

2022

NATIONAL INCOME TAX WORKBOOK

CHAPTER 4: BUSINESS TAX ISSUES



LEARNING OBJECTIVES

P. 127

After completing this session, participants will be able to do the following:

- ✓ Explain how a direct seller of retail products is taxed on their income
- ✓ Understand the expenses that a direct seller can deduct
- ✓ Understand when income from a vacation home is taxable
- ✓ Know how to apply the vacation home loss limitation rules
- ✓ Discuss the tax implications of the sale of a business as an equity sale or an asset sale
- ✓ Report the sale of a business
- ✓ Know when an employer can claim the employee retention credit

ISSUE 1: MULTILEVEL MARKETING

P. 129

Definitions

Federal Trade Commission (FTC)

- Person-to-person sale of product or services
- Selling to retail customers not involved in the MLM
- Recruiting new distributors to create a “downline”

IRS breaks MLM into two categories

- Single-level marketing (SLM) who have no downline
- Multilevel marketing (MLM) earn \$ on sales by down liners

PRACTITIONER NOTE – PYRAMID SCHEMES

P. 130

Pyramid Schemes

Illegal scams with many at the bottom enriching a few at the top

Requires never ending source of new participants

Big promises but no \$

STATUTORY NONEMPLOYEE

P. 130

A direct seller is as statutory nonemployee if:

Selling in the home or nonpermanent retail establishment

Substantially all income is from sales (~90%)

Written contract stating not employee for federal tax purposes

EXAMPLE 4.1

P. 131

Brett sells aluminum siding that includes material and installation. All sales are made in the customer's home

The value of the installation is more than 10% of the total price

Brett is an employee under common law (for installation)

If installation was less than 10% of value, Brett would be a nonemployee for the entire transaction

Prop. Treas. Reg. § 31.3508-1 (j) (2), Examples 2 and 3

MLM INCOME

PP. 131-132

Income for MLM can take many forms:

Direct sale of product

- Commission received only with direct shipment of product
- Gross receipts and COGS when seller touches product
 - Reduce COGS for personal use items

Commissions, bonuses, or percentage from downline

Prizes and awards

Direct seller expenses (like many other small businesses) include:

Start-up costs

- Deduct up to \$5,000
- Amortize over 180 months

Commissions to others

- Form 1099-NEC compliance

MLM DEDUCTIONS (CONT.)

PP. 133-135

Direct seller expenses:

Commissions to others

- Form 1099-NEC compliance

Business gifts

- Samples to downline and customers
- \$25 per year limitation
- Mailing not included - Treas. Reg. § 1.274-3(b)(2)(i)

Automobile expenses

- Actual or standard mileage at 58.5 cents / 62.5 cents

MLM DEDUCTIONS (CONT.)

PP. 135-137

A direct seller expenses continued:

Travel expenses

- Out of town travel, meals, and lodging
- Incremental cost of others not allowed unless connected to business (spouse, family)

Business use of home

- Regular and exclusive use under I.R.C. 280A
- Product storage space exception to exclusive use

Qualified business income deduction

- 20% deduction with potential limits due to AGI, wages, and capital

HOBBY OR BUSINESS

PP. 137-138

When an activity is determined to be “not engaged in for profit” it is commonly referred to as a hobby. If the activity is deemed a hobby:

Income is reportable net of COGS

Operating expenses are nondeductible post-TCJA through 2025

Operating expenses in 2026 forward are itemized subject to 2% AGI floor

ACTIVITY NOT ENGAGED IN FOR PROFIT

P. 138

Treas. Reg. § 1.183-2(b) provides 9 factors to determine whether an activity is not engaged in for profit

1. How the taxpayer carries on the activity
2. The expertise of the taxpayer or his or her advisers
3. The time and effort expended by the taxpayer in carrying on the activity
4. The expectation that the assets used in the activity may appreciate
5. The success of the taxpayer in carrying on other similar or dissimilar activities

ACTIVITY NOT ENGAGED IN FOR PROFIT (CONT.) P. 138

Factors to determine whether an activity is not engaged in for profit:

6. The taxpayer's history of income or losses with respect to the activity
7. The amount of occasional profits, if any, that are earned
8. The financial status of the taxpayer
9. Whether elements of personal pleasure or recreation are involved

No one factor is determinative

Presumptive "for profit" if profitable 3 out of 5 years (2 of 7 for horse activities)

EXAMPLE 4.13 MLM SELLER PROFIT MOTIVE

P. 138

Elizabeth Langston is a real estate agent and also sell Scent Terra Essential Oils.

- Gives samples to real estate clients
- Purchased laptop to maintain inventory
- Hosted one brunch to sell product with no other efforts
- Earned \$425,000 in 2022 in real estate and \$10,000 loss in essential oils
- Likely that essential oils was an activity not engaged in for profit

ISSUE 2: SHORT-TERM VACATION RENTALS

P. 139

Short term rentals of houses, condos, cabins, and even rooms

Property is often advertised through peer-to-peer platforms like Vrbo and Airbnb

Considerations:

Is the income includable in taxable income?

Is there a required allocation of expenses for personal use?

Are the rental losses limited?

Is the income subject to self-employment tax?

IS INCOME TAXABLE?

P. 139

The income is excluded from taxable income if the rental meets the de minimis rule under I.R.C. § 280A(g)

Property was rented for less than 15 days

Was deemed used as a residence for more than the greater of 14 days or 10% of the days rented at FRV

Mortgage interest, property taxes, and casualty loss deductions allowed

If the taxpayer does not establish residence, all income is reportable, and expenses are allocated between rental and personal

EXAMPLE 4.14 SHORT-TERM RENTAL INCOME NOT TAXABLE

P. 139

The rental income is not taxable when the taxpayer has minimal rental activity.

Brent has vacation home in Folly Beach, SC

Deemed personal use for 21 days

Rented at FRV for 9 days

No income is taxable

ALLOCATION FOR PERSONAL USE

P. 140

Personal use includes:

Use by any owner

Use in an exchange arrangement

Use at less than FRV

Use by any family

- Does not apply if family pays FRV and it is the tenant's principal residence

EXAMPLE 4.18 PERSONAL USE OF TIMESHARE

P. 141

Valerie Valdez owns a timeshare interest in Big Sky

Valerie owns 2 weeks

Other owner control another 48 weeks (2 weeks are controlled by management)

Valerie and other owners can trade their weeks for other properties

Valarie and the other owners must compute the combined deemed personal use of all owners to apply I.R.C. 280A

SE TAX ON VACATION RENTALS

P. 141

Generally, rental of real property is excluded from SE

Rental is subject to SE tax if there are substantial personal services

No substantial services provided not subject to SE tax

- Report on Schedule E (Forms 1040 or 1041) or Form 8825 (Forms 1065 or 1120S)

Substantial services provided then subject to SE tax

- Report on Schedule C (Forms 1040 or 1041) or as ordinary income (Forms 1065 or 1120S)

CCA 202151005 – characterization as a rental for PAL rules doesn't matter

LIMITING RENTAL LOSSES

PP. 141-142

If the deemed personal use exceeds the greater of 14 days or 10% of the days rented, expenses are allowed up to income in the following order:

- Advertising, cleaning, management fees, etc. (direct expenses)
- Mortgage interest and property taxes (Tier 1)
- Other operating expenses (Tier 2)
- Depreciation (Tier 3)
- Note short-term rental may be nonresidential - 39-year recovery

Excess Tier 2 and 3 expenses carry forward

EXAMPLE 4.19 EXPENSE LIMITS

P. 142

Denise Davidson rents her condo

70 FRV days

30 personal use days

\$10,000 rental income (net of direct expenses)

Expenses

- \$3,000 mortgage interest
- \$5,800 real estate taxes
- \$2,400 repairs
- \$6,400 depreciation

EXAMPLE 4.19 EXPENSE LIMIT (IRS)

P. 143

Income/Expense Allocation	Amount
Rental income for 70 days	\$10,000
Less tier 1 interest and taxes $[(\$3,000 + \$5,800) \times 70\%]$	(6,160)
Income after tier 1 expenses	<u>\$ 3,840</u>
Less tier 2 other expenses $(\$2,400 \times 70\%)$	(1,680)
Income after tier 2 expenses	<u>\$ 2,160</u>
Less tier 3 depreciation $(\$6,400 \times 70\% = \$4,480)$ but limited to income after tier 2 expenses	(2,160)
Total rental property income	<u>\$ 0</u>

EXAMPLE 4.20 EXPENSE LIMIT (BOLTON)

P. 143

Income/Expense Allocation	Amount
Rental income for 70 days	\$10,000
Less tier 1 interest and taxes [$(\$3,000 + \$5,800) \times 19.18\%$]	(1,688)
Income after tier 1 expenses	<u>\$8,312</u>
Less tier 2 other expenses ($\$2,400 \times 70\%$)	(1,680)
Income after tier 2 expenses	<u>\$6,632</u>
Less tier 3 depreciation ($\$6,400$ $\times 70\%$)	(4,480)
Total rental property income	<u>\$2,152</u>

PASSIVE LOSS TREATMENT

P. 144

Passive activity loss rules apply to all activities

Average customer use 7 days or less it is a nonrental activity

- Reported on Schedule E / Form 8825
- Apply material participation tests

Average customer use more than 7 days it is a rental absent significant personal services

- Reported on Schedule E / Form 8825
- Per se passive absent RE pro status

FIGURE 4.5 FLOWCHART

P. 145

See reporting flowchart on page 145

Note – if 7 days or less rental, any passive loss flows to Form 8582, Part III, Other Passive Activities. No \$25K loss allowance

ISSUE 4: SALE OF A BUSINESS

P. 151

Most sellers prefer stock sale

Most buyers prefer asset sale

Review both for C corporation, S corporation and partnership

C CORPORATION STOCK

PP. 151-152

Sale of stock of C corporation

Corporation

- Not a taxable event

Shareholder

- Compute gain. Long- or short-term based on holding period
- Net investment income tax potential

The new owner basis in stock = purchase price

C CORPORATION ASSET

PP. 152-153

C corporation sale of assets

Corporation

- Gain or loss on sold asset
- Liquidating distributions to the shareholder

Shareholder

- Gain or loss using the liquidating distributions as the sale price against the stock basis
- Long- or short-term based on holding period
- Net investment income tax potential

New owner has new basis in all assets/ new depreciable life

S CORPORATION STOCK

PP. 153-154

Sale of S corporation stock

S Corporation

- Not a taxable event

Shareholder

- Compute gain. Long- or short-term based on holding period
- Net investment income tax potential

The new owner basis in stock = purchase price

S CORPORATION ASSET

PP. 154-155

S corporation Sells Assets

S Corporation

- Gain or loss on sold asset passed through to shareholder via Schedule K-1
- Liquidating distributions to the shareholder

Shareholder

- Gain if liquidating distributions exceed stock basis
- Long- or short-term based on holding period
- Net investment income tax potential

New owner has new basis in all assets/new depreciable life

PARTNERSHIP INTEREST

PP. 155-156

Partner Sells Partnership Interest

Partnership

- Not a taxable event
- Computes short period income/loss for split Schedules K-1
- Note - Partnership can make an I.R.C. 754 election

Partner

- Allocable share of “hot assets” taxed as ordinary income
- Gain or loss using the remaining value against partnership basis
- Long- or short-term based on holding period
- Net investment income tax potential

PARTNERSHIP ASSET

PP. 156-157

Partnership Sale of Assets

Partnership

- No entity level tax as gains / losses flow through to the partners
- Allocate sale price among asset classes to determine tax treatment

Partner

- Gain or loss based on partnership basis
- Long- or short-term based on holding period
- Net investment income tax potential

ALLOCATION PRIORITIES

P. 157

Asset	Seller Priority	Buyer Priority
Land	High	Low
Buildings	Medium-low	Medium-low
Accounts receivable	No preference	No preference
Inventory	Low	High
Equipment	High (up to tax basis)	High
Goodwill	High	Low

REPORTING REQUIREMENTS – ASSET SALES

PP. 158-159

The buyer and seller must complete Form 8594, Asset Acquisition Statement Under Section 1060, and the statements should match. The sale price is allocated between seven different classes:

Class I – cash and general deposit accounts

Class II – CD's, foreign currency, gvt. securities, publicly traded stock

Class III – accounts receivable, mark-to-market items, debt instruments

Class IV – inventory, stock in trade

Class V – assets not identified in other categories – furniture/fixtures, bldgs., land, vehicles, equip

Class VI – Section 197 intangibles excluding goodwill and going concern

Class VII – Goodwill and going concern

REPORTING REQUIREMENTS – EQUITY SALES

P. 159

Equity Sales

Corporation (C or S) – shareholder reports on Form 8949

Partnership – partner reports on Form 8949

- Hot Assets – the selling partner must report the sale to the partnership
- Partnership files Form 8308

CASE STUDY

PP. 160-167

Woods Bay Tax, Inc. is a comprehensive case study of an S corporation asset sale

Agree on allocation

Part capital gain and part ordinary income

See completed forms and closing letter

ISSUE 4: CORPORATE REORGANIZATIONS

PP. 105-113

- No gain or loss in a divisive reorganization
- Two types of divisive reorganizations
 - Spin-off
 - Split-Off

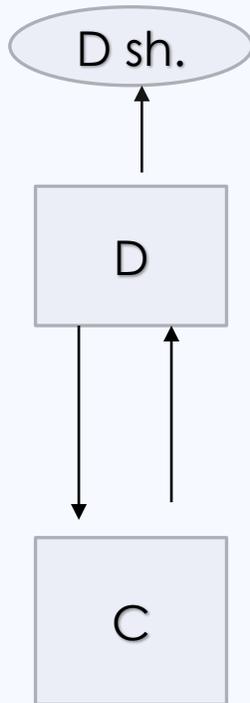
SPIN-OFF

P. 105

- Historic corporation
 - Creates a subsidiary corporation
 - Contributes assets to subsidiary in exchange for all stock
 - Distributes stock to historic shareholders
- Shareholders now own stock in the two separate corporations

SPIN-OFFS

PP. 105-106



step one: distributing (D) creates a subsidiary controlled (C)

step two: D distributes C stock to D shareholders

result: D shareholders own D and C

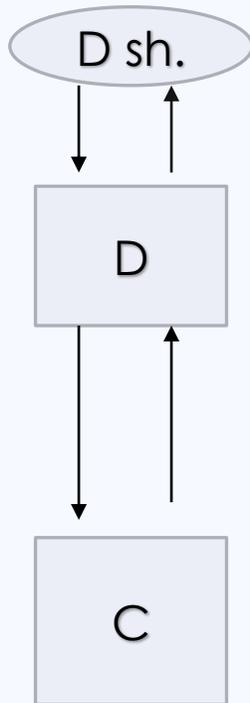
SPLIT-OFF

P. 105

- Historic corporation:
 - Creates a subsidiary corporation
 - Contributes assets to subsidiary in exchange for all stock
 - Distributes stock to some of the historic shareholders in exchange for their shares in the historic corporation
- Some of the historic shareholders now own stock solely in the new corporation
- Remaining historic shareholders retain historic corporation

SPLIT-OFFS

PP. 105-106



step one: distributing (D) creates a subsidiary controlled (C)

step two: D distributes C stock to one or more D shareholders in exchange for their shares in D

result: One or more D shareholders own D and one or more D shareholders own C

SPLIT-OFF REQUIREMENTS

PP. 105-108

- I.R.C. §368 requires execution of a plan under which one or more of the original corporation's shareholders receive control of the newly formed corporation by a qualifying stock distribution from the original corporation
- I.R.C. §355 provides one set of qualifying rules
 - Distributing corporation has control of subsidiary
 - Distributing corporation distributes all subsidiary stock
 - Both corporations are engaged in active trade or business
 - Transactions are not a device to distribute E&P

CONTINUITY OF BUSINESS ENTERPRISE

P. 106

- I.R.C. §355 also requires that the controlled corporation either
 - continues the distributing corporation's historic business or
 - uses a significant portion of the distributing corporation's historic business assets in a business
- Ex. 3.26 logging and farming corp splits - okay

CONTINUITY OF PROPRIETARY INTEREST

P. 106

- In addition, I.R.C. §355 requires that one or more of the original shareholders retains a proprietary interest in the reorganized enterprise
- One or more original owners own, in aggregate, 50% of more of the stock in each corporation after separation
- IRS goal is to prevent use as a disguised sale

BUSINESS PURPOSE

PP. 107-108

- A business purpose must exist for the split
- For both the transfer of assets to the subsidiary and the distribution of the subsidiary's stock
- Rev. Proc. 96-30 provides guidance – “Fit and Focus”

ACTIVE TRADE OR BUSINESS

P. 108

- Generally, a facts and circumstances test
- I.R.C. §355: 5-year requirement for distributing corporation
- Holding land or other property for investment is not an active trade or business

TAX CONSEQUENCES

P. 108

- Considered mere change in form when subsidiary is formed
 - Generally, tax-free unless boot received exceeds basis of contributed assets
 - Watch for debts transferred in excess of ATB of assets
- I.R.C. §355 provides for the tax-free exchange of stock to shareholders

COMPREHENSIVE EXAMPLE

PP. 108-112

- More than 5 years active trade or business
- Management (family) disagreements
- Brother wants to expand orchard with a hard cider operation
- Risk concerns
- Goal: separate farm and orchard businesses

ISSUE 5: EMPLOYEE RETENTION CREDIT (ERC)

P. 168

The Coronavirus Aid, Relief, and Economic Security Act of 2020 (CARES Act) made several changes for 2020 and 2021

Background

Eligibility

Calculation

Recovery startup businesses

Amending returns

BACKGROUND

P. 168

Originally for wages January 1, 2020 – June 30, 2021 – CARES Act 3/25/2020

Can use non-PPP wages – TCDTRA 12/27/2020

Extended to wages paid through December 31, 2021 – ARPA 3/21/2021

Retroactively repealed for 2021 Q4, except recovery startup businesses – IJA
11/15/2021

PUBLISHED GUIDANCE

P. 168

Payroll Period	Relevant IRS Guidance
March 13, 2020 – December 31, 2020	Notice 2021-20, 2021-11 I.R.B. 922; Notice 2021-49, 2021-34 I.R.B. 316; and Rev. Proc. 2021-33, 2021-34 I.R.B. 327
January 1, 2021 – June 30, 2021	Notice 2021-23, 2021-16 I.R.B. 1113; Notice 2021-49; and Rev. Proc. 2021-33
July 1, 2021 – September 30, 2021	Notice 2021-49 and Rev. Proc. 2021-33
October 1, 2021 – December 31, 2021	Notice 2021-49 and Notice 2021-65, 2021-51 I.R.B. 880

ELIGIBILITY

PP. 169-171

Suspended business test – operations were partially or fully suspended by government order OR

Gross receipts test – quarterly revenue significantly declined

- For 2020, less than 50% compared to same quarter in 2019
- For 2021, generally, less than 80% compared to the same quarter in 2019

CALCULATION

P. 171

2020 maximum ERC is 50% of qualified wages plus allocable healthcare with a compensation maximum of \$10,000 per employee for the **year – max ERC \$5k/employee**

January 1, 2021 – September 30, 2021, the maximum ERC is 70% of qualified wages plus healthcare with a compensation maximum of \$10,000 per employee per **quarter – max ERC \$28k/employee**

CALCULATION (CONT.)

P. 171

Payments to related individuals are not qualifying wages. Generally, the excluded employees are:

Child or a descendent of a child

Brother, sister, stepbrother, or stepsister

Father or mother or ancestor of either

Stepfather or stepmother

Niece or nephew

Aunt or uncle

In-laws (son, daughter, father, mother, brother, or sister-in-law)

RECOVERY STARTUP BUSINESSES

PP. 172-173

A qualifying recovery startup business is eligible for ERC in Q3 and Q4 of 2021

Began trade or business activity after February 15, 2020

and

Average annual gross receipts of \$1,000,000 or less in a 3-year lookback

Planning Pointer – a related startup entity may qualify related entity wages for ERC

AMENDING RETURNS

P. 174

Eligible taxpayers can claim ERC retroactively to 2020 and 2021. Quarterly Forms 941-X must be filed considering the following:

Determine eligibility by quarter

Identify qualified wages including allocable healthcare

Remove wages paid with forgiven PPP funds

Remove unqualified employees such as related parties

Complete amended Forms 941-X, 943-X, or 944-X

Amend income tax return to reduce wage deduction (increasing income)

AMENDING RETURNS (CONT.)

P. 174

Statute of limitation issues for ERC:

Amended payroll tax returns SOL generally April 15th, 3 years after tax year

Law Change - ARPA granted the IRS a 5-year SOL to audit Q3 and Q4 of 2021.

- Other quarters retain the normal 3-year SOL

Questions?