SEE

Special Enrollment Exam

Part 2 - Businesses

2018 Study Guide

www.phoenixtax.com

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Introduction

The Phoenix Tax Group Guarantee

We have been successfully preparing tax practitioners to pass the Special Enrollment Exam for over 20 years. Practitioners who have used our study materials, study strategies and have put in the time and effort have had over a 90% passing rate.

30 Day Refund

If you are not satisfied with any of our products, you can return them for a full refund, excluding shipping and handling charges. A refund must be requested within 30 days of purchase, and all hardcopy materials must be returned in the original box. No credit will be given for any materials marked on, missing or damaged in any way. To request a refund, fill out the Refund Request form at the link below.

Pass Guarantee Refund

1. The Pass Guarantee applies only to products designated as "Packages."
2. To receive a refund, you must have taken and failed a test or exam twice.
3. You must provide your failed scores for both failed exams by filling out the online Refund Request Form (see link below). This must be done within 30 days of the second failed exam.
4. Hard copy materials must be returned within 30 days of the second failed exam.
5. If you purchased Enrolled Agent study materials together in a 3 part package, refunds will be pro-rated for the part being returned.
6. The refund will only apply to the person who purchased the study materials from The Phoenix Tax Group. The refund policy does not apply to companies purchasing study materials for employees.

Instructions

To ensure proper credit, please fill out our online refund request form.

http://www.phoenixtax.com/about/refunds

Course Objectives

This course is designed to prepare students to pass the IRS Special Enrollment Examination the first time they take the exam. After completing our course, you should have the tax knowledge needed to pass the exam.

This course is taught at an intermediate level. It is helpful if the student has had some beginning level courses relating to tax laws and at least a year of income tax preparation experience.

Our course is broken down into three parts similar to the parts on the exam. Part 1 discusses individual income tax law, Part 2 discusses sole proprietorship and partnership, corporation (including S corporation), fiduciary, estate, and trust tax law and tax-exempt organizations, and Part 3 discusses practitioner ethics, recordkeeping, IRS tax examination, appeals, and collection procedures, practitioner rules and penalties, and research materials. All the materials have been updated to 2017 tax law.

> **Note:** All references on the examination are to the Internal Revenue Code, forms and publications, as amended through December 31, 2017. Also, unless otherwise stated, all questions relate to the calendar year 2017. Questions that contain the term 'current tax year' refer to the calendar year 2017. In answering questions, candidates should **NOT** take into account any changes as a result of the Tax Cuts and Jobs Act of 2017 or any legislation or court decisions after December 31, 2017.

We feel we have the best and most comprehensive enrolled agent exam preparatory course available. However, we are always looking for ways to improve our course. We would appreciate it if you would take a moment to complete the course evaluation located at the end of each part of the course or complete our online evaluation at www.phoenixtax.com.

If you have any questions, please email us at **support@phoenixtax.com**. Do not call our 800 number.

Good luck on the exam.

How to Prepare for the Exam

The following is a set of guidelines for preparing for the exam:

1. We recommend that you study a minimum of 100 to 120 hours total for all three parts of the exam. For Part 1, we recommend 35-45 hours of study. For Part 2, we recommend 45-60 hours of study. For Part 3, we recommend 20-25 hours of study. Break up your study time. Do not try to study 3 or 4 hours at a time. Most people's comprehension level starts to fade after an hour. You will be surprised how much you can absorb by studying in intervals of 15 to 30 minutes.
2. DO NOT rely on your tax experience to pass this exam. It has been our experience that people with limited tax experience (one year or less) have a far better success rate on this exam than people with many years of tax experience. The reason is that preparers with years of experience tend to rely on their practical knowledge of taxes. This exam tests on theory, not practical experience. The IRS is primarily interested in your ability to understand the tax law and to properly and accurately determine taxable income (i.e., figuring basis in an asset to determine gain, what income is taxable, what deductions are allowed, etc.).
3. You can now use a calculator to do the computational questions. Prometric will provide you with a hand-held calculator. You cannot bring your own calculator.
4. Be familiar with the tax forms and the filing dates for those forms. There is a quick reference in the Appendix.
5. The exam will test on a specific tax law in more than one part. For example, questions pertaining to property basis or retirement plans will be tested in both Part 1 and Part 2; questions pertaining to recordkeeping in Part 1 and Part 2 could be tested in Part 3; taxpayer penalties could be tested in all three parts. Therefore, we strongly recommend you to take the exam in the following order. Take Part 1 first, Part 2 second and Part 3 last. You should also take all three parts of the exam as close together as possible.
6. You must have a positive attitude toward this exam. If you do not think you can pass this exam, you won't. Fifty percent of preparing for this exam is being mentally prepared.

About the Computer Based SEE Exam

The Internal Revenue Service has contracted with Prometric to conduct its examination program. Prometric provides computerized testing at test centers throughout the world. The IRS and Prometric are working together closely to ensure that examinations meet federal requirements as well as professional examination development standards.

Testing Dates

The 2018 SEE examination begins May 1, 2018 and examinations will be offered continuously through February 28, 2019. The exam is in three parts. The three parts **DO NOT** have to be taken at once. You can take one part at a time. Once you have taken and passed one part, you have two years from the date of passing that part to take and pass the other two parts.

Testing Fees

The exam costs $181.94 per part.

Exam Questions

Each part of the exam has 100 questions. All questions are weighted equally.

Time Limited for the Exam

You are given 3.5 hours to complete each part of the exam. The actual seat time is 4 hours to allow for a tutorial at the beginning and a survey at the end.

Examination Results

The exam is graded on a scale of 40 - 130 with 40 being the lowest score and 130 being the highest score possible. You must have a score of 105 or better for each part of the exam to pass. You will receive your scores immediately after taking the exam.

Passing Score. If you pass, the score will only show a passing designation. It will not show a score.

Failing Score. If you fail, your score report will show a scaled score between 40 and 104. You will also receive diagnostic information to assist you with future examination preparation. Diagnostic information will show an indicator of 1, 2, or 3 meaning:

1. Considerably below the minimally acceptable score. It is important for you to approach how you study this topic as you prepare to take the test again. You may want to consider taking a course or participating actively in a study group on this topic.
2. Marginally below the minimally acceptable score. You should study this topic in detail as you prepare to take the test again.
3. At or above the minimally acceptable score. Be sure to review this topic as you prepare to take the test again.

Experimental Questions

The examination may include some experimental questions that will not be scored. If present, they are distributed throughout the exam and will not be identified as such. These are used to gather statistical information on the questions before they are added to the exam as scored items. These experimental questions will not be counted for or against your final score.

Obtain a PTIN

You must have a PTIN to sign up for the Enrolled Agent Exam. Chances are you already have your PTIN, but if you do not, you can still get one. The IRS Tax Professional PTIN Sign-up System is available at www.irs.gov/ptin. Once online, you will need to:

Create Your Account. Provide your name, email address, and security question information. The system will then email your temporary password, which you will change when you go back to enter your information in the PTIN application.

Apply for Your PTIN. Complete the online application by providing personal information, information about your previous year's tax return, professional credentials, and more.

Get Your PTIN. Your PTIN will be provided online.

It takes about 15 minutes to sign up online and receive your PTIN. If you opt to use the paper application, Form W-12 IRS Paid Preparer Tax Identification Number (PTIN) Application, it will take 4-6 weeks to process.

PTIN renewal. PTINs must be renewed annually by December 31 for the following year. Renewal Open Season usually begins each year in mid-October.

Registering and Scheduling an Examination Appointment

Registration Process

You can register and schedule the exam using one of the three following options:

A. Online—a one-step process

The quickest way to register and schedule an examination is online. This is the only way to register and schedule an exam in the same day.

To register and schedule an examination online, follow these steps:

1. Access **www.prometric.com/irs**.
2. Click the **Obtain a PTIN/Register** for My Test button.
3. If it's your first time, click Create Account button to set up your user ID and password.
4. **Register and pay for the test**. You will be asked to provide your PTIN number. Prometric will assign you a candidate number. It will be the same as your PTIN.
5. **Schedule your test**. Again, go to **www.prometric.com/irs**. Click on the **Schedule My Test** button. You will be asked to provide the candidate number that Prometric assigned to you when you registered for your test in step 4. Schedule your test at your closest testing center at a convenient date and time.

B. By phone

1. Call Prometric at 800.306.3926

C. By mail

1. Mail your completed Form 2587 to:

   Prometric
   Attn: IRS Special Enrollment Examination
   7941 Corporate Drive
   Nottingham, MD 21236

2. Wait six to 10 calendar days for delivery and processing before scheduling an examination appointment.

Scheduling an Examination

Candidates can take each part of the examination at their convenience. Consequently, parts do not have to be taken on the same day, or on consecutive days. All parts do not have to be taken or scheduled during an examination window.

Candidates can take examination parts up to four times each during the testing period (May 1, 2018 to February 28, 2019). Once your registration has been processed, you can schedule an examination appointment at any time online at www.prometric.com/irs or by calling 800-306-3926 between 8 a.m. and 9 p.m. (Eastern Time), Monday through Friday. You will be provided a number confirming your appointment. Record and keep this confirmation number for your records—you will need it to reschedule, cancel or change your appointment in any way.

Examination Locations

Examinations are administered by computer at a Prometric Testing Center. Currently, the Special Enrollment Examination is given at nearly 300 Prometric testing centers located across the United States and internationally. Test centers are located in most major metropolitan areas. A complete list of these testing centers, addresses and driving directions is located at www.prometric.com/irs. In the box titled Do More, click on "Continue" and select your preferred test location. Most locations are open on Saturdays and some locations are open on Sundays and evenings.

Testing Fees

The testing fee is $181.94 for each part of the examination. This fee is paid at the time you schedule your examination. Accepted forms of payment include: MasterCard, Visa, American Express, Discover, Diner's Club cards bearing the MasterCard symbol and JCB. Electronic checks are also accepted when scheduling by phone. Money orders, paper checks and cash are not accepted. Examination testing fees are not refundable or transferable.

Rescheduling Your Appointment

If you need to reschedule an examination for another date, time or location, you must contact Prometric. Rescheduling fees will apply as follows:

- No fee if you reschedule at least 30 calendar days prior to your appointment.
- $35 fee if you reschedule five to 29 calendar days before your appointment.
- Another $181.94 full examination fee if you reschedule less than five calendar days before your appointment date.

Chapter One

Business Entities

Chapter One sets the stage for your studies by defining the different legal business entities. It describes the various EIN and reporting requirements as well as accounting periods and methods available to each business entity. The tax treatment of these eight business entities is the primary knowledge area assessed by Part 2 of the Enrolled Agent Exam.

In This Chapter

1. Employer Identification Number
2. Sole Proprietorship
3. Partnership
4. C Corporation
5. S Corporation
6. Limited Liability Company (LLC)
7. Estate
8. Trust
9. Exempt Organizations
10. Accounting Periods
11. Accounting Methods

Employer Identification Number

An employer Identification Number (EIN) is required for the following entities:

1. Reporting employment taxes and excise taxes.
2. A partnership.
3. A corporation.
4. Limited Liability Company (LLC).
5. A trust or an estate.
6. An employee plan.
7. An exempt organization.

How to Apply for an EIN

A taxpayer can apply for an EIN by telephone, fax, mail or internet.

Form SS-4

Use Form SS-4, Application for Employer Identification Number, to apply for an EIN.

Entity Default Rules

An eligible entity is classified for federal tax purposes under the default rules described below unless it files Form 8832, Entity Classification Election or Form 2553, Election by a Small Business Corporation (S corporation).

Domestic Default Rule

Unless an election is made on Form 8832, a domestic eligible entity is:

- A partnership if it has two or more members.
- Disregarded as an entity separate from its owner if it has a single owner.

A change in the number of members of an eligible entity classified as an association does not affect the entity's classification. However, an eligible entity classified as a partnership will become a disregarded entity when the entity's membership is reduced to one member and a disregarded entity will be classified as a partnership when the entity has more than one member.

Foreign Default Rule

Unless an election is made on Form 8832, a foreign eligible entity is:

- A partnership if it has two or more members and at least one member does not have limited liability.
- An association taxable as a corporation if all members have limited liability.
- Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

Association

For purposes of the above rules, an association is an eligible entity taxable as a corporation by election or, for foreign eligible entities, under the default rules.

Sole Proprietorship

Definition

A sole proprietorship is an unincorporated business that is owned by one individual. The business is not a separate entity apart from its owner. Its liabilities are personal liabilities and the owner undertakes the risk of the business for all assets owned, whether or not used in the business.

Reporting Requirements

Business profits or losses of a sole proprietorship are reported on Schedule C, or C-EZ of Form 1040. A sole proprietor may also be required to file other returns (such as employment or excise tax returns).

Employer Identification Number (EIN)

A sole proprietorship does not need a separate EIN, unless required to file employment or excise tax returns.

New EIN Required

A sole proprietor will need a new EIN if any of the following are true:

- Filing for bankruptcy under Chapter 7 (liquidation) or Chapter 11 (reorganization).
- Incorporating.
- A sole proprietor that takes in partners and operate as a partnership.
- Establishing a pension, profit sharing, or retirement plan.

New EIN Not Required

A sole proprietor will not need a new EIN if any of the following are true:

- Change the name of the business.
- Change location or add locations.
- Operating multiple businesses.

Partnership

Definition

A partnership is the relationship between two or more persons who join together to carry on a trade or business. Each partner contributes money, property, labor or skill, and expects to share in the profits and losses of the business. An unincorporated organization with two or more members is generally classified as a partnership for federal tax purposes if its members carry on a trade, business, financial operation, or venture and divide its profits. Partners in a partnership are personally

liable for its debts. A qualified joint venture conducted by a husband and wife who file a joint return is not rated as a partnership for federal tax purposes. A qualified joint venture, for purposes of this provision, includes only businesses that are owned and operated by spouses as co-owners, and not in the name of a state law entity (including a general or limited liability company). A partnership must file an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, it "passes through" any profits or losses to its partners. Each partner includes his or her share of the partnership's items on his or her tax return.

Reporting Requirements

A partnership files Form 1065, U.S. Return of Partnership of Income, plus other returns that apply (such as employment or excise tax returns). The partnership is required to send a copy of Schedule K-1 (Form 1065) to each partner showing each partner's share of the partnership's income, gain, loss, deductions, and credits for the tax year.

Employer Identification Number (EIN)

A partnership is required to obtain an EIN.

New EIN Required

A partnership will need a new EIN if any of the following are true:

- Incorporating.
- One partner takes over and operates as a sole proprietorship.
- The partnership is terminated and a new partnership is begun.

New EIN Not Required

A partnership will not need a new EIN if any of the following are true:

- The partnership declares bankruptcy. However, if a liquidating trust is established for a partnership that is in bankruptcy, an EIN for that trust is required.
- The partnership name changes.
- Change location or add locations.
- The partnership terminates under IRC Section 708(b)(1)(B). A partnership shall be considered terminated if within a 12-month period there is a sale or exchange of at least 50% of the total interest in partnership capital and profits to another partner. If the purchaser and remaining partners immediately contribute the properties to a new partnership, they can retain the old partnership EIN.

C Corporation

Definition

A corporation is defined as a legal entity or structure created under the authority of the laws of a state consisting of a person, or group of persons, who become shareholders. The entity's existence is considered separate and distinct from that of its members. Since a corporation is an entity in its own right, it is liable for its own debts and obligations. In forming a corporation, prospective shareholders transfer

money, property, or both, for the corporation's capital stock. A corporation generally takes the same deductions as a sole proprietorship to figure its taxable income. A corporation can also take special deductions. The profit of a corporation is taxed to the corporation when earned, and then is taxed to the shareholders when distributed as dividends (double taxation). However, shareholders cannot deduct any loss of the corporation.

Reporting Requirements

C Corporations usually file a Form 1120 series return, plus other returns that apply (such as employment or excise tax returns).

Employer Identification Number (EIN)

A corporation is required to obtain an EIN.

New EIN Required

A corporation will need a new EIN if any of the following are true:

- The corporation is a subsidiary of a corporation and currently uses the parent's corporate EIN.
- The corporation becomes a subsidiary of a corporation.
- The corporation becomes a partnership or a sole proprietorship.
- The corporation creates a new corporation after a statutory merger.
- The corporation receives a new corporate charter.

New EIN Not Required

A corporation will not need a new EIN if any of the following are true:

- The corporation is a division of a corporation.
- After a corporate merger, the surviving corporation uses its existing EIN.
- A corporation declares bankruptcy. However, if a liquidating trust is established for a corporation that is in bankruptcy, an EIN for that trust is required.
- Corporate name change or change in location or add locations.
- The corporation elects to be taxed as an S Corporation by filing Form 2553.
- The corporation is sold and the assets, liabilities and charters are obtained by the buyer.
- After a corporate reorganization, the corporation only changes identity, form, or place of organization.

S Corporation

Definition

An eligible domestic corporation can avoid double taxation (once to the corporation and again to the shareholders) by electing to be treated as an S corporation. S corporations are corporations that elect to pass corporate income, losses, deductions and credit through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax

returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. Generally, an S corporation is exempt from federal income tax other than tax on certain capital gains and passive income.

Form 2553

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

Reporting Requirements

S Corporations file a Form 1120S, U.S. Income Tax Return for an S Corporation, plus other returns that apply (such as employment or excise tax returns). The S corporation is required to send a copy of Schedule K-1 (Form 1120S) to each shareholder showing each shareholder's share of the S corporation's income, gain, loss, deductions, and credits for the tax year.

Employer Identification Number (EIN)

An S corporation is required to obtain an EIN.

Limited Liability Company (LLC)

Definition

A limited liability company (LLC) is an entity formed under state law by filing articles of organization as an LLC. Unlike a partnership, none of the members of an LLC are personally liable for its debts. An LLC may be classified for federal income tax purposes as a partnership, a corporation, or an entity disregarded as an entity separate from its owner by applying the rules in regulations section 301.7701-3. A domestic LLC with at least two members that does not file Form 8832 is classified as a partnership for federal income tax purposes.

Single Member LLC

A single member LLC generally has the following choices:

1. File Form 8832 to be taxed as a corporation.
2. If qualified, file Form 2553, Election by a Small Business Corporation (Under Section 1362 of the Internal Revenue Code), to be taxed as an S corporation.
3. Be taxed (by default) as a disregarded entity:
   - If the single member is an individual, the LLC will be taxed as a sole proprietorship.
   - If the single member is a business entity, the LLC will be taxed as a division of the corporation.

> Note: While a single member entity, that does not elect corporate status, will default to a disregarded status for some federal tax purposes, it will not be disregarded for all federal tax purposes. For federal employment taxes (after 1/1/2009) and certain excise taxes (after 1/1/2008) it will be treated as a separate entity.

Multiple Members LLC

A multiple members LLC generally have the following choices:

1. File Form 8832 to be taxed as a corporation.
2. If qualified, file Form 2553 to be taxed as an S-Corporation.
3. Be taxed (by default) as a partnership.

Estate

Definition

An estate is a legal entity created as the result of a person's death. The decedent's estate is a separate legal entity for federal tax purposes. An estate consists of real and/or personal property of the deceased person. The estate pays any debts owed by the decedent and then distributes the balance of the estate's assets to the beneficiaries of the estate. The estate exists until the final distribution of the assets is made to the heirs and other beneficiaries.

Reporting Requirements

Estates file either Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, and/or Form 1041, U.S. Income Tax Return for Estates and Trusts, plus other returns that apply (such as employment or excise tax returns).

Employer Identification Number (EIN)

An estate is required to obtain an EIN.

Trust

Definition

A trust is an arrangement through which trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. A trust is a legal entity created under state law and taxed under federal law. A trust may be created during an individual's lifetime (inter vivos) or at the time of his or her death under a will (testamentary).

Revocable/Irrevocable Trust

An irrevocable trust is a trust, which, by its terms, cannot be modified, amended, or revoked. For tax purposes, an irrevocable trust can be treated as a simple, complex, or grantor trust, depending on the powers listed in the trust instrument. A revocable trust may be revoked and is considered a grantor trust (IRC § 676). State law and the trust instrument establish whether a trust is revocable or irrevocable. If the trust instrument is silent on revocability, then most states consider the trust revocable.

Living Trust

A living person creates an inter vivos trust during that person's lifetime. An inter vivos trust can be established as revocable or irrevocable. An inter vivos trust can be a simple, complex, or grantor trust depending on the trust instrument.

Testamentary Trust

A testamentary trust is created by a will, which begins its existence upon the death of the person making the will, when property is transferred from the decedent's estate. Testamentary trusts are generally simple or complex trusts. A testamentary trust is irrevocable by definition, as it comes into being at the death of the grantor.

Grantor

The grantor (also known as trustor, settlor, or creator) is the creator of the trust relationship and is generally the owner of the assets initially contributed to the trust. The grantor generally establishes, in the trust instrument, the terms and provisions of the trust relationship between the grantor, the trustee, and the beneficiary. The grantor may retain control over all or a portion of the trust, which may result in the grantor being subject to tax on the income from that portion of the trust.

Reporting Requirements

Form 1041, U.S. Income Tax Return for Estates and Trusts, plus other returns that apply (such as employment tax returns).

Employer Identification Number (EIN).

A trust is required to obtain an EIN.

New EIN Required

A trust will need a new EIN if any of the following are true:

- A trust changes to an estate.
- A living (inter vivos) trust changes to a testamentary trust.
- The revocable trust changes to an irrevocable trust.

New EIN Not Required

A trust will not need a new EIN if any of the following are true:

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

Exempt Organizations

Definition

A tax exempt organization is a non-profit organization that is exempt from certain taxes because it is described under Section 501 of the Internal Revenue Code (IRC). Certain organizations are required to apply to the IRS for a determination letter that grants them formal tax exemption, while other organizations are treated as tax exempt as long as they are organized and operated under an applicable section of the Code.

IRC Section 501(c)(3) Organization

This is an organization that is organized and operated exclusively for one or more of the following purposes: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition (but only if none of its activities involve providing athletic facilities or equipment), or the prevention of cruelty to animals. To qualify, the organization must be a corporation, community chest, fund, unincorporated association, or foundation. A trust is a fund or foundation and will qualify. However, an individual or a partnership will not qualify.

Reporting Requirements

Exempt organizations usually file a Form 990 series return plus other returns that apply (such as employment or excise tax returns).

Employer Identification Number (EIN)

All non-profit organizations must apply for an EIN before filing for exempt status.

Accounting Periods

The following are acceptable tax years:

1. Calendar year.
2. Fiscal year (12 consecutive months ending on the last day of any month except December).
3. 52-53 week tax year. The 52-53 week tax year must always end on:
    - Whatever date this same day of the week last occurs in a calendar month, or
    - Whatever date this same day of the week falls that is nearest to the last day of the calendar month.

Adopting a Tax Year

A taxpayer adopts a tax year when filing his or her first income tax return by the due date (NOT including extensions) for filing a return for that year.

Calendar Year

A taxpayer must adopt the calendar year if:

1. A taxpayer keeps no books or records;
2. A taxpayer has no annual accounting period;
3. A taxpayer’s present tax year does not qualify as a fiscal year; or
4. A taxpayer is required to use a calendar year by a provision in the Internal Revenue Code or the Income Tax Regulations

Short Tax Year

A short tax year is a tax year of less than 12 months. A short period tax return may be required when a taxable entity is not in existence for an entire tax year, or changed accounting period.

Death of Individual

When a taxpayer dies, a tax return must be filed for the decedent by the 15th day of the 4th month after the close of the taxpayer's regular tax year. The decedent's final return will be a short period tax return that begins on January 1st, and ends on the date of death.

Change in Accounting Period

A taxpayer must, with certain exceptions, get approval from the IRS to change tax years. To get approval, the taxpayer must file Form 1128, Application to Change a Tax Year, by the due date (not including extensions) of the tax return for the short period required to effect the change.

Individuals

Generally, individuals must adopt the calendar year as their tax year. An individual can adopt a fiscal year provided that the individual maintains his or her books and records on the basis of the adopted fiscal year.

Married Couple

A newly married couple can adopt the accounting period of the other spouse without first getting approval.

Partnerships, S Corporations, and Personal Service Corporations

Generally, partnerships, S corporations (including electing S corporations), and Personal Service Corporations (PSCs) must use a required tax year. A required tax year is a tax year that is required under the Internal Revenue Code and Income Tax Regulations. The entity does not have to use the required tax year if it receives IRS approval to use another permitted tax year or makes an election under section 444 of the Internal Revenue Code.

Accounting Methods

Types of Accounting Methods

There are 4 types of accounting methods:

1. Cash method.
2. Accrual method.
3. Special methods of accounting for certain item of income and expenses.
4. A hybrid method which combines elements of two or more of the above accounting methods.

Combination (hybrid) Method

A taxpayer can use any combination of cash, accrual, and special methods of accounting if the combination clearly shows income and it is used consistently. However, the following restrictions apply:

1. If an inventory is necessary to account for income, the accrual method must be used for purchases and sales. Generally, the cash method can be used for all other items of income and expenses.
2. If the cash method is used for reporting income, the cash method must also be used for reporting expenses.
3. If the accrual method is used for reporting expenses, the accrual method must also be used for reporting income.
4. Any combination that includes the cash method is treated as the cash method.

Two or More Businesses

A taxpayer can use a different accounting method for each separate and distinct business if the method used clearly shows income.

Cash Method

The cash method of accounting is used by most individuals and many small businesses with no inventories. The following entities cannot use the cash method:

1. A corporation (other than an S corporation or a qualified personal service corporation) with average annual gross receipts exceeding $5 million.
2. A partnership with a corporation (other than an S corporation and a qualified personal service corporation) as a partner and with the partnership having average annual gross receipts exceeding $5 million.
3. A tax shelter.

Exceptions

The following entities are not prohibited from using the cash method of accounting.

- Any corporation or partnership, other than a tax shelter, that meets the gross receipts test for all tax years after 1985.
- A qualified personal service corporation (PSC).

Gross receipts test. A corporation or a partnership meets this test if, for each prior tax year beginning after 1985, its average annual gross receipts are $5 million or less.

An entity's average annual gross receipts for a prior tax year is determined by:

1. Adding the gross receipts for that tax year and the 2 preceding tax years; and
2. Dividing the total by 3.

Qualified Personal Service Corporation (PSC). A qualified PSC is a corporation that meets the following function and ownership tests can use the cash method.

Function test. A corporation meets the function test if at least 95% of its activities are in the performance of services in the fields of health, veterinary services, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts, or consulting.

Ownership test. A corporation meets the ownership test if at least 95% of its stock is owned, directly or indirectly, at all times during the year by one or more of the following.

1. Employees performing services for the corporation in a field qualifying under the function test.
2. Retired employees who had performed services in those fields.
3. The estate of an employee described in (1) or (2).
4. Any other person who acquired the stock by reason of the death of an employee referred to in (1) or (2), but only for the 2-year period beginning on the date of death.

Change to accrual method. A corporation that fails to meet the function test or the ownership test at any time during any tax year must change to an accrual method of accounting, effective for the year in which the corporation fails to meet either test. A corporation that fails to meet the function test or the ownership test is not treated as a qualified PSC for any part of that tax year.

Income

Include in gross income all items of income actually or constructively received or made available without restriction during the year. The taxpayer cannot delay receipt of income.

Expenses

Deduct expenses in the year they were actually paid.

Expenses Paid in Advance

Expenses paid in advance are deductible only in the year to which it applies, unless the expense qualifies for the 12-month rule. Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain benefits for the taxpayer that do not extend beyond the earlier of the following.

1. 12 months after the right or benefit begins, or
2. The end of the tax year after the tax year in which payment is made.

Special Rules for Farming Businesses

Generally, a taxpayer engaged in the trade or business of farming is allowed to use the cash method for its farming business. However, certain corporations (other than S corporations) and partnerships that have a partner that is a corporation must use an accrual method for their farming business. For this purpose, farming does not include the operation of a nursery or sod farm or the raising or harvesting of trees (other than fruit and nut trees).

Qualified Personal Service Corporation (PSC)

A PSC that meets the following function and ownership tests can use the cash method.

1. **Function test.** A corporation meets the function test if at least 95% of its activities are in the performance of services in the fields of health, veterinary services, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts, or consulting.
2. **Ownership test.** A corporation meets the ownership test if at least 95% of its stock is owned, directly or indirectly, at all times during the year by one or more of the following.
   a. Employees performing services for the corporation in a field qualifying under the function test.
   b. Retired employees who had performed services in those fields.
   c. The estate of an employee described in (a) or (b).
   d. Any other person who acquired the stock by reason of the death of an employee referred to in (a) or (b), but only for the 2-year period beginning on the date of death.

Accrual Method

Under an accrual method of accounting, income is reported in the year earned and expenses are deducted or capitalized in the year incurred. The purpose of this method of accounting is to match income and expenses in the correct year.

Income

Report income on the earliest of the following dates:

- When payment is received.
- When the income is due.
- When the income is earned.
- When title has passed.

Advance Payment for Services

Postpone including the advance payments in income until they are earned. Do not postpone including the payments beyond the following tax year.

Expenses

Deduct or capitalize business expenses when they become a liability, whether or not paid in the same year.

Inventories

A business that has inventory must use the accrual method.

Related Persons

Do not deduct business expenses and interest owed to a related cash basis person until the payments have been made and the related person includes the payments in their gross income. For the purpose of the related party rule, the following are related persons:

1. Member of a family including brother and sisters (either whole or half), spouses, ancestors, and lineal descendants.
2. Two entities (e.g., partnership, corporation, fiduciary) if the same individual has more than 50% interest in each entity.
3. The fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
4. A tax-exempt educational or charitable organization and a person (if an individual, including the members of the individual's family) who directly or indirectly controls such an organization.
5. The grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
6. A PSC and any employee-owner, regardless of the amount of stock owned by the employee-owner.

Inventories

Items Included in Inventory

1. Merchandise or stock in trade. Merchandise includes the following:
   a. Purchased merchandise if the title has passed to the taxpayer.
   b. Goods under contract for sale that has not yet been segregated and applied to the contract.
   c. Goods out on consignment.
   d. Goods held for sale in display rooms, merchandise mart rooms, or booths located away from place of business.

   Merchandise not included in inventory:

   a. Goods sold, but only if title has passed to buyer.
   b. Goods consigned to the taxpayer.
   c. Goods ordered to future delivery if the taxpayer does not have title.
2. Raw materials.
3. Work in process.
4. Finished products.
5. Supplies that physically become a part of the item intended for sale.
6. C.O.D. mail sales (C.O.D. payment not received).
7. Containers.

Cost Identification

There are three methods of identifying items in inventory:

1. **Specific identification method.** This method is used to identify the cost of each inventoried item by matching the item with its cost of acquisition in addition to other allocable costs, such as labor and transportation.
2. **First-in first-out (FIFO) method.** This method assumes that the items of inventory purchased or produced first are sold first. The items in inventory at the end of the year are valued as the items most recently purchased or produced.
3. **Last-in first-out (LIFO) method.** This method assumes that the items in inventory purchased or produced last are sold first. The items included in closing inventory are considered to be those from the opening inventory plus those items acquired in the current year and not sold.

Valuing Inventory

The following are common ways to value inventory:

1. **Cost method.** The cost of acquisition in addition to costs allocable to the merchandise.
2. **Lower of cost or market method.** This method compares the market value of each item in inventory with its cost and uses the lower value as its inventory value.
3. **Retail method.** The total retail selling price of goods on hand at the end of the year in each department or of each class of goods is reduced to approximate cost by using an average markup expressed as a percentage of the total selling price.

Uniform Capitalization Rules

Under the uniform capitalization rule, direct costs and most indirect costs incurred in production and resale activities must be capitalized (added to basis). Recover these costs through depreciation, amortization, or cost of goods sold.

The following activities are subject to the uniform capitalization rules:

1. Production of real property or tangible personal property for use in a trade or business or an activity engaged in for profit.
2. Production of real property or tangible personal property for sale to customers.
3. Acquired property for resale. However, this rule does not apply to personal property if average annual gross receipts are not more than $10 million.

Producing Property

A taxpayer is producing property if he or she constructs, builds, installs, manufactures, develops, improves, creates, raises, or grows the property. Property produced for the taxpayer under a contract is treated as produced to the extent that the taxpayer makes payments or otherwise incur costs in connection with the property.

Tangible Personal Property

Tangible personal property includes films, sound recordings, video tapes, books, artwork, photographs, or similar property containing words, ideas, concepts, images, or sounds. However, free-lance authors, photographers, and artists are exempt from the uniform capitalization rules if they qualify.

Exceptions to the Uniform Capitalization Rules

The uniform capitalization rules do not apply to the following:

1. Resellers of personal property with average annual gross receipts of $10 million or less.
2. Property produced to use as personal or nonbusiness property or for uses not connected with a trade or business or an activity conducted for profit.
3. Research and experimental expenditures deductible under section 174.
4. Intangible drilling and development costs of oil and gas or geothermal wells or any amortization deduction allowable under section 59(e) for intangible drilling, development, or mining exploration expenditures.
5. Property produced under a long-term contract, except for certain home construction contracts described in section 460(e)(1).
6. Timber and certain ornamental trees raised, harvested, or grown, and the underlying land.
7. Qualified creative expenses paid or incurred as a free-lance (self-employed) writer, photographer, or artist that are otherwise deductible on a tax return.
8. Costs allocable to natural gas acquired for resale to the extent these costs would otherwise be allocable to cushion gas stored underground.
9. Property produced if substantial construction occurred before March 1, 1986.
10. Property provided to customers in connection with providing services. It must be de minimis in amount and not be inventory in the hands of the service provider.
11. Loan origination.
12. The costs of certain producers who use a simplified production method and whose total indirect costs are $200,000 or less.

Change in Accounting Method

Approval Required

The following changes in accounting methods require the consent of the IRS (use Form 3115, Application for Change in Accounting Methods).

1. Change from cash method to the accrual method or vice versa.
2. Change in the method or basis used to value inventories.
3. Change in the method of figuring depreciation or amortization method (except for certain permitted changes to the straight-line method).

Approval Not Required

The following changes in accounting methods do not require the consent of the IRS:

1. A correction of mathematical or posting errors.
2. A correction of errors in computing tax liability (such as an error in computing credits).
3. An adjustment of any item of income or deduction that does not involve the proper time for including it in income or deducting it.
4. Certain adjustments in the useful life of a depreciable or amortizable asset.

Chapter One Review

1. Which of the following must adopt the calendar year as their tax year?

A. A taxpayer who keeps no books or records.
B. An S corporation.
C. A tax shelter.
D. A partnership.

ANSWER: A

A taxpayer must adopt the calendar year if:

- The taxpayer keeps no books or records;
- The taxpayer has no annual accounting period;
- The taxpayer's present tax year does not qualify as a fiscal year; or
- The taxpayer is required to use a calendar year by a provision in the Internal Revenue Code or the Income Tax Regulations.

2. Generally, all of the following entities may use the cash method of accounting EXCEPT:

A. A family farming corporation with gross receipts of $25 million or less.
B. A partnership with no inventories and average annual gross receipts of $5 million or less.
C. A qualified personal service corporation.
D. A corporation (other than an S corporation) with average annual gross receipts exceeding $5 million.

ANSWER: D

The following entities cannot use the cash method, including any combination of methods that includes the cash method:

1. Any corporation (other than an S corporation) with average annual gross receipts exceeding $5 million.
2. A partnership with a corporation (other than an S corporation) as a partner, and with the partnership having average annual gross receipts exceeding $5 million.
3. A tax shelter.

The following entities are not prohibited from using the cash method of accounting:

1. Any corporation or partnership, other than a tax shelter, with average gross receipts of $5 million or less for each prior tax year beginning after 1985.
2. A qualified personal service corporation.
3. Family farming corporations with average annual gross receipts of $25 million or less for each prior tax year after 1985.

3. A calendar year accrual basis taxpayer sold merchandise on December 30. She billed the customer in the first week of January. The billing was returned for insufficient postage and she sent a second bill in February. When should she include the sale in income?

A. January

B. March

C. December

D. February

ANSWER: C

Under the accrual method of accounting, income is reported in the year earned and expenses are deducted or capitalized in the year incurred.

4. Which of the following is NOT considered a related person?

A. Two S Corporations if the same person owns more than 50% of each.

B. Members of a family.

C. An Individual and a Corporation where the individual owns, directly or indirectly 25% of the stock of the Corporation.

D. Grantor of any Trust.

ANSWER: C

All of the following are considered a related person.

1. Members of a family, including only brothers and sisters (either whole or half), husband and wife, ancestors, and lineal descendants.
2. Two corporations that are members of the same controlled group as defined in section 267(f).
3. The fiduciary of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
4. A tax- exempt educational or charitable organization and a person (if an individual, including family members of the individual's family) who directly or indirectly controls the organization.
5. **An individual and a corporation when the individual owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation**.
6. The grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
7. Any two entities, (corporation, S corporation, partnership, trust, etc.) if the same persons own more than 50% of each entity.
8. A personal service corporation and any employee-owner, regardless of the amount of stock owned by the employee-owner.

5. Which of the following accounting changes do NOT require the consent of the IRS?

A. Correction of a math error.
B. Change from accrual method to cash method.
C. Change in the method inventory is valued.
D. Change from cash method to accrual method.

ANSWER: A

The following changes in accounting method require the consent of the IRS:

1. Change from cash to accrual or vice versa (unless required to change to an accrual method and the change is made automatically).
2. Change in the method or basis used to value inventory.
3. Change in the method of figuring depreciation (except certain permitted changes to the straight line method for property placed in service before 1981)

Consent is not required from the IRS for the following changes:

1. A correction of a mathematical or posting error.
2. Correction of an error in computing tax liability (such as an error in computing a credit).
3. An adjustment of any item of income or deduction that does not involve the proper time for including it in income or deducting it.
4. An adjustment in the useful life of a depreciable asset. A taxpayer cannot change the recovery period for ACRS or MACRS property.

6. An employer Identification Number (EIN) is required for the following entities EXCEPT:

A. A sole proprietorship with no employees.
B. A partnership.
C. A trust or an estate.
D. An employee plan.

ANSWER: A

An employer Identification Number (EIN) is required for the following:

1. Reporting employment taxes and excise taxes.
2. A partnership.
3. A corporation.
4. Limited Liability Company (LLC)
5. A trust or an estate.
6. An employee plan.
7. An exempt organization.

7. The following methods of accounting for inventory are considered acceptable EXCEPT:

A. Cost.
B. First In First Out.
C. Last In First Out.
D. Trade Discount Method.

ANSWER: D

There are three methods of identifying item in inventory:

1. Specific identification.
2. First-in first-out (FIFO).
3. Last-in first-out (LIFO).

The common methods to value inventory are:

1. Cost method.
2. Lower of cost or market method.
3. Retail.

8. The uniform capitalization rules will apply in all of the following situations EXCEPT:

A. Produce real or tangible personal property for sale to customers.
B. Acquire property for resale, and average annual gross receipts exceed $10,000,000.
C. Produce real or tangible personal property for use in a business or activity carried on for profit.
D. Produce property under a long-term contract other than a home construction.

ANSWER: D

A taxpayer is subject to uniform capitalization rule if he or she:

1. Produces real property or tangible personal property for use in a trade or business,
2. Produce real property or tangible property for sale to customers, or
3. Acquires property for resale. However, this rule does not apply to personal property if the taxpayer's average gross receipts are not more than $10 million.

9. In order to adopt a fiscal tax year on its first federal income tax return, the taxpayer must

A. Maintain books and records and report income and expenses using that tax year.
B. Attach a completed Form 1128 to its fiscal year basis income tax return.
C. File a short period return.
D. Get IRS approval.

ANSWER: A

To adopt a fiscal year, a taxpayer must maintain books and records and report income and expenses using the same tax year.

10. A partnership, S corporation or personal service corporation can elect to use a tax year other than its required tax year, if it

A. Elects a year that meets the deferral period requirement.

B. Is not a member of a tiered structure as defined by the regulations.

C. Has not previously had an election in effect to use a tax year other than its required tax year.

D. All of the above.

ANSWER: D

A partnership, S corporation, or personal service corporation (PSC) can elect under section 444 to use a tax year other than its required tax year. Certain restrictions apply to the election. A partnership or an S corporation that makes a section 444 election must make certain required payments and a PSC must make certain distributions. A partnership, S corporation, or PSC can make a section 444 election if it meets all the following requirements:

1. It is not a member of a tiered structure (defined in section 1.444-2T of the regulations).
2. It has not previously had a section 444 election in effect.
3. It elects a year that meets the deferral period requirement.