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Enrolled Agent Part 2 Study Guide

Businesses — Special Enrollment Examination Part 2

Tax year 2025 law · for SEE testing July 2026 – Feb 2027

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How to Use This Guide and the Exam Format

Who this guide is for

This guide is for candidates preparing for Part 2 (Businesses) of the IRS Special Enrollment Examination (SEE), the exam that leads to the enrolled agent (EA) credential. It explains in plain language the business tax rules that Part 2 tests: sole proprietors, partnerships, C and S corporations, payroll, depreciation, retirement plans, trusts and estates, exempt organizations, farmers and rental property. Key 2025 numbers are in tables, and each chapter has worked examples you can follow line by line.

Each chapter matches a group of practice tests on UPractice.org. The best routine is simple: read a chapter, take that chapter's practice test, then go back to the "Watch out" boxes for every question you missed.

What law the exam uses

The SEE is updated once a year. For the testing window that runs **July 1, 2026 through February 28, 2027**, the IRS says the exam is based on the Internal Revenue Code, forms and publications as amended **through December 31, 2025**, and that questions refer to **tax year 2025**. In practice:

- All amounts in this guide are 2025 amounts: Rev. Proc. 2024-40 and Notice 2024-80, as changed by the One Big Beautiful Bill Act (OBBBA), signed July 4, 2025.
- OBBBA business changes that already apply to 2025 are covered in full. The biggest are the $2,500,000 Section 179 limit, permanent 100% bonus depreciation for property acquired after January 19, 2025, immediate expensing of domestic research costs, and the return to an EBITDA-based business interest limit.
- Changes that start in 2026 or later (for example, the $2,000 Form 1099-NEC threshold or the 1% floor on corporate charitable gifts) are flagged as "future" items. Answer exam questions with 2025 law.

> **Watch out:** Many older materials still show the pre-OBBBA 2025 Section 179 limit of $1,250,000 (phase-out at $3,130,000) or a 40% bonus rate for everything placed in service in 2025. For property acquired after January 19, 2025, both are wrong.

Exam format at a glance

The SEE moved to a new testing vendor, PSI, in 2026. The facts below come from the IRS enrolled agent FAQ for the current window. Rules can change, so confirm them on IRS.gov and in the PSI candidate bulletin before you schedule.

Item	Part 2 (Businesses)
Questions	100 multiple-choice (85 scored, 15 unscored experimental)
Testing time	3.5 hours
Seat time	4 hours (includes tutorial, survey and two 10-minute breaks)
Score scale	200 to 800
Passing score	500
Fee	$317 per part, paid when you schedule
Domestic testing window	July 1, 2026 – Feb. 28, 2027 (no testing in March and April)
Attempts	Up to 4 times per part per testing window
Credit carryover	A passed part counts for 3 years from the date you passed it

A few practical points:

- You cannot tell which 15 questions are experimental, so treat every question as scored.
- A passing report shows "pass" without a number. A failing report shows a scaled score and diagnostic information by domain.
- Cancelling or rescheduling at least 48 hours ahead is free. Later than that, or missing the appointment, costs the full fee.
- After failing a part you must wait 24 hours before scheduling that part again. Other parts can be scheduled right away.
- You need a PTIN (preparer tax identification number) to register.

> **Exam tip:** With 100 questions in 210 minutes you have just over 2 minutes per question. Answer the short rule questions quickly, and save time for basis roll-forwards and depreciation computations.

The Part 2 content outline

The IRS content outline for Part 2 has three domains. The outline's scored-question counts are shown below.

Domain	Main subjects	Scored questions	Chapters in this guide
1. Business entities and considerations	Entity types and classification, EINs, tax years, hobby rules; partnerships; C corporations (formation, E&P, distributions, liquidations); S corporations	30	2, 3, 10, 11, 12, 13, 14
2. Business tax preparation	Business income, COGS, expenses, depreciation and Section 179, credits, NOLs, QBI, business assets and dispositions, accounting methods, payroll, worker classification, advising	37	3, 4, 5, 6, 7, 8, 9
3. Specialized returns and taxpayers	Trusts and estates, exempt organizations, retirement plans, farmers, rental property	18	15, 16, 17

How the chapters are organised

Every chapter follows the same pattern:

1. A plain-language explanation of each rule the exam tests.
2. Key numbers in tables (2025 amounts).
3. Worked examples in blue boxes, with every step of the arithmetic shown.
4. Green exam tips, red traps and purple memory tricks.
5. A short "Key takeaways" list for review the night before the exam.

Chapter	Topic	Practice-test topic on UPractice.org
2	Business entities	Business entities
3	Accounting methods and periods	Accounting methods & periods
4	Business income	Business income
5	Business expenses	Business expenses
6	QBI deduction, credits and loss limits	Business expenses
7	Depreciation, Section 179 and bonus	Depreciation; Business expenses & depreciation
8	Business assets and dispositions	Depreciation; Business income
9	Employment taxes	Employment taxes
10	Partnerships: formation, operations and basis	Partnerships; Partnerships & S corporations
11	Partnerships: distributions, dispositions and filing	Partnerships
12	C corporations: formation, income and filing	C corporations
13	C corporations: E&P, distributions and liquidations	C corporations
14	S corporations	S corporations; Partnerships & S corporations
15	Retirement plans	Retirement plans
16	Trusts, estates and exempt organizations	Trusts, estates & exempt organizations
17	Specialized returns, farming and rental property	Specialized returns & farming
18	Final review checklist	All topics

A study plan that works

1. **Weeks 1–2:** Chapters 2–6. These set up the vocabulary (gross receipts, ordinary and necessary, basis, at-risk) used everywhere else.
2. **Weeks 3–4:** Chapters 7–9. Do depreciation and payroll by hand until the numbers feel routine.
3. **Weeks 5–6:** Chapters 10–14. Entities are about one third of the exam. Practice partner basis and S shareholder basis until each roll-forward takes under two minutes.
4. **Week 7:** Chapters 15–17, the specialized domain.
5. **Week 8:** Chapter 18, two full timed practice exams, and a review of every missed question.

> **Memory trick:** "P-S-C, 3-3-4": partnerships and S corporations are due on the 15th day of the **3rd** month, and C corporations on the 15th day of the **4th** month after year-end.

Exam-day habits

- On your scratch material, jot down the basis ordering rules and the depreciation conventions in the first minute.
- Read the **entity type** in every question. A rule for partnerships often differs for S corporations (debt basis, for example).
- Look for the **year**. If a question gives a date in 2025, use 2025 law. If it mixes years, note which year each fact belongs to.
- Flag long computations, move on, and come back.
- Never leave a question blank. There is no penalty for guessing.

Key takeaways

- Part 2 tests tax year 2025 law (IRC as amended through Dec. 31, 2025), for testing July 1, 2026 – Feb. 28, 2027.
- 100 questions (85 scored) in 3.5 hours, scaled 200–800, pass at 500, $317 per part, through PSI.
- Domain 2 (Business tax preparation, 37 questions) is the largest. Domain 1 (entities, 30) is next. Domain 3 (specialized returns, 18) is the smallest.
- Learn the OBBBA changes that apply to 2025 and set aside those that start in 2026.

Business Entities

Why entity choice matters

The same business can be run as a sole proprietorship, a partnership, a C corporation or an S corporation. The choice decides who pays the income tax (the business or the owners), which return is filed, how owners pay Social Security and Medicare tax, how losses flow out, and how money comes out of the business. The exam tests both the classification rules and how to compare the entities.

The main entity types

Sole proprietorship

A sole proprietor owns an unincorporated business alone. There is no separate return. Profit or loss goes on **Schedule C** (or **Schedule F** for farming) attached to Form 1040, and net earnings of $400 or more are subject to **self-employment (SE) tax** on Schedule SE.

- SE tax is 15.3% (12.4% Social Security + 2.9% Medicare) on **92.35%** of net SE earnings. The 12.4% part stops at the 2025 wage base of **$176,100** (reduced by any W-2 Social Security wages). The 2.9% part has no cap.
- Half of the SE tax is an adjustment to income on Form 1040. It is not a business expense on Schedule C.
- A married couple who jointly own and run an unincorporated business (not through a state-law entity) can elect to be a **qualified joint venture**. Each spouse then files a separate Schedule C instead of a partnership return, so each spouse earns Social Security credit.

Partnership

A partnership is an unincorporated business with **two or more owners**, such as a general partnership, a limited partnership, or a multi-member LLC that has not elected corporate treatment. It files **Form 1065**, an information return, and gives each partner a **Schedule K-1**. The partnership itself pays no income tax. Partners report their shares whether or not cash is distributed. Chapters 10 and 11 cover partnerships in detail.

C corporation

A corporation formed under state law is taxed as a separate taxpayer on **Form 1120** at a flat **21%** rate. When it later pays dividends, shareholders are taxed again. That is the "double tax." Owners who work in the business are employees and receive W-2 wages. See Chapters 12 and 13.

S corporation

An eligible domestic corporation (or an LLC that has elected to be taxed as a corporation) can elect S status on **Form 2553**. It files **Form 1120-S**. Income generally passes through to

shareholders on Schedule K-1, as with a partnership, but with stricter eligibility rules and different basis rules. Shareholder-employees must receive **reasonable compensation** as W-2 wages. See Chapter 14.

Entity classification ("check-the-box")

The entity classification regulations decide how an **eligible entity** (any business entity that is not automatically a corporation) is taxed.

Entity	Default classification	Can elect
Domestic corporation formed under state corporation law	Corporation ("per se"). It cannot elect otherwise	S status, if eligible (Form 2553)
Domestic LLC with one member	Disregarded entity: a sole proprietorship if owned by an individual, or a branch/division if owned by a corporation	Association taxable as a corporation (Form 8832); S status (Form 2553 alone also works)
Domestic LLC with two or more members	Partnership	Association taxable as a corporation; S status
Foreign eligible entity	Corporation if all members have limited liability; partnership or disregarded entity if at least one member has unlimited liability	Change by Form 8832

Key election rules:

- **Form 8832** elects or changes classification. The election can take effect up to **75 days before** or **12 months after** the date it is filed.
- After a classification change, another change generally cannot be made for **60 months**.
- An eligible entity that files a timely, valid **Form 2553** is treated as having elected corporate status too, so it does not also need Form 8832.
- A single-member LLC is disregarded for **income tax**, but it is treated as a separate entity for **employment taxes** and certain excise taxes. An LLC with employees therefore uses its own EIN for payroll.

> **Watch out:** "LLC" is a state-law label, not a tax classification. Never answer an LLC question until you know how many members it has and whether it made an election.

Employer identification numbers (EINs)

An EIN is applied for on **Form SS-4** (or online). A business needs an EIN if it has employees, operates as a corporation or partnership, files excise or employment tax returns, or has a Keogh/self-employed retirement plan, among other triggers.

A **new EIN** is generally needed when:

- a sole proprietor incorporates or forms a partnership;
- a partnership incorporates, or a new partnership is formed from an old one that ended;
- a corporation becomes a subsidiary of another corporation, or a new corporation is formed in a merger.

A new EIN is generally **not** needed when a corporation elects S status, changes its name or location, or when a sole proprietor changes the business name or adds locations.

Business or hobby?

A taxpayer engaged in an activity **for profit** can deduct its expenses and use a loss against other income. If the activity is **not** engaged in for profit (a hobby), all gross income from it is still taxable, but hobby expenses are **not deductible** (they were miscellaneous itemized deductions, which are no longer allowed). Hobby income is reported on Schedule 1 as other income.

The regulations list nine factors for judging profit motive:

1. The manner in which the activity is carried on (businesslike records, changing methods that lose money).
2. The expertise of the taxpayer or the advisers.
3. Time and effort spent.
4. Expectation that assets will appreciate.
5. Success in similar or dissimilar activities.
6. History of income or losses.
7. Amount of occasional profits.
8. Financial status of the taxpayer (other income that the losses shelter).
9. Elements of personal pleasure or recreation.

Safe-harbor presumption: the activity is presumed to be for profit if it produced a profit in **3 of the last 5** tax years (**2 of 7** for breeding, training, showing or racing horses). A taxpayer can file **Form 5213** to postpone the determination until the fifth (or seventh) year.

> **Example:** A hobby photographer earns $8,000 from selling prints in 2025 and spends $10,000 on equipment and travel for the activity.
>
> Step 1 – Is it a business? No: no profit history, no business plan, mainly personal enjoyment.
>
> Step 2 – Income: the full $8,000 is taxable as other income.
>
> Step 3 – Expenses: the $10,000 is not deductible at all.
>
> Result: $8,000 added to income, and no loss is allowed.

Comparing the entities

Feature	Sole proprietor	Partnership / multi-member LLC	S corporation	C corporation
Return	Schedule C (Form 1040)	Form 1065	Form 1120-S	Form 1120
Due date (calendar year)	April 15	15th day of 3rd month (March 15)	15th day of 3rd month (March 15)	15th day of 4th month (April 15)
Extension (Form 4868 / 7004)	6 months	6 months	6 months	6 months
Who pays income tax	Owner	Partners	Shareholders (with a few entity-level taxes)	Corporation, at 21%
Owner pay	Draws (not deductible)	Guaranteed payments	W-2 wages	W-2 wages
Owner employment tax	SE tax on all net earnings	SE tax for general partners and active LLC members	FICA on wages only; K-1 income is not SE income	FICA on wages only
Number of owners	1	2 or more	1–100 eligible shareholders	No limit
Owner basis includes entity debt?	n/a	Yes, share of partnership liabilities	No, only direct loans by the shareholder	n/a
Losses	Flow to owner	Flow to partners (basis, at-risk, passive limits)	Flow to shareholders (basis, at-risk, passive limits)	Stay in corporation as NOL

For calendar-year 2025 returns, March 15, 2026 is a Sunday, so Forms 1065 and 1120-S are due **Monday, March 16, 2026**. Forms 1120 and 1041 are due **April 15, 2026**.

Example (SE tax: sole proprietor versus S corporation): Maria's business earns $120,000 before any owner pay in 2025.

As a sole proprietor: SE tax = $120,000 × 92.35% × 15.3% = **$16,955.46**. Half of that, $8,477.73, is an adjustment to income.

As an S corporation paying her a reasonable salary of $70,000: FICA = $70,000 × 15.3% = **$10,710** ($5,355 withheld from her pay and $5,355 paid by the corporation). The remaining profit passes through on her K-1 and is not subject to SE tax.

The S corporation saves payroll tax only if the salary is truly reasonable for the work she does. It also adds payroll filings and a separate return.

Penalties for late pass-through returns

A partnership or S corporation that files late (or files an incomplete return) owes a penalty for **each month or part of a month** the return is late, up to **12 months**, multiplied by the **number of partners or shareholders** at any time during the year. For returns required to be filed in 2026 (calendar-year 2025 returns), the monthly amount is **$255** per partner or shareholder (Rev. Proc. 2024-40).

> **Example:** A calendar-year partnership with 4 partners files its 2025 Form 1065 three months late without reasonable cause and without an extension.
>
> Penalty = 4 partners × 3 months × $255 = **$3,060**.

> **Example:** An S corporation with 2 shareholders files its 2025 Form 1120-S five months late.
>
> Penalty = 2 × 5 × $255 = **$2,550**.

> **Exam tip:** Small partnerships (10 or fewer partners, all of them individuals or estates, each partner's share of every item the same) may get first-time or reasonable-cause relief under long-standing IRS procedures. The penalty still exists; relief is requested.

Choosing an entity (advising questions)

The outline asks you to advise on entity selection. Typical points:

- **Liability protection** comes from state law (corporation or LLC), not from the tax classification.
- **Pass-through entities** avoid double tax and let losses flow out. **C corporations** pay a flat 21% and may suit businesses that reinvest profits. Watch for the accumulated earnings tax (Chapter 13).
- **S corporations** can reduce payroll tax but have strict eligibility rules: one class of stock, no nonresident alien shareholders, no more than 100 shareholders.
- **Partnerships** offer the most flexibility: special allocations, and debt basis that includes entity liabilities.
- Owners of pass-throughs may qualify for the **QBI deduction** (Chapter 6). C corporation shareholders do not.

Key takeaways

- Default classification: one-member LLC = disregarded; two or more = partnership; state-law corporation = corporation.
- Form 8832 elects classification (75 days back, 12 months forward, then a 60-month wait). Form 2553 elects S status.
- Hobby income is taxable, but hobby expenses are not deductible. The presumption of profit is 3 of 5 years (2 of 7 for horses).
- Calendar-year due dates for 2025 returns: 1065/1120-S March 16, 2026 (March 15 is a Sunday); 1120 April 15, 2026.
- Late 1065/1120-S penalty: $255 × owners × months (up to 12) for 2025 returns filed in 2026.
- SE tax: 92.35% × 15.3%, with the Social Security part capped at the $176,100 wage base for 2025.

Accounting Methods and Periods

Overview

An **accounting method** decides *when* income and expenses are reported. An **accounting period** (tax year) decides the 12-month window used. The exam tests who may use the cash method, the accrual rules, inventory, method changes on Form 3115, and the required tax years of pass-through entities.

The cash method

Under the cash method, income is reported when it is **actually or constructively received**, and expenses are deducted when **paid**.

- **Constructive receipt:** income is received when it is credited to the taxpayer's account or made available without substantial restriction. A check received on December 31 is 2025 income even if it is deposited in January.
- **Prepaid expenses:** generally deducted over the period they cover. The **12-month rule** lets a cash-method taxpayer deduct a prepayment that creates a right or benefit lasting no more than 12 months and not extending beyond the end of the following tax year.
- Paying by **credit card** counts as payment when charged. Giving a **note** (a promise to pay) does not.

The accrual method

Under the accrual method:

- **Income** is reported when the **all-events test** is met: all events have occurred that fix the right to receive it, and the amount can be determined with reasonable accuracy. It is no later than when the income is received, due or earned.
- **Expenses** are deducted when all events fixing the liability have occurred, the amount is reasonably determinable, and **economic performance** has occurred (services or property provided, or payment made for items such as taxes and tort liabilities).
- **Recurring item exception:** certain recurring expenses can be deducted in the year the all-events test is met if economic performance happens within 8½ months after year-end.
- **Compensation:** accrued bonuses are deductible in the accrual year if paid within **2½ months** after year-end.
- **Related parties (§267):** an accrual-method payer cannot deduct an amount owed to a related cash-method payee (for example, a more-than-50% shareholder) until the payee includes it in income.

Advance payments

An accrual-method taxpayer that receives an **advance payment** for goods or services may defer the part not earned by year-end to the **next tax year only** (§451(c)), if the same deferral applies in its financial statements.

> **Example:** On October 1, 2025, an accrual-method calendar-year company receives $24,000 for a 24-month service contract.
>
> Earned in 2025: $24,000 × 3/24 = **$3,000** (October through December).
>
> Deferred: $24,000 − $3,000 = **$21,000**, all of which must be included in 2026, even though part of the service is performed in 2027.

> **Example (cash versus accrual):** A consultant collects $90,000 in 2025 for work billed in 2025, collects $5,000 in 2025 for work billed in 2024, and bills $12,000 in December 2025 that is collected in January 2026.
>
> Cash method 2025 income: $90,000 + $5,000 = **$95,000**.
>
> Accrual method 2025 income: $90,000 + $12,000 = **$102,000** (the $5,000 was 2024 income).

Who may use the cash method

Any taxpayer may use the cash method **except**:

- a **C corporation**, or a **partnership with a C corporation partner**, whose average annual gross receipts for the 3 prior tax years exceed the **gross receipts test** amount: **$31,000,000** for tax years beginning in 2025;
- a **tax shelter**, which can never use the cash method.

S corporations, partnerships without C corporation partners, and sole proprietors are not limited by the gross receipts test for the cash method (unless they are tax shelters). Qualified personal service corporations (health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting) may use the cash method regardless of size.

The same **$31 million** test also exempts small businesses from:

Rule	Small business relief (average gross receipts ≤ $31,000,000)
Inventories	May treat inventory as non-incidental materials and supplies, or follow the method in their books
Uniform capitalization (UNICAP, §263A)	Exempt
Long-term contracts	May use the completed-contract method for contracts expected to finish within the allowed period
Business interest limit (§163(j))	Exempt (Chapter 6)

Example: A C corporation had gross receipts of $28,000,000 in 2022, $33,000,000 in 2023 and $30,000,000 in 2024.

Average = ($28,000,000 + $33,000,000 + $30,000,000) ÷ 3 = **$30,333,333**.

That is not more than $31,000,000, so the corporation may use the cash method in 2025, even though one year was above the limit.

Watch out: The test uses the average of the **three prior** years, not the current year. Gross receipts of related businesses under common control are aggregated.

Inventories

A business that must keep inventories values them at **cost**, or at **lower of cost or market**. Common cost-flow assumptions:

- **Specific identification:** each item is tracked (cars, jewelry).
- **FIFO** (first-in, first-out): ending inventory is the most recent purchases.
- **LIFO** (last-in, first-out): elected on **Form 970**. A business that uses LIFO for tax must also use it for financial reports to owners and creditors (the **LIFO conformity** rule). LIFO cannot be combined with lower of cost or market.

Cost of goods sold is covered in Chapter 4.

Hybrid methods

A business may use a combination, for example accrual for purchases and sales of inventory and cash for everything else, if the combination clearly reflects income and is used consistently.

Changing an accounting method

A change in the overall method, or in the treatment of a material item, requires IRS consent, generally on **Form 3115**.

- **Automatic changes** (listed in the current revenue procedure): file Form 3115 with the timely filed return (including extensions) for the year of change, and send a copy to the IRS.
- **Non-automatic changes:** file during the year of change and pay a user fee.
- **Section 481(a) adjustment:** prevents income from being doubled or skipped because of the change. A **positive** (income-increasing) adjustment is generally spread over **4 years** (the year of change and the next 3). A **negative** adjustment is taken entirely in the **year of change**.

Correcting a math or posting error is **not** a change in method. Changing the treatment of an item consistently used on two or more returns **is**.

> **Example:** A business switches from cash to accrual in 2025. The change creates a positive §481(a) adjustment of $120,000 (receivables never taxed under the cash method).
>
> Spread over 4 years: $120,000 ÷ 4 = **$30,000** a year for 2025, 2026, 2027 and 2028.
>
> If the adjustment had been negative, the whole amount would be deducted in 2025.

Accounting periods (tax years)

A tax year can be:

- a **calendar year** (January 1 – December 31);
- a **fiscal year**: 12 consecutive months ending on the last day of any month except December;
- a **52–53-week year**: always ending on the same day of the week.

Individuals almost always use the calendar year. A taxpayer that keeps no books, or has no annual accounting period, must use the calendar year.

Required tax years for pass-throughs

Entity	Required year
Partnership	1) **Majority interest** year: the year of partners owning more than 50% of profits and capital. 2) If none, the year of all **principal partners** (5% or more). 3) If none, the year resulting in the **least aggregate deferral** of income
S corporation	Calendar year
Personal service corporation (PSC)	Calendar year
Trust	Calendar year (except tax-exempt and charitable trusts)
Estate	Any year, calendar or fiscal

Exceptions to the required year:

- **Business purpose / natural business year:** generally, 25% or more of gross receipts are earned in the last 2 months of the year for 3 consecutive years.
- **Section 444 election (Form 8716):** permits a year with a **deferral period of 3 months or less** (for example, a September 30 year-end instead of December 31). Partnerships and S corporations making the election must make **required payments** (Form 8752). PSCs must make minimum distributions to owner-employees.

> **Memory trick:** "More than half, then the principals, then the least." That is the order of the partnership required-year tests.

Changing a tax year

Use **Form 1128**, unless an automatic procedure applies. A change creates a **short tax year**. Individuals and most entities must annualize income for a short year caused by a change of year. Because C corporations pay a flat 21%, annualizing does not change a C corporation's tax rate, but short years still matter for due dates and depreciation (short-year conventions).

> **Watch out:** A short year caused by a business **starting or ending** (first or final return) is **not** annualized. Annualization applies to a short year caused by a **change** of tax year.

Recordkeeping

- Keep records supporting income, deductions and credits until the **period of limitations** expires: generally **3 years** after the return is filed, 6 years if more than 25% of gross income is omitted, and indefinitely if no return or a fraudulent return is filed.
- Employment tax records: at least **4 years** after the tax is due or paid, whichever is later.
- Property records: until the period of limitations expires for the year the property is **disposed of**.
- Commingling personal and business funds makes records hard to prove and is a common advising issue.

Key takeaways

- Cash: income when actually or constructively received; expenses when paid (12-month rule for prepaids).
- Accrual: all-events test plus economic performance for expenses; bonuses paid within 2½ months; advance payments deferred one year at most.
- Gross receipts test for 2025: **$31,000,000** average over the 3 prior years. It controls the cash method for C corporations, inventories, UNICAP and §163(j).
- Form 3115 for method changes. A positive §481(a) adjustment is spread over 4 years; a negative one is taken at once.
- S corporations and PSCs use the calendar year. Partnerships: majority interest → principal partners → least aggregate deferral. §444 allows up to 3 months' deferral.

Business Income

What counts as business income

Gross income of a business includes all income from whatever source unless a specific rule excludes it. For a sole proprietor, it is reported on Schedule C. For entities, it is reported on the entity return.

Common items:

- **Gross receipts** from sales of goods and services, in cash, property or services.
- **Barter income**: the fair market value (FMV) of goods or services received in exchange for the taxpayer's own goods or services.
- **Recoveries** of amounts deducted in earlier years (bad debts later collected, refunds of deducted expenses), to the extent the earlier deduction gave a tax benefit (the tax benefit rule).
- **Damages** for lost profits, and kickbacks, side commissions and prizes received in the business.
- **Cancellation of business debt** (see below).
- **Rents** received by a business, unless the rental activity is reported separately (Schedule E or Form 8825).

Not business income: loans received, contributions of capital by owners, sales tax collected and owed to a state (if the business records it as a liability), and the value of the owner's own services.

Information reporting on business receipts

Form	When filed for 2025
1099-NEC	$600 or more paid to a nonemployee for services in the course of a trade or business
1099-MISC	$600 or more of rents and certain other payments; $10 or more of royalties
1099-K	Payment card transactions (any amount); third-party network payments over $20,000 **and** more than 200 transactions (threshold restored by OBBBA)
8300	Cash over $10,000 received in one transaction or related transactions; filed within 15 days

Exam tip: OBBBA raises the 1099-NEC and 1099-MISC threshold to $2,000 for payments made **after December 31, 2025**. For 2025 payments, the threshold is still **$600**.

Watch out: Income is taxable whether or not a Form 1099 is issued. A business must report all of its gross receipts.

Cost of goods sold

A business that makes or buys goods to sell figures gross profit by subtracting **cost of goods sold (COGS)** from net receipts. On Schedule C, COGS is computed in Part III:

Line	Amount
Beginning inventory	+
Purchases (less items withdrawn for personal use)	+
Cost of labor (production workers, not the owner)	+
Materials and supplies	+
Other costs (freight-in, factory overhead, containers)	+
Less ending inventory	−
= Cost of goods sold	

Example: A retailer has beginning inventory of $40,000, purchases of $210,000, and direct labor of $15,000. Ending inventory is $55,000. Gross sales are $480,000, and returns and allowances are $6,000.

COGS = $40,000 + $210,000 + $15,000 − $55,000 = **$210,000**.

Net receipts = $480,000 − $6,000 = $474,000.

Gross profit = $474,000 − $210,000 = **$264,000**.

Watch out: Items the owner takes from inventory for personal use are removed from purchases. They are not deducted as a business expense.

Remember the inventory relief for small businesses from Chapter 3: a business meeting the $31 million gross receipts test may skip formal inventories and UNICAP.

Cancellation of debt (COD) income

When a lender forgives a business debt, the forgiven amount is generally income. Exclusions (in priority order) are claimed on **Form 982**:

1. **Bankruptcy** (Title 11 case): fully excluded.

2. **Insolvency**: excluded up to the amount by which liabilities exceed the FMV of assets immediately before the cancellation.
3. **Qualified farm indebtedness**: for eligible farmers.
4. **Qualified real property business indebtedness**: debt secured by business real property (not available to C corporations). Limited to the depreciable basis of the property.

Excluded COD income reduces **tax attributes** (NOLs, credits, capital loss carryovers, basis and so on) in a set order. A taxpayer may elect to reduce the basis of depreciable property first.

For partnerships, the exclusions apply at the **partner** level. For S corporations, they apply at the **corporation** level.

> **Example:** A sole proprietor's lender cancels $40,000 of business debt. Just before the cancellation, her liabilities are $250,000 and her assets are worth $220,000.
>
> Insolvency = $250,000 − $220,000 = $30,000.
>
> Excluded: **$30,000**. Taxable COD income: $40,000 − $30,000 = **$10,000**.
>
> She reduces tax attributes by the $30,000 excluded.

> **Exam tip:** If a cancellation is really a price reduction by the seller of property, or the debt would have been deductible if paid (for example, a cash-basis taxpayer's unpaid business expense), it is not COD income.

The at-risk rules (§465)

A loss from an activity is deductible only to the extent the taxpayer is **at risk** in that activity. Losses not allowed are carried forward to the next year in the same activity (Form 6198).

The amount at risk includes:

- money and the adjusted basis of property contributed;
- amounts borrowed for the activity for which the taxpayer is **personally liable** (recourse debt), or for which property not used in the activity is pledged;
- **qualified nonrecourse financing** for real estate (from a commercial lender or government, secured by the real property).

It does **not** include ordinary nonrecourse debt, amounts protected by guarantees or stop-loss agreements, or loans from someone with an interest in the activity (other than a creditor).

At-risk is applied **after** basis limits and **before** passive activity limits.

Example: An investor puts $30,000 of cash into an equipment-leasing activity, borrows $20,000 on a recourse loan, and the activity also has $50,000 of nonrecourse seller financing (not qualified nonrecourse financing). Her share of the 2025 loss is $65,000.

Amount at risk = $30,000 + $20,000 = **$50,000** (the nonrecourse seller debt is excluded).

Deductible loss (before passive limits) = **$50,000**. Suspended at-risk loss carried forward = $65,000 − $50,000 = **$15,000**.

The order of loss limitations

For an owner of a business or pass-through interest, apply the limits in this order:

1. **Basis** (partner or shareholder basis).
2. **At-risk** (§465).
3. **Passive activity** rules (§469, Chapter 17).
4. **Excess business loss** (§461(l)).

Memory trick: "**B**ig **A**pples **P**ass **E**asily": Basis, At-risk, Passive, Excess business loss.

Excess business loss limit (§461(l))

Non-corporate taxpayers cannot deduct an **excess business loss**, which is the amount by which total business deductions exceed total business income and gains plus a threshold. For 2025, the threshold is **$313,000** (**$626,000** for married filing jointly). OBBBA made this limit permanent. The disallowed amount becomes part of the taxpayer's **NOL carryforward** to the next year (Form 461).

Example: A single taxpayer has a 2025 net business loss of $420,000 from her sole proprietorship (after basis, at-risk and passive limits). She has wage income from another job.

Excess business loss = $420,000 − $313,000 = **$107,000**.

She deducts $313,000 against her other income in 2025. The $107,000 is carried forward as an NOL.

Example: A married couple filing jointly has combined business losses of $900,000.

Excess = $900,000 − $626,000 = **$274,000**, carried forward as an NOL.

Watch out: Wages are **not** business income for this limit. A taxpayer cannot use W-2 wages to absorb business losses above the threshold.

Key takeaways

- All gross receipts are income, including barter (at FMV), recoveries and COD income, with or without a Form 1099.
- For 2025, 1099-NEC/MISC apply at $600. The $2,000 threshold starts with 2026 payments.
- COGS = beginning inventory + purchases + labor + materials + other costs − ending inventory.
- COD exclusions: bankruptcy, insolvency (to the extent insolvent), qualified farm, and qualified real property business debt. They reduce tax attributes.
- At-risk includes cash, property basis, recourse debt and qualified nonrecourse real estate financing. Disallowed losses carry forward.
- Loss order: basis → at-risk → passive → excess business loss ($313,000 / $626,000 for 2025, with the excess carried forward as an NOL).

Business Expenses

The basic test

Section 162 allows a deduction for expenses that are **ordinary** (common and accepted in the taxpayer's trade or business) and **necessary** (helpful and appropriate), paid or incurred during the year in carrying on a trade or business. The expense must also be reasonable in amount and must not be a capital expenditure.

Expenses are **not deductible** if they are:

- **personal**, living or family expenses;
- **capital expenditures**: they are recovered through depreciation or amortization (Chapters 7 and 8);
- **fines and penalties** paid to a government for violating a law (restitution and amounts paid to come into compliance may be deductible if identified as such in the order or settlement);
- **political contributions** and most **lobbying** costs;
- **club dues** for business, social, athletic, luncheon or sporting clubs (professional and civic organizations such as a bar association or Rotary are allowed);
- **entertainment** (tickets, golf, hunting trips), even when directly related to business.

Compensation

Wages, salaries, bonuses and commissions are deductible if they are **reasonable** and are for services actually performed.

- **Reasonable compensation** is the amount similar businesses would pay for similar services. Excessive pay to a shareholder-employee of a C corporation may be recharacterized as a **nondeductible dividend**. In an S corporation, the IRS more often challenges pay that is too **low** (Chapter 14).
- **Publicly held corporations** cannot deduct more than **$1,000,000** a year of pay to each covered employee (§162(m)).
- **Fringe benefits** provided to employees (health insurance, group-term life insurance up to $50,000 of coverage, educational assistance up to $5,250, working-condition and de minimis fringes) are generally deductible by the employer and excluded by the employee.
- **Employee achievement awards** of tangible personal property (length of service or safety): the employer's deduction is limited to **$400** per employee per year, or **$1,600** for qualified plan awards.

Watch out: A sole proprietor's draws, and a partner's draws, are never wages. Wages paid to the owner's child under 18 by a sole proprietorship (or a partnership owned only by the child's parents) are deductible and are exempt from Social Security and Medicare tax.

Rent, interest, insurance and taxes

- **Rent** for property used in the business is deductible. A "lease" that is really a purchase (the payments build equity, or there is a nominal purchase option) is treated as a purchase and depreciated.
- **Interest** on debt used in the business is deductible. Interest is traced to how the borrowed money is used. Larger businesses face the §163(j) limit (Chapter 6).
- **Insurance**: casualty, liability, malpractice, workers' compensation and business-interruption premiums are deductible. Self-insurance reserves are not. Life insurance premiums are not deductible if the business is the beneficiary.
- **Self-employed health insurance**: a sole proprietor, partner or more-than-2% S corporation shareholder can deduct health, dental and qualified long-term care premiums as an **adjustment to income** on Form 1040, not on Schedule C. The deduction is limited to earned income from the business, and is not allowed for any month the person was eligible for an employer-subsidized plan.
- **Taxes**: state and local real estate, personal property, excise, and the employer's share of payroll taxes are deductible business expenses. A sole proprietor's own **federal income tax** and **state income tax** are not Schedule C expenses (the state tax is a possible itemized deduction). A corporation deducts state income taxes. Federal income tax is never deductible.

Bad debts

A **business bad debt** arises from the taxpayer's trade or business (for example, a customer receivable). It is an **ordinary** deduction, and partially worthless business debts can be deducted to the extent charged off on the books.

Rules to remember:

- The debt must be **bona fide** and have **basis**. A **cash-method** business cannot deduct unpaid fees or sales because it never included them in income.
- Use the **specific charge-off** method. The reserve method is not allowed (except for certain financial institutions).
- A **nonbusiness bad debt** (for example, a loan to a friend) is deductible only when **totally** worthless, as a **short-term capital loss**.
- A shareholder's loan to his corporation is usually a nonbusiness bad debt, unless the loan protects his **employment** (his dominant motive was his salary, not his investment).

Travel, meals and gifts

Travel

Travel expenses are deductible when the taxpayer is traveling **away from tax home** overnight (or long enough to need sleep or rest) for business. The **tax home** is the regular place of business, not where the family lives.

- Deductible: airfare, lodging, car rental, taxis, baggage, laundry, tips, and 50% of meals.
- A temporary assignment expected to last (and actually lasting) **one year or less** is away from home. An assignment expected to last more than one year is indefinite, and travel expenses are not deductible.
- **Domestic trip:** if the trip is **primarily for business**, all transportation is deductible, but lodging and meals for personal days are not.
- **Foreign trip** of more than a week where 25% or more of the time is personal: transportation must be allocated between business and personal days.
- A spouse's travel is deductible only if the spouse is an employee, has a bona fide business purpose, and the expense would otherwise be deductible.

Meals

- Business meals are **50%** deductible if they are not lavish, the taxpayer (or an employee) is present, and the food is provided to a current or potential business contact. Meals while traveling away from home are also 50%.
- **100%** exceptions include: meals provided for a company-wide holiday party or picnic, food made available to the general public, meals sold to customers, and meals treated as taxable compensation to the employee.
- **Entertainment** is 0%. If food is bought at an entertainment event, it is 50% deductible only if invoiced separately.

> **Example:** A consultant flies to a 4-night client engagement. Airfare is $600, lodging is $210 a night, and business meals total $380.
>
> Lodging = 4 × $210 = $840.
>
> Meals = $380 × 50% = $190.
>
> Deductible travel = $600 + $840 + $190 = **$1,630**.

Business gifts

The deduction for business gifts is limited to **$25 per recipient per year**. Incidental costs (engraving, packaging, shipping) don't count toward the $25. Items costing $4 or less that bear the business name, and signs or display racks, are not treated as gifts.

Example: A business gives a $40 gift basket to each of 12 clients.

Deduction = 12 × $25 = **$300** (not $480).

Vehicles

A business can deduct car expenses using either method:

- **Standard mileage rate: 70 cents per mile** for 2025, plus business parking fees and tolls. Interest on a car loan is also deductible by a self-employed person (business portion). The rate replaces depreciation, gas, insurance, repairs and lease payments. It must be chosen in the **first year** the car is used in the business (for an owned car). It cannot be used for five or more cars used at the same time (a fleet).
- **Actual expenses:** gas, oil, repairs, insurance, registration, lease payments or depreciation, multiplied by the business-use percentage. Depreciation is subject to the luxury-auto limits (Chapter 7).

Commuting between home and a regular work location is personal. Trips from a home office that is the principal place of business, or to a temporary work location, are business.

Example: A self-employed contractor drives 14,000 business miles in 2025 and pays $260 for business parking and tolls.

Standard mileage = 14,000 × $0.70 = $9,800.

Total deduction = $9,800 + $260 = **$10,060**.

Home office

A self-employed taxpayer can deduct expenses for part of a home that is used **regularly and exclusively** as:

- the **principal place of business** (including a place used for administrative or management activities when there is no other fixed location for them);
- a place to **meet clients or customers** in the normal course of business; or
- a **separate structure** used in connection with the business.

Exceptions to the exclusive-use test apply to storage of inventory or product samples and to licensed day-care facilities.

Method	Computation	Notes
Simplified	**$5 × square feet**, up to **300** sq ft (maximum $1,500)	No depreciation, no carryover. Mortgage interest and taxes stay fully on Schedule A
Regular (Form 8829)	Business % × indirect expenses (mortgage interest, taxes, insurance, utilities, repairs, depreciation) + direct expenses	Deduction limited to gross income from the business use. The excess carries forward. Depreciation reduces the home's basis

Example: A sole proprietor uses a 250 sq ft room exclusively for business. Simplified method: 250 × $5 = **$1,250**.

Using the regular method instead: a 300 sq ft office in a 2,000 sq ft home, with $18,000 of total indirect home expenses (including depreciation). Business percentage = 300 ÷ 2,000 = 15%. Deduction = 15% × $18,000 = **$2,700**, subject to the gross income limit.

Start-up and organizational costs

Start-up costs are costs of investigating or creating an active business before it begins (market surveys, advertising, training employees before opening). **Organizational costs** are costs of forming a corporation or partnership (legal fees for the charter or partnership agreement, state filing fees).

For each category separately:

- Deduct up to **$5,000** in the year the business begins, reduced dollar for dollar by the amount by which that category's costs exceed **$50,000**.
- Amortize the rest ratably over **180 months**, beginning with the **month the active business begins**.

Costs of issuing stock or syndicating partnership interests (commissions, prospectus) are **never** deductible or amortizable.

Example: A sole proprietor has $53,000 of start-up costs and opens for business on July 1, 2025.

Immediate deduction = $5,000 − ($53,000 − $50,000) = **$2,000**.

Remaining = $53,000 − $2,000 = $51,000.

Amortization for 2025 = $51,000 ÷ 180 × 6 months = **$1,700**.

Total 2025 deduction = $2,000 + $1,700 = **$3,700**.

Example: Start-up costs are $40,000 and the business begins on October 1, 2025.

Immediate deduction = $5,000 (no reduction, because costs are under $50,000).

Amortization = ($40,000 − $5,000) ÷ 180 × 3 = $583.33.

Total 2025 deduction = **$5,583.33**.

Watch out: Start-up costs of $55,000 or more get **no** immediate deduction. Everything is amortized over 180 months.

Research and experimental (R&E) costs

OBBBA added **§174A**. For tax years beginning after December 31, 2024, **domestic** research and experimental expenditures (including software development) can again be **deducted currently**. Alternatively, the taxpayer can elect to capitalize them and amortize them over at least 60 months.

- **Foreign** research costs must still be capitalized and amortized over **15 years**.
- Small businesses meeting the **$31 million** gross receipts test may elect to apply the new rule retroactively to tax years beginning after December 31, 2021, by amending those returns.
- Taxpayers can elect to deduct the remaining unamortized domestic costs from 2022–2024 in 2025 (or over 2025 and 2026).

Other common deductions and non-deductions

Deductible	Not deductible
Advertising	Lobbying and political contributions
Professional fees (legal, accounting) for the business	Legal fees to acquire property (capitalize)
Business education that maintains or improves current skills	Education that qualifies the taxpayer for a **new** trade or business
Work clothing not suitable for everyday wear (uniforms, safety gear)	Ordinary clothing, even if worn only at work
Supplies, utilities, telephone (business portion)	First residential landline of the home
Business use of a cell phone	Fines, penalties and entertainment

Key takeaways

- A deduction requires ordinary, necessary, reasonable, and not capital or personal.

- Meals are 50% (with 100% exceptions such as company parties), entertainment is 0%, and gifts are capped at $25 per recipient.
- Standard mileage rate for 2025 is 70 cents per mile, and it must be chosen in the first year.
- Home office: regular and exclusive use. Simplified method is $5 × up to 300 sq ft.
- Start-up and organizational costs: $5,000 each, phased out above $50,000, with the rest over 180 months.
- Domestic R&E costs are deductible again for tax years beginning after 2024 (§174A); foreign R&E is amortized over 15 years.
- Business bad debts are ordinary (partial allowed). Nonbusiness bad debts are short-term capital losses (total worthlessness only).

QBI Deduction, Business Credits, NOLs and the Interest Limit

The qualified business income (QBI) deduction (§199A)

Owners of sole proprietorships, partnerships, S corporations, and some trusts and estates may deduct up to **20% of qualified business income** from each qualified trade or business. They may also deduct 20% of qualified REIT dividends and publicly traded partnership (PTP) income. The deduction is taken **after AGI**. It is not an itemized deduction and does not reduce AGI or self-employment tax. C corporations cannot claim it. OBBBA made the deduction permanent.

What is QBI?

QBI is the net amount of ordinary income, gain, deduction and loss from a qualified U.S. trade or business. It **excludes**:

- capital gains and losses, dividends, and interest not allocable to the business;
- **reasonable compensation** paid to an S corporation shareholder;
- **guaranteed payments** paid to a partner for services or capital;
- qualified tips (excluded from QBI starting in 2025).

QBI is reduced by the deductible part of SE tax, the self-employed health insurance deduction, and deductions for contributions to self-employed retirement plans, to the extent they come from the business.

The overall limit

The deduction can never exceed **20% of taxable income before the QBI deduction, minus net capital gain** (including qualified dividends).

2025 thresholds

Filing status	Threshold (limits start)	End of phase-in range (limits fully apply)
Married filing jointly	$394,600	$494,600
All other filers	$197,300	$247,300

- **At or below the threshold:** deduction = 20% of QBI (subject to the overall limit). The W-2 wage/property limit and the SSTB rule do **not** apply.
- **Above the top of the range:** the deduction for each business is limited to the **greater of** (a) **50% of W-2 wages**, or (b) **25% of W-2 wages + 2.5% of the unadjusted basis immediately after acquisition (UBIA)** of qualified property. A **specified service trade or business (SSTB)** gets **no** deduction at all.
- **Within the range:** the limits phase in proportionally (see the examples).

SSTBs include health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage, investment management, trading, and any business whose principal asset is the reputation or skill of its owners or employees. Engineering and architecture are **not** SSTBs.

Example (below the threshold): A single taxpayer has QBI of $80,000 from a sole proprietorship. Taxable income before the QBI deduction is $95,000, which includes $5,000 of net capital gain.

20% of QBI = $80,000 × 20% = $16,000.

Overall limit = 20% × ($95,000 − $5,000) = $18,000.

QBI deduction = lesser = **$16,000**.

Example (above the range): A single owner of a manufacturing business (not an SSTB) has taxable income of $300,000, QBI of $200,000, W-2 wages paid by the business of $60,000, and UBIA of $400,000.

20% of QBI = $40,000.

Limit (a) = 50% × $60,000 = $30,000.

Limit (b) = 25% × $60,000 + 2.5% × $400,000 = $15,000 + $10,000 = $25,000.

Wage/property limit = greater of (a) and (b) = $30,000.

Overall limit = 20% × $300,000 = $60,000.

QBI deduction = **$30,000**.

Example (in the phase-in range): A single taxpayer has taxable income of $222,300, QBI of $150,000 from a non-SSTB business, W-2 wages of $20,000 and no qualified property.

Amount over the threshold = $222,300 − $197,300 = $25,000. Phase-in percentage = $25,000 ÷ $50,000 = 50%.

20% of QBI = $30,000. Wage limit = 50% × $20,000 = $10,000.

Reduction = ($30,000 − $10,000) × 50% = $10,000.

Deduction = $30,000 − $10,000 = $20,000. Overall limit = 20% × $222,300 = $44,460, so it does not bind.

QBI deduction = **$20,000**.

Watch out: If the business were an **SSTB** in the phase-in range, the taxpayer would first count only the "applicable percentage" (100% − phase-in percentage) of QBI, W-2 wages and UBIA. Above $247,300 (single), an SSTB's QBI is ignored completely.

- A **net QBI loss** for the year gives no deduction and carries forward to reduce QBI in the next year.
- The deduction is figured on **Form 8995** (simplified, at or below the threshold) or **Form 8995-A**.
- Partnerships and S corporations report each owner's QBI, W-2 wages and UBIA on the K-1. The deduction is figured by the owner.

Exam tip: OBBBA widens the phase-in ranges (to $75,000 and $150,000) and adds a $400 minimum deduction, but only for tax years beginning after 2025. For 2025, use the $50,000 / $100,000 ranges above.

The general business credit

Most business credits are combined on **Form 3800** as the **general business credit (GBC)**. The total allowed in a year is limited to:

> net income tax − the **greater of** (a) tentative minimum tax, or (b) **25%** of net regular tax liability above **$25,000**

Unused credits are carried **back 1 year** and **forward 20 years**.

Example: A corporation has net income tax (regular tax) of $90,000 and tentative minimum tax of $0.

25% × ($90,000 − $25,000) = $16,250.

GBC limit = $90,000 − $16,250 = **$73,750**.

Credits often tested

Credit (form)	Key rules
Work opportunity credit (5884)	For hiring members of targeted groups who begin work before Jan. 1, 2026. Generally 40% of up to $6,000 of first-year wages (up to $2,400) if the worker performs at least 400 hours. Certification (Form 8850) must be requested within 28 days after the start date. The deduction for wages is reduced by the credit
Research credit (6765)	Based on increases in qualified research expenses. A qualified small business (gross receipts under $5 million, and no gross receipts more than 5 years ago) may apply up to $500,000 against payroll taxes
Small employer health insurance credit (8941)	Fewer than 25 full-time equivalents (FTEs). Pays at least 50% of employee-only premiums through the SHOP Marketplace. Credit up to 50% of premiums (35% for tax-exempt employers), for 2 consecutive years. For 2025 it phases out as average annual wages rise above $33,300, reaching zero at $66,600, and as FTEs rise above 10
Pension start-up credit (8881)	Small employers (100 or fewer employees) that start a new plan. Up to 100% of start-up costs (50% if more than 50 employees), maximum $5,000 a year for 3 years. Additional $500 a year for 3 years for auto-enrollment
Disabled access credit (8826)	Eligible small business (gross receipts of $1 million or less, or 30 or fewer full-time employees). 50% of eligible expenditures over $250 up to $10,250, for a maximum of $5,000
Employer-provided child care credit (8882)	25% of qualified child care facility costs plus 10% of resource and referral costs, up to $150,000 for 2025 (OBBBA increases it from 2026)
Paid family and medical leave credit (8994)	12.5%–25% of wages paid during qualifying leave, under a written policy. Made permanent by OBBBA

Watch out: Many credits require reducing the related deduction (for example, wages used for the WOTC or research credit). A credit does not stack on top of a full deduction for the same dollars.

Net operating losses (NOLs)

An NOL arises when allowable business deductions exceed gross income (individuals adjust for nonbusiness items, the QBI deduction, and capital losses). For NOLs arising in tax years beginning after 2020:

- **No carryback** (except **farming losses**, which may be carried back **2 years**, and certain insurance company losses).
- **Indefinite carryforward**.
- The deduction in a carryforward year is limited to **80% of taxable income** (figured without the NOL deduction, and for individuals also without the QBI deduction).

- NOLs from tax years beginning before 2018 keep the old rules (2 years back, 20 forward, no 80% limit) and are used first.

> **Example:** A C corporation carries forward a $500,000 NOL from 2023. Its 2025 taxable income before the NOL deduction is $400,000.
>
> 80% limit = $400,000 × 80% = **$320,000**, the NOL deduction for 2025.
>
> 2025 taxable income = $400,000 − $320,000 = $80,000.
>
> NOL carried to 2026 = $500,000 − $320,000 = **$180,000**.

The business interest limit (§163(j))

The deduction for **business interest expense** is limited to:

> business interest income + **30% of adjusted taxable income (ATI)** + floor plan financing interest

- For tax years beginning after **December 31, 2024**, OBBBA restored the **EBITDA** definition of ATI. Depreciation, amortization and depletion are again added back, which makes the limit more generous.
- **Exempt:** small businesses meeting the **$31 million** gross receipts test (unless they are tax shelters); electing real property trades or businesses (which must then use ADS for certain property); electing farming businesses; regulated utilities; and employees' wages.
- Disallowed interest is carried forward **indefinitely**. For partnerships, the excess is allocated to the partners as "excess business interest expense" and is used only against future excess taxable income from the same partnership.
- Figured on **Form 8990**.

> **Example:** A corporation with average gross receipts of $80 million (not exempt) has 2025 ATI of $2,000,000, business interest income of $20,000 and business interest expense of $750,000.
>
> Limit = $20,000 + 30% × $2,000,000 = $20,000 + $600,000 = **$620,000**.
>
> Disallowed and carried forward = $750,000 − $620,000 = **$130,000**.

Key takeaways

- QBI deduction = 20% of QBI, capped at 20% of (taxable income − net capital gain). Wages and guaranteed payments are not QBI.
- 2025 thresholds: $197,300 ($394,600 MFJ). Above $247,300 ($494,600 MFJ), the wage/UBIA limit fully applies and SSTBs get nothing.
- Wage/property limit = greater of 50% of W-2 wages, or 25% of wages + 2.5% of UBIA.

- GBC limit: net income tax − greater of TMT or 25% of net regular tax over $25,000. Carry back 1 year, forward 20.
- Post-2020 NOLs: no carryback (farm 2 years), indefinite carryforward, 80% of taxable income limit.
- §163(j): interest income + 30% of ATI (EBITDA again for 2025). Small businesses (≤ $31M) are exempt.

Depreciation, Section 179 and Bonus Depreciation

What can be depreciated

Depreciation recovers the cost of business or income-producing property over time. Property is depreciable if it:

- is **owned** by the taxpayer (or the taxpayer bears the burdens of ownership, as with some capital improvements to leased property);
- is used in a **business** or held to produce income;
- has a **determinable useful life**; and
- is expected to last **more than one year**.

Never depreciable: **land**, inventory, property placed in service and disposed of in the same year, and personal-use property. Intangibles such as goodwill are **amortized** instead (see below).

Depreciation begins when property is **placed in service**, meaning ready and available for its specific use, even if it is not yet being used. It ends when the cost is fully recovered or the property is retired.

The depreciable basis is generally cost (Chapter 8), reduced by any §179 deduction and bonus depreciation, and by the business-use percentage if the property is partly personal.

MACRS: the system, the class, the convention, the method

Most tangible property placed in service after 1986 uses the **Modified Accelerated Cost Recovery System (MACRS)**. It has two systems:

- **GDS** (General Depreciation System): the normal system, with shorter lives.
- **ADS** (Alternative Depreciation System): straight-line over longer lives. Required for listed property used 50% or less for business, tangible property used mainly outside the U.S., tax-exempt use and tax-exempt bond-financed property, certain farm property when the farmer elects out of UNICAP, and real property of an electing real property business under §163(j). It can also be elected.

Recovery periods (GDS)

Class	Examples	Method
3-year	Tractor units for over-the-road use, racehorses over 2 years old when placed in service, qualified rent-to-own property	200% DB
5-year	Cars, light trucks, computers and peripherals, office machinery (copiers), research equipment, cattle for breeding or dairy, **new farm machinery and equipment**	200% DB
7-year	Office furniture and fixtures, most machinery and equipment, property with no class life	200% DB
10-year	Vessels, barges, single-purpose agricultural or horticultural structures, fruit- or nut-bearing trees and vines	200% DB
15-year	Land improvements (sidewalks, fences, roads, shrubbery), **qualified improvement property (QIP)**, retail motor fuel outlets	150% DB
20-year	Farm buildings (other than single-purpose structures), municipal sewers	150% DB
27.5-year	**Residential rental property** (80% or more of gross rents from dwelling units)	Straight-line
39-year	**Nonresidential real property** (office buildings, stores, warehouses)	Straight-line

Property that has no assigned class life defaults to 7 years.

Qualified improvement property (QIP) is an improvement to the **interior** of a nonresidential building placed in service after the building was first placed in service. It excludes enlargements, elevators and escalators, and the internal structural framework. QIP is 15-year property and qualifies for bonus depreciation and §179.

Conventions

Convention	Used for	First-year effect
Half-year (HY)	Personal property (3- to 20-year), unless mid-quarter applies	Half a year of depreciation in the first year, regardless of the date placed in service (and half a year in the year of disposal)
Mid-quarter (MQ)	Personal property, when **more than 40%** of the year's depreciable basis (excluding real property and amounts expensed under §179) is placed in service in the **last 3 months** of the tax year	Each asset is treated as placed in service in the middle of its quarter
Mid-month (MM)	Residential rental and nonresidential real property	Placed in service in the middle of the month

MACRS percentage tables (half-year convention)

These are the IRS Table A-1 rates (200% DB switching to straight-line). Multiply the original depreciable basis by the year's percentage.

Year	3-year	5-year	7-year
1	33.33%	20.00%	14.29%
2	44.45%	32.00%	24.49%
3	14.81%	19.20%	17.49%
4	7.41%	11.52%	12.49%
5		11.52%	8.93%
6		5.76%	8.92%
7			8.93%
8			4.46%

Notice that 5-year property takes **6 calendar years** and 7-year property takes **8**, because of the half-year convention.

Mid-quarter rates for 5-year property, first year: 35% (Q1), 25% (Q2), 15% (Q3), 5% (Q4). Each is 40% (the 200% DB rate for 5 years) × the months in service from mid-quarter ÷ 12: 10.5, 7.5, 4.5 and 1.5 months.

Real property: the mid-month formula

First-year depreciation = basis ÷ recovery period × (months in service ÷ 12), where months in service = 12 − month number + 0.5.

Month placed in service	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Months counted in year 1	11.5	10.5	9.5	8.5	7.5	6.5	5.5	4.5	3.5	2.5	1.5	0.5
27.5-year first-year %	3.485	3.182	2.879	2.576	2.273	1.970	1.667	1.364	1.061	0.758	0.455	0.152

Example (7-year equipment): A business places $80,000 of manufacturing equipment in service in May 2025, with no §179 or bonus (elected out). Half-year convention applies.

2025: $80,000 × 14.29% = **$11,432**.

2026: $80,000 × 24.49% = **$19,592**.

Example (residential rental): A rental building (land excluded) with a basis of $330,000 is placed in service in April 2025.

Full-year amount = $330,000 ÷ 27.5 = $12,000.

2025 = $12,000 × 8.5/12 = **$8,500**.

Example (nonresidential): An office building with a basis of $780,000 is placed in service in September 2025.

Full-year amount = $780,000 ÷ 39 = $20,000.

2025 = $20,000 × 3.5/12 = **$5,833** (rounded).

Example (mid-quarter): In 2025 a calendar-year business places in service a $50,000 machine (5-year) in February and $60,000 of computers (5-year) in November. Nothing is expensed, and bonus is elected out.

Fourth-quarter share = $60,000 ÷ $110,000 = 54.5%, which is more than 40%, so the mid-quarter convention applies to both.

February asset: $50,000 × 35% = $17,500. November assets: $60,000 × 5% = $3,000.

Total 2025 depreciation = **$20,500** (compared with $22,000 under the half-year convention).

Watch out: Amounts expensed under §179 are **excluded** when you run the 40% test, so expensing fourth-quarter purchases can avoid the mid-quarter convention.

Section 179 expensing

Section 179 lets a taxpayer elect to deduct the cost of qualifying property in the year it is placed in service, instead of depreciating it.

2025 item (OBBBA)	Amount
Maximum §179 deduction	**$2,500,000**
Phase-out threshold (reduce dollar for dollar above this)	**$4,000,000** of §179 property placed in service
Fully phased out	$6,500,000
Sport utility vehicle (over 6,000 lbs GVWR) §179 cap	**$31,300**

These amounts apply to property placed in service in tax years beginning after December 31, 2024. They are indexed for inflation after 2025.

Qualifying property: tangible personal property (machinery, equipment, furniture, vehicles), off-the-shelf computer software, **qualified improvement property**, and these improvements to **nonresidential** real property: roofs, HVAC, fire protection and alarm systems, and security systems. The property must be bought for use in an active trade or business more than 50% of the time, and must not be acquired from a related person.

Not qualifying: land, buildings and structural components (other than those listed), property held for investment, property used mainly outside the U.S., and most property used for lodging (residential rentals). Property a noncorporate lessor leases to others qualifies only in limited cases.

Business income limit: the §179 deduction cannot exceed taxable income from **all active trades or businesses** (including wages earned as an employee), figured without §179, the deduction for half of SE tax, and any NOL. A deduction disallowed by this limit **carries forward** indefinitely. A deduction lost to the dollar limit or phase-out does **not** carry forward.

Pass-throughs: the dollar limit applies at **both** the entity and the owner level. A partner or S shareholder cannot use more than $2,500,000 in total from all sources.

> **Example (phase-out):** A business places $4,300,000 of qualifying equipment in service in 2025.
>
> Reduction = $4,300,000 − $4,000,000 = $300,000.
>
> Maximum §179 = $2,500,000 − $300,000 = **$2,200,000**.

> **Example (income limit):** A sole proprietor elects $70,000 of §179 but has only $40,000 of taxable income from active trades or businesses.
>
> Deduction for 2025 = **$40,000**. Carryforward = $70,000 − $40,000 = **$30,000**.

Note: on a joint return, the business income limit counts the active business income (including wages) of **both** spouses.

The election is made on **Form 4562** and can be made or revoked on an amended return.

Special (bonus) depreciation

Bonus depreciation (§168(k)) gives an additional first-year deduction for qualified property: generally MACRS property with a recovery period of **20 years or less**, off-the-shelf software, and QIP. It can be **new or used**, as long as the taxpayer never used the used property before and did not acquire it from a related party.

When the property was acquired	2025 bonus rate
After January 19, 2025 (written binding contract date)	**100%** (made permanent by OBBBA)
Before January 20, 2025, and placed in service in 2025	**40%** (60% for long-production-period property and certain aircraft)

- For the first tax year ending after January 19, 2025, a taxpayer may **elect** 40% (60%) instead of 100%.
- Bonus is **automatic** unless the taxpayer **elects out**, which is done by **class** of property (for example, all 5-year property) for the year.
- Bonus has **no** dollar limit and **no** business income limit, so it can create or increase an NOL. That is the key difference from §179.
- **Order:** §179 first, then bonus on the remaining basis, then regular MACRS on what is left.

Qualified production property (QPP), new under OBBBA: a taxpayer may elect 100% depreciation for nonresidential real property used as an integral part of manufacturing, production or refining. Construction must begin after January 19, 2025 and before 2029, and the property must be placed in service after July 4, 2025 and before 2031. Office, sales and administrative space doesn't qualify.

Example (§179 + bonus + MACRS): A company signed a binding contract in December 2024 for a $150,000 machine (5-year property), and placed it in service in March 2025. It elects §179 of $30,000.

Remaining basis = $150,000 − $30,000 = $120,000.

Bonus (acquired before Jan. 20, 2025, so 40%) = $120,000 × 40% = $48,000.

Remaining basis = $120,000 − $48,000 = $72,000.

Regular MACRS year 1 = $72,000 × 20% = $14,400.

Total 2025 deduction = $30,000 + $48,000 + $14,400 = **$92,400**.

If the contract had been signed after January 19, 2025, 100% bonus would allow the full **$150,000** with no §179 election needed.

Watch out: The acquisition date (binding contract date), not the placed-in-service date, decides 40% versus 100%.

Listed property and the luxury-auto limits (§280F)

Listed property includes passenger automobiles, other property used for transportation, and property used for entertainment, recreation or amusement. (Computers were removed from the list after 2017.)

- If qualified **business use is 50% or less**, the property must use **ADS** straight-line and gets **no §179 and no bonus**.
- If business use **drops to 50% or less** in a later year, the excess depreciation previously claimed (over ADS) is **recaptured** as ordinary income in that year.
- Investment use doesn't count toward the more-than-50% test (it does count when figuring the deduction).

Passenger automobiles (rated 6,000 lbs gross vehicle weight or less) are subject to annual dollar caps on depreciation plus §179. For vehicles placed in service in 2025 (Rev. Proc. 2025-16):

Year	With bonus depreciation	Without bonus
1st tax year	**$20,200**	**$12,200**
2nd tax year	$19,600	$19,600
3rd tax year	$11,800	$11,800
Each later year	$7,060	$7,060

The caps are multiplied by the **business-use percentage**.

Example: A self-employed consultant buys a $50,000 car in June 2025 (acquired after January 19, 2025) and uses it 75% for business.

Business basis = $50,000 × 75% = $37,500. With 100% bonus, the computed amount would be $37,500.

Year-1 cap = $20,200 × 75% = **$15,150**, so 2025 depreciation is limited to $15,150.

Year-2 cap = $19,600 × 75% = $14,700.

If she had elected out of bonus: MACRS = $37,500 × 20% = $7,500, which is under the $12,200 × 75% = $9,150 cap, so she deducts $7,500.

Heavy SUVs, pickups and vans over 6,000 lbs GVWR are not passenger automobiles, so the §280F caps don't apply. The §179 deduction for an SUV is limited to **$31,300** for 2025, but bonus depreciation can cover the rest of the cost.

Example: A $90,000 SUV (7,000 lbs GVWR) acquired and placed in service in August 2025 is used 100% for business. The owner may expense $31,300 under §179 and take 100% bonus on the remaining $90,000 − $31,300 = $58,700, for a full **$90,000** deduction in 2025 (or simply take 100% bonus on the whole amount).

Amortization of intangibles (§197)

Purchased **§197 intangibles** are amortized straight-line over **15 years** (180 months), starting with the month of acquisition. Examples: **goodwill**, going-concern value, covenants not to compete entered into with the purchase of a business, customer and supplier lists, licenses and permits, franchises, trademarks and trade names.

Self-created intangibles are generally **not** §197 property, unless created in connection with buying a business. Off-the-shelf software is depreciated over 36 months (or expensed under §179 or bonus).

Memory trick: "Goodwill takes a quinceañera": 15 years for §197 intangibles.

Form 4562

Form 4562 is required for the first year property is placed in service, for any §179 deduction or carryover, for all depreciation of listed property (including cars), and for amortization that begins in the year. A corporation (other than an S corporation) must file it whenever it claims depreciation.

Key takeaways

- Land is never depreciable. Depreciation starts when property is placed in service.
- Classes: 5-year (cars, computers, new farm machinery), 7-year (furniture, most equipment), 15-year (land improvements, QIP), 27.5 residential, 39 nonresidential.
- Conventions: half-year for personal property, mid-quarter if more than 40% falls in Q4, mid-month for real property.
- §179 for 2025: $2,500,000, phased out above $4,000,000, SUVs $31,300. Limited to business income (the excess carries forward).
- Bonus: 100% for property acquired after Jan. 19, 2025; 40% if acquired earlier and placed in service in 2025. No income limit. Apply §179 first, then bonus, then MACRS.
- Listed property at 50% or less business use goes to ADS, with no §179 or bonus. 2025 auto caps: $20,200 (with bonus) / $12,200, then $19,600, $11,800 and $7,060.
- §197 intangibles: 15 years.

Business Assets: Basis, Repairs and Dispositions

Basis of business property

Cost basis is the purchase price plus costs to acquire the property and get it ready for use: sales tax, freight, installation and testing, legal and recording fees, and title costs. For real estate, it also includes any back taxes or liens the buyer assumes.

Adjusted basis = cost basis + capital improvements − depreciation (allowed or allowable), §179, bonus, casualty losses and insurance reimbursements.

How acquired	Basis
Purchase	Cost (including assumed debt)
Received for services	FMV, which is also income to the recipient
Gift	Donor's basis (for loss, the lower of donor's basis or FMV at the date of the gift)
Inheritance	FMV at date of death (or alternate valuation date)
Constructed by the taxpayer	All direct and indirect construction costs (UNICAP, unless exempt)
Lump-sum purchase of several assets	Allocate by relative FMV. For a business purchase, use the residual method on Form 8594 (goodwill gets what is left)

> **Exam tip:** "Allowed or allowable" means basis is reduced by the depreciation the taxpayer **could** have claimed, even if he never claimed it. A missed deduction can usually be corrected with Form 3115 (Chapter 3).

Converted property

When personal-use property (for example, a former home) is converted to business or rental use, its basis **for depreciation** is the **lesser of** its adjusted basis or its FMV on the date of conversion. This stops a taxpayer from deducting a decline in value that happened during personal use.

Capitalize or deduct? The tangible property regulations

Amounts paid to **acquire or produce** a unit of property, or to **improve** it, must be capitalized. An amount is an improvement if it results in a:

- **Betterment**: fixes a pre-existing defect, enlarges or expands the property, or increases its capacity, productivity or quality;

- **Adaptation** to a new or different use; or
- **Restoration**: replaces a major component or substantial structural part, rebuilds the property to like-new condition after it fell into disrepair, or restores it after a casualty loss for which basis was reduced.

> **Memory trick:** "**BAR** the door to deductions": Betterment, Adaptation, Restoration must be capitalized.

Routine repairs that keep property in ordinary operating condition are deductible. Three safe harbors simplify the decision:

Safe harbor	Rule
De minimis (annual election on the return)	Deduct items costing up to **$2,500** per invoice or item, or up to **$5,000** if the taxpayer has an applicable financial statement (AFS), such as an audited statement. The amounts must also be expensed on the books
Routine maintenance	Recurring work the taxpayer expects to do more than once during the class life (or within 10 years for buildings) to keep property in its ordinary operating condition
Small taxpayer safe harbor for buildings (annual election)	Average gross receipts of **$10 million** or less, and building unadjusted basis of **$1,000,000** or less. Deduct total repairs, maintenance and improvements on the building for the year if they don't exceed the **lesser of $10,000 or 2%** of the building's unadjusted basis

> **Example:** A landlord owns a building with an unadjusted basis of $800,000. Her average gross receipts are $600,000.
>
> Safe harbor ceiling = lesser of $10,000 or 2% × $800,000 ($16,000) = **$10,000**.
>
> If her total repairs and improvements for the building in 2025 are $9,200, she can deduct them all. If they are $12,000, the safe harbor is not available for any of it, and she must apply the BAR tests to each item.

Character of gain or loss on business property

Section 1231 property

Section 1231 property is depreciable property and real property used in a trade or business and held **more than one year** (also certain livestock, timber, coal and unharvested crops). Net §1231 results for the year get the best of both worlds:

- a **net §1231 gain** is treated as **long-term capital gain**;
- a **net §1231 loss** is treated as an **ordinary loss**.

Five-year lookback: a net §1231 gain is treated as **ordinary income** to the extent of **nonrecaptured net §1231 losses** from the previous **5 years**.

Example: In 2025 a business has a net §1231 gain of $30,000. In 2022 it had a net §1231 loss of $12,000 (deducted as ordinary), and it has had no §1231 gains since.

Ordinary income (lookback) = **$12,000**.

Long-term capital gain = $30,000 − $12,000 = **$18,000**.

Section 1245 recapture (personal property)

On the sale of depreciable personal property (equipment, vehicles, furniture) and amortizable §197 intangibles, gain is **ordinary income** up to all depreciation and amortization taken (including §179 and bonus). Any remaining gain is §1231 gain. A loss is a §1231 loss.

Example: Equipment cost $60,000, and $42,000 of depreciation was claimed. It is sold for $50,000.

Adjusted basis = $60,000 − $42,000 = $18,000.

Gain = $50,000 − $18,000 = $32,000.

§1245 recapture = lesser of gain ($32,000) or depreciation ($42,000) = **$32,000 ordinary income**. There is no §1231 gain.

If it had sold for $70,000, the gain would be $52,000: $42,000 ordinary and $10,000 §1231.

Section 1250 property (buildings)

For real property placed in service after 1986, MACRS is straight-line, so there is **no** "additional depreciation" to recapture as ordinary income for individuals. However:

- **Unrecaptured §1250 gain** is the gain attributable to straight-line depreciation. For individuals, estates and trusts, it is taxed at a **maximum 25%** rate.
- The rest of the gain is §1231 gain (usually taxed at 0/15/20%).
- **Corporations** (§291) must treat **20%** of the depreciation that would have been ordinary if the property were §1245 property as ordinary income.

Example: An individual sells a commercial building (land excluded) for $560,000. It cost $500,000, and $120,000 of straight-line depreciation was claimed.

Adjusted basis = $500,000 − $120,000 = $380,000.

Gain = $560,000 − $380,000 = $180,000.

Unrecaptured §1250 gain (max 25%) = lesser of gain or depreciation = **$120,000**.

Remaining §1231 gain = $180,000 − $120,000 = **$60,000**.

Memory trick: "**45** is **all** ordinary; **50** is **fifty-fifty**": §1245 recapture is fully ordinary; §1250 gain is split between 25% and regular capital gain rates.

Related-party sales

- **§1239:** gain on the sale of depreciable property between related persons (for example, an owner and his more-than-50%-owned corporation) is **ordinary income**.
- **§267:** a **loss** on a sale to a related person is **disallowed**. The buyer may use the disallowed loss to reduce gain on a later sale.

Like-kind exchanges (§1031)

After 2017, only **real property** held for use in a business or for investment qualifies. Personal property (equipment, vehicles) no longer qualifies. U.S. and foreign real property are not like-kind.

- Gain is **deferred**, except to the extent of **boot** received: cash, other property, or **net** relief from liabilities.
- **Deadlines** for a deferred exchange: identify replacement property within **45 days**, and receive it by the **earlier of 180 days** or the due date (with extensions) of the return for the year of transfer.
- A qualified intermediary must hold the proceeds. The taxpayer cannot have actual or constructive receipt.
- **Related parties:** if either party disposes of the property within **2 years**, the deferred gain is triggered.
- Losses are **never** recognized in a like-kind exchange.
- Reported on **Form 8824**.

Basis of replacement property = basis of property given up + gain recognized + boot paid − boot received (or, equivalently, FMV of the new property − deferred gain).

Example: A business exchanges an office building (adjusted basis $400,000, FMV $900,000) for a warehouse worth $820,000 plus $80,000 cash.

Realized gain = $900,000 − $400,000 = $500,000.

Recognized gain = lesser of realized gain or boot = **$80,000**.

Deferred gain = $500,000 − $80,000 = $420,000.

Basis of the warehouse = $400,000 + $80,000 − $80,000 = **$400,000** (check: $820,000 − $420,000 = $400,000).

Watch out: Depreciation recapture can be triggered in an exchange to the extent of boot, and the replacement property's basis continues the depreciation schedule of the old property.

Installment sales

When at least one payment is received after the year of sale, gain is reported as payments are received (Form 6252), unless the taxpayer elects out.

- **Gross profit percentage** = gross profit ÷ contract price.
- Gain each year = payments received × gross profit percentage.
- **All depreciation recapture** (§1245 and §1250 ordinary) is recognized in the **year of sale**, even if no payment is received.
- Not available for sales of inventory, sales by dealers, or publicly traded securities.

Example: A business sells land (basis $120,000) for $200,000 and receives $50,000 in 2025, with the rest due in later years.

Gross profit = $200,000 − $120,000 = $80,000; gross profit percentage = $80,000 ÷ $200,000 = 40%.

2025 gain = $50,000 × 40% = **$20,000**.

Involuntary conversions (§1033)

When property is destroyed, stolen or condemned and the owner receives insurance or an award, gain can be **deferred** by buying **similar or related-in-service** replacement property within:

- **2 years** after the end of the first tax year in which any gain is realized (general rule);
- **3 years** for condemned business or investment **real property** (which may be replaced with like-kind property);
- 4 years for a main home in a federally declared disaster area.

Gain is recognized only to the extent proceeds are **not reinvested**.

Business casualty and theft losses

Unlike personal casualty losses, business casualty and theft losses are deductible without the $100 / 10%-of-AGI floors or the federally declared disaster requirement (Form 4684, then Form 4797).

Situation	Loss before insurance
Business property **completely destroyed** or stolen	**Adjusted basis**
Business property **partly damaged**	**Lesser of** decline in FMV or adjusted basis

Subtract insurance and other reimbursements.

> **Example (total destruction):** A delivery van with an adjusted basis of $30,000 (FMV $25,000) is destroyed. Insurance pays $18,000.
>
> Loss = $30,000 − $18,000 = **$12,000** (adjusted basis is used, not FMV).

> **Example (partial damage):** A machine's FMV drops from $40,000 to $10,000 after a flood. Adjusted basis is $22,000, and insurance pays $5,000.
>
> Loss = lesser of $30,000 decline or $22,000 basis = $22,000; minus $5,000 = **$17,000**.

Key takeaways

- Adjusted basis = cost + improvements − depreciation allowed or allowable. Converted property is depreciated from the lesser of basis or FMV.
- Capitalize betterments, adaptations and restorations. De minimis safe harbor is $2,500 per item ($5,000 with an AFS). Small-building safe harbor is the lesser of $10,000 or 2%.
- Net §1231 gain = LTCG (after the 5-year lookback); net §1231 loss = ordinary.
- §1245: gain is ordinary up to depreciation. Unrecaptured §1250: up to 25% for individuals; corporations recapture 20% under §291.
- §1031: real property only, 45/180 days, boot is taxed, losses are never recognized.
- Installment sales: recapture is taxed in the year of sale.
- Business casualty: total destruction uses adjusted basis; partial uses the lesser of FMV decline or basis.

Employment Taxes and Worker Classification

Employee or independent contractor?

Employment taxes apply only to **employees**. Under the common-law rules, a worker is an employee if the business has the **right to control** what is done **and how** it is done, even if it doesn't actually use that right. The IRS groups the evidence into three categories:

Category	Points toward employee	Points toward contractor
Behavioral control	Detailed instructions on when, where and how; training in the company's methods; evaluation of how work is done	Instructions only about results
Financial control	Business reimburses expenses; worker has no significant investment; paid by the hour or week; cannot profit or lose	Significant investment; unreimbursed expenses; offers services to the market; paid by the job; can make a profit or loss
Relationship	Benefits (insurance, pension, vacation); indefinite relationship; services are a key activity of the business	Written contract (helpful but not decisive); project-based; no benefits

- Either party can ask the IRS for a determination on **Form SS-8**.
- **Statutory employees** (certain drivers, full-time life insurance salespeople, home workers, traveling salespeople) have FICA withheld but report income and expenses on Schedule C.
- **Statutory nonemployees**: direct sellers, licensed real estate agents, and certain companion sitters. They are treated as self-employed when pay is based on output, not hours, under a written contract.
- **Section 530 relief** may protect a business from federal employment tax assessments if it had a **reasonable basis** for treating workers as contractors, filed all required Forms 1099, and treated similar workers consistently.
- The **Voluntary Classification Settlement Program (VCSP)** lets a business reclassify workers prospectively and pay 10% of one year's employment tax liability computed at reduced rates (Form 8952).

> **Watch out:** Calling someone a "contractor" in a contract, or issuing a Form 1099-NEC, does not make the person a contractor. The facts of control decide.

FICA: Social Security and Medicare

2025 item	Employee	Employer
Social Security (OASDI)	6.2%	6.2%
Social Security wage base	$176,100	$176,100
Medicare (HI)	1.45% (no cap)	1.45% (no cap)
Additional Medicare Tax	0.9% on wages over **$200,000** paid to the employee in the calendar year	None

- The employer must begin withholding Additional Medicare Tax in the pay period in which wages exceed **$200,000**, regardless of the employee's filing status. The employee reconciles the actual liability on Form 8959 using the filing status thresholds ($250,000 MFJ, $125,000 MFS, $200,000 others).
- If an employee works for two employers and earns more than $176,100 in total, each employer withholds Social Security up to the base. The employee claims the excess as a credit on Form 1040. The employers get no refund.

Example: An employee earns $185,000 in 2025.

Employee Social Security = $176,100 × 6.2% = **$10,918.20** (wages above the base are not taxed).

Employee Medicare = $185,000 × 1.45% = **$2,682.50**.

The employer pays the same $10,918.20 and $2,682.50. There is no Additional Medicare Tax because wages don't exceed $200,000.

Example: An employee earns $260,000.

Social Security = $10,918.20. Medicare = $260,000 × 1.45% = $3,770.

Additional Medicare Tax withheld = ($260,000 − $200,000) × 0.9% = **$540**, employee only.

Other withholding rules

- Income tax withholding is based on **Form W-4**.
- **Supplemental wages** (bonuses, commissions) paid separately can be withheld at a flat **22%**. Supplemental wages over **$1 million** in the year must be withheld at **37%**.
- **Backup withholding** on reportable payments to payees who fail to provide a correct TIN is **24%**.

- **Household employees:** FICA applies if cash wages to the employee are **$2,800** or more in 2025. **Election workers:** $2,400 or more in 2025.

Federal unemployment tax (FUTA)

FUTA is paid **only by the employer**. It is never withheld from wages.

Item	Rule
Rate	6.0% of the first **$7,000** of each employee's wages
Credit for state unemployment tax paid	Up to **5.4%**, so the net rate is usually **0.6%** (maximum $42 per employee)
Credit reduction states	States with unpaid federal loans: employers there lose part of the credit (Schedule A of Form 940)
Who is liable (general)	Paid wages of **$1,500** or more in any calendar quarter, **or** had at least one employee for some part of a day in **20 or more weeks**
Household employers	Cash wages of **$1,000** or more in any calendar quarter
Agricultural employers	Cash wages of **$20,000** or more in any quarter, or **10 or more** farmworkers in 20 or more weeks
Deposits	Deposit by the last day of the month after the quarter when undeposited FUTA exceeds **$500**. Otherwise carry it forward
Return	**Form 940**, due January 31 (February 10 if all tax was deposited on time)

> **Example:** A business has 8 employees, each earning more than $7,000 in 2025, and pays state unemployment tax on time in a state with no credit reduction.
>
> FUTA = 8 × $7,000 × 0.6% = **$336**.
>
> Without any state credit, it would be 8 × $7,000 × 6.0% = $3,360.

Not subject to FUTA: wages paid to the owner's child under 21, to a spouse, or to a parent of a sole proprietor; and wages paid by a partnership owned only by the parents of the employee child.

Depositing employment taxes

Federal tax deposits must be made by **electronic funds transfer** (usually EFTPS). The deposit schedule for Form 941 taxes depends on the **lookback period**: the 12 months ending June 30 of the prior year. For 2025, that is **July 1, 2023 – June 30, 2024**.

Total taxes reported in the lookback period	Schedule for the year
$50,000 or less	**Monthly**: deposit by the 15th of the following month
More than $50,000	**Semiweekly**: wages paid Wed–Fri are deposited by the next Wednesday; wages paid Sat–Tue are deposited by the next Friday

Special rules:

- **$100,000 next-day rule:** if accumulated tax reaches $100,000 on any day, deposit by the **next business day**. A monthly depositor then becomes a semiweekly depositor for the rest of the year and the next year.
- **$2,500 de minimis rule:** if total tax for the quarter (or the prior quarter) is less than $2,500 and the business doesn't incur a $100,000 liability, it may pay with the timely filed return.
- New employers are monthly depositors (their lookback liability is zero).

> **Example:** A business reported $48,000 of employment taxes on its Forms 941 for the lookback period. It is a **monthly** depositor for 2025, so January 2025 taxes are due by February 18, 2025 (the 15th was a Saturday and the following Monday was a federal holiday).

Returns and information returns

Form	Purpose	Due
941	Quarterly income tax withholding and FICA	Last day of the month after the quarter (Apr 30, Jul 31, Oct 31, Jan 31). Ten more days if all deposits were timely
944	Annual version, only for employers the IRS notifies (generally $1,000 or less of annual liability)	January 31
943	Agricultural employees	January 31
940	FUTA	January 31
W-2 / W-3	Wages to employees and to the SSA	January 31 (both copies)
1099-NEC	Nonemployee compensation of $600 or more (2025)	January 31 (to recipient and IRS)

For 2025 forms, January 31, 2026 falls on a Saturday, so these are due **Monday, February 2, 2026**.

Penalties

Failure to deposit (§6656):

Deposit made	Penalty
1–5 days late	2%
6–15 days late	5%
16 or more days late (or paid within 10 days of the first IRS notice, or paid directly to the IRS instead of deposited)	10%
More than 10 days after the first IRS notice, or on the day demand is made for immediate payment	15%

> **Example:** A $20,000 deposit is made 10 days late.
>
> Penalty = $20,000 × 5% = **$1,000**.

Trust fund recovery penalty (TFRP, §6672): income tax withheld and the **employee's** share of FICA are "trust fund" taxes. Any **responsible person** (an officer, owner, or even a bookkeeper with check-signing authority) who **willfully** fails to collect, account for or pay them is personally liable for a penalty equal to **100%** of the unpaid trust fund taxes. The employer's share of FICA and FUTA are not trust fund taxes.

Tips

- Employees must report tips of **$20 or more** in a month to the employer by the **10th** of the following month (Form 4070 or similar).
- The employer withholds income tax and the employee's FICA on reported tips and pays the employer's FICA.
- Large food and beverage establishments (more than 10 employees on a typical business day) file **Form 8027** and may have to allocate tips.
- Employers in food and beverage businesses can claim a credit for the employer's FICA on tips above the federal minimum wage (Form 8846).

Fringe benefits and the Affordable Care Act

- Taxable fringe benefits (personal use of a company car, excess group-term life insurance over $50,000, gift cards) are wages, subject to withholding and FICA.
- Excludable fringe benefits include: health coverage, de minimis fringes, working-condition fringes, qualified transportation fringes (up to **$325 a month** for 2025), and educational assistance up to $5,250.
- **ACA employer mandate:** an **applicable large employer** (50 or more full-time employees, including FTEs, in the prior year) must offer affordable minimum-value

coverage to full-time employees (30+ hours a week) or may owe the §4980H shared responsibility payment. ALEs report coverage on Forms **1094-C and 1095-C**.

Key takeaways

- Worker status depends on control: behavioral, financial and relationship. Form SS-8 asks the IRS. Section 530 can give relief.
- 2025 FICA: 6.2% up to $176,100 plus 1.45% with no cap, for each side. Withhold 0.9% Additional Medicare above $200,000 of wages (employee only).
- FUTA: 6.0% of the first $7,000, net 0.6% after the 5.4% state credit. Form 940. Liability starts at $1,500 in a quarter or 1 employee in 20 weeks.
- Deposits: lookback ≤ $50,000 → monthly; more → semiweekly; $100,000 → next day; under $2,500 a quarter → pay with return.
- Failure-to-deposit penalty: 2/5/10/15%. TFRP = 100% of trust fund taxes, against responsible persons who act willfully.
- W-2, W-3 and 1099-NEC are due January 31 (February 2, 2026 for 2025 forms).

Partnerships: Formation, Operations and Basis

The aggregate and entity views

A partnership is a pass-through. It files **Form 1065** but pays no income tax. Each partner reports a **distributive share** of every item, as shown on **Schedule K-1**, whether or not anything is distributed. Some rules treat the partnership as a separate entity (it chooses accounting methods and makes most elections). Others treat it as an aggregate of its partners (each partner's share of liabilities is included in basis).

Forming a partnership

Contributions of property (§721)

Generally, **no gain or loss** is recognized when a partner contributes property in exchange for a partnership interest.

- **Partner's basis in the interest** ("outside basis") = cash + adjusted basis of property contributed (§722), adjusted for liabilities (below).
- **Partnership's basis in the property** ("inside basis") = the partner's adjusted basis (§723), a **carryover** basis.
- **Holding period:** the partnership tacks the partner's holding period for the property. The partner's holding period for the interest tacks for capital and §1231 assets contributed.
- **Built-in gain or loss (§704(c)):** when contributed property's FMV differs from its basis, the pre-contribution gain or loss must be allocated back to the **contributing partner** when the partnership sells the property (and through depreciation).

Exceptions: when gain is recognized

1. **Services for an interest.** A partner who receives a **capital interest** for services has **ordinary income** equal to the FMV of the interest. That amount becomes his basis. Receipt of a pure **profits interest** for services is generally not taxed when received.
2. **Liabilities exceeding basis.** If the net decrease in the partner's share of liabilities exceeds his basis, the excess is treated as a cash distribution and is **gain**.
3. **Investment partnerships**: contributions to a partnership that would be an investment company if incorporated, where diversification results.
4. **Disguised sales**: a contribution followed by a related distribution (generally within 2 years) may be treated as a sale.

Liabilities (§752)

- An **increase** in a partner's share of partnership liabilities is treated as a **contribution of money**, which increases basis.

- A **decrease** is treated as a **distribution of money**, which decreases basis.
- **Recourse** liabilities are shared by **economic risk of loss** (who would pay if the partnership could not).
- **Nonrecourse** liabilities are generally shared in proportion to **profits**.

Example: Ann contributes land with an FMV of $100,000 and an adjusted basis of $40,000, subject to a $30,000 mortgage that the partnership assumes. She receives a 25% interest.

Liability relief: Ann is relieved of the whole $30,000 but keeps 25% of it as a partner, so her net decrease is $30,000 − $7,500 = $22,500.

Ann's outside basis = $40,000 − $22,500 = **$17,500**. No gain, because her basis exceeds the net liability relief.

Partnership's basis in the land = **$40,000** (carryover).

The other partners' outside bases increase by their shares of the $30,000 (75% = $22,500 in total).

Example (gain on contribution): Same facts, but Ann's basis in the land is only $10,000.

$10,000 − $30,000 + $7,500 = −$12,500. Basis cannot go below zero.

Ann recognizes **$12,500 of gain**, and her outside basis is **$0**.

Example (services): Ben receives a 20% **capital** interest worth $50,000 in exchange for services.

Ben has **$50,000 of ordinary income** (compensation), and his basis in the interest is **$50,000**. The partnership generally deducts or capitalizes the same amount, depending on the nature of the services.

Partnership operations

What the partnership reports

The partnership computes **ordinary business income or loss** (Form 1065, page 1) and also reports **separately stated items** on Schedule K and each partner's K-1, because those items may be treated differently on each partner's return. Common separately stated items:

- net rental real estate income and other rental income;
- interest, dividends (qualified and ordinary) and royalties;

- short- and long-term capital gains and losses, and §1231 gains and losses;
- **§179 deduction** (limited at both levels);
- **charitable contributions** (partners deduct them on their own returns);
- **guaranteed payments**;
- tax-exempt income and nondeductible expenses (for basis);
- foreign taxes, credits, AMT items, and QBI information.

Partnerships don't deduct charitable contributions, NOLs, the dividends-received deduction, or personal items such as partners' health insurance (unless treated as guaranteed payments).

Allocations

Items are allocated according to the **partnership agreement** if the allocation has **substantial economic effect**. Otherwise, they are allocated by the partners' interests in the partnership. If a partner's interest changes during the year, items are allocated using the interim closing-of-the-books method or the proration method, with the varying-interest rule.

Guaranteed payments (§707(c))

Guaranteed payments are payments to a partner for **services** or the **use of capital**, determined **without regard to partnership income**.

- The partnership **deducts** them (if they would be deductible as an ordinary business expense) in figuring ordinary income.
- The partner reports them as **ordinary income** in the partnership year in which they are deducted, even if paid later.
- Guaranteed payments for services are **self-employment income**, even for a limited partner.
- They are **not** wages (no withholding or W-2) and **not QBI**.
- They do **not** increase the partner's outside basis by themselves, and they are not a distribution reducing basis. They are treated like a salary paid to an outsider.

> **Example:** A partnership earns $150,000 before a $40,000 guaranteed payment to partner Ann for services. Ann and Ben are equal general partners.
>
> Ordinary business income = $150,000 − $40,000 = $110,000. Each partner's share = **$55,000**.
>
> Ann reports: guaranteed payment $40,000 + share $55,000 = **$95,000** of self-employment income.
>
> Ben reports **$55,000**.

Example (guaranteed payment creates a loss): Income before guaranteed payments is $30,000, and Ann's guaranteed payment is $50,000.

Ordinary loss = $30,000 − $50,000 = −$20,000, split −$10,000 each.

Ann reports the $50,000 guaranteed payment and a $10,000 loss (net $40,000). Ben reports a $10,000 loss, subject to the basis, at-risk and passive limits.

Self-employment tax for partners

- **General partners**: their distributive share of ordinary business income plus guaranteed payments is SE income.
- **Limited partners**: only guaranteed payments for services are SE income.
- LLC members are treated under the facts. Members who participate in management or operations are generally treated like general partners.

Transactions between partner and partnership (§707)

- A partner dealing with the partnership in a non-partner capacity (for example, renting property to it) is treated like an outsider.
- **Losses** on sales between a partnership and a partner owning **more than 50%** (directly or indirectly), or between two partnerships with more than 50% common ownership, are **disallowed**.
- **Gain** on such a sale is **ordinary** if the property is not a capital asset in the buyer's hands.

Family partnerships

A family member is a partner if he or she owns a capital interest in a partnership in which **capital is a material income-producing factor**, even if the interest was a gift. The donee's distributive share must be figured after **reasonable compensation** to the donor for services. The donee's share of income from donated capital cannot be proportionately greater than the donor's share.

Outside basis: the roll-forward

A partner's basis is adjusted each year in this order:

Increases	Decreases (not below zero)
Additional contributions (cash and adjusted basis of property)	Distributions of cash (including decreases in liability share) and the basis of distributed property
Share of taxable income and gains	Share of nondeductible, non-capital expenditures
Share of **tax-exempt** income	Share of losses and deductions (including separately stated losses and §179)
Increase in share of liabilities	Depletion deductions (oil and gas)

The regulations apply **distributions first**, then nondeductible expenses, then **losses** last, so losses are limited to the basis remaining after distributions.

> **Example:** At the start of 2025, Carla's outside basis is $50,000. For 2025 her K-1 shows a $30,000 share of ordinary income, $2,000 of tax-exempt interest, a $24,000 guaranteed payment, cash distributions of $40,000, $1,000 of nondeductible expenses, and a $10,000 increase in her share of partnership liabilities.
>
> Increases: $50,000 + $30,000 + $2,000 + $10,000 = $92,000.
>
> Decreases: −$40,000 distributions, then −$1,000 nondeductible = **$51,000** ending basis.
>
> The guaranteed payment is ignored for basis. It was deducted in arriving at her ordinary-income share and is taxed to her separately.

Loss limits

A partner's share of losses is deductible only to the extent of **outside basis** (§704(d)). It then passes the at-risk, passive activity and excess business loss limits (Chapter 4). Losses disallowed by basis carry forward indefinitely until basis is restored.

> **Example:** Dev's basis before losses is $45,000, and his share of the 2025 ordinary loss is $70,000.
>
> Deductible = **$45,000**. Suspended = $70,000 − $45,000 = **$25,000**, carried forward. Dev's basis is now $0.

> **Memory trick:** Partner basis = "**I**ncome **I**n, **L**iabilities **L**ift; **D**istributions **D**rop, **L**osses **L**ast."

> **Watch out:** Unlike an S corporation shareholder, a partner's basis **includes his share of entity liabilities**, including nonrecourse debt (at-risk may still limit losses from nonrecourse debt).

Capital accounts

Partnerships must report each partner's capital account on Schedule K-1 using the **tax basis method**. A partner's tax capital account is generally outside basis **minus** his share of partnership liabilities.

Key takeaways

- Contributions of property: no gain or loss. Outside basis = cash + property basis. The partnership takes a carryover basis and tacked holding period.
- Gain arises when services are exchanged for a capital interest (ordinary income) or when net liability relief exceeds basis.
- An increase in liability share = contribution; a decrease = distribution of money.
- Guaranteed payments: deductible by the partnership, ordinary SE income to the partner, not QBI, and no basis effect.
- Basis order: increases → distributions → nondeductible expenses → losses (losses are limited to remaining basis and carry forward).
- Losses between a partnership and a more-than-50% partner are disallowed.

Partnerships: Distributions, Dispositions, Filing and Audits

Current (non-liquidating) distributions

A **current distribution** reduces a partner's interest but doesn't end it. The rules (§731–§732) are designed to defer gain:

1. **Gain** is recognized only if **money** distributed exceeds the partner's outside basis just before the distribution. Money includes a **decrease in the partner's share of liabilities** and, generally, **marketable securities** at FMV. The gain is generally **capital gain**.
2. **No loss** is ever recognized on a current distribution.
3. Basis is reduced **first by money**. Then **unrealized receivables and inventory** take a carryover basis (limited to remaining basis). Then **other property** takes the partnership's basis, limited to the partner's remaining outside basis.
4. The partner's basis in distributed property = the **lesser of** the partnership's inside basis or the partner's remaining outside basis.

Example: Elena's outside basis is $60,000. She receives a current distribution of $20,000 cash and land with a partnership basis of $50,000 and an FMV of $70,000.

Step 1 – Cash: $60,000 − $20,000 = $40,000 remaining. Cash doesn't exceed basis, so no gain.

Step 2 – Land: basis = lesser of $50,000 or $40,000 = **$40,000**.

Elena's outside basis after the distribution = **$0**. No gain or loss is recognized.

Example (cash exceeds basis): Frank's basis is $15,000. He receives $22,000 cash.

Gain = $22,000 − $15,000 = **$7,000** (capital gain). His basis is now $0.

Example (liability decrease): Gina's basis is $12,000. The partnership pays off debt, which reduces her share of liabilities by $18,000.

The $18,000 is a deemed cash distribution. Gain = $18,000 − $12,000 = **$6,000**.

Liquidating distributions

A **liquidating distribution** ends the partner's entire interest. The partner's **entire remaining outside basis** is assigned to the property received (§732(b)):

- Money reduces basis first. If money exceeds basis, there is gain.
- **Unrealized receivables and inventory** take the partnership's basis (not more than the remaining outside basis).
- Any remaining basis goes to **other property**, even if this pushes its basis above the partnership's basis or FMV.
- A **loss** is recognized only if the partner receives **nothing but money, unrealized receivables and inventory**, and their total is less than outside basis. The loss is generally capital.

Example (loss allowed): Hal's outside basis is $80,000. In complete liquidation he receives $30,000 cash and inventory with a partnership basis of $20,000.

Basis after cash = $80,000 − $30,000 = $50,000. Inventory takes $20,000.

Because he received only cash and inventory, he recognizes a **$30,000 capital loss** ($50,000 − $20,000).

Example (no loss, basis shifts to land): Same facts, but instead of inventory he receives land with a partnership basis of $10,000.

Basis after cash = $50,000. The land takes the **entire** remaining basis: **$50,000**. No loss is recognized.

Disproportionate distributions (§751(b))

If a distribution changes a partner's share of **hot assets** (unrealized receivables and substantially appreciated inventory), part of it may be recast as a taxable sale between the partner and the partnership. Know that the rule exists; detailed computations are rarely tested.

Selling a partnership interest

The sale of a partnership interest is generally a sale of a **capital asset** (§741). Exceptions:

- **Amount realized** includes cash, the FMV of property received, and the selling partner's **share of partnership liabilities** that he is relieved of.
- Gain attributable to **§751 hot assets** (unrealized receivables, including depreciation recapture, and inventory) is **ordinary income**.
- The rest is capital gain or loss. Long-term or short-term depends on how long the partner held the interest.
- The partnership's tax year **closes** for the selling partner on the date of sale. The partner reports his share of income up to that date, which adjusts basis before figuring gain.

- The partnership files **Form 8308** for a sale involving §751 property. The transferor must notify the partnership.

Example: Ivy sells her partnership interest for $120,000 (including liability relief). Her outside basis on the date of sale is $70,000. Her share of the partnership's unrealized receivables (zero basis, FMV $15,000) is the only hot asset.

Total gain = $120,000 − $70,000 = $50,000.

Ordinary income (§751) = **$15,000**.

Capital gain = $50,000 − $15,000 = **$35,000**.

Watch out: Don't forget liability relief in the amount realized. If a buyer pays $100,000 cash and assumes Ivy's $20,000 share of partnership debt, the amount realized is $120,000.

Inside basis adjustments: the §754 election

When an interest is sold or inherited, or property is distributed, the partnership's inside basis can get out of line with the partners' outside bases.

- **§754 election:** a partnership may elect to adjust inside basis. Once made, it applies to all later transfers and distributions until revoked with IRS consent.
- **§743(b):** on a **transfer** of an interest (sale or death), the transferee gets a special basis adjustment to his share of partnership property, equal to the difference between his outside basis and his share of inside basis.
- **§734(b):** on a **distribution**, the partnership adjusts the basis of its remaining property for gain or loss recognized, or basis changes in the distributed property.
- **Mandatory** adjustments apply even without an election when there is a **substantial built-in loss** (inside basis exceeds FMV by more than **$250,000**), or a **substantial basis reduction** on a distribution (more than $250,000).

When a partnership terminates

A partnership terminates **only** when **no part of any business** continues to be carried on by any of its partners in a partnership. (The old "technical termination" on a 50% sale of interests was repealed for tax years beginning after 2017.)

- A partnership with only two partners ends when one partner buys out the other: it becomes a sole proprietorship.
- **Mergers:** the resulting partnership is generally the continuation of the merging partnership whose members own more than 50% of the new partnership.

- **Divisions:** a resulting partnership whose members owned more than 50% of the prior partnership continues it.
- The final Form 1065 is due by the 15th day of the 3rd month after the termination date.

Filing requirements

Item	Rule
Return	Form 1065 with Schedules K, K-1 (and K-2/K-3 when international items are relevant)
Due date	15th day of the **3rd month** after year-end (March 16, 2026 for calendar 2025, because March 15 is a Sunday)
Extension	**6 months** with Form 7004 (to September 15)
K-1s to partners	By the return due date (including extensions)
Electronic filing	Required for partnerships with **more than 100 partners**, or that file **10 or more** information returns of any type during the calendar year
Late-filing penalty	$255 × number of partners × months late (up to 12), for 2025 returns filed in 2026
Schedules L, M-1, M-2 and item F	Not required if total receipts < $250,000, total assets < $1 million, K-1s are timely, and no Schedule M-3 is required

> **Exam tip:** Partnerships report capital accounts on the **tax basis** method on Schedule K-1, item L.

Partnership audits: the centralized audit regime (BBA)

For tax years beginning after 2017, partnership audits are handled at the **partnership level**:

- Each partnership must designate a **partnership representative (PR)**, who need not be a partner but must have a substantial U.S. presence. The PR has **sole authority** to act for the partnership, and all partners are bound by the PR's actions.
- Adjustments generally produce an **imputed underpayment** paid by the partnership in the year the audit ends (the "adjustment year"), at the highest individual or corporate rate, which can be reduced through modification procedures.
- **Push-out election** (§6226): instead of paying, the partnership can push the adjustments out to those who were partners in the reviewed year, who pay with an increased interest rate.
- **Election out** (made annually on a timely filed return): available only to partnerships with **100 or fewer** partners (counting each S corporation shareholder), **all** of whom are eligible partners: individuals, C corporations, S corporations, estates of deceased partners, and

foreign entities that would be C corporations. A partnership with **any** partner that is a partnership, trust, disregarded entity or nominee **cannot** elect out.

- A partnership corrects an earlier return by filing an **administrative adjustment request (AAR)** rather than amended K-1s (Form 1065-X, or electronically through Form 8082).

Key takeaways

- Current distributions: gain only when money (including liability decreases) exceeds basis. Never a loss. Property basis = lesser of inside basis or remaining outside basis.
- Liquidating distributions: all remaining basis goes to the property received. A loss is allowed only if the partner receives just money, receivables and inventory.
- Sale of an interest: capital gain, except the ordinary part attributable to §751 hot assets. Include liability relief in the amount realized.
- §754 election (§743(b) for transfers, §734(b) for distributions). Mandatory when the built-in loss or basis reduction exceeds $250,000.
- A partnership terminates only when no business continues. There is no technical termination after 2017.
- BBA audits: partnership representative, imputed underpayment, push-out, and election out for ≤100 eligible partners.

C Corporations: Formation, Taxable Income and Filing

Forming a corporation (§351)

Transferring property to a corporation in exchange for its stock is normally a taxable exchange. **Section 351** makes it tax-free if:

1. one or more persons transfer **property** (cash and other property; **services are not property**);
2. solely in exchange for **stock** of the corporation; and
3. **immediately after** the exchange, the transferors as a group are **in control**: they own at least **80%** of the total combined voting power **and** at least 80% of each other class of stock.

Boot and liabilities

- If the transferor receives **boot** (cash or other property) along with stock, gain is recognized up to the **lesser of realized gain or boot**. Losses are never recognized.
- **Liabilities** assumed by the corporation are generally **not** boot (§357(a)), with two exceptions:
- §357(b): if the principal purpose of the assumption is tax avoidance, or there is no bona fide business purpose, **all** liabilities are treated as boot.
- §357(c): if total liabilities assumed **exceed** the total adjusted basis of property transferred by that transferor, the **excess** is gain.
- A person who receives stock for **services** has ordinary income equal to the stock's FMV. If that person transfers only services, his stock doesn't count toward the 80% control group, unless he also transfers property worth more than a nominal amount.

Basis rules

Party	Basis
Shareholder's stock (§358)	Basis of property transferred + gain recognized − boot received (FMV) − liabilities assumed by the corporation
Shareholder's boot	FMV
Corporation's basis in property (§362)	Transferor's basis + gain recognized by the transferor

Example: Jae transfers land (FMV $200,000, adjusted basis $80,000) to a new corporation in a §351 exchange and receives stock worth $180,000 plus $20,000 cash.

Realized gain = $200,000 − $80,000 = $120,000.

Recognized gain = lesser of $120,000 or boot $20,000 = **$20,000**.

Jae's stock basis = $80,000 + $20,000 − $20,000 = **$80,000**.

Corporation's basis in the land = $80,000 + $20,000 = **$100,000**.

Example (§357(c)): Kim transfers equipment with an adjusted basis of $50,000, subject to a $70,000 loan that the corporation assumes, for 100% of the stock.

Liabilities exceed basis by $70,000 − $50,000 = **$20,000**, which is recognized gain.

Stock basis = $50,000 + $20,000 gain − $70,000 liabilities = **$0**.

Other formation points

- **Organizational costs** (Chapter 5): $5,000 deduction phased out above $50,000, with the rest over 180 months. Stock issuance costs are not deductible.
- **Section 1244 stock:** an individual original shareholder of a small business corporation (capital received of $1 million or less) may deduct a loss on the stock as an **ordinary** loss, up to **$50,000** a year (**$100,000** on a joint return). Any excess is a capital loss.
- **Section 1202 (qualified small business stock):** for stock acquired after July 4, 2025, OBBBA allows a 50% exclusion of gain after 3 years, 75% after 4 years, and 100% after 5 years. The per-issuer cap is $15 million, and the gross asset limit for the issuing corporation is $75 million. Stock acquired earlier keeps the prior rules (generally a 5-year holding period and a $10 million cap).
- **Capital contributions** by shareholders are not income to the corporation. Contributions by non-shareholders (for example, a city) are generally income after 2017.

Computing corporate taxable income

A C corporation reports on **Form 1120**. Taxable income is computed like an individual's business income, with these differences:

Item	Corporate rule
Tax rate	Flat **21%**
Capital gains	Taxed at 21%. No preferential rate
Capital losses	Deductible **only against capital gains**. A net capital loss is carried **back 3 years** and **forward 5 years**, as a short-term loss
Charitable contributions	Limited to **10%** of taxable income figured before the charitable deduction, the DRD, NOL carrybacks and capital loss carrybacks. Excess carries forward **5 years**. An accrual-basis corporation may deduct a gift authorized by the board and paid within 3½ months after year-end
Dividends-received deduction (DRD)	See below
NOL	80% limit, indefinite carryforward (Chapter 6)
Passive activity rules	Apply only to closely held C corporations and personal service corporations
Standard deduction / personal items	None

Exam tip: Under OBBBA, for tax years beginning after 2025, corporate charitable gifts are deductible only to the extent they exceed **1%** of taxable income (still capped at 10%). For 2025, there is **no** 1% floor.

Example (charitable limit): A corporation has taxable income of $300,000 before the charitable deduction and the DRD, and gives $45,000 to charity.

Limit = 10% × $300,000 = **$30,000** deductible in 2025.

Carryforward = $45,000 − $30,000 = **$15,000** (5 years).

Example (capital loss): A corporation has a $10,000 capital gain and a $40,000 capital loss in 2025.

Net capital loss = $30,000. **None** of it is deductible against operating income in 2025. It is carried back to the 3 prior years (against capital gains), then forward up to 5 years.

Dividends-received deduction

A corporation receiving dividends from a **domestic** corporation deducts a percentage based on its ownership of the payer:

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

Taxable income limitation: the 50% or 65% DRD cannot exceed that percentage of taxable income (figured without the DRD, NOL deduction and capital loss carryback). The limit **does not apply** if taking the full DRD creates or increases an NOL.

The stock must be held more than **45 days** during the 91-day period beginning 45 days before the ex-dividend date. Debt-financed portfolio stock reduces the DRD.

> **Example:** A corporation has $200,000 of operating income and receives $100,000 of dividends from a domestic corporation it owns 15% of.
>
> DRD = 50% × $100,000 = $50,000. Check the limit: 50% × $300,000 = $150,000, so it doesn't bind.
>
> Taxable income = $300,000 − $50,000 = $250,000. Tax = $250,000 × 21% = **$52,500**.

> **Example (limit applies):** Same dividends, but an operating **loss** of $30,000.
>
> Taxable income before DRD = −$30,000 + $100,000 = $70,000.
>
> Full DRD of $50,000 would leave $20,000 of income, so it doesn't create an NOL, and the limit applies: 50% × $70,000 = $35,000.
>
> DRD = **$35,000**. Taxable income = **$35,000**.
>
> If the operating loss were large enough that the full $50,000 DRD created an NOL, the full $50,000 would be allowed.

Related corporations and closely held issues

- **Controlled groups** share one set of certain tax benefits (for example, the accumulated earnings credit and the §179 dollar limit) and are tested together for the gross receipts test.
- **Parent-subsidiary:** a common parent owns at least 80% (vote or value) of at least one corporation, and the chain links at 80%.
- **Brother-sister:** the same **five or fewer** individuals, estates or trusts own **more than 50%** (identical ownership, vote or value) of each corporation.
- **Personal service corporations** (owner-employees performing services in health, law, accounting and similar fields) pay the flat 21% rate like other C corporations, but must

generally use a calendar year (Chapter 3).

- **Corporate alternative minimum tax (CAMT):** a 15% minimum tax on adjusted financial statement income applies only to corporations with average annual AFSI over **$1 billion**. Small corporations are exempt. A prior-year **minimum tax credit** can reduce regular tax in later years.

Estimated tax

A corporation that expects to owe **$500 or more** must pay estimated tax in four installments, due on the 15th day of the **4th, 6th, 9th and 12th months** of the tax year (April 15, June 15, September 15 and December 15 for a calendar year).

Each installment is 25% of the **required annual payment**, which is the **lesser of**:

- 100% of the tax shown on the **current-year** return; or
- 100% of the tax shown on the **prior-year** return (only if the prior year was a full 12 months and showed a positive tax).

A **large corporation** (taxable income of $1 million or more in any of the 3 prior years) can use the prior-year safe harbor **only for the first installment**. The annualized income and adjusted seasonal installment methods are also available. Underpayment penalty is figured on **Form 2220**.

> **Example:** A corporation (not large) expects 2025 tax of $120,000. Its 2024 tax was $100,000.
>
> Required annual payment = lesser of $120,000 or $100,000 = $100,000.
>
> Each installment = $100,000 ÷ 4 = **$25,000**.

Filing Form 1120

Item	Rule
Who files	Every domestic corporation (unless exempt), even with no income
Due date	15th day of the **4th month** after year-end (April 15, 2026 for calendar 2025)
June 30 year-ends	For tax years beginning before 2026, due the 15th day of the **3rd** month (September 15), with a 7-month extension
Extension	**6 months** (Form 7004). The extension is for filing only; tax is due by the original date
Schedule M-1	Reconciles book income to taxable income
Schedule M-3	Required instead of M-1 if total assets are **$10 million** or more
Schedules L, M-1, M-2	Not required if total receipts **and** total assets at year-end are each less than **$250,000**
Form 1125-E	Officer compensation, if total receipts are $500,000 or more

Book-tax reconciliation (Schedule M-1)

Start with net income per books, then:

- **Add:** federal income tax expense, excess of capital losses over capital gains, income taxed but not recorded on the books, nondeductible expenses (50% of meals, fines, entertainment, political contributions), book depreciation in excess of tax depreciation.
- **Subtract:** income recorded on the books but not taxed (tax-exempt interest), tax deductions not charged against book income (tax depreciation in excess of book depreciation).

> **Example:** A corporation's book net income is $400,000. Its books include federal income tax expense of $84,000, a $10,000 net capital loss, $12,000 of meals (only half deductible, so $6,000 is nondeductible) and $5,000 of tax-exempt interest. Book depreciation is $30,000, and tax depreciation is $50,000.
>
> Taxable income = $400,000 + $84,000 + $10,000 + $6,000 − $5,000 − ($50,000 − $30,000) = **$475,000**.

Key takeaways

- §351: property for stock, with the transferors holding 80% control immediately after. Gain = lesser of realized gain or boot. §357(c) gain when liabilities exceed basis.
- Stock basis = property basis + gain − boot − liabilities. Corporation's basis = transferor's basis + gain.
- 21% flat rate. Capital losses only offset capital gains (3 back, 5 forward).
- Charitable: 10% of modified taxable income, 5-year carryforward (no 1% floor until 2026).
- DRD 50/65/100%, with the taxable income limit unless the full DRD creates an NOL.

- Estimated tax if $500 or more, due the 15th of months 4, 6, 9 and 12. Large corporations use the prior-year safe harbor only for the first installment.
- Form 1120 is due the 15th day of the 4th month, with a 6-month extension. M-3 at $10 million of assets.

C Corporations: Earnings and Profits, Distributions and Liquidations

Earnings and profits (E&P)

Earnings and profits measure a corporation's economic ability to pay dividends. A distribution is a **dividend** only to the extent of E&P. There are two pools:

- **Current E&P**: the E&P of the current tax year, figured at year-end.
- **Accumulated E&P**: undistributed E&P from all prior years (since February 28, 1913).

Computing current E&P

Start with **taxable income**, then adjust:

Add back	Subtract
Tax-exempt income (municipal bond interest, life insurance proceeds)	**Federal income tax** paid or accrued
Dividends-received deduction	Nondeductible expenses (50% of meals, fines, penalties, political contributions, entertainment)
NOL and capital loss carryovers deducted this year	Excess capital losses not deductible this year
Excess of accelerated tax depreciation (including §179 and bonus) over **ADS straight-line** depreciation (§179 is spread over 5 years for E&P)	Charitable contributions above the 10% limit
Deferred gain on installment sales (E&P uses full recognition)	Related-party losses disallowed under §267

Example: A corporation has 2025 taxable income of $200,000. It also has $10,000 of tax-exempt interest, federal income tax of $42,000, $3,000 of nondeductible meals, and tax depreciation that exceeds ADS depreciation by $15,000.

Current E&P = $200,000 + $10,000 − $42,000 − $3,000 + $15,000 = **$180,000**.

Ordering of cash distributions (§301 and §316)

A distribution of cash to shareholders with respect to their stock is taxed in this order:

1. **Dividend** to the extent of **current E&P** (allocated pro rata to all distributions during the year).
2. **Dividend** to the extent of **accumulated E&P** (applied in chronological order).

3. **Return of capital**, a tax-free reduction of the shareholder's stock basis.
4. **Capital gain**, once basis reaches zero.

Example: At the start of 2025 a corporation has accumulated E&P of $25,000. Its current E&P for 2025 is $40,000. It distributes $90,000 to its sole shareholder, whose stock basis is $15,000.

Dividend from current E&P = $40,000; from accumulated E&P = $25,000; total dividend = **$65,000**.

Return of capital = $15,000 (basis reduced to $0).

Capital gain = $90,000 − $65,000 − $15,000 = **$10,000**.

Example (accumulated deficit): A corporation has an accumulated E&P **deficit** of $50,000 but current E&P of $30,000. It distributes $40,000.

Dividend = **$30,000** (current E&P counts, even with an accumulated deficit). The other $10,000 reduces basis.

Example (current deficit): A calendar-year corporation has accumulated E&P of $50,000 on January 1 and a current E&P **deficit** of $20,000 for the full year. It distributes $40,000 on July 1.

The current deficit is prorated to the distribution date: $20,000 × 181/365 = $9,918.

Accumulated E&P available on July 1 = $50,000 − $9,918 = $40,082.

The whole $40,000 is a **dividend**.

Memory trick: "**Current** is **king**": current E&P makes a distribution a dividend even when accumulated E&P is negative. When current E&P is negative, look at the **net** on the date of the distribution.

Property distributions

When a corporation distributes **property** other than cash:

- **Corporation:** recognizes **gain** as if it sold the property at FMV (§311(b)). It does **not** recognize a loss. If the property is subject to a liability greater than FMV, FMV is treated as at least the liability.

- **Shareholder:** the amount distributed is the **FMV** of the property **minus** any liability the shareholder assumes. That amount is a dividend to the extent of E&P.
- **Shareholder's basis** in the property = **FMV**.
- **E&P:** increased by the gain recognized, and reduced by the FMV of the property (net of the liability).

> **Example:** A corporation with ample E&P distributes land (FMV $70,000, basis $25,000) subject to a $10,000 mortgage that the shareholder assumes.
>
> Corporation's recognized gain = $70,000 − $25,000 = **$45,000**.
>
> Amount distributed (dividend) = $70,000 − $10,000 = **$60,000**.
>
> Shareholder's basis in the land = **$70,000**.

Constructive dividends

Benefits given to shareholders without a formal declaration may be treated as dividends: unreasonable compensation, below-market loans, personal use of corporate property, payment of a shareholder's personal expenses, and bargain sales to shareholders. The corporation loses the deduction (for example, the excessive part of salary).

Stock dividends (§305)

A distribution of the corporation's **own stock** is generally **not taxable**. The shareholder allocates basis between old and new shares. Exceptions (taxable) include distributions where any shareholder can choose cash or property instead, and distributions that change proportionate interests.

Stock redemptions (§302)

When a corporation buys back its own stock, the shareholder has **sale or exchange** treatment (capital gain or loss: amount received minus basis of the shares) if any of these tests is met. Otherwise, the whole amount is a §301 **distribution** (dividend to the extent of E&P).

Test	Requirement
Substantially disproportionate (§302(b)(2))	After the redemption the shareholder owns **less than 50%** of voting power, **and** his percentage of voting stock is **less than 80%** of his percentage before
Complete termination (§302(b)(3))	All of the shareholder's stock is redeemed. Family attribution can be waived if he keeps no interest (other than as a creditor) for **10 years** and files an agreement
Not essentially equivalent to a dividend (§302(b)(1))	A meaningful reduction in the shareholder's proportionate interest (facts and circumstances)
Partial liquidation (§302(b)(4))	Noncorporate shareholders only, when the corporation contracts its business

Stock ownership is figured with the **§318 attribution rules**: stock owned by a spouse, children, grandchildren and parents (not siblings) is treated as owned by the shareholder, along with stock owned through entities.

> **Example:** Lena owns 60 of the 100 outstanding shares (60%). The corporation redeems 30 of her shares for $90,000. Her basis is $1,000 per share. No other shareholders are related to her.
>
> After: Lena owns 30 of 70 shares = 42.86%. That is less than 50%, and less than 80% × 60% = 48%.
>
> The redemption is substantially disproportionate, so it gets exchange treatment: gain = $90,000 − (30 × $1,000) = **$60,000** capital gain.

Complete liquidations

Party	Rule
Liquidating corporation (§336)	Recognizes gain **and loss** as if it sold its assets at FMV. Losses on distributions to related persons (more than 50% shareholders) of non-pro-rata or recently contributed property are limited
Shareholders (§331)	Treat the amounts received as full payment for their stock: **capital gain or loss** = FMV received − stock basis. Their basis in property received is FMV
Subsidiary liquidation into an 80% parent (§332)	**No** gain or loss to the parent. The parent takes the subsidiary's basis in the assets (§334(b)) and inherits its tax attributes (NOLs, E&P). The subsidiary recognizes no gain or loss on distributions to the parent (§337)

The corporation files **Form 966** within **30 days** after adopting a plan of dissolution or liquidation. The final Form 1120 has the "final return" box checked.

Example: In complete liquidation, a shareholder receives cash and property worth $500,000 for stock with a basis of $120,000.

Capital gain = $500,000 − $120,000 = **$380,000**. Her basis in the property received is its FMV.

Penalty taxes on retained income

Accumulated earnings tax (AET, §531)

A C corporation that accumulates earnings **beyond the reasonable needs of the business** to help its shareholders avoid dividend tax may owe a **20%** tax on **accumulated taxable income**. It is assessed by the IRS (there is no form).

- **Accumulated earnings credit:** every corporation may accumulate at least **$250,000** of E&P (**$150,000** for personal service corporations in health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting) without justification. A controlled group shares one credit.
- **Reasonable needs** include documented plans for expansion, working capital (often measured by the *Bardahl* formula), debt retirement, and self-insurance. Vague plans and loans to shareholders hurt.
- Dividends paid (including consent dividends and dividends paid within 2½ months after year-end) reduce accumulated taxable income.

Example: A non-PSC corporation begins the year with accumulated E&P of $180,000. Its minimum accumulated earnings credit for the year is $250,000 − $180,000 = **$70,000**, so it can retain another $70,000 of current earnings without having to show business needs.

Personal holding company (PHC) tax (§541)

A corporation is a PHC if both:

1. **Income test:** at least **60%** of adjusted ordinary gross income is PHC income (dividends, interest, royalties, certain rents, and personal service contracts naming a 25% owner); and
2. **Ownership test: more than 50%** of the stock value is owned by **5 or fewer** individuals at any time during the **last half** of the tax year.

A **20%** tax applies to undistributed PHC income. It is self-assessed on **Schedule PH** (Form 1120). A corporation subject to the PHC tax is not also subject to the AET.

Watch out: S corporations, partnerships and tax-exempt organizations are not subject to the AET or PHC tax. Both are C corporation penalty taxes.

Key takeaways

- E&P starts from taxable income: add tax-exempt income and the DRD; subtract federal income tax and nondeductible expenses; use ADS depreciation.
- Distribution order: current E&P → accumulated E&P → return of basis → capital gain.
- Property distributions: the corporation recognizes gain (never loss); the shareholder's dividend = FMV − liability; basis = FMV.
- Redemptions get exchange treatment if substantially disproportionate (<50% and <80% of before), a complete termination, not essentially equivalent, or a partial liquidation. Apply §318 attribution.
- Liquidations: the corporation recognizes gain and loss; shareholders have capital gain or loss. §332 parent-subsidiary liquidations are tax-free with carryover basis.
- AET 20% (credit $250,000; $150,000 for PSCs). PHC tax 20% (60% income test, 5-or-fewer ownership test).

S Corporations

Eligibility

A corporation can elect S status only if it is a **small business corporation**:

Requirement	Detail
Domestic	Organized in the U.S. (a domestic LLC that elects to be taxed as a corporation qualifies)
100 or fewer shareholders	Members of a family (a common ancestor and lineal descendants within six generations, plus spouses and former spouses) count as **one** shareholder. Spouses always count as one
Eligible shareholders only	Individuals who are U.S. citizens or residents; estates; certain trusts (grantor trusts, **qualified subchapter S trusts (QSSTs)**, **electing small business trusts (ESBTs)**, and testamentary trusts for 2 years); §501(c)(3) organizations and qualified retirement plan trusts
Not eligible as shareholders	Partnerships, corporations (except an S corporation parent of a **QSub**), most LLCs taxed as partnerships, **nonresident aliens**, IRAs (except certain bank stock)
One class of stock	All shares have identical rights to distributions and liquidation proceeds. **Differences in voting rights are allowed**
Not an ineligible corporation	Not a bank using the reserve method, an insurance company, or a current or former DISC

Watch out: A nonresident alien spouse in a community property state, or a partnership buying shares, can **terminate** the election. Watch for "foreign" or "LLC" shareholders in exam questions.

Making the election

- File **Form 2553**, signed by **all shareholders** on the day it is filed (and anyone who held stock earlier in the year before the election).
- To be effective for the current year, file it no later than **2 months and 15 days** after the beginning of the tax year (March 15 for a calendar year), or at any time in the prior year. A late election takes effect the following year.
- The corporation must meet the requirements on every day of the pre-election part of the year, and every shareholder during that part of the year must consent.
- **Late election relief** (Rev. Proc. 2013-30) is generally available within **3 years and 75 days** of the intended effective date, with reasonable cause.
- A parent S corporation can treat a 100%-owned subsidiary as a **qualified subchapter S subsidiary (QSub)** by filing **Form 8869**. The QSub's items are included on the parent's

return.

Termination

Cause	Effective date
Revocation by shareholders owning **more than 50%** of the shares (voting and nonvoting)	First day of the tax year if made by the 15th day of the 3rd month. Otherwise the next year, or any later date specified
Ceasing to qualify (101st shareholder, ineligible shareholder, second class of stock)	The **date** of the terminating event. The year splits into an S short year and a C short year
Excess passive investment income: passive investment income above **25%** of gross receipts for **3 consecutive years** while the corporation has **accumulated C corporation E&P**	First day of the **4th** year

After a termination or revocation, the corporation generally cannot re-elect S status for **5 years** without IRS consent. The IRS may grant relief for **inadvertent** terminations corrected promptly.

How an S corporation is taxed

An S corporation files **Form 1120-S**, due the 15th day of the **3rd month** (March 16, 2026 for calendar 2025), with a 6-month extension on Form 7004. Like a partnership, it computes **ordinary business income** and passes through **separately stated items** on Schedule K-1 (capital gains, §1231, charitable contributions, §179, tax-exempt income, investment interest, credits and QBI information).

Per-share, per-day allocation

Items are allocated to shareholders **pro rata per share per day**. Special allocations are **not** allowed (one class of stock). A selling shareholder is treated as owning the shares on the day of the sale. If a shareholder's interest terminates, all affected shareholders can agree to **close the books** instead of prorating.

> **Example:** An S corporation earns $365,000 of ordinary income in 2025 (a 365-day year). Ana and Chris each own 50%. Ana sells all of her shares to Ben, effective April 9, 2025 (day 99 of the year).
>
> Ana: $365,000 × 50% × 99/365 = **$49,500**.
>
> Ben: $365,000 × 50% × 266/365 = **$133,000**.
>
> Chris: $365,000 × 50% = **$182,500**.

Entity-level taxes

Most S corporations pay no income tax, but three taxes can apply:

Tax	When it applies	Rate
Built-in gains (BIG) tax (§1374)	A former C corporation (or one that acquired assets from a C corporation in a carryover-basis transaction) sells assets within the **5-year recognition period** after the S election. Tax is on the **recognized built-in gain**, limited to the net unrealized built-in gain at conversion and to taxable income	21%
Excess net passive income tax (§1375)	Corporation has accumulated C corporation E&P **and** passive investment income above 25% of gross receipts	21% of excess net passive income
LIFO recapture (§1363(d))	A C corporation using LIFO converts to S. Recapture is reported in the last C year and paid in 4 installments	C corporation rate

The BIG tax paid is passed through to shareholders as a loss of the same character as the gain.

> **Example:** A C corporation elected S status on January 1, 2023, when its net unrealized built-in gain was $100,000. In 2025 it sells an asset that had a built-in gain of $40,000 at conversion. The total gain on the sale is $55,000 (the asset appreciated $15,000 more after conversion). Taxable income is ample.
>
> Recognized built-in gain = $40,000 (only pre-conversion appreciation).
>
> BIG tax = $40,000 × 21% = **$8,400**. The remaining $15,000 of gain is not subject to the BIG tax.

Shareholder compensation and fringe benefits

- Shareholder-employees must be paid **reasonable compensation** as W-2 wages before taking non-wage distributions. The IRS may reclassify distributions as wages when salary is unreasonably low, assessing FICA, FUTA, interest and penalties.
- A **more-than-2% shareholder** is treated like a partner for fringe benefits. **Health insurance** premiums paid by the corporation are included in his W-2 **box 1 wages** (not subject to Social Security or Medicare when paid under a plan), and he may then take the **self-employed health insurance deduction**. Other benefits (group-term life insurance, cafeteria plans) are also taxable to him.
- K-1 ordinary income is **not** self-employment income.

Shareholder basis

Each shareholder tracks **stock basis** and, separately, **debt basis**. Shareholders must attach **Form 7203** when they claim a loss, receive a distribution, dispose of stock, or receive a loan repayment.

Stock basis

- **Starting basis:** cost, or the basis in property contributed (§351 rules), or the basis received by gift or inheritance.
- Annual adjustments, in this order: 1. **Increase** for income items (including separately stated and **tax-exempt** income) and contributions. 2. **Decrease** for **distributions** (not below zero). 3. **Decrease** for **nondeductible, noncapital expenses** (for example, 50% of meals, penalties). 4. **Decrease** for **losses and deductions** (including §179 and charitable contributions).
- A shareholder may elect to deduct losses before nondeductible expenses.

Debt basis

- **Only direct loans** from the shareholder to the S corporation create debt basis. **Guarantees** of bank loans and loans from related entities do **not**, until the shareholder actually pays on the guarantee.
- Corporate liabilities are **not** included in stock basis (the key difference from partnerships).
- Losses reduce stock basis first, then debt basis.
- Later net increases **restore debt basis first**, before stock basis.
- Repayment of a loan with reduced debt basis produces gain (capital if the debt is a formal note; ordinary if an open account).

Example (stock basis roll-forward): Ming's stock basis on January 1, 2025 is $20,000. Her 2025 K-1 shows ordinary income of $30,000, tax-exempt interest of $2,000, a §179 deduction of $5,000, nondeductible expenses of $1,000, and distributions of $35,000.

1. Increases: $20,000 + $30,000 + $2,000 = $52,000.
2. Distributions: $52,000 − $35,000 = $17,000 (no gain, because distributions don't exceed basis).
3. Nondeductible expenses: $17,000 − $1,000 = $16,000.
4. Losses and deductions: $16,000 − $5,000 = **$11,000** ending stock basis.

Example (debt basis): Ray has stock basis of $10,000 and lent the S corporation $15,000 directly. His share of the 2025 ordinary loss is $32,000.

Loss allowed = stock basis $10,000 + debt basis $15,000 = **$25,000**. Both are reduced to $0.

Suspended loss = $32,000 − $25,000 = **$7,000**, carried forward indefinitely while he owns the stock.

In 2026 his share of income is $12,000. The $7,000 carried-over loss is treated as a 2026 loss and is now allowed. The net increase of $5,000 restores his **debt** basis to $5,000 (stock basis stays $0).

Distributions

No accumulated E&P (an S corporation that was never a C corporation, or that has no C corporation E&P): distributions are **tax-free** to the extent of stock basis. Any excess is **capital gain**.

With accumulated E&P (from C corporation years), distributions come out in this order:

1. **Accumulated adjustments account (AAA)**: S corporation earnings that have already been taxed. This is tax-free, reducing basis.
2. **Accumulated E&P**: a **dividend** (taxable).
3. Remaining **stock basis**: tax-free.
4. **Capital gain** after basis is zero.

With the consent of all shareholders receiving distributions, the corporation can elect to distribute E&P **first** (for example, to avoid the passive income tax or termination).

Example: An S corporation (a former C corporation) has AAA of $30,000 and accumulated E&P of $20,000. It distributes $45,000 to its sole shareholder, who has ample stock basis.

From AAA: **$30,000**, tax-free (reduces basis).

From accumulated E&P: **$15,000**, a taxable dividend.

Memory trick: "**A**lways **AA**A **A**head": AAA comes before E&P unless all shareholders elect otherwise.

S corporation versus partnership: quick contrast

Issue	S corporation	Partnership
Owners	≤100 eligible shareholders	Any number, any type
Allocations	Per share, per day only	Special allocations allowed
Entity debt in owner basis	No (only direct shareholder loans)	Yes
Owner pay	W-2 wages (reasonable compensation)	Guaranteed payments (SE income)
Owner's share of ordinary income subject to SE tax	No	Yes for general partners
Distributions of appreciated property	Corporation recognizes gain	Generally no gain
Contribution of property	§351 (80% control needed)	§721 (no control test)

Key takeaways

- Eligibility: domestic, ≤100 shareholders (families count as one), eligible shareholders only (no partnerships, corporations or nonresident aliens), one class of stock (voting differences OK).
- Form 2553 by the 15th day of the 3rd month, with all shareholders consenting. Termination: >50% revocation, failing a requirement, or excess passive income for 3 years with C corporation E&P. A 5-year wait before re-electing.
- Per-share, per-day allocation. Entity taxes: BIG (5-year period), excess net passive income, LIFO recapture.
- Basis order: income → distributions → nondeductibles → losses. Debt basis comes only from direct loans and is restored first. File Form 7203.
- Distributions with E&P: AAA (tax-free) → E&P (dividend) → basis → gain.
- More-than-2% shareholders: health insurance goes in W-2 wages, then the SEHI deduction. K-1 income is not SE income.

Retirement Plans for Businesses

Qualified versus nonqualified plans

A **qualified plan** meets the requirements of §401(a) (coverage, nondiscrimination, vesting, contribution and benefit limits, and a written plan document). The benefits are significant:

- the employer **deducts** contributions when made (within limits);
- employees are **not taxed** until they receive distributions;
- earnings grow tax-deferred in a tax-exempt trust.

A **nonqualified** deferred compensation plan (for example, a deferred bonus plan for executives) does not have to cover rank-and-file employees. However, the employer cannot deduct the deferred amount until the **employee includes it in income**. Such plans must follow §409A (timing of deferral elections and payment events) or the deferred amounts become immediately taxable with a 20% additional tax.

Types of plans

Plan	Basic idea
Defined benefit (DB)	Promises a specific benefit at retirement (for example, a percentage of final pay). The employer bears the investment risk. Contributions are actuarially determined
Defined contribution (DC)	Each participant has an individual account. The benefit depends on contributions and earnings. Includes profit-sharing, money purchase and 401(k) plans
401(k)	A profit-sharing plan with a cash-or-deferred feature: employees elect pre-tax (or Roth) elective deferrals. Employer may match
SEP (simplified employee pension)	Employer contributes to traditional IRAs for each eligible employee. No employee deferrals (new SARSEPs cannot be set up)
SIMPLE IRA	Small employers (100 or fewer employees). Employee deferrals plus a required employer match or nonelective contribution
Solo (one-participant) 401(k)	A 401(k) covering only the owner (and spouse). Allows both employee deferrals and employer contributions

2025 dollar limits (Notice 2024-80)

Limit	2025
Elective deferrals: 401(k), 403(b), governmental 457(b) (§402(g))	**$23,500**
Catch-up, age 50 or older (401(k), 403(b), 457(b))	**$7,500**
Catch-up, ages **60–63** (401(k), 403(b), 457(b))	**$11,250** (instead of $7,500)
SIMPLE deferrals	**$16,500** ($17,600 for certain small plans)
SIMPLE catch-up, age 50 or older	**$3,500** (ages 60–63: $5,250)
Annual additions to a DC plan (§415(c))	**$70,000** (or 100% of compensation if less), not counting catch-ups
Annual benefit, DB plan (§415(b))	**$280,000**
Compensation limit (§401(a)(17))	**$350,000**
Highly compensated employee (§414(q))	**$160,000** (applies to 2025 compensation, used to identify HCEs for 2026)
Key employee officer (§416(i))	**$230,000**
SEP minimum compensation for participation	**$750**
IRA contribution limit (for reference)	$7,000 (+ $1,000 catch-up)

Deduction limits and the self-employed computation

- **Profit-sharing, SEP and 401(k) employer contributions:** deductible up to **25% of total compensation** of participating employees. Elective deferrals don't count against the 25%.
- **Self-employed individuals** (sole proprietors and partners) don't have "wages." Their compensation is **net earnings from self-employment minus the deduction for half of SE tax minus the contribution itself**. Because of that circular computation, a 25% plan rate becomes an effective **20%** of net earnings after the half-SE-tax deduction (25% ÷ 125%).
- The owner's contribution is deducted on **Form 1040, Schedule 1** (not on Schedule C). Contributions for employees are business expenses on Schedule C.

Example (SEP for a sole proprietor): Paula's 2025 Schedule C net profit is $120,000, and her SEP plan uses a 25% rate.

SE tax = $120,000 × 92.35% × 15.3% = $16,955.46. Half = $8,477.73.

Net earnings for the plan = $120,000 − $8,477.73 = $111,522.27.

Maximum SEP contribution = $111,522.27 × 20% = **$22,304.45** (well under the $70,000 limit).

Example (high earner): Net profit is $400,000.

SE tax: Social Security part = $176,100 × 12.4% = $21,836.40; Medicare part = $400,000 × 92.35% × 2.9% = $10,712.60; total = $32,549.00, half = $16,274.50.

Net earnings = $400,000 − $16,274.50 = $383,725.50; × 20% = $76,745.10.

Compensation cap: 25% × $350,000 = $87,500.

Annual additions limit: **$70,000**, which is the maximum contribution.

Example (solo 401(k) through an S corporation): Omar, age 52, is the only employee of his S corporation and receives W-2 wages of $100,000.

Employee deferral: $23,500 + age-50 catch-up $7,500 = $31,000.

Employer profit-sharing contribution: 25% × $100,000 = $25,000.

Total = **$56,000**. Annual additions not counting catch-up = $23,500 + $25,000 = $48,500, under $70,000.

SEP rules

- **Eligibility:** must cover each employee who is at least **21**, has worked for the employer in at least **3 of the last 5 years**, and received at least **$750** of compensation in 2025. The employer can use less restrictive requirements.
- Contributions must be the **same percentage** of compensation for every eligible employee, including the owner. They are fully vested immediately.
- A SEP can be **established and funded** as late as the **due date of the employer's return, including extensions**.
- Uses Form 5305-SEP (or a prototype). There is **no Form 5500** filing.

SIMPLE IRA rules

- Employer has **100 or fewer** employees who earned **$5,000 or more** in the preceding year, and maintains **no other** retirement plan.
- Employees eligible: earned at least $5,000 in any 2 preceding years and expected to earn $5,000 this year.
- **Employer contribution** (choose one each year):
- **Matching** contributions dollar for dollar up to **3%** of compensation (the employer may reduce it to as low as 1% in no more than 2 of any 5 years); or
- a **2% nonelective** contribution for every eligible employee, whether or not the employee defers. Compensation is capped at **$350,000** for this purpose.
- Generally must be set up by **October 1** of the year (later for a new business).
- Withdrawals within the first **2 years** of participation are subject to a **25%** additional tax (instead of 10%) if no exception applies.

> **Example:** An employee earning $50,000 defers $6,000 to a SIMPLE IRA.
>
> 3% match = lesser of $6,000 or 3% × $50,000 = **$1,500**.
>
> If the employer instead elected the 2% nonelective contribution: 2% × $50,000 = **$1,000**, paid even if the employee deferred nothing.
>
> For an employee earning $400,000, the 2% nonelective contribution is limited to 2% × $350,000 = $7,000.

Qualified plan requirements

- **Coverage (§410(b)):** generally the plan must benefit at least **70%** of non-highly compensated employees (or pass the ratio or average-benefits test).
- **Minimum participation:** employees age **21** with **1 year of service** (1,000 hours) must be allowed in. Plans may require 2 years if contributions are 100% vested immediately.
- **Highly compensated employee (HCE):** a **5% owner** at any time in the current or preceding year, or someone whose compensation in the preceding year exceeded the threshold ($155,000 for 2024 compensation, used to identify 2025 HCEs).
- **Nondiscrimination:** 401(k) plans must pass the **ADP** test (deferrals) and **ACP** test (matching and after-tax contributions), unless they adopt a **safe harbor** design (for example, 100% match on the first 3% of pay plus 50% on the next 2%, or a 3% nonelective contribution, fully vested).
- **Top-heavy:** if more than **60%** of account balances belong to **key employees**, non-key employees must receive a minimum contribution (generally **3%** of compensation) and faster vesting.
- **Vesting** of employer contributions (DC plans): either **3-year cliff** or **2- to 6-year graded**. Employee deferrals are always 100% vested.
- **Required minimum distributions** generally begin at age **73** (a 5% owner cannot delay to retirement).

Deadlines for setting up plans

Plan	Latest date to establish for 2025	Latest date to contribute
Qualified plan (profit-sharing, DB)	Due date of the employer's return, including extensions	Due date of the return, including extensions
Solo 401(k), elective deferrals	Sole proprietors may set up a new solo 401(k) and make first-year deferrals by the return due date (without extensions)	Return due date
SEP	Due date of the return, including extensions	Same
SIMPLE IRA	October 1, 2025 (generally)	Deferrals within 30 days after the month withheld; employer contribution by the return due date with extensions

Small employer credits

- **Pension start-up credit (Form 8881):** for employers with 100 or fewer employees starting a new plan. Up to 100% (50% if more than 50 employees) of qualified start-up costs, maximum $5,000 a year, for 3 years.
- **Auto-enrollment credit:** $500 a year for 3 years for adding an automatic enrollment feature.

Prohibited transactions (§4975)

A **disqualified person** (the employer, plan fiduciaries, owners of 50% or more, family members of these people, and service providers) may not engage in transactions with the plan, such as:

- a sale, exchange or lease of property between the plan and a disqualified person;
- lending money or extending credit;
- furnishing goods, services or facilities (except reasonable arrangements for necessary services);
- transfer or use of plan assets for the benefit of a disqualified person;
- a fiduciary dealing with plan assets in his own interest.

Excise tax	Rate
First-tier tax on the disqualified person	**15%** of the amount involved, for each year in the taxable period
Second-tier tax if not corrected within the taxable period	**100%** of the amount involved

The taxes are reported on **Form 5330**. For an **IRA**, a prohibited transaction by the owner generally disqualifies the entire IRA. It is treated as distributed on January 1 of that year.

Reporting: Form 5500

Form	Who files
Form 5500	Qualified plans and other ERISA plans (with schedules)
Form 5500-SF	Small plans (generally fewer than 100 participants) that meet certain conditions, filed electronically
Form 5500-EZ	**One-participant plans** (owner and spouse only), and foreign plans. Not required if plan assets are **$250,000 or less** at the end of every plan year (except the final year)

Form 5500 is due by the **last day of the 7th month** after the plan year ends (July 31 for a calendar-year plan). Form 5558 gives a 2½-month extension. SEPs and SIMPLE IRAs do **not** file Form 5500. The penalty for a late Form 5500-EZ is $250 a day, up to $150,000 per return.

Key takeaways

- 2025 limits: deferral $23,500; catch-up $7,500 ($11,250 at ages 60–63); SIMPLE $16,500 (catch-up $3,500); §415(c) $70,000; DB $280,000; compensation $350,000; HCE $160,000; key employee $230,000.
- Employer deduction limit: 25% of compensation. Self-employed: effectively 20% of (net profit − ½ SE tax).
- SEP: age 21, 3 of 5 years, $750. Set up and fund by the return due date with extensions. No Form 5500.
- SIMPLE IRA: ≤100 employees, no other plan, 3% match or 2% nonelective, set up by October 1, 25% penalty within 2 years.
- Prohibited transactions: 15% first-tier, 100% second-tier (Form 5330).
- Form 5500-EZ: one-participant plans with assets over $250,000. Due the last day of the 7th month.

Trusts, Estates and Exempt Organizations

Part A – Trusts and estates (Form 1041)

The cast of characters

- **Grantor (settlor):** creates the trust and transfers property to it.
- **Fiduciary:** the trustee of a trust, or the executor (personal representative) of an estate.
- **Beneficiaries:** income beneficiaries and remainder beneficiaries.
- **Decedent's estate:** comes into existence at death and lasts for the period of administration.

Types of trusts

Type	Tax treatment
Grantor trust (including most revocable living trusts)	Ignored for income tax. All items are taxed to the **grantor**. Form 1041 may be filed as an information return, or an optional method may be used
Simple trust	Must distribute **all income** currently, makes **no** charitable contributions, and distributes no corpus during the year. Exemption **$300**
Complex trust	Any trust that is not simple (may accumulate income, distribute principal, or give to charity). Exemption **$100**
Decedent's estate	Taxed like a complex trust. Exemption **$600**
Qualified disability trust	Larger exemption, tied to the individual exemption amount

A trust can be simple in one year and complex in another (for example, in a year it distributes corpus). A trust is **always complex in its final year**.

> **Watch out: Abusive trust arrangements** that claim to move business income or personal expenses into a trust (for example, deducting a family home's costs as "trust expenses") do not work. The IRS disregards them or treats them as grantor trusts, and promoters and participants face penalties.

Filing requirements

- A trust or estate must file **Form 1041** if it has **gross income of $600 or more**, any taxable income (trusts), or a beneficiary who is a nonresident alien.
- **Due date:** the 15th day of the **4th month** after year-end: **April 15, 2026** for calendar 2025.
- **Extension: 5½ months** with Form 7004 (to September 30 for calendar-year filers).

- **Tax year:** trusts must use the **calendar year** (except tax-exempt and charitable trusts). An **estate** may choose **any fiscal year** ending within 12 months of death.
- **§645 election:** a qualified revocable trust can elect to be treated as part of the decedent's estate, which lets it use a fiscal year and other estate benefits.
- **Estimated tax:** trusts and estates generally pay quarterly estimated tax, but an **estate** (and a grantor trust receiving the residue under a will) is exempt for tax years ending within **2 years** of the decedent's death.
- The fiduciary may get an EIN for the estate or trust and should file **Form 56** to notify the IRS of the fiduciary relationship.

2025 tax rates for trusts and estates (Rev. Proc. 2024-40)

Taxable income	Tax
$0 – $3,150	10%
$3,150 – $11,450	$315 + 24% of the excess over $3,150
$11,450 – $15,650	$2,307 + 35% of the excess over $11,450
Over $15,650	$3,777 + 37% of the excess over $15,650

Capital gains and qualified dividends	2025 taxable income breakpoints
0% rate	Up to $3,250
15% rate	$3,250 – $15,900
20% rate	Over $15,900

The **3.8% net investment income tax** applies to the lesser of undistributed net investment income or AGI above the dollar amount where the top bracket begins (**$15,650** for 2025).

> **Example:** A complex trust has 2025 taxable income of $20,000, all ordinary income.
>
> Tax = $3,777 + 37% × ($20,000 − $15,650) = $3,777 + $1,609.50 = **$5,386.50**.
>
> At $10,000 of taxable income: $315 + 24% × ($10,000 − $3,150) = **$1,959**.

Distributable net income (DNI)

DNI does three jobs:

1. It **caps the distribution deduction** of the trust or estate.
2. It **caps the amount taxable** to beneficiaries.
3. It gives the distributed income its **character** (tax-exempt interest, qualified dividends and so on keep their character in the beneficiaries' hands).

DNI ≈ taxable income of the trust before the distribution deduction and the exemption, **plus** net tax-exempt interest, **minus** capital gains allocated to corpus (and not distributed), with

other adjustments.

- **Capital gains** are generally allocated to **corpus** and excluded from DNI, so they are taxed to the trust. Exceptions: when the governing instrument or local law allocates them to income, when they are actually distributed, or in the final year.
- **Distribution deduction** = **lesser of** (a) amounts required to be distributed plus other amounts properly paid, or (b) DNI, in both cases excluding the tax-exempt part.
- **Tier system** (complex trusts): **first-tier** distributions (income required to be distributed) carry out DNI first. **Second-tier** distributions (all other amounts) carry out what is left.
- **65-day rule:** a complex trust or estate may elect to treat distributions made within the first **65 days** of the next year as made in the current year.
- Beneficiaries receive **Schedule K-1 (Form 1041)** showing their shares of income by character.
- **Fiduciary accounting income** (under the trust instrument and state law) decides what must be distributed. It is different from taxable income: for example, fees charged to principal reduce taxable income but not accounting income.

Example (simple trust): In 2025 a simple trust receives $12,000 of taxable interest, $8,000 of qualified dividends and a $5,000 long-term capital gain (allocated to corpus under the trust instrument). It pays a $2,000 trustee fee, charged half to income and half to principal.

Fiduciary accounting income = $12,000 + $8,000 − $1,000 = $19,000, all of which must be distributed.

DNI = $12,000 + $8,000 − $2,000 = **$18,000** (capital gain excluded).

Distribution deduction = lesser of $19,000 or $18,000 = **$18,000**.

Taxable income = $12,000 + $8,000 + $5,000 − $2,000 − $18,000 − $300 exemption = **$4,700**, which is the remaining capital gain.

Tax on the gain: 0% on the first $3,250, then 15% × ($4,700 − $3,250) = **$217.50**.

The beneficiary reports $18,000 of income, split between interest and qualified dividends in proportion.

Deductions and special items

- **Fiduciary fees, tax preparation fees and other costs** that would not have been incurred if the property were not held in a trust or estate are deductible in full (they are not subject to the 2% floor).
- **Charitable deduction (§642(c)):** unlimited, but only for amounts paid from **gross income** under the governing instrument.
- **Income in respect of a decedent (IRD)**, such as unpaid wages, IRA balances and installment payments, is income to whoever receives it. A **§691(c) deduction** is allowed

for estate tax paid on IRD.

- **Final year:** unused capital loss carryovers, NOL carryovers and excess deductions pass through to the beneficiaries who succeed to the property.

Penalties

The usual failure-to-file and failure-to-pay penalties apply to Form 1041. Fiduciaries who distribute assets before paying the decedent's or the estate's taxes can become **personally liable** for the unpaid tax (to the extent of the distributions).

Part B – Exempt organizations

Getting and keeping exemption

Item	Rule
§501(c)(3) organizations (charitable, religious, educational, scientific)	Apply on **Form 1023** (electronic). Smaller organizations may use **Form 1023-EZ**: projected annual gross receipts of **$50,000 or less** for the next 3 years and total assets of **$250,000 or less**
Other §501(c) organizations (social welfare, labor, business leagues, social clubs)	Apply on Form 1024 (or Form 1024-A for some (c)(4)s). A §501(c)(4) must also notify the IRS on Form 8976 within 60 days of formation
Timing	If filed within **27 months** after the end of the month the organization was formed, exemption is retroactive to formation
Churches	Exempt automatically, with no application or annual return required (many apply anyway)
Prohibitions for §501(c)(3)	**No private inurement** (net earnings may not benefit insiders); **no participation in political campaigns** for or against candidates (absolute); lobbying may not be a substantial part of activities (or the organization elects the expenditure test under §501(h))

Automatic revocation: an organization that fails to file a required Form 990-series return or notice for **3 consecutive years** loses its exemption automatically, as of the due date of the third return.

Public charities versus private foundations

Every §501(c)(3) organization is presumed to be a **private foundation** unless it shows it is a public charity (churches, schools, hospitals, organizations with broad public support, supporting organizations). Private foundations:

- file **Form 990-PF** regardless of size;
- pay a **1.39%** excise tax on net investment income for 2025;
- face excise taxes on self-dealing, failure to distribute income, excess business holdings, jeopardizing investments and taxable expenditures.

Annual returns

Return	Who files (normally)
Form 990-N (e-Postcard)	Gross receipts normally **$50,000 or less**
Form 990-EZ	Gross receipts **less than $200,000** and total assets **less than $500,000**
Form 990	All others (gross receipts **$200,000 or more**, or total assets **$500,000 or more**)
Form 990-PF	Private foundations
Form 990-T	Gross income from unrelated business of **$1,000 or more**

The due date is the 15th day of the **5th month** after year-end (**May 15, 2026** for calendar 2025), with an automatic **6-month** extension on Form 8868. Forms 990 and 990-T must be e-filed.

Late filing penalty (organization, for returns due in 2026): **$25 a day**, up to the lesser of $13,000 or 5% of gross receipts. For organizations with gross receipts above $1,309,500, it is $130 a day, up to $65,000.

Annual returns (Forms 990, 990-EZ and 990-PF) and the exemption application must be made available for **public inspection**. Form 990-T of a §501(c)(3) must also be made available.

Unrelated business income tax (UBIT)

Income is **unrelated business taxable income (UBTI)** if it comes from a **trade or business**, **regularly carried on**, that is **not substantially related** to the exempt purpose (apart from the need for the money).

Not UBTI:

- activities run substantially by **volunteers**;
- sales of **donated merchandise** (thrift shops);
- activities carried on mainly for the **convenience** of members, students, patients or employees;
- **passive income**: dividends, interest, annuities, royalties, rents from real property (and incidental personal property), and gains on sales of non-inventory property. Passive income becomes taxable to the extent the property is **debt-financed**;
- qualified sponsorship payments (no substantial return benefit beyond acknowledgment), qualified bingo games, and certain trade shows and convention activities.

Computing the tax:

- Gross UBI minus directly connected expenses, computed **separately for each unrelated trade or business** (losses from one generally cannot offset income from another).
- A **$1,000 specific deduction**.

- Corporations pay the **21%** corporate rate. Organizations organized as trusts pay **trust rates**.
- Reported on **Form 990-T**. Estimated tax applies if the expected tax is $500 or more.

> **Example:** A §501(c)(3) museum (a corporation) runs a regularly operated restaurant open to the general public, not just museum visitors. The restaurant has gross income of $60,000 and directly connected expenses of $35,000.
>
> UBTI = $60,000 − $35,000 − $1,000 specific deduction = $24,000.
>
> UBIT = $24,000 × 21% = **$5,040**, reported on Form 990-T.
>
> A café used mainly by museum visitors and staff could fall under the convenience exception.

Key takeaways

- Grantor trusts are taxed to the grantor. Simple trusts must distribute all income (exemption $300). Complex trusts $100. Estates $600.
- File Form 1041 at $600 of gross income. Due April 15 (calendar year), with a 5½-month extension. Estates may use a fiscal year and skip estimated tax for 2 years.
- 2025 trust brackets reach 37% at $15,650. 0% capital gains up to $3,250; 20% above $15,900.
- DNI caps the distribution deduction and carries out character. Capital gains usually stay in corpus. There is a 65-day election.
- §501(c)(3): Form 1023 (1023-EZ if ≤$50,000 receipts and ≤$250,000 assets), within 27 months for retroactive exemption. No political campaign activity. Automatic revocation after 3 years of not filing.
- 990-N ≤$50,000; 990-EZ <$200,000 receipts and <$500,000 assets; 990 otherwise. Due the 15th day of the 5th month.
- UBTI = regularly carried on, unrelated trade or business. $1,000 specific deduction; 990-T at $1,000 gross; 21% rate for corporations.

Specialized Returns: Farming and Rental Property

Part A – Farmers

Who files what

A farmer who operates a farm business as a sole proprietor reports on **Schedule F** (Form 1040), and pays SE tax on Schedule SE. Partnerships and corporations that farm report on their own returns. Farm landlords who don't materially participate report rent on **Form 4835** (not subject to SE tax). A landlord who materially participates in farm production under a crop-share arrangement reports on Schedule F, and the income is SE income.

Farmers may use the **cash** or **accrual** method. Farming C corporations (and partnerships with C corporation partners) above the $31 million gross receipts test must use accrual.

Farm income

Item	Treatment
Sales of **raised** livestock, produce and grain	Ordinary income on Schedule F. Raised animals usually have **zero basis** for a cash-method farmer (costs were deducted)
Sales of livestock **bought for resale**	Sales price minus cost, on Schedule F
Sales of livestock held for **draft, breeding, dairy or sporting** purposes	**Form 4797** (§1231) if held **24 months or more** for cattle and horses, or **12 months or more** for other livestock (poultry is excluded)
Cooperative distributions (Form 1099-PATR)	Income, except patronage dividends from purchases of personal-use items
Agricultural program payments	Income when received
Commodity Credit Corporation (CCC) loans	Can elect to report the loan as income in the year received (the election applies to all later years unless the IRS consents to a change)
Crop insurance and disaster payments	Generally income when received. A cash-method farmer can **elect to defer** to the next year if he can show he normally sells the crop in the year after it is produced
Weather-related sales of livestock	Excess livestock sold because of drought, flood or other weather conditions in a federally declared disaster area: income from the **extra** animals may be deferred **one year** (if the farmer normally reports sales the next year). Draft, breeding or dairy animals sold because of drought may instead qualify for **involuntary conversion** deferral if replaced within **2 years** (4 years, or longer, in certain drought areas)

Example: A rancher normally sells 100 head of cattle a year. Because of a 2025 drought in a federally declared disaster area, she sells 160 head at $1,300 each.

Extra head = 160 − 100 = 60. Deferrable income = 60 × $1,300 = **$78,000**, which she may elect to report in 2026. The income from the normal 100 head ($130,000) is reported in 2025.

Farm expenses

Ordinary and necessary farm expenses are deductible on Schedule F, including feed, seed, fertilizer, labor, repairs, fuel and insurance. Special rules:

- **Prepaid farm supplies:** a cash-method farmer's deduction for prepaid feed, seed and fertilizer is limited to **50%** of other deductible farm expenses for the year, unless he is a

"farm-related taxpayer" with a change in business operations or meets a 3-year average exception.

- **Soil and water conservation expenses** that are consistent with a conservation plan can be deducted, limited to **25% of gross income from farming**. The excess carries forward.
- **Pre-productive period costs:** plants with a pre-productive period of more than 2 years must be capitalized under UNICAP unless the farmer elects out. A farmer who elects out must use **ADS** for all farm property placed in service while the election is in effect.
- **Personal or family expenses**, and the value of the farmer's own labor, are never deductible.

Farm depreciation

- **New** farm machinery and equipment placed in service after 2017 is **5-year** property. Used farm machinery is generally 7-year.
- Farm property placed in service after 2017 may use **200% DB**. **150% DB** still applies to **15- and 20-year** property.
- **Single-purpose agricultural or horticultural structures** (for example, a hog barn) and trees or vines bearing fruit or nuts are **10-year** property. **General-purpose farm buildings** are **20-year** property.
- Breeding and dairy cattle are 5-year property. Breeding hogs are 3-year property.
- §179 and bonus depreciation are available. **Fruit- and nut-bearing plants** planted or grafted after January 19, 2025 qualify for 100% bonus (40% if planted or grafted from January 1 to January 19, 2025).
- Land is never depreciable. Clearing land is a capital cost added to the land's basis.

Farm losses

- A **farming loss** may be carried **back 2 years** (or the farmer can waive the carryback), and then forward indefinitely. It is subject to the 80% limit in carryforward years.
- The **hobby** rules apply to farming. Horse breeding uses the "2 of 7 years" profit presumption.

Farm income averaging

An individual farmer or fisherman may elect on **Schedule J** to spread "elected farm income" over the prior **3 years**, using those years' tax brackets. This can lower tax in a high-income year. It affects income tax only, not SE tax.

Estimated tax for farmers

A taxpayer qualifies for the special farmer rules if at least **two-thirds** of gross income for either 2024 or 2025 came from farming. Gross income from farming includes Schedule F gross income, Form 4835 rents, and gains from sales of livestock used for draft, breeding or dairy. (A joint return counts both spouses' gross income.)

A qualifying farmer can either:

- make **one** estimated payment by **January 15, 2026**, equal to the lesser of **66⅔%** of the 2025 tax or **100%** of the 2024 tax; or
- skip estimated payments and **file the 2025 return and pay all tax by March 2, 2026** (March 1, 2026 is a Sunday).

> **Example:** A farmer's 2025 gross income is $120,000, of which $90,000 is gross income from farming.
>
> Farming share = $90,000 ÷ $120,000 = 75%, which is at least two-thirds, so she qualifies.
>
> Her 2025 total tax is $9,000, and her 2024 tax was $7,000. Required estimated payment by January 15, 2026 = lesser of 66⅔% × $9,000 ($6,000) or $7,000 = **$6,000**. Or she can file and pay in full by March 2, 2026 and owe no penalty.

Employment taxes on farm workers

- Agricultural employers report FICA and income tax withholding on **Form 943** (annual).
- Farmworkers' wages are subject to FICA if the employer pays the worker **$150 or more** in cash wages in the year, **or** the employer's total farm wages are **$2,500 or more** for the year.
- FUTA applies if the employer paid **$20,000** or more in cash wages in any quarter, or employed **10 or more** farmworkers during some part of a day in **20 or more weeks** (Chapter 9).

Part B – Rental property

Rental income and expenses

- Rental income includes advance rent (taxable when received, whatever period it covers), lease cancellation payments, expenses paid by the tenant on behalf of the landlord, and the FMV of property or services received instead of rent. A **security deposit** is not income unless it is kept (or is really advance rent).
- Expenses include mortgage interest, taxes, insurance, repairs, management fees, travel to the property, and depreciation (27.5 years residential, 39 years commercial; land excluded).
- Individuals report on **Schedule E**. Partnerships and S corporations report rental real estate on **Form 8825**.

Personal use: vacation homes (§280A)

Situation	Treatment
Rented fewer than **15 days** in the year	Rental income is **not taxable**; no rental expenses are deductible (mortgage interest and taxes stay on Schedule A)
Personal use more than the **greater of 14 days or 10% of days rented** at fair rent	The property is a **residence**. Rental expenses are allocated by days and are deductible **only up to rental income** (no loss), in a set order: interest and taxes, then operating expenses, then depreciation
Personal use within those limits	Treated as a rental. Expenses are allocated, and a loss is possible (subject to the passive rules)

Days spent mainly on repairs and maintenance are not personal days. Days rented to a relative at less than fair rent **are** personal days.

> **Example:** A beach house is rented for 90 days at fair rent and used personally for 30 days. Total expenses (interest, taxes, utilities, depreciation) are $24,000.
>
> Rental share = 90 ÷ 120 = 75%; rental expenses = $24,000 × 75% = **$18,000**.
>
> Personal use (30 days) exceeds the greater of 14 days or 10% × 90 = 9 days, so it is a residence. The $18,000 is deductible only up to the rental income. Any excess carries forward.

Passive activity rules (§469)

Losses from **passive activities** can offset only passive income. Unused losses are suspended and carried forward. They are freed up when the taxpayer disposes of the **entire** interest in a fully taxable transaction to an unrelated party.

- A **trade or business** is passive unless the taxpayer **materially participates** (for example, 500 or more hours during the year, or one of the other 7 tests).
- **Rental activities are passive** regardless of participation, with two exceptions: 1. **$25,000 special allowance:** an individual who **actively participates** (owns at least 10% and makes management decisions such as approving tenants and setting rents) can deduct up to $25,000 of rental real estate losses against non-passive income. It phases out by **50%** of modified AGI over **$100,000**, and is gone at **$150,000**. (Married filing separately and living apart all year: $12,500, phased out from $50,000.) 2. **Real estate professional:** more than **half** of the taxpayer's personal services are in real property trades or businesses in which he materially participates, **and** more than **750 hours** a year are spent in them. His rentals are not automatically passive, but he must still materially participate in each rental (or elect to group all rentals as one activity).
- Activities that are **not** "rental activities" for these rules include rentals with an **average stay of 7 days or less** (for example, many short-term vacation rentals), which are tested as businesses for material participation.

- Closely held C corporations and personal service corporations are also subject to the passive rules.

Example: Tom actively manages a rental house that produced a $14,000 loss in 2025. His modified AGI is $130,000, and he has no passive income.

Reduction = 50% × ($130,000 − $100,000) = $15,000. Allowance = $25,000 − $15,000 = **$10,000**.

Tom deducts $10,000 of the loss. The other $4,000 is suspended and carried forward (Form 8582).

Watch out: "Active participation" (for the $25,000 allowance) is a much lower bar than "material participation" (for businesses). Limited partners never actively participate.

Key takeaways

- Schedule F for farm sole proprietors. Form 4835 for non-participating farm landlords (no SE tax).
- Breeding, dairy and draft livestock are §1231 property after 24 months (cattle and horses) or 12 months (others). Raised livestock has no basis.
- Deferral elections: crop insurance/disaster payments (1 year), weather-related excess livestock sales (1 year), or involuntary conversion with replacement in 2 years (4 in drought areas).
- New farm machinery: 5-year. Single-purpose structures: 10-year. General farm buildings: 20-year. Electing out of UNICAP requires ADS.
- Farm NOLs: 2-year carryback. Schedule J income averaging over 3 prior years.
- Farmer estimated tax (two-thirds test): pay by January 15, 2026 (66⅔% of current or 100% of prior), or file and pay by March 2, 2026.
- Vacation home: under 15 rental days is tax-free. Personal use over the greater of 14 days or 10% makes it a residence (no rental loss).
- Rental losses are passive. Active participation allows up to $25,000 (phased out from $100,000 to $150,000 MAGI). Real estate professionals need more than 750 hours and more than half of their work time.

Final Review Checklist

Use this chapter in the last week before the exam. Read each line and ask yourself, "Could I answer a question on this in under two minutes?" If not, go back to the chapter shown and take that chapter's practice test on UPractice.org again.

Key 2025 numbers at a glance

Topic	2025 figure	Chapter
§179 limit / phase-out threshold	$2,500,000 / $4,000,000	7
§179 SUV cap	$31,300	7
Bonus depreciation	100% if acquired after Jan. 19, 2025; 40% if acquired earlier	7
Auto depreciation caps, year 1	$20,200 with bonus; $12,200 without	7
Auto caps, years 2 / 3 / later	$19,600 / $11,800 / $7,060	7
Gross receipts test (cash method, UNICAP, §163(j))	$31,000,000	3
Excess business loss threshold	$313,000 ($626,000 MFJ)	4
QBI thresholds	$197,300 / $394,600 MFJ (ranges $50,000 / $100,000)	6
§163(j) limit	Interest income + 30% of ATI (EBITDA)	6
Standard mileage rate	70 cents per mile	5
Business gifts	$25 per recipient	5
Start-up / organizational costs	$5,000 each, phased out above $50,000, rest over 180 months	5
De minimis safe harbor	$2,500 per item ($5,000 with AFS)	8
Social Security wage base	$176,100	9
Additional Medicare withholding	0.9% over $200,000	9
FUTA	6.0% of $7,000 (net 0.6%)	9
Late 1065 / 1120-S penalty (filed in 2026)	$255 per owner per month, up to 12 months	2, 11
401(k) deferral / catch-up / ages 60–63	$23,500 / $7,500 / $11,250	15
SIMPLE deferral / catch-up	$16,500 / $3,500	15
§415(c) / DB / compensation limit	$70,000 / $280,000 / $350,000	15
HCE / key employee	$160,000 / $230,000	15
Trust top bracket starts	$15,650 (37%)	16
Estate / simple / complex exemption	$600 / $300 / $100	16
Corporate rate / AET / PHC	21% / 20% / 20%	12, 13
Accumulated earnings credit	$250,000 ($150,000 PSC)	13

Due dates for calendar-year 2025 returns

Return	Due	Extended
Forms W-2, W-3, 1099-NEC, 940, 941 (Q4), 943, 944	Feb. 2, 2026 (Jan. 31 is a Saturday)	–
Farmers' single estimated payment	Jan. 15, 2026	Or file and pay by Mar. 2, 2026
Form 1065, Form 1120-S	Mar. 16, 2026 (Mar. 15 is a Sunday)	Sept. 15, 2026
Form 1120, Form 1040	Apr. 15, 2026	Oct. 15, 2026
Form 1041	Apr. 15, 2026	Sept. 30, 2026
Form 990 series	May 15, 2026	Nov. 16, 2026 (Nov. 15 is a Sunday)
Form 5500 (calendar plan year)	July 31, 2026	Oct. 15, 2026

Domain 1 – Business entities and considerations

- [ ] Default classification of one- and multi-member LLCs; Form 8832 timing (75 days back, 12 months forward, 60-month lock).
- [ ] When a new EIN is needed.
- [ ] Hobby versus business: the nine factors; 3 of 5 years (2 of 7 for horses); hobby income taxable, expenses not deductible.
- [ ] Partnership formation: §721, §722, §723; liabilities increase or decrease basis; gain when net liability relief exceeds basis; services for a capital interest are ordinary income.
- [ ] Partner basis roll-forward: increases → distributions → nondeductibles → losses.
- [ ] Guaranteed payments: deductible, SE income, not QBI, no basis effect.
- [ ] Current versus liquidating distributions; when a loss is allowed; §751 hot assets on sale.
- [ ] §754, §743(b), §734(b); mandatory adjustments over $250,000.
- [ ] BBA audit regime: partnership representative; election out for ≤100 eligible partners.
- [ ] §351: 80% control, boot, §357(c), stock and asset basis.
- [ ] DRD 50/65/100% and the taxable income limit; 10% charitable limit; capital losses 3 back, 5 forward.
- [ ] E&P computation; distribution ordering; property distributions; redemption tests; liquidations (§331, §336, §332).
- [ ] AET and PHC tests.
- [ ] Corporate estimated tax (months 4, 6, 9, 12); large corporation rule.
- [ ] S corporation eligibility, election timing, termination events, 5-year wait.
- [ ] S shareholder stock and debt basis; Form 7203; AAA ordering; BIG tax.

Domain 2 – Business tax preparation

- [ ] COGS formula; inventory methods; LIFO conformity.
- [ ] COD exclusions and attribute reduction (Form 982).
- [ ] Loss limit order: basis → at-risk → passive → excess business loss.
- [ ] Meals 50% (and 100% exceptions), entertainment 0%, gifts $25, travel away from tax home.
- [ ] Vehicles: 70 cents a mile versus actual; listed property >50% test.
- [ ] Home office tests; simplified $5 × 300 sq ft.
- [ ] Business versus nonbusiness bad debts.
- [ ] §174A domestic R&E expensing (tax years beginning after 2024).
- [ ] QBI: below threshold, phase-in, above range; SSTBs.
- [ ] GBC limit and 1-back, 20-forward carryover; major credits (WOTC, small employer health, pension start-up, disabled access).
- [ ] NOLs: 80% limit, indefinite carryforward, farm 2-year carryback.
- [ ] MACRS classes, conventions (mid-quarter 40% test), tables; §179 limits and income limit; bonus 100% / 40%; auto caps.
- [ ] Repair regulations: BAR test, de minimis, routine maintenance, small-building safe harbor.
- [ ] §1231 netting and 5-year lookback; §1245; unrecaptured §1250 at 25%; §291 for corporations.
- [ ] Like-kind exchanges (real property only, 45/180 days, boot, basis); installment sales (recapture in the year of sale).
- [ ] Cash versus accrual; $31 million test; Form 3115 and §481(a) (4 years / 1 year); required tax years.
- [ ] Worker classification; FICA, FUTA, deposit schedules, failure-to-deposit penalties, TFRP.

Domain 3 – Specialized returns and taxpayers

- [ ] Simple, complex and grantor trusts; estates; exemptions; Form 1041 filing threshold and due date.
- [ ] DNI, distribution deduction, 65-day rule, capital gains to corpus.
- [ ] Exempt organization applications (1023, 1023-EZ, 27-month rule); 990 series thresholds; automatic revocation.
- [ ] UBTI: three-part test, exceptions, $1,000 specific deduction, Form 990-T.
- [ ] Retirement plans: 2025 limits; SEP and SIMPLE rules; self-employed 20% computation; prohibited transactions 15% / 100%; Form 5500-EZ $250,000.
- [ ] Farming: Schedule F, livestock holding periods, deferral elections, farm depreciation, two-thirds estimated tax rule, Form 943.
- [ ] Rentals: vacation home 14-day / 10% test; $25,000 allowance and phase-out; real estate professional 750 hours.

Common traps to avoid on test day

Watch out: Using the pre-OBBBA $1,250,000 §179 limit or treating all 2025 property as 40% bonus property.

Watch out: Adding entity debt to an **S corporation** shareholder's basis. Only direct shareholder loans count.

Watch out: Forgetting that a decrease in a partner's share of liabilities is a **deemed cash distribution**.

Watch out: Deducting a corporation's net capital loss against operating income. It only offsets capital gains.

Watch out: Counting the full month for mid-month real property depreciation (a July placement is 5.5 months, not 6).

Watch out: Applying the Additional Medicare Tax to the employer. It is employee-only.

Watch out: Treating guaranteed payments or S corporation wages as QBI.

Watch out: Answering with 2026 rules (the $2,000 Form 1099 threshold, the 1% corporate charitable floor, wider QBI ranges) on a 2025 question.

Final tips

- Sleep matters more than one more hour of review.
- Bring the required identification. Check the PSI confirmation email for arrival time and rules (or the remote-testing requirements if you test online).

- During the exam, read the last line of the question first so you know what is being asked, then read the facts.
- If you are torn between two answers, look for the one that follows the general rule. Exceptions are usually signaled clearly in the facts.

> **Exam tip:** After the exam, if you need to retake a part, use your diagnostic report to find your weakest domain, reread those chapters, and retake the matching practice tests before rescheduling.

Key takeaways

- Know the 2025 numbers in the first table cold.
- Know the due dates (and the weekend shifts for 2026).
- Entity questions are about one third of the exam. Basis roll-forwards and distribution rules are the core.
- Use 2025 law throughout, including the OBBBA changes that apply to 2025.

Now practice it

Every chapter in this guide has matching practice tests, simulations and mock exams at **UPractice.org**.