Chapter 2: Small Business Issues

Corrections were made to this workbook through January of 2014. No subsequent modifications were made.

SIMPLIFIED OPTION FOR CLAIMING HOME OFFICE DEDUCTION[1]

In January 2013, the IRS announced a new method for claiming home office expenses. This new method is expected to save taxpayers 1.6 million hours of recordkeeping annually.[2]

Previously, the only method of deducting qualified home office expenses required determining the applicable business percentage. This can be calculated by comparing the total square footage of the home office with the square footage of the entire home. The business percentage is then applied to the applicable household expenses to determine the expenses attributable to the business area of the home.

Under the new method, taxpayers may deduct $5 per square foot of home office space, up to a maximum of $1,500 per year. One of the key benefits of the method is that taxpayers are **not** required to substantiate the expenses incurred for their home.

This simplified method is also referred to as a **safe harbor method** by the IRS. The use of this method is **an election** available to taxpayers with qualifying home offices.

Note. The new simplified method is for determining the **amount** of the deduction. It does not change the requirements that must be met for a home office to be a considered a **qualified** home office. For more information on these requirements, see the 2012 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 7: Office in Home.

For tax years starting on or after January 1, 2013, taxpayers may elect to use the safe harbor method to determine the amount of deductible expenses for their home offices. For 2013, taxpayers may choose to deduct $5 per square foot of home office space instead of using actual expenses. The $5 rate may be adjusted in the future if the IRS deems that the rate is no longer appropriate.

The election to use the safe harbor method must be made on a **timely filed original return using Schedule C.** See the following page for a draft version of the bottom portion of page 1 of 2013 Schedule C. The election is made simply by using this method. **However, once made, the election is irrevocable for the tax year.**

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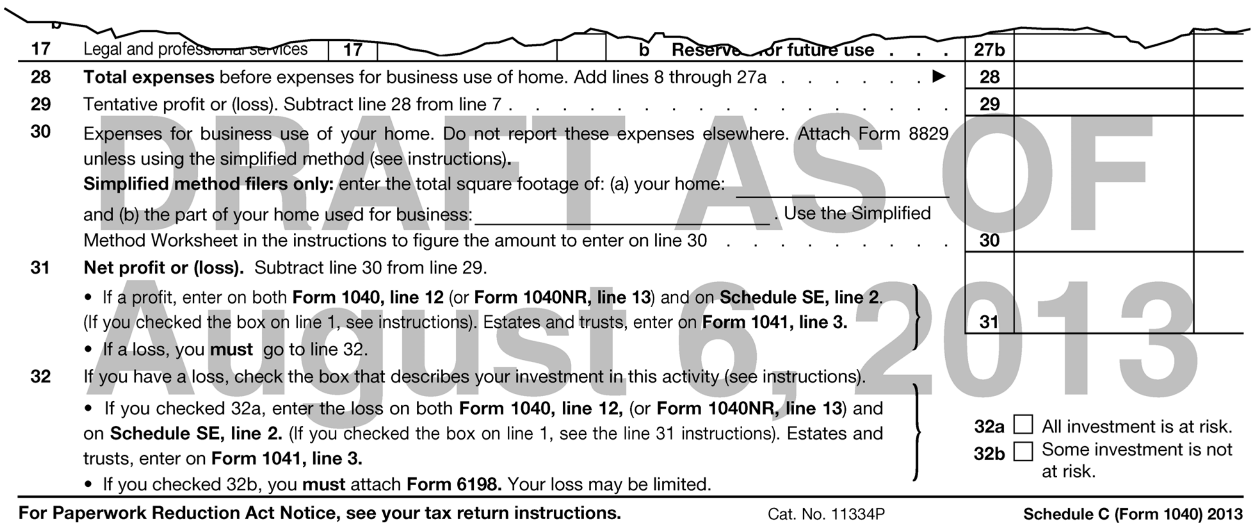
[1] Rev. Proc. 2013-13, 2013-6 IRB 478.

[2] IRS News Rel. IR-2013-5 (Jan. 15, 2013).



17 Legal and professional services 17 b Reserved for future use . . . 27b

28 **Total expenses** before expenses for business use of home. Add lines 8 through 27a . . . . . . ▶ 28

29 Tentative profit or (loss). Subtract line 28 from line 7 29

30 Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions).
Simplified method filers only: enter the total square footage of: (a) your home: ____________
and (b) the part of your home used for business: ____________ . Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30 30

31 **Net profit or (loss).** Subtract line 30 from line 29.
- If a profit, enter on both **Form 1040, line 12** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** (If you checked the box on line 1, see instructions). Estates and trusts, enter on **Form 1041, line 3.**
- If a loss, you **must** go to line 32.

31

32 If you have a loss, check the box that describes your investment in this activity (see instructions).
- If you checked 32a, enter the loss on both **Form 1040, line 12,** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on **Form 1041, line 3.**
- If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11334P **Schedule C (Form 1040) 2013**

AVERAGE SQUARE FOOTAGE CALCULATION

The maximum number of square feet that may be used for this calculation is 300. For purposes of determining the allowable square footage, a taxpayer with a qualified business use of a home for a portion of the tax year or a taxpayer who changes the square footage for a qualified business use during the tax year must determine the average of the monthly allowable square footage for the year. In determining the average monthly allowable square footage, no more than 300 square feet may be taken into account for any month. For the purposes of this calculation, if the taxpayer uses the home office for at least 15 days, it is counted as being used for the entire month.

Example 1. Trista starts a business as a wedding planner on June 1, 2013. She uses 108 square feet of her home as a qualified home office. In 2013, she did not track her applicable home expenses, so she computes her home office deduction using the optional safe harbor method, as follows.

	Square Feet Used		Applicable Months		Total
January–May	0	×	5	=	0
June–December	108	×	7	=	756
Total use over 12 months					756
					÷ 12
Average monthly square foot usage					63
Multiplied by the standard square footage allowance					× $5
Home office deduction					**$315**

DEPRECIATION ISSUES RELATED TO THE SAFE HARBOR METHOD

Taxpayers who use the safe harbor method **cannot** deduct any depreciation for the qualified home office for that tax year. The depreciation deduction **allowable** for that portion of the home for that tax year is deemed to be zero.

If a taxpayer uses the safe harbor method for one year and uses the actual expense method for any subsequent year, the taxpayer must calculate the depreciation deduction allowable in the subsequent year by using the appropriate optional depreciation table applicable for the property. This is true regardless of whether the taxpayer used an optional depreciation table for the property in the year it was placed in service. The optional depreciation tables for MACRS property are provided in IRS Pub. 946, *How To Depreciate Property*. The appropriate optional depreciation table is based on the depreciation system, depreciation method, recovery period, and convention applicable to the property at the time it was placed in service.

The allowable depreciation deduction is calculated in the subsequent year by multiplying the remaining adjusted depreciable basis of the home office by the annual depreciation rate specified in the appropriate optional depreciation table. The applicable year to use in the table is the year that corresponds with the current tax year based on the placed-in-service date of the property.

Example 2. Use the same facts as **Example 1.** In 2014, Trista tracks the expenses and determines that using the actual expense method will be more beneficial. To calculate the depreciation portion of the 2014 deduction, she first determines her remaining adjusted basis of the home office portion of the home. In 2013, when she placed the home office in service, the portion of the home's basis allocable to the home office was $10,000. Under the safe harbor method, the allowed or allowable depreciation for 2013 is $0. Therefore, her remaining adjusted basis at the beginning of 2014 is still $10,000.

The appropriate optional depreciation table in IRS Pub. 946 is A-7a, which follows. It shows that the depreciation rate for year two is 2.564%. Accordingly, Trista's 2014 depreciation deduction for the home office is $256 ($10,000 × .02564). Her adjusted depreciable basis at the end of 2014 is $9,744 ($10,000 − $256).

Table A-7a. **Nonresidential Real Property**
Mid-Month Convention
Straight Line—39 Years

Year	**Month property placed in service**											
	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**
1	2.461%	2.247%	2.033%	1.819%	1.605%	1.391%	1.177%	0.963%	0.749%	0.535%	0.321%	0.107%
2–39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
40	0.107	0.321	0.535	0.749	0.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

Note. Taxpayers who sell their homes after claiming depreciation for a home office may have to pay taxes on the depreciation portion of any gain realized.[3] However, if they have used the safe harbor method of calculating their home office deductions for the entire time that they had a home office, there is **no** allowed or allowable depreciation to recapture.

QUESTIONS AND ANSWERS

Question 1. Once a taxpayer elects to use the safe harbor method, may they use the actual method in future years?[4]

Answer 1. Yes. The election is made on a year-by-year basis.

Question 2. May employers use the safe harbor method to reimburse employees for qualified employee home offices?[5]

Answer 2. No. The IRS will not allow employers to use this method for reimbursing employees.

Question 3. Does using the safe harbor method reduce the amount of itemized deductions allowed on Schedule A, *Itemized Deductions*?[6]

Answer 3. No. Mortgage interest and real estate taxes are deductible on Schedule A **in full** without any adjustment for having used the safe harbor method to determine the deduction for the business use of the home.

Note. This may be one of the most taxpayer-friendly provisions under the new method. In addition to the home office business deduction, taxpayers are allowed to deduct 100% of their otherwise allowable mortgage interest and real estate taxes.

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[3] IRC §121(d)(6).

[4] Rev. Proc. 2013-13 §4.03, 2013-6 IRB 478.

[5] Rev. Proc. 2013-13 §4.02, 2013-6 IRB 478.

[6] Rev. Proc. 2013-13 §4.04, 2013-6 IRB 478.

Question 4. What happens if the deduction is more than a taxpayer's net income from the business prior to the deduction?[7]

Answer 4. The deductible amount of home office expenses under the safe harbor method is limited to the net income of the business before accounting for these expenses. Any excess is disallowed and **cannot** be carried over to any other tax year.

Question 5. If a taxpayer has a carryforward of excess home office expenses from previous years and elects to use the safe harbor method, may the taxpayer use the carryforward in the current year?[8]

Answer 5. No. Home office expenses that were disallowed in previous years due to income limitations that have carried forward to the current tax year may **not** be used if the taxpayer uses the safe harbor method in the current year.

Question 6. Once the taxpayer uses the safe harbor method, are the home office expenses that were carried forward lost forever?[9]

Answer 6. No. The amounts carried forward may be used in any tax year that the taxpayer uses the traditional actual expense method assuming that all other conditions are met.

Question 7. May a husband and wife both use the safe harbor method?[10]

Answer 7. Yes. However, they may **not** use it for the same portion of the home.

Question 8. Does the 300-square-foot limitation apply separately to each of the spouses on a joint return or to the home?[11]

Answer 8. The 300-square-foot limitation applies to each taxpayer separately, regardless of filing status.

Question 9. What if a taxpayer has two activities, each with a qualified home office?[12]

Answer 9. The taxpayer must use the same method for both activities. In addition, no more than 300 square feet may be used by the taxpayer in calculating their deductible home office expenses. The taxpayer may, however, allocate the square footage between the two activities using any reasonable method that does not allocate more square footage to any venture than actually used in that activity.

Question 10. May a taxpayer use the safe harbor method to calculate expenses related to rental use of the home?[13]

Answer 10. No. The safe harbor method may not be used to calculate rental expenses.

Question 11. May a taxpayer use the safe harbor method for more than one home?[14]

Answer 11. No. The safe harbor method may only be used for one home in any given tax year. However, actual expenses may be used to calculate the deductible business-use portion of the other home.

Note. Rev. Proc. 2013-13 does not provide any examples for taxpayers who have home offices in more than one home. Presumably, this rule applies in both of the following situations.

1. The taxpayer moves during the year from one principal residence to another.
2. The taxpayer owns two homes simultaneously.

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[7] Rev. Proc. 2013-13 §4.08(2), 2013-6 IRB 478.

[8] Rev. Proc. 2013-13 §4.08(3), 2013-6 IRB 478.

[9] Rev. Proc. 2013-13 §4.08(3), 2013-6 IRB 478.

[10] Rev. Proc. 2013-13 §4.08(5), 2013-6 IRB 478.

[11] Rev. Proc. 2013-13 §4.08(6), 2013-6 IRB 478.

[12] Rev. Proc. 2013-13 §4.08(6), 2013-6 IRB 478.

[13] Rev. Proc. 2013-13 §4.04, 2013-6 IRB 478.

[14] Rev. Proc. 2013-13 §4.08(7), 2013-6 IRB 478.

SELF-EMPLOYED HEALTH INSURANCE ISSUES

Starting in 2014, the individual mandate provision of the Affordable Care Act (ACA)[15] of 2010 calls for each individual to either:

1. Have minimum essential health insurance coverage for each month,
2. Qualify for an exemption, **or**
3. Make a payment when filing their federal income tax return.

Due to this requirement, tax practitioners may find that more of their self-employed clients will have deductible self-employed health insurance. This may be an important factor in the planning that is done in 2013 for the 2014 tax year.

> **Note.** For more information about the individual mandate and other provisions of the ACA, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Affordable Care Act Update.

QUALIFYING FOR THE SELF-EMPLOYED HEALTH INSURANCE DEDUCTION

Taxpayers may be able to deduct premiums paid for medical, dental, and qualified long-term care insurance that covers themselves, their spouses, and their dependents. The insurance may also cover a taxpayer's child who was under age 27 at the end of the tax year, even if the child was **not** the taxpayer's dependent.

To qualify for the deduction, **one** of the following statements must be true.[16]

1. The taxpayer was self-employed and had a net profit for the year.
2. The taxpayer used one of the optional methods on Schedule SE, *Self-Employment Tax,* to figure their net earnings from self-employment.
3. The taxpayer was a partner with net earnings from self-employment for the year as reported in box 14 of Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*
4. The taxpayer received wages for the year from an S corporation in which they owned more than 2% of the outstanding stock. The health insurance premiums paid or reimbursed by the S corporation must be shown as wages on the taxpayer's Form W-2, *Wage and Tax Statement.*

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[15] PL 111-148.

[16] IRS Pub. 535, *Business Expenses.*

The **insurance plan** must be established, or considered to be established, under the business in one of the following ways.[17]

1. For self-employed individuals, a policy can be either in the name of the business or in the name of the individual.
2. For partners, a policy may be either in the name of the partnership or in the name of the partner. Premiums may be paid either by the partner or the partnership. However, if the policy is in the partner's name and the partner pays the premiums personally, the partnership must reimburse the partner for the premiums paid. Regardless of who initially pays, the partnership must report the premium amounts on Schedule K-1 as guaranteed payments to be included in the partner's gross income. Otherwise, the insurance plan is **not** considered to be established under a business.
3. For more than 2% shareholders, a policy may be either in the name of the S corporation or in the name of the shareholder. The taxpayer can pay the premiums personally or the S corporation can pay them. However, if the policy is in the taxpayer's name and they pay the premiums personally, the S corporation must reimburse them for the premiums paid. Regardless of who initially pays, the premium amounts must be included on Form W-2 as wages. Otherwise, the insurance plan will **not** be considered to be established under a business.

Note. For S corporation owner-employees, these premiums are included in wages subject to withholding, but are **not** included in wages subject to social security and Medicare taxes.[18]

In addition to these requirements, the taxpayer does not qualify for the self-employed health insurance deduction for any month **in which they were eligible to participate** under an employer's **subsidized** plan maintained by any employer of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent.[19]

SPECIAL TYPES OF INSURANCE PLANS

Medicare

Medicare premiums that taxpayers voluntarily pay to obtain insurance are included in self-employed health insurance premiums. Deductible premiums include Medicare Part A, B, C, or D. Historically, the IRS position on this has fluctuated. In 2012, the IRS Chief Counsel issued a memorandum authorizing the deduction of Medicare premiums for the taxpayer, the taxpayer's spouse, and any qualified children.[20]

Note. Most people do **not** pay for Medicare Part A insurance. However, there are people who did not earn enough social security or railroad retirement credits while they were working to qualify for Medicare. These people must pay for coverage if they want Medicare insurance. In 2013, the maximum monthly premium is $441.[21]

Retirement Plans

Health insurance premiums paid by the taxpayer via deductions from their taxable retirement income can be included in their self-employed health insurance costs. However, premiums paid from **nontaxable** retirement plans covering retired public safety officers **cannot** be included in the costs.

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[17] Ibid.

[18] *S Corporation Compensation and Medical Insurance Issues.* [www.irs.gov/Businesses/Small-Businesses-%26-Self-Employed/S-Corporation-Compensation-and-Medical-Insurance-Issues] Accessed on Jun. 3, 2013.

[19] IRC §162(l)(2)(B).

[20] CCA 201228037 (May 1, 2012).

[21] *Part A Costs.* Centers for Medicare & Medicaid Services. [www.medicare.gov/your-medicare-costs/part-a-costs/part-a-costs.html] Accessed on Jun. 14, 2013.

Qualified Long-Term Care Insurance

Premiums paid for a qualified long-term care insurance policy may be included as self-employed health insurance. However, for each person covered, only the smaller of the following amounts is included.

1. The amount paid for that person
2. The amount shown in the following table, using the person's age at the end of 2013[22] (These amounts are adjusted annually for inflation.)

Age	Amount
40 or younger	$ 360
41 to 50	680
51 to 60	1,360
61 to 70	3,640
71 or older	4,550

A qualified long-term care insurance contract is one that provides coverage only for qualified long-term care services. Qualified long-term care services are necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance and personal care services that are:

- Required by a chronically ill individual, and
- Provided pursuant to a plan of care prescribed by a licensed health care practitioner.[23]

A qualified long-term care insurance contract must meet all the following requirements.[24]

1. It must be guaranteed renewable.
2. It must provide that refunds (other than refunds on the death of the insured or complete surrender or cancellation of the contract) and dividends under the contract may be used only to reduce future premiums or increase future benefits.
3. It must not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed.
4. It generally must not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except when Medicare is a secondary payer or the contract makes per diem or other periodic payments without regard to expenses.

Note. For more information about long-term care insurance, see the 2011 *University of Illinois Federal Tax Workbook,* Chapter 2: Long-Term Care. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

Self-Insurance Reserve Funds

Amounts credited to a reserve set up for self-insurance are not deductible as self-employed health insurance costs. This applies even if the taxpayer is unable to obtain any other form of health insurance.

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[22] Rev. Proc. 2012-41, 2012-45 IRB 539.

[23] IRS Pub. 502, *Medical and Dental Expenses.*

[24] Ibid.

Disability Insurance

Premiums for a policy that pays for lost earnings due to sickness or disability are not deductible as self-employed health insurance costs.

CALCULATING THE DEDUCTION

In general, the total self-employed health insurance deduction is limited to the self-employment (SE) income from the business under which the insurance is established. For these purposes, SE income is determined as follows.

- For individuals with **coverage under their own name,** SE income for this purpose is equal to the net income from their businesses less the deductible part of SE tax.
- If the insurance is **established under a specific business** and not under the individual's name, the deduction is limited to the income of only that business less the portion of the SE tax attributable to that business.
- For **individuals who elect to use one of the optional methods of calculating SE tax,** net income is equal to the amount of the optional SE income (shown on Schedule SE, section B, line 4b) less the portion of the SE tax attributable to that business.
- For **partners**, SE income is the amount reported on Schedule K-1, box 14, code A, less the portion of the SE tax attributable to that business.
- For **shareholders** of an S corporation who own 2% or more of the company, SE income is the amount of Medicare wages reported on the Form W-2 from that corporation for the current year.
- Taxpayers who **exclude foreign earned income** from their adjusted gross income (AGI) must also adjust their SE income in determining the maximum amount of SE health insurance that they may deduct. Any excluded foreign income from the business under which the insurance is established must also be excluded from SE income in making this calculation.

Example 3. Glen is a 60% member-partner in Morgan Lawn, LLC. As part of his compensation, the partnership pays Glen guaranteed payments of $65,000 and reimburses him for all of his health-related insurance premiums. Glen's share of the partnership's net nonfarm income for the year is $12,000.

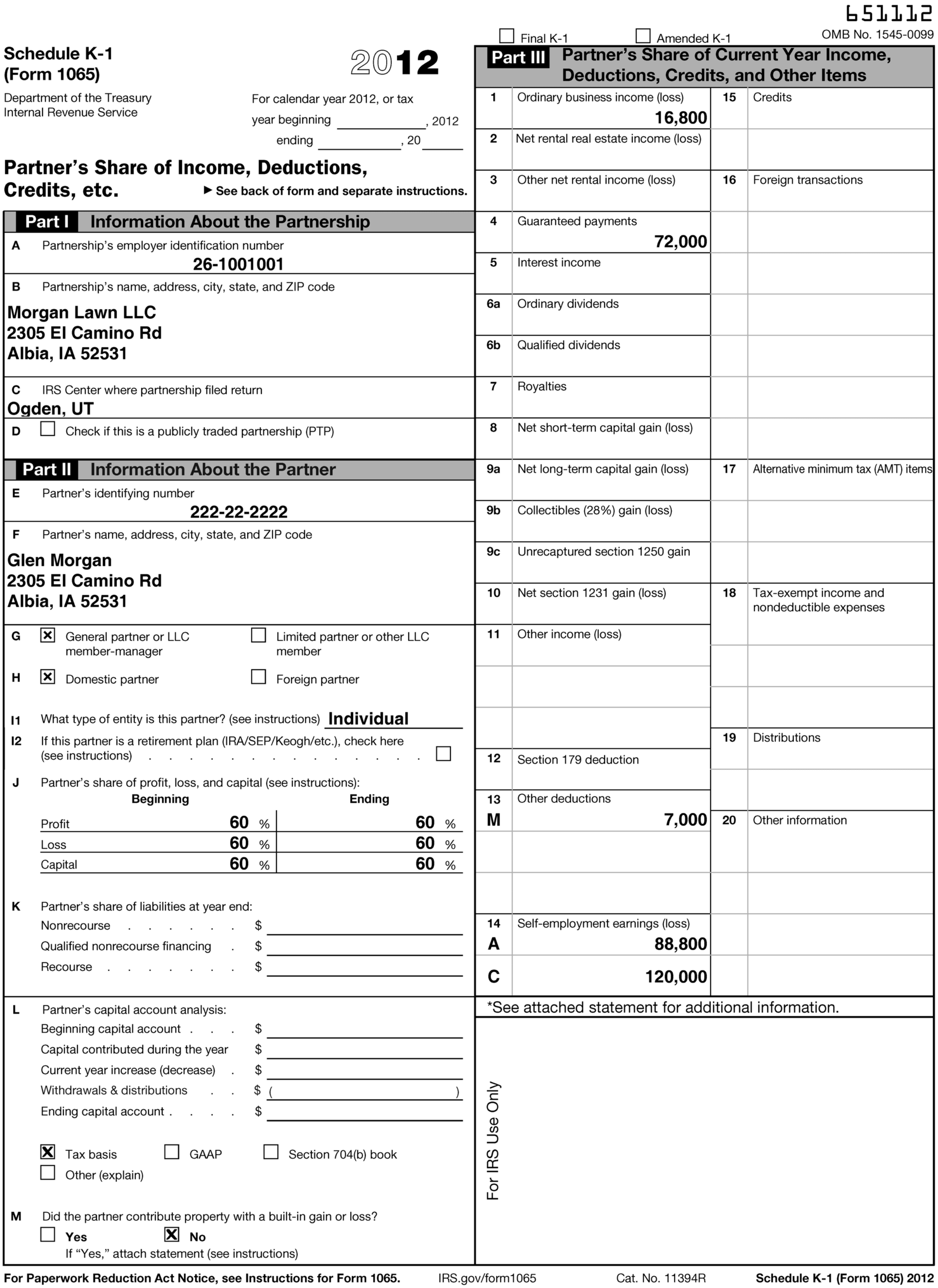
Glen received the following payments from the LLC during 2012.

Direct guaranteed payments to Glen		$65,000
Reimbursement for Medicare supplement premiums	$4,000	
Reimbursement for Medicare Parts B and D premiums	2,000	
Reimbursement for dental insurance	1,000	
Subtotal of health insurance reimbursements	$7,000	7,000
Total guaranteed payments and health insurance premiums		$72,000

Prior to accounting for these payments to Glen, the LLC's 2012 net income is $100,000. The LLC deducts the entire $72,000 as a guaranteed payment to a partner, leaving ordinary business income of $28,000. Glen's portion is $16,800 (60% of $28,000). The other members of the LLC do not receive any guaranteed payments in 2012. Glen receives a Schedule K-1 from the company for 2012.

Glen is able to deduct 100% of the health insurance premiums reimbursed by the LLC. The first page of his Form 1040 and the worksheet showing how his deductible premiums were calculated are shown after the following Schedule K-1.

For Example 3



651112

☐ Final K-1 ☐ Amended K-1

OMB No. 1545-0099

Schedule K-1
(Form 1065)

2012

Department of the Treasury
Internal Revenue Service

For calendar year 2012, or tax year beginning ____________, 2012 ending ____________, 20____

Partner's Share of Income, Deductions, Credits, etc.

▶ **See back of form and separate instructions.**

Part I Information About the Partnership

A Partnership's employer identification number
26-1001001

B Partnership's name, address, city, state, and ZIP code
Morgan Lawn LLC
2305 El Camino Rd
Albia, IA 52531

C IRS Center where partnership filed return
Ogden, UT

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number
222-22-2222

F Partner's name, address, city, state, and ZIP code
Glen Morgan
2305 El Camino Rd
Albia, IA 52531

G ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☒ Domestic partner ☐ Foreign partner

I1 What type of entity is this partner? (see instructions) **Individual**

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here (see instructions) . . . . ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	**Ending**
Profit	**60** %	**60** %
Loss	**60** %	**60** %
Capital	**60** %	**60** %

K Partner's share of liabilities at year end:
Nonrecourse . . . . $ ____________
Qualified nonrecourse financing . $ ____________
Recourse . . . . $ ____________

L Partner's capital account analysis:
Beginning capital account . . . . $ ____________
Capital contributed during the year $ ____________
Current year increase (decrease) . $ ____________
Withdrawals & distributions . . . $ (____________)
Ending capital account . . . . . $ ____________

☒ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?
☐ **Yes** ☒ **No**
If "Yes," attach statement (see instructions)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	**16,800**	**15**	Credits
2	Net rental real estate income (loss)			
3	Other net rental income (loss)		**16**	Foreign transactions
4	Guaranteed payments	**72,000**		
5	Interest income			
6a	Ordinary dividends			
6b	Qualified dividends			
7	Royalties			
8	Net short-term capital gain (loss)			
9a	Net long-term capital gain (loss)		**17**	Alternative minimum tax (AMT) items
9b	Collectibles (28%) gain (loss)			
9c	Unrecaptured section 1250 gain			
10	Net section 1231 gain (loss)		**18**	Tax-exempt income and nondeductible expenses
11	Other income (loss)			
			19	Distributions
12	Section 179 deduction			
13	Other deductions			
M		**7,000**	**20**	Other information
14	Self-employment earnings (loss)			
A		**88,800**		
C		**120,000**		

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. IRS.gov/form1065 Cat. No. 11394R **Schedule K-1 (Form 1065) 2012**

For Example 3

Schedule K-1 (Form 1065) 2012 **GLEN MORGAN** **26-1001001** Page **2**

This list identifies the codes used on Schedule K-1 for all partners and provides summarized reporting information for partners who file Form 1040. For detailed reporting and filing information, see the separate Partner's Instructions for Schedule K-1 and the instructions for your income tax return.

1. Ordinary business income (loss). Determine whether the income (loss) is passive or nonpassive and enter on your return as follows.

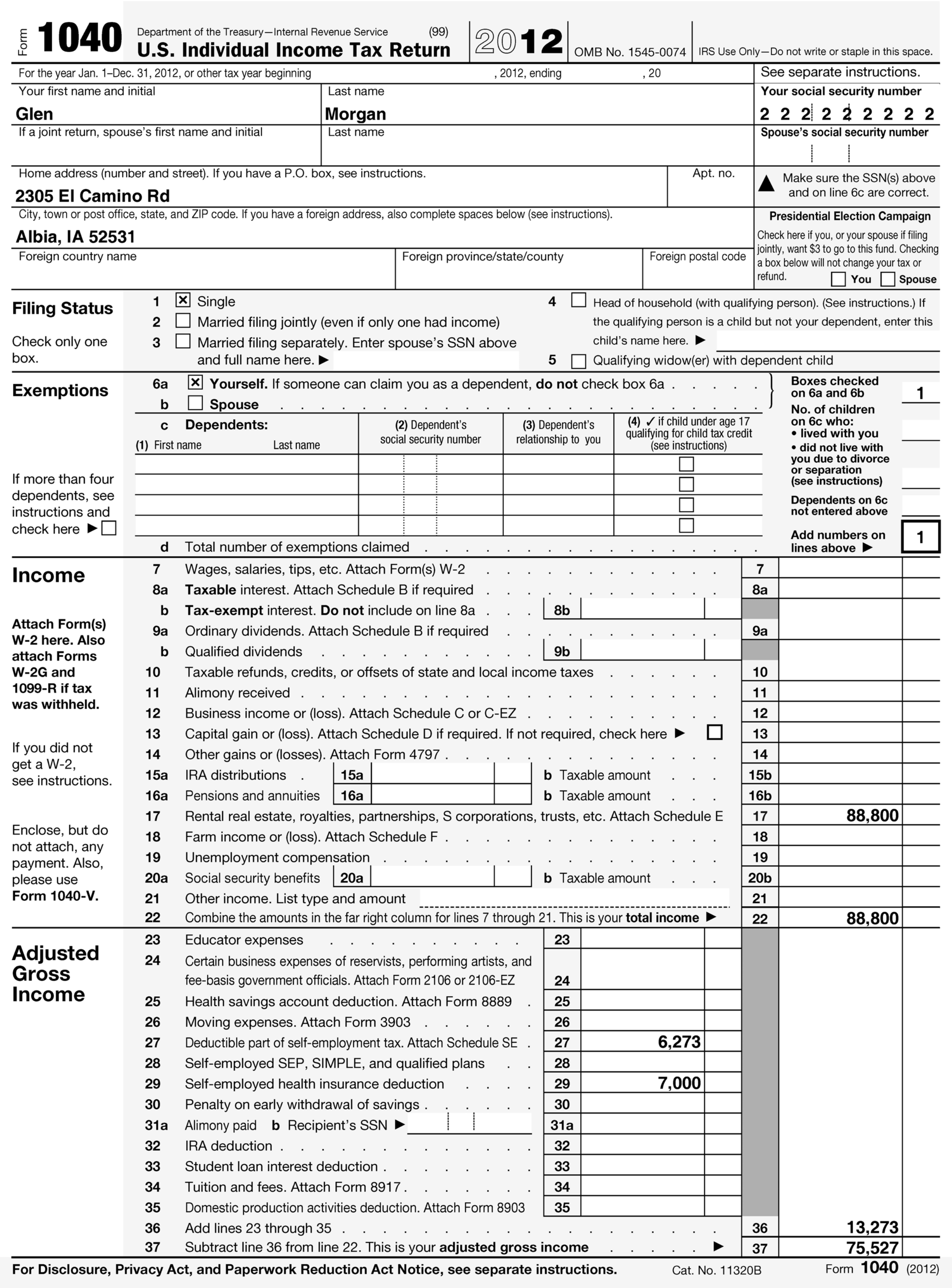
		Report on
	Passive loss	See the Partner's Instructions
	Passive income	Schedule E, line 28, column (g)
	Nonpassive loss	Schedule E, line 28, column (h)
	Nonpassive income	Schedule E, line 28, column (j)
2.	**Net rental real estate income (loss)**	See the Partner's Instructions
3.	**Other net rental income (loss)**	
	Net income	Schedule E, line 28, column (g)
	Net loss	See the Partner's Instructions
4.	**Guaranteed payments**	Schedule E, line 28, column (j)
5.	**Interest income**	Form 1040, line 8a
6a.	**Ordinary dividends**	Form 1040, line 9a
6b.	**Qualified dividends**	Form 1040, line 9b
7.	**Royalties**	Schedule E, line 4
8.	**Net short-term capital gain (loss)**	Schedule D, line 5
9a.	**Net long-term capital gain (loss)**	Schedule D, line 12
9b.	**Collectibles (28%) gain (loss)**	28% Rate Gain Worksheet, line 4 (Schedule D instructions)
9c.	**Unrecaptured section 1250 gain**	See the Partner's Instructions
10.	**Net section 1231 gain (loss)**	See the Partner's Instructions
11.	**Other income (loss)**	
	Code	
A	Other portfolio income (loss)	See the Partner's Instructions
B	Involuntary conversions	See the Partner's Instructions
C	Sec. 1256 contracts & straddles	Form 6781, line 1
D	Mining exploration costs recapture	See Pub. 535
E	Cancellation of debt	Form 1040, line 21 or Form 982
F	Other income (loss)	See the Partner's Instructions
12.	**Section 179 deduction**	See the Partner's Instructions
13.	**Other deductions**	
A	Cash contributions (50%)	See the Partner's Instructions
B	Cash contributions (30%)	
C	Noncash contributions (50%)	
D	Noncash contributions (30%)	
E	Capital gain property to a 50% organization (30%)	
F	Capital gain property (20%)	
G	Contributions (100%)	
H	Investment interest expense	Form 4952, line 1
I	Deductions—royalty income	Schedule E, line 19
J	Section 59(e)(2) expenditures	See the Partner's Instructions
K	Deductions—portfolio (2% floor)	Schedule A, line 23
L	Deductions—portfolio (other)	Schedule A, line 28
M	Amounts paid for medical insurance	Schedule A, line 1 or Form 1040, line 29
N	Educational assistance benefits	See the Partner's Instructions
O	Dependent care benefits	Form 2441, line 12
P	Preproductive period expenses	See the Partner's Instructions
Q	Commercial revitalization deduction from rental real estate activities	See Form 8582 instructions
R	Pensions and IRAs	See the Partner's Instructions
S	Reforestation expense deduction	See the Partner's Instructions
T	Domestic production activities information	See Form 8903 instructions
U	Qualified production activities income	Form 8903, line 7b
V	Employer's Form W-2 wages	Form 8903, line 17
W	Other deductions	See the Partner's Instructions
14.	**Self-employment earnings (loss)**	

Note. *If you have a section 179 deduction or any partner-level deductions, see the Partner's Instructions before completing Schedule SE.*

A	Net earnings (loss) from self-employment	Schedule SE, Section A or B
B	Gross farming or fishing income	See the Partner's Instructions
C	Gross non-farm income	See the Partner's Instructions
15.	**Credits**	
A	Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	See the Partner's Instructions
B	Low-income housing credit (other) from pre-2008 buildings	
C	Low-income housing credit (section 42(j)(5)) from post-2007 buildings	
D	Low-income housing credit (other) from post-2007 buildings	
E	Qualified rehabilitation expenditures (rental real estate)	
F	Other rental real estate credits	
G	Other rental credits	
H	Undistributed capital gains credit	Form 1040, line 71; check box a
I	Alcohol and cellulosic biofuel fuels credit	See the Partner's Instructions

	Code	*Report on*
J	Work opportunity credit	See the Partner's Instructions
K	Disabled access credit	
L	Empowerment zone and renewal community employment credit	
M	Credit for increasing research activities	
N	Credit for employer social security and Medicare taxes	
O	Backup withholding	
P	Other credits	
16.	**Foreign transactions**	
A	Name of country or U.S. possession	Form 1116, Part I
B	Gross income from all sources	
C	Gross income sourced at partner level	
	Foreign gross income sourced at partnership level	
D	Passive category	Form 1116, Part I
E	General category	
F	Other	
	Deductions allocated and apportioned at partner level	
G	Interest expense	Form 1116, Part I
H	Other	Form 1116, Part I
	Deductions allocated and apportioned at partnership level to foreign source income	
I	Passive category	Form 1116, Part I
J	General category	
K	Other	
	Other information	
L	Total foreign taxes paid	Form 1116, Part II
M	Total foreign taxes accrued	Form 1116, Part II
N	Reduction in taxes available for credit	Form 1116, line 12
O	Foreign trading gross receipts	Form 8873
P	Extraterritorial income exclusion	Form 8873
Q	Other foreign transactions	See the Partner's Instructions
17.	**Alternative minimum tax (AMT) items**	
A	Post-1986 depreciation adjustment	See the Partner's Instructions and the Instructions for Form 6251
B	Adjusted gain or loss	
C	Depletion (other than oil & gas)	
D	Oil, gas, & geothermal—gross income	
E	Oil, gas, & geothermal—deductions	
F	Other AMT items	
18.	**Tax-exempt income and nondeductible expenses**	
A	Tax-exempt interest income	Form 1040, line 8b
B	Other tax-exempt income	See the Partner's Instructions
C	Nondeductible expenses	See the Partner's Instructions
19.	**Distributions**	
A	Cash and marketable securities	See the Partner's Instructions
B	Distribution subject to section 737	
C	Other property	
20.	**Other information**	
A	Investment income	Form 4952, line 4a
B	Investment expenses	Form 4952, line 5
C	Fuel tax credit information	Form 4136
D	Qualified rehabilitation expenditures (other than rental real estate)	See the Partner's Instructions
E	Basis of energy property	See the Partner's Instructions
F	Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
G	Recapture of low-income housing credit (other)	Form 8611, line 8
H	Recapture of investment credit	See Form 4255
I	Recapture of other credits	See the Partner's Instructions
J	Look-back interest—completed long-term contracts	See Form 8697
K	Look-back interest—income forecast method	See Form 8866
L	Dispositions of property with section 179 deductions	See the Partner's Instructions
M	Recapture of section 179 deduction	
N	Interest expense for corporate partners	
O	Section 453(l)(3) information	
P	Section 453A(c) information	
Q	Section 1260(b) information	
R	Interest allocable to production expenditures	
S	CCF nonqualified withdrawals	
T	Depletion information—oil and gas	
U	Amortization of reforestation costs	
V	Unrelated business taxable income	
W	Precontribution gain (loss)	
X	Section 108(i) information	
Y	Other information	

For Example 3



Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2012** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2012, or other tax year beginning , 2012, ending , 20 See separate instructions.

Your first name and initial **Glen**	Last name **Morgan**	**Your social security number** **222 22 2222**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions. **2305 El Camino Rd**	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). **Albia, IA 52531**		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county	Foreign postal code

Filing Status

Check only one box.

1 ☒ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**

Boxes checked on 6a and 6b: **1**

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see instructions)

Dependents on 6c not entered above

d Total number of exemptions claimed

Add numbers on lines above ▶ **1**

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2			7	
8a	**Taxable** interest. Attach Schedule B if required			8a	
b	**Tax-exempt** interest. **Do not** include on line 8a	8b			
9a	Ordinary dividends. Attach Schedule B if required			9a	
b	Qualified dividends	9b			
10	Taxable refunds, credits, or offsets of state and local income taxes			10	
11	Alimony received			11	
12	Business income or (loss). Attach Schedule C or C-EZ			12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			13	
14	Other gains or (losses). Attach Form 4797			14	
15a	IRA distributions	15a		b Taxable amount 15b	
16a	Pensions and annuities	16a		b Taxable amount 16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17	88,800
18	Farm income or (loss). Attach Schedule F			18	
19	Unemployment compensation			19	
20a	Social security benefits	20a		b Taxable amount 20b	
21	Other income. List type and amount			21	
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶			22	88,800

Adjusted Gross Income

23	Educator expenses	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	Health savings account deduction. Attach Form 8889	25			
26	Moving expenses. Attach Form 3903	26			
27	Deductible part of self-employment tax. Attach Schedule SE	27	6,273		
28	Self-employed SEP, SIMPLE, and qualified plans	28			
29	Self-employed health insurance deduction	29	7,000		
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid b Recipient's SSN ▶	31a			
32	IRA deduction	32			
33	Student loan interest deduction	33			
34	Tuition and fees. Attach Form 8917	34			
35	Domestic production activities deduction. Attach Form 8903	35			
36	Add lines 23 through 35			36	13,273
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶			37	75,527

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2012)

For Example 3

Worksheet 6-A. **Self-Employed Health Insurance Deduction Worksheet** *Keep for Your Records*

Note. Use a separate worksheet for each trade or business under which an insurance plan is established.

1. Enter the total amount paid in 2012 for health insurance coverage established under your business for 2012 for you, your spouse, and your dependents. Your insurance can also cover your child who was under age 27 at the end of 2012, even if the child was not your dependent. But **do not** include the following.

- Amounts for any month you were eligible to participate in a health plan subsidized by your or your spouse's employer or the employer of either your dependent or your child who was under the age of 27 at the end of 2012.
- Any amounts paid from retirement plan distributions that were nontaxable because you are a retired public safety officer.
- Any amounts you included on Form 8885, line 4.
- Any qualified health insurance premiums you paid to "U.S. Treasury-HCTC."
- Any health coverage tax credit advance payments shown in box 1 of Form 1099-H.
- Any payments for qualified long-term care insurance (see line 2) **1.** 7,000

2. For coverage under a qualified long-term care insurance contract, enter for each person covered the ***smaller*** of the following amounts.

a) Total payments made for that person during the year.

b) The amount shown below. Use the person's age at the end of the tax year.

$350— if that person is age 40 or younger
$660— if age 41 to 50
$1,310— if age 51 to 60
$3,500— if age 61 to 70
$4,370— if age 71 or older

Do not include payments for any month you were eligible to participate in a long-term care insurance plan subsidized by your or your spouse's employer or the employer of either your dependent or your child who was under the age of 27 at the end of 2012. If more than one person is covered, figure separately the amount to enter for each person. Then enter the total of those amounts . . . . **2.** ______

3. Add lines 1 and 2 . . . . **3.** 7,000

4. Enter your net profit* and any other earned income** from the trade or business under which the insurance plan is established. Do not include Conservation Reserve Program payments exempt from self-employment tax. If the business is an S corporation, skip to line 11 . . . . **4.** 88,800

5. Enter the total of all net profits* from: Schedule C (Form 1040), line 31; Schedule C-EZ (Form 1040), line 3; Schedule F (Form 1040), line 34; or Schedule K-1 (Form 1065), box 14, code A; plus any other income allocable to the profitable businesses. Do not include Conservation Reserve Program payments exempt from self-employment tax. See the Instructions for Schedule SE (Form 1040). ***Do not*** include any net losses shown on these schedules. **5.** 88,800

6. Divide line 4 by line 5 . . . . **6.** 1.000

7. Multiply Form 1040, line 27, by the percentage on line 6 . . . . **7.** 6,273

8. Subtract line 7 from line 4 . . . . **8.** 82,527

9. Enter the amount, if any, from Form 1040, line 28, attributable to the same trade or business in which the insurance plan is established . . . . **9.** ______

10. Subtract line 9 from line 8 . . . . **10.** 82,527

11. Enter your Medicare wages (Form W-2, box 5) from an S corporation in which you are a more-than-2% shareholder and in which the insurance plan is established . . . . **11.** ______

12. Enter any amount from Form 2555, line 45, attributable to the amount entered on line 4 or 11 above, or any amount from Form 2555-EZ, line 18, attributable to the amount entered on line 11 above . . . . **12.** ______

13. Subtract line 12 from line 10 or 11, whichever applies **13.** 82,527

14. Enter the **smaller** of line 3 or line 13 here and on Form 1040, line 29. **Do not** include this amount when figuring any medical expense deduction on Schedule A (Form 1040). **14.** 7,000

* If you used either optional method to figure your net earnings from self-employment from any business, do not enter your net profit from the business. Instead, enter the amount attributable to that business from Schedule SE (Form 1040), Section B, line 4b.

** ***Earned income*** includes net earnings and gains from the sale, transfer, or licensing of property you created. However, it does not include capital gain income.

Benefits received. For information on excluding benefits you receive from a long-term care contract from gross income, see Publication 525.

Other coverage. You cannot take the deduction for any month you were eligible to participate in any employer (including your spouse's) subsidized health plan at any time during that month, even if you did not actually participate. In addition, if you were eligible for any month or part of a month to participate in any subsidized health plan maintained by the employer of either your dependent or your child who was under age 27 at the end of 2012, do not use amounts paid for coverage for that month to figure the deduction.These rules are applied separately to plans that provide long-term care insurance and plans that do not provide long-term care insurance. However, any medical insurance payments not deductible on Form 1040, line 29, can be included as medical expenses on Schedule A (Form 1040), Itemized Deductions, if you itemize deductions.

Effect on itemized deductions. Subtract the health insurance deduction from your medical insurance when figuring medical expenses on Schedule A (Form 1040) if you itemize deductions.

SMALL BUSINESS RETIREMENT PLANS

Small businesses have many different options when considering which type of retirement plans they want to establish. Each type of plan comes with its own rules and limitations. There are three basic types of plans.

1. Individual retirement arrangements (IRAs)
2. Defined contribution plans
3. Defined benefit plans

IRA plans allow employees to have certain amounts deducted from their wages and remitted to their personal IRA accounts. In addition to traditional IRAs, plans under this category include Roth IRAs, SIMPLE IRAs, and SEP IRAs. SIMPLE and SEP plans incorporate aspects of defined contribution plans in addition to the employee deferrals.

In **defined contribution plans,** a specified amount or percentage of wages is paid into accounts for the benefit of the recipients. Plans in this category include 401(k) accounts and profit-sharing arrangements. These plans **may** include employee deferrals in addition to employer contributions.

Defined benefit plans promise to pay out a certain amount in the future after the recipient retires. Defined benefit plans are becoming less popular because the company bears the investment risks. These plans are **not** covered in this chapter.

The appendix to this chapter contains charts that summarize the key provisions and differences between the plans.

ESTABLISHING A PLAN[25]

Sponsoring a retirement plan has four stages.

1. Choosing
2. Establishing
3. Operating
4. Terminating

A plan sponsor should choose a plan by considering the retirement goals of its participants and learning about the specific ways that money can be put aside for retirement, including types of tax-qualified retirement plans.

Depending on the type of plan chosen, the steps necessary to establish a plan may include the following.

1. Adopting a written plan
2. Arranging a fund for the plan’s assets
3. Notifying eligible employees about the terms of the plan
4. Developing a recordkeeping system

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[25] *Lots of Benefits — When You Set Up an Employee Retirement Plan.* [www.irs.gov/Retirement-Plans/Plan-Sponsor/Lots-of-Benefits---when-you-set-up-an-employee-retirement-plan] Accessed on Jun. 3, 2013.

It is important for plan sponsors to operate the retirement plan so that the assets in the plan continue to grow and the tax benefits of the plan are preserved. The ongoing steps needed to operate the plan may vary depending on the type of plan established. The basic steps usually include the following.

1. Covering eligible employees
2. Making contributions
3. Keeping the plan up to date with retirement plan laws
4. Managing the plan assets
5. Providing information to employees participating in the plan
6. Distributing benefits

When the plan no longer suits the business, the sponsor may terminate the plan. At that time, it must notify the appropriate parties that the plan has been discontinued.

TOP-HEAVY PROVISIONS[26]

The Code requires that **most** qualified retirement plans meet additional conditions when the plans are found to be top-heavy. A top-heavy plan is one that mainly favors partners, sole proprietors, and other key employees.

The term **key employee** means an employee who, at any time during the plan year, may be described in one of the following ways.

1. An officer of the employer having an annual compensation greater than $165,000 in 2013[27]
2. A 5% owner of the employer (If the employer is a corporation, a 5% owner is any employee who owns more than 5% of the value or combined voting power of the corporation's stock. For noncorporate employers, a 5% owner is any employee who owns more than 5% of the capital or profits interest in the employer.[28])
3. A 1% owner of the employer having an annual compensation from the employer of more than $150,000 (The rules used to determine which employees are 1% owners are the same as those listed in item 2, substituting "1%" for "5%.")

For employees, the term **"compensation"** must be defined in the plan documents. The regulations allow for four specific definitions. Alternatively, employers can adopt any definition that is "reasonable."[29]

1. Compensation includes all wages, salaries, and other amounts received that are includible in the employee's gross income without subtracting elective deferrals.
2. Under the "traditional safe harbor" definition,[30] compensation includes all gross wages, plus fringe benefits and reimbursements or other expense allowances under nonaccountable plans. However, the specific items listed under Treas. Reg. §1.415-2(d)(2)(ii)–(vi) **may** be excluded from the safe harbor definition of compensation.
3. The second safe harbor definition[31] generally allows a plan to use the compensation reported in box 1 of Form W-2, *Wage and Tax Statement,* plus elective deferrals to retirement plans.
4. The third safe harbor definition[32] only includes wages subject to federal income tax withholding plus elective deferrals to retirement plans. This is a less inclusive definition of compensation than the other two safe harbors, because it excludes all taxable reimbursements and the taxable cost of group-term life insurance coverage.

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[26] IRC §416.

[27] IRS News Rel. IR-2012-77 (Oct. 18, 2012).

[28] Treas. Reg. §1.416-1.

[29] *Compensation.* [www.irs.gov/pub/irs-tege/epchd304.pdf] Accessed on Jun. 4, 2013.

[30] Treas. Reg. §1.415-2(d)(10).

[31] Treas. Reg. §1.415-2(d)(11)(i).

[32] Treas. Reg. §1.415-2(d)(11)(ii).

For self-employed individuals, compensation is defined differently, depending on the plan. The two basic methods are described in this text as the **SEP method** and the **SIMPLE method.** These are defined later in this section.

Annual Testing[33]

Plan sponsors must test certain tests each year to ensure that the amount of contributions made by and for **non-highly-compensated** employees (NHCE) are proportional to contributions made for **highly-compensated** employees (HCE). These nondiscrimination tests are known as the **actual deferral percentage (ADP)** and **actual contribution percentage (ACP)** tests.

The **ADP** test counts **elective deferrals** (both pretax and Roth deferrals, but **not** catch-up contributions) of the HCEs and NHCEs. Dividing a participant's elective deferrals by the participant's compensation determines each participant's actual deferral ratio (ADR). The average ADR for all NHCEs (even those who chose **not** to defer) is the ADP for the NHCE group. The same type of calculation is done for the HCEs to determine their ADP.

The ADP test is met if the ADP for the eligible HCEs does not exceed the **greater** of the following.

1. 125% of the ADP for the group of NHCEs
2. The lesser of:
   - **a.** 200% of the ADP for the group of all NHCEs, or
   - **b.** 102% of the ADP for the participating NHCEs

The **ACP** is calculated in the same manner, except that that it uses **the matching and after-tax contributions** for each participant, rather than the elective deferrals used in the ADP test. The ACP test is met if the ACP for the eligible HCEs does not exceed the **greater** of the following.

1. 125% of the ACP for the group of NHCEs
2. The lesser of:
   - **a.** 200% of the ACP for the group of NHCEs, or
   - **b.** 102% of the ACP for the participating NHCEs.

The ADP and ACP percentages for NHCEs may be based on either the current- or prior-year contributions. The election to use current- or prior-year data is contained in the plan document. Under limited circumstances, the election may be changed.

> **Note.** These calculations can be complex and must be done in accordance with the definitions found in the plan documents as well as in the Code and regulations. Practitioners are advised to consult with professional plan administrators whenever possible. Additional information, including how to fix common errors, may be found at **www.irs.gov/Retirement-Plans/IRC-401(k)-Plans-Additional-Resources.**

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[33] *401(k) Plan Fix-It Guide — The Plan Failed the 401(k) ADP and ACP Nondiscrimination Tests.* [www.irs.gov/Retirement-Plans/401(k)-Plan-Fix-It-Guide---The-plan-failed-the-401(k)-ADP-and-ACP-nondiscrimination-tests.] Accessed on Jun. 11, 2013.

IRA-BASED PLANS[34]

Payroll Deduction IRAs

Even if an employer does not want to adopt a retirement plan, the employer can allow its employees to contribute to an IRA through payroll deductions. This provides the employees with a simple and direct way to save for retirement. In this type of arrangement, the employee always makes the decisions about whether, when, and how much to contribute to the IRA. The maximum contributions for 2013 are $5,500 for individuals under age 50 and $6,500 for individuals who are age 50 or older.

This type of arrangement is not considered a retirement plan.[35] Therefore, the employees' gross wages are not reduced by the amounts the employer withheld on behalf of the employee. In addition, the retirement plan box in box 13 of Form W-2 should not be checked. For the employees' convenience, employers may indicate in box 14 the amount and type of payroll deduction IRA contributions withheld for the year, but this is not required.

Simplified Employee Pensions (SEP)[36]

A SEP plan allows employers to set up SEP IRAs for themselves and their employees. The employer always contributes to this type of plan. Employees are only given the option to make voluntary contributions under SARSEP plans established prior to 1997.

Employers must contribute a uniform percentage of pay for each employee. However, under this type of plan, employers are not required to make contributions every year. Because the employer can decide how much to put into a SEP each year, this plan gives the company the flexibility to deal with fluctuating business conditions.

Most employers, including individuals who are self-employed, can establish a SEP plan. SEPs have low start-up and operating costs and can be established using Form 5305-SEP, *Simplified Employee Pension — Individual Retirement Accounts Contribution Agreement*.

SEP IRA plans **are** subject to top-heavy requirements. However, if the total employer contributions are at least 3% of the non-key employees' wages, the employer qualifies for an exception to the top-heavy restrictions.[37] If total employer contributions are less than 3%, the employer may elect to use either an aggregate employer contributions test or an aggregate account values test to determine whether the plan is subject to additional top-heavy requirements.[38]

Employers have until the due date of the return, including extensions, to make contributions to the plan. The contributions are deductible on the return for the year for which the contributions are made, even if the taxpayer uses the cash basis for tax reporting.

Employer contributions are not taxable to the employees until withdrawn. In addition, they are not reported on the employees' Forms W-2. However, the retirement plan box must be checked. **Elective deferrals** by employees in a SARSEP plan reduce the wages reported in box 1 of Form W-2 and are reported in box 12 using code "F."[39]

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[34] IRS Pub. 3998, *Choosing a Retirement Solution for Your Small Business,* and IRS Pub. 560, *Retirement Plans for Small Business.*

[35] 2013 General Instructions for Forms W-2 and W-3.

[36] IRC §408(k).

[37] IRC §408(k)(1)(B), referencing IRC §416(c)(2).

[38] IRC §416(i)(6)(B).

[39] General Instructions for Forms W-2 and W-3.

The most significant downside to the SEP plan is the broad eligibility requirements. It must cover all employees who:

1. Are at least 21 years of age,
2. Were employed by the employer for three of the last five years, and
3. Received compensation of $550 or more in 2013.

> **Note.** Employees who meet the above three requirements in the year in question must be covered regardless of whether the employee was temporary, part time, or not employed at yearend.

Employer contributions are limited to the **lesser** of 25% of the employee's pay (limited to $255,000 per participant) or $51,000 in 2013.[40] The effective limit for self-employed individuals is their net profit after contributions to employees' accounts less the deductible portion of SE taxes, multiplied by 20%.

Example 4. Doris is the sole proprietor of a very successful insurance business, which reports its income and expenses on the cash basis. She has one employee, Fred. The company has a SEP plan in place.

In 2013, Fred earns $20,000 in gross wages. Doris's net income shown on Schedule C, *Profit or Loss from Business,* is $150,000 before considering any SEP contributions. After projecting her 2013 tax liability, Doris decides to make the maximum contribution to the SEP accounts for each of them.

The amount that she may contribute to Fred's SEP IRA is 25% of $20,000, or $5,000. She **may deduct** this contribution on her 2013 Schedule C even though she does not remit the money until after the end of the year. She has until the deadline of her return, including extensions, to make the contribution.

The amount that she will contribute to her SEP IRA is $27,202, as calculated below.

Rate:			
	A.	Plan contribution rate (not reduced rate)	25%
		Plan contribution rate on line A plus one	÷ 125%
	B.	Self-employed reduced rate	20%
Steps:			
		Net profit from self-employment before SEP contributions	$150,000
		Contribution to Fred's SEP	(5,000)
		Net profit from self-employment after SEP contributions	$145,000
		Deduction for employer's portion of SE tax	(8,991)
		Net profit after adjustment for SE taxes	$136,009
		Multiply by self-employed reduced rate from line B above	× 20%
	C.	Result	$ 27,202
		Maximum wage amount	$255,000
		Multiplied by plan contribution rate from line A above	× 25%
	D.	Result	$ 63,750
	E.	Enter the lesser of C or D	$ 27,202
	F.	Contribution dollar limit for 2013	$ 51,000
		SEP IRA contribution (lesser of E or F)	$ 27,202

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[40] IRS Pub. 560, *Retirement Plans for Small Business.*

SIMPLE IRA Plans[41]

A SIMPLE IRA plan is a retirement plan option for employers with 100 or fewer employees. This plan allows **employees** to contribute a percentage of their salary each pay period. It also requires that **employers** contribute certain minimum amounts.

Under SIMPLE IRA plans, employees can contribute up to $12,000 in 2013 ($14,500 if age 50 or older) by payroll deduction. Employers must either:

1. **Match** employee contributions dollar-for-dollar **up to 3% of an employee's compensation**, or
2. Make a **fixed contribution of 2% of compensation for all eligible employees**, even if the employees choose **not** to contribute.

If the employer chooses a matching contribution of less than 3%, the percentage **cannot** be less than 1%. In addition, the employees must be notified of the lower match within a reasonable period of time before the employees must determine their elective deferrals for the calendar year. Furthermore, employers **cannot** choose a percentage less than 3% for more than two years during the 5-year period that ends with the year for which the choice is effective.

The eligibility requirements for SIMPLE IRA plans are more employer-friendly than those for the SEP IRA plans. Any employee who received at least $5,000 in compensation during any two years preceding the current calendar year and who is reasonably expected to receive at least $5,000 during the current calendar year is eligible to participate. Here, the term "employee" includes a self-employed individual who realizes a profit from their sole proprietorship.

If the plan provides for it, employers may choose to automatically enroll employees in SIMPLE IRA plans. However, the employees must be allowed to choose the amount of their salary reduction contributions or to contribute nothing.

SIMPLE IRA plans are easy to set up. Form **5304**-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) — Not for Use With a Designated Financial Institution,* is used if the employees are allowed to select the financial institution where the SIMPLE IRA is established. Form **5305**-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—for Use With a Designated Financial Institution,* is used if all contributions under the plan are deposited initially at a designated financial institution of the employer's choosing.

The SIMPLE IRA contributions made by the employer are not taxable to the employees until withdrawn. On the employee's Form W-2, voluntary salary deferrals are deducted from the wages reported in box 1. The deferral amount is reported in box 12 using code "S."[42]

SIMPLE IRA contributions are deductible in the tax year within which the calendar year for which contributions were made ends. Matching and nonelective contributions for a particular tax year must be made by the due date, including extensions, of the employer's income tax return for that year.

> **Example 5.** Sammie Jo is a sole proprietor whose tax year is the calendar year. Contributions made under a SIMPLE IRA plan for the calendar year 2012 (including contributions made in 2013 by April 15, 2013) are deductible by Sammie Jo in the 2012 tax year.

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[41] IRC §408(p).

[42] General Instructions for Forms W-2 and W-3.

Example 6. Use the same facts as **Example 4,** except that Doris has a SIMPLE IRA plan instead of a SEP. In October 2012, Doris notified Fred that she planned to match employee contributions up to 3% of compensation in 2013. Fred chooses to contribute the maximum amount allowed; he is under age 50 in 2013, so his voluntary payroll deduction is $12,000 for 2013.

Fred's 2013 wages are $20,000. Doris's 3% match into Fred's SIMPLE IRA is capped at $600. Doris has 30 days after withholding Fred's voluntary contributions to deposit them into his account. She has until the due date of her return, including extensions, to deposit the matching contribution of $600.

Doris is over age 50, so her maximum deferral for 2013 is $14,500. The calculation of her matching contribution of $4,139 follows.

Net profit from self-employment before SIMPLE matching contributions	$150,000
Less: contribution to Fred's SIMPLE	(600)
Net profit from self-employment after SIMPLE matching	$149,400
Multiplied by taxable SE percentage	× 92.35%
Net earnings from self-employment	$137,971
Multiplied by matching percentage	× 3.00%
Matching contribution	$ 4,139

Observations

1. SE income is determined differently in **Example 4** and **Example 6.** SE income under the SEP plan is based on IRC §401(c)(2), while SE income under the SIMPLE plan is based on IRC §1402(a).[43] There are two distinguishing factors in the calculations.
   a. The SEP calculation subtracts the self-employed person's IRA contribution from qualified earnings, while the SIMPLE calculation does not.
   b. The SEP calculation includes a deduction for the employer's portion of SE taxes, while the SIMPLE calculation adjusts for this factor by multiplying earnings by 92.35%.
2. In **Example 4,** Doris saves approximately $9,000 in federal income and SE taxes by contributing to her and Fred's SEP IRAs. After consideration of the $5,000 paid to fund Fred's SEP, she saves approximately $4,000. This observation does not consider the contribution to her SEP as an expense because the money belongs to her and is under her control.
3. In **Example 6,** Doris saves approximately $5,400 in federal income and SE taxes by contributing to her and Fred's SIMPLE IRAs. After consideration of the $600 paid to match Fred's voluntary contributions, she saves approximately $4,800. As explained in **observation 2,** this does not consider the contributions to her SIMPLE IRA as an expense.
4. In **Example 4,** Doris is permitted to contribute **$27,202** to her own retirement funds, while in **Example 6,** her maximum contribution is only **$18,639** ($14,500 elective deferral + $4,139 matching contribution). Which plan is better for Doris depends in part on how much available cash she has each year to fund the plan.
5. The SEP plan is subject to top-heavy requirements, but the SIMPLE plan is not.

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[43] IRC §408(p)(6)(A)(ii).

DEFINED CONTRIBUTION PLANS[44]

A defined contribution plan provides an individual account for each plan participant. It provides benefits to a participant largely based on the amount contributed to that participant's account. The two basic types of employer-funded plans are the following.

1. **Profit-sharing** plans, in which the employer has the option of whether to contribute to the plan
2. **Money purchase** plans, in which the contribution is set each year

In addition to the employer-funded plans, many small businesses also offer 401(k) plans, which let the employees elect to defer some of their current compensation into the plan. Some employers use a combination of these types of plans.

Under both types of plans, contributions made by the employer are not taxable to the employees until withdrawn. On Form W-2, voluntary salary deferrals are deducted from the wages reported in box 1. The deferral amount is reported in box 12 of Form W-2 using code "D."[45]

Qualification Rules

To qualify for the tax benefits available to qualified plans, most plans must meet certain requirements, such as the following.

1. Plan assets must not be diverted. The plan must prohibit its assets from being used for, or diverted to, purposes other than the benefit of employees and their beneficiaries.
2. Minimum coverage requirements must be met. The plan must benefit at least the lesser of the following.
   - **a.** 50 employees
   - **b.** The greater of:
     - **i.** 40% of all employees
     - **ii.** Two employees

   If there is only one employee, the plan must benefit that employee.
3. Contributions must not discriminate in favor of HCEs.
4. Annual contributions must not be more than certain limits.
5. Minimum vesting standards must be met. A benefit is vested when it becomes nonforfeitable. Special rules apply to forfeited benefit amounts. In defined contribution plans, forfeitures can be allocated to the accounts of remaining participants in a nondiscriminatory way, or they can be used to reduce the employer's contributions.
6. In general, an employee must be allowed to participate in the plan if the employee has:
   - **a.** Reached age 21, and
   - **b.** Provided at least one year of service. This eligibility requirement can be modified to two years if the plan is **not** a 401(k) plan and if it provides 100% vesting after **not more than** two years.
7. A plan **cannot** exclude employees because they have reached a specified age.
8. For 2013, no more than $255,000 of the employee's compensation can be taken into account when calculating matching contributions and nonelective contributions.

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[44] IRS Pub. 3998, *Choosing a Retirement Solution for Your Small Business,* and IRS Pub. 560, *Retirement Plans for Small Business.*

[45] General Instructions for Forms W-2 and W-3.

Profit-Sharing Plans

Employer contributions to a profit-sharing plan can be discretionary. Depending on the plan terms, there is often no set amount that an employer needs to contribute each year.

The plan must have a set formula for determining how the contributions are allocated among plan participants. The funds are accounted for separately for each employee.

Profit-sharing plans can vary greatly in complexity. Many financial institutions offer prototype profit-sharing plans that can reduce the administrative burden on individual employers.

The term "profit-sharing plan" can be misleading. The business does not actually have to show a profit for the year in order to make a contribution to employees' accounts. However, contributions by self-employed taxpayers to their own accounts are limited to adjusted SE income from the business under which the plan is established.

Money Purchase Plans

Contributions to a money purchase plan are fixed and not discretionary. For example, if the plan requires that contributions be 10% of the participants' compensation, the plan is a money purchase plan. The 10% also applies to the net profits from the business of a self-employed individual as adjusted for contributions and SE taxes.

401(k) Plans

Section 401(k) plans have become a widely accepted retirement savings vehicle for small businesses. Under these plans, employees can choose to defer up to a certain portion of their salary. These deferrals are accounted for separately for each employee. Generally, deferrals are made on a pretax basis but, if the plan allows, they can also be made on an after-tax (Roth) basis at the employee's option.

Many 401(k) plans provide for employer matching or other contributions. Depending on the terms of the plan, 401(k) contributions may include elective deferrals, profit sharing, and/or money purchase components.

Unless specified differently, the following provisions apply to all types of 401(k) plans.

1. **Limit on elective deferrals.** For 2013, the basic limit on elective deferrals is $17,500. This limit applies to all salary reduction contributions and elective deferrals. If, in conjunction with other plans, the deferral limit is exceeded, the difference is included in the employee's gross income.

2. **Catch-up contributions.** A 401(k) plan can permit participants who are age 50 or over at the end of the calendar year to make additional catch-up contributions. The catch-up contribution limit for 2013 is $5,500. Elective deferrals are not treated as catch-up contributions for 2013 until they exceed the $17,500 limit, the application of participation and discrimination standards (ADP) test limit,[46] or the plan limit (if any). However, the catch-up contribution a participant can make for a year **cannot** exceed the lesser of the following amounts.

    a. The catch-up contribution limit

    b. The excess of the participant's compensation over the elective deferrals that are not catch-up contributions

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[46] IRC §401(k)(3).

Like most profit-sharing plans, 401(k) plans can vary significantly in their complexity. However, under IRS provisions, the plans can be classified into four basic types.

1. Traditional 401(k)
2. SIMPLE
3. Safe harbor 401(k)
4. Automatic enrollment 401(k)

> **Note.** A "solo 401(k)" is a 401(k) whose only participant is the owner of the business (or general partners of a partnership). A solo 401(k) plan may incorporate the rules for any of the four types of 401(k) plans. One significant benefit of choosing to establish a solo 401(k) over any of the IRA-based plans is the ability to borrow from the account.

Traditional 401(k).[47] A traditional 401(k) plan offers the maximum flexibility among the various types of plans. Employers have discretion over whether to make contributions for all participants, to match employees' deferrals, to do both, or to do neither. In addition, the contributions can be subject to a vesting schedule, which provides that an employee's right to employer contributions becomes nonforfeitable only after a certain period of time.

However, annual testing must be done to ensure that the benefits for rank-and-file employees (NHCEs) are proportional to benefits for owners/managers (HCEs). The required ADP and ACP tests are discussed earlier in this chapter.

SIMPLE 401(k).[48] Employers may adopt a SIMPLE 401(k) plan if there are 100 employees or fewer. The key benefit is that a SIMPLE 401(k) plan is not subject to the nondiscrimination and top-heavy rules if the following conditions are met.

1. Under the plan, employees can elect to defer a certain percentage of their compensation but not more than $12,000 for 2013. If permitted under the plan, an employee who is age 50 or over can also make a catch-up contribution of up to $2,500 for 2013.
2. The employer must either make:
   a. **Matching** contributions up to 3% of compensation for the year, **or**
   b. **Nonelective** contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation for the year.
3. No other contributions can be made to the assets under the plan.
4. No contributions are made, and no benefits accrue, **under any other** qualified retirement plan sponsored by the employer on behalf of any employee eligible to participate in the SIMPLE 401(k) plan.
5. All contributions vest immediately to the employees.

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[47] IRS Pub. 4222, *401(k) Plans for Small Businesses.*

[48] IRS Pub. 560, *Retirement Plans for Small Business; Choosing a Retirement Plan: SIMPLE 401(k) Plan.* [www.irs.gov/Retirement-Plans/Choosing-a-Retirement-Plan:-SIMPLE-401%28k%29-Plan] Accessed on Jun. 12, 2013.

Safe Harbor 401(k). If the plan meets the requirements for a safe harbor 401(k) plan, it does not have to satisfy either the ADP test or the ACP test. For the plan to be a safe harbor plan, it must meet the following conditions.

1. **Matching or nonelective contributions.** The employer must make either matching or nonelective contributions according to **one** of the following formulas.
    a. **Matching contributions.** The employer must make the following matching contributions and the matching funds must vest immediately.
        i. The employer must contribute an amount equal to 100% of each NHCE's elective deferrals, up to 3% of compensation.
        ii. The employer must contribute an amount equal to 50% of each NHCE's elective deferrals that exceed 3% but do not exceed 5% of compensation.
        iii. The rate of matching contributions for HCEs, including a self-employed owner, must **not** exceed the rates for NHCEs.
    b. **Nonelective contributions.** The employer must make nonelective contributions, without regard to whether the employee made elective deferrals, on behalf of all NHCEs eligible to participate in the plan, equal to at least 3% of the employee's compensation.
2. **Notice requirement.** The employer must give eligible employees written notice of their rights and obligations with regard to contributions under the plan within a reasonable period before the plan year.

Automatic Enrollment 401(k). An employer's 401(k) plan may have an eligible automatic contribution arrangement (EACA). Under this feature, the employer automatically enrolls all qualifying employees as participants in the plan. Each participant is treated as having elected to make contributions in an amount equal to a uniform percentage of compensation. This automatic election remains in place until the participant specifically elects not to have such deferral percentage made or elects a different percentage. These automatic contributions are still considered elective deferrals. The automatic enrollment feature encourages employees' saving for retirement and helps the plan pass nondiscrimination testing, if applicable.

Note. For more information, see IRS Pub. 4674, *Automatic Enrollment 401(k) Plans for Small Businesses.*

Under an EACA, the plan may allow participants to **withdraw their automatic contributions** to the plan if both of the following conditions are met.

1. The participant elects to withdraw no later than 90 days after the date of the first elective contributions under the EACA.
2. The participant withdraws the entire amount of EACA default contributions, including any earnings thereon.

If the plan allows withdrawals under the EACA, the amount of the withdrawal, other than the amount of any designated Roth contributions, must be included in the employee's gross income for the tax year in which the distribution is made. The additional 10% tax on early distributions does **not** apply to the distribution.

Employees must be given written notice of the terms of the EACA within a reasonable period of time before each plan year. The notice must be written in a manner calculated to be understood by the average employee and be sufficiently accurate and comprehensive in order to apprise the employee of their rights and obligations under the EACA. The notice must include an explanation of the employee's right to elect **not** to have elective contributions made on their behalf or to elect a different percentage, and the employee must be given a reasonable period of time after receipt of the notice before the first elective contribution is made. The notice also must explain how contributions will be invested in the absence of an investment election by the employee.

A **qualified automatic contribution arrangement** (QACA) is a new type of safe harbor plan that also has the EACA feature. In addition to the automatic enrollment feature, mandatory employer contributions are required. If the plan includes a QACA, it is not subject to the ADP test. Additionally, the plan is not subject to the ACP test if certain other requirements are met. Under a QACA, each employee who is eligible to participate in the plan is treated as having elected to make elective deferral contributions equal to a certain default percentage of compensation. In order to **not** have default elective deferrals made, an employee must make an affirmative election specifying a deferral percentage (which can be zero, if desired). If an employee does not make an affirmative election, the default deferral percentage must meet the following conditions.

1. It must be applied uniformly.
2. It must not exceed 10%.
3. It must be at least 3% in the first plan year it applies to an employee and through the end of the following year.
4. It must increase to at least 4% in the following plan year.
5. It must increase to at least 5% in the following plan year.
6. It must increase to at least 6% in subsequent plan years.

Under the terms of the QACA, the employer must make **either** matching or nonelective contributions according to the following terms.

1. **Matching contributions.** The employer must make matching contributions on behalf of each NHCE in the following amounts.

    a. 100% of elective deferrals, up to 1% of compensation

    b. 50% of elective deferrals that exceed 1% but do not exceed 6% of compensation

    Other formulas may be used as long as they are at least as favorable to NHCEs. The rate of matching contributions for HCEs, including a self-employed owner, must not exceed the rates for NHCEs.

2. **Nonelective contributions.** The employer must make nonelective contributions on behalf of every NHCE eligible to participate in the plan, regardless of whether they elected to participate, in an amount equal to at least 3% of their compensation.

All accrued benefits attributed to matching or nonelective contributions under the QACA must be 100% vested for all employees who complete two years of service. These contributions are subject to special withdrawal restrictions not covered in this text.

Each employee eligible to participate in the QACA must receive **written notice** of their rights and obligations under the QACA within a reasonable period before each plan year. The notice is subject to the same requirements as those specified previously for the EACA.

NOL CARRYFORWARDS

The rules governing net operating loss (NOL) carrybacks and carryforwards generally apply to all taxpayers regardless of whether the taxpayer is an individual, corporation, partnership, trust, or estate. If the carryback period is waived or if there is any NOL remaining after the carryback is applied, the NOL carryforward is entered on the following year's return. If there is any NOL remaining at that time, it continues to carry forward until it is completely depleted or until it expires at the end of 20 years. When losses from more than one NOL year are carried forward, the earliest year is utilized first.

INDIVIDUALS

Calculating the NOL Carryforward

If an individual's taxable income before subtracting exemptions is positive, the taxpayer does not have an NOL. If this number is negative, the taxpayer **may** have an NOL.

The income and losses on the return must be analyzed to determine whether the taxpayer actually has an NOL and, if so, the amount of the NOL. The first step is to separate the taxpayer's current-year return into business and nonbusiness activities.

Tax preparation software can categorize some of the activities; however, most programs require that the user manually allocate some of the income and expenses. The worksheets in **Example 7** show how the income and deductions are classified when computing the amount of the NOL. They also show which items the software may classify automatically and which items may require user intervention. On the worksheets, "xxxxxxxx" means that an amount **cannot** be entered on that line.

> **Example 7.** Amy is a neuroscientist who left her job at a prominent state university in 2011, where she earned $7,000 in wages, to open a high-end fashion boutique at the behest of her best friend, Penny. In 2011, her retail establishment, a sole proprietorship, incurred a net loss of $100,000.
>
> Amy funded the venture with money she had set aside in 2007 after selling a patent for a drug that cures social anxiety. She also sold some stocks, incurring a $5,000 loss on the sale. During 2011, Amy used $12,000 in alimony and $6,350 of interest income to fund her frugal lifestyle.
>
> Excerpts from her 2011 Form 1040 and the classification worksheets follow.

For Example 7

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return 2011 OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2011, or other tax year beginning , 2011, ending , 20 See separate instructions.

Your first name and initial Amy	Last name Birder	**Your social security number** 3 5 5 5 5 5 5 5 5
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions. 123 Green St	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Urbana, IL 61801		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/county	Foreign postal code

Filing Status

Check only one box.

1 ☒ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**

Boxes checked on 6a and 6b: 1

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see instructions)

Dependents on 6c not entered above

d Total number of exemptions claimed

Add numbers on lines above ▶ 1

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

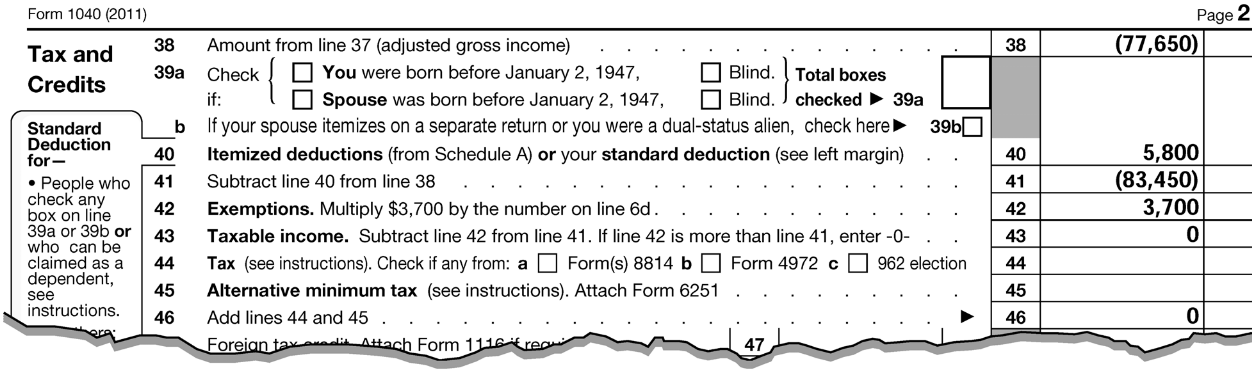
7	Wages, salaries, tips, etc. Attach Form(s) W-2			7	7,000
8a	**Taxable** interest. Attach Schedule B if required			8a	6,350
b	**Tax-exempt** interest. **Do not** include on line 8a	8b			
9a	Ordinary dividends. Attach Schedule B if required			9a	
b	Qualified dividends	9b			
10	Taxable refunds, credits, or offsets of state and local income taxes			10	
11	Alimony received			11	12,000
12	Business income or (loss). Attach Schedule C or C-EZ			12	(100,000)
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			13	(3,000)
14	Other gains or (losses). Attach Form 4797			14	
15a	IRA distributions	15a		b Taxable amount 15b	
16a	Pensions and annuities	16a		b Taxable amount 16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17	
18	Farm income or (loss). Attach Schedule F			18	
19	Unemployment compensation			19	
20a	Social security benefits	20a		b Taxable amount 20b	
21	Other income. List type and amount			21	
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶			22	(77,650)

Adjusted Gross Income

23	Educator expenses	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	Health savings account deduction. Attach Form 8889	25			
26	Moving expenses. Attach Form 3903	26			
27	Deductible part of self-employment tax. Attach Schedule SE	27			
28	Self-employed SEP, SIMPLE, and qualified plans	28			
29	Self-employed health insurance deduction	29			
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid b Recipient's SSN ▶	31a			
32	IRA deduction	32			
33	Student loan interest deduction	33			
34	Tuition and fees. Attach Form 8917	34			
35	Domestic production activities deduction. Attach Form 8903	35			
36	Add lines 23 through 35			36	
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶			37	(77,650)

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2011)

For Example 7



Form 1040 (2011) Page **2**

Tax and Credits	38	Amount from line 37 (adjusted gross income)	38	(77,650)
	39a	Check if: ☐ **You** were born before January 2, 1947, ☐ Blind. ☐ **Spouse** was born before January 2, 1947, ☐ Blind. } **Total boxes checked ▶ 39a** ☐		
	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b☐		
Standard Deduction for— • People who check any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions.	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	40	5,800
	41	Subtract line 40 from line 38	41	(83,450)
	42	**Exemptions.** Multiply $3,700 by the number on line 6d	42	3,700
	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	0
	44	**Tax** (see instructions). Check if any from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ 962 election	44	
	45	**Alternative minimum tax** (see instructions). Attach Form 6251	45	
	46	Add lines 44 and 45 ▶	46	0
		Foreign tax credit. Attach Form 1116 if requi	47	

NOL Worksheet 1

Allocation of ***Income*** *between Business Income and Nonbusiness Income*

Location on 2011 Form 1040	Item	Amount on Tax Return	Disposition	Amount as Business	Amount as Nonbusiness	AMT Nonbusiness
A. Line 7	Wages, salary, etc.	7,000	Business	7,000	xxxxxxxx	xxxxxxxx
B. Line 8a	Taxable interest	6,350	Nonbusiness	xxxxxxxx	6,350	
C. Line 8b	Tax-exempt interest		Nonbusiness [a]	xxxxxxxx	xxxxxxxx	
D. Line 9a	Ordinary dividends		Nonbusiness	xxxxxxxx		
E. Line 10	Taxable refunds		Allocate [b]			
F. Line 11	Alimony	12,000	Nonbusiness	xxxxxxxx	12,000	
G. Line 12	Business income (loss) Schedule C	(100,000)	Business	(100,000)	xxxxxxxx	xxxxxxxx
H. Line 14	Form 4797 gain (loss)		Business		xxxxxxxx	xxxxxxxx
I. Line 15b	Taxable amount of IRA distributions		Nonbusiness	xxxxxxxx		
J. Line 16b	Taxable amount of pensions		Nonbusiness	xxxxxxxx		
K. Line 17	Rents, royalties, and partnership income		Usually business			
L. Line 18	Farm income (loss)		Business		xxxxxxxx	xxxxxxxx
M. Line 19	Unemployment compensation		Business		xxxxxxxx	xxxxxxxx
N. Line 20b	Taxable social security benefits		Nonbusiness	xxxxxxxx		
O. Line 21	Other income		Allocate			
P. Total		(74,650)		(93,000)	18,350	

[a] Nontaxable interest is nonbusiness income for AMT purposes only.

[b] The state and local income tax refund is to be allocated between business and nonbusiness income according to the income of the year that created the refund. For this allocation, salaries and wages are treated as business income. State and local income tax refunds are not included when calculating AMT.

NOTE: "xxxxxxxx" means that an amount cannot be added on that line.

For Example 7

NOL Worksheet 2

Allocation of ***Deductions*** *between Business Deductions and Nonbusiness Deductions*

Location on 2011 Form 1040	Item	Amount on Tax Return	Disposition	Amount as Business	Amount as Nonbusiness	AMT Nonbusiness
A. Line 23	Educator expenses		Business		xxxxxxxx	xxxxxxxx
B. Line 24	Business expense of reservists, etc.[a]		Business		xxxxxxxx	xxxxxxxx
C. Line 25	HSA & MSA ded.		Nonbusiness	xxxxxxxx		
D. Line 26	Moving expenses		Business		xxxxxxxx	xxxxxxxx
E. Line 27	SE tax deduction		Business		xxxxxxxx	xxxxxxxx
F. Line 28	SEP, SIMPLE, & qualified plans		Nonbusiness	xxxxxxxx		
G. Line 29	SE health insurance		Business		xxxxxxxx	xxxxxxxx
H. Line 30	Penalty, early withdrawal		Nonbusiness	xxxxxxxx		
I. Line 31a	Alimony		Nonbusiness	xxxxxxxx		
J. Line 32	IRA deduction		Nonbusiness	xxxxxxxx		
K. Line 33	Student loan interest ded.		Nonbusiness	xxxxxxxx		
L. Line 34	Tuition & fee deduction		Nonbusiness	xxxxxxxx		
M. Line 40a	Standard deduction (if claimed)	5,800	Nonbusiness	xxxxxxxx	5,800	xxxxxxxx[b]
Schedule A (Form 1040) (Itemized deductions, if claimed)						
N. Line 4	Medical		Nonbusiness	xxxxxxxx		[c]
O. Line 9	Taxes		Allocate[d]			xxxxxxxx
P. Line 15	Interest		Nonbusiness	xxxxxxxx		[e]
Q. Line 19	Contributions		Nonbusiness	xxxxxxxx		
R. Line 20	Casualty		Business		xxxxxxxx	xxxxxxxx
S. Line 27	Misc. (2% floor)		Allocate[f]			xxxxxxxx
T. Line 28	Other misc.		Allocate[g]			
U. Total		5,800			5,800	

[a] Include only "other" items such as unreimbursed expenses of artists (IRC §62(b)). Do not include amounts reported on lines 23 through 35.

[b] If the standard deduction was claimed for the regular tax, neither the standard deduction nor the itemized deductions can be claimed for the AMT.

[c] The medical deduction floor is 10% of the adjusted gross income for AMT purposes.

[d] The state and local income taxes paid are allocated between business and nonbusiness deductions according to the income of the year that created the taxes. For this allocation, salaries and wages are treated as business income. Taxes are not allowed as a deduction when calculating AMT.

[e] The alternative minimum tax interest deduction is the same as the regular tax interest deduction except for the following adjustments: (1) if debt on a personal residence has been refinanced, interest on debt in excess of the debt before refinancing cannot be deducted for AMT purposes; and (2) the investment interest deduction must be recalculated to include income from private activity bonds in investment income and the expenses on those bonds in investment expenses.

[f] Because the amount on line 27, Schedule A, is reduced by 2% of AGI, the amounts allocated to business and nonbusiness must be reduced on a pro-rata basis. Therefore, the amount in the business column should be the amount from line 27, Schedule A, multiplied by the total business miscellaneous deductions subject to the 2% floor and divided by the total miscellaneous deductions subject to the 2% floor. The amount in the nonbusiness column should be the amount from line 27, Schedule A, multiplied by the total nonbusiness deductions subject to the 2% floor and divided by the total miscellaneous deductions subject to the 2% floor. Miscellaneous itemized deductions are not allowed as a deduction when calculating AMT.

[g] Deductions allowable for impairment-related work expenses are business deductions. Other deductions reported on line 28, Schedule A, are nonbusiness deductions.

NOTE: "xxxxxxxx" means that an amount cannot be entered on that line.

On the classification worksheet (shown next), the $5,000 capital loss is allocated to the nonbusiness column. This is because the stock sale was not related to the business operation. For this purpose, the full $5,000 is used, not just the $3,000 capital loss that appears on Form 1040, line 13.

NOL Worksheet 3

Allocation of Capital Losses between Business Capital Losses and Nonbusiness Capital Losses

Where Loss Is Reported on 2011 Sched. D (Form 1040) [a]	Amount Reported on Tax Return	Disposition	Business	Nonbusiness
A. Lines 1, 2, and 3, column h		Allocate [b]		
B. Line 4, column h		Allocate [b]		
C. Line 5, column h		Allocate [c]		
D. Line 6, column h		Allocate [d]		
E. Lines 8, 9, and 10, column h	5,000	Allocate [b]		5,000
F. Line 11, column h		Allocate [b]		
G. Line 12, column h		Allocate [c]		
H. Line 14, column h		Allocate [d]		
I. Total	5,000			5,000

[a] Enter the amount from the designated lines on Schedule D only if they are losses. Enter the amounts as positive numbers.

[b] In most cases, losses reported on lines 1, 2, 3, 4, 8, 9, 10, and 11 of Schedule D (Form 1040) are nonbusiness capital losses for purposes of the NOL calculation, since losses from property used in a trade or business are reported on Form 4797 and are treated as ordinary deductions. However, losses reported on those lines can be business capital losses if the asset on which the loss was realized was an IRC §1221 asset rather than an IRC §1231 asset but was purchased for a trade or business reason rather than for investment. For example, loss realized on stock in another company that is purchased to enhance the taxpayer's business would be reported on one of those lines but would be treated as a business capital loss for purposes of the NOL calculation. See *Trammel Crow,* 79 TC 541 (1982).

[c] The character of the loss reported on line 5 or 12 of Schedule D (Form 1040) is determined by the character of the loss to the partnership, S corporation, or fiduciary. In most cases, losses reported on lines 5 and 12 of Schedule D (Form 1040) are nonbusiness capital losses, but see footnote "b" for a discussion of when losses from an IRC §1221 asset may be treated as a business capital loss for purposes of the NOL calculation.

[d] Capital loss carryovers must be allocated between business and nonbusiness capital losses according to the proportionate contribution of business and nonbusiness capital losses to the capital loss carryover.

For Example 7

NOL Worksheet 4

Allocation of Capital Gains between Business Capital Gains and Nonbusiness Capital Gains

Where Gain Is Reported on 2011 Sched. D (Form 1040) [a]	Amount Reported on Tax Return	Disposition	Business	Nonbusiness
A. Line 1, column h	________	Allocate [b]	______	______
B. Line 2, column h	________	Allocate [b]	______	______
C. Line 3, column h	________	Allocate [b]	______	______
D. Line 4, column h	________	Allocate [b]	______	______
E. Line 5, column h	________	Allocate [c]	______	______
F. Line 8, column h	________	Allocate [b]	______	______
G. Line 9, column h	________	Allocate [b]	______	______
H. Line 10, column h	________	Allocate [b]	______	______
I. Line 11, column h	________	Allocate [d]	______	______
J. Line 12, column h	________	Allocate [c]	______	______
K. Line 13, column h	________	Allocate [b]	______	______
L. Total	________		______	______

[a] Enter the amounts from the designated lines only if they are gains.

[b] In most cases, gains reported on lines 1, 2, 3, 4, 8, 9, 10, and 13 of Schedule D (Form 1040) are nonbusiness capital gains for purposes of the NOL calculation, because gains from property used in a trade or business are reported on Form 4797 and are carried to Line 11 of Schedule D (Form 1040) if they are treated as long-term capital gain. However, gains reported on lines 1, 2, 3, 4, 8, 9, 10, and 13 of Schedule D (Form 1040) can be business capital gains if the asset on which the gain was realized was an IRC §1221 asset rather than an IRC §1231 asset but was purchased for a trade or business reason rather than for investment. For example, gain realized on stock in another company that is purchased to enhance the taxpayer's business would be reported on one of those lines but would be treated as a business capital gain for purposes of the NOL calculation. See *Trammel Crow,* 79 TC 541 (1982).

[c] The character of the gain reported on line 5 or 12 of Schedule D (Form 1040) is determined by the character of the gain to the partnership, S corporation, or fiduciary. In most cases, gains reported on lines 5 and 12 of Schedule D (Form 1040) are nonbusiness capital gains, but see footnote "b" for a discussion of when gains from an IRC §1221 asset may be treated as a business capital gain for purposes of the NOL calculation.

[d] Gain from Form 4797, Part I, is business gain. Gain from Form 2439, Form 4684, Form 6252, Form 6781, or Form 8824 is nonbusiness gain in most cases. See footnote "b" for a discussion of when gains from an IRC §1221 asset may be treated as a business capital gain for purposes of the NOL calculation.

Once the income and expenses are properly classified, Schedule A–NOL of Form 1045, *Application for Tentative Refund,* is used to calculate the amount of the 2011 NOL to carry forward to 2012.

Example 8. Use the same facts as **Example 7.** Amy's accountant, Wyatt, prepared Form 1045, Schedule A–NOL, and was surprised that the amount of the NOL ($80,450) was **not** equal to Form 1040, line 41 ($83,450).

After reviewing the schedule, he realized that the allowed capital loss of $3,000 shown on Form 1040 was **not** included in the NOL. This makes sense because the entire capital loss of $5,000 carries over to 2012.[49]

On Amy's 2011 return, she elected to forgo the NOL carryback and carry the NOL forward to 2012. The calculation on Schedule A–NOL follows.

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[49] IRC §1212(b).

For Example 8

Form 1045 (2011) Page **2**

Schedule A—NOL (see instructions)

1	Enter the amount from your 2011 Form 1040, line 41, or Form 1040NR, line 39. Estates and trusts, enter taxable income increased by the total of the charitable deduction, income distribution deduction, and exemption amount					**1**	**(83,450)**
2	Nonbusiness capital losses before limitation. Enter as a positive number			**2**	**5,000**		
3	Nonbusiness capital gains (without regard to any section 1202 exclusion)			**3**			
4	If line 2 is more than line 3, enter the difference. Otherwise, enter -0-			**4**	**5,000**		
5	If line 3 is more than line 2, enter the difference. Otherwise, enter -0-	**5**	**0**				
6	Nonbusiness deductions (see instructions)			**6**	**5,800**		
7	Nonbusiness income other than capital gains (see instructions)	**7**	**18,350**				
8	Add lines 5 and 7			**8**	**18,350**		
9	If line 6 is more than line 8, enter the difference. Otherwise, enter -0-					**9**	**0**
10	If line 8 is more than line 6, enter the difference. Otherwise, enter -0-. **But do not enter more than line 5**	**10**	**0**				
11	Business capital losses before limitation. Enter as a positive number			**11**			
12	Business capital gains (without regard to any section 1202 exclusion)	**12**					
13	Add lines 10 and 12			**13**	**0**		
14	Subtract line 13 from line 11. If zero or less, enter -0-			**14**	**0**		
15	Add lines 4 and 14			**15**	**5,000**		
16	Enter the loss, if any, from line 16 of your 2011 Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 15, column (3), of Schedule D (Form 1041).) Enter as a positive number. If you do not have a loss on that line (and do not have a section 1202 exclusion), skip lines 16 through 21 and enter on line 22 the amount from line 15			**16**	**5,000**		
17	Section 1202 exclusion. Enter as a positive number					**17**	
18	Subtract line 17 from line 16. If zero or less, enter -0-			**18**	**5,000**		
19	Enter the loss, if any, from line 21 of your 2011 Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 16 of Schedule D (Form 1041).) Enter as a positive number			**19**	**3,000**		
20	If line 18 is more than line 19, enter the difference. Otherwise, enter -0-			**20**	**2,000**		
21	If line 19 is more than line 18, enter the difference. Otherwise, enter -0-					**21**	**0**
22	Subtract line 20 from line 15. If zero or less, enter -0-					**22**	**3,000**
23	Domestic production activities deduction from your 2011 Form 1040, line 35, or Form 1040NR, line 34 (or included on Form 1041, line 15a)					**23**	
24	NOL deduction for losses from other years. Enter as a positive number					**24**	
25	**NOL.** Combine lines 1, 9, 17, and 21 through 24. If the result is less than zero, enter it here and on page 1, line 1a. If the result is zero or more, you **do not** have an NOL					**25**	**(80,450)**

Form **1045** (2011)

Using the Individual NOL Carryforward

For individuals, the NOL carryforward is entered as a negative amount on Form 1040, line 21 (other income). After the return is completed, Table 1 and the worksheet instructions in IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*, are used to calculate the remaining portion, if any, to carry forward to the next year.

Caution. Tax software may **not** perform this calculation correctly. Practitioners are advised to manually complete the Table 1 worksheet in IRS Pub. 536 to verify the calculation of the carryforward. Another way to verify the calculation is to complete Form 1045, Schedule B–NOL Carryover, for the carryforward year.

Example 9. Use the same facts as **Example 8.** In 2012, Amy adds comic books and memorabilia to the merchandise for sale in her establishment. The new line of products allows the venture to attract a new market base, and the store starts to turn a profit. By the end of 2012, Amy's profit is $10,000 for the year. Portions of her 2012 return and the worksheet to calculate the NOL carryforward to 2013 follow.

Note. NOLs that carry back or forward do **not** reduce SE income in the carry year. Therefore, Amy must pay SE taxes on her 2012 profit.

For Example 9

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2012** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2012, or other tax year beginning , 2012, ending , 20 See separate instructions.

Your first name and initial **Amy**	Last name **Birder**	**Your social security number** **3 5 5 5 5 5 5 5 5**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions. **123 Green St**	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). **Urbana, IL 61801**		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county	Foreign postal code

Filing Status

Check only one box.

1 ☒ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a . . . . .
b ☐ **Spouse** . . . . .

Boxes checked on 6a and 6b: 1

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see instructions)

Dependents on 6c not entered above

d Total number of exemptions claimed . . . . .

Add numbers on lines above ▶ 1

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

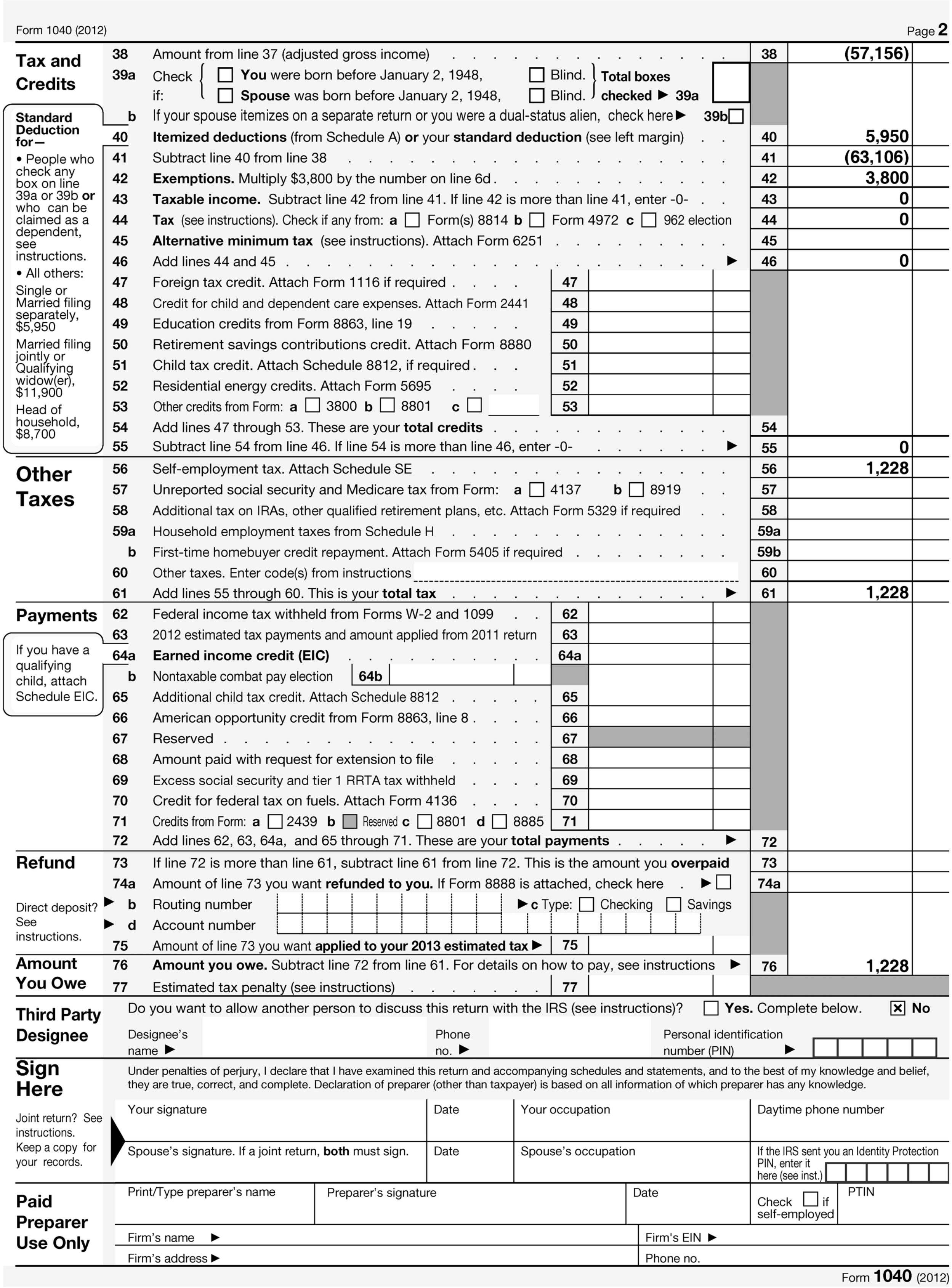
7	Wages, salaries, tips, etc. Attach Form(s) W-2			7	
8a	**Taxable** interest. Attach Schedule B if required			8a	5,000
b	**Tax-exempt** interest. **Do not** include on line 8a	8b			
9a	Ordinary dividends. Attach Schedule B if required			9a	
b	Qualified dividends	9b			
10	Taxable refunds, credits, or offsets of state and local income taxes			10	
11	Alimony received			11	12,000
12	Business income or (loss). Attach Schedule C or C-EZ			12	10,000
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			13	(3,000)
14	Other gains or (losses). Attach Form 4797			14	
15a	IRA distributions	15a	b Taxable amount	15b	
16a	Pensions and annuities	16a	b Taxable amount	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17	
18	Farm income or (loss). Attach Schedule F			18	
19	Unemployment compensation			19	
20a	Social security benefits	20a	b Taxable amount	20b	
21	Other income. List type and amount **Net Operating Loss**			21	(80,450)
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶			22	(56,450)

Adjusted Gross Income

23	Educator expenses	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	Health savings account deduction. Attach Form 8889	25			
26	Moving expenses. Attach Form 3903	26			
27	Deductible part of self-employment tax. Attach Schedule SE	27	706		
28	Self-employed SEP, SIMPLE, and qualified plans	28			
29	Self-employed health insurance deduction	29			
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid b Recipient's SSN ▶	31a			
32	IRA deduction	32			
33	Student loan interest deduction	33			
34	Tuition and fees. Attach Form 8917	34			
35	Domestic production activities deduction. Attach Form 8903	35			
36	Add lines 23 through 35			36	706
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶			37	(57,156)

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2012)

For Example 9



Form 1040 (2012) Page **2**

Tax and Credits	38	Amount from line 37 (adjusted gross income)			38	(57,156)
	39a	Check if: { ☐ **You** were born before January 2, 1948, ☐ Blind. ☐ **Spouse** was born before January 2, 1948, ☐ Blind. } **Total boxes checked** ▶ **39a** ☐				
	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ **39b** ☐				
	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			40	5,950
	41	Subtract line 40 from line 38			41	(63,106)
	42	**Exemptions.** Multiply $3,800 by the number on line 6d			42	3,800
	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-			43	0
	44	**Tax** (see instructions). Check if any from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ 962 election			44	0
	45	**Alternative minimum tax** (see instructions). Attach Form 6251			45	
	46	Add lines 44 and 45 ▶			46	0
	47	Foreign tax credit. Attach Form 1116 if required	47			
	48	Credit for child and dependent care expenses. Attach Form 2441	48			
	49	Education credits from Form 8863, line 19	49			
	50	Retirement savings contributions credit. Attach Form 8880	50			
	51	Child tax credit. Attach Schedule 8812, if required	51			
	52	Residential energy credits. Attach Form 5695	52			
	53	Other credits from Form: **a** ☐ 3800 **b** ☐ 8801 **c** ☐	53			
	54	Add lines 47 through 53. These are your **total credits**			54	
	55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶			55	0
Other Taxes	56	Self-employment tax. Attach Schedule SE			56	1,228
	57	Unreported social security and Medicare tax from Form: **a** ☐ 4137 **b** ☐ 8919			57	
	58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required			58	
	59a	Household employment taxes from Schedule H			59a	
	b	First-time homebuyer credit repayment. Attach Form 5405 if required			59b	
	60	Other taxes. Enter code(s) from instructions			60	
	61	Add lines 55 through 60. This is your **total tax** ▶			61	1,228
Payments	62	Federal income tax withheld from Forms W-2 and 1099	62			
	63	2012 estimated tax payments and amount applied from 2011 return	63			
	64a	**Earned income credit (EIC)**	64a			
	b	Nontaxable combat pay election **64b**				
	65	Additional child tax credit. Attach Schedule 8812	65			
	66	American opportunity credit from Form 8863, line 8	66			
	67	Reserved	67			
	68	Amount paid with request for extension to file	68			
	69	Excess social security and tier 1 RRTA tax withheld	69			
	70	Credit for federal tax on fuels. Attach Form 4136	70			
	71	Credits from Form: **a** ☐ 2439 **b** ▨ Reserved **c** ☐ 8801 **d** ☐ 8885	71			
	72	Add lines 62, 63, 64a, and 65 through 71. These are your **total payments** ▶			72	
Refund	73	If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you **overpaid**			73	
	74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐			74a	
Direct deposit? ▶ See instructions.	b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings				
▶	d	Account number				
	75	Amount of line 73 you want **applied to your 2013 estimated tax** ▶	75			
Amount You Owe	76	**Amount you owe.** Subtract line 72 from line 61. For details on how to pay, see instructions ▶			76	1,228
	77	Estimated tax penalty (see instructions)	77			

Standard Deduction for—
- People who check any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions.
- All others:

Single or Married filing separately, $5,950

Married filing jointly or Qualifying widow(er), $11,900

Head of household, $8,700

If you have a qualifying child, attach Schedule EIC.

Third Party Designee Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete below. ☒ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶		Firm's EIN ▶		
Firm's address ▶		Phone no.		

Form **1040** (2012)

For Example 9

Table 1. **Worksheet for NOL Carryover From 2012 to 2013 (For an NOL Year Before 2012)***

For Use by Individuals, Estates, and Trusts (Keep for your records.)
See the instructions under NOL Carryover From 2012 to 2013.

NOL YEAR: 2011

USE YOUR 2012 FORM 1040, FORM 1040NR (OR FORM 1041) TO COMPLETE THIS WORKSHEET:

1.	Enter as a positive number your NOL deduction for the NOL year entered above from line 21 (Form 1040 or Form 1040NR) or line 15a (Form 1041)		80,450
2.	Enter your taxable income without the NOL deduction for 2012 (see instructions)	13,544	
3.	Enter as a positive number any net capital loss deduction	3,000	
4.	Enter as a postive number any gain excluded on the sale or exchange of qualified small business stock		
5.	Enter the amount of any domestic production activities deduction		
6.	Enter any adjustments to your adjusted gross income (see instructions)		
7.	Enter any adjustments to your itemized deductions from line 33 below (see instructions)		
8.	Enter your deduction for exemptions from line 42 (Form 1040), line 40 (Form 1040NR), or line 20 (Form 1041)	3,800	
9.	**Modified taxable income.** Combine lines 2 through 8. Enter the result (but not less than zero)		20,344
10.	**NOL carryover to 2013.** Subtract line 9 from line 1. Enter the result (but not less than zero) here and on the "other income" line of Form 1040 or Form 1040NR (or the line on Form 1041 for deductions NOT subject to the 2% floor) in 2013		60,106

ADJUSTMENTS TO ITEMIZED DEDUCTIONS (INDIVIDUALS ONLY):

11.	Enter your adjusted gross income without the NOL deduction for the NOL year entered above or later years. (see instructions)		
12.	Combine lines 3, 4, 5, and 6 above		
13.	**Modified adjusted gross income.** Combine lines 11 and 12 above		

ADJUSTMENT TO MEDICAL EXPENSES:

14.	Enter your medical expenses from Schedule A (Form 1040), line 4		
15.	Enter your medical expenses from Schedule A (Form 1040), line 1		
16.	Multiply line 13 above by 7.5% (.075)		
17.	Subtract line 16 from line 15. Enter the result (but not less than zero)		
18.	Subtract line 17 from line 14		

ADJUSTMENT TO MORTGAGE INSURANCE PREMIUMS:

19.	Enter your mortgage insurance premiums deduction from Schedule A (Form 1040), line 13		
20.	Refigure your mortgage insurance premiums deduction using line 13 above as your adjusted gross income (see instructions)		
21.	Subtract line 20 from line 19		

ADJUSTMENT TO CHARITABLE CONTRIBUTIONS:

22.	Enter your charitable contributions deduction from Schedule A (Form 1040), line 19, or Schedule A (Form 1040NR), line 5		
23.	Refigure your charitable contributions deduction using line 13 above as your adjusted gross income. (see instructions)		
24.	Subtract line 23 from line 22		

ADJUSTMENT TO CASUALTY AND THEFT LOSSES:

25.	Enter your casualty and theft losses from Form 4684, line 18		
26.	Multiply line 13 above by 10% (.10)		
27.	Subtract line 26 from line 25. Enter the result (but not less than zero)		

ADJUSTMENT TO MISCELLANEOUS DEDUCTIONS:

28.	Enter your miscellaneous deductions from Schedule A (Form 1040), line 27, or Schedule A (Form 1040NR), line 13		
29.	Enter your miscellaneous deductions from Schedule A (Form 1040), line 24, or Schedule A (Form 1040NR), line 10		
30.	Multiply line 13 above by 2% (.02)		
31.	Subtract line 30 from line 29. Enter the result (but not less than zero)		
32.	Subtract line 31 from line 28.		

TENTATIVE TOTAL ADJUSTMENT:

33.	Combine lines 18, 21, 24, 27, and 32, and enter the result here		

***Note:** *If you choose to waive the carryback period, and instead you choose to only carry your 2012 NOL forward, use Schedule A, Form 1045 to compute your 2012 NOL that will be carried over to 2013. Report your 2012 NOL from line 25, Schedule A, Form 1045, on the "other income" line of your 2013 Form 1040 or Form 1040NR, or the line on Form 1041 for deductions NOT subject to the 2% floor in 2013.*

C CORPORATIONS

Calculating the NOL Carryforward

Calculating the NOL for a C corporation is easier than calculating the NOL for an individual. The income and expenses of the corporation are **not** separated between business and nonbusiness transactions.[50] However, there are a few adjustments that must be made when calculating the NOL, including the following.

1. The domestic production activities deduction (DPAD) under IRC §199 is **not** included in the NOL.[51]
2. The deductions for dividends received are computed without regard to the limits based on taxable income that normally apply.[52]
3. Interest expense on corporate equity reduction transactions is **not** included in the NOL.[53]

Note. In general, a **corporate equity reduction** transaction is a major stock acquisition or an excess distribution. The interest portion of an NOL created by such a transaction is subject to its own carryback and carryforward rules. However, under the de minimis rules, only interest in excess of $1 million is subject to these provisions.

Example 10. Leonard's Lasers, Ltd., manufactures missile defense lasers, and is taxed as a C corporation. The company has invested the cash that management believes will not be needed immediately into dividend-producing stocks, which paid $20,000 of dividends in 2011. However, after operating expenses, the enterprise realized a loss of $230,000 before the dividends received deduction. In the previous two years, the profit was minimal and Leonard expects 2012 to be extremely profitable. Therefore, he chooses to forgo the carryback period and carry the loss forward. The corporation's 2011 NOL is $244,000.

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[50] IRC §172(d)(4).

[51] IRC §172(d)(7).

[52] IRC §172(d)(5).

[53] IRC §172(h).

For Example 10

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2011 or tax year beginning ________________, 2011, ending ________________, 20 ____
▶ See separate instructions.

OMB No. 1545-0123
2011

A Check if:
1a Consolidated return (attach Form 851) ☐
b Life/nonlife consolidated return ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 attached ☐

TYPE OR PRINT

Name
Leonard's Lasers Ltd

Number, street, and room or suite no. If a P.O. box, see instructions.
2311 N Los Robles Apt 4A

City or town, state, and ZIP code
Pasadena, CA 91101

B Employer identification number
26-8888888

C Date incorporated
09/24/2007

D Total assets (see instructions)
$ **670,000**

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

Income

1a	Merchant card and third-party payments. For 2011, enter -0-	1a	0		
b	Gross receipts or sales not reported on line 1a (see instructions)	1b	800,000		
c	Total. Add lines 1a and 1b	1c	800,000		
d	Returns and allowances plus any other adjustments (see instructions)	1d			
e	Subtract line 1d from line 1c			1e	800,000
2	Cost of goods sold from Form 1125-A, line 8 (attach Form 1125-A)			2	400,000
3	Gross profit. Subtract line 2 from line 1e			3	400,000
4	Dividends (Schedule C, line 19)			4	20,000
5	Interest			5	
6	Gross rents			6	
7	Gross royalties			7	
8	Capital gain net income (attach Schedule D (Form 1120))			8	
9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	
10	Other income (see instructions—attach schedule)			10	
11	**Total income.** Add lines 3 through 10 ▶			11	420,000

Deductions (See instructions for limitations on deductions.)

12	Compensation of officers from Form 1125-E, line 4 (attach Form 1125-E) ▶			12	200,000
13	Salaries and wages (less employment credits)			13	400,000
14	Repairs and maintenance			14	
15	Bad debts			15	
16	Rents			16	
17	Taxes and licenses			17	50,000
18	Interest			18	
19	Charitable contributions			19	
20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			20	
21	Depletion			21	
22	Advertising			22	
23	Pension, profit-sharing, etc., plans			23	
24	Employee benefit programs			24	
25	Domestic production activities deduction (attach Form 8903)			25	0
26	Other deductions (attach schedule)			26	
27	**Total deductions.** Add lines 12 through 26 ▶			27	650,000
28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11.			28	(230,000)
29a	Net operating loss deduction (see instructions)	29a			
b	Special deductions (Schedule C, line 20)	29b	14,000		
c	Add lines 29a and 29b			29c	14,000

Tax, Refundable Credits, and Payments

30	**Taxable income.** Subtract line 29c from line 28 (see instructions)	30	(244,000)
31	Total tax (Schedule J, Part I, line 11)	31	
32	Total payments and refundable credits (Schedule J, Part II, line 21)	32	
33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐	33	
34	**Amount owed.** If line 32 is smaller than the total of lines 31 and 33, enter amount owed	34	
35	**Overpayment.** If line 32 is larger than the total of lines 31 and 33, enter amount overpaid	35	
36	Enter amount from line 35 you want: **Credited to 2012 estimated tax ▶** Refunded ▶	36	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer Date ▶ Title

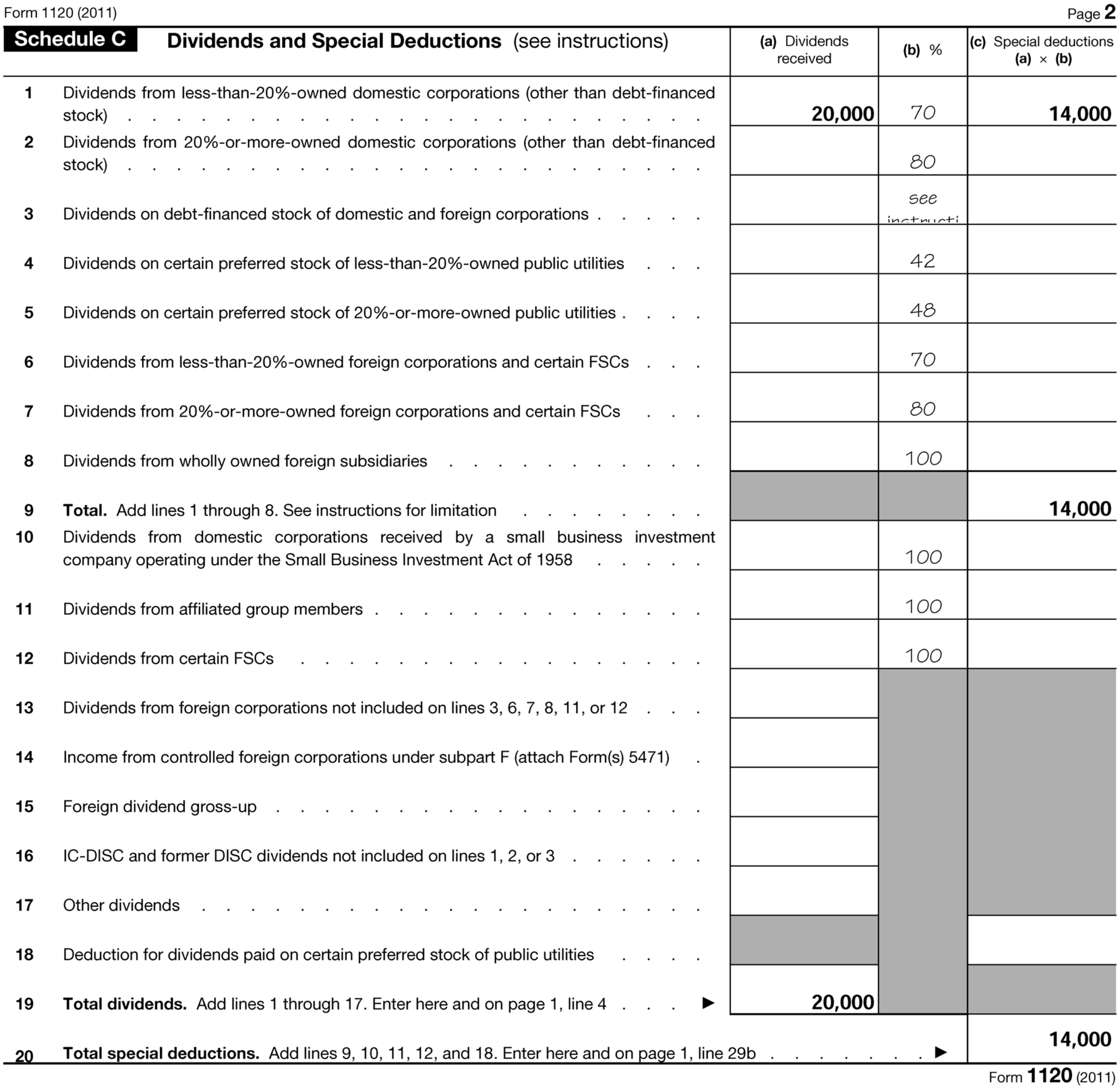
May the IRS discuss this return with the preparer shown below (see instructions)? ☒ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN
Firm's name ▶ | Firm's EIN ▶
Firm's address ▶ | Phone no.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2011)

For Example 10



Form 1120 (2011) Page **2**

	Schedule C Dividends and Special Deductions (see instructions)	(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)	20,000	70	14,000
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations		see instructi	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Total.** Add lines 1 through 8. See instructions for limitation			14,000
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	**Total dividends.** Add lines 1 through 17. Enter here and on page 1, line 4 ▶	20,000		
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			14,000

Form **1120** (2011)

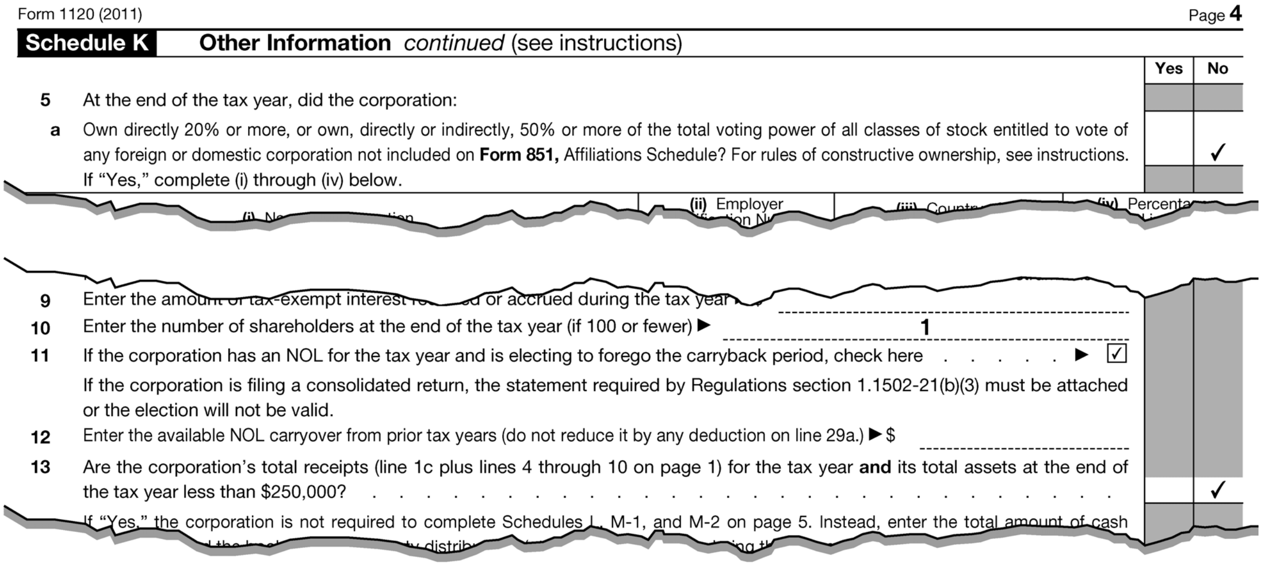
Observations.

1. The dividends received deduction is normally limited by IRC §246. If this company had a 2011 profit of $15,000 instead of a $230,000 loss **before the special dividends received deduction,** the dividends received deduction would have been limited to 70% of the $15,000 (or $10,500) on Form 1120, *U.S. Corporation Income Tax Return*, page 2, Schedule C, line 9. There are no carryback or carryforwards for the unused dividends received deduction, so the additional deduction would be lost forever.

2. As a manufacturer with wages, Leonard's Lasers, Ltd., might have qualified for the DPAD. However, the deduction is limited by net income from qualified activities. Therefore, the company cannot claim this deduction. In addition, IRC §172(d)(7) expressly prohibits any allowed DPAD from being included in the NOL carryforward.

3. To make the election to forgo the NOL carryback period, the company marked the box on page 4 of Form 1120, line 11, as shown on the following page.

For Example 10



Form 1120 (2011) Page **4**

Schedule K **Other Information** *continued* (see instructions)

		Yes	No
5	At the end of the tax year, did the corporation:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on **Form 851,** Affiliations Schedule? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below.		✓

(ii) Employer (iv) Percenta

9 Enter the amou tax-exempt interest or accrued during the tax year

10 Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶ 1

11 If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here . . . . . . ▶ ☑

If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.

12 Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ▶ $

		Yes	No
13	Are the corporation's total receipts (line 1c plus lines 4 through 10 on page 1) for the tax year **and** its total assets at the end of the tax year less than $250,000?		✓

If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total amount of cash

> **Note.** Special rules apply to NOLs for real estate investment trusts (REIT), public utilities, and personal service corporations. These rules are not discussed in this chapter.

Using the C Corporation NOL Carryforward[54]

NOLs may be carried forward until the entire NOL has been used for up to 20 years after the tax year in which the NOL was generated. When the available NOL is more than the taxable income for the carryforward year, the remainder is carried to the next year. The amount to carry forward is the available NOL that exceeds the modified taxable income for the carryforward year.

If a corporation carries forward its NOL, it enters the carryover on Form 1120, Schedule K, line 12. It also enters the deduction for the carryforward on line 29(a) of Form 1120, or the applicable line of the corporation's income tax return. The deduction cannot be more than the corporation's modified taxable income. Modified taxable income is the taxable income for that year with the following exceptions.

1. Only the NOLs for years prior to the NOL year for which the carryforward is being calculated are deducted. The earlier year NOLs are included in modified taxable income when determining what amount from the NOL year is needed to reduce taxable income to zero.
2. The deduction for charitable contributions is calculated without consideration of any NOL carrybacks.

Example 11. Use the same facts as **Example 10,** except that the corporation also had an NOL carryforward from 2010 of $11,000 for a total NOL carryforward of $255,000. In 2012, the company had a net profit of $90,000 before any NOL carryforwards. This includes a $5,000 donation to a charitable foundation for preservation of Star Trek memorabilia. Excerpts from the entity's 2012 Form 1120 follow.

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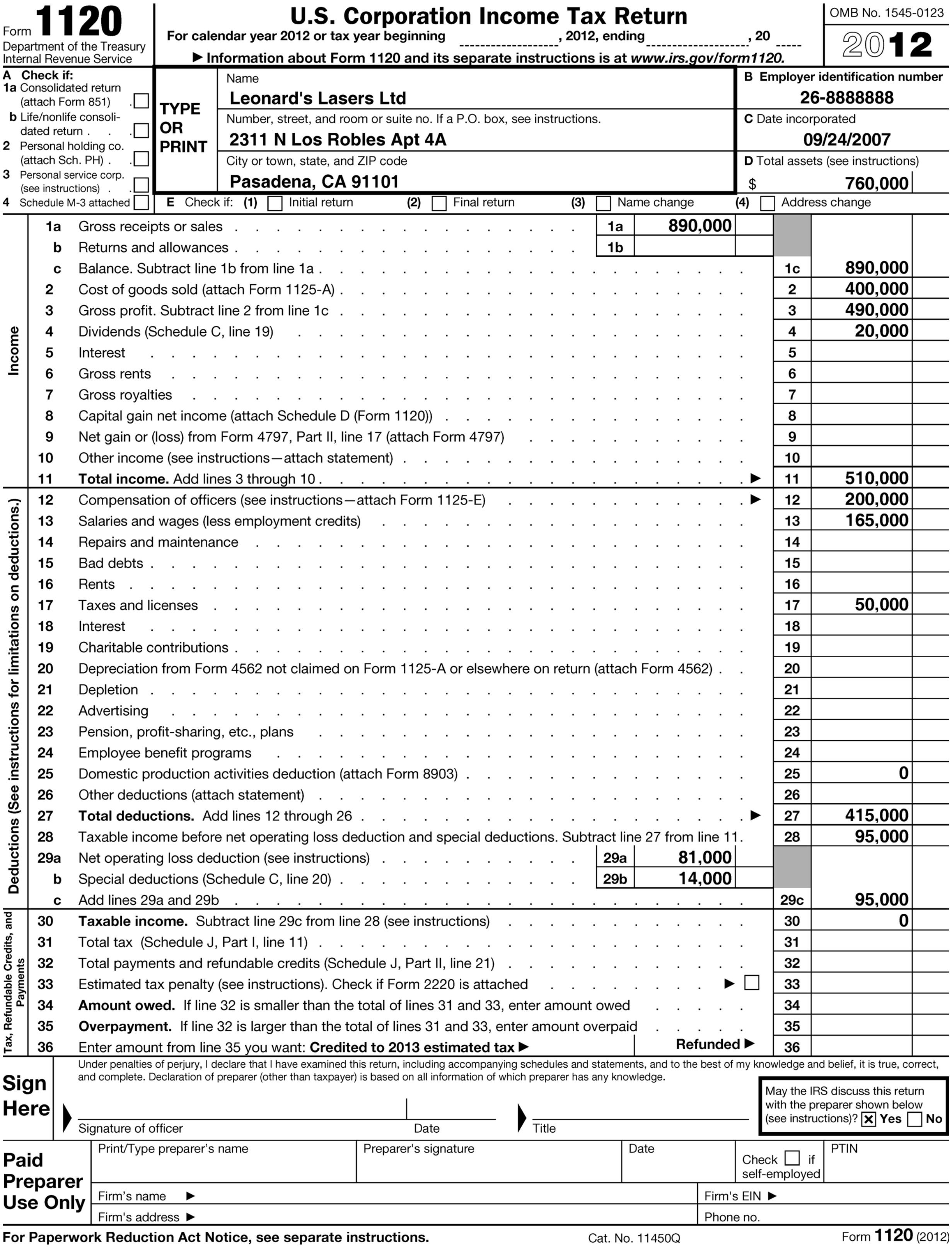
[54] IRS Pub. 542, *Corporations.*

For Example 11



Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2012 or tax year beginning ________________, 2012, ending ________________, 20 ____

▶ **Information about Form 1120 and its separate instructions is at *www.irs.gov/form1120*.**

OMB No. 1545-0123

2012

A Check if:
- **1a** Consolidated return (attach Form 851) ☐
- **b** Life/nonlife consolidated return ☐
- **2** Personal holding co. (attach Sch. PH) ☐
- **3** Personal service corp. (see instructions) ☐
- **4** Schedule M-3 attached ☐

TYPE OR PRINT

Name
Leonard's Lasers Ltd

Number, street, and room or suite no. If a P.O. box, see instructions.
2311 N Los Robles Apt 4A

City or town, state, and ZIP code
Pasadena, CA 91101

B Employer identification number
26-8888888

C Date incorporated
09/24/2007

D Total assets (see instructions)
$ **760,000**

E Check if: **(1)** ☐ Initial return **(2)** ☐ Final return **(3)** ☐ Name change **(4)** ☐ Address change

Income	1a	Gross receipts or sales	1a	890,000		
	b	Returns and allowances	1b			
	c	Balance. Subtract line 1b from line 1a			1c	890,000
	2	Cost of goods sold (attach Form 1125-A)			2	400,000
	3	Gross profit. Subtract line 2 from line 1c			3	490,000
	4	Dividends (Schedule C, line 19)			4	20,000
	5	Interest			5	
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	
	10	Other income (see instructions—attach statement)			10	
	11	**Total income.** Add lines 3 through 10 ▶			11	510,000
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ▶			12	200,000
	13	Salaries and wages (less employment credits)			13	165,000
	14	Repairs and maintenance			14	
	15	Bad debts			15	
	16	Rents			16	
	17	Taxes and licenses			17	50,000
	18	Interest			18	
	19	Charitable contributions			19	
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			20	
	21	Depletion			21	
	22	Advertising			22	
	23	Pension, profit-sharing, etc., plans			23	
	24	Employee benefit programs			24	
	25	Domestic production activities deduction (attach Form 8903)			25	0
	26	Other deductions (attach statement)			26	
	27	**Total deductions.** Add lines 12 through 26 ▶			27	415,000
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11.			28	95,000
	29a	Net operating loss deduction (see instructions)	29a	81,000		
	b	Special deductions (Schedule C, line 20)	29b	14,000		
	c	Add lines 29a and 29b			29c	95,000
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28 (see instructions)			30	0
	31	Total tax (Schedule J, Part I, line 11)			31	
	32	Total payments and refundable credits (Schedule J, Part II, line 21)			32	
	33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐			33	
	34	**Amount owed.** If line 32 is smaller than the total of lines 31 and 33, enter amount owed			34	
	35	**Overpayment.** If line 32 is larger than the total of lines 31 and 33, enter amount overpaid			35	
	36	Enter amount from line 35 you want: **Credited to 2013 estimated tax** ▶	Refunded ▶		36	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of preparer has any knowledge.

Signature of officer ________ Date ________ Title ________

May the IRS discuss this return with the preparer shown below (see instructions)? ☒ **Yes** ☐ **No**

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2012)

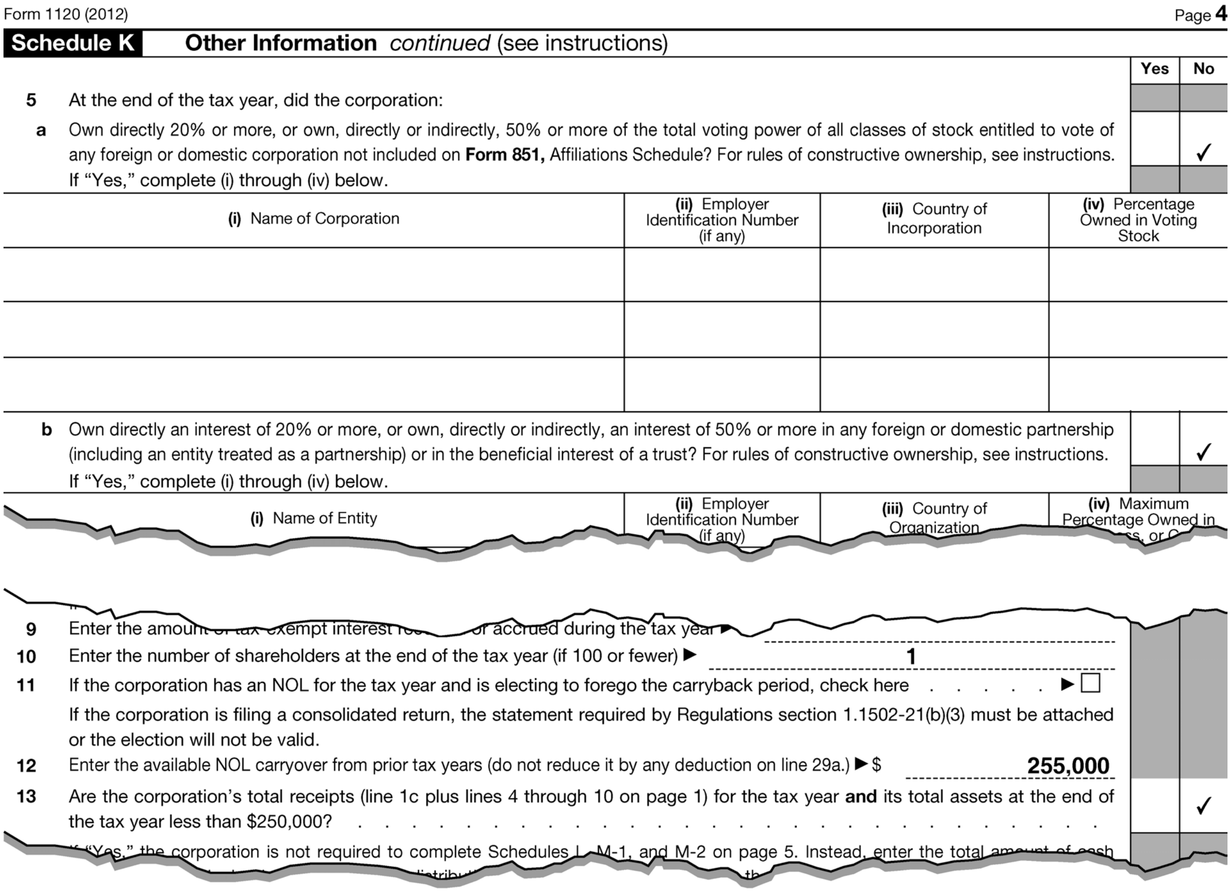
For Example 11

Form 1120 (2012) Page **2**

	Schedule C Dividends and Special Deductions (see instructions)	**(a)** Dividends received	**(b)** %	**(c)** Special deductions **(a)** × **(b)**
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)	**20,000**	70	**14,000**
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Total.** Add lines 1 through 8. See instructions for limitation			**14,000**
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	**Total dividends.** Add lines 1 through 17. Enter here and on page 1, line 4 ▶	**20,000**		
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			**14,000**

Form **1120** (2012)

For Example 11



Form 1120 (2012) Page **4**

Schedule K **Other Information** *continued* (see instructions)

		Yes	No
5	At the end of the tax year, did the corporation:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on **Form 851,** Affiliations Schedule? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below.		✓

(i) Name of Corporation	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Incorporation	**(iv)** Percentage Owned in Voting Stock

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below.		✓

(i) Name of Entity	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Organization	**(iv)** Maximum Percentage Owned in

		Yes	No
9	Enter the amoun xempt interest re r accrued during the tax year ▶		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶ 1		
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here . . . . . . ▶ ☐ If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.		
12	Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ▶ $ 255,000		
13	Are the corporation's total receipts (line 1c plus lines 4 through 10 on page 1) for the tax year **and** its total assets at the end of the tax year less than $250,000?		✓
	If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total am of cash		

Observations.

1. The dividends received deduction is calculated before the NOL carryforwards. Therefore, the company deducted the entire $14,000 allowed under these provisions prior to calculating any adjustments for charitable contributions or NOL carryforwards.
2. Because the NOL carryforwards reduce taxable income to zero, the corporation's allowed DPAD for 2012 was also zero.[55]
3. None of the $5,000 charitable contribution was shown as a deduction for 2012. Furthermore, the $5,000 contribution does not carry forward to future years.[56] However, the remaining NOL carryforward was adjusted to increase the amount available for future years.[57]
4. The calculation of the 2012 NOL deduction is shown on the following page.

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[55] Instructions for Form 8903, *Domestic Production Activities Deduction*.

[56] IRC §170(d)(2)(B).

[57] IRC §172(b).

Calculation of Line 29a on Form 1120

	2012 taxable income	$ 95,000	
	Dividends received deduction (Line 29b "Special deductions")	(14,000)	
	Adjusted taxable income before NOL carryforwards	$ 81,000	
	2010 NOL	(11,000)	$11,000
A.	Remaining taxable income before 2011 NOL carryforward	$ 70,000	
B.	2011 NOL	$244,000	
C.	Lesser of lines A or B		70,000
	Total NOL deduction		$81,000

5. The calculation of the remaining 2011 NOL carryforward follows.

2011 NOL	$244,000
Less: carryforward used in 2012 (line C in observation 4)	(70,000)
Plus: adjustment for charitable contributions eliminated by NOL (IRC §172(b)(2))	5,000
Remaining 2011 NOL carried forward to 2013	$179,000

ATRA DEPRECIATION CHANGES FOR 2013

Note. For comprehensive explanations of depreciation methods, see the 2011 *University of Illinois Federal Tax Fundamentals,* Chapter 4: Depreciation Basics; and the 2011 *University of Illinois Federal Tax Workbook,* Chapter 1: Depreciation. These can be found at **www.taxschool.illinois.edu/taxbookarchive.**

The American Taxpayer Relief Act of 2012 (ATRA), enacted on January 2, 2013, affected several depreciation options.

1. Bonus depreciation was extended and modified.[58]
2. The 15-year straight-line depreciation method was extended for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements.[59]
3. IRC §179 limits were increased, and the election to treat certain real property as §179 property was extended.

The following table summarizes the provisions in effect during 2013 with respect to qualified real property.

Depreciation Provisions Related to Qualified Real Property

	Leasehold Improvements	**Restaurant Buildings and Improvements**	**Retail Improvements**
15-year depreciable life	Yes, if placed in service before 2014	Yes, if placed in service before 2014	Yes, if placed in service before 2014
Bonus depreciation	Yes, if placed in service before 2014 and lease is between unrelated parties	No	No
Section 179 (limited to $250,000)	Yes, if placed in service before 2014	Yes, if placed in service before 2014	Yes, if placed in service before 2014

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[58] IRC §168(k).

[59] IRC §168(e)(3)(E).

BONUS DEPRECIATION

ATRA extended the 50% bonus depreciation for qualifying assets placed in service **before** January 1, 2014. For property with a longer production period[60] and certain noncommercial aircraft,[61] this deadline is extended for one year. Therefore, this property must be placed in service before January 1, 2015. Unless Congress passes additional extensions or modifications, all provisions for bonus depreciation expire after December 31, 2014.

Qualified leasehold improvements are eligible for bonus depreciation. However, the Code specifically **excludes** restaurant buildings and improvements[62] and retail improvements[63] from bonus depreciation provisions. Nonetheless, if an improvement to a restaurant or retail establishment also meets all of the requirements for qualified leasehold improvements, bonus depreciation can be used for that improvement.

QUALIFIED 15-YEAR PROPERTY[64]

ATRA extended the availability of the shorter 15-year depreciation class for certain real estate improvements described below. These provisions expire December 31, 2013. Unless Congress passes additional extensions, these types of properties placed in service on or after January 1, 2014, will be depreciated over 39 years.

Qualified Leasehold Improvement Property

Generally, qualified leasehold improvement property is any improvement to an interior part of a building that is nonresidential real property, if all the following requirements are met.

1. The lease agreement is between **unrelated** parties. (See IRS Pub. 946, *How To Depreciate Property*, for a list of parties considered to be related for these purposes.)
2. The improvement is made under the terms of the lease by the lessee (or any sublessee) or the lessor of that part of the building.
3. That part of the building is to be occupied exclusively by the lessee (or any sublessee) of that part.
4. The improvement is placed in service more than three years after the date the building was first placed in service by any person.
5. The improvement is IRC §1250 property.

However, a qualified leasehold improvement does **not** include any improvement for which the expenditure is attributable to any of the following.

- The enlargement of the building
- Any elevator or escalator
- Any structural component benefiting a common area
- The internal structural framework of the building

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[60] IRC §168(k)(2)(B).

[61] IRC §168(k)(2)(A)(iv) and §168(k)(2)(C).

[62] IRC §168(e)(7)(B).

[63] IRC §168(e)(8)(D).

[64] IRS Pub. 946, *How to Depreciate Property.*

Qualified Restaurant Property

Qualified restaurant property is any real property in which more than 50% of the building's square footage is devoted to the preparation of meals and seating for on-premise consumption of prepared meals. Both original buildings and improvements may qualify. This provision does **not** require that the lessor and lessee be unrelated parties.

Qualified Retail Improvement Property

Qualified retail improvement property is any improvement to an interior portion of nonresidential real property if it meets the following requirements. This provision does **not** require that the lessor and lessee be unrelated parties.

1. The portion is open to the general public and is used in a retail trade selling tangible property to the general public.
2. The improvement is placed in service more than three years after the date the building was first placed in service.
3. The expenses are **not** for the enlargement of the building, any elevator or escalator, any structural components benefiting a common area, or the internal structural framework of the building.

IRC §179

ATRA extended the higher dollar limit and investment limit for qualified property. The maximum amount a taxpayer may elect for tax years beginning in 2013 is $500,000 of the cost of qualifying property placed in service for the tax year. The $500,000 amount is reduced on a dollar-for-dollar basis by the amount by which the cost of qualifying property placed in service during the tax year exceeds $2 million. Unless Congress changes the law, these limits will revert to $25,000 and $200,000 (plus adjustments for inflation) for tax years beginning after December 31, 2013.

In addition to increasing the limits, ATRA allowed qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property to continue to qualify as §179 property. However, the maximum §179 expense deduction for these types of property is $250,000. If the §179 deduction of these assets is limited by income, the excess **may not** be carried over to tax years beginning after December 31, 2013.[65] Unless modified by Congress, these types of assets will no longer qualify for §179 for tax years beginning after 2013.

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[65] IRC §179(f)(4).

Payroll Deduction IRA

Key advantage	Easy to set up and maintain.
Employer eligibility	Any employer with one or more employees.
Employer's role	Arrange for employees to make payroll deduction contribution. Transmit contributions for employees to IRA. No annual filing requirement for employer.
When to set up the plan	Any time up to the due date of the employee's return, excluding extensions.
Contributors to the plan	Employee contributions remitted through payroll deduction.
Maximum annual contribution (per participant)	$5,500 for 2013. Participants age 50 or over can make additional contribution up to $1,000.
Contributor's options	Employee can decide how much to contribute at any time.
Minimum employee coverage requirements	There is no requirement. Can be made available to any employee.
Withdrawals, loans and payments	Withdrawals permitted anytime subject to federal income taxes; early withdrawals subject to an additional tax (special rules apply to Roth IRAs).
Last date for employer contributions	N/A
Top-heavy restrictions	No
Vesting	Contributions are immediately 100% vested.
Compensation from self-employment defined **(See Observation 1 after Example 6)**	SEP method
IRC reference for calculation	IRC §219(f)(1) referencing IRC §401(c)(2)

SEP

Key advantage	Easy to set up and maintain.
Employer eligibility	Any employer with one or more employees.
Employer's role	May use IRS Form 5305-SEP to set up the plan. No annual filing requirement for employer.
When to set up the plan	Any time up to the due date of the employer's return, including extensions.
Contributors to the plan	Employer contributions only.
Maximum annual contribution (per participant)	Up to 25% of compensation but no more than $51,000 for 2013. Maximum compensation on which contributions can be based is $255,000 for 2013.
Contributor's options	Employer can decide whether to make contributions year-to-year.
Minimum employee coverage requirements	Must cover all employees who are at least 21 years of age, employed by the employer for 3 of the last 5 years and had compensation of $550 for 2013.
Withdrawals, loans and payments	Withdrawals permitted anytime subject to federal income taxes; early withdrawls subject to an additional tax.
Last date for employer contributions	Due date of the employer's return, including extensions
Top-heavy restrictions	Yes
Vesting	Contributions are immediately 100% vested.
Compensation from self-employment defined **(See Observation 1 after Example 6)**	SEP method
IRC reference for calculation	IRC §408(k) which references §414(s), which references Treas. Reg. §1.414(s)-1(b)(3) and (c)(2), which reference IRC §415(c)(3)(B), which references IRC §401(c)(2)

SIMPLE IRA Plan

Key advantage	Salary reduction plan with little administrative paperwork.
Employer eligibility	Any employer with 100 or fewer employees that does not curently maintain another retirement plan.
Employer's role	May use IRS Forms 5304-SIMPLE or 5305-SIMPLE to set up the plan. No annual filing requirement for employer. Bank or financial institution handles most of the paperwork.
When to set up the plan	Any time between 1/1 and 10/1 of the calendar year. For a new employer coming into existence after 10/1, as soon as administratively possible.
Contributors to the plan	Employee salary reduction contributions and employer contributions.
Maximum annual contribution (per participant)	**Employee:** $12,000 in 2013. Participants age 50 or over can make additional contributions up to $2,500. **Employer:** Either match employee contributions 100% of first 3% of compensation (can be reduced to as low as 1% in any 2 out of 5 years.); or contribute 2% of each eligible employee's compensation, up to $255,000 in 2013 wages.
Contributor's options	Employee can decide how much to contribute. Employer must make matching contributions or contribute 2% of each employee's compensation.
Minimum employee coverage requirements	Must be offered to all employees who have earned income of at least $5,000 in any prior 2 years, and are reasonably expected to earn at least $5,000 in the current year.
Withdrawals, loans and payments	Withdrawals permitted anytime subject to federal income taxes; early withdrawals subject to an additional tax.
Last date for employer contributions	Due date of the employer's return, including extensions.
Top-heavy restrictions	No
Vesting	Employee salary reduction contributions and employer contributions are immediately 100% vested.
Compensation from self-employment defined **(See Observation 1 after Example 6)**	SIMPLE method
IRC reference for calculation	IRC §408(p)(6)(A)(ii), which references IRC §1402(a)

Profit Sharing

Key advantage	Permits employer to make large contributions for employees.
Employer eligibility	Any employer with one or more employees.
Employer's role	No model form to establish this plan. May need advice from a financial institution or employee benefit adviser. Must file annual Form 5500.
When to set up the plan (see IRS Pub. 560)	By the end of the tax year.
Contributors to the plan	Annual employer contribution is discretionary.
Maximum annual contribution (per participant)	Up to the lesser of 100% of compensation or $51,000 for 2013. Employer can deduct amounts that do not exceed 25% of aggregate compensation for all participants.
Contributor's options	Employer makes contribution as set by plan terms.
Minimum employee coverage requirements	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.
Withdrawals, loans and payments	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination, etc.) subject to federal income taxes. Plan may permit loans and hardship withdrawals; early withdrawals subject to an additional tax.
Last date for employer contributions (see IRS Pub. 560)	Due date of the employer's return including extensions
Top-heavy restrictions	Yes
Vesting	May vest over time according to plan terms.
Compensation from self-employment defined **(See Observation 1 after Example 6)**	SEP method
IRC reference for calculation	IRC §401(c)(2)

Traditional 401(k)

Key advantage	Permits high level of salary deferrals by employees.
Employer eligibility	Any employer with one or more employees.
Employer's role	No model form to establish this plan. May need advice from a financial institution or employee benefit adviser. Must file annual Form 5500. Requires annual nondiscrimination testing to ensure that plan does not discriminate in favor of highly compensated employees.
When to set up the plan (see IRS Pub. 560)	By the end of the tax year.
Contributors to the plan	Employee salary reduction contributions and maybe employer contributions.
Maximum annual contribution (per participant)	**Employee:** $17,500 in 2013. Participants age 50 or over can make additional contributions up to $5,500. **Employer/Employee Combined:** Up to the lesser of 100% of compensation or $51,000 for 2013. Employer can deduct (1) amounts that do not exceed 25% of aggregate compensation for all participants and (2) all salary reduction contributions.
Contributor's options	Employee can decide how much to contribute based on a salary reduction agreement. The employer can make additional contributions, including matching contributions as set by plan terms.
Minimum employee coverage requirements	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.
Withdrawals, loans and payments	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination, etc.) subject to federal income taxes. Plan may permit loans and hardship withdrawals; early withdrawals subject to an additional tax.
Last date for employer contributions (see IRS Pub. 560)	Due date of the employer's return including extensions
Top-heavy restrictions	Yes
Vesting	Employee salary redution contributions are immediately 100% vested. Employer contributions may vest over time according to plan terms.
Compensation from self-employment defined **(See Observation 1 after Example 6)**	SEP method
IRC reference for calculation	IRC §401(k)(9), which references §414(s), which references Treas. Reg. §1.414(s)-1(b)(3) and (c)(2), which reference IRC §415(c)(3)(B), which references IRC §401(c)(2)

SIMPLE 401(k) [a]

Key advantage	Avoids annual testing.
Employer eligibility	Any employer with 100 or fewer employees who make $5,000 or more in the preceding year. The employer must not currently maintain another retirement plan.
Employer's role	No model form to establish this plan. May need advice from a financial institution or employee benefit adviser. A minimum amount of employer contributions is required. Must file annual Form 5500.
When to set up the plan (see IRS Pub. 560)	Any time between 1/1 and 10/1 of the calendar year. For a new employer coming into existence after 10/1, as soon as administratively feasible.
Contributors to the plan	Employee salary deferrals and employer contributions.
Maximum annual contribution (per participant)	**Employee:** $12,000 in 2013. Participants age 50 and over can make additional contributions up to $2,500. **Employer:** Either match employee contributions 100% of first 3% of compensation; or contribute 2% of each eligible employee's compensation, up to $255,000 in 2013 wages.
Contributor's options	Employee can decide how much to contribute. Employer must make matching contributions or contribute 2% of each employee's compensation.
Minimum employee coverage requirements	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.
Withdrawals, loans and payments	Withdrawals permitted anytime subject to federal income taxes. Plan may permit loans and hardship withdrawals. Early withdrawals subject to an additional tax.
Last date for employer contributions (see IRS Pub. 560)	Due date of the employer's return including extensions
Top-heavy restrictions	No
Vesting	Employee and employer contributions are immediatey 100% vested.
Compensation from self-employment defined **(see Observation 1 after Example 6)**	SIMPLE Method
IRC reference for calculation	IRC §401(k)(11)(D)(i), which references IRC §408(p), which references IRC §1402(a)

[a] www.irs.gov/Retirement-Plans/Choosing-a-Retirement-Plan:-SIMPLE-401(k)-Plan

Safe Harbor 401(k)

Key advantage	Permits high level of salary deferrals by employees without annual nondiscrimination testing.
Employer eligibility	Any employer with one or more employees.
Employer's role	No model form to establish this plan. May need advice from a financial institution or employee benefit adviser. A minimum amount of employer contributions is required. Must file annual Form 5500.
When to set up the plan (see IRS Pub. 560)	By the end of the tax year.
Contributors to the plan	Employee salary reduction contributions and employer contributions.
Maximum annual contribution (per participant)	**Employee:** $17,500 in 2013. Participants age 50 or over can make additional contributions up to $5,500. **Employer/Employee Combined:** Up to the lesser of 100% of compensation or $51,000 for 2013. Employer can deduct (1) amounts that do not exceed 25% of aggregate compensation for all participants and (2) all salary reduction contributions.
Contributor's options	Employee can decide how much to contribute based on a salary reduction agreement. The employer must make either specified matching contributions or a 3% contribution for all participants.
Minimum employee coverage requirements	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.
Withdrawals, loans and payments	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination, etc.) subject to federal income taxes. Plan may permit loans and hardship withdrawals; early withdrawals subject to an additional tax.
Last date for employer contributions (see IRS Pub. 560)	Due date of the employer's return including extensions
Top-heavy restrictions	No
Vesting	Employee salary reduction contribution and most employer contributions are immediately 100% vested. Some employer contribution may vest over time according to plan terms.
Compensation from self-employment defined **(See Observation 1 after Example 6)**	SEP method
IRC reference for calculation	IRC §401(k)(9), which references §414(s), which references Treas. Reg. §1.414(s)-1(b)(3) and (c)(2), which reference IRC §415(c)(3)(B), which references IRC §401(c)(2)

Automatic Enrollment 401(k)

Key advantage	Provides high level of participation and permits high level of salary deferrals by employees. Also safe harbor relief for default investments.
Employer eligibility	Any employer with one or more employees.
Employer's role	No model form to establish this plan. May need advice from a financial institution or employee benefit adviser. Must file annual form 5500. May require annual nondiscrimination testing to ensure that plan does not discriminate in favor of highly compensated employees.
When to set up the plan (see IRS Pub. 560)	By the end of the tax year.
Contributors to the plan	Employee salary reduction contributions and maybe employer contributions.
Maximum annual contribution (per participant)	**Employee:** $17,500 in 2013. Participants age 50 or over can make additional contributions up to $5,500. **Employer/Employee Combined:** Up to the lesser of 100% of compensation or $51,000 for 2013. Employer can deduct (1) amounts that do not exceed 25% of aggregate compensation for all participants and (2) all salary reduction contributions.
Contributor's options	Employees, unless they opt otherwise, make salary reduction contributions specified by the employer. The employer can make additional contributions, including matching contributions as set by plan terms.
Minimum employee coverage requirements	Generally, must be offered to all employees at least 21 years of age who worked at least 1,000 hours in a previous year.
Withdrawals, loans and payments	Withdrawals permitted after a specified event occurs (e.g., retirement, plan termination, etc.) subject to federal income taxes. Plan may permit loans and hardship withdrawals; early withdrawals subject to an additional tax.
Last date for employer contributions (see IRS Pub. 560)	Due date of the employer's return including extensions
Top-heavy restrictions	Depends on plan
Vesting	Employee salary reduction contributions are immediately 100% vested. Employer contributions may vest over time according to plan terms.
Compensation from self-employment defined **(See Observation 1 after Example 6)**	SEP method
IRC reference for calculation	IRC §401(k)(9), which references §414(s), which references Treas. Reg. §1.414(s)-1(b)(3) and (c)(2), which reference IRC §415(c)(3)(B), which references IRC §401(c)(2)