liabilities) distributed exceeds outside basis. A partner recognizes **loss** only in a **liquidating** distribution consisting solely of cash, unrealized receivables, and inventory, and only to the extent basis exceeds the amounts received. Distributed property takes a carryover basis in the partner’s hands, limited to the partner’s remaining outside basis.

	Current (nonliquidating) distribution	Liquidating distribution
Cash in excess of basis	Capital gain	Capital gain
Property distributed	Basis = partnership’s basis, limited to partner’s outside basis after cash	Basis = partner’s remaining outside basis, allocated among the property received
Loss recognized	Never	Only if partner receives only cash, unrealized receivables, and inventory, and basis exceeds their total

	Current (nonliquidating) distribution	Liquidating distribution
Partner's basis after	Reduced by cash and basis of property, not below zero	Zero
Holding period	Includes partnership's	Includes partnership's

Order of allocation when property is distributed: cash first, then unrealized receivables and inventory (carryover basis, limited), then other property receives whatever basis remains.

Hot assets. Unrealized receivables (including depreciation recapture) and inventory are “section 751 property.” A distribution that shifts a partner’s share of hot assets is treated as a taxable exchange so that ordinary income cannot be converted to capital gain, and a sale of a partnership interest produces ordinary income to the extent of the seller’s share of hot assets.

Worked example. Carlos’s outside basis is \$28,500. The LLC distributes to him, in a current distribution, \$10,000 cash and a mower with an inside basis of \$25,000 and value of \$27,000. Cash reduces basis to \$18,500. The mower would take a \$25,000 carryover basis, but that is limited to his remaining \$18,500. Carlos takes an \$18,500 basis in the mower and his outside basis is zero. No gain is recognized; the \$6,500 of lost basis is simply gone unless the partnership has a section 754 election.

Worked example (liquidating loss). Priya’s basis in a partnership is \$40,000. In complete liquidation of her interest she receives \$32,000 cash and nothing else. She recognizes an \$8,000 capital loss. Had she received \$32,000 cash and a parcel of land, she would recognize no loss; the land would take an \$8,000 basis.

Exam trap. A decrease in a partner’s share of partnership liabilities is a deemed cash distribution. When a partnership pays off a loan, each partner’s basis falls, and a partner with low basis can recognize gain without receiving a penny.

2.7 Sale of a partnership interest and the death of a partner

The rule. A partnership interest is a capital asset, so its sale produces capital gain or loss equal to the amount realized (cash plus the buyer’s assumption of the seller’s share of liabilities) minus outside basis. The portion of gain attributable to the seller’s share of **hot assets** (unrealized receivables and inventory) is **ordinary income** under section 751. The buyer’s outside basis is cost plus the buyer’s share of liabilities.

The buyer’s inside basis in partnership assets stays at the partnership’s historical cost unless the partnership has a **section 754 election** in effect, which permits an adjustment under section 743(b) to the buyer’s share of inside basis (and under section 734(b) after distributions). A 754 election is made on the partnership return and is revocable only with IRS consent.

The partnership's tax year **closes with respect to a partner** who sells or exchanges the entire interest, or who dies. It does not close for the other partners. A partner who sells part of an interest continues as a partner and the year does not close.

When a partner dies, the estate or successor's outside basis is the fair market value of the interest at death (or alternate valuation date), plus the successor's share of partnership liabilities, minus the portion attributable to income in respect of a decedent such as unrealized receivables.

Worked example. Carlos sells his entire 50% interest to Priya for \$60,000 cash on July 1, 2025. His outside basis is \$28,500, which includes his \$16,000 share of liabilities that Priya assumes. Amount realized: $\$60,000 + \$16,000 = \$76,000$. Total gain: $\$76,000 - \$28,500 = \$47,500$. If Carlos's share of unrealized receivables is \$5,000, then \$5,000 is ordinary income and \$42,500 is capital gain. The LLC's year closes for Carlos on July 1, and his K-1 covers January 1 through July 1.

2.8 Termination of a partnership

The rule. A partnership terminates for tax purposes only when no part of any business, financial operation, or venture continues to be carried on by any of its partners in a partnership. The sale of 50% or more of the interests within 12 months, which formerly caused a "technical termination," no longer does. A two-partner partnership that becomes one-owner (because one partner buys the other out or dies and the estate sells) terminates because a partnership requires at least two partners.

On termination the partnership files a final Form 1065, due the 15th day of the third month after the termination date, and distributes its assets in liquidation under the rules in 2.6.

2.9 Filing requirements, due dates, and penalties

The rule. Every domestic partnership must file Form 1065 for each year it has income, deductions, or credits, by the 15th day of the third month after year end (March 15 for calendar years), with an automatic six-month extension on Form 7004 (to September 15). Each partner must receive a Schedule K-1 by the same date. The partnership pays no income tax, so there is no failure-to-pay penalty, but the failure-to-file penalty is steep and is multiplied by the number of partners.

Failure	Penalty (returns required to be filed in 2026)
Late or incomplete Form 1065	\$255 per partner per month (or part of a month), for up to 12 months. For returns required to be filed in 2025 the amount was \$245.
Failure to furnish Schedule K-1 to a partner	\$340 per K-1 (information return penalty, with reductions for prompt correction)

Failure	Penalty (returns required to be filed in 2026)
Failure to file electronically when required	Partnerships with more than 100 partners must e-file; those filing 10 or more information returns of any type must e-file them

A **small partnership** with 10 or fewer partners, all of whom are individuals (other than nonresident aliens), C corporations, or estates of deceased partners, with no special allocations, and whose partners all timely reported their shares, is treated as meeting the reasonable-cause exception to the late-filing penalty under Rev. Proc. 84-35, provided it has not elected out of the small-partnership treatment. The IRS applies this relief narrowly; it does not excuse the partners' own reporting.

Worked example. Lopez Brothers Landscaping (two partners) files its 2025 Form 1065 on June 20, 2026, with no extension. It is three months late plus part of a fourth, so four months count. Penalty: $\$255 \times 2 \text{ partners} \times 4 \text{ months} = \$2,040$, unless the partnership qualifies for first-time abatement or the small-partnership reasonable-cause relief.

2.10 Cancellation of partnership debt

The rule. When a partnership's debt is forgiven, the discharge-of-indebtedness income is determined at the partnership level and passed through to the partners as a **separately stated item** in their profit-sharing ratios. Whether any of it can be excluded under section 108 is decided **partner by partner**: a partner who is insolvent or in bankruptcy may exclude his or her share and must reduce tax attributes on Form 982, while a solvent partner reports the share as ordinary income.

Because the forgiven debt was included in each partner's outside basis, the reduction in liabilities is also a deemed distribution that lowers basis. The income allocation raises basis first, so in most cases the two offset.

Worked example. A bank forgives \$20,000 of the LLC's recourse loan. David and Carlos each are allocated \$10,000 of COD income and each experiences a \$10,000 deemed distribution from the debt reduction. David is solvent and reports \$10,000 of ordinary income. Carlos, whose liabilities exceeded his assets by \$25,000 immediately before the discharge, is insolvent and excludes his \$10,000, reducing his tax attributes on Form 982.

2.11 The centralized partnership audit regime

The rule. Under the Bipartisan Budget Act regime that applies to all partnership tax years beginning after 2017, the IRS audits the partnership rather than the partners, and any resulting **imputed underpayment** is assessed against and paid by the **partnership** in the year the audit concludes (the adjustment year), computed at the highest individual rate. The partnership acts through a **partnership representative**, who has sole authority to bind the partnership and all partners. Partnerships may avoid the regime only by electing out annually, if eligible, or may shift the liability to the partners with a push-out election.

Feature	Rule
Partnership representative	Designated on each year's Form 1065; may be any person (including an entity, which must name a designated individual) with a substantial U.S. presence; replaces the former tax matters partner; partners have no right to notice or to participate
Election out	Available only to partnerships with 100 or fewer partners for the year, all of whom are individuals, C corporations, foreign entities taxable as C corporations, S corporations (each S shareholder counts toward the 100), or estates of deceased partners; not available if any partner is a partnership, a trust, a disregarded entity, or a nominee. Made annually on Schedule B of Form 1065 with disclosure of every partner's name and TIN
Imputed underpayment	Net adjustments $\times$ highest individual rate; may be reduced by showing some partners are tax-exempt or taxed at lower rates (modification request within 270 days of the notice of proposed adjustment)
Push-out election	Within 45 days after the final partnership adjustment (FPA), the partnership may elect to furnish adjusted statements to the reviewed-year partners, who then pay the tax (with interest at an extra 2 points)
Administrative adjustment request (AAR)	A partnership under the regime may not file an amended Form 1065; it files an AAR on Form 8082 within three years of the later of filing or the due date, and the adjustments flow to the current-year partners
Petition	The partnership (not the partners) may contest the FPA in Tax Court within 90 days

Memory cue. "One representative, one bill, one hundred partners to opt out." The regime centralizes everything at the partnership; only partnerships of 100 or fewer eligible partners can leave it.

Exam trap. A partnership with two partners, one of whom is a revocable trust, cannot elect out, because a trust is an ineligible partner. A partnership with 60 individual partners and one S corporation with 50 shareholders cannot elect out either, because the S corporation's shareholders count toward the 100 limit ($60 + 1 + 50 = 111$).

Quick Check: Chapter 2

1. Priya contributes land with an adjusted basis of \$50,000 and a fair market value of \$120,000 to a new partnership for a 25% interest. What are her recognized gain and her outside basis?
 - A. Gain \$70,000; basis \$120,000
 - B. Gain \$0; basis \$50,000
 - C. Gain \$0; basis \$120,000
 - D. Gain \$70,000; basis \$50,000
2. Under the Lopez Brothers Landscaping agreement, Carlos receives \$2,000 per month for bookkeeping services whether or not the LLC has profit, plus 50% of the remaining profit. In 2025 the LLC has a \$10,000 loss after deducting Carlos's payments. Which statement is correct?
 - A. Carlos reports \$24,000 of guaranteed payments as ordinary income and a \$5,000 loss.
 - B. Carlos reports no income because the LLC had a loss.
 - C. Carlos reports \$24,000 of wages on a Form W-2.
 - D. The \$24,000 is a distributive share and is not subject to self-employment tax.
3. Maria's outside basis is \$20,000. In a current distribution she receives \$8,000 cash and equipment with an inside basis of \$15,000 and a fair market value of \$18,000. What is her basis in the equipment?
 - A. \$15,000
 - B. \$12,000
 - C. \$18,000
 - D. \$20,000
4. Carlos's outside basis is \$9,000. The partnership distributes \$12,000 cash to him in a current distribution. Carlos recognizes:
 - A. No gain; basis becomes negative \$3,000.
 - B. \$3,000 of ordinary income.
 - C. \$3,000 of capital gain.
 - D. \$12,000 of capital gain.

5. In complete liquidation of her interest, Priya receives \$30,000 cash and inventory with an inside basis of \$5,000. Her outside basis was \$45,000. She recognizes:

- A. A \$10,000 capital loss.
- B. No loss; the inventory takes a \$15,000 basis.
- C. A \$15,000 capital loss.
- D. A \$10,000 ordinary loss.

6. Which item is **not** separately stated on Schedule K-1?

- A. Charitable contributions
- B. Net section 1231 gain
- C. Depreciation on equipment used in the trade or business
- D. Section 179 expense

7. A partnership with a December 31 year end has 11 partners, all individuals. It files its 2025 Form 1065 on April 10, 2026, without an extension. Which statement is correct?

- A. No penalty applies because the return was filed within one month of the due date.
- B. The penalty is $\$255 \times 11 \text{ partners} \times 1 \text{ month} = \$2,805$, subject to reasonable cause.
- C. The penalty is 5% of the unpaid tax per month.
- D. The penalty is $\$245 \times 11 \times 1 = \$2,695$.

8. Which partnership may elect out of the centralized partnership audit regime for 2025?

- A. A partnership with 90 partners, one of which is a partnership
- B. A partnership with 3 partners, one of which is a grantor trust
- C. A partnership with 95 individual partners and an S corporation partner that has 3 shareholders
- D. A partnership with 2 partners, one of which is a single-member LLC owned by an individual

9. David sells his entire partnership interest for \$50,000 cash. His outside basis is \$35,000, including a \$15,000 share of liabilities the buyer assumes. His share of the partnership's unrealized receivables is \$6,000. What are his ordinary income and capital gain?

- A. Ordinary \$6,000; capital \$9,000
- B. Ordinary \$0; capital \$15,000
- C. Ordinary \$6,000; capital \$24,000
- D. Ordinary \$0; capital \$30,000

10. A partnership's lender forgives \$40,000 of recourse debt. Partner A (50%) is solvent; Partner B (50%) is insolvent by \$30,000. Which statement is correct?

- A. The partnership excludes the income because it is insolvent at the entity level.
- B. Each partner is allocated \$20,000 of COD income; A reports it as income and B excludes it, reducing tax attributes on Form 982.
- C. The income is excluded entirely because the debt was recourse.
- D. Each partner reports \$20,000 of capital gain.

Answers.

- 1. B.** Section 721 applies to contributions of property regardless of the size of the interest received. Priya recognizes no gain and takes a carryover outside basis of \$50,000. The partnership also takes a \$50,000 inside basis, and the \$70,000 of built-in gain will be allocated to Priya when the land is sold.
- 2. A.** A payment for services determined without regard to income is a guaranteed payment: ordinary income to Carlos, subject to self-employment tax, deducted by the LLC, and not reported on a Form W-2. The LLC's \$10,000 loss after the payments is split 50/50, so Carlos also reports a \$5,000 loss, subject to the basis, at-risk, and passive limits.
- 3. B.** Cash is applied first, reducing basis from \$20,000 to \$12,000. The equipment would take a \$15,000 carryover basis, but that is limited to Maria's remaining outside basis of \$12,000. No gain is recognized in a current distribution of property, and her outside basis falls to zero.
- 4. C.** Cash distributed in excess of outside basis is gain from the sale of a partnership interest, which is capital gain. Basis can never be negative.
- 5. A.** Loss is recognized in a liquidating distribution only when the partner receives solely cash, unrealized receivables, and inventory. Priya did. The inventory takes its \$5,000 carryover basis, cash is \$30,000, and the \$10,000 excess of her \$45,000 outside basis is a capital loss.
- 6. C.** Ordinary depreciation is part of the computation of ordinary business income on page 1 of Form 1065. Section 179 expense is separately stated because the dollar limit applies at the partner level, as are charitable contributions and section 1231 gains.
- 7. B.** The return was due March 16, 2026 (March 15 falls on a Sunday), and was filed in April, so one month (or part of a month) applies. For returns required to be filed in 2026 the amount is \$255 per partner. The partnership has 11 partners, so it does not qualify for the 10-or-fewer small-partnership relief, although ordinary reasonable cause may still be shown.
- 8. C.** Each S corporation shareholder counts toward the 100-partner limit; $95 + 1 + 3 = 99$, and S corporations are eligible partners. A partnership, a trust (including a grantor trust), and a disregarded entity are each ineligible partners that bar the election.
- 9. C.** Amount realized is \$50,000 cash plus \$15,000 of liabilities assumed, \$65,000. Total gain is $\$65,000 - \$35,000 = \$30,000$. The \$6,000 attributable to unrealized receivables is ordinary income under section 751, and the remaining \$24,000 is capital gain. Answer A forgets to include the assumed liabilities in the amount realized.
- 10. B.** COD income is determined at the partnership level and allocated to the partners. The insolvency and bankruptcy exclusions are applied at the partner level, so A reports ordinary income and B excludes it and reduces tax attributes on Form 982. COD income is ordinary, not capital.

Chapter 3. C Corporations

Domain 1, continued • Corporations in general and forming a corporation

What the outline tests: filing requirements, due dates, and penalties; earnings and profits; shareholder dividends, distributions, and recognition rules; special deductions and credits (the dividends-received deduction, the charitable deduction); liquidations and stock redemptions; the accumulated earnings tax; estimated tax payments; the corporate minimum tax credit; forming a corporation (services for stock, section 351 exchanges, money or property received in addition to stock, property subject to debt); controlled groups; and closely held corporations.

The C corporation is the only business form that is itself a taxpayer. That single fact creates every topic in this chapter. Because the corporation pays tax, Congress worried about shareholders getting appreciated property in and out without a second tax, so section 351 governs formation and the distribution rules govern the way out. Because the corporation pays tax at a flat 21% while individuals pay up to 37%, Congress worried about hoarding, so there is an accumulated earnings tax. Keep the “two taxpayers, two taxes” picture in mind and the rules will seem less arbitrary.

3.1 Forming the corporation: section 351

The rule. No gain or loss is recognized when one or more persons transfer **property** to a corporation **solely in exchange for its stock**, if the transferors as a group are in **control** immediately after the exchange. Control means owning at least **80%** of the total combined voting power and at least 80% of each class of nonvoting stock. Services are not property. If a transferor also receives money or other property (boot), gain is recognized up to the lesser of the boot or the realized gain, but loss is never recognized.

Element	Rule
Who counts toward 80%	Every person who transfers property in the same transaction. A person who transfers only services does not count, and neither does the stock received for services, unless that person also transfers property worth at least 10% of the stock received for services.
Services for stock	Ordinary income to the service provider equal to the stock's fair market value; the corporation deducts or capitalizes it; the provider's stock basis equals the income recognized
Boot received	Gain recognized = lesser of boot or realized gain, character determined by the asset transferred; no loss recognized

Element	Rule
Liabilities assumed by the corporation	Not boot, except : (1) if total liabilities assumed exceed the total adjusted basis of property transferred by that shareholder, the excess is recognized gain (section 357(c)); (2) if the principal purpose of shifting the debt is tax avoidance, all liabilities are boot (section 357(b))
Shareholder's stock basis	Basis of property transferred + gain recognized – boot received – liabilities assumed by the corporation
Corporation's basis in property	Shareholder's basis + gain recognized by the shareholder (limited to fair market value for built-in loss property)
Holding periods	Shareholder's stock tacks the holding period of capital and section 1231 assets transferred; corporation tacks the shareholder's holding period in the property

Worked example. David transfers equipment with a basis of \$40,000 and a value of \$100,000 to Bayou Fabrication, Inc., for 60% of its stock. Priya transfers \$60,000 cash for the other 40%. Together they own 100%, so control exists. David recognizes no gain. His stock basis is \$40,000, and the corporation's basis in the equipment is \$40,000. Priya's stock basis is \$60,000.

Worked example (boot and debt). Suppose David's equipment is subject to a \$25,000 loan that the corporation assumes, and the corporation also pays him \$10,000 cash. Realized gain: $\$100,000 - \$40,000 = \$60,000$. Recognized gain: the lesser of the boot (\$10,000) or realized gain, so \$10,000. The \$25,000 of debt is not boot because it does not exceed his \$40,000 basis. Stock basis: $\$40,000 + \$10,000 - \$10,000 - \$25,000 = \$15,000$. Corporate basis in equipment: $\$40,000 + \$10,000 = \$50,000$.

Worked example (liabilities exceeding basis). Instead, the loan is \$55,000 and there is no cash. Liabilities (\$55,000) exceed basis (\$40,000) by \$15,000, so David recognizes \$15,000 of gain under section 357(c). Stock basis: $\$40,000 + \$15,000 - \$55,000 = \$0$. Corporate basis: $\$40,000 + \$15,000 = \$55,000$.

Memory cue. "Eighty to be free; boot makes you pay; debt over basis is boot anyway." Section 351 requires 80% control, boot triggers gain up to the boot, and debt exceeding basis is taxed like boot.

Exam trap. Section 351 is **not elective**. If the requirements are met, nonrecognition is mandatory, which means a shareholder cannot deliberately recognize a loss on built-in-loss property by contributing it. To recognize the loss the shareholder must sell the property to an unrelated party.

3.2 Section 1244 stock and qualified small business stock

The rule. A loss on **section 1244 stock** is an **ordinary loss** rather than a capital loss, up to **\$50,000 per year (\$100,000 on a joint return)**; the excess is capital loss. The stock must have been issued by a domestic corporation for money or property (not services or stock) at a time when the corporation's total capital did not exceed **\$1,000,000**, to an individual or partnership that is the original holder, and the corporation must have derived more than 50% of its gross receipts from active business for the five preceding years.

Qualified small business stock (section 1202). A noncorporate shareholder who holds QSBS of a domestic C corporation for more than five years may exclude gain, generally 100% for stock acquired after September 27, 2010, up to the greater of \$10 million or 10 times the stock's basis, provided the corporation's gross assets did not exceed \$50 million when the stock was issued and it is an active business other than a service, finance, farming, hospitality, or extraction business.

New for 2025. For QSBS issued after July 4, 2025, the One Big Beautiful Bill Act created a tiered exclusion of 50% after three years, 75% after four years, and 100% after five years; raised the per-issuer cap to \$15 million (indexed); and raised the gross asset test to \$75 million. Stock issued on or before July 4, 2025 keeps the prior rules.

3.3 Computing corporate taxable income

The rule. A C corporation's taxable income is gross income minus all deductions, taxed at a flat **21%**. Corporations have no standard deduction, no itemized deductions, no personal exemptions, and no preferential capital gains rate. Three deductions follow corporate-only rules: charitable contributions, the dividends-received deduction, and capital losses.

Charitable contributions

Rule	Detail
Limit	10% of taxable income computed before the charitable deduction, the dividends-received deduction, any NOL carryback, and any capital loss carryback (NOL carryforwards do reduce the base)
Excess	Carried forward five years , used after the current year's contributions
Accrual-method election	A contribution authorized by the board during the year and paid by the 15th day of the fourth month after year end may be deducted in the year authorized

Rule	Detail
Property	Generally the lesser of basis or fair market value for ordinary-income property; fair market value for long-term capital gain property; enhanced deduction (basis plus half the appreciation, limited to twice basis) for inventory given for the care of the ill, needy, or infants

Not on your exam. Beginning with tax years after 2025, a corporation may deduct charitable contributions only to the extent they exceed **1% of taxable income**, and the 10% ceiling remains. For 2025 there is no floor.

Dividends-received deduction (DRD)

Ownership of the paying corporation	DRD percentage
Less than 20%	50%
20% to less than 80%	65%
80% or more (affiliated group)	100%

The DRD is limited to the same percentage (50% or 65%) of the corporation's taxable income computed before the DRD, any NOL deduction, and any capital loss carryback, **unless** taking the full DRD creates or increases a net operating loss, in which case the full DRD is allowed. The stock must be held more than 45 days during the 91-day window around the ex-dividend date, and no DRD is allowed on debt-financed portfolio stock.

Worked example. Bayou Fabrication owns 10% of a supplier and receives \$20,000 of dividends. Its taxable income before the DRD is \$30,000. The tentative DRD is $50\% \times \$20,000 = \$10,000$. The limit is $50\% \times \$30,000 = \$15,000$, which is higher, so the full \$10,000 is allowed. If taxable income before the DRD had been \$16,000, the limit would be $50\% \times \$16,000 = \$8,000$. Taking the full \$10,000 would leave taxable income of \$6,000, not a loss, so the exception does not apply and the DRD is \$8,000. Had taxable income before the DRD been \$9,000, a full \$10,000 DRD would create a \$1,000 NOL, and the full \$10,000 would be allowed.

Capital losses

A corporation may deduct capital losses **only against capital gains**. A net capital loss is carried **back three years and forward five**, always as a **short-term** loss. There is no \$3,000 deduction against ordinary income.

Organizational and start-up costs

A corporation may deduct up to **\$5,000** of organizational expenditures (legal fees for the charter and bylaws, state incorporation fees, organizational meetings) and separately up to **\$5,000** of start-up costs in the year business begins. Each \$5,000 is reduced dollar for dollar by the amount by which that category exceeds **\$50,000**, and the remainder is amortized over **180 months**. Costs of issuing stock (underwriting, printing certificates) are neither deductible nor amortizable.

Net operating losses

A corporate NOL arising in 2018 or later is carried **forward indefinitely** (no carryback, except two years for certain farming losses) and may offset only **80% of taxable income** in the carryforward year.

Exam trap. Taxable income for the charitable limit is computed **before** the DRD; taxable income for the DRD limit is computed **after** the charitable deduction. Order of operations: charitable first, then DRD.

3.4 Filing, estimated taxes, and penalties

The rule. Every C corporation in existence during any part of the year must file Form 1120 by the **15th day of the fourth month** after year end (April 15 for calendar years; September 15 for June 30 year ends), with an automatic six-month extension on Form 7004 (seven months for June 30 years). A corporation that expects to owe **\$500 or more** must pay estimated tax in four installments on the 15th day of the **4th, 6th, 9th, and 12th months** of its tax year, electronically through EFTPS.

Estimated tax safe harbor	Available to
100% of the current year's tax (annualized income method also permitted)	All corporations
100% of the prior year's tax	Only if the prior year was a full 12 months and showed a tax liability; a large corporation (taxable income of \$1,000,000 or more in any of the three preceding years) may use it only for the first installment and must make up the difference in the second

Penalties mirror the individual rules: failure to file is 5% of the unpaid tax per month up to 25%, with a minimum of **\$525** (returns required to be filed in 2026) when the return is more than 60 days late; failure to pay is 0.5% per month up to 25%; underpayment of estimated tax is computed on Form 2220 at the underpayment interest rate, which for large corporate underpayments is the federal short-term rate plus 5 points.

Schedules that accompany Form 1120: **Schedule L** (balance sheet), **Schedule M-1** (reconciliation of book income to taxable income) or **Schedule M-3** for corporations with total assets of \$10 million or more, and **Schedule M-2** (analysis of unappropriated retained earnings). Corporations with total receipts and total assets both under \$250,000 may skip Schedules L, M-1, and M-2.

Worked example. Bayou Fabrication, a calendar-year corporation, had 2024 tax of \$30,000 on taxable income of \$143,000 and expects 2025 tax of \$42,000. It is not a large corporation. It may pay four installments of \$7,500 (100% of prior year) on April 15, June 16, September 15, and December 15, 2025, and pay the remaining \$12,000 with its return by April 15, 2026, with no underpayment penalty.

3.5 Earnings and profits

The rule. Earnings and profits (E&P) measures a corporation's economic capacity to pay dividends. It starts with taxable income and adds back items that were excluded or deducted for tax but represent real economic income, and subtracts items that were real economic costs but were not deductible. **Current E&P** is the figure for the year; **accumulated E&P** is the total of prior years' current E&P less prior distributions.

Adjustment to taxable income	Direction
Tax-exempt interest, life insurance proceeds	Add
Dividends-received deduction	Add
Excess of accelerated (MACRS) over straight-line (ADS) depreciation; section 179 expense beyond ratable 5-year recovery	Add
Deferred gain on installment sales	Add (E&P recognizes the full gain in the year of sale)
Federal income taxes paid or accrued	Subtract
Nondeductible expenses: penalties, fines, 50% of meals, premiums on officer life insurance where the corporation is beneficiary, political contributions	Subtract
Charitable contributions and capital losses in excess of the deductible limits	Subtract (they are real outlays)
NOL and charitable carryovers deducted this year	Add back (they reduced E&P in the year incurred)

Worked example. Bayou Fabrication's 2025 taxable income is \$100,000. It also had \$4,000 of tax-exempt municipal interest, paid \$21,000 of federal income tax, paid a \$2,000 nondeductible fine, and claimed \$9,000 more MACRS depreciation than straight-line would have allowed. Current E&P: $\$100,000 + \$4,000 - \$21,000 - \$2,000 + \$9,000 = \$90,000$.

3.6 Distributions to shareholders

The rule. A distribution of cash or property to a shareholder is a **dividend** to the extent of the corporation's **current E&P**, then **accumulated E&P**. Any excess is a tax-free **return of capital** that reduces the shareholder's stock basis, and any amount beyond basis is **capital gain**. Current E&P is allocated to the year's distributions pro rata; accumulated E&P is applied to distributions in chronological order.

Layer	Treatment to shareholder
1. Current E&P	Dividend (qualified dividend rates for individuals if the holding period is met)
2. Accumulated E&P	Dividend
3. Stock basis	Return of capital, reduces basis
4. Beyond basis	Capital gain

A **current-year loss** (negative current E&P) with positive accumulated E&P is netted to the date of distribution unless the corporation can show otherwise. Positive current E&P with a deficit in accumulated E&P still produces a dividend to the extent of current E&P.

Property distributions. The shareholder's amount is the property's fair market value minus any liability assumed; the shareholder's basis in the property is its fair market value. The **corporation recognizes gain** (never loss) as if it had sold the property at fair market value, and that gain increases current E&P. E&P is then reduced by the greater of the property's basis or its fair market value, minus liabilities assumed.

Constructive dividends. Excessive compensation to a shareholder-employee, personal expenses paid by the corporation, below-market rent or interest on loans to shareholders, bargain sales of corporate property, and corporate payment of a shareholder's debts are all dividends to the extent of E&P, even though no dividend was declared.

Stock dividends are generally tax-free; the shareholder allocates existing basis across the old and new shares. A stock dividend is taxable when any shareholder can elect cash instead of stock or when the distribution is disproportionate.

Worked example. Bayou Fabrication has current E&P of \$90,000 and accumulated E&P of \$30,000. In 2025 it distributes \$150,000 cash, \$90,000 to David (60%) and \$60,000 to Priya (40%). Total E&P available is \$120,000, so \$120,000 of the distribution is dividend and \$30,000 is return of capital. David: \$72,000 dividend ($\$120,000 \times 60\%$), \$18,000 return of capital against his \$15,000 basis, so \$15,000 reduces basis to zero and the remaining \$3,000 is capital gain. Priya: \$48,000 dividend, \$12,000 return of capital against her \$60,000 basis, leaving a basis of \$48,000.

Worked example (property). Instead, the corporation distributes land with a basis of \$20,000 and value of \$50,000 to Priya. The corporation recognizes a \$30,000 gain, which raises current E&P. Priya has a \$50,000 distribution (dividend to the extent of E&P) and takes a \$50,000 basis in the land. If the land's basis had been \$70,000, the corporation would recognize no loss and Priya would still have a \$50,000 distribution.

Memory cue. "Current, accumulated, basis, gain." Say the four layers in order before you compute any distribution question.

Exam trap. A corporation with a deficit in accumulated E&P but positive current E&P pays a dividend. Candidates who net the two and conclude “no E&P, so return of capital” are wrong. Netting applies only in the opposite case, a current-year deficit with accumulated E&P.

3.7 Stock redemptions

The rule. When a corporation buys back its own stock, the shareholder would prefer **sale or exchange** treatment (capital gain measured against basis) over **dividend** treatment (ordinary dividend to the extent of E&P with no basis offset). Section 302 grants exchange treatment only if the redemption meets one of four tests; otherwise it is a distribution taxed under the rules in 3.6. In applying the tests, stock owned by certain family members and related entities is **attributed** to the shareholder.

Test	Requirement
Substantially disproportionate	After the redemption the shareholder owns less than 50% of the voting power and less than 80% of the percentage owned before the redemption
Complete termination	The shareholder owns no stock after the redemption; family attribution may be waived if the shareholder has no interest in the corporation other than as a creditor for 10 years and files the required agreement
Not essentially equivalent to a dividend	A meaningful reduction in the shareholder’s interest, judged by the facts; rarely satisfied by a majority shareholder
Partial liquidation	Distribution to a noncorporate shareholder attributable to the corporation’s termination of one of two or more active businesses conducted for five years
Redemption to pay death taxes (section 303)	Exchange treatment for redemptions from an estate up to the amount of estate taxes and funeral and administration expenses, if the stock exceeds 35% of the adjusted gross estate

Attribution (section 318). An individual is treated as owning stock owned by a spouse, children, grandchildren, and parents, but **not** siblings or grandparents. Stock owned by a partnership, estate, or trust is attributed proportionately to the owners and beneficiaries, and stock owned by a 50%-or-more shareholder of a corporation is attributed to and from the corporation.

Worked example. Bayou Fabrication has 1,000 shares outstanding: David 600, Priya 400. It redeems 300 of David’s shares. Before: 60%. After: $300 \div 700 = 42.9\%$. He is below 50% and below 80% of 60% (48%), so the redemption is substantially disproportionate and David has a capital gain of the redemption price minus the basis of 300 shares. Had the corporation redeemed only 100 shares, he would own $500 \div 900 = 55.6\%$, failing the test, and the entire payment would be a dividend to the extent of E&P.

3.8 Liquidations

The rule. In a complete liquidation, the **shareholder** treats amounts received as full payment for the stock and recognizes **capital gain or loss** equal to the fair market value of property received (less liabilities assumed) minus stock basis, taking a fair-market-value basis in the property. The **corporation** recognizes gain **and loss** as if it had sold the distributed property at fair market value, subject to limits on losses involving related parties and property contributed with built-in losses within the prior five years. The corporation files **Form 966** within 30 days after adopting the plan of liquidation.

The exception is the liquidation of an **80%-owned subsidiary** into its parent (section 332): no gain or loss to either, and the parent takes the subsidiary's basis in the assets and inherits its tax attributes.

	Nonliquidating distribution	Complete liquidation
Shareholder	Dividend to extent of E&P, then basis, then gain	Capital gain or loss against stock basis
Corporation	Gain recognized, loss not recognized	Gain and loss recognized (with limits)
Basis of property to shareholder	Fair market value	Fair market value
E&P	Reduced	Disappears with the corporation

Worked example. Bayou Fabrication liquidates, distributing to Priya cash and equipment worth a total of \$110,000; her stock basis is \$48,000. She recognizes a \$62,000 long-term capital gain and takes a basis in the equipment equal to its fair market value. The corporation recognizes gain or loss on the equipment measured against its own basis.

3.9 Penalty taxes on undistributed income

The rule. The **accumulated earnings tax** is a **20%** penalty tax on a corporation's accumulated taxable income for the year to the extent it is retained **beyond the reasonable needs of the business**. Every corporation gets a credit of at least **\$250,000** of accumulated earnings (**\$150,000** for a personal service corporation) before the tax can apply. The tax is assessed by the IRS on audit; it is not self-reported.

Reasonable needs include specific, definite, and feasible plans for expansion, acquiring a business, retiring debt, working capital measured by the business cycle, and redeeming stock to pay death taxes. Loans to shareholders, investments unrelated to the business, and vague future plans are evidence of an unreasonable accumulation.

The **personal holding company tax** is a separate 20% tax on undistributed personal holding company income of a corporation that (1) has more than 50% of its stock owned by five or fewer individuals during the last half of the year and (2) derives 60% or more of its adjusted ordinary gross income from passive sources such as

dividends, interest, rents, royalties, and certain personal service contracts. It is self-assessed on Schedule PH and can be avoided with a deficiency dividend. A corporation cannot owe both penalty taxes in the same year; the PHC tax takes priority.

Corporate alternative minimum tax and the minimum tax credit. The 15% corporate AMT on adjusted financial statement income applies only to corporations whose average annual financial statement income exceeds \$1 billion over three years. Any corporate AMT paid becomes a **minimum tax credit** (Form 8827) that carries forward indefinitely and offsets regular tax in later years when regular tax exceeds the tentative minimum tax. For a small or mid-sized corporation the only practical point is that the credit exists and never expires.

3.10 Controlled groups, consolidated returns, and closely held corporations

The rule. Corporations under common control are treated as one corporation for certain limits so the owners cannot multiply the benefits by splitting a business into several corporations. A **parent-subsidiary** group exists when one corporation owns at least **80%** of another. A **brother-sister** group exists when **five or fewer** individuals, estates, or trusts own at least **80%** of each corporation and more than **50%** of each corporation counting only identical ownership. Members of a controlled group share one \$250,000 accumulated earnings credit and one section 179 limit, and are treated as one employer for retirement plan and employment tax purposes.

An **affiliated group** (80% parent-subsidiary chain, measured by vote and value) may elect to file a **consolidated return** on Form 1120 with Form 851 and, in the first year, Form 1122 consents from each subsidiary. Intercompany dividends are eliminated, losses of one member offset income of another, and the election is binding in later years unless the IRS consents to its revocation.

Closely held corporations (more than 50% owned by five or fewer individuals during the last half of the year) are subject to the at-risk rules and a modified passive activity rule: passive losses may offset active business income but not portfolio income. Section 267 disallows losses on sales between a corporation and a more-than-50% shareholder, and an accrual-basis corporation may not deduct an expense owed to a cash-basis related party until the related party includes it in income.

Worked example. David owns 100% of Bayou Fabrication and 100% of a second corporation, Gulf Coast Tooling, Inc. The two are a brother-sister controlled group (one person owns 80% or more of each, with identical ownership over 50%). In 2025 they share a single \$2,500,000 section 179 limit and a single \$250,000 accumulated earnings credit, allocated between them.

Exam trap. The 80% control test under section 351 and the 80% affiliated group test both use 80%, but the brother-sister controlled group test has two prongs, 80% common ownership and more than 50% identical ownership. A question that gives only the 80% figure for a brother-sister group has not given you enough to conclude.

Quick Check: Chapter 3

1. Maria transfers a building (basis \$60,000, value \$200,000, subject to a \$90,000 mortgage the corporation assumes) to a new corporation for 100% of its stock. What gain does she recognize?
 - A. \$0
 - B. \$30,000
 - C. \$90,000
 - D. \$140,000
2. Three people form a corporation. Ana transfers property for 70% of the stock, Ben transfers property for 20%, and Cal performs legal services for 10%. Which statement is correct?
 - A. All three qualify for section 351 because together they own 100%.
 - B. Ana and Ben qualify because property transferors own 90%; Cal has ordinary income equal to the value of his stock.
 - C. No one qualifies because a service provider received stock.
 - D. Only Ana qualifies because she alone has control.
3. A corporation has taxable income of \$200,000 before any charitable deduction and before a \$30,000 DRD. It contributed \$25,000 to charity. Its deductible charitable contribution for the year is:
 - A. \$25,000
 - B. \$20,000
 - C. \$17,000
 - D. \$0
4. A corporation owns 30% of another corporation and receives \$100,000 in dividends. Its taxable income before the DRD is \$90,000. The dividends-received deduction is:
 - A. \$65,000
 - B. \$58,500
 - C. \$50,000
 - D. \$45,000
5. A calendar-year corporation that is not a large corporation had a \$12,000 tax liability for 2024 on a full-year return and expects \$20,000 for 2025. What is the smallest total of timely estimated payments that avoids an underpayment penalty for 2025?
 - A. \$0, because corporations are exempt from estimated tax if the prior year's tax was under \$500
 - B. \$12,000
 - C. \$18,000
 - D. \$20,000

6. A corporation has current E&P of \$10,000 and a deficit in accumulated E&P of \$(40,000). It distributes \$25,000 to its sole shareholder, whose stock basis is \$8,000. The shareholder reports:
- A. \$25,000 dividend
 - B. \$10,000 dividend, \$8,000 return of capital, \$7,000 capital gain
 - C. \$0 dividend, \$8,000 return of capital, \$17,000 capital gain
 - D. \$10,000 dividend and \$15,000 return of capital
7. A corporation distributes land with a basis of \$30,000 and a fair market value of \$75,000 to a shareholder. Which statement is correct?
- A. The corporation recognizes no gain and the shareholder has a \$30,000 distribution.
 - B. The corporation recognizes a \$45,000 gain and the shareholder has a \$75,000 distribution with a \$75,000 basis in the land.
 - C. The corporation recognizes a \$45,000 gain and the shareholder has a \$30,000 distribution.
 - D. Neither party recognizes anything until the shareholder sells the land.
8. A corporation has 1,000 shares outstanding. Carlos owns 500 shares. The corporation redeems 150 of his shares. Is the redemption substantially disproportionate?
- A. Yes; he now owns 41.2%, which is below both 50% and 40%.
 - B. Yes; he now owns 41.2%, which is below 50% and below 80% of his prior 50%.
 - C. No; he must own less than 40% after the redemption.
 - D. No; he still owns more than 35% of the corporation.
9. In complete liquidation, a shareholder with a stock basis of \$70,000 receives equipment worth \$100,000 subject to a \$15,000 liability she assumes. She recognizes:
- A. \$30,000 capital gain
 - B. \$15,000 capital gain
 - C. \$85,000 dividend
 - D. \$0 until she sells the equipment
10. Which corporation is most clearly exposed to the accumulated earnings tax?
- A. A manufacturing corporation with \$400,000 of accumulated earnings and a signed contract to build a \$900,000 plant addition next year
 - B. A personal service corporation with \$120,000 of accumulated earnings
 - C. A manufacturing corporation with \$1,200,000 of accumulated earnings, \$600,000 of which is invested in unrelated marketable securities, and no written expansion plans
 - D. A corporation that has paid out 100% of its earnings as dividends every year

Answers.

1. B. Liabilities assumed (\$90,000) exceed the basis of property transferred (\$60,000), so the \$30,000 excess is recognized gain under section 357(c). Her stock basis becomes $\$60,000 + \$30,000 - \$90,000 = \$0$.

- 2. B.** Only property transferors count toward the 80% control test. Ana and Ben together own 90%, so their transfers are tax-free. Cal's stock is compensation for services and is ordinary income equal to its fair market value; his shares do not count toward control.
- 3. B.** The charitable limit is 10% of taxable income computed before the charitable deduction and before the DRD: $10\% \times \$200,000 = \$20,000$. The remaining \$5,000 carries forward five years.
- 4. B.** Ownership of 20% to under 80% gives a 65% DRD: \$65,000 tentative. The limit is 65% of taxable income before the DRD, $65\% \times \$90,000 = \$58,500$. Taking the full \$65,000 would produce a \$25,000 taxable income, not an NOL ($\$90,000 - \$65,000 = \$25,000$), so the limit applies and the DRD is \$58,500.
- 5. B.** A corporation that is not a large corporation may base all four installments on 100% of the prior year's tax when the prior year was a full 12 months with a tax liability. Four payments of \$3,000 totaling \$12,000 avoid the penalty; the \$8,000 balance is paid with the return.
- 6. B.** Positive current E&P produces a dividend even when accumulated E&P is a deficit; the two are not netted in this direction. \$10,000 is a dividend, the next \$8,000 is a return of capital that reduces basis to zero, and the final \$7,000 is capital gain.
- 7. B.** A corporation recognizes gain, but not loss, on a distribution of appreciated property as if it had sold the property at fair market value. The shareholder's distribution is the fair market value, and the shareholder takes a fair-market-value basis.
- 8. C.** After the redemption Carlos owns $350 \div 850 = 41.2\%$. The test requires less than 50% of the voting power **and** less than 80% of his prior percentage ($80\% \times 50\% = 40\%$). He meets the first prong but not the second, because 41.2% is not below 40%, so the redemption fails and is treated as a dividend to the extent of E&P. Answers A and B misstate the arithmetic of the 80% prong.
- 9. B.** Amount realized is \$100,000 of value minus the \$15,000 liability assumed, \$85,000. Gain is $\$85,000 - \$70,000 = \$15,000$, capital in character because a liquidation is treated as a sale of the stock.
- 10. C.** Accumulations far above the \$250,000 credit, invested in assets unrelated to the business, with no specific, definite, and feasible plans, are the classic fact pattern. A signed expansion contract is a reasonable need; \$120,000 is under even the \$150,000 PSC credit; a corporation that distributes everything has no accumulation.

Chapter 4. S Corporations

Domain 1, concluded • S corporations

What the outline tests: requirements to qualify (eligible shareholders); the election procedure; income, expenses, and separately stated items; treatment of distributions; the shareholder's basis (loan basis, distributions and losses in excess of basis, services for stock); revocation, termination, and reinstatement; and debt discharge.

An S corporation is a corporation under state law that has asked to be taxed like a partnership. The hybrid creates a predictable set of exam questions: where the rules follow partnerships (pass-through, separately stated items, basis limits on losses) and where they follow corporations (one class of stock, wages for owner-employees, no special allocations, no debt basis from guarantees). The comparison table at the end of this chapter is the single most valuable page in Domain 1.

4.1 Eligibility and the election

The rule. A corporation elects S status on **Form 2553**, signed by **every shareholder** (including a spouse who holds a community property interest). To take effect for the current year, the election must be filed by the **15th day of the third month** of that year (March 15 for a calendar year), or at any time during the preceding year. An election filed later takes effect the following year unless late-election relief is granted under Rev. Proc. 2013-30, which allows relief for up to three years and 75 days when there was reasonable cause and the corporation and shareholders have consistently reported as an S corporation.

For a newly formed corporation the tax year begins on the earliest of the day it first has shareholders, first has assets, or first begins business; the election deadline is two months and 15 days after that date. The eligibility requirements (100 shareholders, eligible shareholders, one class of stock, domestic corporation) are in Chapter 1, section 1.5, and must be met on the day of the election and every day thereafter.

Three trusts need a closer look because the exam asks about them:

Trust	Eligible?	Detail
Grantor trust	Yes	Treated as owned by an individual; remains eligible for two years after the grantor's death
Testamentary trust	Yes, for two years after the stock is transferred to it	After two years it must qualify as a QSST or ESBT or the election terminates

Trust	Eligible?	Detail
Qualified subchapter S trust (QSST)	Yes, by beneficiary election	One income beneficiary who receives all income annually; the beneficiary is treated as the shareholder
Electing small business trust (ESBT)	Yes, by trustee election	May have multiple beneficiaries; the trust itself pays tax on the S income at the highest individual rate
IRA or Roth IRA	No (except certain bank stock)	An IRA shareholder terminates the election

Worked example. Panadería Lopez, Inc. is incorporated on June 1, 2025, and issues stock to Maria the same day. To be an S corporation for its first year, it must file Form 2553 by August 15, 2025 (two months and 15 days after June 1). If Maria files it on September 10, 2025, the election takes effect January 1, 2026 unless she requests late-election relief with a reasonable-cause statement.

Exam trap. Form 2553 must be signed by all shareholders at the time of the election, but **revocation** requires the consent only of shareholders holding **more than 50%** of the shares. The exam likes to swap these two thresholds.

4.2 Income, deductions, and separately stated items

The rule. An S corporation files Form 1120-S by the 15th day of the third month after year end (March 15), with a six-month extension to September 15, and furnishes each shareholder a Schedule K-1. Ordinary business income and each separately stated item are allocated to shareholders **pro rata, per share, per day**. Shareholders report their shares whether or not distributed, in their tax year that includes the corporation's year end.

The separately stated items are the same as for partnerships (Chapter 2, section 2.2): capital gains and losses, section 1231 gains, charitable contributions, interest and dividends, rental income, section 179 expense, foreign taxes, investment interest, tax-exempt income, nondeductible expenses, and credits. Unlike a partnership, an S corporation **cannot make special allocations**; every item follows stock ownership.

Shareholder-employees. An S corporation has no guaranteed payments. A shareholder who works in the business is an **employee** and must be paid **reasonable compensation** reported on Form W-2 and subject to FICA before any distributions are made. The IRS recharacterizes distributions as wages when salaries are unreasonably low, assessing employment taxes and penalties. The remaining profit passes through on Schedule K-1 and is **not** subject to self-employment tax.

Fringe benefits. A shareholder owning **more than 2%** of the stock (directly or by attribution from a spouse, child, parent, or grandparent) is treated like a partner for fringe benefit purposes. Health insurance premiums paid for a more-than-2% shareholder are deductible by the corporation, included in the shareholder's W-2

wages (subject to income tax withholding but exempt from FICA if the plan covers employees generally), and then deductible by the shareholder as the self-employed health insurance adjustment if the shareholder is not eligible for other employer coverage. Group-term life, cafeteria plans, and meals and lodging exclusions are likewise unavailable to more-than-2% shareholders.

Worked example. Panadería Lopez, Inc. has \$150,000 of profit in 2025 before paying Maria. It pays her a \$70,000 salary (Form W-2, FICA withheld) and \$14,000 of health premiums, which are added to her W-2 wages for income tax purposes. The corporation's ordinary income is $\$150,000 - \$70,000 - \$14,000 = \$66,000$, reported on Maria's K-1 and not subject to self-employment tax. Maria deducts the \$14,000 as self-employed health insurance on Schedule 1.

Memory cue. "Partners get guaranteed payments; S shareholders get paychecks." If a question describes an S shareholder receiving a guaranteed payment, the question is testing whether you know the term does not apply.

4.3 Entity-level taxes

The rule. An S corporation generally pays no federal income tax, with three exceptions that apply only to corporations that were once C corporations: the **built-in gains tax**, the **excess net passive income tax**, and **LIFO recapture**. An S corporation that has always been an S corporation never owes any of them.

Tax	When it applies	Rate and base
Built-in gains (section 1374)	Assets held on the date a C corporation converted to S are sold within the 5-year recognition period	21% of the lesser of net recognized built-in gain or taxable income; limited to the net unrealized built-in gain at conversion; the tax paid passes through as a loss to shareholders
Excess net passive income (section 1375)	The corporation has accumulated E&P from C years and passive investment income (royalties, rents, dividends, interest, annuities) exceeds 25% of gross receipts	21% of excess net passive income; if this happens for three consecutive years , the S election terminates on the first day of the fourth year
LIFO recapture	A C corporation using LIFO converts to S	The LIFO reserve is included in the final C year's income, with the tax paid in four annual installments

Worked example. Bayou Fabrication converts to S status on January 1, 2026, holding land with a basis of \$100,000 and a value of \$160,000. If the S corporation sells the land in 2028 for \$190,000, the \$60,000 of built-in gain existing at conversion is taxed to the corporation at 21% (\$12,600); the additional \$30,000 of post-conversion appreciation passes through untaxed at the entity level. A sale in 2032, after the five-year period, would avoid the tax entirely.

4.4 Shareholder basis: stock and debt

The rule. A shareholder's **stock basis** begins with the cost of the stock (or the section 351 carryover basis) and is adjusted each year in a fixed order: **increased** by contributions and the shareholder's share of income (including tax-exempt income); then **decreased** by distributions; then by nondeductible, noncapital expenses; then by losses and deductions. Basis cannot fall below zero. Losses in excess of stock basis may be deducted against the shareholder's **debt basis**, which is the shareholder's basis in loans made **directly** by the shareholder to the corporation. Guaranteeing a bank loan creates **no** debt basis.

Order of stock-basis adjustments	Item
1. Increase	Capital contributions; ordinary income; separately stated income; tax-exempt income; excess depletion
2. Decrease	Distributions (other than dividends from C-year E&P)
3. Decrease	Nondeductible, noncapital expenses (penalties, 50% of meals, life insurance premiums)
4. Decrease	Ordinary loss, separately stated losses and deductions, section 179

Rules for debt basis:

- Losses reduce **stock basis first**, then **debt basis**. Distributions **never** reduce debt basis; a distribution in excess of stock basis is capital gain even if debt basis remains.
- When income is later allocated, it restores **debt basis first** (up to the original face amount), then stock basis.
- If the corporation repays a loan while its basis is below face, the shareholder recognizes gain: **capital gain** if the loan is evidenced by a written note, **ordinary income** if it is an open-account advance.
- Shareholders who report losses, receive distributions, or dispose of stock must attach **Form 7203** to compute and report basis.

Worked example. Maria's stock basis in Panadería Lopez, Inc. is \$10,000 at the start of 2025, and she has lent the corporation \$20,000 on a written note. Her 2025 K-1 shows a \$25,000 ordinary loss and no distributions. The loss uses her \$10,000 stock basis, then \$15,000 of debt basis. Stock basis is \$0; debt basis is \$5,000. In 2026 the K-1 shows \$18,000 of income. The income restores debt basis first: \$15,000 brings it back to \$20,000, and the remaining \$3,000 goes to stock basis.

Worked example (distribution versus debt basis). Same facts at the start of 2025, but instead of a loss the corporation allocates Maria \$4,000 of income and distributes \$18,000 to her. Stock basis after income is \$14,000. The distribution exceeds it by \$4,000, which is capital gain, even though her \$20,000 debt basis is untouched.

Exam trap. A shareholder who personally **guarantees** the corporation's bank loan gets no basis unless and until the shareholder actually pays on the guarantee. A partner who guarantees a partnership loan **does** get basis, because the partner bears the economic risk of loss. This is the most tested partnership-versus-S corporation difference.

4.5 Distributions

The rule. If the S corporation has **no accumulated E&P** from C years, a distribution is **tax-free to the extent of stock basis**, and any excess is **capital gain**. If the corporation **has accumulated E&P**, distributions come first from the **accumulated adjustments account (AAA)**, tax-free to the extent of basis; then from **accumulated E&P** as a **taxable dividend**; then from any remaining stock basis tax-free; then as capital gain. The corporation may elect, with the consent of all affected shareholders, to distribute E&P first.

The AAA is a corporate-level account that tracks undistributed S-corporation income that has already been taxed to shareholders. It is increased by income (but **not** tax-exempt income) and decreased by losses, nondeductible expenses, and distributions. It can go negative from losses but not from distributions.

Layer (corporation with C-year E&P)	Tax to shareholder	Effect on basis
1. AAA	Tax-free (to extent of basis)	Reduces
2. Accumulated E&P	Dividend (Form 1099-DIV, qualified rates)	None
3. Remaining stock basis (including the other adjustments account)	Tax-free	Reduces to zero
4. Excess	Capital gain	None

Property distributions. The corporation recognizes gain (not loss) as if it sold the property at fair market value; the gain passes through to shareholders and increases their basis before the distribution is applied. The shareholder's distribution amount and basis in the property are its fair market value.

Worked example. Bayou Fabrication, now an S corporation, has an AAA of \$40,000 and accumulated E&P from its C years of \$25,000. David's stock basis is \$50,000. The corporation distributes \$80,000 to David, its sole shareholder. The first \$40,000 is from AAA, tax-free, reducing basis to \$10,000. The next \$25,000 is a dividend from E&P with no effect on basis. The next \$10,000 is tax-free and reduces basis to zero. The final \$5,000 is capital gain.

Memory cue. "AAA, E&P, basis, gain." Compare the C corporation order in Chapter 3: "current, accumulated, basis, gain." The S corporation inserts the already-taxed AAA layer in front.

4.6 Revocation, termination, and reinstatement

The rule. An S election ends in one of three ways: a **voluntary revocation** by shareholders holding more than 50% of the shares; an **involuntary termination** on the day the corporation ceases to meet an eligibility requirement; or **termination** after three consecutive years of excess passive investment income while the corporation has C-year E&P. After termination, the corporation generally may not re-elect S status for **five years** without IRS consent.

Event	Effective date
Revocation filed by the 15th day of the third month of the year	First day of that year (unless a later prospective date is specified)
Revocation filed after that date	First day of the following year (unless a prospective date is specified)
Ineligible shareholder (for example, stock transferred to a partnership or nonresident alien), more than 100 shareholders, or a second class of stock	The day the disqualifying event occurs; the year is split into an S short year and a C short year, with income allocated per day unless the corporation elects to close the books
Three consecutive years of passive income over 25% with C-year E&P	First day of the fourth year

Inadvertent termination relief. If the termination was inadvertent, the corporation corrects the problem within a reasonable time, and the corporation and shareholders agree to any IRS-required adjustments, the IRS may treat the election as having continued. Rev. Proc. 2022-19 lets many common defects (missing spousal consents, one-class-of-stock issues from governing documents) be corrected without a ruling request.

Post-termination transition period. For at least **one year** after termination, former shareholders may receive tax-free distributions of the remaining AAA and may deduct suspended losses to the extent they contribute capital.

Worked example. On August 10, 2025, Priya, a 40% shareholder, sells her stock in an S corporation to a partnership. The election terminates on August 10. The corporation files an S short-year return for January 1 to August 9 and a C short-year return for August 10 to December 31, allocating each item by days unless all affected shareholders elect to close the books. Without IRS consent it cannot re-elect S status until its fifth tax year beginning after 2025, which is 2030.

4.7 Debt discharge

The rule. Cancellation-of-debt income is determined and, if excludable, **excluded at the corporate level**. If the S corporation is insolvent or in bankruptcy, the excluded income does **not** pass through and does **not** increase shareholder basis; instead the corporation reduces its own tax attributes, including suspended losses that are treated as the corporation's NOL for this purpose. If the corporation is solvent, the COD income passes through as ordinary income and increases shareholder basis like any other income.

Exam trap. Partnership versus S corporation again: a partnership's COD exclusion is tested **partner by partner**; an S corporation's is tested at the **corporate** level. An insolvent partner excludes his share; a solvent shareholder of an insolvent S corporation excludes her share too, because the test was applied to the corporation.

4.8 Partnerships and S corporations side by side

Issue	Partnership	S corporation
Owners	Two or more, any type	100 or fewer, eligible persons only
Special allocations	Permitted if they have substantial economic effect	Not permitted; pro rata per share per day
Owner compensation for services	Guaranteed payments (SE tax, no W-2)	Wages on Form W-2 (FICA, withholding)
SE tax on remaining profit	Yes for general partners	No
Entity debt in owner basis	Yes, share of all partnership liabilities	No; only direct loans from the shareholder
Loan guarantees	Create basis (recourse)	Do not create basis
Contribution of appreciated property	Tax-free under 721, no control test	Tax-free under 351 only with 80% control
Built-in gain on contributed property	Allocated to contributor (704(c))	Shared by all shareholders
Distribution of appreciated property	No gain to entity or partner (generally)	Gain recognized by corporation, passed through

Issue	Partnership	S corporation
Cash distribution over basis	Capital gain	Capital gain
COD exclusion tested at	Partner level	Corporate level
Fringe benefits for owners	Taxable	Taxable for more-than-2% shareholders
Inside basis step-up on owner's death or sale	Section 754 election available	Not available
Audit regime	Centralized partnership audit (unless elected out)	Shareholder-level
Return and due date	Form 1065, March 15	Form 1120-S, March 15

Quick Check: Chapter 4

1. Which corporation is eligible to elect S status for 2025?

- A. A domestic corporation with 90 shareholders, one of whom is a resident alien, and one class of stock
- B. A domestic corporation with 60 shareholders, one of whom is a partnership
- C. A domestic corporation with 40 shareholders and both common and preferred stock
- D. A corporation with 10 shareholders, one of whom is a nonresident alien

2. A calendar-year C corporation files Form 2553 on April 2, 2025, with no reasonable-cause statement. Its S election is effective:

- A. January 1, 2025
- B. April 2, 2025
- C. January 1, 2026
- D. Never, because the form was late

3. Priya owns 100% of an S corporation that earned \$120,000 in 2025. She performed substantial services and took \$100,000 of distributions but no salary. Which statement is correct?

- A. The arrangement is proper because S corporation income is never subject to employment taxes.
- B. The IRS may recharacterize a reasonable portion of the distributions as wages subject to FICA.
- C. The \$100,000 is a guaranteed payment subject to self-employment tax.
- D. The \$120,000 is subject to self-employment tax on Schedule SE.

4. At the beginning of 2025, Carlos's stock basis in an S corporation is \$5,000 and his basis in a written note from a direct loan to the corporation is \$10,000. His 2025 K-1 shows a \$12,000 ordinary loss. How much may he deduct, and what are his ending bases?

- A. \$12,000; stock \$0, debt \$3,000
- B. \$5,000; stock \$0, debt \$10,000
- C. \$12,000; stock \$0, debt \$0
- D. \$15,000; stock \$0, debt \$0

5. An S corporation with no accumulated E&P distributes \$30,000 cash to its sole shareholder, whose stock basis after the year's income adjustments is \$22,000. The shareholder reports:

- A. \$30,000 dividend
- B. \$8,000 capital gain
- C. \$8,000 ordinary income
- D. Nothing; the excess reduces debt basis

6. An S corporation has AAA of \$15,000 and accumulated E&P from C years of \$10,000. Its sole shareholder's stock basis is \$40,000. It distributes \$30,000. How much is a taxable dividend?

- A. \$0
- B. \$5,000
- C. \$10,000
- D. \$15,000

7. Which action creates debt basis for an S corporation shareholder?

- A. Personally guaranteeing the corporation's \$100,000 bank line of credit
- B. Lending the corporation \$20,000 from personal funds on a written note
- C. Pledging personal stock as collateral for a corporate loan
- D. Co-signing a corporate equipment lease

8. An S corporation's shareholders holding 60% of the shares file a revocation on February 20, 2025, specifying no effective date. The revocation is effective:

- A. January 1, 2025
- B. February 20, 2025
- C. January 1, 2026
- D. Only if 100% of shareholders consent

9. An S corporation that has always been an S corporation earns \$200,000 of gross receipts in 2025, of which \$90,000 is interest and dividends. Which statement is correct?

- A. It owes the excess net passive income tax because passive income exceeds 25% of gross receipts.
- B. Its election terminates if this continues for three consecutive years.
- C. It owes no entity-level tax, because the passive income tax applies only to corporations with accumulated E&P from C years.
- D. It owes the built-in gains tax on the passive income.

10. An insolvent S corporation has \$50,000 of debt forgiven and excludes it under section 108. Its sole shareholder, who is personally solvent, has suspended losses of \$30,000. Which statement is correct?

- A. The shareholder reports \$50,000 of ordinary income because she is solvent.
- B. The excluded income increases the shareholder's stock basis by \$50,000.
- C. The income is excluded at the corporate level, does not increase the shareholder's basis, and the corporation reduces its tax attributes, including the suspended losses.
- D. The shareholder may exclude only \$30,000.

Answers.

- 1. A.** Resident aliens are eligible shareholders, 90 is within the 100 limit, and one class of stock is required. A partnership shareholder, a nonresident alien shareholder, and a second class of stock (preferred) each disqualify the corporation.
- 2. C.** An election filed after the 15th day of the third month takes effect for the following tax year. Late-election relief under Rev. Proc. 2013-30 could make it effective for 2025, but only with a reasonable-cause statement, which was not provided.
- 3. B.** A shareholder who performs substantial services must receive reasonable compensation on Form W-2 before taking distributions. The IRS may recharacterize distributions as wages and assess FICA taxes and penalties. S corporations have no guaranteed payments, and pass-through income is not subject to self-employment tax.
- 4. A.** Losses are deductible up to stock basis plus debt basis, \$15,000, so the full \$12,000 is allowed. The loss reduces stock basis first (\$5,000 to \$0), then debt basis (\$10,000 to \$3,000).
- 5. B.** With no accumulated E&P, a distribution is tax-free up to stock basis and the excess is capital gain. Distributions never reduce debt basis.
- 6. C.** The first \$15,000 comes from AAA and is tax-free, reducing basis to \$25,000. The next \$10,000 is a dividend from accumulated E&P. The remaining \$5,000 is tax-free against the remaining stock basis. The taxable dividend is \$10,000.
- 7. B.** Only a direct loan from the shareholder to the corporation creates debt basis. Guarantees, pledges, and co-signing create no basis until the shareholder actually pays the corporation's obligation.
- 8. A.** A revocation requires the consent of shareholders holding more than 50% of the shares, so 60% suffices. Filed by the 15th day of the third month (March 15) without a specified date, it takes effect on the first day of the year.
- 9. C.** The excess net passive income tax and the three-year termination rule apply only when the corporation has accumulated earnings and profits from C corporation years. A corporation that has always been an S corporation has no such E&P and is not affected, no matter how much passive income it earns. The built-in gains tax likewise applies only to former C corporations.
- 10. C.** For an S corporation, the section 108 exclusion is tested and applied at the corporate level. Excluded COD income does not pass through and does not increase shareholder basis; the corporation reduces its attributes, treating the shareholder's suspended losses as its NOL for this purpose.

Chapter 5. Business Income, Expenses, Depreciation, and Credits

Domain 2 • 37 scored questions (44%) • Chapters 5 and 6

What the outline tests in this chapter: gross receipts and other income; cost of goods sold (inventory methods, included costs, uniform capitalization); net income or loss and the at-risk rules; cancellation of business debt; business expenses, including officer and employee compensation and fringe benefits, family employment, statutory employees; rent and self-rentals; depreciation, amortization, section 179, bonus depreciation, depletion, and correcting errors; bad debts; travel, meals, and gifts; vehicles; interest; insurance; taxes; employment taxes; casualties, thefts, and condemnations; qualified business income; general business credits; the net operating loss deduction; and the home office.

Domain 2 is the largest on the exam and this chapter carries most of it. The organizing idea is Schedule C, because the same income and expense rules apply whether the business is a sole proprietorship, a partnership, or a corporation; only the form changes. Read each section as “what goes on the return, how much, and when.”

5.1 Gross receipts and other business income

The rule. Gross income from a business includes all receipts from sales and services, plus other income connected with the business: bartered goods and services at fair market value, recovered bad debts previously deducted, prizes, interest on business accounts, kickbacks, rebates, cancellation of debt, and gains on the sale of business assets (reported on Form 4797 rather than as gross receipts). A **cash-method** business reports income when actually or constructively received; an **accrual-method** business reports income when all events fixing the right to receive it have occurred and the amount can be determined with reasonable accuracy, and no later than when the income is recognized in an applicable financial statement.

Item	Treatment
Sales tax collected and remitted to the state	Not income, not expense (a pass-through) unless the business includes it in gross receipts and deducts the payment
Customer deposits that are refundable	Not income until applied to a sale or forfeited
Advance payments for goods or services (accrual method)	Includible in the year received, or, under section 451(c), deferred to the following year to the extent not recognized in financial statements
Bartering	Fair market value of what is received, when received

Item	Treatment
Recovery of a bad debt deducted in a prior year	Income in the year recovered, to the extent the earlier deduction produced a tax benefit
Loan proceeds	Never income
Gain on sale of equipment	Form 4797 (Chapter 6), not gross receipts

A **small business taxpayer**, one whose average annual gross receipts for the three prior years do not exceed **\$31,000,000** for 2025, may use the cash method regardless of entity type (other than a tax shelter), is exempt from the uniform capitalization rules, and may treat inventory as non-incidental materials and supplies or follow its financial statement method.

Worked example. Panadería Lopez, a cash-method business, delivered \$3,000 of wedding cakes in December 2025 and received a check dated December 30, 2025 that Maria did not deposit until January 3, 2026. The \$3,000 is 2025 income because she had unrestricted access to the funds in 2025 (constructive receipt). A \$500 deposit received in December for a February 2026 event is also 2025 income for a cash-method taxpayer, because cash received is income when received.

5.2 Cost of goods sold and inventory

The rule. A business that produces or buys goods for resale computes cost of goods sold as beginning inventory plus purchases (net of returns and withdrawals for personal use), direct labor, materials, and other allocable costs, minus ending inventory. Inventory is valued by **cost, lower of cost or market** (not available with LIFO), or **retail**, and cost is tracked by **specific identification, FIFO, or LIFO**. LIFO is elected on **Form 970** and requires that the taxpayer also use LIFO for financial reporting (the conformity rule).

Uniform capitalization (section 263A). Producers and resellers that are not small business taxpayers must capitalize into inventory the direct costs and an allocable share of indirect costs (such as purchasing, handling, storage, and a portion of general and administrative costs) rather than deducting them currently. Marketing, selling, and research costs are never capitalized under UNICAP.

Worked example. Panadería Lopez begins 2025 with \$4,000 of flour, sugar, and packaging on hand, purchases \$60,000 of ingredients during the year, withdraws \$1,000 of them for family use, and ends the year with \$5,000 on hand. Cost of goods sold: $\$4,000 + \$60,000 - \$1,000 - \$5,000 = \$58,000$. The \$1,000 personal withdrawal is removed from purchases so it is never deducted.

Exam trap. In a year of rising prices, LIFO produces **higher** cost of goods sold, **lower** ending inventory, and **lower** taxable income than FIFO. Questions that ask which method minimizes current tax in an inflationary period want LIFO.

5.3 Loss limits and cancellation of business debt

The at-risk, passive, and excess business loss gates were introduced in Chapter 1, section 1.11. For a sole proprietor the at-risk rules apply on **Form 6198** to each activity; amounts at risk include cash and the adjusted basis of property contributed, amounts borrowed for which the taxpayer is personally liable or has pledged non-activity property, and **qualified nonrecourse financing** on real property from a commercial lender or government.

The rule. When a business debt is forgiven, the borrower has ordinary income equal to the amount canceled, unless an exclusion applies. The exclusions, claimed on **Form 982**, are bankruptcy (unlimited), insolvency (to the extent of insolvency immediately before the discharge), qualified farm indebtedness, qualified real property business indebtedness (by election, treated as a basis reduction in depreciable real property), and a purchase-price reduction by the seller. In exchange for the exclusion, the taxpayer must reduce tax attributes in a set order unless an election is made to reduce depreciable basis first.

Order of attribute reduction: net operating losses; general business credit carryovers; minimum tax credit; net capital losses; basis of property; passive activity loss and credit carryovers; foreign tax credit carryovers. Reductions are dollar for dollar, except credits are reduced one-third of a dollar for each dollar excluded.

Worked example. A supplier forgives \$15,000 that Panadería Lopez owes for ingredients. Immediately before the discharge Maria's business and personal liabilities total \$200,000 and her assets total \$190,000, so she is insolvent by \$10,000. She excludes \$10,000 and reports \$5,000 of ordinary business income. She reduces her tax attributes by \$10,000 on Form 982.

5.4 Compensation, fringe benefits, and family employment

The rule. Compensation is deductible if it is an **ordinary and necessary** expense, **reasonable in amount**, and paid for services actually rendered. An accrual-method employer may deduct a bonus accrued at year end only if it is paid within **two and a half months** after year end and the employee is not a related party. Payments to a more-than-50% owner or a family member are deductible only when the recipient includes them in income.

Statutory employees. Four categories of workers are treated as employees for FICA (and sometimes FUTA) even though they are independent contractors under the common-law test: full-time life insurance salespeople, agent or commission drivers delivering food, beverages, or laundry, home workers using employer-provided materials, and traveling or city salespersons working full time for one firm. The employer withholds and matches FICA but **does not withhold income tax**, checks the "statutory employee" box on Form W-2, and the worker deducts business expenses on **Schedule C** rather than as an employee.

Family employment. The exemptions below apply only to a sole proprietorship or a partnership in which every partner is a parent of the child; they never apply to a corporation.

Worker	FICA	FUTA	Income tax withholding
Child under 18 employed by parent	Exempt	Exempt (until age 21)	Applies
Child 18 to 20 employed by parent	Applies	Exempt	Applies
Spouse employed by spouse	Applies	Exempt	Applies
Parent employed by child (business)	Applies	Exempt	Applies

Fringe benefits. The employer deducts the cost; the employee excludes the value only when a Code section says so.

Benefit	2025 exclusion
Employer-paid health insurance; HSA contributions	Fully excludable; HSA limits \$4,300 self-only, \$8,550 family
Group-term life insurance	Cost of the first \$50,000 of coverage
Dependent care assistance	\$5,000 (\$2,500 MFS)
Educational assistance (section 127), including student loan repayments	\$5,250 per year
Adoption assistance	\$17,280 , phased out from MAGI \$259,190 to \$299,190
Qualified transportation (transit pass or parking)	\$325 per month each
Employee achievement awards (tangible property for length of service or safety)	\$400 nonqualified plan; \$1,600 qualified plan
Meals and lodging furnished on the business premises for the employer's convenience (lodging must be a condition of employment)	Fully excludable
No-additional-cost services, qualified employee discounts (20% on services; gross profit percentage on goods), working condition fringes, de minimis fringes	Excludable
Moving expense reimbursements	Excludable only for active-duty military moves under orders

Partners and more-than-2% S corporation shareholders cannot exclude health insurance, group-term life, meals and lodging, or cafeteria plan benefits; the value is income to them, although health premiums then qualify for the self-employed health insurance deduction.

Worked example. Maria hires Mateo, 16, to work the counter at Panadería Lopez (a sole proprietorship) for \$6,000 in 2025. The wages are deductible, no Social Security, Medicare, or FUTA tax applies because he is under 18 and employed by his parent, and Mateo's wages are earned income that can fund a Roth IRA. If the bakery were a corporation, FICA and FUTA would apply.

Exam trap. Reasonable compensation cuts both ways. For a C corporation the IRS argues salaries are **too high** (disguised dividends). For an S corporation it argues salaries are **too low** (disguised distributions escaping FICA). A question that mentions “unreasonable” compensation is almost always testing which direction applies to which entity.

5.5 Rent and self-rentals

The rule. Rent paid for property used in a trade or business is deductible when paid or incurred, but rent paid in advance is deductible only in the year to which it applies (subject to the 12-month rule for cash-method taxpayers). Rent paid to a related party is deductible only if it is reasonable. A taxpayer who rents property to a business in which the taxpayer **materially participates** is subject to the **self-rental rule**: net rental **income** from that property is treated as **nonpassive**, so it cannot absorb passive losses, while a net rental **loss** stays passive.

A tenant’s cost of improvements to leased property is depreciated by the tenant over the property’s recovery period (not the lease term). A lessor does not include the value of tenant improvements in income unless they are a substitute for rent. Payments to acquire a lease are amortized over the lease term, including renewal periods if less than 75% of the cost is attributable to the original term.

Worked example. David owns the yard that Lopez Brothers Landscaping rents for \$24,000 a year, and he materially participates in the LLC. His net rental income from the yard is \$9,000. Under the self-rental rule the \$9,000 is nonpassive, so he cannot use it to free up the \$12,000 of suspended passive losses he has from an unrelated limited partnership.

5.6 Depreciation, section 179, bonus, amortization, and depletion

The rule. The cost of property with a useful life beyond the year is recovered over time through depreciation (tangible property), amortization (intangibles), or depletion (natural resources), unless an expensing election applies. Under MACRS, each asset is assigned a recovery period and convention; the taxpayer may instead elect to expense up to **\$2,500,000** of qualifying property under **section 179** for 2025, and may claim **100% bonus depreciation** on qualified property acquired and placed in service after **January 19, 2025**. Land is never depreciated.

MACRS classes and conventions

Recovery period	Typical property	Method
3-year	Tractor units, racehorses, certain tools	200% declining balance

Recovery period	Typical property	Method
5-year	Cars, light trucks, computers, office machinery, appliances in rentals, breeding cattle, new farm machinery	200% DB
7-year	Office furniture and fixtures, most machinery and equipment, used farm machinery, property with no assigned class	200% DB
10-year	Vessels, single-purpose agricultural structures, fruit and nut trees	200% DB
15-year	Land improvements (fences, sidewalks, parking lots), qualified improvement property, restaurant furniture	150% DB
20-year	Farm buildings (other than single-purpose structures)	150% DB
27.5-year	Residential rental property	Straight line, mid-month
39-year	Nonresidential real property (including a home office)	Straight line, mid-month

Conventions: **half-year** for personal property, unless more than **40%** of the basis of personal property placed in service during the year is placed in service in the **last quarter**, in which case the **mid-quarter** convention applies to all personal property placed in service that year. Real property always uses **mid-month**. The alternative depreciation system (ADS) uses straight line over longer periods and is required for listed property used 50% or less for business, tax-exempt use property, property used predominantly outside the United States, and property of an electing real property or farming business.

Section 179

Element	2025
Maximum deduction	\$2,500,000
Phase-out begins when qualifying property placed in service exceeds	\$4,000,000 (fully phased out at \$6,500,000)
Heavy SUV limit (over 6,000 but not over 14,000 pounds)	\$31,300
Qualifying property	New or used tangible personal property used more than 50% in business; off-the-shelf software; qualified improvement property; roofs, HVAC, fire protection, alarm, and security systems in nonresidential buildings
Business income limit	Deduction cannot exceed aggregate taxable income from active trades or businesses (including wages); excess carries forward indefinitely

Element	2025
Not eligible	Land, buildings (other than the improvements listed), property held for investment, property used 50% or less in business, property acquired from a related party or by gift or inheritance

The section 179 deduction is taken **first**, then bonus depreciation on the remaining basis, then regular MACRS on what is left.

Bonus depreciation

Property	Allowance
Qualified property acquired and placed in service after January 19, 2025	100% (permanent)
Qualified property acquired before January 20, 2025 and placed in service in 2025	40%
Elective reduced rate for the first tax year ending after January 19, 2025	40% (60% for long-production-period property) instead of 100%

Qualified property is MACRS property with a recovery period of **20 years or less**, computer software, water utility property, and qualified film, television, and theatrical productions; used property qualifies if it was not previously used by the taxpayer and was not acquired from a related party. Unlike section 179, bonus depreciation has **no dollar cap and no business income limit**, and it applies automatically unless the taxpayer **elects out** by class of property.

New for 2025. The One Big Beautiful Bill Act raised the section 179 limit from the previously indexed \$1,250,000 to \$2,500,000 (phase-out from \$4,000,000) for tax years beginning after 2024, and made 100% bonus depreciation permanent for property acquired after January 19, 2025. It also created a 100% allowance for **qualified production property**, nonresidential real property used as an integral part of manufacturing, production, or refining, constructed after January 19, 2025 and placed in service after July 4, 2025.

Listed property and passenger automobiles

Listed property (passenger automobiles and other property used for transportation or entertainment) must be used **more than 50%** for business to qualify for section 179, bonus, or accelerated MACRS. If business use drops to 50% or less in a later year, prior accelerated depreciation in excess of ADS straight line is **recaptured** as ordinary income.

Passenger automobiles (rated at 6,000 pounds gross vehicle weight or less) are subject to annual depreciation caps that include section 179 and bonus:

Year placed in service 2025	With bonus	Without bonus
Year 1	\$20,200	\$12,200

Year placed in service 2025	With bonus	Without bonus
Year 2	\$19,600	\$19,600
Year 3	\$11,800	\$11,800
Each later year	\$7,060	\$7,060

The caps are reduced proportionately for business use under 100%. Heavy SUVs over 6,000 pounds escape the caps but are limited to \$31,300 of section 179 (bonus is not limited).

Amortization

Intangible	Period
Section 197 intangibles acquired in a business purchase: goodwill, going-concern value, customer lists, covenants not to compete, licenses, trademarks, franchises	15 years , straight line, beginning the month of acquisition; no loss on disposition of one 197 intangible while others from the same purchase are retained
Start-up costs and organizational costs	\$5,000 each immediately (reduced dollar for dollar above \$50,000), remainder over 180 months
Domestic research and experimental expenditures	Deducted currently under new section 174A for tax years beginning after 2024, or elected amortization over at least 60 months; foreign research amortized over 15 years
Computer software not acquired with a business	36 months (or bonus/179)

New for 2025. Section 174A restores the immediate deduction of domestic research and experimental expenditures, reversing the five-year amortization that applied for 2022 through 2024. Small business taxpayers may elect to apply the change retroactively to 2022 by filing by July 4, 2026.

Depletion

Owners of an economic interest in minerals, oil, gas, or timber recover their cost through **cost depletion** (basis $\times$ units sold $\div$ estimated recoverable units) or, for most minerals and for independent oil and gas producers, **percentage depletion** (a statutory percentage of gross income from the property, limited to 50% of taxable income from the property, or 100% for oil and gas, and for oil and gas to 65% of the taxpayer's overall taxable income). The taxpayer uses whichever gives the larger deduction each year. Percentage depletion may continue after basis reaches zero; timber uses cost depletion only.

De minimis safe harbor and correcting errors

A taxpayer may elect annually to deduct, rather than capitalize, items costing **\$2,500 or less** per invoice or item (**\$5,000** if the taxpayer has an applicable financial statement). The election is made by statement on a timely filed return and must match the taxpayer's book policy.

Depreciation errors: if an impermissible method (including no depreciation at all) has been used on **two or more** consecutive returns, it is an accounting method, and the correction is made by filing **Form 3115** with a **section 481(a) adjustment** that captures all missed depreciation in the year of change. An error on only one return is corrected by **amending** that return. Depreciation that was “allowable” reduces basis whether or not it was claimed.

Worked example. On March 3, 2025, Lopez Brothers Landscaping buys a used skid steer for \$60,000 (7-year property) and a new passenger car for \$45,000 used 100% for business. It elects section 179 only on the skid steer: \$60,000 deducted in full. For the car, bonus depreciation of 100% would be \$45,000, but the first-year cap for a car with bonus is \$20,200, so the 2025 deduction is \$20,200 and the remainder is recovered in later years within the caps.

Worked example (mid-quarter). Bayou Fabrication places \$100,000 of equipment in service in February 2025 and \$80,000 in November 2025, electing out of bonus and section 179. Because $\$80,000 \div \$180,000 = 44\%$ was placed in service in the last quarter, the mid-quarter convention applies to **both** assets: the February equipment gets 10.5 months of depreciation and the November equipment gets 1.5 months.

Memory cue. “179 first, bonus second, MACRS third. 179 has a cap and an income limit; bonus has neither.” And for cars: “Twelve-two without, twenty-two with” (\$12,200 without bonus, \$20,200 with).

Exam trap. Section 179 cannot create or increase a business loss; bonus depreciation can. A business with \$30,000 of taxable income that buys \$50,000 of equipment can deduct only \$30,000 under section 179 (carrying \$20,000 forward) but could deduct all \$50,000 with bonus depreciation, producing a \$20,000 loss.

5.7 Bad debts

The rule. A **business bad debt** is deductible as an **ordinary** loss in the year it becomes wholly or **partially** worthless, using the specific charge-off method. A debt is deductible only if it was previously included in income or represents cash actually lent, so a **cash-method** business cannot deduct an uncollected receivable for services it never reported as income. A **nonbusiness bad debt** (a personal loan) is deductible only when **wholly** worthless, as a **short-term capital loss**.

	Business bad debt	Nonbusiness bad debt
Character	Ordinary deduction	Short-term capital loss
Partial worthlessness	Deductible	Not deductible

	Business bad debt	Nonbusiness bad debt
Who	Debt created or acquired in a trade or business, or whose loss is closely related to the business	Everyone else, including a shareholder's loan to his own corporation unless the dominant motive was protecting employment
Later recovery	Income to the extent of prior tax benefit	Income to the extent of prior tax benefit

Worked example. Bayou Fabrication, an accrual-method corporation, billed a customer \$8,000 in 2024 and included it in income. In 2025 the customer files for bankruptcy and the trustee reports that unsecured creditors will receive 25 cents on the dollar. The corporation may deduct the \$6,000 partially worthless portion in 2025. Had Panadería Lopez (cash method) made the same sale on credit, Maria could deduct nothing, because the \$8,000 was never in her income.

5.8 Travel, meals, entertainment, and gifts

The rule. Travel expenses (transportation, lodging, and incidentals) are deductible when the taxpayer travels **away from the tax home overnight** or long enough to require sleep or rest, for a **temporary** assignment expected to last **one year or less**. Business **meals** are **50%** deductible if not lavish and the taxpayer or an employee is present. **Entertainment** is **not deductible** at all. Business **gifts** are limited to **\$25 per recipient per year**.

Expense	Deductible portion
Transportation and lodging while traveling away from home	100%
Meals while traveling; meals with clients; per diem meal allowance	50%
Meals provided for the convenience of the employer on premises (2025)	50%
Company holiday party or recreational event primarily for rank-and-file employees	100%
Food sold to customers; meals included in taxable compensation	100%
Entertainment (tickets, club dues, golf), even with a business discussion	0%
Gifts	\$25 per recipient per year; packaging and engraving excluded; items costing \$4 or less with the business name imprinted not counted
Commuting between home and the regular workplace	0%

Other rules the exam tests:

- **Temporary versus indefinite.** An assignment expected to last more than one year, or that in fact lasts more than one year, is indefinite, and the new location becomes the tax home, ending the deduction.
- **Combined business and personal travel inside the United States.** If the trip is primarily business, the full transportation cost is deductible and personal days' lodging and meals are not. If primarily personal, no transportation is deductible, but business expenses at the destination are.
- **Travel outside the United States** lasting more than one week with 25% or more personal days requires allocation of the transportation cost, unless the taxpayer had no substantial control over the trip.
- **Conventions** outside the North American area require a showing that it was as reasonable to hold them there as inside; cruise ship conventions are limited to **\$2,000** per year with detailed statements.
- **Per diem.** Employers may reimburse lodging and meals using federal per diem rates (or the high-low method) in place of actual receipts, but the meal portion is still 50% deductible by the employer. Self-employed taxpayers may use the per diem **only for meals and incidentals**, not lodging.
- **Accountable plans.** Reimbursements are excluded from employee income and deductible by the employer if there is a business connection, substantiation within a reasonable time, and return of excess within a reasonable time. Otherwise the reimbursement is wages.

Not on your exam. Beginning in 2026, the 50% deduction for most employer-provided meals that are excludable to employees (on-premises meals for the employer's convenience, de minimis food) is eliminated. For 2025 those meals remain 50% deductible.

Worked example. Priya flies from Houston to Chicago for a three-day consulting engagement and stays two extra days to visit friends. Airfare \$400, hotel \$200 per night for five nights, meals \$80 per day. The trip is primarily business. Deductible: airfare \$400; three nights of hotel \$600; three days of meals $\$240 \times 50\% = \$120$. Total \$1,120. The two personal nights and personal-day meals are not deductible.

5.9 Vehicle expenses

The rule. A taxpayer who uses a vehicle for business may deduct either the **standard mileage rate, 70 cents per mile for 2025**, plus business parking and tolls, or the business percentage of **actual expenses** (gas, oil, repairs, insurance, registration, lease payments or depreciation). The standard mileage rate must be chosen in the **first year** the vehicle is used in business; a taxpayer who starts with actual expenses and accelerated depreciation can never switch that vehicle to the standard rate. It is not available for five or more vehicles used simultaneously (fleet operations).

Issue	Rule
Depreciation built into the 2025 standard rate	33 cents per mile reduces basis

Issue	Rule
Switching from standard rate to actual	Permitted, but depreciation must then be straight line over the remaining life
Leased vehicles	If the standard rate is used, it must be used for the entire lease; if actual expenses are used, a lease inclusion amount from the IRS table is added to income for vehicles above the value threshold
Commuting	Never deductible, including the first and last trip of the day to a regular workplace; travel between two workplaces and from home to a temporary work location are deductible
Substantiation	Contemporaneous log with date, mileage, destination, and business purpose; an employer-provided vehicle's personal use is a taxable fringe

Worked example. Carlos drove the LLC's truck 20,000 miles in 2025, of which 15,000 were business. Using the standard rate, the deduction is $15,000 \times \$0.70 = \$10,500$ plus \$300 of business tolls, \$10,800. Actual expenses were \$14,000 including \$6,000 of depreciation; 75% business use would allow \$10,500. The two methods are close here; the standard rate wins by the tolls, which are allowed under either method.

5.10 Interest, insurance, and taxes

Interest

The rule. Interest on debt used in a trade or business is deductible, with three limits. **Section 163(j)** caps the net business interest deduction at business interest income plus **30% of adjusted taxable income** plus floor plan financing interest, but **exempts small business taxpayers** (average gross receipts of \$31,000,000 or less) and lets real property and farming businesses elect out in exchange for using ADS depreciation. **Prepaid interest** is deducted over the period to which it relates. Interest incurred to **construct** real property during the production period is capitalized.

The use of the borrowed funds, not the collateral, determines the character of the interest (the tracing rules). A sole proprietor's interest on a tax deficiency is personal interest even if the deficiency relates to Schedule C. Interest paid to a related cash-method lender is deductible by an accrual-method borrower only when paid.

New for 2025. Adjusted taxable income for section 163(j) is again computed **before** depreciation, amortization, and depletion (an EBITDA-style base) for tax years beginning after 2024, which increases the interest that larger businesses may deduct. Small business taxpayers remain exempt from the limit entirely.

Insurance

Deductible	Not deductible
Fire, theft, flood, and liability coverage on business property; malpractice; workers' compensation; group health and life for employees; business interruption (overhead) insurance; credit insurance; vehicle insurance (actual-expense method)	Premiums on life insurance where the business is the beneficiary (key-person coverage); self-insurance reserves; disability insurance covering the owner's lost earnings; premiums paid in advance for coverage beyond 12 months after year end (deducted ratably)

A self-employed person (sole proprietor, partner, or more-than-2% S shareholder) deducts 100% of health, dental, and qualified long-term care premiums for the taxpayer, spouse, dependents, and children under 27 as an adjustment to income, limited to the net earnings of the business, for months in which the taxpayer was not eligible for an employer-subsidized plan.

Taxes

Deductible on the business return	Treatment
Employer's share of FICA and FUTA; state unemployment tax	Deductible
Real estate and personal property taxes on business property	Deductible; assessments for local benefits that increase value (sidewalks, sewer lines) are capitalized
State and local income taxes paid by a corporation; state franchise taxes	Deductible by the corporation
Sales tax paid on business purchases	Part of the cost of the item: deducted with a deductible expense, capitalized with a depreciable asset
Excise taxes and fuel taxes on business use	Deductible (fuel tax credits on Form 4136 may apply instead)
Federal income tax; sole proprietor's state income tax	Never deductible on Schedule C (state income tax is an itemized deduction); half of self-employment tax is an adjustment to income
Fines and penalties paid to a government for violating a law	Not deductible, unless paid as restitution or to come into compliance and so identified in the settlement

5.11 Casualties, thefts, and condemnations

The rule. A business casualty or theft loss is fully deductible (the \$100 and 10%-of-AGI floors apply only to personal losses). For property **partially** destroyed, the loss is the **lesser of the adjusted basis or the decline in fair market value**, minus insurance. For property **completely** destroyed, the loss is the **adjusted basis minus insurance**. If insurance exceeds basis, the result is a **gain**, which may be deferred under **section 1033** by buying replacement property within **two years** after the close of the year the gain is realized (**three years** for condemned business real property). Losses are reported on Form 4684 and carried to Form 4797.

Element	Rule
Year of deduction	Year of the casualty; theft in the year discovered ; if a reimbursement claim exists, only the unreimbursed portion in that year
Replacement property	Must be similar or related in service or use; for condemned real property held for business or investment, like-kind property suffices
Basis of replacement	Cost minus deferred gain
Partial deferral	Gain is recognized to the extent the insurance proceeds exceed the cost of the replacement
Election	Made by not reporting the gain; the statute of limitations stays open three years after the taxpayer notifies the IRS of replacement or failure to replace

Worked example. A fire destroys Bayou Fabrication's press (adjusted basis \$30,000, value \$75,000). Insurance pays \$70,000. Realized gain: $\$70,000 - \$30,000 = \$40,000$. The corporation buys a replacement press for \$65,000 within two years. Gain recognized: $\$70,000 - \$65,000 = \$5,000$. Gain deferred: \$35,000. Basis of the new press: $\$65,000 - \$35,000 = \$30,000$.

5.12 Employment taxes

The rule. An employer withholds federal income tax and the employee's share of Social Security (6.2% up to the **\$176,100** wage base for 2025) and Medicare (1.45% on all wages, plus **0.9% Additional Medicare Tax** withheld on wages over **\$200,000**, with no employer match), pays a matching employer share of Social Security and Medicare, and pays **FUTA** of 6.0% on the first **\$7,000** of each employee's wages, reduced by a credit of up to 5.4% for state unemployment tax paid, for a net rate of **0.6%** (\$42 per employee). Withheld taxes are **trust funds** held for the government, and deposits are made electronically through EFTPS on a schedule set by the employer's past liability.

Return	Reports	Due
Form 941	Quarterly income tax withholding and FICA	Last day of the month after the quarter: April 30, July 31, October 31, January 31 (10 extra days if all deposits were timely)
Form 944	Annual version for employers notified by the IRS that their annual liability is \$1,000 or less	January 31
Form 943	Agricultural employees	January 31

Return	Reports	Due
Form 940	Annual FUTA	January 31 (February 10 if all deposits were timely)
Form 945	Backup withholding and nonpayroll withholding (pensions, gambling)	January 31
Forms W-2 and W-3	Wage statements to employees and the SSA	January 31
Schedule H (Form 1040)	Household employees paid \$2,800 or more in cash wages in 2025	With the Form 1040

Deposit schedules

Schedule	Who	When deposits are due
Monthly	Total Form 941 taxes in the lookback period (the four quarters ending the preceding June 30) were \$50,000 or less	By the 15th of the following month
Semiweekly	Lookback-period taxes exceeded \$50,000	Paydays Wednesday through Friday: by the following Wednesday ; paydays Saturday through Tuesday: by the following Friday
Next-day	Any employer that accumulates \$100,000 or more on any day	By the next business day ; the employer becomes a semiweekly depositor for the rest of the year and the next year
Quarterly with return	Total quarterly liability under \$2,500	Pay with the Form 941
FUTA	All employers	Quarterly when the cumulative FUTA liability exceeds \$500 ; otherwise carry forward and pay with Form 940

New employers are monthly depositors. A new employer's lookback period liability is zero.

Failure-to-deposit penalty

Days late	Penalty
1 to 5	2%
6 to 15	5%
More than 15 days (or within 10 days of the first IRS notice)	10%
Not paid within 10 days after an IRS notice, or paid directly to the IRS instead of by required electronic deposit	15%

Owners, officers, and others who are responsible for collecting and paying over the withheld taxes and willfully fail to do so are personally liable for the **trust fund recovery penalty**, equal to 100% of the unpaid withheld income tax and employee FICA (not the employer's share or FUTA). Part 3 covers the penalty in depth.

Tips

Employees must report cash tips of **\$20 or more** in a month to the employer by the 10th of the next month (Form 4070 or equivalent). The employer withholds income and FICA tax on reported tips and pays the employer FICA share. Large food and beverage establishments (more than 10 employees on a typical day) file **Form 8027** and must allocate tips to employees if reported tips fall below **8%** of gross receipts. Employers may claim the **FICA tip credit** (Form 8846) for the employer Social Security and Medicare tax paid on tips above the federal minimum wage (frozen at \$5.15 for this purpose).

Worked example. Panadería Lopez, Inc. reported \$38,000 of total Form 941 taxes for the four quarters ending June 30, 2024, so it is a **monthly** depositor for 2025. Its January 2025 payroll taxes of \$3,400 must be deposited by February 18, 2025 (February 15 falls on a Saturday and February 17 is a federal holiday). If it instead deposits on March 10, the deposit is 20 days late, so the penalty is $10\% \times \$3,400 = \$340$; a deposit on February 21, three days late, would have cost 2%, or \$68.

Memory cue. “Fifty thousand splits the schedules; one hundred thousand means tomorrow; five hundred triggers FUTA; two-five-hundred rides with the return.”

Exam trap. The lookback period is **not** the prior calendar year. It is the 12 months ending the **preceding June 30**. For 2025 deposits, the lookback period is July 1, 2023 through June 30, 2024.

5.13 The qualified business income deduction

The rule. A noncorporate taxpayer may deduct **20% of qualified business income** from sole proprietorships, partnerships, S corporations, and certain trusts and estates, plus 20% of qualified REIT dividends and publicly traded partnership income, limited overall to **20% of taxable income before the QBI deduction minus net capital gain**. Above the taxable income thresholds, **\$197,300 (single, HOH, MFS) and \$394,600 (MFJ)** for 2025, two further limits phase in over the next \$50,000 (\$100,000 joint): the deduction for each business is capped by its **W-2 wages and UBIA**, and income from a **specified service trade or business** phases out entirely.

Element	Detail
Qualified business income	Net income from a U.S. trade or business, excluding capital gains and losses, dividends, interest not allocable to the business, reasonable compensation paid to the owner, guaranteed payments, and wages. Reduced by the deductible half of SE tax, SE health insurance, and SE retirement contributions attributable to the business
W-2 wage/UBIA limit (fully applicable above the phase-in range)	Deduction for each business limited to the greater of (a) 50% of W-2 wages paid by the business, or (b) 25% of W-2 wages plus 2.5% of the unadjusted basis immediately after acquisition of qualified depreciable property
Specified service trade or business (SSTB)	Health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage, investing and investment management, trading, and any business whose principal asset is the reputation or skill of its owners or employees. Architecture and engineering are not SSTBs. Below the threshold an SSTB is treated like any business; within the range its QBI, wages, and UBIA are phased down; above the range it yields no deduction
Negative QBI	Netted against positive QBI from other businesses; a net loss carries forward and reduces next year's QBI
Rental real estate	Qualifies if it rises to a trade or business, or under the safe harbor requiring 250 or more hours of rental services per year with contemporaneous records
Forms	Form 8995 (taxable income at or below the threshold); Form 8995-A (above)
Who cannot claim it	C corporations; employees for their wages

Worked example. Maria's bakery produces \$80,000 of QBI (after the SE tax and health insurance reductions). The Lopezes' 2025 joint taxable income before the QBI deduction is \$130,000, including \$4,000 of net capital gain. Tentative deduction: $20\% \times \$80,000 = \$16,000$. Overall limit: $20\% \times (\$130,000 - \$4,000) = \$25,200$. The deduction is \$16,000. Because taxable income is under \$394,600, the W-2 wage limit and the SSTB rule are irrelevant.

Worked example (SSTB above the range). Priya's consulting practice, an SSTB, produces \$300,000 of QBI, and her taxable income as a single filer is \$320,000. That is above \$247,300, the top of the single phase-in range, so her QBI deduction is **\$0**. Had her business been engineering instead of consulting, she would be subject only to the W-2 wage/UBIA limit.

Memory cue. "Twenty percent, two thresholds, two limits." 20% of QBI; thresholds \$197,300 and \$394,600; above them the wage/UBIA limit for everyone and the SSTB phase-out for service businesses.

Not on your exam. For tax years beginning after 2025, the phase-in ranges widen to \$75,000 (\$150,000 joint) and a minimum \$400 deduction applies to taxpayers with at least \$1,000 of QBI from businesses in which they materially participate. The deduction itself was made permanent.

5.14 General business credits

The rule. Most business credits are components of the **general business credit** reported on **Form 3800**. The combined credit for the year is limited to the taxpayer's net income tax minus the greater of the tentative minimum tax or **25% of net regular tax liability above \$25,000**. Unused credits carry **back one year and forward 20 years**. Credits are claimed in a prescribed order, and most require that the related deduction be reduced by the credit.

Credit	Form	2025 rule
Disabled access credit	8826	50% of eligible access expenditures between \$250 and \$10,250 (maximum \$5,000); eligible small business has gross receipts of \$1,000,000 or less or 30 or fewer full-time employees in the prior year
Research credit	6765	20% of qualified research expenses over a base amount, or the alternative simplified credit of 14% over 50% of the prior three-year average; a qualified small business (under \$5,000,000 of gross receipts and no gross receipts more than five years ago) may apply up to \$500,000 against payroll tax
Small business health care credit	8941	Up to 50% of premiums paid (35% for tax-exempt employers) through a SHOP marketplace, for employers with fewer than 25 full-time-equivalent employees and average annual wages under \$66,600 , with the full credit available at 10 or fewer FTEs and average wages of \$33,300 or less; available for only two consecutive years

Credit	Form	2025 rule
Work opportunity credit	5884	40% of the first \$6,000 of first-year wages (\$2,400) for employees from targeted groups who work at least 400 hours; 25% for 120 to 399 hours; higher wage bases for certain veterans; applies to employees who begin work by December 31, 2025
Employer credit for paid family and medical leave	8994	12.5% to 25% of wages paid during up to 12 weeks of qualifying leave to employees earning under a threshold; made permanent
Retirement plan start-up credit	8881	Employers with up to 50 employees: 100% of start-up costs up to \$5,000 (51 to 100 employees: 50%), plus a credit for employer contributions up to \$1,000 per employee, plus \$500 per year for three years for automatic enrollment
Employer-provided childcare credit	8882	25% of qualified childcare facility expenditures plus 10% of resource and referral costs, up to \$150,000
FICA tip credit	8846	Employer FICA on tips above the \$5.15 minimum wage
Rehabilitation credit	3468	20% of qualified expenditures on certified historic structures, claimed ratably over five years
Low-income housing credit	8586	Allocated by state housing agencies over 10 years
Foreign tax credit (corporations)	1118	Not a general business credit, but creditable dollar for dollar against U.S. tax on foreign-source income, subject to the limitation fraction

Worked example. Panadería Lopez spends \$9,000 to install a wheelchair ramp and widen its restroom door in 2025. Eligible expenditures above \$250: \$8,750. Credit: $50\% \times \$8,750 = \$4,375$. Maria reduces the depreciable basis of the improvements by \$4,375.

Not on your exam. For tax years beginning after 2025 the employer-provided childcare credit rises to 40% (50% for eligible small businesses) with a \$500,000 (\$600,000) cap. The work opportunity credit expires for employees who begin work after December 31, 2025 unless Congress extends it.

5.15 Net operating losses

The rule. A net operating loss arises when business deductions exceed income for the year. Losses arising in 2018 and later carry **forward indefinitely**, may **not** be carried back (except two years for farming losses), and may offset only **80% of taxable income** in the carryforward year, computed without the NOL deduction itself and without the QBI deduction.

For an individual, the NOL is computed by starting with the negative taxable income and adding back: any NOL deduction from other years, the excess of capital losses over capital gains, the QBI deduction, and the excess of nonbusiness deductions (the standard deduction or itemized deductions, IRA contributions, alimony) over nonbusiness income (interest, dividends, pensions). Wages are business income for this purpose. A farmer may elect to waive the two-year carryback; a carryback is claimed quickly on **Form 1045**, which the IRS must act on within 90 days, or on an amended return.

Worked example. Carlos, single, has a \$60,000 Schedule C loss in 2025, \$5,000 of interest income, no capital transactions, and takes the \$15,750 standard deduction. Taxable income is \$(70,750). Nonbusiness deductions (\$15,750) exceed nonbusiness income (\$5,000) by \$10,750, which is added back. NOL: \$70,750 – \$10,750 = \$60,000. In 2026, if his taxable income before the NOL is \$50,000, he may use \$40,000 (80%) and carry \$20,000 forward.

5.16 The home office deduction

The rule. A self-employed taxpayer may deduct expenses for the part of a home used **regularly and exclusively** as (1) the **principal place of business**, including a space used for administrative or management activities when there is no other fixed location for them, (2) a place to meet patients, clients, or customers in the normal course of business, or (3) a **separate structure** not attached to the home. The deduction (other than the portion that would be deductible anyway, such as mortgage interest and taxes) is **limited to the gross income from the business use** minus other business expenses; the excess carries forward. Employees may not deduct a home office for 2025.

Method	Computation	Carryover	Depreciation
Regular (Form 8829)	Business percentage (square feet or rooms) × actual expenses: insurance, utilities, repairs, rent, depreciation on the business portion over 39 years	Yes	Yes, and later recaptured as unrecaptured section 1250 gain (25% maximum rate)
Simplified	\$5 per square foot , up to 300 square feet (\$1,500 maximum)	No	None; basis unaffected

Two exceptions waive the **exclusive** use requirement: space used to store inventory or product samples when the home is the only fixed business location, and space used as a licensed **daycare** facility (prorated by hours of use). Under either method, the business percentage of mortgage interest and real estate taxes that is not deducted on Schedule C remains deductible on Schedule A.

When the home is later sold, the section 121 exclusion applies to the home office portion if it is within the same dwelling unit, except that depreciation taken after May 6, 1997 cannot be excluded.

Worked example. Priya uses a 200-square-foot room exclusively as the office where she manages her consulting practice; she has no other office. Her home is 2,000 square feet, so the business percentage is 10%. Regular method: 10% of \$18,000 of utilities, insurance, and repairs is \$1,800, plus depreciation on 10% of the home's \$300,000 basis over 39 years, about \$769. Simplified method: $200 \times \$5 = \$1,000$. She chooses the regular method, provided her consulting income exceeds the total.

Exam trap. The home office deduction cannot create a business **loss**, but the business percentage of mortgage interest and taxes is deductible regardless of income because it would be deductible on Schedule A anyway; only the "other" expenses and depreciation are subject to the gross income limit, in that order.

Quick Check: Chapter 5

1. A cash-method consultant performed \$10,000 of services in December 2025, billed the client on December 28, and received payment on January 10, 2026. The client went out of business in March 2026 without paying a second \$4,000 invoice. Which statement is correct?
 - A. The \$10,000 is 2025 income and the \$4,000 is a 2026 bad debt deduction.
 - B. The \$10,000 is 2026 income and the \$4,000 is not deductible.
 - C. Both amounts are 2025 income and the \$4,000 is deductible in 2026.
 - D. The \$10,000 is 2026 income and the \$4,000 is a short-term capital loss.
2. A retailer began 2025 with \$50,000 of inventory, purchased \$300,000 of goods, returned \$10,000 of defective goods for credit, and ended the year with \$70,000 of inventory. Cost of goods sold is:
 - A. \$270,000
 - B. \$280,000
 - C. \$290,000
 - D. \$330,000

- 3.** On August 1, 2025, a sole proprietor with \$400,000 of business taxable income buys and places in service a used machine costing \$90,000 and a new passenger automobile costing \$50,000 used 100% for business. She elects section 179 on the machine only and does not elect out of bonus depreciation. Her total 2025 depreciation for the two assets is:
- A. \$140,000
 - B. \$110,200
 - C. \$102,200
 - D. \$90,000
- 4.** Bayou Fabrication places \$200,000 of equipment in service in April 2025 and \$150,000 in December 2025 and elects out of all bonus and section 179. Which convention applies?
- A. Half-year for both, because the December equipment is less than 50% of the total
 - B. Mid-quarter for both, because more than 40% of the year's personal property was placed in service in the fourth quarter
 - C. Mid-quarter for the December equipment only
 - D. Mid-month for both
- 5.** Maria's sole proprietorship employs her 17-year-old son and her husband David. Which statement about 2025 employment taxes is correct?
- A. Both are exempt from FICA and FUTA.
 - B. The son is exempt from FICA and FUTA; David is subject to FICA but exempt from FUTA.
 - C. Both are subject to FICA and FUTA.
 - D. The son is subject to FICA but exempt from FUTA; David is exempt from both.
- 6.** Which travel expense is fully deductible by a sole proprietor?
- A. A \$300 dinner with a client at which a contract was signed
 - B. \$900 of airfare to a three-day business conference
 - C. \$500 of golf fees with a prospect
 - D. A \$75 gift basket for a customer
- 7.** An employer's total Form 941 taxes for the four quarters ending June 30, 2024 were \$48,000. On Friday, March 14, 2025, its payroll generates \$9,000 of employment taxes. The deposit is due:
- A. Wednesday, March 19, 2025
 - B. Friday, March 21, 2025
 - C. April 15, 2025
 - D. April 30, 2025

- 8.** A married couple filing jointly has 2025 taxable income of \$150,000 before the QBI deduction, including \$10,000 of net long-term capital gain. The wife's accounting practice (an SSTB) produced \$90,000 of QBI. Their QBI deduction is:
- A. \$0, because accounting is an SSTB
 - B. \$18,000
 - C. \$28,000
 - D. \$30,000
- 9.** A business with \$800,000 of gross receipts spends \$12,000 to make its store accessible to customers with disabilities. Its disabled access credit is:
- A. \$6,000
 - B. \$5,875
 - C. \$5,000
 - D. \$2,500
- 10.** A sole proprietor had a \$40,000 NOL in 2024 and \$45,000 of taxable income in 2025 before the NOL deduction. The NOL deduction allowed in 2025 is:
- A. \$45,000
 - B. \$40,000
 - C. \$36,000
 - D. \$9,000
- 11.** Rosa runs a licensed daycare in her living room, which she and her family also use evenings and weekends. Which statement is correct?
- A. No home office deduction is allowed because the room is not used exclusively for business.
 - B. A deduction is allowed, prorated by the hours the room is used for daycare.
 - C. The full business percentage is deductible because daycare is an exempt activity.
 - D. Only the simplified method may be used for daycare.
- 12.** Insurance proceeds of \$90,000 are received for a fully destroyed business truck with an adjusted basis of \$40,000. The owner buys a replacement truck for \$85,000 within the replacement period and elects section 1033. The recognized gain and basis of the new truck are:
- A. Gain \$50,000; basis \$85,000
 - B. Gain \$5,000; basis \$40,000
 - C. Gain \$0; basis \$35,000
 - D. Gain \$5,000; basis \$85,000

Answers.

1. B. A cash-method taxpayer reports income when received, so the \$10,000 is 2026 income. The unpaid \$4,000 was never included in income, so there is no bad debt deduction; a cash-method business cannot deduct a receivable it never reported.

- 2. A.** $\$50,000 + \$300,000 - \$10,000 - \$70,000 = \$270,000$. Returns reduce purchases, and ending inventory is subtracted.
- 3. B.** Machine: $\$90,000$ fully expensed under section 179 (within the $\$2,500,000$ limit and her business income). Car: 100% bonus would be $\$50,000$, but the 2025 first-year cap for a passenger automobile with bonus is $\$20,200$. Total: $\$90,000 + \$20,200 = \$110,200$.
- 4. B.** $\$150,000 \div \$350,000 = 42.9\%$ of the personal property placed in service during the year went into service in the last quarter, exceeding 40%. The mid-quarter convention then applies to **all** personal property placed in service during the year.
- 5. B.** A child under 18 employed by a parent's sole proprietorship is exempt from FICA, and the exemption from FUTA lasts until 21. A spouse employed by a spouse is subject to FICA but exempt from FUTA.
- 6. B.** Transportation to a business destination is 100% deductible. Client meals are 50%; entertainment such as golf is 0%; business gifts are limited to $\$25$ per recipient.
- 7. C.** Lookback-period taxes of $\$48,000$ are $\$50,000$ or less, so the employer is a monthly depositor, and taxes for March paydays are due by the 15th of the following month, April 15, 2025. The semiweekly Wednesday and Friday rules apply only to semiweekly depositors; April 30 is the Form 941 due date, not the deposit date.
- 8. B.** Taxable income of $\$150,000$ is below the $\$394,600$ joint threshold, so the SSTB rule and the wage limit do not apply. Tentative deduction: $20\% \times \$90,000 = \$18,000$. Overall limit: $20\% \times (\$150,000 - \$10,000) = \$28,000$. The deduction is the smaller, $\$18,000$.
- 9. C.** Eligible expenditures are those between $\$250$ and $\$10,250$, a maximum of $\$10,000$, so the credit is $50\% \times \$10,000 = \$5,000$ regardless of how much more was spent. The business qualifies because gross receipts are $\$1,000,000$ or less.
- 10. C.** The NOL deduction is limited to 80% of taxable income computed without the NOL: $80\% \times \$45,000 = \$36,000$. The remaining $\$4,000$ carries forward indefinitely.
- 11. B.** Licensed daycare is one of two exceptions to the exclusive-use rule. The deduction is computed by multiplying the business percentage of the home by the fraction of total hours the space is used for daycare. Either method may be used.
- 12. B.** Realized gain is $\$90,000 - \$40,000 = \$50,000$. Gain is recognized to the extent proceeds exceed the cost of the replacement: $\$90,000 - \$85,000 = \$5,000$. Deferred gain is $\$45,000$, and the basis of the new truck is $\$85,000 - \$45,000 = \$40,000$. Answer D uses the full cost as basis, which would allow the deferred gain to escape tax.

Chapter 6. Business Assets, Financial Records, and Advising the Business Taxpayer

Domain 2, concluded • Business assets; analysis of financial records; advising the business taxpayer

What the outline tests: basis of assets; dispositions; like-kind exchanges; converted property; the capitalization and repair regulations and their elections; proper business type and classification codes; income statements and balance sheets; accounting methods and changes (Form 3115); depreciation recapture (including section 280F); pass-through activity and K-1 items; book-to-tax reconciliation (Schedules M-1, M-2, M-3); related-party activity; loans to and from owners; reporting and filing obligations (extensions, penalties, international information returns, the 1099 series, Form 8300); payment and deposit obligations; record-keeping; entity selection; commingling; advice on accounting methods; transfers of property in and out of the business; the business life cycle; industry-specific issues; worker classification; tax-planning choices among deductions and credits; and ACA compliance.

This chapter finishes Domain 2 with two skills the exam treats as the mark of a professional: reading a business's own records (and spotting when they do not reconcile to the return) and advising the owner before the transaction happens rather than after. The asset rules come first because the advice usually depends on them.

6.1 Basis of business assets

The rule. The basis of purchased property is its **cost**, including sales tax, freight, installation, testing, legal fees, and any liabilities assumed. **Adjusted basis** adds capital improvements and subtracts depreciation **allowed or allowable** (basis is reduced even if no depreciation was claimed), casualty losses deducted, and section 179 and bonus deductions. Property acquired other than by purchase takes the basis the Code assigns: carryover basis for gifts (with a fair-market-value limit for losses), fair market value at death for inherited property, and substituted basis in a like-kind exchange or section 351 or 721 transfer.

Acquisition	Basis for gain	Basis for loss	Basis for depreciation
Purchase	Cost	Cost	Cost
Gift	Donor's adjusted basis (plus gift tax on appreciation)	Lesser of donor's basis or FMV at gift	Same as gain basis
Inheritance	FMV at death (or alternate valuation date)	Same	Same
Personal property converted to business use	Adjusted basis	Lesser of adjusted basis or FMV at conversion	Lesser of adjusted basis or FMV at conversion

Acquisition	Basis for gain	Basis for loss	Basis for depreciation
Like-kind exchange	Basis of property given up + boot paid + gain recognized – boot received	Same	Same (carryover portion continues old schedule)
Lump-sum purchase of several assets	Allocated by relative fair market value; in a business purchase, by the residual method on Form 8594 (cash, then securities, then receivables, then inventory, then other tangible property, then section 197 intangibles other than goodwill, then goodwill)		

Worked example. Maria converts her personal van, bought for \$32,000, to 100% business use in 2025 when it is worth \$18,000. Her depreciable basis is \$18,000, the lesser of cost or value at conversion. If she later sells the van for \$25,000 after taking \$6,000 of depreciation, gain is measured from $\$32,000 - \$6,000 = \$26,000$ (no gain); loss is measured from $\$18,000 - \$6,000 = \$12,000$ (no loss). A sale price between the two produces neither gain nor loss.

6.2 Dispositions of business property: sections 1231, 1245, and 1250

The rule. Gain or loss on business property is amount realized minus adjusted basis, reported on **Form 4797**. Depreciable property and land used in a trade or business and held **more than one year** is **section 1231 property**: if the year's section 1231 gains exceed losses, the net gain is **long-term capital gain**; if losses exceed gains, the net loss is **ordinary**. Before that netting, **depreciation recapture** converts part of any gain to ordinary income: all depreciation on personal property under **section 1245**, and for individuals the straight-line depreciation on real property is taxed as **unrecaptured section 1250 gain** at a maximum 25% rate.

Property	Recapture rule
Section 1245: equipment, vehicles, furniture, purchased intangibles, single-purpose agricultural structures	Gain is ordinary to the extent of all depreciation, amortization, section 179, and bonus taken; any gain beyond original cost is section 1231 gain
Section 1250: buildings and structural components (individuals)	Gain attributable to depreciation in excess of straight line is ordinary (rare for post-1986 property); gain attributable to straight-line depreciation is unrecaptured section 1250 gain , taxed at up to 25%; the rest is section 1231 gain
Section 291: buildings sold by a C corporation	20% of the straight-line depreciation is recaptured as ordinary income; the remainder is section 1231 gain

Property	Recapture rule
Property held one year or less	Ordinary gain or loss; no section 1231 treatment
Inventory, receivables, copyrights created by the taxpayer	Never section 1231; always ordinary

Five-year lookback. Net section 1231 gain is treated as **ordinary income** to the extent of net section 1231 **losses** deducted in the five preceding years that have not yet been recaptured. The rule prevents a taxpayer from taking ordinary losses one year and capital gains the next on the same class of property.

Installment sales. Gain on a sale with at least one payment after the year of sale may be reported as payments are received (**Form 6252**), using the gross profit percentage. Exceptions: **depreciation recapture is recognized in full in the year of sale** regardless of payments; inventory and publicly traded securities are not eligible; a sale to a related party who resells within two years accelerates the gain; and interest must be charged at least at the applicable federal rate or interest will be imputed.

Related parties. A loss on a sale to a related party (spouse, siblings, ancestors, descendants, a more-than-50%-owned corporation or partnership, certain trusts) is **disallowed**, though the buyer may use it to offset gain on a later sale (section 267). Gain on the sale of **depreciable** property to a related party is **ordinary** (section 1239), because the buyer will depreciate the stepped-up cost.

Worked example. Lopez Brothers Landscaping sells a mower bought for \$12,000, on which it took \$9,000 of depreciation (basis \$3,000), for \$7,500. Gain is \$4,500. All of it is ordinary under section 1245 because it is less than the \$9,000 of depreciation. Had the mower sold for \$13,000, gain would be \$10,000: \$9,000 ordinary recapture and \$1,000 section 1231 gain.

Worked example (1231 netting). In 2025 Bayou Fabrication (a C corporation) has a \$20,000 section 1231 gain on land and an \$8,000 section 1231 loss on a machine (after section 1245 recapture). Net section 1231 gain of \$12,000 is treated as long-term capital gain, which for a corporation is taxed at the ordinary 21% rate but can absorb capital losses. Had the corporation deducted a \$5,000 net section 1231 loss in 2023, \$5,000 of the 2025 gain would be recharacterized as ordinary under the lookback rule.

Memory cue. “1245: all depreciation is ordinary. 1250: individuals pay 25% on straight-line depreciation; corporations recapture 20% of it as ordinary. 1231: net gain is capital, net loss is ordinary, and look back five years.”

Exam trap. The “best of both worlds” result of section 1231 (capital gain, ordinary loss) applies **after** recapture. A question that asks for the character of gain on equipment sold for less than its original cost has only one answer: ordinary income under section 1245.

6.3 Like-kind exchanges

The rule. No gain or loss is recognized when **real property** held for business or investment is exchanged solely for other real property held for business or investment (section 1031). Since 2018 the rule applies **only to real property**; vehicles, equipment, and other personal property no longer qualify. If **boot** (cash, other property, or net relief from liabilities) is received, gain is recognized to the extent of the **lesser of the boot or the realized gain**; loss is never recognized. The basis of the property received is the basis of the property given up, plus boot paid and gain recognized, minus boot received.

Element	Rule
Like-kind	All U.S. real property is like-kind to all other U.S. real property (land for a building, a rental house for a warehouse). U.S. and foreign real property are not like-kind. A personal residence, inventory, and dealer property do not qualify
Deferred exchange deadlines	Replacement property must be identified within 45 days after the transfer and received within 180 days (or by the due date of the return including extensions, if earlier)
Liabilities	Debt relief is boot received; debt assumed is boot paid; the two are netted. Cash paid can offset debt relief, but debt assumed cannot offset cash received
Related parties	If either party disposes of the exchanged property within two years , the deferred gain is recognized
Reporting	Form 8824 in the year of the exchange
Holding period	Tacks for the carryover portion of basis

Worked example. Rosa exchanges a rental duplex (adjusted basis \$150,000, value \$400,000, subject to a \$100,000 mortgage) for a small commercial building worth \$350,000 and \$50,000 of cash, with the other party assuming her mortgage. Boot received: \$50,000 cash + \$100,000 debt relief = \$150,000. Realized gain: $(\$350,000 + \$150,000) - \$150,000 = \$350,000$. Recognized gain: lesser of \$150,000 boot or \$350,000 realized, so \$150,000. Basis of the building: $\$150,000 + \$150,000 \text{ gain} - \$150,000 \text{ boot} = \$150,000$. Check: value \$350,000 minus deferred gain \$200,000 = \$150,000.

Exam trap. A taxpayer who trades in a business truck for a new one in 2025 does **not** have a like-kind exchange. The trade-in is a sale of the old truck (with section 1245 recapture) and a purchase of the new one, whose basis is its full cost.

6.4 The capitalization and repair regulations

The rule. An expenditure on tangible property must be **capitalized** if it is an **improvement**: a **betterment** (fixes a pre-existing defect, enlarges, or materially increases capacity or quality), a **restoration** (replaces a major component, rebuilds to like-new condition after the class life, or returns property to use after it had deteriorated to disrepair), or an **adaptation** to a new or different use. Everything else that keeps property in ordinarily efficient operating condition is a deductible **repair**. Several safe harbors allow current deductions by election.

Safe harbor or election	Rule
De minimis	Items costing \$2,500 or less per invoice or item (\$5,000 with an applicable financial statement); annual election by statement; must match book policy
Routine maintenance	Recurring activities expected to be performed more than once during the class life (more than once in 10 years for buildings) to keep property in operating condition
Small taxpayer safe harbor for buildings	Taxpayers with average gross receipts of \$10,000,000 or less may deduct repairs, maintenance, and improvements on a building with an unadjusted basis of \$1,000,000 or less, if the year's total does not exceed the lesser of \$10,000 or 2% of the building's unadjusted basis
Materials and supplies	Items costing \$200 or less, or with a useful life of 12 months or less, deducted when used or consumed
Partial disposition	Election to recognize loss on the remaining basis of a component (an old roof) that is replaced, so the taxpayer is not depreciating two roofs

Each building is analyzed by its **unit of property**: the building structure and each of nine building systems (HVAC, plumbing, electrical, escalators, elevators, fire protection, security, gas distribution, and other).

Replacing a building's entire HVAC system is a restoration of that system and must be capitalized; replacing one of ten rooftop units generally is a repair.

Worked example. Rosa owns a rental duplex with an unadjusted basis of \$300,000 and has \$90,000 of gross receipts. In 2025 she spends \$4,800 on a new water heater, repainting, and gutter repairs. Under the small taxpayer safe harbor she may deduct all of it, because \$4,800 does not exceed the lesser of \$10,000 or $2\% \times \$300,000 = \$6,000$. Had she spent \$7,000, the safe harbor would be unavailable and each item would be tested on its own as a repair or improvement.

6.5 Reading the business's financial records

The rule. The preparer's first job is to confirm that the business's records support the return. The **income statement** shows revenue, cost of goods sold, gross profit, operating expenses, and net income for the year. The **balance sheet** shows assets, liabilities, and owners' equity at a point in time, and must balance (assets = liabilities + equity). The two statements are linked: net income increases retained earnings or owners' capital; depreciation expense increases accumulated depreciation; and the ending balance sheet of one year must be the beginning balance sheet of the next.

Checks the exam expects you to perform:

- **Proof the beginning balances.** Schedule L, column (a), must equal the prior year's column (d). A difference means a prior-year error or an unrecorded transaction.
- **Tie depreciation.** Book depreciation expense on the income statement should equal the change in accumulated depreciation (adjusted for disposals), and tax depreciation from Form 4562 flows to Schedule M-1.
- **Tie retained earnings.** Beginning retained earnings + net income (book) – distributions ± other adjustments = ending retained earnings, as analyzed on Schedule M-2.
- **Compare year to year.** Gross profit percentage, expense ratios, and inventory turnover should be consistent with the prior year and the industry; a gross profit percentage that falls from 60% to 30% without explanation suggests unreported sales or overstated purchases.
- **Choose the right business code.** The six-digit **principal business activity code** (based on the North American Industry Classification System) is entered on Schedule C, Form 1065, Form 1120, and Form 1120-S; it should describe the activity producing the largest share of receipts. The IRS uses it to compare the return with industry norms.

6.6 Accounting methods and Form 3115

The rule. A taxpayer's **overall method** is cash, accrual, or a hybrid, and it must clearly reflect income and be applied consistently. The cash method may be used by individuals, S corporations, partnerships without C corporation partners, and any **small business taxpayer** (average gross receipts of \$31,000,000 or less); C corporations and partnerships with C corporation partners above that level, and all tax shelters, must use accrual. A business with inventories must use accrual for purchases and sales unless it is a small business taxpayer. Changing a method requires IRS consent, requested on **Form 3115**.

Method	Income	Expenses
Cash	When actually or constructively received	When paid; prepaid expenses deductible if the benefit does not extend beyond the earlier of 12 months after the benefit begins or the end of the following year (the 12-month rule)
Accrual	When all events have occurred that fix the right to receive it and the amount is reasonably determinable (all-events test), and no later than when it appears in an applicable financial statement	When all events have occurred that fix the liability, the amount is reasonably determinable, and economic performance has occurred (services performed, property delivered, or property used); the recurring item exception allows a deduction if performance occurs within 8½ months after year end
Hybrid	Accrual for purchases and sales of inventory; cash for everything else	

Form 3115 mechanics. Automatic changes (listed by designated change number in Rev. Proc. 2025-23 and its successors) are filed in duplicate: attached to the timely filed return for the year of change and a copy sent to the IRS in Ogden, with no user fee. Non-automatic changes require a user fee and must be filed during the year of change. The **section 481(a) adjustment** prevents duplication or omission of income when methods change: a **negative** adjustment (taxpayer-favorable) is deducted entirely in the year of change; a **positive** adjustment is spread over **four years**, or taken in one year if the taxpayer elects to and it is less than \$50,000.

Worked example. Bayou Fabrication, accrual method, pays a \$12,000 insurance premium on December 1, 2025 for the 12 months beginning that day. Economic performance occurs as coverage is provided, so only one month, \$1,000, is deductible in 2025 under the general rule; the recurring item exception does not apply to insurance. If Panadería Lopez, cash method, paid the same premium, Maria could deduct the entire \$12,000 in 2025 under the 12-month rule, because the benefit ends November 30, 2026, within 12 months.

Memory cue. “Negative 481 now; positive 481 over four.” The IRS lets you take a favorable adjustment at once and makes you spread an unfavorable one.

6.7 Depreciation recapture under section 280F and pass-through items

Section 280F applies to **listed property** (passenger automobiles and other property used for transportation, entertainment, or recreation). If qualified business use is more than 50% in the year the property is placed in service, accelerated depreciation, section 179, and bonus are allowed, subject to the automobile caps in Chapter

5. If business use later drops to **50% or less**, the taxpayer must **recapture** as ordinary income (Form 4797, Part IV) the excess of the depreciation actually taken over what straight-line ADS depreciation would have been, and must use ADS straight line thereafter.

Pass-through items on Schedule K-1. The owner's return reports each item in its own character: ordinary business income on Schedule E, capital gains on Schedule D, section 1231 gains on Form 4797, charitable contributions on Schedule A, section 179 subject to the owner's own limit, and credits on the owner's Form 3800. **Nondeductible expenses** (penalties, 50% of meals, life insurance premiums) reduce the owner's basis without a deduction, and **tax-exempt income** increases basis without inclusion. Guaranteed payments and S corporation wages appear separately and are never part of QBI.

6.8 Reconciling books to the return: Schedules M-1, M-2, and M-3

The rule. **Schedule M-1** reconciles net income per books to taxable income before the NOL and special deductions. **Schedule M-2** reconciles beginning to ending unappropriated retained earnings (or, for partnerships and S corporations, partners' capital and the AAA). **Schedule M-3** replaces M-1 for corporations and partnerships with total assets of **\$10,000,000 or more** and provides a far more detailed reconciliation. Corporations with total receipts and total assets each under \$250,000 are excused from Schedules L, M-1, and M-2.

Schedule M-1: Add to book income	Schedule M-1: Subtract from book income
Federal income tax expense per books	Tax-exempt interest income
Excess of capital losses over capital gains	Excess of tax depreciation over book depreciation
Income subject to tax not recorded on books this year (prepaid rent received)	Income recorded on books not taxed this year (installment gain deferred)
Expenses recorded on books not deducted: 50% of meals, entertainment, penalties, officer life insurance premiums, book depreciation in excess of tax, charitable contributions above 10%, bad debt reserve additions	Deductions on the return not expensed on books: section 179 and bonus beyond book depreciation, DRD is not here (it comes after the M-1 result)

Worked example. Bayou Fabrication's books show net income of \$100,000 after \$25,000 of federal income tax expense, \$8,000 of meals (100% expensed on books), \$3,000 of tax-exempt interest, and book depreciation of \$20,000 against tax depreciation of \$32,000. Taxable income: $\$100,000 + \$25,000 + \$4,000$ (nondeductible half of meals) $- \$3,000 - \$12,000 = \$114,000$.

6.9 Related parties and loans to and from owners

Related parties for the loss-disallowance and deferred-deduction rules of section 267 include family members (spouse, siblings, ancestors, lineal descendants, but not in-laws, aunts, uncles, or cousins), an individual and a corporation or partnership the individual owns more than 50% of (counting attributed stock), two corporations

in the same controlled group, a grantor and fiduciary of a trust, and a fiduciary and beneficiary. An accrual-basis business may not deduct an amount owed to a related cash-basis person until that person includes it in income, which is why year-end bonuses accrued to a majority shareholder are deductible only when paid.

The rule. Loans between a business and its owners are respected only if they look like loans: a written note, a fixed maturity date, a reasonable interest rate, actual repayments, and security or a realistic expectation of repayment. A “loan” that lacks these features is recharacterized: a corporation’s advance to a shareholder becomes a **constructive dividend**; a shareholder’s advance to a thinly capitalized corporation becomes a **capital contribution** (so repayments are distributions and the interest deduction disappears). Loans that carry **below-market interest** are subject to section 7872, which imputes interest at the applicable federal rate.

Below-market loan	Imputed consequences	De minimis exception
Corporation to shareholder	Corporation is treated as paying a dividend equal to the forgone interest; shareholder is treated as paying interest back	Aggregate loans of \$10,000 or less, if not tax-motivated
Employer to employee	Forgone interest is compensation (deductible by the employer, wages to the employee) and interest income to the employer	\$10,000 or less
Gift loan between individuals	Forgone interest is a gift from lender and interest income to the lender	\$10,000 or less; for loans of \$100,000 or less, imputed interest is limited to the borrower’s net investment income

Owner loans also affect basis: a partner’s loan to the partnership is a partnership liability that increases the lending partner’s basis; a shareholder’s direct loan to an S corporation creates debt basis; and a guarantee creates basis only for a partner. Forgiveness of a shareholder’s loan by a C corporation is a constructive dividend; forgiveness by an S corporation is a distribution.

6.10 Reporting, filing, and payment obligations

The rule. An extension of time to **file** is never an extension of time to **pay**. The failure-to-file penalty is **5%** of the unpaid tax per month, up to 25%, with a minimum of **\$525** (returns required to be filed in 2026) when a return is more than 60 days late; the failure-to-pay penalty is **0.5%** per month, up to 25%; when both apply in a month, the combined rate is 5%. Pass-through entities owe the per-owner penalties in Chapters 2 and 4 instead, because they owe no tax.

International information returns

Form	Who files	Penalty for failure
5471	U.S. persons who are officers, directors, or 10%-or-more shareholders of a foreign corporation	\$10,000 per form per year, plus continuation penalties
5472	A U.S. corporation that is 25% or more foreign-owned, or a foreign corporation engaged in a U.S. business, reporting transactions with related parties; also a foreign-owned U.S. disregarded entity	\$25,000 per form
8865	U.S. persons with interests in foreign partnerships	\$10,000 per form
8938	Specified individuals (and certain domestic entities) with specified foreign financial assets above thresholds	\$10,000, up to \$50,000
FinCEN Form 114 (FBAR)	Any U.S. person, including corporations, partnerships, and LLCs , with a financial interest in or signature authority over foreign accounts whose aggregate value exceeded \$10,000 at any time; due April 15 with an automatic extension to October 15; filed with FinCEN, not the IRS	Up to \$10,000 (indexed) per non-willful violation; the greater of \$100,000 (indexed) or 50% of the balance if willful
1042 and 1042-S	Withholding agents paying U.S.-source income to foreign persons (30% withholding unless a treaty applies)	Information return penalties

Excise taxes and other payment obligations

Obligation	Form and timing
Federal excise taxes (fuel, air transportation, indoor tanning, certain manufacturers' taxes)	Form 720, quarterly, due the last day of the month after the quarter; semimonthly deposits for most taxes
Heavy highway vehicle use tax (vehicles of 55,000 pounds or more)	Form 2290, due the last day of the month after the vehicle is first used (August 31 for a July 1 tax year)
Wagering taxes	Forms 730 (monthly) and 11-C (annual occupational tax)
Estimated tax, sole proprietors and partners (paid individually)	Form 1040-ES on April 15, June 16, September 15, 2025, and January 15, 2026; safe harbor is the lesser of 90% of the current year's tax or 100% of the prior year's (110% if prior-year AGI exceeded \$150,000)
Estimated tax, C corporations	15th day of the 4th, 6th, 9th, and 12th months (Chapter 3)

Obligation	Form and timing
All federal tax deposits	EFTPS; paying a deposit by check with the return draws the 10% failure-to-deposit penalty

Record-keeping

Records	Retain
Returns and supporting records, general rule	3 years from the later of the due date or filing date
If income was underreported by more than 25%	6 years
Bad debt or worthless securities deductions	7 years
Employment tax records	4 years after the tax is due or paid, whichever is later
Records supporting basis of property	Until the limitations period expires for the year the property is disposed of
No return filed, or a fraudulent return	Indefinitely
Travel, meals, gifts, listed property (section 274(d))	Contemporaneous records of amount, time, place, and business purpose (and business relationship for meals and gifts); receipts required for lodging and for other expenses of \$75 or more

An **accountable plan** reimbursement requires a business connection, adequate substantiation within a reasonable time (60 days is deemed reasonable), and return of any excess within a reasonable time (120 days). Reimbursements that do not meet all three are wages.

6.11 Advising the owner

Choosing an entity

Consideration	Sole proprietorship	Partnership or LLC	S corporation	C corporation
Formation cost and complexity	Lowest	Moderate (agreement)	Moderate (state filing plus Form 2553)	Highest (charter, bylaws, minutes)
Self-employment or payroll tax on profits	SE tax on all profit	SE tax on general partners' shares	FICA only on reasonable wages	FICA on wages; dividends not subject
Double taxation	No	No	No (with exceptions)	Yes
Losses to owners	Yes	Yes	Yes	No (stay in corporation)
Owner fringe benefits	Taxable	Taxable	Taxable over 2%	Excludable
QBI deduction	Yes	Yes	Yes	No
Flexibility in allocating income	None	High (special allocations)	None (pro rata)	Through classes of stock

Consideration	Sole proprietorship	Partnership or LLC	S corporation	C corporation
Raising outside capital	Limited	Moderate	Limited (100 shareholders, one class)	Best
Basis from entity debt	N/A	Yes	No	No
Sale of the business	Asset sale	Asset or interest sale	Stock sale possible; buyers may prefer assets	Stock sale (QSBS exclusion possible)

Commingling, transfers, and the life cycle

- **Separate accounts.** Business and personal funds should never share a bank account. Personal expenses paid from a business account are **draws** for a sole proprietor, **distributions** for a partner or S shareholder, and **constructive dividends** for a C corporation shareholder; they are never deductible, and routine commingling is the fastest way to lose limited liability protection under state law.
- **Transfers in.** Contributions of property are tax-free under section 721 (partnerships, no control test) or section 351 (corporations, 80% control). The entity takes a carryover basis, so appreciated property brings its built-in gain with it.
- **Transfers out.** Distributions of appreciated property are tax-free from a partnership but trigger corporate-level gain for C and S corporations. Converting a business asset to personal use is not a sale, but it ends depreciation and, for listed property that drops to 50% or less, triggers recapture.
- **Dissolution.** A corporation adopting a plan of liquidation files **Form 966** within 30 days; every entity files a **final return** with the “final return” box checked, final employment tax returns, final Forms W-2 and 1099, and a letter to close its EIN account. Liquidating distributions follow the rules in Chapters 2 through 4. Unamortized start-up and organizational costs are deducted in the final year.

Industry-specific issues

Industry	Issue
Specified service businesses (consulting, health, law, accounting, financial services)	QBI deduction phases out above the thresholds; entity choice does not change SSTB status; reasonable compensation scrutiny
Cash-intensive businesses (restaurants, salons, used car lots)	Form 8300 reporting; tip reporting; IRS indirect methods of reconstructing income
Construction	Long-term contracts must use the percentage-of-completion method unless the contractor is a small business taxpayer and the contract is expected to take two years or less (completed-contract method available)
Real estate	Passive activity rules; real estate professional status; depreciation recapture; like-kind exchanges
Farming	Chapter 7

Worker classification

The rule. Whether a worker is an **employee** or an **independent contractor** depends on the common-law test, organized into three categories of evidence: **behavioral control** (instructions, training, evaluation), **financial control** (investment, unreimbursed expenses, opportunity for profit or loss, services available to the market, method of payment), and the **type of relationship** (written contracts, benefits, permanency, whether the work is a key aspect of the business). No single factor controls, and the labels the parties use, full-time versus part-time status, and where the work is performed do not decide the question.

Tool	Use
Form SS-8	Either the business or the worker may ask the IRS for a determination; there is no appeal, and the IRS may take months
Form 8919	A worker who believes he or she was misclassified reports the employee share of FICA without paying the employer share
Section 530 relief	A business that had a reasonable basis (judicial precedent, a prior IRS audit, or industry practice) for treating workers as contractors, consistently treated similar workers the same way, and filed all required Forms 1099 is relieved of employment tax liability for the misclassification
Section 3509	Reduced employer liability rates for unintentional misclassification when Forms 1099 were filed (1.5% of wages for income tax withholding and 20% of the employee FICA share)
Voluntary Classification Settlement Program (Form 8952)	A business not under employment tax audit may reclassify workers prospectively and pay 10% of the section 3509 liability for the most recent year, with no interest or penalties
Statutory employees and statutory nonemployees	Statutory employees (Chapter 5) are employees for FICA regardless of the common-law test; direct sellers, licensed real estate agents, and certain companion sitters are statutory nonemployees (contractors) if paid by output and under a written contract

Worked example. Lopez Brothers Landscaping pays Jorge \$25 an hour, sets his schedule, provides the mowers and truck, trains him on the LLC's methods, and has used him 40 hours a week for two years with no written contract. Despite calling him a "1099 contractor," every category points to employment: behavioral control (schedule and training), financial control (no investment, hourly pay, no chance of loss), and relationship (permanent, core work). The LLC should put Jorge on payroll; if the IRS reclassifies him, section 530 relief fails because the LLC had no reasonable basis, but the reduced section 3509 rates apply if Forms 1099 were filed.

Tax planning with deductions and credits

- **Timing.** A cash-method business can accelerate deductions by paying expenses before year end (within the 12-month rule) and defer income by delaying billing, though it cannot refuse payment that is available (constructive receipt). An accrual-method business cannot deduct by prepaying.
- **Section 179 versus bonus versus MACRS.** Section 179 can be taken asset by asset and in any amount, but cannot create a loss. Bonus is all or nothing by class, has no income limit, and can create an NOL. Regular MACRS spreads deductions into future years when the owner expects higher rates. Many states do not conform to bonus or to the \$2,500,000 section 179 limit, so state taxable income may differ.
- **Retirement plans.** Employer contributions to a SEP or profit-sharing plan may be made up to the **due date of the return including extensions**; elective deferrals to a 401(k) or SIMPLE must come out of pay by December 31. A new plan may be adopted after year end (by the return due date) for the prior year.
- **NOLs.** Because the carryforward is limited to 80% of taxable income, a business expecting a loss may prefer to defer deductions into the profitable year rather than enlarge the NOL.
- **Credits before deductions.** A dollar of credit is worth more than a dollar of deduction, but most credits require reducing the related deduction by the credit amount.

ACA compliance for employers

The rule. An **applicable large employer (ALE)** is one with an average of **50 or more full-time employees** (including full-time equivalents) in the prior calendar year, where full-time means **30 or more hours per week** (130 hours per month). An ALE must offer minimum essential coverage that is **affordable** and provides **minimum value** to at least 95% of its full-time employees and their dependents, or pay the **employer shared responsibility payment**, and must report on **Forms 1094-C and 1095-C**. Employers with fewer than 50 full-time employees owe no payment and, unless self-insured, file nothing.

2025 element	Amount or rule
Payment for not offering coverage to 95% (section 4980H(a)), if at least one employee receives a premium tax credit	\$2,900 per year × (full-time employees – 30)
Payment for offering coverage that is unaffordable or lacks minimum value (section 4980H(b))	\$4,350 per year for each full-time employee who receives a premium tax credit, capped at the (a) amount
Affordability	Employee's required contribution for self-only coverage does not exceed 9.02% of household income (safe harbors: W-2 wages, rate of pay, federal poverty line)
Minimum value	Plan pays at least 60% of total allowed costs
Forms 1095-C to employees	By March 2, 2026 (for 2025 coverage); Forms 1094-C and 1095-C to the IRS by March 31, 2026 if filed electronically (required for 10 or more returns)
Small employers with self-insured plans	Forms 1094-B and 1095-B

2025 element	Amount or rule
Qualified small employer HRA (QSEHRA)	Employers with fewer than 50 employees and no group plan may reimburse premiums and medical costs up to \$6,350 self-only or \$12,800 family for 2025
Small business health care credit	Chapter 5, section 5.14

Worked example. Bayou Fabrication averaged 60 full-time employees in 2024 and offers no health coverage in 2025. Two employees buy marketplace coverage and receive the premium tax credit. The 4980H(a) payment is $\$2,900 \times (60 - 30) = \$87,000$ for the year, assessed by IRS letter after the employees' returns are processed. Had it offered affordable, minimum-value coverage to 95% of full-time employees, the only exposure would be \$4,350 for each full-time employee who still qualified for a credit.

Quick Check: Chapter 6

- Carlos converts a personal computer that cost \$3,000 to 100% business use when it is worth \$1,200. His depreciable basis is:
 - \$3,000
 - \$1,200
 - \$1,800
 - \$0, because personal property converted to business use cannot be depreciated
- A sole proprietor sells a machine for \$18,000. He bought it for \$20,000 and claimed \$14,000 of depreciation. The gain is:
 - \$12,000, all ordinary income under section 1245
 - \$12,000, all long-term capital gain under section 1231
 - \$12,000: \$2,000 ordinary and \$10,000 capital
 - \$2,000 capital loss
- During 2025 a C corporation has a \$30,000 section 1231 gain and a \$10,000 section 1231 loss, and it deducted a net section 1231 loss of \$12,000 in 2022. How much of the 2025 net section 1231 gain is treated as ordinary income?
 - \$0
 - \$8,000
 - \$12,000
 - \$20,000

- 4.** Rosa exchanges investment land (basis \$80,000, value \$200,000) for a rental building worth \$170,000 plus \$30,000 cash. Her recognized gain and basis in the building are:
- A. Gain \$120,000; basis \$170,000
 - B. Gain \$30,000; basis \$80,000
 - C. Gain \$30,000; basis \$110,000
 - D. Gain \$0; basis \$50,000
- 5.** Which expenditure must be capitalized rather than deducted as a repair?
- A. Replacing the entire roof of a warehouse
 - B. Repainting the warehouse interior
 - C. Replacing three broken windows out of forty
 - D. Annual servicing of the HVAC units
- 6.** A partnership changes from an impermissible to a permissible depreciation method with IRS consent and computes a positive section 481(a) adjustment of \$80,000. Absent any election, the adjustment is:
- A. Included in income entirely in the year of change
 - B. Spread evenly over four years, \$20,000 per year
 - C. Spread over the remaining recovery period of the assets
 - D. Ignored, because depreciation changes have no 481(a) adjustment
- 7.** A C corporation's books show net income of \$200,000, which includes \$40,000 of federal income tax expense, \$6,000 of tax-exempt interest, and \$10,000 of meals expensed in full. Tax depreciation exceeds book depreciation by \$15,000. Taxable income on Schedule M-1 is:
- A. \$224,000
 - B. \$239,000
 - C. \$229,000
 - D. \$219,000
- 8.** Which pair are related parties for purposes of the section 267 loss disallowance rule?
- A. A taxpayer and her brother-in-law
 - B. A taxpayer and her brother
 - C. A taxpayer and her aunt
 - D. A taxpayer and a corporation in which she owns 40% of the stock
- 9.** A business that filed its 2025 Form 1120 four months late with \$10,000 of unpaid tax owes a failure-to-file penalty of:
- A. \$500
 - B. \$2,000
 - C. \$1,800
 - D. \$525

- 10.** Which fact most strongly indicates that a worker is an independent contractor?
- A. The worker is paid by the hour.
 - B. The worker receives detailed instructions on how to do the job.
 - C. The worker has a significant investment in her own equipment and offers services to the public.
 - D. The worker has been engaged continuously for five years.
- 11.** How long must an employer retain employment tax records?
- A. 3 years from the date the return was filed
 - B. 4 years after the tax becomes due or is paid, whichever is later
 - C. 6 years from the end of the calendar year
 - D. 7 years
- 12.** An employer averaged 70 full-time employees in 2024, offered no coverage in 2025, and three employees received the premium tax credit. Its 2025 employer shared responsibility payment is:
- A. \$13,050
 - B. \$116,000
 - C. \$203,000
 - D. \$0, because only three employees received the credit

Answers.

- 1. B.** When personal property is converted to business use, the basis for depreciation (and for loss) is the lesser of adjusted basis or fair market value at conversion, \$1,200.
- 2. A.** Gain is $\$18,000 - (\$20,000 - \$14,000) = \$12,000$. Because the gain does not exceed the \$14,000 of depreciation taken, all of it is section 1245 ordinary income. Section 1231 gain arises only to the extent the sale price exceeds original cost.
- 3. C.** Net section 1231 gain for 2025 is $\$30,000 - \$10,000 = \$20,000$. The five-year lookback recharacterizes it as ordinary to the extent of unrecaptured net section 1231 losses from 2020 through 2024, here \$12,000. The remaining \$8,000 is long-term capital gain.
- 4. B.** Realized gain is $\$200,000 - \$80,000 = \$120,000$. Boot received is \$30,000 cash, so recognized gain is \$30,000, the lesser of boot or realized gain. Basis in the building: $\$80,000$ old basis + \$30,000 gain recognized – \$30,000 boot received = \$80,000. Check against value: $\$170,000 - \$90,000$ deferred gain = \$80,000.
- 5. A.** Replacing the entire roof is a restoration of a major component of the building structure and must be capitalized. Repainting, replacing a small fraction of windows, and routine servicing are repairs or routine maintenance.
- 6. B.** A positive (unfavorable) section 481(a) adjustment is taken into income ratably over four years beginning with the year of change, unless it is under \$50,000 and the taxpayer elects a one-year inclusion. A negative adjustment is deducted entirely in the year of change.

7. A. $\$200,000 + \$40,000$ (federal tax) + $\$5,000$ (nondeductible 50% of meals) – $\$6,000$ (tax-exempt interest) – $\$15,000$ (excess tax depreciation) = $\$224,000$.

8. B. Section 267 family members are spouses, siblings (whole or half blood), ancestors, and lineal descendants. In-laws, aunts, uncles, and cousins are not related parties. A corporation is related only if the taxpayer owns more than 50% of its stock.

9. B. The failure-to-file penalty is 5% of the unpaid tax per month or part of a month, up to 25%: $5\% \times \$10,000 \times 4 = \$2,000$. The \$525 minimum applies only when it exceeds the computed penalty for a return more than 60 days late.

10. C. Significant investment and making services available to the market are financial-control factors pointing to independent contractor status. Hourly pay, detailed instructions, and a continuing relationship all point toward employment.

11. B. Employment tax records must be kept for at least four years after the date the tax becomes due or is paid, whichever is later.

12. B. Because the employer offered no coverage and at least one full-time employee received the credit, the 4980H(a) payment applies: $\$2,900 \times (70 - 30) = \$116,000$. The number of employees who actually received the credit matters only for the 4980H(b) payment, which applies when coverage is offered but is unaffordable or lacks minimum value.

Chapter 7. Specialized Returns and Taxpayers

Domain 3 • 18 scored questions (21%)

What the outline tests: trust and estate income tax (trust types, distributable net income and accounting income, exclusions, exemptions and deductions, fraudulent trusts, income allocation between corpus and income, K-1 items, filing requirements, tax years, and penalties); exempt organizations (qualifying for and maintaining exempt status, applying on Forms 1023 and 1024, the Form 990 series, unrelated business taxable income); retirement plans (employer and employee contributions, reporting, plans for the self-employed, prohibited transactions, qualified versus nonqualified plans, nondiscrimination rules); farmers (farm income, depreciation, disaster provisions, farm rentals, Schedule J, Schedule SE, estimated tax); and rental property (real estate professionals, commercial versus residential, mixed-use and vacation homes, the passive loss rules and the \$25,000 allowance, rental income and expenses).

Domain 3 is five small specialties, each with its own form and its own vocabulary. The exam does not expect you to be a fiduciary accountant or a farm specialist; it expects you to know the thresholds, the forms, and the handful of rules that differ from the general business rules you learned in Chapters 5 and 6. This chapter is organized to make those differences visible.

7.1 Trusts and estates: who files, when, and at what rates

The rule. An **estate** must file Form 1041 if it has gross income of **\$600 or more** for the year or any beneficiary who is a nonresident alien. A **trust** must file if it has **any taxable income**, gross income of \$600 or more, or a nonresident alien beneficiary. The return is due the **15th day of the fourth month** after year end (April 15 for calendar years), with a **5½-month** extension on Form 7004 (to September 30). Estates may choose a fiscal year; trusts must use the calendar year, except that a qualified revocable trust may elect under section 645 to be treated as part of the estate.

2025 element	Amount
Tax brackets	10% up to \$3,150; 24% up to \$11,450; 35% up to \$15,650; 37% above \$15,650
Net investment income tax	3.8% on the lesser of undistributed net investment income or AGI above \$15,650
AMT exemption	\$30,700
Exemption (in lieu of a standard deduction)	Estate \$600 ; simple trust \$300 ; complex trust \$100

2025 element	Amount
Estimated tax	Required of trusts and of estates after their first two tax years, using the individual rules
Capital gains	Taxed at the 0%, 15%, and 20% rates with compressed thresholds

Memory cue. “Six, three, one”: \$600 for an estate, \$300 for a simple trust, \$100 for a complex trust. The simple trust must distribute all its income, so it gets more; the complex trust may accumulate, so it gets less.

Types of trusts

Trust	Defining feature	Who pays the tax
Simple	Required to distribute all income currently; makes no charitable contributions; distributes no corpus during the year	Beneficiaries, on the income required to be distributed (whether or not paid)
Complex	Any trust that is not simple in that year (may accumulate income, distribute corpus, or give to charity)	Split between trust and beneficiaries under the DNI rules
Grantor	The grantor (or another person) keeps a power over or interest in the trust: the power to revoke, a reversionary interest worth more than 5%, control over beneficial enjoyment, certain administrative powers, or the right to income. Every revocable living trust is a grantor trust	The grantor, on his or her own Form 1040; the trust files no return or an information-only Form 1041
Irrevocable (non-grantor)	Grantor has given up the powers above	Trust and beneficiaries
Testamentary	Created by will; funded at death	Trust and beneficiaries
Foreign	Not subject to the primary supervision of a U.S. court and control of U.S. persons	U.S. owners and beneficiaries report on Forms 3520 and 3520-A
Abusive (“fraudulent”) trusts	Arrangements that purport to shift a taxpayer’s wages or business income to a trust, deduct personal living expenses as trust expenses, or layer domestic and foreign trusts to hide income	The taxpayer; the IRS disregards sham trusts, assesses tax, penalties, and interest, and may pursue promoters criminally

Exam trap. A trust can be simple one year and complex the next. The classification is made **annually** based on what the trust actually did that year. A trust whose instrument requires all income to be distributed is still complex in any year it distributes corpus.

7.2 Accounting income, distributable net income, and the distribution deduction

The rule. A trust or estate is a conduit for the income it distributes and a taxpayer on the income it keeps. **Distributable net income (DNI)** is the measuring stick: it caps the **distribution deduction** the entity takes and the amount of income the **beneficiaries** must report, and it carries the **character** of the income (interest, dividends, tax-exempt) through to them. DNI is taxable income before the distribution deduction and the exemption, **plus** net tax-exempt interest, **minus** capital gains allocated to corpus (and **plus** capital losses that reduced taxable income).

Concept	Definition	Governs
Fiduciary accounting income (FAI)	Income as defined by the trust instrument and state law; typically interest, dividends, and rents; capital gains are usually corpus	What a simple trust must distribute; first-tier distributions
Distributable net income (DNI)	Taxable income + exemption + tax-exempt interest – capital gains allocated to corpus + capital losses	Maximum distribution deduction and maximum beneficiary inclusion
Distribution deduction	Lesser of DNI (less tax-exempt income) or amounts distributed or required to be distributed	What the entity deducts
Beneficiary's inclusion	Lesser of DNI or distributions, in the character of DNI	What goes on Schedule K-1

Simple trust. Beneficiaries report the lesser of DNI or the accounting income required to be distributed, whether or not it was actually paid. The trust pays tax only on capital gains allocated to corpus (less its \$300 exemption).

Complex trusts and estates. Distributions are divided into **tiers**: first-tier distributions (income required to be distributed currently) absorb DNI first; second-tier distributions (everything else) absorb the remainder. If total distributions exceed DNI, the excess is a tax-free distribution of corpus. Two elections and one exclusion matter:

- The **65-day election** (section 663(b)) lets a complex trust or estate treat a distribution made within the first 65 days of the following year as made on December 31.
- **Specific bequests** of a sum of money or specific property paid in three or fewer installments (section 663(a)) are neither deductible by the estate nor taxable to the beneficiary.

- The **separate share rule** computes DNI separately for each beneficiary's share when the instrument creates substantially separate and independent shares.

Worked example. The Rosa Lopez Family Trust, a simple trust, earns \$20,000 of dividends and \$4,000 of tax-exempt interest, pays a \$1,000 trustee fee (allocated to taxable income), and realizes a \$6,000 capital gain allocated to corpus. Accounting income: \$24,000 (the gain is corpus). Taxable income before distribution deduction and exemption: $\$20,000 - \$1,000 + \$6,000 = \$25,000$. DNI: $\$25,000 + \$4,000 - \$6,000 = \$23,000$. Distribution deduction: $\$23,000 - \$4,000 \text{ tax-exempt} = \$19,000$. The beneficiary reports \$19,000 of dividends and receives \$4,000 of tax-exempt interest. The trust pays tax on $\$6,000 - \$300 = \$5,700$ of capital gain.

Worked example (complex trust). A complex trust has DNI of \$30,000, all interest. It is required to distribute \$18,000 of income to Maria (first tier) and the trustee also distributes \$20,000 of accumulated funds to Mateo (second tier). Maria reports \$18,000. The remaining \$12,000 of DNI goes to Mateo, who reports \$12,000; the other \$8,000 he received is tax-free corpus. The trust deducts the full \$30,000 of DNI and has no taxable income.

Deductions, allocations, and K-1 items

Item	Treatment on Form 1041
Fiduciary, attorney, and accounting fees; other administration costs that would not have been incurred if the property were not held in trust	Fully deductible; not subject to the suspended 2% miscellaneous rule (section 67(e)). An estate may not deduct the same expense on both Form 706 and Form 1041; it must waive the estate-tax deduction
Charitable contributions	Deductible without percentage limit by complex trusts and estates, but only if paid from gross income under the terms of the governing instrument; simple trusts by definition make none
Depreciation and depletion	Allocated between the entity and beneficiaries in proportion to the accounting income allocated to each, unless the instrument requires a reserve
Income in respect of a decedent (IRD)	Taxed to whoever receives it (estate or beneficiary); a deduction is allowed for the estate tax attributable to the IRD (section 691(c))
Medical expenses of the decedent paid by the estate within one year of death	May be deducted on the decedent's final Form 1040 by election instead of on Form 706
Funeral expenses	Never deductible on Form 1041 (Form 706 only)
Excess deductions and unused capital loss and NOL carryovers in the final year	Pass through to beneficiaries on Schedule K-1 (box 11); excess deductions retain their character as adjustments to income or itemized deductions

Item	Treatment on Form 1041
Tax-exempt income	Reported to beneficiaries; related expenses are not deductible

Schedule K-1 (Form 1041) separately states each class of income (interest, ordinary and qualified dividends, net short- and long-term capital gain when distributed, rental and business income, other income), directly apportioned deductions (depreciation), credits, and the final-year items above.

Penalties

Form 1041 is subject to the same failure-to-file (5% per month, minimum \$525 if more than 60 days late for returns required to be filed in 2026) and failure-to-pay (0.5%) penalties as other income tax returns, plus information-return penalties for late or incorrect Schedules K-1 and the estimated tax penalty on Form 2210.

7.3 Exempt organizations

The rule. An organization is exempt under **section 501(c)(3)** if it is organized and operated **exclusively** for religious, charitable, scientific, literary, educational, public-safety-testing, amateur-sports, or cruelty-prevention purposes; no part of its net earnings **inures** to any private shareholder or individual; **no substantial part** of its activities is lobbying; and it participates in **no political campaign** whatsoever. Only contributions to 501(c)(3) organizations (and a few others, such as veterans' organizations) are deductible by donors. Most other 501(c) organizations are exempt from tax but do not receive deductible contributions.

Section	Organization	Lobbying	Political campaigns	Donor deduction
501(c)(3)	Charities, churches, schools, hospitals, foundations	No substantial part (or the section 501(h) expenditure test by election on Form 5768)	Absolutely prohibited	Yes
501(c)(4)	Social welfare organizations, civic leagues	Unlimited if related to purpose	Permitted if not the primary activity	No
501(c)(5)	Labor, agricultural, horticultural organizations	Permitted	Limited	No
501(c)(6)	Business leagues, chambers of commerce, trade associations	Permitted (members' dues partly nondeductible)	Limited	No (dues may be business expenses)
501(c)(7)	Social and recreational clubs	Permitted	Limited	No

Section	Organization	Lobbying	Political campaigns	Donor deduction
501(c)(19)	Veterans' organizations	Permitted	Limited	Yes, if 90% war veterans

Applying for recognition

Form	Who	User fee	Notes
1023	501(c)(3) applicants	\$600	Filed electronically on Pay.gov; recognition is retroactive to formation if filed within 27 months of the end of the month of formation
1023-EZ	Small 501(c)(3) applicants: projected annual gross receipts of \$50,000 or less for three years and total assets of \$250,000 or less ; not churches, schools, hospitals, or supporting organizations	\$275	Streamlined online form
1024	Most other 501(c) organizations	\$600	
1024-A	501(c)(4) organizations seeking a determination letter	\$600	Every 501(c)(4) must also notify the IRS of its existence on Form 8976 within 60 days of formation, whether or not it applies
None required	Churches, their integrated auxiliaries, and organizations whose gross receipts are normally \$5,000 or less		Exempt automatically, but may apply to receive a determination letter

A 501(c)(3) organization is a **private foundation** unless it demonstrates public support (generally one-third of support from the public or government) or is a church, school, hospital, or supporting organization. Private foundations file Form 990-PF, pay a 1.39% excise tax on net investment income, must distribute about 5% of asset value annually, and face excise taxes on self-dealing with substantial contributors and managers.

Annual filing and maintaining status

Form	Who files	Due
990-N (e-Postcard)	Gross receipts normally \$50,000 or less	15th day of the 5th month after year end (May 15 for calendar years)

Form	Who files	Due
990-EZ	Gross receipts under \$200,000 and total assets under \$500,000	May 15
990	Gross receipts of \$200,000 or more or total assets of \$500,000 or more	May 15
990-PF	Every private foundation, regardless of size	May 15
990-T	Any exempt organization with \$1,000 or more of gross unrelated business income	May 15 (April 15 for trusts)
8868	Automatic six-month extension for the above (not for 990-N)	By the original due date

Churches, their auxiliaries, and governmental units are exempt from filing. An organization that fails to file for **three consecutive years** has its exemption **automatically revoked**; reinstatement requires a new application, and small organizations that apply within 15 months of revocation may be reinstated retroactively.

Compliance rule	Detail
Late Form 990 penalty (returns required to be filed in 2026)	\$25 per day , up to the lesser of \$13,000 or 5% of gross receipts; \$130 per day up to \$65,000 for organizations with gross receipts over \$1,309,500 ; a separate \$10-per-day penalty on responsible managers who ignore an IRS demand
Public disclosure	Forms 990 (and 990-T for charities) for the last three years and the exemption application must be available for public inspection; penalties of \$25 per day
Donor acknowledgments	A donor may not deduct any single contribution of \$250 or more without a contemporaneous written acknowledgment stating whether goods or services were provided; for a payment over \$75 that is partly a contribution and partly a purchase (quid pro quo), the charity must disclose the deductible portion
Excess benefit transactions (501(c)(3) and (c)(4))	Excise tax of 25% on the disqualified person who receives an excess benefit (200% if not corrected) and 10% on managers who approved it

Unrelated business taxable income

The rule. An exempt organization is taxed at the **21% corporate rate** (or trust rates for trusts) on income from a **trade or business** that is **regularly carried on** and **not substantially related** to its exempt purpose, less directly connected deductions and a **\$1,000 specific deduction**, reported on **Form 990-T**. Each unrelated business is computed separately so a loss in one cannot offset income in another. The fact that the profits fund the exempt purpose does not make the activity related.

Excluded from UBTI	Included in UBTI
Dividends, interest, annuities, royalties, and rents from real property (unless debt-financed)	Rents from personal property; rents from debt-financed property in proportion to the debt
Gains on the sale of property other than inventory	Sales of inventory in an unrelated business
Activities performed substantially by volunteers ; sales of donated merchandise (thrift shops); activities for the convenience of members, students, patients, or employees (a university cafeteria)	A commercial restaurant open to the public run by a museum
Qualified sponsorship payments (acknowledgment without advertising); bingo in states where it is legal and commercially unavailable; distribution of low-cost articles (\$13.60 or less for 2025); qualified convention and trade show income	Advertising in the organization's publications; sale of mailing lists to commercial firms
Research for government or by a university or hospital	Services unrelated to the exempt purpose sold to the public

Worked example. Houston Reading Alliance, a 501(c)(3), had 2025 gross receipts of \$180,000 and year-end assets of \$320,000, so it files Form 990-EZ by May 15, 2026. It also earned \$9,000 selling advertising in its newsletter, with \$2,500 of directly connected costs. UBTI: \$9,000 – \$2,500 – \$1,000 specific deduction = \$5,500, taxed at 21% (\$1,155) on Form 990-T. The \$30,000 it earned from a thrift shop selling donated books is excluded.

Exam trap. Form 990-N eligibility is based on gross receipts **normally** \$50,000 or less (an average over three years), not the current year alone. And “under \$200,000 and under \$500,000” means an organization must fail **either** test to be forced onto the full Form 990: \$150,000 of receipts with \$600,000 of assets requires Form 990.

7.4 Retirement plans

The rule. A **qualified plan** gives the employer a current deduction, lets the trust's earnings grow tax-free, and defers the employee's tax until distribution, in exchange for meeting strict rules on participation, vesting, nondiscrimination, contribution limits, and reporting. A **nonqualified** deferred compensation plan has none of those rules, but the employer's deduction is deferred until the employee is taxed, and amounts that are not subject to a substantial risk of forfeiture may be taxed immediately.

2025 limits

Limit	2025 amount
Elective deferrals to 401(k), 403(b), and most 457 plans	\$23,500
Catch-up contribution, age 50 and over	\$7,500; \$11,250 for participants who reach age 60, 61, 62, or 63 during 2025
Total annual additions to a defined contribution account (employer + employee, excluding catch-up)	\$70,000
Annual benefit from a defined benefit plan	\$280,000
Compensation taken into account	\$350,000
Highly compensated employee	Compensation above \$160,000 in the prior year, or a more-than-5% owner
Key employee (top-heavy test)	Officer with compensation above \$230,000 , a more-than-5% owner, or a more-than-1% owner with compensation above \$150,000
SIMPLE IRA deferral	\$16,500 ; catch-up \$3,500 (age 50) or \$5,250 (ages 60 to 63); employers with 25 or fewer employees may permit \$17,600 and \$3,850
SEP minimum compensation to require coverage	\$750
Employer deduction, defined contribution plans	25% of aggregate compensation (elective deferrals do not count against the 25%)
Form 5500-EZ filing threshold (one-participant plans)	Plan assets over \$250,000 at year end

Qualified plan requirements

Requirement	Rule
Participation	May not exclude employees who are age 21 and have one year of service (1,000 hours); long-term part-time employees with 500 hours in two consecutive years must be allowed to defer (401(k)) beginning in 2025

Requirement	Rule
Vesting of employer contributions	Either 3-year cliff or 2-to-6-year graded (20% per year); elective deferrals, SEP, SIMPLE, and safe-harbor contributions are always 100% vested
Coverage	Must benefit at least 70% of non-highly compensated employees relative to highly compensated (ratio percentage test) or satisfy the average benefit test
Nondiscrimination (401(k))	The ADP/ACP tests compare average deferral and matching percentages of highly compensated to non-highly compensated employees; failing plans refund excess deferrals. A safe harbor 401(k) (3% nonelective contribution to all, or a match of 100% on the first 3% plus 50% on the next 2%) is exempt from the tests
Top-heavy	If key employees' account balances exceed 60% of the total, non-key employees must receive a minimum 3% contribution and faster vesting
Contribution deadline	Employer contributions deductible if made by the due date of the return including extensions ; elective deferrals must be deposited as soon as administratively feasible (small plans: within 7 business days)
Reporting	Form 5500 series by the last day of the 7th month after the plan year (July 31 for calendar years), extended 2½ months on Form 5558 ; Form 1099-R for distributions; Form 945 for withholding; Form 8955-SSA for separated participants with deferred benefits

Distributions

Distributions before age **59½** are subject to a **10% additional tax** unless an exception applies (death, disability, separation from service at 55 or later, substantially equal periodic payments, medical expenses above 7.5% of AGI, QDRO payments, up to \$1,000 for personal emergencies, and others). Eligible rollover distributions paid to the participant are subject to **20% mandatory withholding**; a direct rollover avoids it. Required minimum distributions begin at age **73** (the required beginning date is April 1 of the following year, or after retirement for non-5%-owners still working), with a **25% excise tax** on shortfalls, reduced to 10% if corrected within two years. Plan loans are limited to the lesser of \$50,000 or 50% of the vested balance and generally must be repaid within five years.

Plans for the self-employed

	SEP-IRA	SIMPLE IRA	Solo 401(k)
Who may adopt	Any employer	Employers with 100 or fewer employees who earned \$5,000 or more, with no other plan	Owner-only businesses (and spouse)

	SEP-IRA	SIMPLE IRA	Solo 401(k)
Employee deferrals	None	Up to \$16,500 plus catch-up	Up to \$23,500 plus catch-up
Employer contribution	Discretionary, up to 25% of compensation (20% of net SE earnings after the SE tax deduction for the owner), maximum \$70,000	Mandatory: either a 100% match up to 3% of pay (may be cut to 1% in two of five years) or a 2% nonelective contribution to all eligible employees	Up to 25% of compensation, combined with deferrals capped at \$70,000
Who must be covered	Employees age 21 who worked in 3 of the last 5 years and earned at least \$750	Employees who earned \$5,000 in any two prior years and are expected to this year	Not applicable
Vesting	100% immediate	100% immediate	Immediate for deferrals
Deadline to establish	Return due date including extensions	October 1 of the year (or as soon as feasible for new employers)	December 31 to make deferrals
Deadline to contribute	Return due date including extensions	Deferrals within 30 days after month end; employer contributions by return due date including extensions	Same as SEP for employer share
Early withdrawal	10% additional tax before 59½	25% additional tax during the first two years of participation, 10% thereafter	10%
Annual report	None (Form 5305-SEP)	None (Form 5304-SIMPLE or 5305-SIMPLE)	Form 5500-EZ if assets exceed \$250,000

Worked example. Priya's consulting practice (sole proprietorship) has net profit of \$120,000 in 2025 and no employees. Her deductible half of SE tax is about \$8,478, leaving \$111,522. SEP contribution: $20\% \times \$111,522 = \$22,304$, deductible on Schedule 1 and payable as late as October 15, 2026 if she extends. A solo 401(k) would let her defer \$23,500 plus make the same \$22,304 employer contribution, for \$45,804.

Worked example (SIMPLE match). Panadería Lopez, Inc. adopts a SIMPLE IRA with the 3% match. An employee earning \$40,000 defers \$3,000 (7.5%); the corporation must contribute \$1,200 (3% of \$40,000). An employee earning \$40,000 who defers nothing receives no match. Had the corporation chosen the 2% nonelective option, both employees would receive \$800.

Prohibited transactions

A **prohibited transaction** is a sale, exchange, lease, loan, or furnishing of goods or services between a plan and a **disqualified person** (the employer, a fiduciary, a 50%-or-more owner, family members, and a person providing services to the plan), or use of plan assets for a fiduciary's own benefit. The disqualified person owes

an excise tax of **15%** of the amount involved for each year until corrected, rising to **100%** if not corrected. If an **IRA** owner engages in a prohibited transaction, the account ceases to be an IRA as of January 1 of that year and its entire value is deemed distributed. Plan loans to participants are permitted under the statutory exemption if they meet the dollar and repayment limits.

Qualified versus nonqualified plans

	Qualified	Nonqualified
Employer deduction	When contributed	When the employee includes the amount in income
Employee taxation	When distributed	When paid, or earlier if vested and funded (or if section 409A's election and distribution timing rules are violated: income plus a 20% additional tax)
Assets	Held in trust beyond the reach of the employer's creditors	Generally unfunded promises; a "rabbi trust" remains subject to the employer's creditors
Who may participate	Must satisfy coverage and nondiscrimination rules	May be limited to a select group of management or highly compensated employees
Limits	Statutory dollar limits	None
Reporting	Form 5500	Generally none

7.5 Farmers

The rule. A farmer reports income and expenses from cultivating land or raising livestock, poultry, fish, or crops on **Schedule F**. Farmers may use the cash method regardless of size (except C corporations and partnerships with C corporation partners above the gross-receipts test), and they benefit from special rules on timing of income, depreciation, estimated tax, and income averaging. Sales of raised livestock and crops are ordinary income; sales of **draft, breeding, dairy, and sporting** animals held long enough are **section 1231** transactions reported on Form 4797.

Farm income

Item	Treatment
Sales of raised crops and livestock held for sale	Ordinary income, Schedule F
Sales of livestock purchased for resale	Ordinary income; cost deducted in the year of sale
Sales of draft, breeding, dairy, or sporting livestock held 24 months (cattle and horses) or 12 months (other livestock)	Section 1231, Form 4797; raised animals have zero basis

Item	Treatment
Crop insurance proceeds and federal disaster payments for crop damage	Income in the year received, or by election deferred to the following year if the farmer normally would have sold the crop in the following year
Weather-related sales of livestock in a federally designated disaster area	Two options: (1) section 451(g) , defer to the following year the income from animals sold in excess of normal practice, any class of livestock; (2) section 1033(e) , treat sales of draft, breeding, or dairy animals as an involuntary conversion and replace them within two years (four years in drought areas)
Commodity Credit Corporation loans	Loan proceeds may be treated as income in the year received by election; otherwise income when the crop is forfeited or sold
Agricultural program payments, cost-sharing payments	Income; certain conservation cost-sharing payments are excludable under section 126
Patronage dividends from cooperatives	Income when received (Form 1099-PATR), to the extent related to deductible business purchases
Conservation Reserve Program payments	Ordinary income and SE income, except for recipients of Social Security retirement or disability benefits
Crop shares received as rent	Income when sold or used, on Form 4835 (landowner not materially participating; not SE income) or Schedule F (materially participating; SE income)
Cash rent for farmland	Schedule E; not SE income

Farm expenses and depreciation

Rule	Detail
Prepaid farm supplies (feed, seed, fertilizer)	Cash-method deduction limited to 50% of other deductible farm expenses, unless the farmer qualifies for the farm-related taxpayer exception
Soil and water conservation, endangered species recovery	Deductible (rather than capitalized) up to 25% of gross farm income if consistent with a government-approved plan; excess carries forward
Fertilizer and lime	Deductible when applied or capitalized by election
Uniform capitalization	Not required for plants with a preproductive period of two years or less; farmers may elect out for others in exchange for ADS depreciation
New farm machinery and equipment	5-year property
Used farm machinery, agricultural fences, grain bins	7-year
Single-purpose agricultural or horticultural structures; fruit- and nut-bearing trees and vines	10-year

Rule	Detail
General-purpose farm buildings	20-year
Breeding cattle and dairy cattle	5-year; breeding hogs 3-year
Depreciation method	200% declining balance permitted for 3-, 5-, 7-, and 10-year farm property placed in service after 2017; section 179 and bonus available

Farm tax computation

Provision	Rule
Schedule J income averaging	A farmer or fisherman may elect to tax any portion of current electd farm income (Schedule F income and gains on farm property other than land) at the rates of the three prior years , spreading it equally; the election does not change prior-year returns
Schedule SE farm optional method	A farmer with low or negative net earnings may elect to report two-thirds of gross farm income (up to a statutory ceiling) as SE earnings to earn Social Security credits
Estimated tax	If at least two-thirds of gross income (current or prior year) is from farming or fishing, the farmer may either make one estimated payment by January 15 equal to 66⅔% of the current year's tax (or 100% of the prior year's), or skip estimates entirely by filing and paying in full by March 1 . The underpayment penalty is computed on Form 2210-F
Net operating losses	Farming losses may be carried back two years (election to waive available), then forward subject to the 80% limit
Excess business loss	Applies to farmers like other noncorporate taxpayers (\$313,000 / \$626,000)

Worked example. Tomás, Rosa's brother, sells \$90,000 of raised calves (ordinary, Schedule F) and a raised breeding bull held three years for \$4,000 (zero basis, \$4,000 section 1231 gain on Form 4797). A drought forces him to sell 30 more cows than usual for \$45,000; his county is federally designated for drought assistance, so he elects under section 451(g) to report the \$45,000 in 2026. Because more than two-thirds of his gross income is from farming, he files and pays by March 2, 2026 (March 1 is a Sunday) and owes no estimated tax penalty.

Memory cue. "Two-thirds farming, one payment or March first." Farmers either pay once by January 15 or file by March 1.

7.6 Rental property

The rule. Rental income and expenses are reported on **Schedule E**. Income includes rent, **advance rent** in the year received, **lease cancellation payments**, expenses paid by the tenant on the landlord's behalf, and the fair value of property or services received as rent; **security deposits** are not income until applied or forfeited. Expenses include mortgage interest, taxes, insurance, repairs, management fees, utilities, and depreciation over **27.5 years** for residential property (80% or more of gross rents from dwelling units) or **39 years** for commercial property, both straight line with the mid-month convention. Improvements are capitalized and depreciated; repairs are deducted.

Mixed-use and vacation homes

Personal use during the year	Treatment
Rented fewer than 15 days	Rental income is excluded and rental expenses are not deductible (mortgage interest and taxes may still go on Schedule A)
Personal use does not exceed the greater of 14 days or 10% of the days rented at fair rental	Not a residence: expenses are allocated between rental and personal days, and a rental loss is allowed (subject to the passive rules)
Personal use exceeds the greater of 14 days or 10% of rental days	A residence : expenses are allocated, and rental deductions are limited to rental income in this order: interest and taxes, then operating expenses, then depreciation; disallowed amounts carry forward

Personal use days include use by the owner, by **family members** (even at fair rent, unless the home is the family member's principal residence), by anyone paying less than fair rent, and under reciprocal arrangements. Days spent primarily **repairing and maintaining** the property do not count as personal use. A property rented at **less than fair rental value** (to a relative, for example) is treated as personal use for those days, and if no profit motive exists, the "not-for-profit" rules apply: income on Schedule 1, no deductible expenses for 2025.

Worked example. Rosa rents a lake cabin for 100 days at fair rent and uses it personally 20 days. The greater of 14 days or 10% of 100 is 14; her 20 days exceed it, so the cabin is a residence. Expenses are allocated 100/120 to rental. If allocated rental expenses exceed rental income, the excess is not deductible this year and carries forward. Had she used it only 10 days, the cabin would not be a residence and a loss would be allowed, subject to the passive loss rules.

The passive activity rules for rentals

The rule. Rental activity is **passive by definition**, regardless of how many hours the owner works, so rental losses offset only passive income, with two exceptions. First, an individual who **actively participates** may deduct up to **\$25,000** of rental real estate losses against nonpassive income, phased out by **50% of modified AGI above \$100,000** (fully phased out at \$150,000). Second, a **real estate professional** who materially participates in the rental treats it as nonpassive without limit.

Exception	Requirements
\$25,000 allowance	Owns at least 10% of the property; makes management decisions (approving tenants, setting rents, arranging repairs); is not a limited partner. Phase-out: $\$25,000 - 50\% \times (\text{MAGI} - \$100,000)$. Married filing separately: \$12,500 and a \$50,000 to \$75,000 phase-out, but zero if the spouses lived together at any time during the year
Real estate professional	More than 750 hours during the year in real property trades or businesses in which the taxpayer materially participates, and more than half of all personal services performed in those businesses; on a joint return one spouse alone must meet both tests. The taxpayer must then materially participate in each rental (or elect to aggregate all rentals as one activity)
Disposition	Suspended losses are released in full when the taxpayer disposes of the entire interest in a fully taxable transaction to an unrelated party

Worked example. Rosa actively participates in managing her duplex, which produces a \$14,000 loss in 2025. Her modified AGI is \$120,000. Allowance: $\$25,000 - 50\% \times (\$120,000 - \$100,000) = \$15,000$. She may deduct the full \$14,000 against her other income. If her MAGI were \$140,000, the allowance would be \$5,000, and \$9,000 would be suspended on Form 8582.

Commercial versus residential

	Residential rental	Commercial rental
Depreciation	27.5 years	39 years
Definition	80% or more of gross rents from dwelling units (not transient lodging such as hotels)	Everything else
Typical lease	Gross lease; landlord pays expenses	Often triple-net , tenant pays taxes, insurance, and maintenance; a triple-net lease may not rise to a trade or business for the QBI deduction or the 250-hour safe harbor

	Residential rental	Commercial rental
Qualified improvement property	Not applicable	Interior improvements to nonresidential buildings are 15-year property eligible for bonus and section 179
Section 179 on the building's roof, HVAC, fire, and security systems	Not available	Available

Exam trap. The \$25,000 allowance requires **active** participation, a lower standard than **material** participation; a limited partner can never actively participate, and a 5% owner cannot either. A real estate professional needs **material** participation. Questions that swap the two words are testing whether you know which exception uses which standard.

Quick Check: Chapter 7

- A calendar-year estate had \$450 of interest income in 2025 and no other income. Is a Form 1041 required?
 - Yes, because every estate must file.
 - No, because gross income is under \$600.
 - Yes, because estates have no filing threshold once probate opens.
 - No, because interest is excluded from the test.
- A simple trust has \$30,000 of taxable interest, \$2,000 of trustee fees, and a \$10,000 long-term capital gain allocated to corpus. Its DNI is:
 - \$38,000
 - \$28,000
 - \$30,000
 - \$40,000
- A complex trust's trustee distributes \$15,000 to a beneficiary on February 20, 2026. Which statement is correct?
 - The distribution may be treated as made on December 31, 2025 under the 65-day election.
 - The distribution must be reported in 2026 because the 65-day election is available only to simple trusts.
 - The distribution is taxable to the trust in 2025 and to the beneficiary in 2026.
 - The distribution is tax-free to the beneficiary because it was made after year end.
- Which organization must file a full Form 990 for 2025?
 - A charity with \$45,000 of gross receipts and \$100,000 of assets
 - A charity with \$180,000 of gross receipts and \$450,000 of assets
 - A charity with \$150,000 of gross receipts and \$700,000 of assets
 - A church with \$2,000,000 of gross receipts

- 5.** A 501(c)(3) museum operates a gift shop selling reproductions of works in its collection and also sells advertising in its quarterly magazine. Which statement is correct?
- A. Both activities produce unrelated business taxable income.
 - B. Neither activity produces UBTI because the profits fund the museum.
 - C. The advertising income is UBTI; the gift shop sales related to the collection are not.
 - D. The gift shop sales are UBTI; the advertising income is not.
- 6.** A charity that files Form 990-N for 2023, 2024, and 2025 but fails to file anything for 2026, 2027, and 2028:
- A. Owes a \$25-per-day penalty for each year
 - B. Has its exemption automatically revoked
 - C. Must file Form 990-EZ for all three years before any penalty applies
 - D. Keeps its exemption because 990-N filers are exempt from the revocation rule
- 7.** A self-employed consultant, age 45, has net SE earnings of \$100,000 after the deduction for half of SE tax. The maximum 2025 SEP-IRA contribution is:
- A. \$25,000
 - B. \$23,500
 - C. \$20,000
 - D. \$70,000
- 8.** Which employee must be eligible for an employer's SIMPLE IRA in 2025?
- A. An employee who earned \$4,000 in each of 2023 and 2024
 - B. An employee who earned \$6,000 in 2023 and \$7,000 in 2024 and expects to earn \$6,000 in 2025
 - C. An employee hired in January 2025 who expects to earn \$50,000
 - D. An employee who earned \$5,000 in 2024 only and expects \$5,000 in 2025
- 9.** A plan participant, age 52, withdraws \$20,000 from her SIMPLE IRA 18 months after she began participating. In addition to income tax, she owes an additional tax of:
- A. \$0
 - B. \$2,000
 - C. \$5,000
 - D. \$10,000
- 10.** Tomás, a cash-method farmer, received \$30,000 of crop insurance proceeds in November 2025 for hail damage to a crop he would normally have sold in 2026. Which statement is correct?
- A. He must report the \$30,000 in 2025.
 - B. He may elect to report the \$30,000 in 2026.
 - C. He must report the \$30,000 in 2026.
 - D. Crop insurance proceeds are excluded from income.

- 11.** Rosa rents a condo for 200 days at fair rent and uses it personally for 22 days. Which statement is correct?
- A. The condo is not a residence because 22 days is less than 10% of 200 days plus 14.
 - B. The condo is a residence because 22 days exceeds the greater of 14 days or 20 days.
 - C. The condo is a residence because any personal use over 14 days makes it one.
 - D. The condo is not a residence because personal use was under 10% of total days.
- 12.** David and Maria, filing jointly with modified AGI of \$130,000, actively participate in a rental that lost \$20,000 in 2025. They have no passive income. Their deductible rental loss is:
- A. \$20,000
 - B. \$15,000
 - C. \$10,000
 - D. \$0

Answers.

- 1. B.** An estate files Form 1041 only if it has gross income of \$600 or more (or a nonresident alien beneficiary). The threshold is the same amount as the estate's exemption.
- 2. B.** Taxable income before the distribution deduction and exemption is $\$30,000 - \$2,000 + \$10,000 = \$38,000$. DNI removes the capital gain allocated to corpus: $\$38,000 - \$10,000 = \$28,000$. There is no tax-exempt interest to add back.
- 3. A.** A complex trust (or an estate) may elect under section 663(b) to treat amounts distributed within the first 65 days of the following year as distributed on the last day of the prior year. February 20 is within 65 days of December 31.
- 4. C.** Form 990 is required when gross receipts are \$200,000 or more **or** total assets are \$500,000 or more. Assets of \$700,000 force the full form even though receipts are under \$200,000. The first organization may file Form 990-N; the second may file Form 990-EZ; churches are exempt from filing.
- 5. C.** Sales of reproductions of the collection are substantially related to the museum's educational purpose. Advertising income is the classic example of UBTI, even when the publication itself is related. Using profits for the exempt purpose never makes an activity related.
- 6. B.** Failure to file a required annual return or notice (including the Form 990-N) for three consecutive years results in automatic revocation of exempt status. There is no monetary penalty for a late 990-N, which is why Congress added the revocation rule.
- 7. C.** For a self-employed person the contribution rate is applied to net SE earnings after the SE tax deduction, and the effective rate for a 25% plan is 20%: $20\% \times \$100,000 = \$20,000$, well under the \$70,000 cap. Age does not increase a SEP contribution; SEPs have no catch-up.
- 8. B.** An employee must be eligible if he or she received at least \$5,000 in compensation in any two preceding years and is reasonably expected to receive \$5,000 in the current year. Only B meets both parts; the employer may choose to be more generous but is not required to.

9. C. Withdrawals from a SIMPLE IRA during the first two years of participation by a participant under 59½ are subject to a 25% additional tax, not 10%: $25\% \times \$20,000 = \$5,000$.

10. B. A cash-method farmer who receives crop insurance or disaster payments may elect to include them in the following year's income if, under normal business practice, the damaged crop would have been sold in the following year. The election is optional; the default is inclusion in the year received.

11. B. The residence test is personal use exceeding the greater of 14 days or 10% of fair-rental days. Ten percent of 200 is 20, which is greater than 14, so the threshold is 20 days. Her 22 days exceed it, and the condo is a residence whose rental deductions are limited to rental income.

12. C. The \$25,000 allowance is reduced by 50% of MAGI above \$100,000: $\$25,000 - 50\% \times \$30,000 = \$10,000$. The remaining \$10,000 of the loss is suspended and carried forward on Form 8582.

Part III. Practice Exam

50 questions • 105 minutes • 2025 tax law

This practice exam mirrors the domain weighting of the real Part 2 exam: 18 questions on Business Entities and Considerations, 22 on Business Tax Preparation, and 10 on Specialized Returns and Taxpayers. Set a timer for 105 minutes, which matches the pace of 100 questions in 3.5 hours. Mark each question you are unsure of and come back to it. Unless a question says otherwise, all facts relate to calendar year 2025 and all entities use the calendar year. The answer key with explanations follows the last question. All questions are original study questions and are not actual exam items.

Questions

1. Priya forms a single-member LLC for her consulting practice and files no election with the IRS. For federal tax purposes the LLC is:
 - A. A C corporation
 - B. A disregarded entity, reported on Priya's Schedule C
 - C. A partnership
 - D. An S corporation
2. A multi-member LLC files Form 8832 on June 1, 2025 electing to be taxed as a corporation. Which effective date is **not** permitted?
 - A. June 1, 2025
 - B. March 20, 2025
 - C. January 1, 2025
 - D. January 1, 2026
3. Carlos contributes land with an adjusted basis of \$50,000 and a fair market value of \$80,000, subject to a \$20,000 mortgage the partnership assumes, for a 50% interest in Lopez Brothers Landscaping, LLC. His initial basis in the partnership interest is:
 - A. \$40,000
 - B. \$30,000
 - C. \$50,000
 - D. \$70,000

- 4.** A partnership pays a general partner a \$60,000 guaranteed payment for services, determined without regard to partnership income. Which statement is correct?
- A. The payment is a nondeductible distribution to the partner.
 - B. The payment is deductible by the partnership and is a capital gain to the partner.
 - C. The payment is exempt from self-employment tax because it is fixed.
 - D. The payment is deductible by the partnership, is ordinary income to the partner, and is subject to self-employment tax.
- 5.** David's basis in his partnership interest at the beginning of 2025 is \$15,000. His distributive share of the partnership's 2025 ordinary loss is \$22,000, and he is at risk and materially participates. He may deduct in 2025:
- A. \$22,000
 - B. \$15,000
 - C. \$7,000
 - D. \$0
- 6.** A partner with an outside basis of \$25,000 receives a nonliquidating cash distribution of \$30,000. The partner:
- A. Recognizes no gain and reduces basis to zero
 - B. Recognizes \$5,000 of ordinary income
 - C. Recognizes a \$5,000 capital gain
 - D. Recognizes \$30,000 of ordinary income
- 7.** A three-partner partnership files its 2025 Form 1065 on May 10, 2026 with no extension. The late-filing penalty is:
- A. \$1,530
 - B. \$510
 - C. \$765
 - D. \$0, because partnerships owe no income tax
- 8.** Maria transfers equipment with a basis of \$40,000 and a value of \$100,000 to a new corporation in exchange for 100% of its stock worth \$90,000 plus \$10,000 cash. She recognizes:
- A. No gain, because she controls the corporation
 - B. \$10,000 of gain, the amount of boot received
 - C. \$60,000 of gain
 - D. \$10,000 of gain only if the corporation is a C corporation
- 9.** A C corporation has a \$30,000 net capital loss in 2025 and no capital gains in the three prior years. The loss:
- A. Is deducted against ordinary income up to \$3,000
 - B. Is deducted in full against ordinary income
 - C. Is carried forward indefinitely as a long-term capital loss
 - D. Is carried forward five years as a short-term capital loss

- 10.** Bayou Fabrication owns 30% of another domestic corporation and receives a \$50,000 dividend. Before the taxable income limit, its dividends-received deduction is:
- A. \$25,000
 - B. \$50,000
 - C. \$32,500
 - D. \$0
- 11.** A C corporation's charitable contribution deduction for the year is generally limited to:
- A. 10% of taxable income computed before the contribution deduction, the dividends-received deduction, and any capital loss and NOL carrybacks
 - B. 60% of taxable income
 - C. 25% of taxable income
 - D. 10% of gross income
- 12.** The accumulated earnings credit allows most C corporations to accumulate at least how much without exposure to the accumulated earnings tax?
- A. \$150,000
 - B. \$250,000
 - C. \$500,000
 - D. \$1,000,000
- 13.** Which shareholder would terminate a corporation's S election?
- A. A resident alien individual
 - B. An estate of a deceased shareholder
 - C. A grantor trust owned by a U.S. citizen
 - D. A nonresident alien individual
- 14.** A calendar-year C corporation wants S corporation status beginning January 1, 2026. Without relying on late-election relief, the latest date to file Form 2553 is:
- A. January 31, 2026
 - B. December 31, 2025
 - C. March 16, 2026
 - D. April 15, 2026
- 15.** In what order does an S corporation shareholder adjust stock basis for the year?
- A. Increase for income items; decrease for distributions; decrease for nondeductible expenses; decrease for losses and deductions
 - B. Decrease for losses; increase for income; decrease for distributions; decrease for nondeductible expenses
 - C. Increase for income; decrease for losses; decrease for distributions
 - D. Decrease for distributions; increase for income; decrease for losses

- 16.** An S corporation with no accumulated earnings and profits distributes \$40,000 to a shareholder whose stock basis is \$35,000. The shareholder:
- A. Reports \$40,000 of dividend income
 - B. Reports a \$5,000 capital gain and reduces stock basis to zero
 - C. Reports \$5,000 of ordinary income
 - D. Reports nothing, because S corporation distributions are never taxable
- 17.** A C corporation that elects S status with appreciated assets is subject to the built-in gains tax on gains recognized during the:
- A. 10-year period after conversion, at the shareholders' rates
 - B. 3-year period after conversion, at 21%
 - C. 5-year period after conversion, at the shareholders' rates
 - D. 5-year period after conversion, at 21%
- 18.** For the 100-shareholder limit, how are a husband, wife, their three children, and the husband's mother counted?
- A. As six shareholders
 - B. As two shareholders
 - C. As one shareholder, by election to treat the family as one
 - D. As five shareholders
- 19.** Panadería Lopez provides \$2,000 of catering to an electrician in exchange for \$2,000 of wiring work. Maria must:
- A. Include \$2,000 in gross receipts and may deduct the \$2,000 cost of the wiring as a business expense
 - B. Include nothing, because no cash changed hands
 - C. Include \$2,000 in gross receipts but may not deduct the wiring
 - D. Report the transaction only on Form 1099-B
- 20.** A retailer has beginning inventory of \$20,000, purchases of \$90,000, and ending inventory of \$25,000. Cost of goods sold is:
- A. \$95,000
 - B. \$85,000
 - C. \$135,000
 - D. \$65,000
- 21.** A new corporation incurs \$52,000 of start-up costs in 2025 and begins business in October. Its 2025 deduction for start-up costs before amortization is:
- A. \$5,000
 - B. \$0
 - C. \$3,000
 - D. \$52,000

22. The 2025 maximum section 179 deduction and the investment level at which the phase-out begins are:

- A. \$1,250,000 and \$3,130,000
- B. \$2,500,000 and \$4,000,000
- C. \$1,000,000 and \$2,500,000
- D. \$2,500,000 and \$3,130,000

23. Machinery purchased under a binding contract signed March 1, 2025 and placed in service in June 2025 qualifies for bonus depreciation of:

- A. 100%
- B. 40%
- C. 60%
- D. 80%

24. Bayou Fabrication places a \$60,000 passenger automobile in service in 2025, uses it 100% for business, and claims bonus depreciation. Its maximum 2025 depreciation deduction for the automobile is:

- A. \$12,200
- B. \$60,000
- C. \$31,300
- D. \$20,200

25. During 2025 a business spends \$4,000 on meals with clients at restaurants, \$3,000 on tickets to sporting events for clients, and \$1,500 on meals during employee overnight travel. The total deduction is:

- A. \$8,500
- B. \$2,750
- C. \$5,500
- D. \$4,250

26. A cash-method consulting firm billed a client \$8,000 in 2025 and the client went bankrupt without paying. The firm's bad debt deduction is:

- A. \$8,000 as an ordinary loss
- B. \$8,000 as a short-term capital loss
- C. \$3,000 in 2025 with the remainder carried forward
- D. \$0

27. Maria's 2025 Schedule C net profit is \$60,000. Her self-employment tax is approximately:

- A. \$8,478
- B. \$9,180
- C. \$4,239
- D. \$7,650

- 28.** Priya, single, operates a consulting practice (a specified service trade or business) with \$150,000 of qualified business income. Her 2025 taxable income before the QBI deduction is \$260,000. Her QBI deduction is:
- A. \$30,000
 - B. \$0
 - C. \$15,000
 - D. Limited to 50% of W-2 wages
- 29.** Lopez Brothers Landscaping paid an unincorporated subcontractor \$4,500 for services in 2025. The LLC must:
- A. File Form 1099-NEC by February 2, 2026 reporting the \$4,500
 - B. File nothing, because payments under \$5,000 are not reportable
 - C. File Form 1099-MISC by March 31, 2026
 - D. File Form 1099-K
- 30.** A sole proprietor sells equipment that cost \$50,000, on which \$30,000 of depreciation was taken, for \$45,000. The result is:
- A. \$25,000 of section 1231 gain
 - B. \$5,000 of ordinary income and \$20,000 of capital gain
 - C. \$25,000 of long-term capital gain
 - D. \$25,000 of ordinary income
- 31.** In 2025 a business trades its delivery van (adjusted basis \$5,000) for a new van, receiving a \$12,000 trade-in allowance. Which statement is correct?
- A. No gain is recognized under section 1031.
 - B. The \$7,000 gain is deferred and reduces the basis of the new van.
 - C. The trade is a sale; \$7,000 of gain is recognized, and the new van's basis is its full cost.
 - D. The gain is deferred only if the business identifies the new van within 45 days.
- 32.** A business without an applicable financial statement that has a written capitalization policy may elect to deduct items costing up to what amount per invoice or item under the de minimis safe harbor?
- A. \$2,500
 - B. \$5,000
 - C. \$500
 - D. \$10,000
- 33.** A corporation receives IRS consent to change its method of accounting and computes a positive section 481(a) adjustment of \$100,000. Absent an election, the adjustment is reported:
- A. Entirely in the year of change
 - B. Over the remaining life of the affected assets
 - C. In the year of change and the prior year
 - D. Ratably over four years, beginning with the year of change

34. On Schedule M-1 of Form 1120, which item is **added** to net income per books to arrive at taxable income?

- A. Tax-exempt interest income
- B. Federal income tax expense recorded on the books
- C. Tax depreciation in excess of book depreciation
- D. The dividends-received deduction

35. David sells a truck used in his business to his sister Rosa for \$9,000. His adjusted basis is \$14,000. David:

- A. May not deduct the \$5,000 loss because Rosa is a related party
- B. Deducts a \$5,000 ordinary loss
- C. Deducts a \$5,000 capital loss
- D. Deducts a \$3,000 loss this year and carries the rest forward

36. A used car dealer receives \$14,000 in cash from a customer for a vehicle. The dealer must:

- A. Report the payment on Form 1099-MISC by January 31
- B. Report nothing, because the sale is in the ordinary course of business
- C. Report the payment to FinCEN on Form 114
- D. File Form 8300 within 15 days after receiving the cash

37. How long must an employer keep records supporting Forms 941 and W-2?

- A. 3 years from the date filed
- B. At least 4 years after the tax becomes due or is paid, whichever is later
- C. 7 years
- D. 10 years

38. A business that has treated its delivery drivers as independent contractors is audited. Which condition is **required** for section 530 relief from employment taxes?

- A. The business must have obtained a Form SS-8 determination.
- B. The drivers must have paid their own income tax.
- C. The business must have filed all required Forms 1099 for the drivers and treated similar workers consistently.
- D. The drivers must have worked fewer than 30 hours per week.

39. For the employer shared responsibility provisions of the Affordable Care Act, an employer is an applicable large employer if it averaged at least how many full-time employees (including equivalents) in the prior year?

- A. 50
- B. 100
- C. 25
- D. 30

40. A U.S. corporation that is 30% owned by a foreign individual and had reportable transactions with that shareholder during 2025 must file:

- A. Form 5471
- B. Form 8865
- C. Form 8938
- D. Form 5472

41. The exemption amount allowed to an estate on Form 1041 is:

- A. \$100
- B. \$300
- C. \$600
- D. \$1,350

42. A simple trust has \$12,000 of taxable interest, \$8,000 of dividends, a \$1,000 trustee fee, and a \$5,000 long-term capital gain allocated to corpus. Its distributable net income is:

- A. \$24,000
- B. \$19,000
- C. \$20,000
- D. \$14,000

43. A complex trust's trustee wants a distribution made on February 10, 2026 to count as a 2025 distribution. The trustee:

- A. May make the section 663(b) election because the distribution is within 65 days of year end
- B. Cannot do so, because distributions are taxed in the year paid
- C. May do so only if the trust is converted to a simple trust
- D. May do so only with IRS consent on Form 3115

44. A 501(c)(3) organization with gross receipts that are normally \$45,000 and assets of \$200,000 satisfies its annual filing requirement by filing:

- A. Form 990
- B. Form 990-EZ
- C. Form 990-PF
- D. Form 990-N

45. An exempt organization must file Form 990-T when its gross income from unrelated businesses is at least:

- A. \$600
- B. \$1,000
- C. \$5,000
- D. \$50,000

- 46.** An employee age 55 participates in her employer's 401(k) plan. Her maximum 2025 elective deferral, including the catch-up contribution, is:
- A. \$23,500
 - B. \$34,750
 - C. \$31,000
 - D. \$70,000
- 47.** Which employee must be included in an employer's SEP-IRA for 2025?
- A. An employee age 30 who worked for the employer in 3 of the last 5 years and earned \$900 in 2025
 - B. An employee age 19 who has worked full time for two years
 - C. An employee who earned \$400 in 2025
 - D. A part-time employee who worked in 2 of the last 5 years
- 48.** Tomás, a farmer, earned 80% of his 2025 gross income from farming and made no estimated tax payments. Which statement is correct?
- A. He owes an underpayment penalty regardless of when he files.
 - B. He must have paid four equal estimated installments.
 - C. He avoids the penalty only if he paid his entire tax by January 15, 2026.
 - D. He avoids the penalty if he files his 2025 return and pays the full tax by March 2, 2026.
- 49.** Rosa rents her home for 12 days during a major Houston event and receives \$4,000. She uses the home personally the rest of the year. She:
- A. Reports \$4,000 on Schedule E and deducts 12/365 of her expenses
 - B. Excludes the \$4,000 and deducts no rental expenses
 - C. Reports \$4,000 on Schedule 1 as other income
 - D. Reports the \$4,000 and deducts up to \$4,000 of expenses
- 50.** To qualify as a real estate professional so that rental losses are nonpassive, a taxpayer must:
- A. Hold a real estate license and own at least 10% of each property
 - B. Spend at least 500 hours on rental activities
 - C. Spend more than 750 hours and more than half of all personal services in real property trades or businesses in which the taxpayer materially participates
 - D. Have modified AGI under \$150,000

Answer Key and Explanations

- 1. B.** A single-member LLC that makes no election is disregarded as separate from its owner. Priya reports the business on Schedule C and pays self-employment tax on the profit. An election on Form 8832 (or Form 2553) is required to be taxed as a corporation.

- 2. C.** Form 8832 may be effective up to 75 days before the filing date or up to 12 months after it. Seventy-five days before June 1, 2025 is March 18, 2025, so March 20 is permitted and January 1, 2025 is not. The first option, the filing date itself, and January 1, 2026 all fall within the window.
- 3. A.** Basis equals the adjusted basis of property contributed, minus liabilities assumed by the partnership, plus the partner's share of partnership liabilities: $\$50,000 - \$20,000 + (50\% \times \$20,000) = \$40,000$. Fair market value never enters the computation.
- 4. D.** Guaranteed payments for services are deductible by the partnership (or capitalized if required), are ordinary income to the partner, and are included in net earnings from self-employment for a general partner. They are reported separately on Schedule K-1 and are never capital gain.
- 5. B.** A partner's deductible loss is limited to outside basis at year end before the loss, here \$15,000. The remaining \$7,000 is suspended and carries forward until David has basis. The at-risk and passive rules are met, so the basis limit is the only limit.
- 6. C.** Cash distributions reduce basis; cash in excess of basis produces capital gain. $\$30,000 - \$25,000 = \$5,000$ of capital gain. Only cash (and marketable securities) can trigger gain on a current distribution; property distributions never do.
- 7. A.** The penalty is \$255 per partner per month or part of a month, for up to 12 months, for returns required to be filed in 2026. Form 1065 was due March 16, 2026; filing on May 10 is one full month plus part of a second, so two months: $\$255 \times 3 \times 2 = \$1,530$.
- 8. B.** The transfer qualifies under section 351 because Maria controls the corporation (at least 80%) immediately after the exchange. Gain is recognized to the extent of boot received, \$10,000, but never more than realized gain of \$60,000. The rule is the same for C and S corporations.
- 9. D.** Corporations deduct capital losses only against capital gains. A net capital loss is carried back three years and forward five, always as a short-term capital loss. The \$3,000 ordinary-income offset is for individuals only.
- 10. C.** Ownership of 20% to less than 80% earns a 65% dividends-received deduction: $65\% \times \$50,000 = \$32,500$. Under 20% ownership earns 50%; 80% or more (affiliated) earns 100%.
- 11. A.** The corporate charitable deduction is limited to 10% of taxable income computed before the charitable deduction, the dividends-received deduction, and any capital loss carryback or NOL carryback. The excess carries forward five years.
- 12. B.** The minimum accumulated earnings credit is \$250,000 for most corporations and \$150,000 for personal service corporations in health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.
- 13. D.** Nonresident aliens may not be S corporation shareholders. Resident aliens, estates, and grantor trusts owned by U.S. citizens or residents are all eligible shareholders.
- 14. C.** Form 2553 must be filed by the 15th day of the third month of the tax year for which the election is to be effective. March 15, 2026 is a Sunday, so the deadline moves to Monday, March 16, 2026. Filing anytime in 2025 would also work (the election can be filed any time during the preceding year), but December 31, 2025 is not the latest date.

15. A. The ordering rule increases basis for income (including tax-exempt income), then decreases it for distributions, then for nondeductible noncapital expenses, and finally for losses and deductions. The order ensures that distributions are tested against basis before losses can reduce it.

16. B. With no accumulated E&P, distributions are a tax-free return of basis, and any excess is capital gain from the sale of stock: $\$40,000 - \$35,000 = \$5,000$. Basis is reduced to zero.

17. D. The built-in gains tax applies to net recognized built-in gain during the five-year recognition period after conversion, at the highest corporate rate (21%), and is paid by the S corporation. The gain also passes through to the shareholders, reduced by the tax.

18. C. Members of a family, defined as a common ancestor, lineal descendants, and their spouses within six generations, may be treated as one shareholder for the 100-shareholder limit. Without the rule, the six individuals would count as six.

19. A. Bartered services are included in gross income at fair market value. The wiring is a deductible (or depreciable) business expense in the same amount, so the net effect may be zero, but both sides must be reported.

20. B. Cost of goods sold = beginning inventory + purchases – ending inventory = $\$20,000 + \$90,000 - \$25,000 = \$85,000$.

21. C. The \$5,000 first-year deduction is reduced dollar for dollar by start-up costs over \$50,000: $\$5,000 - (\$52,000 - \$50,000) = \$3,000$. The remaining \$49,000 is amortized over 180 months beginning with the month business begins, with three months of amortization in 2025.

22. B. For 2025 the section 179 limit is \$2,500,000 and the phase-out begins when qualifying property placed in service exceeds \$4,000,000. The \$1,250,000 and \$3,130,000 figures were the pre-OBBA amounts.

23. A. Property acquired after January 19, 2025 qualifies for 100% bonus depreciation. The binding contract date of March 1, 2025 is the acquisition date, and it is after January 19. Property acquired under a contract signed before January 20, 2025 would be limited to 40%.

24. D. The first-year depreciation cap for passenger automobiles placed in service in 2025 is \$20,200 when bonus depreciation is claimed (\$12,200 without bonus). The \$31,300 figure is the section 179 limit for heavy SUVs, which does not apply to a passenger automobile.

25. B. Business meals, including meals during employee travel, are 50% deductible: $50\% \times (\$4,000 + \$1,500) = \$2,750$. Entertainment, including sporting event tickets, is not deductible at all.

26. D. A cash-method taxpayer never included the \$8,000 in income, so there is no basis in the receivable and no bad debt deduction. A business bad debt deduction requires that the amount was previously reported as income or was cash actually lent.

27. A. Net earnings from self-employment are 92.35% of net profit: $\$60,000 \times 0.9235 = \$55,410$. Self-employment tax is 15.3% of that amount: $\$55,410 \times 15.3\% = \$8,478$ (rounded). Half of it, \$4,239, is deductible on Schedule 1.

- 28. B.** Priya's taxable income of \$260,000 exceeds the 2025 single threshold of \$197,300 plus the \$50,000 phase-in range (\$247,300). Above that level a specified service trade or business produces no QBI deduction regardless of wages or property.
- 29. A.** Payments of \$600 or more to a nonemployee for services in 2025 are reported on Form 1099-NEC, due to both the IRS and the recipient by January 31, which falls on a Saturday in 2026, moving the deadline to Monday, February 2, 2026. The \$2,000 threshold applies only to payments made after 2025.
- 30. D.** Gain is $\$45,000 - (\$50,000 - \$30,000) = \$25,000$. Because the gain does not exceed the \$30,000 of depreciation taken, all of it is section 1245 ordinary income. Section 1231 gain would arise only on the portion of the price above the original \$50,000 cost.
- 31. C.** Since 2018, section 1031 applies only to real property. The trade-in of a vehicle is treated as a sale of the old van for \$12,000 (gain of \$7,000, ordinary under section 1245 to the extent of prior depreciation) and a purchase of the new van, whose basis is its full cost.
- 32. A.** The de minimis safe harbor allows a deduction for items costing up to \$2,500 per invoice or item for taxpayers without an applicable financial statement, and \$5,000 for those with one, if the taxpayer has a consistent capitalization policy and makes the annual election.
- 33. D.** A positive section 481(a) adjustment (one that increases income) is generally taken into account ratably over four tax years beginning with the year of change. A negative adjustment is deducted in full in the year of change. A taxpayer may elect a one-year inclusion if the positive adjustment is less than \$50,000.
- 34. B.** Federal income tax is deducted on the books but is not deductible for tax, so it is added back. Tax-exempt interest and excess tax depreciation are subtractions. The dividends-received deduction is taken after the Schedule M-1 reconciliation, on page 1 of Form 1120.
- 35. A.** Siblings are related parties under section 267, so David's \$5,000 loss is disallowed. Rosa's basis is her \$9,000 cost, but she may use David's disallowed loss to offset gain if she later sells the truck for more than \$9,000.
- 36. D.** A trade or business that receives more than \$10,000 in cash in one transaction or related transactions must file Form 8300 by the 15th day after the cash is received and furnish a statement to the payer by January 31 of the following year. Being in the ordinary course of business is exactly when the rule applies.
- 37. B.** Employment tax records must be kept for at least four years after the date the tax becomes due or is paid, whichever is later. The general three-year rule applies to income tax records.
- 38. C.** Section 530 relief requires a reasonable basis for contractor treatment (judicial precedent, prior audit, or industry practice), consistent treatment of similar workers, and the filing of all required information returns (Forms 1099) for the workers. A Form SS-8 ruling is not required and, if adverse, ends the inquiry.
- 39. A.** An applicable large employer averaged at least 50 full-time employees, counting full-time equivalents, during the preceding calendar year. Full-time means an average of 30 or more hours per week. Smaller employers owe no shared responsibility payment.

- 40. D.** Form 5472 is filed by a U.S. corporation that is at least 25% foreign-owned (and by foreign corporations engaged in a U.S. business) to report transactions with related parties. The penalty for failure to file is \$25,000 per form. Form 5471 is the mirror image, for U.S. persons who own foreign corporations.
- 41. C.** An estate is allowed a \$600 exemption; a simple trust, \$300; a complex trust, \$100. The \$600 figure is also the estate's gross-income filing threshold.
- 42. B.** DNI starts with taxable income before the distribution deduction and exemption, $\$12,000 + \$8,000 - \$1,000 + \$5,000 = \$24,000$, then removes capital gains allocated to corpus: $\$24,000 - \$5,000 = \$19,000$. The \$19,000 is the maximum distribution deduction and the amount taxed to the beneficiary.
- 43. A.** A complex trust or estate may elect under section 663(b) to treat distributions made within the first 65 days of a tax year as made on the last day of the preceding year. February 10 is day 41. Simple trusts do not need the election because their beneficiaries are taxed on income required to be distributed whether or not paid.
- 44. D.** Organizations whose gross receipts are normally \$50,000 or less may file the Form 990-N electronic notice. Asset level does not matter for the 990-N test; it matters only for choosing between Form 990-EZ (assets under \$500,000) and Form 990.
- 45. B.** Form 990-T is required when gross income from unrelated trades or businesses is \$1,000 or more; the \$1,000 specific deduction means tax is owed only on net UBTI above that amount.
- 46. C.** The 2025 elective deferral limit is \$23,500, and participants age 50 or older may add a \$7,500 catch-up, for \$31,000. The \$11,250 enhanced catch-up (which would total \$34,750) is available only to participants who reach ages 60 through 63 during the year. The \$70,000 figure is the overall annual additions limit including employer contributions.
- 47. A.** A SEP must cover every employee who is at least 21, has worked for the employer in at least 3 of the preceding 5 years, and received at least \$750 of compensation in 2025. The employee in A meets all three tests. The others fail the age, compensation, or service test.
- 48. D.** Because at least two-thirds of his gross income is from farming, Tomás may avoid the estimated tax penalty entirely by filing his return and paying the full tax by March 1. In 2026 that date falls on a Sunday, so the deadline is Monday, March 2, 2026. The alternative was a single estimated payment by January 15, 2026.
- 49. B.** A dwelling unit used as a residence and rented for fewer than 15 days during the year is treated as not rented at all: the income is excluded and no rental expenses are deductible. Mortgage interest and property taxes remain deductible on Schedule A as personal residence expenses.
- 50. C.** A real estate professional must perform more than 750 hours of services during the year in real property trades or businesses in which he or she materially participates, and more than half of all personal services in all trades or businesses must be in those real property businesses. The tests are applied to one spouse alone on a joint return. A license is not required.

Scoring Your Practice Exam

Correct answers	Reading
43–50	You are performing above the level the passing standard requires. Spend your remaining time on the domains where you missed questions and on Appendix A.
36–42	You are on track. Re-read the chapters for the domains with two or more misses, then retake the Quick Checks for those chapters.
28–35	Solid foundation with gaps. Work through each missed question's explanation, find the rule in the chapter, and write the rule in your own words.
Under 28	Take a second full pass through Chapters 1 to 7 before scheduling the exam. Focus on the comparison tables, which carry most of the testable distinctions.

Because the real exam reports a scaled score rather than a percentage, no practice score converts exactly to a 500. As a planning guide, candidates who consistently answer about 70% or more of well-constructed practice questions correctly are usually prepared.

APPENDICES

Reference

2025 numbers at a glance, a forms directory, a glossary, sources, and the 2026 changes that are not on your exam.

Appendix A. 2025 Numbers at a Glance

Print this appendix and review it in the final week. Every figure applies to tax year 2025, the year tested in the July 1, 2026 – February 28, 2027 window. Penalty amounts are those for returns required to be filed in 2026.

Entities and filing

Item	2025
Form 1065 and Form 1120-S due date (calendar year)	March 16, 2026 (March 15 is a Sunday); extension to September 15, 2026
Form 1120 due date (calendar year)	April 15, 2026; extension to October 15, 2026
Form 1041 due date	April 15, 2026; 5½-month extension to September 30, 2026
Form 990 series due date	May 15, 2026; 6-month extension to November 16, 2026
Form 2553 deadline for a 2026 election	March 16, 2026 (15th day of the 3rd month)
Form 8832 effective date window	75 days before to 12 months after filing
Late Form 1065 / 1120-S penalty	\$255 per owner per month, up to 12 months
Failure-to-file penalty	5% per month, maximum 25%; minimum \$525 if more than 60 days late
Failure-to-pay penalty	0.5% per month, maximum 25%
Failure-to-deposit penalty	2% (1–5 days), 5% (6–15 days), 10% (16+ days), 15% (after notice)
Corporate tax rate	21% flat
Dividends-received deduction	50% (<20% owned); 65% (20% to <80%); 100% (80%+)
Corporate charitable limit	10% of adjusted taxable income; 5-year carryforward
Accumulated earnings credit	\$250,000 (\$150,000 for personal service corporations)
Corporate capital loss carryover	Back 3 years, forward 5, as short-term
Corporate estimated tax	15th day of 4th, 6th, 9th, 12th months; large corporations (\$1,000,000+) must use current-year tax
Section 351 control	80% of voting power and 80% of each class of nonvoting stock
S corporation shareholder limit	100 (family members may elect to count as one)
Built-in gains tax	21% on gains recognized within 5 years of conversion

Item	2025
Excess net passive income tax	25% of gross receipts from passive sources with C corporation E&P; termination after 3 consecutive years
Small business taxpayer gross receipts test (section 448(c))	\$31,000,000
Excess business loss limit (section 461(l))	\$313,000 single; \$626,000 married filing jointly
NOL deduction	80% of taxable income; indefinite carryforward; 2-year carryback for farming losses only
QSBS exclusion (section 1202)	100% for stock acquired after September 27, 2010 and held more than 5 years; \$10,000,000 cap; for stock issued after July 4, 2025: 50% at 3 years, 75% at 4, 100% at 5, \$15,000,000 cap

Depreciation, vehicles, and asset expensing

Item	2025
Section 179 limit / phase-out threshold	\$2,500,000 / \$4,000,000
Section 179 heavy SUV limit	\$31,300
Bonus depreciation	100% for property acquired after January 19, 2025; 40% if acquired on or before that date
Passenger automobile caps (bonus claimed)	\$20,200; \$19,600; \$11,800; \$7,060 thereafter
Passenger automobile first-year cap (no bonus)	\$12,200
Standard mileage rate	70 cents per mile (33 cents depreciation component)
De minimis safe harbor	\$2,500 per item (\$5,000 with applicable financial statement)
Small taxpayer building safe harbor	Gross receipts $\leq$ \$10,000,000; building $\leq$ \$1,000,000; annual total $\leq$ lesser of \$10,000 or 2%
Start-up and organizational costs	\$5,000 each, reduced above \$50,000; remainder over 180 months
Recovery periods	5-year: autos, computers, new farm equipment; 7-year: furniture, used farm equipment; 15-year: land improvements, QIP; 20-year: farm buildings; 27.5-year: residential rental; 39-year: nonresidential
Section 197 intangibles	15 years, straight line
Research and experimental expenditures (section 174A)	Domestic: deductible currently (or amortized by election); foreign: 15 years
Business interest limit (section 163(j))	30% of adjusted taxable income computed with depreciation and amortization added back; small business taxpayers exempt

Item	2025
Business gifts	\$25 per recipient per year
Business meals / entertainment	50% / 0%

Payroll and self-employment

Item	2025
Social Security wage base	\$176,100
FICA rates	6.2% + 1.45% each; 0.9% Additional Medicare on wages over \$200,000 (employee only)
Self-employment tax	15.3% on 92.35% of net profit; 2.9% above the wage base; half deductible
FUTA	6.0% on first \$7,000; 5.4% credit; net 0.6% (\$42 per employee); deposit when liability exceeds \$500
Deposit schedule lookback	\$50,000 or less: monthly; more than \$50,000: semiweekly; \$100,000 next-day rule
Form 941 due dates	April 30, July 31, October 31, January 31 (February 2, 2026 for Q4 2025)
Form 944 eligibility	Annual employment tax liability of \$1,000 or less
Forms W-2 / W-3 and 1099-NEC due	February 2, 2026 (January 31 is a Saturday)
Form 1099-NEC / 1099-MISC threshold	\$600
Form 1099-K threshold	\$20,000 and more than 200 transactions
Form 8300	Cash of more than \$10,000; file within 15 days
Information return penalties (section 6721)	\$60 (within 30 days); \$130 (by August 1); \$340 (after); small business ($\leq$ \$5,000,000 receipts) maximums \$239,000 / \$683,000 / \$1,366,000; intentional disregard greater of \$680 or 10%
Household employee FICA threshold	\$2,800
Child employed by parent's sole proprietorship	Exempt from FICA under 18; exempt from FUTA under 21
Section 530 relief	Reasonable basis, consistent treatment, all Forms 1099 filed

QBI, credits, and other limits

Item	2025
QBI deduction thresholds	\$197,300 single / \$394,600 joint; phase-in \$50,000 / \$100,000

Item	2025
Work opportunity credit	40% of first \$6,000 of first-year wages (\$2,400); 25% if 120–399 hours; expires for workers beginning after 2025
Disabled access credit	50% of expenditures between \$250 and \$10,250 (maximum \$5,000); gross receipts $\leq$ \$1,000,000 or $\leq$ 30 employees
Small employer pension startup credit	100% of costs up to \$5,000 ($\leq$ 50 employees); 50% (51–100); plus auto-enrollment \$500
Small business health care credit	Up to 50% of premiums; fewer than 25 FTEs; average wages below \$33,300 (phase-out)
Research credit (ASC)	14% of QREs above 50% of prior 3-year average; startup payroll tax election up to \$500,000
Employer-provided childcare credit	25% of facility costs + 10% of referral costs, maximum \$150,000
Paid family and medical leave credit	12.5% to 25% of wages paid during leave
Home office simplified method	\$5 per square foot, maximum 300 square feet (\$1,500)
Per diem (high-low method, Oct 2025)	\$319 high / \$225 low
ACA employer mandate	ALE at 50 FTEs; 4980H(a) \$2,900; 4980H(b) \$4,350; affordability 9.02%; minimum value 60%
QSEHRA limits	\$6,350 self-only / \$12,800 family
International penalties	Form 5471 \$10,000; Form 5472 \$25,000; Form 8865 \$10,000; FBAR threshold \$10,000 aggregate

Trusts, estates, and exempt organizations

Item	2025
Form 1041 filing threshold	Estate: gross income $\geq$ \$600; trust: any taxable income or gross income $\geq$ \$600
Exemptions	Estate \$600; simple trust \$300; complex trust \$100
Fiduciary brackets	10% to \$3,150; 24% to \$11,450; 35% to \$15,650; 37% above
Net investment income tax threshold (trusts)	\$15,650
65-day election	Distributions by March 6, 2026 may be treated as 2025 distributions
Form 1023 / 1023-EZ user fee	\$600 / \$275
Form 1023-EZ eligibility	Gross receipts $\leq$ \$50,000 (projected 3 years) and assets $\leq$ \$250,000
Form 990-N	Gross receipts normally $\leq$ \$50,000

Item	2025
Form 990-EZ	Gross receipts < \$200,000 and assets < \$500,000
Form 990-T threshold	Gross UBTI $\geq$ \$1,000; \$1,000 specific deduction; 21% rate
Automatic revocation	3 consecutive years of nonfiling
Late Form 990 penalty	\$25/day, maximum lesser of \$13,000 or 5% of receipts; \$130/day and \$65,000 if receipts > \$1,309,500
Low-cost article threshold	\$13.60
Donor acknowledgment / quid pro quo disclosure	\$250 / more than \$75
Private foundation excise tax on net investment income	1.39%

Retirement plans

Item	2025
401(k) / 403(b) elective deferral	\$23,500
Catch-up, age 50+ / ages 60–63	\$7,500 / \$11,250
Defined contribution annual additions (415(c))	\$70,000
Defined benefit annual benefit	\$280,000
Compensation limit	\$350,000
Highly compensated employee	\$160,000 (prior-year compensation)
Key employee (officer)	\$230,000
SEP contribution / compensation threshold	25% up to \$70,000 / \$750
SIMPLE deferral / catch-up 50+ / catch-up 60–63	\$16,500 / \$3,500 / \$5,250 (\$17,600 / \$3,850 for employers with ≤ 25 employees)
SIMPLE employer contribution	100% match up to 3%, or 2% nonelective
SIMPLE early withdrawal (first 2 years)	25% additional tax
IRA contribution / catch-up	\$7,000 / \$1,000
Form 5500 due date	July 31, 2026; extension 2½ months on Form 5558
Form 5500-EZ threshold	Plan assets over \$250,000
Prohibited transaction excise tax	15%; 100% if uncorrected
Mandatory withholding on eligible rollover distributions	20%
RMD age / excise tax	73 / 25% (10% if corrected in 2 years)
Plan loan limit	Lesser of \$50,000 or 50% of vested balance

Farmers and rentals

Item	2025
Farmer estimated tax	66⅔% rule; one payment by January 15, 2026 or file and pay by March 2, 2026
Prepaid farm supplies limit	50% of other deductible farm expenses
Soil and water conservation limit	25% of gross farm income
Livestock holding period for section 1231	24 months (cattle, horses); 12 months (others)
Weather-related livestock replacement period	2 years (4 in drought areas)
Vacation home residence test	Personal use > greater of 14 days or 10% of rental days
Minimal rental exclusion	Rented fewer than 15 days
Rental real estate allowance	\$25,000; phase-out MAGI \$100,000–\$150,000
Real estate professional	More than 750 hours and more than 50% of personal services

Appendix B. Forms Directory

Form or schedule	Purpose	Chapter
Schedule C (Form 1040)	Profit or loss from a sole proprietorship or single-member LLC	1, 5
Schedule E (Form 1040)	Rental income, royalties, and pass-through income from partnerships, S corporations, estates, and trusts	1, 7
Schedule F (Form 1040)	Profit or loss from farming	7
Schedule J (Form 1040)	Income averaging for farmers and fishermen	7
Schedule SE (Form 1040)	Self-employment tax	5
Form 1040-ES	Estimated tax for individuals, including sole proprietors and partners	6
Form 1065	U.S. return of partnership income	2
Schedule K-1 (Form 1065)	Partner's share of income, deductions, credits	2
Schedule K-2 / K-3	Items of international tax relevance (partnerships and S corporations)	2, 4
Form 8825	Rental real estate income of a partnership or S corporation	2
Form 1120	U.S. corporation income tax return	3
Form 1120-W	Corporate estimated tax worksheet (not filed)	3
Form 1120-S	U.S. income tax return for an S corporation	4
Schedule K-1 (Form 1120-S)	Shareholder's share of income, deductions, credits	4
Form 1120-H	Homeowners association return	3
Form 1120-POL	Political organization return	7
Form 2553	Election by a small business corporation (S election)	4
Form 8832	Entity classification election	1
Form 7004	Automatic extension for business, trust, and information returns	1–4, 7

Form or schedule	Purpose	Chapter
Form 966	Corporate dissolution or liquidation	3, 6
Form 1099-DIV	Dividends and distributions	3
Form 5452	Corporate report of nondividend distributions	3
Form 1125-A	Cost of goods sold	5
Form 1125-E	Compensation of officers	3
Form 4562	Depreciation and amortization, section 179 election	5
Form 4797	Sales of business property; section 1231, 1245, 1250 recapture; 280F recapture	6
Form 6252	Installment sale income	6
Form 8824	Like-kind exchanges	6
Form 8594	Asset acquisition statement (residual method)	6
Form 3115	Application for change in accounting method	6
Form 8829	Expenses for business use of the home	5
Form 6198	At-risk limitations	1
Form 8582	Passive activity loss limitations	1, 7
Form 461	Limitation on business losses	1
Form 8995 / 8995-A	Qualified business income deduction (simplified / full)	5
Form 3800	General business credit	5
Form 5884 / 8826 / 8881 / 8941 / 6765 / 8882 / 8994	Work opportunity, disabled access, pension startup, small employer health, research, childcare, paid leave credits	5
Form 941 / 944 / 940	Quarterly employment taxes / annual employment taxes / FUTA	5
Form 943	Employment taxes for agricultural employees	5, 7
Form 945	Annual return of withheld federal income tax (nonpayroll, including retirement distributions)	5, 7

Form or schedule	Purpose	Chapter
Forms W-2 / W-3 / W-4 / W-9	Wage statement / transmittal / employee withholding certificate / TIN request	5
Form 1099-NEC / 1099-MISC / 1099-K / 1099-PATR	Nonemployee compensation / miscellaneous income / payment card and third-party network / cooperative distributions	5, 7
Form 8300	Report of cash payments over \$10,000	6
Form 8919	Uncollected Social Security and Medicare tax on wages (misclassified worker)	6
Form SS-8	Determination of worker status	6
Form 8952	Voluntary Classification Settlement Program application	6
Form 720 / 2290 / 730 / 11-C	Quarterly excise tax / heavy highway vehicle use / wagering / occupational wagering tax	6
Form 5471 / 5472 / 8865 / 8938 / FinCEN 114	Foreign corporation / 25% foreign-owned U.S. corporation / foreign partnership / specified foreign financial assets / FBAR	6
Form 1042 / 1042-S	Withholding on U.S.-source income of foreign persons	6
Forms 1094-C / 1095-C / 1094-B / 1095-B	ACA employer coverage reporting	6
Form 1041	U.S. income tax return for estates and trusts	7
Schedule K-1 (Form 1041)	Beneficiary's share of income, deductions, credits	7
Form 1041-ES / 1041-T	Estimated tax for trusts and estates / allocation of estimated tax to beneficiaries	7
Form 3520 / 3520-A	Foreign trust transactions / annual return of foreign trust with U.S. owner	7
Form 1023 / 1023-EZ / 1024 / 1024-A / 8976	Applications for exemption; 501(c)(4) notice	7
Form 990 / 990-EZ / 990-N / 990-PF / 990-T	Exempt organization returns and unrelated business income tax	7
Form 8868	Extension for exempt organization returns	7

Form or schedule	Purpose	Chapter
Form 5768	Section 501(h) lobbying expenditure election	7
Form 5500 / 5500-SF / 5500-EZ / 5558	Annual retirement plan reports and extension	7
Form 1099-R	Distributions from pensions, IRAs, and retirement plans	7
Form 5305-SEP / 5304-SIMPLE / 5305-SIMPLE	Model plan documents	7
Form 5329 / 5330	Additional taxes on retirement accounts / excise taxes on plans (prohibited transactions)	7
Form 4835	Farm rental income (landowner not materially participating)	7
Form 2210-F	Underpayment of estimated tax by farmers and fishermen	7
Form 4684	Casualties and thefts	7

Appendix C. Glossary

Accountable plan. An expense reimbursement arrangement requiring a business connection, substantiation, and return of excess amounts, so reimbursements are excluded from wages.

Accumulated adjustments account (AAA). An S corporation's running record of undistributed income already taxed to shareholders, used to source distributions when the corporation has C corporation earnings and profits.

Accumulated earnings tax. A 20% penalty tax on C corporation earnings retained beyond the reasonable needs of the business and the \$250,000 (\$150,000) credit.

Adjusted basis. Original basis plus improvements, minus depreciation allowed or allowable and other reductions.

All-events test. The accrual-method standard: income or expense is recognized when all events fixing the right or liability have occurred and the amount can be determined with reasonable accuracy.

Applicable large employer (ALE). An employer with an average of 50 or more full-time employees (including equivalents) in the prior year, subject to the ACA employer mandate.

At-risk amount. The amount a taxpayer could economically lose in an activity; limits deductible losses under section 465.

Boot. Cash, other property, or net debt relief received in an otherwise nontaxable exchange; triggers recognition of gain up to its amount.

Built-in gains tax. The corporate-level tax on appreciation that existed when a C corporation became an S corporation, if recognized within five years.

Capital account. A partner's equity in the partnership under the agreement; differs from outside basis because it excludes the partner's share of liabilities.

Common-law employee. A worker whom the business has the right to control as to what will be done and how, under the behavioral, financial, and relationship factors.

Constructive dividend. An economic benefit a C corporation provides to a shareholder without declaring a dividend (personal expenses, below-market loans, excessive rent), taxed as a dividend to the extent of earnings and profits.

Debt basis. An S corporation shareholder's basis in loans made directly to the corporation; available to absorb losses after stock basis is exhausted.

De minimis safe harbor. The election to deduct, rather than capitalize, items costing \$2,500 or less (\$5,000 with an applicable financial statement).

Disregarded entity. A single-owner business entity treated as not separate from its owner for income tax purposes.

Distributable net income (DNI). The measure of a trust's or estate's income available for distribution; caps the distribution deduction and the beneficiaries' inclusion and carries character.

Dividends-received deduction (DRD). A C corporation's deduction of 50%, 65%, or 100% of dividends from other domestic corporations.

Earnings and profits (E&P). A corporation's economic capacity to pay dividends; distributions are dividends to the extent of current and accumulated E&P.

Economic performance. The point at which services are performed, property is provided, or property is used, required before an accrual-method taxpayer may deduct a liability.

Excess business loss. A noncorporate taxpayer's aggregate business losses in excess of \$313,000 (\$626,000 joint), carried forward as an NOL.

Fiduciary accounting income. Income as defined by the trust instrument and state law, as distinct from taxable income or DNI.

Form 3115. The application for a change in accounting method; automatic changes are filed with the return and copied to the IRS.

Grantor trust. A trust whose income is taxed to the grantor because the grantor retains powers or interests described in sections 671 through 679.

Guaranteed payment. A payment by a partnership to a partner for services or capital determined without regard to partnership income; ordinary income to the partner and deductible by the partnership.

Hot assets. Unrealized receivables and inventory items of a partnership; produce ordinary income on a sale of a partnership interest.

Inside basis / outside basis. The partnership's basis in its assets / a partner's basis in the partnership interest.

Like-kind exchange. A tax-deferred exchange of real property held for business or investment for other real property under section 1031.

Listed property. Passenger automobiles and other property used for transportation or entertainment, subject to section 280F substantiation and recapture rules.

Lookback period. The 12-month period ending June 30 of the prior year used to determine whether an employer deposits monthly or semiweekly.

Material participation. Regular, continuous, and substantial involvement in an activity under one of seven tests (500 hours is the most common); distinguishes active from passive income.

Net operating loss (NOL). The excess of allowable deductions over gross income; carried forward indefinitely and limited to 80% of taxable income.

Organizational costs. Costs of creating a corporation or partnership (legal fees, state fees); \$5,000 deductible, remainder amortized over 180 months.

Personal service corporation. A C corporation whose principal activity is services in health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, performed substantially by employee-owners.

Qualified business income (QBI). Net income from a domestic trade or business other than wages, guaranteed payments, capital gains, and investment income; basis for the 20% deduction.

Qualified improvement property (QIP). Interior improvements to nonresidential buildings placed in service after the building; 15-year property eligible for bonus.

Reasonable compensation. Wages an S corporation must pay a shareholder-employee for services before making distributions; also the ceiling on deductible C corporation officer pay.

Recapture. Recharacterization of gain as ordinary income to the extent of prior depreciation (sections 1245 and 1250) or of prior deductions (section 280F, section 179 business-use drop).

Related party. Persons listed in section 267 (family members, more-than-50%-owned entities, and others) between whom losses are disallowed and deductions deferred.

Residual method. The allocation of a lump-sum business purchase price among asset classes in order, with goodwill last (Form 8594).

Section 179 expense. The election to deduct the cost of qualifying tangible personal property and certain improvements in the year placed in service, up to \$2,500,000.

Section 481(a) adjustment. The cumulative catch-up required when a taxpayer changes accounting methods, so that no item is duplicated or omitted.

Section 530 relief. Statutory protection from employment tax liability for a business that had a reasonable basis for treating workers as contractors, treated them consistently, and filed Forms 1099.

Section 1231 property. Depreciable property and land used in a trade or business and held more than one year; net gains are capital, net losses ordinary.

Section 1245 property. Depreciable personal property (and certain real property); gain is ordinary to the extent of all depreciation taken.

Section 1250 property. Depreciable real property; for individuals, gain attributable to straight-line depreciation is taxed at a maximum 25% rate.

Separately stated item. An item of partnership or S corporation income, deduction, or credit that could affect owners differently and is therefore reported individually on Schedule K-1.

Simple trust. A trust required to distribute all income currently, with no charitable contributions and no corpus distributions in the year.

Small business taxpayer. A taxpayer with average annual gross receipts of \$31,000,000 or less for the three prior years; eligible for the cash method, inventory simplification, UNICAP exemption, and the section 163(j) exemption.

Specified service trade or business (SSTB). A business in health, law, accounting, consulting, financial services, athletics, performing arts, and similar fields whose QBI deduction phases out above the thresholds.

Statutory employee. A worker treated as an employee for FICA by statute (certain drivers, life insurance salespeople, home workers, traveling salespeople) regardless of common-law status.

Unrelated business taxable income (UBTI). Income of an exempt organization from a regularly carried on trade or business not substantially related to its exempt purpose; taxed at 21% on Form 990-T.

Unrecaptured section 1250 gain. The portion of gain on real property attributable to straight-line depreciation, taxed to individuals at a maximum rate of 25%.

Appendix D. Sources and Authorities

This guide is built on the following primary sources, as amended through December 31, 2025. Every figure in Appendix A traces to one of them. Readers should consult the current versions of these documents, since the IRS updates publications and instructions each year.

Exam administration

- PSI Services LLC, Candidate Information Bulletin: IRS Enrolled Agent Special Enrollment Examination (revised 2026), including the Part 2 Examination Content Outline and scoring information. <https://test-takers.psigo.gov/irs>
- Internal Revenue Service, “Enrolled Agents: Frequently Asked Questions.” <https://www.irs.gov/tax-professionals/enrolled-agents/enrolled-agents-frequently-asked-questions>
- Internal Revenue Service, “Become an Enrolled Agent.” <https://www.irs.gov/tax-professionals/enrolled-agents/become-an-enrolled-agent>

Inflation adjustments and 2025 figures

- Rev. Proc. 2024-40, 2025 inflation adjustments (penalties under sections 6651, 6652(c), 6695, 6698, 6699, 6721, and 6722; QBI thresholds; section 448(c) gross receipts; section 461(l) excess business loss; fiduciary rate brackets; section 513(h) low-cost articles; section 6334 exempt amounts; and other items). <https://www.irs.gov/pub/irs-drop/rp-24-40.pdf>
- Rev. Proc. 2023-34, 2024 inflation adjustments (penalty amounts for returns filed in 2025). <https://www.irs.gov/pub/irs-drop/rp-23-34.pdf>
- Notice 2024-80, 2025 retirement plan and IRA limits. <https://www.irs.gov/pub/irs-drop/n-24-80.pdf>
- Rev. Proc. 2025-16, 2025 depreciation limits for passenger automobiles and lease inclusion amounts. <https://www.irs.gov/pub/irs-drop/rp-25-16.pdf>
- Rev. Proc. 2025-28, procedures for implementing the One Big Beautiful Bill Act business provisions (research expenditures, bonus depreciation elections). <https://www.irs.gov/pub/irs-drop/rp-25-28.pdf>
- IRS Notice 2025-5, 2025 standard mileage rates. <https://www.irs.gov/pub/irs-drop/n-25-05.pdf>

One Big Beautiful Bill Act (P.L. 119-21) guidance

- Internal Revenue Service, “One Big Beautiful Bill provisions.” <https://www.irs.gov/newsroom/one-big-beautiful-bill-provisions>
- Internal Revenue Service, “Understanding the Working Families Tax Cuts: Business tax provisions” (video transcript covering bonus depreciation, section 179, section 174A, section 163(j), QSBS, Form 1099 thresholds, and meals). <https://www.irs.gov/newsroom/understanding-the-working-families-tax-cuts-business-tax-provisions-youtube-video-text-script>
- Internal Revenue Service, “Form 1099-K FAQs: General information.” <https://www.irs.gov/newsroom/form-1099-k-faqs-general-information>

Forms, instructions, and publications

- Instructions for Form 4562, Depreciation and Amortization (2025). <https://www.irs.gov/instructions/i4562>
- Publication 463, Travel, Gift, and Car Expenses (2025). <https://www.irs.gov/pub/irs-pdf/p463.pdf>
- Publication 15 (Circular E), Employer's Tax Guide (2025). <https://www.irs.gov/publications/p15>
- Publication 15-B, Employer's Tax Guide to Fringe Benefits. <https://www.irs.gov/publications/p15b>
- Publication 334, Tax Guide for Small Business. <https://www.irs.gov/publications/p334>
- Publication 535 successor guidance on business expenses, now in Publication 334 and the Schedule C instructions. <https://www.irs.gov/instructions/i1040sc>
- Publication 538, Accounting Periods and Methods. <https://www.irs.gov/publications/p538>
- Publication 541, Partnerships. <https://www.irs.gov/publications/p541>
- Publication 542, Corporations. <https://www.irs.gov/publications/p542>
- Instructions for Form 1120-S. <https://www.irs.gov/instructions/i1120s>
- Publication 544, Sales and Other Dispositions of Assets. <https://www.irs.gov/publications/p544>
- Publication 946, How To Depreciate Property. <https://www.irs.gov/publications/p946>
- Publication 225, Farmer's Tax Guide. <https://www.irs.gov/publications/p225>
- Publication 527, Residential Rental Property. <https://www.irs.gov/publications/p527>
- Publication 925, Passive Activity and At-Risk Rules. <https://www.irs.gov/publications/p925>
- Publication 560, Retirement Plans for Small Business. <https://www.irs.gov/publications/p560>
- Publication 557, Tax-Exempt Status for Your Organization. <https://www.irs.gov/publications/p557>
- Publication 598, Tax on Unrelated Business Income of Exempt Organizations. <https://www.irs.gov/publications/p598>
- Instructions for Form 1041 and Schedules A, B, G, J, and K-1. <https://www.irs.gov/instructions/i1041>
- Publication 15-A, Employer's Supplemental Tax Guide (worker classification). <https://www.irs.gov/publications/p15a>
- Instructions for Form 8300. <https://www.irs.gov/instructions/i8300>
- Instructions for Forms 1094-C and 1095-C. <https://www.irs.gov/instructions/i109495c>

Exempt organizations and retirement plans

- Internal Revenue Service, "Form 990 series: Which forms do exempt organizations file." <https://www.irs.gov/charities-non-profits/form-990-series-which-forms-do-exempt-organizations-file-filing-phase-in>
- Internal Revenue Service, "Form 1023 and 1023-EZ: Amount of user fee." <https://www.irs.gov/charities-non-profits/form-1023-and-1023-ez-amount-of-user-fee>
- Internal Revenue Service, "Automatic revocation of exemption." <https://www.irs.gov/charities-non-profits/automatic-revocation-of-exemption>
- Internal Revenue Service, "Retirement topics: 401(k) and profit-sharing plan contribution limits." <https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-401k-and-profit-sharing-plan-contribution-limits>
- Internal Revenue Service, "SIMPLE IRA plan." <https://www.irs.gov/retirement-plans/plan-sponsor/simple-ira-plan>

Employment tax, worker classification, and ACA

- Internal Revenue Service, “Independent contractor (self-employed) or employee?” <https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee>
- Internal Revenue Service, “Voluntary Classification Settlement Program.” <https://www.irs.gov/businesses/small-businesses-self-employed/voluntary-classification-settlement-program>
- Internal Revenue Service, “Employer shared responsibility provisions.” <https://www.irs.gov/affordable-care-act/employers/employer-shared-responsibility-provisions>
- Internal Revenue Service, “E-file requirements for specified tax return preparers.” <https://www.irs.gov/e-file-providers/frequently-asked-questions-e-file-requirements-for-specified-tax-return-preparers-sometimes-referred-to-as-the-e-file-mandate>

Statutes and regulations

- Internal Revenue Code of 1986, as amended through December 31, 2025, including sections 11, 162, 163(j), 168, 174A, 179, 195, 199A, 243, 248, 267, 269, 274, 280F, 301–318, 351–368, 441–483, 531–537, 641–692, 701–777, 1031, 1202, 1231, 1239, 1245, 1250, 1361–1379, 1401–1402, 3101–3134, 3301–3311, 3401–3406, 3509, 4975, 4980H, 6031–6050, 6651, 6652, 6656, 6698, 6699, 6721, 6722. <https://uscode.house.gov/browse/prelim@title26>
- Treasury Regulations, Title 26, Code of Federal Regulations, including §§1.263(a)-1 through -3 (tangible property), §301.7701-1 through -3 (entity classification), and §31.3121(d)-1 (employee status). <https://www.ecfr.gov/current/title-26>

Appendix E. Changes That Take Effect in 2026 and Are Not on Your Exam

The exam tests law as of December 31, 2025. The following changes take effect for tax years beginning after 2025 or for returns filed in 2027. Knowing them protects you from choosing an answer built on a 2026 rule.

Area	2025 rule (on the exam)	2026 change (not on the exam)
Section 179	\$2,500,000 limit; \$4,000,000 phase-out; \$31,300 SUV	\$2,560,000; \$4,090,000; \$32,000 SUV
Form 1099-NEC and 1099-MISC threshold	\$600	\$2,000 (indexed after 2026)
Employer-provided meals and de minimis food	50% deductible	Not deductible (certain exceptions, such as fishing vessels and restaurants' own employees, remain)
Social Security wage base	\$176,100	\$184,500
QBI deduction phase-in range	\$50,000 / \$100,000	\$75,000 / \$150,000, plus a \$400 minimum deduction for active businesses with \$1,000 or more of QBI
401(k) elective deferral / catch-up	\$23,500 / \$7,500	\$24,500 / \$8,000 (ages 60–63 catch-up remains \$11,250)
Defined contribution annual additions	\$70,000	\$72,000
Defined benefit limit	\$280,000	\$290,000
Compensation limit	\$350,000	\$360,000
Key employee threshold	\$230,000	\$235,000
SEP compensation threshold	\$750	\$800
SIMPLE deferral / catch-up	\$16,500 / \$3,500	\$17,000 / \$4,000
IRA contribution / catch-up	\$7,000 / \$1,000	\$7,500 / \$1,100
Catch-up contributions by higher earners	May be pre-tax or Roth	Must be Roth for participants whose prior-year FICA wages exceeded \$150,000
Fiduciary brackets	10% to \$3,150; 24% to \$11,450; 35% to \$15,650	10% to \$3,300; 24% to \$11,700; 35% to \$16,000
Late Form 1065 / 1120-S penalty	\$255 per owner per month	\$260 per owner per month (returns required to be filed in 2027)

Area	2025 rule (on the exam)	2026 change (not on the exam)
Work opportunity tax credit	Available for employees beginning work by December 31, 2025	Expired for employees beginning work after 2025
Section 1202 QSBS (stock issued after July 4, 2025)	Already in effect for new issuances	Tiered exclusion continues; thresholds indexed beginning 2027
Clean energy business credits (sections 45L, 179D, 30C, 45W)	Available for property placed in service or acquired within 2025 deadlines	Terminated or phased out on various 2026 dates
Employer-provided childcare credit	\$150,000 maximum	\$500,000 (\$600,000 for small businesses)
Paid family and medical leave credit	Expires after 2025 under prior law	Made permanent, with insurance premium option
Trump accounts	Not applicable to employers	Employers may contribute up to \$2,500 per employee beginning July 4, 2026
Charitable contributions by corporations	10% limit, no floor	1% floor; only contributions above 1% of taxable income are deductible, within the 10% limit

A final word from the author. Part 2 covers more ground than the other two parts, but its logic is consistent: every business question comes down to who the taxpayer is (entity), when and how much is recognized (preparation), and what the owner should do next (advising). If you can work through the Lopez family's businesses in this book and explain each result to a client in plain English, you are ready. Schedule the exam, bring your government-issued ID, read every question twice, and trust the rule.

Kenneth Omoruyi, M. Tax, EA, CPA
EnrolledAgent.com