

Chapter 5: Small Business Issues

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Please note. Corrections were made to this workbook through January of 2021. No subsequent modifications were made.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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“TRADE OR BUSINESS” OR HOBBY?

In May 2020, an advertisement was running on national television touting the entrepreneurial spirit of Americans making items to sell from their homes. In addition to these types of money-making adventures, many taxpayers are entering into other arrangements to generate income. Accordingly, tax practitioners may see an unusually high number of new businesses start in 2020.

Many tax provisions, including the qualified business income deduction (QBID) and self-employment (SE) tax, only apply to activities that qualify as a trade or business. **A sporadic activity, hobby, or amusement diversion does not qualify as a business.**¹ While these types of activities are not subject to SE tax, deductions against the income generated are limited.

Note. Ventures that do not meet the trade or business test are sometimes referred to as hobbies or as activities not engaged in for profit. While the latter phrase is technically more accurate, for brevity purposes, this text uses the phrases interchangeably to indicate an activity that does not rise to the level of a trade or business.

The IRS specifically warns against using schemes designed to create the **appearance** of having a home-based business, where none actually exists. The purpose of such schemes is to convert otherwise nondeductible personal, living, or family expenses into purportedly legitimate deductions. Arguments that such schemes generate tax benefits are frivolous. The IRS warns that in addition to the actual tax due plus statutory interest, it may impose civil penalties against taxpayers where appropriate and those taxpayers also may face criminal prosecution. Preparers and promoters may also be penalized and prosecuted if found to be advocating such schemes.²

In addition to tax consequences, a tax return is often used to establish the presence or absence of business ventures. For example, many pandemic-relief programs (e.g., the Paycheck Protection Program (PPP)³) are only available to businesses. Accordingly, it is imperative that practitioners understand the parameters for classifying an activity as a business.

Note. Historically, the hobby versus trade or business issue was mainly concerned with the proper treatment of losses. Now, with the QBID, the PPP, and economic injury disaster loans (EIDL)⁴ focused on a trade or business with a profit, the tax professional must ask more questions to determine whether an activity is a hobby or a trade or business. In addition, consistency between years of reporting the activity is important.

BASIC HOBBY LOSS RULE

IRC §183 provides the “hobby loss rule.” It states in part:

In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

¹ See *Comm’r v. Robert P. Groetzinger*, 480 U.S. 23 (1987).

² Rev. Rul. 2004-32, 2004-12 IRB 621.

³ See, e.g., *Paycheck Protection Program*. U.S. Small Business Administration. [www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program] Accessed on Jun. 22, 2020.

⁴ For information about EIDLs, see *Economic Injury Disaster Loans*. U.S. Small Business Administration. [www.sba.gov/funding-programs/loans/coronavirus-relief-options/economic-injury-disaster-loans] Accessed on Aug. 14, 2020.

Whether an activity is engaged in for profit is a facts and circumstances determination. **Neither the Code nor regulations provide an absolute definition.** However, the Code and regulations serve as a guide in formulating the facts necessary to determine whether an activity is not engaged in for profit. Taxpayers bear the burden of proving that they engage in the activity with an actual and honest objective of realizing a profit.⁵

Several Code sections have an impact on the deductibility of expenses. **Under IRC §212, expenses related to the production of income or investment income are generally deductible against unrelated income.** Under IRC §162, business expenses can be deducted only if the activity qualifies as a **trade or business**. IRC §162(a) allows deductions for all ordinary and necessary expenses paid or incurred during the year in carrying on a trade or business. Even though the intent is to make a profit, the IRS can deem the business to be a hobby under §183.⁶

SELF-EMPLOYMENT TAX

A trade or business is a for-profit activity. If the trade or business is conducted as a sole proprietorship or partnership, profits are taxed as SE income. However, it is possible to have a for-profit activity that does not qualify as a trade or business and is exempt from SE tax.

Despite the numerous Code provisions relying upon the definition of the phrase “trade or business,” the Code does not provide one. Instead, the burden was left to the courts to establish the defining traits of a trade or business. In the seminal case, *Comm’r v. Robert P. Groetzinger*,⁷ the U.S. Supreme Court established a 2-prong test to apply to the facts and circumstances of each situation to determine if an activity constitutes a trade or business. To qualify, the taxpayer must:

1. Be involved in the activity with continuity and regularity, and
2. Intend to generate a profit.

CONTINUITY AND REGULARITY

There is no bright-line test to determine continuity and regularity. The Court in *Groetzinger* quoting *Higgins v. Comm’r* observed that “resolution of this issue ‘requires an examination of the facts in each case.’”⁸

The IRS provides the following explanation and example of a part-time activity that is engaged in with continuity and regularity.⁹

You do not have to carry on regular full-time business activities to be self-employed. Having a part-time business in addition to your regular job or business also may be self-employment.

Example: *You are employed full time as an engineer at the local plant. You fix televisions and radios during the weekends. You have your own shop, equipment, and tools. You get your customers from advertising and word-of-mouth. You are self-employed as the owner of a part-time repair shop.*

Review of various court decisions can provide tax practitioners with additional understanding of how the courts have regarded the facts in cases where the taxpayers and the IRS disagree on whether the activity constitutes a business. The facts and conclusions used for the examples in this section are **all based on court cases**.

⁵. *Keanini v. Comm’r*, 94 TC 41 (1990).

⁶. IRC §183(c).

⁷. *Comm’r v. Robert P. Groetzinger*, 480 U.S. 23 (1987).

⁸. *Comm’r v. Robert P. Groetzinger*, 480 U.S. 23 (1987), quoting *Higgins v. Comm’r*, 312 U.S. 212 (1941).

⁹. *Business Activities*. May 26, 2020. IRS. [www.irs.gov/businesses/small-businesses-self-employed/business-activities] Accessed on Jun. 24, 2020.

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Example 1. Melvin operated a retail store selling electronic goods and collectibles for over 50 years. He also created and patented inventions sporadically in his spare time. Melvin did not develop or design inventions on a continuous or regular basis. His patents were a result of sudden inspirations.¹⁰

One of his patents was for a microwaveable cookware container. He received an award against a company for patent infringement. The award included a license agreement for use of the patent, under which he received significant sums over several years. The court held that despite the regularity of the payments he received, his involvement was sporadic and therefore did not rise to the level of a trade or business.

Example 2. Bruce was a retired auto mechanic. He spent about one month helping install office windows at a local business. He had never done that type of work before and did not continue with this type of work after the project was finished. The business for which he did the work issued him a Form 1099-MISC, *Miscellaneous Income*, reporting the payments he received as nonemployee compensation. Bruce's "one-time job" was not regular or continuous; accordingly, he was not engaged in a trade or business.¹¹

Note. Bruce should report the income on Schedule C because he received a Form 1099-MISC. He should then enter an offsetting deduction equal to the income in the expense section of Schedule C. The income should then be reflected on the Form 1040, Schedule 1, *Additional Income and Adjustments to Income*, line 8, as miscellaneous income not subject to SE tax. Various tax preparation software packages may handle these transactions differently.

Example 3. From 1974 through 1978, Anna was an assistant professor at Iowa State University. On January 16, 1976, she accepted a contract to co-author the fifth edition of a textbook. This work was completed in 1977 and the book was published in 1979. Anna received book royalty income from the publisher in 1980, 1981, 1982, and 1983. The royalties she received in 1983 were attributable solely to services rendered in 1976 and 1977.¹²

On December 7, 1983, Anna accepted a contract to be the principal author of the sixth edition of the textbook. This contract was amended by letter on June 20, 1986, making her a co-principal author, entitling her to receive 35% of the royalties. On her 1983 federal income tax return, she listed her occupation as "author and homemaker."

Anna's royalties were not contingent on any performance of future services and continued until the volume of sales of the fifth edition of the textbook fell below an agreed level. There was no express or implied understanding that she would have any part in the sixth edition until December 1983. The 5-year hiatus between her work on the fifth edition of the textbook in 1976 and 1977 and the sixth edition in 1983 proved that her authoring activities were not engaged in regularly.

Example 4. Robert had worked for 20 years in sales and market research for an Illinois manufacturer when his position was terminated. During the remainder of that year, he busied himself with parimutuel wagering, primarily on greyhound races. He gambled at tracks in Florida and Colorado. He went to the track six days per week for 48 weeks that year. He spent a substantial amount of time studying racing forms, programs, and other materials. He devoted from 60 to 80 hours each week to these gambling-related endeavors. He never placed bets on behalf of any other person, or sold tips, or collected commissions for placing bets, or functioned as a bookmaker. He gambled solely for his own account. He had no other profession or type of employment during this time. Robert's activity was a trade or business because he pursued the gambling activity full-time, in good faith, with continuity and regularity, for the production of income for a livelihood.¹³

¹⁰ This example is taken from the facts and conclusions in *Levinson v. Comm'r*, TC Memo 1999-212 (Jun. 29, 1999).

¹¹ This example is taken from the facts and conclusions in *Batok v. Comm'r*, TC Memo 1992-727 (Dec. 28, 1992). See also *Sloan v. Comm'r*, TC Memo 1988-294 (Jul. 11, 1988).

¹² This example is taken from the facts and conclusions in *Langford v. Comm'r*, TC Memo 1988-300 (Jul. 19, 1988).

¹³ This example is taken from the facts and conclusions in *Comm'r v. Groetzinger*, 480 U.S. 23 (1987).

Fiduciaries of Trusts and Estates

Although it may take a substantial amount of regular and continuous activities to serve as an **executor** of an estate, in most cases an executor is not considered self-employed, especially if they are a friend or relative of the deceased person.¹⁴

Executor fees paid to a **professional** executor are included in business income. For a **nonprofessional** executor, executor compensation is only treated as business income if **all** of the following conditions are satisfied.¹⁵

1. A trade or business is included in the estate's assets.
2. The executor actively participates in the operation of this trade or business.
3. The fees of the executor are related to the operation of the trade or business.

A member of a **board of directors** is treated as self-employed if, by the nature of their duties, they are involved in the efforts on a continuous and regular basis.¹⁶

PROFIT MOTIVE

In order to be engaged in a trade or business, one of the taxpayer's main purposes must be to make a profit. If the taxpayer does not have a profit motive, an activity is not a business.¹⁷ People typically enter into income-generating activities with the hope of making a profit.

The hope of making a profit is not enough to qualify an activity as a business. Additionally, the existence of a profit does **not** mean that the taxpayer has a profit **intent**.¹⁸ In making the for-profit determination, greater weight is placed on objective facts than on the taxpayer's statement of intent. All the facts and circumstances are taken into account, but there are nine particular factors that should be considered. These factors and any other relevant factors are weighed in the determination according to their importance in the situation at hand.¹⁹

The nine factors that should be considered are the following.²⁰

1. **The manner in which the taxpayer carries on the activity** — If the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records, this may indicate the taxpayer has a profit motive. A change of operating methods, adoption of new technologies, or abandonment of unprofitable methods may also indicate a profit motive.
2. **The expertise of the taxpayer and the taxpayer's advisors** — Preparation for the activity by studying its accepted business, economic, and scientific practices may indicate the taxpayer has a profit motive. If a taxpayer has such preparation or obtains expert advice but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated.
3. **The time and effort the taxpayer expends in carrying on the activity** — The fact that the taxpayer devotes much of their personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of their energies to the activity may also be evidence that the activity is engaged in for profit.

¹⁴ IRS Pub. 559, *Survivors, Executors, and Administrators*.

¹⁵ Rev. Rul. 58-5, 1958-1 CB 322.

¹⁶ Rev. Rul. 72-86, 1972-1 CB 273. See also Rev. Rul. 68-595, 1968-2 CB 378.

¹⁷ *Comm'r v. Robert P. Groetzinger*, 480 U.S. 23 (1987).

¹⁸ *Ibid.*

¹⁹ Treas. Reg. §1.183-2.

²⁰ Treas. Reg. §1.183-2(b).

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4. **The taxpayer's expectation that assets used in the activity may appreciate in value** — The taxpayer may intend to derive a profit from the operation of the activity if an overall profit will result when appreciation in the value of assets used in the activity is realized.
5. **The taxpayer's record of prior business successes or failures** — The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that the taxpayer is engaged in the present activity for profit.
6. **The taxpayer's history of income and losses from the particular activity** — If losses are sustained because of unforeseen or fortuitous circumstances that are beyond the control of the taxpayer, such losses are not an indication that the activity is not engaged in for profit. A series of years in which net income was realized is strong evidence that the activity is engaged in for profit.
7. **The amount of occasional profits, if any, that are earned** — The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent.
8. **The taxpayer's financial status** — The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit.
9. **Elements of personal pleasure or recreation** — The presence of personal motives in carrying on an activity may indicate that the activity is not engaged in for profit, especially when there are recreational or personal elements involved. However, it is not necessary that an activity be engaged in with the exclusive intention of deriving a profit or maximizing profits. In addition, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors.

Note. No one factor is considered to be more important than another. Furthermore, it is not necessary to have a positive result to more of the nine factors than negative results. Having more positive results to the factors may help support the for-profit argument, but the IRS may also argue against a for-profit motive merely by the failure of just one factor.

§183 Safe Harbor

A taxpayer may use the §183 safe harbor to shift the burden to the **IRS to prove** a profit motive does **not** exist. Under the safe harbor, if the taxpayer realizes a net profit from the activity in **three out of five** of the consecutive tax years that end with the tax year, the taxpayer is presumed to have a profit motive. Taxpayers engaged in breeding, training, showing, or racing horses are presumed to have a profit motive if they show a profit in **two out of seven** consecutive tax years.²¹

Note. The IRS audit technique guide (ATG) for activities not engaged in for profit cautions examiners that failing to meet the safe harbor **cannot** be used as the sole justification for determining that an activity is not engaged in for profit.²²

²¹ IRC §183(d).

²² IRC §183: *Activities Not Engaged in For Profit (ATG)*. Jun. 2009. IRS. [www.irs.gov/pub/irs-utl/irc183activitiesnotengagedinforprofit.pdf] Accessed on May 20, 2020.

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To elect to postpone an IRS decision on whether an activity is engaged in for profit, taxpayers may file Form 5213, *Election to Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit*. If the taxpayer timely files this form, the IRS generally postpones the determination until after the end of the fourth tax year (or sixth tax year for a horse activity).²³

To make the election, the taxpayer must file this form within three years after the due date (excluding extensions) of their return for the first tax year in which they engaged in the activity, or within 60 days after receiving a notice that the IRS proposes to disallow deductions attributable to the activity.²⁴

Example 5. Janet started a horse breeding activity in 2019. She reports losses from 2019 through 2021 for the horse breeding activity, which she reports on Schedules C. Her return for 2020 is audited in June 2022, and the IRS determines that she did not have sufficient profit motive to deduct her losses. In 2022, at the time of the audit, Janet has experienced three tax years of losses, but it is too early to know if she will have two years of profit in the next four years. To postpone the determination, she must file Form 5213 within 60 days of the IRS notice of intent to treat her business as a hobby. If she had not been audited, her last day to file the form would have been April 15, 2023 (i.e., three years after the due date of her 2019 return).

5

Understanding Profit Motive

The following examples demonstrate how the nine factors can be analyzed when assessing a taxpayer's profit motive.

Example 6. From February to August 2020, Samantha watched her sister's child at her parent's home while her sister worked. She was paid \$4,000 by the state and received the following Form 1099-NEC, *Nonemployee Compensation*, at the end of the year showing the income as nonemployee compensation.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. State of Illinois 101 Lincoln Ave. Springfield, IL 62629		OMB No. 1545-0116 2020 Form 1099-NEC		Nonemployee Compensation Copy B For Recipient This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
		1 Nonemployee compensation \$ 4,000.00		
PAYER'S TIN 36-0000000	RECIPIENT'S TIN 999-88-7777	2		
RECIPIENT'S name Samantha Kidd		3		
Street address (including apt. no.) 1001 Laurel Lane		4 Federal income tax withheld \$		
City or town, state or province, country, and ZIP or foreign postal code Sandwich, IL 60548				
FATCA filing requirement <input type="checkbox"/>				
Account number (see instructions)		5 State tax withheld \$	6 State/Payer's state no. \$	7 State income \$

Form **1099-NEC** (keep for your records) www.irs.gov/Form1099NEC Department of the Treasury - Internal Revenue Service

²³ Instructions for Form 5213.

²⁴ Ibid.

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Samantha does not have a daycare license and does not watch any other children. She has no out-of-pocket costs because her sister provides all of the child's food, toys, and other needs.

Note. Beginning with the 2020 tax year, Form 1099-NEC is used to report nonemployee compensation. In previous years, box 7 of Form 1099-MISC was used for this purpose. Accordingly, Form 1099-MISC has been redesigned for the 2020 tax year.²⁵

Samantha was 19 and living at home during the time she was babysitting. She had no other income. In August, she left home to go to college. Her parents provided over half of her support.

Samantha goes to Brian Trist, CPA, to have her 2020 tax return prepared. Brian asks Samantha whether she had a profit motive for the babysitting activity. Samantha responds that, although she appreciated being paid, her motive was to help her sister, not to make money. She also told him that she enjoyed spending time with her niece, so babysitting was enjoyable to her.

Brian analyzes the nine factors to determine whether Samantha had a profit motive.

1. **Manner in which the taxpayer carries on the activity** — Samantha does not describe herself as being in the babysitting business. She did not keep separate records, advertise, or attempt to obtain additional customers. This suggests that she did not have a profit motive.
2. **The expertise of the taxpayer or her advisors** — Samantha has no childcare training or licensing nor did she seek the advice of experts. This factor suggests that she did not have a profit motive.
3. **The time and effort expended by the taxpayer in carrying on the activity** — Samantha spent six months engaged in the activity, but she made no efforts to build an ongoing business. This suggests that she did not have a profit motive.
4. **Expectation that assets used in the activity may appreciate in value** — This factor is not applicable to Samantha's situation.
5. **The success of the taxpayer in carrying on other similar or dissimilar activities** — Samantha did not engage in similar activities in the past. Therefore, this factor is not applicable.
6. **The taxpayer's history of income or losses with respect to the activity** — Samantha did not report income from the babysitting activity in previous years, so this factor is neutral.
7. **The amount of occasional profits, if any, which are earned** — Samantha did not incur losses in previous years and she did not invest any resources in the activity. This suggests that she may have a profit motive.
8. **The financial status of the taxpayer** — Samantha had no other sources of income and was supported by her parents. This factor suggests that she may have a profit motive.
9. **Elements of personal pleasure or recreation** — Samantha enjoyed spending time with her niece. This factor suggests that she did not have a profit motive.

After analyzing the nine factors, Brian believes that Samantha has a defensible position for treating this activity as a hobby that is not subject to SE tax, despite the activity's profit.

²⁵ Instructions for Forms 1099-MISC and 1099-NEC.

Example 7. Tao has a bachelor of science degree from the California Institute of Technology, as well as a master of science degree in electrical engineering from the University of Illinois, Urbana-Champaign. While employed with Broadcom, a microchip manufacturer, Tao obtained his real estate broker's license, which allowed him to engage in various real estate transactions, including loan brokerage activities. In addition, he enrolled in a masters of business administration (MBA) program at the Wharton School of the University of Pennsylvania while he was employed at Broadcom and graduated with honors in April 2012.²⁶

After obtaining his real estate license, Tao signed contracts with four clients to represent them in transactions, using template forms from his realtor association. However, he did not generate any income from the real estate activity, never represented any clients in a real estate transaction, never made any written offers on a client's behalf, and never offered any properties for sale. He had no business plan, books, business bank account, or business credit card. Expenses were charged to his personal credit card or bank account. He maintained a handwritten log and calendar to track appointments and mileage.

In December 2009, Tao signed an agreement with Info Loan to broker loans. He also developed a "mortgage shuttle" concept to save the cost of applying for a mortgage by "batching" mortgage applications, but these endeavors did not generate any income.

Tao claimed on his 2010 and 2011 returns that he had been in business and had incurred substantial losses in those years. He reported a salary on his returns of \$527,860 and \$117,888 for 2010 and 2011, respectively. When his return was audited, the IRS disallowed the business losses, and Tao took the issue to court. The court's analysis of the nine factors is summarized below.

- 1. Manner in which the taxpayer carries on the activity** — Tao did not maintain complete and accurate books and records. He did not have a business plan or an accounting system for his business, and his recordkeeping was incomplete and disorganized. He also did not have a business bank account or credit card for his real estate activity. This factor does not support Tao's claim that he had a profit motive.
- 2. The expertise of the taxpayer or his advisors** — Tao studied for the California exam for real estate brokers and was issued a real estate broker's license on November 7, 2009. Thus, he put in time and effort to study for the real estate exam to become licensed in the field. He used a template for his buyer broker agreements with clients, demonstrating that he knew some of a broker's practices. Additionally, he spent time researching the residential real estate market in his area and the surrounding areas and presented this research to clients. This factor supports Tao's claim that he had a profit motive.
- 3. The time and effort expended by the taxpayer in carrying on the activity** — Considering the demands on Tao's time created by full-time employment in a management position, as well as his MBA studies at which he excelled, he did not appear to have time to devote himself to the real estate activity. From his calendars and other records, the time he devoted to his real estate activity was part-time at most and appeared to be insubstantial, despite his verbal claims of having devoted significant time to the activities. This factor indicates that Tao did not have a profit motive.
- 4. Expectation that assets used in the activity may appreciate in value** — Tao did not acquire any assets that might appreciate as part of his real estate activity. This factor is neutral.
- 5. The success of the taxpayer in carrying on other similar or dissimilar activities** — Tao did not engage in other financial endeavors outside of his salaried work that were successful. This factor is neutral.

²⁶ This example is taken from the facts and conclusions in *Tao Long v. Comm'r*, TC Summ. Op. 2016-88 (Dec. 20, 2016).

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6. **The taxpayer's history of income or losses with respect to the activity** — Tao was engaged in the real estate activity for approximately two years. He claimed that he did not generate any commissions or other income from his real estate activity because the real estate market had not sufficiently recovered from an economic recession. He also claimed that because of the depressed real estate market he could not secure investor funding for his mortgage shuttle concept. This factor is neutral.
7. **The amount of occasional profits, if any, which are earned** — Tao did not report any gross receipts or profit, even occasional, from his real estate activity. Instead, he reported substantial losses from the activity. Residential real estate is not a “highly speculative venture” in which his losses could be justified by an expectation of “substantial ultimate profit.” Therefore, this factor does not indicate a profit motive.
8. **The financial status of the taxpayer** — Tao's reported income from wages was \$527,860 for 2010 and \$117,888 for 2011. The losses on the activities generated significant tax savings. Therefore, this factor does not indicate a profit motive.
9. **Elements of personal pleasure or recreation** — Tao claimed travel expenses for 14 business trips to popular tourist destinations despite having no records as to the business nature of the trips or attending any business-related meetings while there. This factor does not indicate that he had a profit motive.

On the basis of this analysis, the court concluded that Tao did not engage in the real estate activity for profit. Therefore, the deductions attributable to his real estate activity are limited to the gross income derived from the activity.

Example 8. John began his track and field coaching career in 1984. He earned an annual salary of \$55,000 to \$65,000 as an educator/coach.²⁷

John also did some freelance writing for track and field publications. At one point, he was the editor, publisher, and owner of a cross-country running magazine called “The Harrier.” In 2003, he stopped publishing in print and became involved in web-based publishing.

In 2006, John discontinued his writing and publishing and started conducting track camps and clinics. He also began focusing more of his time on a running club, which he ran from 2003 through 2008. He usually had 12–20 participants for which he received between \$125–\$200 each. In 2006, he lost the use of the track facilities he had been using and moved his efforts to substandard facilities until 2007. At that time, he became the track coach at a high school and was able to use those facilities for his private coaching activities. John's efforts in both 2006 and 2007 were unprofitable due to the loss of several of his private coaching athletes.

John normally spent 25 to 30 hours per week on his private coaching and a lesser amount when he had high school coaching responsibilities. In addition, during 2006, 2007, and 2008, he spent 6, 32, and 36 days, respectively, traveling to track meets. Because of the substantial portion of his nonemployment time that he devoted to his private coaching activity, his personal life and marriage were negatively impacted.

John coached a gifted athlete, Ryan Bailey, who qualified for the Olympic trials in Oregon in 2008. He then became Bailey's professional coach and manager, earning compensation of \$5,000 in 2009 and \$10,000 in subsequent years.

John reported his coaching activities on Schedules C as follows.

²⁷ This example is taken from the facts and conclusions in *John Dalton Parks III v. Comm'r*, TC Summ. Op. 2012-105 (Oct. 25, 2012).

Year	Gross Receipts	Expenses	Gain or (Loss)
2003	\$11,707	\$ 30,284	(\$18,577)
2004	11,950	29,415	(17,465)
2005	9,115	27,531	(18,416)
2006	7,744	25,125	(17,381)
2007	5,785	38,646	(32,861)
2008	7,647	44,448	(36,801)
2009	5,000	9,057	(4,057)
2010	11,270	19,243	(7,973)
2011	16,925	16,882	43
Total	\$87,143	\$240,631	(\$153,488)

When his return was audited, the IRS disallowed the business losses, and John took the issue to court. The court's analysis of the nine factors is summarized below.

- 1. Manner in which the taxpayer carries on the activity** — John's approach to his private coaching activity was business-like and he sought ways to improve his success, including the abandonment of his journalistic pursuits. He kept records and segregated the activity's banking and financial transactions from his personal transactions. His educational background and extensive coaching experience qualified him to train and coach track and field athletes. This factor indicates John was engaged in the activity with a profit motive.
- 2. The expertise of the taxpayer or his advisors** — John clearly has the expertise to coach track and field. This factor indicates he had a profit motive.
- 3. The time and effort expended by the taxpayer in carrying on the activity** — John devoted significant time and effort to the activity to the detriment of his marriage. This factor indicates he had a profit motive.
- 4. Expectation that assets used in the activity may appreciate in value** — John did not use any significant assets in connection with his activity. This factor is neutral.
- 5. The success of the taxpayer in carrying on other similar or dissimilar activities** — John did not offer any evidence regarding his success in comparable activities. This factor is neutral.
- 6. The taxpayer's history of income or losses with respect to the activity** — John's income was increasing, his losses were decreasing, and his potential for success was improving. However, he incurred losses for several years; therefore, this factor indicates that he did not have a profit motive.
- 7. The amount of occasional profits, if any, which are earned** — Although John improved his potential for gain, the continued losses without meaningful gain indicate that he did not have a profit motive.
- 8. The financial status of the taxpayer** — Because it was likely that the expenses John incurred in his private coaching activity were a financial hardship, the activity reduced the amount available to pay his personal living expenses. This factor indicates that he had a profit motive.
- 9. Elements of personal pleasure or recreation** — John spent considerable nonemployment time on the activity. Even though he may have derived personal pleasure from his involvement in teaching and coaching, the court found that the nature of the activity indicates he had a profit motive.

Overall, the court found that the factors indicating that John had a profit motive are more compelling than the evidence that suggests he did not. Accordingly, John was entitled to deduct his losses for the years at issue.

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Caution. The determination of whether an activity is a trade or business must be based on the facts of the situation, not the desired tax result. Very often, the most significant factor is the continuity and regularity of the taxpayer's involvement in the activity. If the taxpayer's involvement is not continuous and regular, the existence of an intent to generate a profit is irrelevant. Because this factor can vary from year to year, tax practitioners should annually evaluate whether the taxpayer had a trade/business or a hobby.

Suggested Action Plan for Determining Profit Motive

The following table may serve as a resource for tax practitioners to give to clients to help them translate the nine factors from Treas. Reg. §1.183-2(b) into an action plan to establish profit motive.²⁸

Regulation Factors	Action Plan Subfactors
1. Manner in which taxpayer carries on the activity	<ul style="list-style-type: none"> a. Operate activity in businesslike manner. b. Maintain acceptable financial books and records. c. Change operating methods to try to improve profitability. d. Operate activity in manner similar to other comparable enterprises. e. Maintain a separate bank account. f. Engage in advertising and promotion. g. Select a formal business name. h. Join business-related association or industry group.
2. Expertise of the taxpayer or their advisers	<ul style="list-style-type: none"> a. Solicit expert advice when starting activity and follow it. b. Have prior experience or conduct extensive study. c. Solicit ongoing advice and follow it.
3. Time and effort expended by the taxpayer in carrying on the activity	<ul style="list-style-type: none"> a. Allocate significant time to the operation. b. Employ a competent manager. c. Withdraw from another occupation to attend to the operation. d. Track time spent on activity.
4. Expectation that the assets used in the activity may appreciate in value	<ul style="list-style-type: none"> a. Identify property expected to appreciate in value. b. Document value over time showing that the property has increased in value, via appraisals or other reputable sources.
5. Success of the taxpayer in carrying on other similar or dissimilar activities	<ul style="list-style-type: none"> a. Keep records of prior experience in similar, successful business activities. b. Be able to demonstrate how past experiences position the taxpayer to make this activity profitable.
6. Taxpayer's history of income or losses with respect to the activity	<ul style="list-style-type: none"> a. Be able to explain losses that continue beyond start-up period. b. Show that the magnitude of losses is decreasing or projected to decrease. c. Document cause of losses due to circumstances beyond the taxpayer's control.

²⁸ Adapted from the 1997 *University of Illinois Farm Tax School Workbook*, Chapter 1: Agriculture Issues, which was adapted from Daughtrey, Bunn, and Burkel, "Farm Business or Farm Hobby: Separating the Grain from the Chaff," *Journal of Agricultural Taxation and Law*, Fall 1986, pp. 187–207.

Regulation Factors	Action Plan Subfactors
7. Amount of occasional profits earned, if any	<ul style="list-style-type: none"> a. Realize occasional but significant profits. b. Show that losses are small in relation to value of assets used in the activity. c. Document the opportunity for substantial profit if the activity is a highly speculative venture.
8. Financial status of the taxpayer	<ul style="list-style-type: none"> a. Demonstrate that the existence of tax savings from the losses are not a significant consideration in continuing operations.
9. Elements of personal pleasure or recreation	<ul style="list-style-type: none"> a. Avoid significant personal pleasure from activity. b. Account for personal-use assets separately from income-generating assets. c. Separate expenses related to recreational aspects from ordinary and necessary business expenses.
10. Other factors	<ul style="list-style-type: none"> a. Develop an exit plan if the activity continues to be unprofitable.

MULTIPLE ACTIVITIES²⁹

When a taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity. In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the situation must be considered. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose that is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of the various activities.

Generally, the IRS accepts the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that their characterization is artificial and cannot be reasonably supported under the facts and circumstances of the activity.

If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying the loss limitations under §183.

²⁹ Treas. Reg. §1.183-1.

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Example 9. Trilby operated a tax and accounting business, focusing mostly on preparing tax returns. She began boarding, conditioning, and selling horses and competing in endurance horse riding. Trilby combined her horse activity with her tax return preparation service on one Schedule C, where the horse activity expenses were deducted as advertising and promotional expenses. She claimed that the only purpose for the horse activity was to gain clients for the tax preparation business. However, she provided no evidence that any of her colleagues in the equine community were clients of her tax preparation business.³⁰

The court ruled that the horse activity was a separate activity. The horse activity had no profit objective because Trilby:

- Kept poor records,
- Made no profit in 10 years,
- Had not thoroughly investigated profitability,
- Had substantial income from other sources to finance the horse activity, and
- Derived personal pleasure and recreation from it.

Owning Land and Farming Activities³¹

Treas. Reg. §1.183-1(d) specifically addresses whether farming and holding land for appreciation are considered a single activity if the property was purchased primarily for appreciation. According to the regulation, the activities may only be considered a single activity if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, to qualify, the income derived from farming must exceed the deductions attributable to the farming activity that are **not** directly attributable to holding land. Deductions attributable to holding land include interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land.

Example 10. Lawrence purchased a 392-acre farm. He intended to benefit from the land's appreciation, but he also intended to use the land to generate net income. He undertook a number of endeavors to generate income, including the following.³²

- Leasing some of the acres to a crop-share farmer
- Leasing hunting rights
- Boarding and training horses
- Breeding gamebirds

Each of the operational activities was organizationally and economically interrelated with the ownership of the land. Because Lawrence's intent was to use the land to generate farming-related income, not to benefit from land appreciation, the general rule applies in determining whether there was a single activity. The court found that because of the interrelationship, Lawrence's characterization of the farming and holding of the land as a single activity was reasonable.

³⁰ This example is taken from the facts and conclusions in *Trilby Pederson v. Comm'r*, TC Memo 1994-555 (Nov. 2, 1994).

³¹ Treas. Reg. §1.183-1(d).

³² This example is taken from the facts and conclusions in *Lawrence T. Hoyle, Jr. v. Comm'r*, TC Memo 1994-592 (Dec. 5, 1994).

REPORTING INCOME AND EXPENSES OF NONBUSINESS ACTIVITIES

IRC §183 disallows any net loss from an activity conducted without a bona fide profit motive. This Code section specifically applies to individuals and S corporations. The IRS applies the provision to partnerships, as well.³³

Note. C corporations are not subject to the §183 restrictions. However, C corporation losses may be subject to disallowance under the personal expense test of IRC §262.

If an activity is **not** engaged in for profit, gross income from the activity is generally reported on Form 1040, Schedule 1, line 8 (other income).³⁴ Prior to the Tax Cuts and Jobs Act (TCJA), deductible expenses were claimed on Schedule A, *Itemized Deductions*.³⁵ During the TCJA period (2018–2025), miscellaneous itemized deductions are not allowed. As a result, for hobby activities, only cost of goods sold and expenses that would otherwise be deductible (i.e., mortgage interest, real estate taxes, and contributions) are allowed.

Note. Sales of capital assets are reported on Form 8949, *Sales and Other Dispositions of Capital Assets*. Inventory for sale to customers in the ordinary course of business is not a capital asset.³⁶ However, some practitioners believe that for an activity not engaged in for profit, the products for sale are classified as capital assets because there is no business. Under this approach, sales of products and the related cost of the goods are reported on Form 8949. Net gains are then reported as either short-term or long-term depending on the holding period. **Net losses from sales of merchandise used in a hobby activity are not deductible.**³⁷

Gross Income Defined

Gross income for an activity not engaged in for profit includes the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from the activity. This generally includes capital gains and rents received for the use of property held in connection with the activity. The taxpayer can determine gross income from an activity by subtracting the cost of goods sold from the gross receipts, as long as this practice is consistently followed and conforms to generally accepted accounting methods.³⁸

Cost of goods sold includes the purchase price of the items sold and the cost of all raw materials or parts purchased for creating a finished product. Freight-in, express-in, and cartage-in on raw materials and supplies used in production are also included. Other direct expenses may be included, but only those that are necessary to create the product.³⁹

Expenses⁴⁰

Treasury regulations stipulate three ordered categories of deductions for expenses related to not-for-profit activities. However, two of the categories fall into the classification of miscellaneous itemized deductions subject to the 2% of adjusted gross income limit. For tax years 2018 through 2025 under the TCJA, no deductions are allowed for this class of deductions.⁴¹

³³ Rev. Rul. 77-320, 1977-2 CB 78.

³⁴ Instructions for Form 1040.

³⁵ See IRS Pub. 535, *Business Expenses*.

³⁶ IRC §1221.

³⁷ IRC §183.

³⁸ Treas. Reg. §1.183-1(e).

³⁹ IRS Pub. 334, *Tax Guide for Small Business*.

⁴⁰ Treas. Reg. §1.183-1(b).

⁴¹ IRC §67(g).

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As mentioned earlier, the only expenses (other than cost of goods sold) allowed for hobby activities are those that would otherwise be deductible, such as mortgage interest, real estate taxes, and contributions. These expenses are included in their respective sections of Schedule A.

Example 11. Paige started making facemasks for her family and friends in April 2020. She even bought a \$350 embroidery machine to personalize the masks. She loved playing with the fabrics and designs, so she decided to start selling masks on Etsy. By the end of 2020, she had made 200 masks. She gave 180 to her friends, family, and co-workers. She sold 10 via Etsy and had 10 remaining.

In addition to the masks she sold, one of her friends paid her \$500 to embroider a tapestry, which the friend supplied. Paige bought another embroidery machine for the project, thinking that this might be a good side business for her. However, Paige found that it was a horrible experience and decided she never wanted to do any large fabric projects again.

Paige's income from selling the masks was \$200 in 2020. After discussion of the 2-prong test and nine factors with her tax preparer, they agreed that she was not in the business of mask making or embroidering in 2020.

Paige calculated that she had spent \$1,200 on the fabrics and embroidery materials used to make the 200 masks. Thus, her cost per mask was \$6.

Paige reported the \$500 income from the tapestry embroidery on line 8 of Schedule 1. She reported mask sales of \$200 with a cost of \$60 ($\$6 \text{ cost} \times 10 \text{ sold}$) on her 2020 Form 9949 as a short-term gain. She was unable to deduct the cost of the embroidery machines.

CHANGE IN BUSINESS ACTIVITY

Just as there is **no definitive rule** to determine if an activity is a business or a hobby, **no criteria exist that determines when a business changes into a hobby or vice versa.**

Consider the following situations and the classification of each.

Example 12. The Auto Mechanic. John owned a profitable automobile repair shop five years ago. When he retired from the business, he sold the building where the shop was located. He now repairs cars in his garage at home to supplement his social security and investment income. For the last three years, he has reported a loss on the activity.

John believes that he devotes sufficient time and effort to his work to classify it as a business. He intends to make a profit. John demonstrates that the loss he reports is created by taking advantage of the home office deductions for mortgage interest and real estate taxes. He indicates these expenses would continue even if he closed the business. He contends that a review of the facts in relation to the nine tests for profit motive shows that he has the expertise and track record sufficient to prove a profit motive.

The IRS may challenge John's classification of his work as a business on the basis that John's sporadic work repairing cars does not rise to the level of a legitimate business activity. Because he has not met the safe harbor test of profits in three out of the last five years, John must prove that his profit motive is sufficient to classify this activity as a business. The IRS may contend that a review of the facts in relation to the nine tests for profit motive leads them to conclude that:

- He is not conducting the activity in a businesslike manner,
- He does not devote enough time to the business to show a profit motive,
- There is no expectation of asset appreciation, and
- His income from other sources is such that he does not need profits from his car repair work to support himself.

Example 13. The Home Enthusiast. Richard is a retired teacher with a flair for home remodeling and decorating. He holds a real estate license. Periodically, he purchases run-down homes and fixes them up in his spare time. After the homes are refurbished, he sells them at a profit. He usually does not sell more than one home per year. He does not need the income and he spends a great deal of his time each year traveling for pleasure.

Richard tells his tax preparer that the homes are investments, subject to capital gain treatment. He says that he does not sell enough homes nor devote enough of his time to the investments to be considered in business.

The IRS may challenge Richard's classification of home sales on the basis that he has a clear profit motive related to the real estate activities. He has a real estate license. Although his sales are not frequent, they do generate a substantial level of gross income. Furthermore, the fact that Richard has been participating in this activity for several years indicates that it is an ongoing business venture.

Example 14. The Crafter. Geoff is a stay-at-home dad. His wife has an executive position with a local corporation. Geoff makes decorative doodads and sells them at the annual citywide craft fair. For the past two years, he reported his income as hobby income. This year, he stepped up the pace of production, began selling at other craft fairs, and placed his products on consignment with a local craft store. He traveled quite a bit during the summer and purchased a lot of supplies for setting up his craft booths. He even applied for a sales tax number and purchased a laptop for keeping track of his business transactions. He hopes that the venture will become profitable in the next few years.

Geoff contends that he is now in the business of making doodads. He is devoting a substantial amount of time and effort to the activity and intends to make money as soon as his doodads become popular. The fact that he has registered with the state and is keeping business records proves that he is serious about this business.

The IRS may contend that Geoff has not proved he has a profit motive in the activity. Although the activity is currently conducted in a business-like manner as compared to the past, he still does not meet most of the other tests for profit motive, such as expertise, time, and past success.

Example 15. The Artist. Jane paints landscapes. For the past 10 years, she has been selling her work in art galleries and craft shows, as well as painting commissioned pieces. Historically, she made enough to support herself and appropriately reported her profits as business income. Two years ago, she got tired of subsistence living and got a full-time job with CPA Geeks, Inc. She has not painted anything new since she started with the CPA firm, but last year she sold two pieces from her collection. She says she is holding the remaining pieces in the collection as investments.

When discussing her finances with her CPA, Jane insists that she is no longer in business as an artist. She believes that reporting her sales as long-term capital gains (subject to a maximum tax rate of 28%) is correct because she spends almost no time on her painting activities.

The IRS may contend that Jane's sales are a result of her previous self-employed activities. According to Treas. Reg. §1.1402(a)-1(c), income derived from an individual's trade or business may be subject to SE tax even when the income is from services rendered in a prior tax year.

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COMPREHENSIVE EXAMPLE

The following comprehensive example compares two taxpayers with identical financial situations. The distinguishing factor is one taxpayer's activity qualifies as a business and the other taxpayer's does not.

Example 16. Pauline and Eppie are identical twin sisters who each provide babysitting services on an ongoing basis. Pauline intends to use her babysitting business to supplement her other income. She spends a great deal of time promoting her services. Eppie has a dozen grandchildren and babysits exclusively for family members.

Both sisters' babysitting services meet the test of being more than occasional or sporadic activities. However, only Pauline intends to generate a profit. She discussed the activity with her tax preparer, Fred. After a review of all the facts, including the 9-factor test, Fred determined that Pauline had the requisite profit motive. On the other hand, Eppie's primary intent is to be with her grandchildren. Accordingly, Pauline's babysitting service qualifies as a trade or business and Eppie's does not.

In 2019, Pauline and Eppie are both single and had identical income and expenses from the babysitting activity, as shown in the following table.

Income		\$15,000
Expenses		
Tax preparation fees for business	\$ 200	
Supplies (diapers, wipes, paper towels, etc.)	2,000	
Meals provided (100% deductible ⁴²)	800	
Home office expenses	4,000	
Total expenses	\$7,000	7,000
Net profit		\$ 8,000

Both sisters received \$13,000 in social security benefits in 2019, of which \$1,600 paid their Medicare Part B premiums. In addition, they each received \$20,000 in pension benefits.

Pauline was able to take advantage of the deduction for self-employed health insurance and the QBID, in addition to deducting the direct expenses of the babysitting activity.

Eppie was not able to take any of these deductions because her activity was not a business. Moreover, because her standard deduction exceeded her itemized deductions, she was unable to benefit from the otherwise deductible mortgage interest and real estate taxes.

Pauline's total federal tax liability for 2019 was \$2,673, consisting of \$1,130 of SE tax and \$1,543 of income taxes. Eppie's total federal tax liability was \$3,649, consisting entirely of income taxes.

⁴² IRC §162(a). See also Rev. Proc. 2003-22, 2003-1 CB 577.

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Following is a summary of the tax results for each sister.

	Pauline		Eppie	
Pension		\$20,000		\$20,000
Taxable social security benefits		3,668		10,875 ^a
Gross income from babysitting/daycare	\$15,000		\$15,000	
Allowable expenses for babysitting/daycare	(7,000)		(0)	
Net Schedule C	\$ 8,000	8,000	\$15,000	0
Adjustments to income from Schedule 1		(2,165) ^b		0
Adjusted gross income		\$29,503		\$45,875
Standard deduction		(13,850)		(13,850)
QBIID		(1,167)		0
Taxable income		\$14,486		\$32,025
Income tax		\$ 1,543		\$ 3,649
SE tax		1,130		0
Total taxes		\$ 2,673		\$ 3,649

^a For information about the taxability of social security benefits, see IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits*.

^b This amount is composed of half of the SE tax, or \$565, plus the Medicare Part B premium of \$1,600. For information about why the Medicare premium qualifies as SE health insurance, see CCA 201228037 (May 1, 2012).

Pauline and Eppie's tax returns are shown on the following pages.

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For Example 16

Form	1040-SR	Department of the Treasury—Internal Revenue Service (99)	2019	OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.																																																																																
U.S. Tax Return for Seniors																																																																																					
Filing Status <input checked="" type="checkbox"/> Single <input type="checkbox"/> Married filing jointly <input type="checkbox"/> Married filing separately (MFS) <input type="checkbox"/> Head of household (HOH) <input type="checkbox"/> Qualifying widow(er) (QW) <small>Check only one box.</small> If you checked the MFS box, enter the name of spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent. ▶																																																																																					
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6	Capital gain or (loss). Attach Schedule D if required. If not required, check here . ▶ <input type="checkbox"/>	6																																																																																			
7a	Other income from Schedule 1, line 9	7a	8,000																																																																																		
b	Add lines 1, 2b, 3b, 4b, 4d, 5b, 6, and 7a. This is your total income ▶	7b	31,668																																																																																		
8a	Adjustments to income from Schedule 1, line 22	8a	2,165																																																																																		
b	Subtract line 8a from line 7b. This is your adjusted gross income ▶	8b	29,503																																																																																		
9	Standard deduction or itemized deductions (from Schedule A)	9	13,850																																																																																		
10	Qualified business income deduction. Attach Form 8995 or Form 8995-A	10	1,167																																																																																		
11a	Add lines 9 and 10	11a	15,017																																																																																		
b	Taxable income. Subtract line 11a from line 8b. If zero or less, enter -0-	11b	14,486																																																																																		
Standard Deduction Chart* Add the number of boxes checked in the "Age/Blindness" section of <i>Standard Deduction</i> . . . ▶																																																																																					
IF your filing status is . . .		AND the number of boxes checked is . . .		THEN your standard deduction is . . .																																																																																	
Single		1		13,850																																																																																	
		2		15,500																																																																																	
Married filing jointly		1		25,700																																																																																	
or		2		27,000																																																																																	
Qualifying widow(er)		3		28,300																																																																																	
		4		29,600																																																																																	
Head of household		1		20,000																																																																																	
		2		21,650																																																																																	
Married filing separately		1		13,500																																																																																	
		2		14,800																																																																																	
		3		16,100																																																																																	
		4		17,400																																																																																	

* Don't use this chart if someone can claim you (or your spouse if filing jointly) as a dependent, your spouse itemizes on a separate return, or you were a dual-status alien. Instead, see instructions.

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 71930F

Form **1040-SR** (2019)

2020 Workbook

For Example 16

Form 1040-SR (2019)

Page **2**

12a Tax (see instructions). Check if any from:			
1 <input type="checkbox"/> Form(s) 8814	2 <input type="checkbox"/> Form 4972	3 <input type="checkbox"/> _____	12a 1,543
b Add Schedule 2, line 3, and line 12a and enter the total			12b 1,543
13a Child tax credit or credit for other dependents		13a	
b Add Schedule 3, line 7, and line 13a and enter the total			13b
14 Subtract line 13b from line 12b. If zero or less, enter -0-			14 1,543
15 Other taxes, including self-employment tax, from Schedule 2, line 10			15 1,130
16 Add lines 14 and 15. This is your total tax			16 2,673
17 Federal income tax withheld from Forms W-2 and 1099			17
18 Other payments and refundable credits:			
a Earned income credit (EIC)			18a
b Additional child tax credit. Attach Schedule 8812			18b
c American opportunity credit from Form 8863, line 8			18c
d Schedule 3, line 14			18d
e Add lines 18a through 18d. These are your total other payments and refundable credits ▶			18e
19 Add lines 17 and 18e. These are your total payments ▶			19
Refund			
20 If line 19 is more than line 16, subtract line 16 from line 19. This is the amount you overpaid			20
21a Amount of line 20 you want refunded to you . If Form 8888 is attached, check here ▶ <input type="checkbox"/>			21a
Direct deposit? ▶ See instructions.	b Routing number X X X X X X X X X X ▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings		
	d Account number X X X X X X X X X X X X X X X X X X		
22 Amount of line 20 you want applied to your 2020 estimated tax ▶			22
Amount You Owe			
23 Amount you owe . Subtract line 19 from line 16. For details on how to pay, see instructions ▶			23 2,673
24 Estimated tax penalty (see instructions) ▶			24
Third Party Designee			
Do you want to allow another person (other than your paid preparer) to discuss this return with the IRS? See instructions. <input type="checkbox"/> Yes. Complete below. <input checked="" type="checkbox"/> No			
(Other than paid preparer)	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
	Spouse's signature. If a joint return, both must sign.		Date
	Your occupation Childcare		If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Spouse's occupation		If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.)	
Phone no.		Email address	
Preparer's name		Preparer's signature	Date
Firm's name ▶		PTIN	Check if: <input type="checkbox"/> 3rd Party Designee <input type="checkbox"/> Self-employed
Firm's address ▶		Phone no. Firm's EIN ▶	

Go to www.irs.gov/Form1040SR for instructions and the latest information.

Form **1040-SR** (2019)

5

2020 Workbook

For Example 16

SCHEDULE 1 (Form 1040 or 1040-SR)

Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

► Attach to Form 1040 or 1040-SR.
► Go to www.irs.gov/Form1040 for instructions and the latest information.

OMB No. 1545-0074

2019
Attachment
Sequence No. **01**

Name(s) shown on Form 1040 or 1040-SR

Pauline Filips

Your social security number

355-55-5555

At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency? ☐ Yes ☒ No

Part I Additional Income

1	Taxable refunds, credits, or offsets of state and local income taxes	1	
2a	Alimony received	2a	
b	Date of original divorce or separation agreement (see instructions) ►		
3	Business income or (loss). Attach Schedule C	3	8,000
4	Other gains or (losses). Attach Form 4797	4	
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	5	
6	Farm income or (loss). Attach Schedule F	6	
7	Unemployment compensation	7	
8	Other income. List type and amount ►	8	
9	Combine lines 1 through 8. Enter here and on Form 1040 or 1040-SR, line 7a	9	8,000

Part II Adjustments to Income

10	Educator expenses	10	
11	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	11	
12	Health savings account deduction. Attach Form 8889	12	
13	Moving expenses for members of the Armed Forces. Attach Form 3903	13	
14	Deductible part of self-employment tax. Attach Schedule SE	14	565
15	Self-employed SEP, SIMPLE, and qualified plans	15	
16	Self-employed health insurance deduction	16	1,600
17	Penalty on early withdrawal of savings	17	
18a	Alimony paid	18a	
b	Recipient's SSN		
c	Date of original divorce or separation agreement (see instructions) ►		
19	IRA deduction	19	
20	Student loan interest deduction	20	
21	Tuition and fees. Attach Form 8917	21	
22	Add lines 10 through 21. These are your adjustments to income . Enter here and on Form 1040 or 1040-SR, line 8a	22	2,165

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 71479F

Schedule 1 (Form 1040 or 1040-SR) 2019

SCHEDULE 2 (Form 1040 or 1040-SR)

Department of the Treasury
Internal Revenue Service

Additional Taxes

► Attach to Form 1040 or 1040-SR.
► Go to www.irs.gov/Form1040 for instructions and the latest information.

OMB No. 1545-0074

2019
Attachment
Sequence No. **02**

Name(s) shown on Form 1040 or 1040-SR

Pauline Filips

Your social security number

355-55-5555

Part I Tax

1	Alternative minimum tax. Attach Form 6251	1	
2	Excess advance premium tax credit repayment. Attach Form 8962	2	
3	Add lines 1 and 2. Enter here and include on Form 1040 or 1040-SR, line 12b	3	

Part II Other Taxes

4	Self-employment tax. Attach Schedule SE	4	1,130
5	Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 8919	5	
6	Additional tax on IRAs, other qualified retirement plans, and other tax-favored accounts. Attach Form 5329 if required	6	
7a	Household employment taxes. Attach Schedule H	7a	
b	Repayment of first-time homebuyer credit from Form 5405. Attach Form 5405 if required	7b	
8	Taxes from: a <input type="checkbox"/> Form 8959 b <input type="checkbox"/> Form 8960	8	
c	<input type="checkbox"/> Instructions; enter code(s)		
9	Section 965 net tax liability installment from Form 965-A	9	
10	Add lines 4 through 8. These are your total other taxes . Enter here and on Form 1040 or 1040-SR, line 15	10	1,130

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 71478U

Schedule 2 (Form 1040 or 1040-SR) 2019

2020 Workbook

For Example 16

SCHEDULE C (Form 1040 or 1040-SR)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business (Sole Proprietorship)

► Go to www.irs.gov/ScheduleC for instructions and the latest information.

► Attach to Form 1040, 1040-SR, 1040-NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2019

Attachment
Sequence No. **09**

Name of proprietor

Pauline Filips

Social security number (SSN)

355-55-5555

A Principal business or profession, including product or service (see instructions)

Childcare provider

B Enter code from instructions

► **6 2 4 4 1 0**

C Business name. If no separate business name, leave blank.

D Employer ID number (EIN) (see instr.)

E Business address (including suite or room no.) ► **2013 Abby Lane**

City, town or post office, state, and ZIP code **Sugar Grove, IL 60554**

F Accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) ►

G Did you "materially participate" in the operation of this business during 2019? If "No," see instructions for limit on losses ☒ Yes ☐ No

H If you started or acquired this business during 2019, check here ☐

I Did you make any payments in 2019 that would require you to file Form(s) 1099? (see instructions) ☐ Yes ☒ No

J If "Yes," did you or will you file required Forms 1099? ☐ Yes ☐ No

Part I Income

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked <input type="checkbox"/>	1	15,000
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	15,000
4	Cost of goods sold (from line 42)	4	
5	Gross profit. Subtract line 4 from line 3	5	15,000
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7	Gross income. Add lines 5 and 6	7	15,000

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8		18	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		a	Vehicles, machinery, and equipment	20a	
12	Depreciation	12		b	Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	0	21	Repairs and maintenance	21	
14	Employee benefit programs (other than on line 19)	14		22	Supplies (not included in Part III)	22	2,000
15	Insurance (other than health)	15		23	Taxes and licenses	23	
16	Interest (see instructions):			24	Travel and meals:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel	24a	
b	Other	16b		b	Deductible meals (see instructions)	24b	800
17	Legal and professional services	17	200	25	Utilities	25	
28	Total expenses before expenses for business use of home. Add lines 8 through 27a	28	3,000	26	Wages (less employment credits)	26	
29	Tentative profit or (loss). Subtract line 28 from line 7	29	12,000	27a	Other expenses (from line 48)	27a	
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	4,000	27b	Reserved for future use	27b	
31	Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Schedule 1 (Form 1040 or 1040-SR), line 3 (or Form 1040-NR, 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	8,000				
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 Schedule 1 (Form 1040 or 1040-SR), line 3 (or Form 1040-NR, 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 the separate instructions.

Cat. No. 11334P

Schedule C (Form 1040 or 1040-SR) 2019

2020 Workbook

For Example 16

SCHEDULE SE (Form 1040 or 1040-SR)

Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

► Go to www.irs.gov/ScheduleSE for instructions and the latest information.
► Attach to Form 1040, 1040-SR, or 1040-NR.

OMB No. 1545-0074

2019

Attachment
Sequence No. **17**

Name of person with self-employment income (as shown on Form 1040, 1040-SR, or 1040-NR)

Pauline Filips

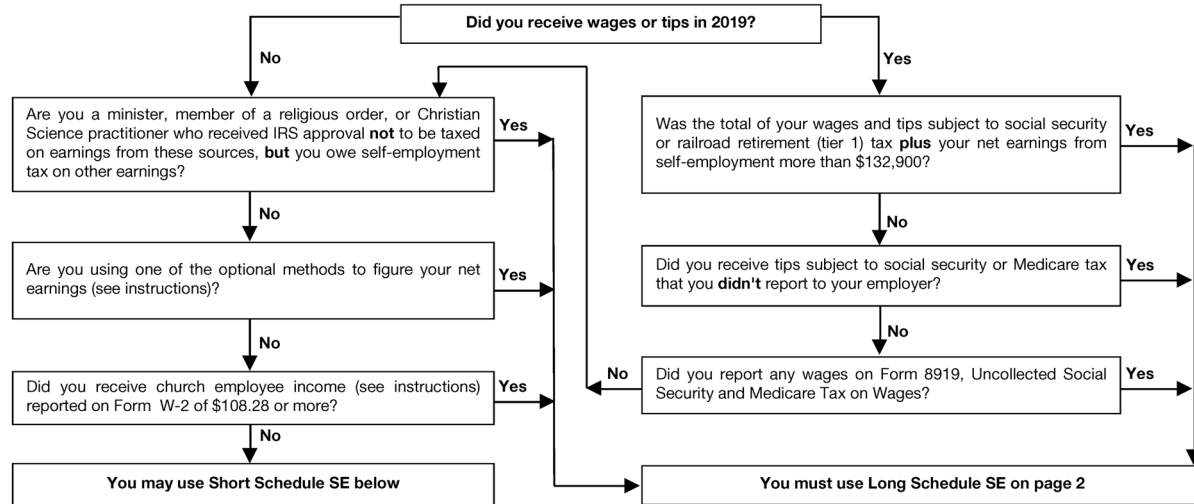
Social security number of person
with self-employment income ►

355-55-5555

Before you begin: To determine if you must file Schedule SE, see the instructions.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note: Use this flowchart **only** if you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.



Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.

1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a	
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AH	1b	()
2	Net profit or (loss) from Schedule C, line 31; and Schedule K-1 (Form 1065), box 14, code A (other than farming). Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report	2	8,000
3	Combine lines 1a, 1b, and 2	3	8,000
4	Multiply line 3 by 92.35% (0.9235). If less than \$400, you don't owe self-employment tax; don't file this schedule unless you have an amount on line 1b ►	4	7,388
Note: If line 4 is less than \$400 due to Conservation Reserve Program payments on line 1b, see instructions.			
5	Self-employment tax. If the amount on line 4 is: • \$132,900 or less, multiply line 4 by 15.3% (0.153). Enter the result here and on Schedule 2 (Form 1040 or 1040-SR), line 4, or Form 1040-NR, line 55. • More than \$132,900, multiply line 4 by 2.9% (0.029). Then, add \$16,479.60 to the result. Enter the total here and on Schedule 2 (Form 1040 or 1040-SR), line 4, or Form 1040-NR, line 55 .	5	1,130
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (0.50). Enter the result here and on Schedule 1 (Form 1040 or 1040-SR), line 14, or Form 1040-NR, line 27	6	565

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11358Z

Schedule SE (Form 1040 or 1040-SR) 2019

2020 Workbook

For Example 16

Form 8995 Department of the Treasury Internal Revenue Service	Qualified Business Income Deduction Simplified Computation ► Attach to your tax return. ► Go to www.irs.gov/Form8995 for instructions and the latest information.	OMB No. 1545-0123 <div style="font-size: 2em; font-weight: bold;">2019</div> Attachment Sequence No. 55
Name(s) shown on return Pauline Filips		Your taxpayer identification number 355-55-5555
1	(a) Trade, business, or aggregation name	(b) Taxpayer identification number
i	Pauline Filips	355-55-5555
ii		
iii		
iv		
v		
2	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	2 5,835
3	Qualified business net (loss) carryforward from the prior year	3 ()
4	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	4 5,835
5	Qualified business income component. Multiply line 4 by 20% (0.20)	5 1,167
6	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	6 ()
7	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	7 ()
8	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	8 ()
9	REIT and PTP component. Multiply line 8 by 20% (0.20)	9 ()
10	Qualified business income deduction before the income limitation. Add lines 5 and 9	10 1,167
11	Taxable income before qualified business income deduction	11 15,653
12	Net capital gain (see instructions)	12 0
13	Subtract line 12 from line 11. If zero or less, enter -0-	13 15,653
14	Income limitation. Multiply line 13 by 20% (0.20)	14 3,131
15	Qualified business income deduction. Enter the lesser of line 10 or line 14. Also enter this amount on the applicable line of your return ►	15 1,167
16	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-	16 (0)
17	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-	17 (0)

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 37806C Form **8995** (2019)

5

2020 Workbook

For Example 16

Form 8829 Department of the Treasury Internal Revenue Service (99)	Expenses for Business Use of Your Home ▶ File only with Schedule C (Form 1040 or 1040-SR). Use a separate Form 8829 for each home you used for business during the year. ▶ Go to www.irs.gov/Form8829 for instructions and the latest information.	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold; margin: 5px 0;">2019</div> Attachment Sequence No. 176
Name(s) of proprietor(s) Pauline Filips		Your social security number 355-55-5555
Part I Part of Your Home Used for Business		
1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)	1 1,500
2	Total area of home	2 1,500
3	Divide line 1 by line 2. Enter the result as a percentage	3 100 %
For daycare facilities not used exclusively for business, go to line 4. All others, go to line 7.		
4	Multiply days used for daycare during year by hours used per day	4 2,500 hr.
5	If you started or stopped using your home for daycare during the year, see instructions; otherwise, enter 8,760	5 8,760 hr.
6	Divide line 4 by line 5. Enter the result as a decimal amount	6 .2854
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3	7 28.54 %
Part II Figure Your Allowable Deduction		
8	Enter the amount from Schedule C, line 29, plus any gain derived from the business use of your home, minus any loss from the trade or business not derived from the business use of your home (see instructions)	8 12,000
<div style="display: flex; justify-content: space-between;"> See instructions for columns (a) and (b) before completing lines 9-22. (a) Direct expenses (b) Indirect expenses </div>		
9	Casualty losses (see instructions)	9
10	Deductible mortgage interest (see instructions)	10 3,000
11	Real estate taxes (see instructions)	11 5,000
12	Add lines 9, 10, and 11	12 8,000
13	Multiply line 12, column (b), by line 7	13 2,283
14	Add line 12, column (a), and line 13	14 2,283
15	Subtract line 14 from line 8. If zero or less, enter -0-	15 9,717
16	Excess mortgage interest (see instructions)	16
17	Excess real estate taxes (see instructions)	17
18	Insurance	18 1,500
19	Rent	19
20	Repairs and maintenance	20
21	Utilities	21 4,000
22	Other expenses (see instructions)	22
23	Add lines 16 through 22	23 5,500
24	Multiply line 23, column (b), by line 7	24 1,570
25	Carryover of prior year operating expenses (see instructions)	25
26	Add line 23, column (a), line 24, and line 25	26 1,570
27	Allowable operating expenses. Enter the smaller of line 15 or line 26	27 1,570
28	Limit on excess casualty losses and depreciation. Subtract line 27 from line 15	28 8,147
29	Excess casualty losses (see instructions)	29
30	Depreciation of your home from line 42 below	30 147
31	Carryover of prior year excess casualty losses and depreciation (see instructions)	31
32	Add lines 29 through 31	32 147
33	Allowable excess casualty losses and depreciation. Enter the smaller of line 28 or line 32	33 147
34	Add lines 14, 27, and 33	34 4,000
35	Casualty loss portion, if any, from lines 14 and 33. Carry amount to Form 4684 (see instructions)	35
36	Allowable expenses for business use of your home. Subtract line 35 from line 34. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions	36 4,000
Part III Depreciation of Your Home		
37	Enter the smaller of your home's adjusted basis or its fair market value (see instructions)	37 21,093
38	Value of land included on line 37	38 1,000
39	Basis of building. Subtract line 38 from line 37	39 20,093
40	Business basis of building. Multiply line 39 by line 7	40 5,735
41	Depreciation percentage (see instructions)	41 2.5641 %
42	Depreciation allowable (see instructions). Multiply line 40 by line 41. Enter here and on line 30 above	42 147
Part IV Carryover of Unallowed Expenses to 2020		
43	Operating expenses. Subtract line 27 from line 26. If less than zero, enter -0-	43 0
44	Excess casualty losses and depreciation. Subtract line 33 from line 32. If less than zero, enter -0-	44 0

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 13232M

Form **8829** (2019)

2020 Workbook

For Example 16

Form 1040-SR (2019)

Page **2**

12a Tax (see instructions). Check if any from:																					
1 <input type="checkbox"/> Form(s) 8814	2 <input type="checkbox"/> Form 4972	3 <input type="checkbox"/> _____	12a 3,649																		
b Add Schedule 2, line 3, and line 12a and enter the total			12b 3,649																		
13a Child tax credit or credit for other dependents		13a																			
b Add Schedule 3, line 7, and line 13a and enter the total			13b																		
14 Subtract line 13b from line 12b. If zero or less, enter -0-			14 3,649																		
15 Other taxes, including self-employment tax, from Schedule 2, line 10			15 0																		
16 Add lines 14 and 15. This is your total tax			16 3,649																		
17 Federal income tax withheld from Forms W-2 and 1099			17																		
18 Other payments and refundable credits:																					
a Earned income credit (EIC)			18a																		
b Additional child tax credit. Attach Schedule 8812			18b																		
c American opportunity credit from Form 8863, line 8			18c																		
d Schedule 3, line 14			18d																		
e Add lines 18a through 18d. These are your total other payments and refundable credits ▶			18e																		
19 Add lines 17 and 18e. These are your total payments			19																		
Refund		20 If line 19 is more than line 16, subtract line 16 from line 19. This is the amount you overpaid	20																		
21a Amount of line 20 you want refunded to you . If Form 8888 is attached, check here ▶ <input type="checkbox"/>		21a																			
Direct deposit? ▶ See instructions.	b Routing number <table border="1" style="display: inline-table; text-align: center; width: 150px;"><tr><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td></tr></table>	x	x	x	x	x	x	x	x	x	x	c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings									
x	x	x	x	x	x	x	x	x	x												
	d Account number <table border="1" style="display: inline-table; text-align: center; width: 200px;"><tr><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td><td>x</td></tr></table>	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x		
x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x				
22 Amount of line 20 you want applied to your 2020 estimated tax ▶			22																		
Amount You Owe		23 Amount you owe . Subtract line 19 from line 16. For details on how to pay, see instructions ▶	23 3,649																		
24 Estimated tax penalty (see instructions)		24																			
Third Party Designee Do you want to allow another person (other than your paid preparer) to discuss this return with the IRS? See instructions. <input type="checkbox"/> Yes. Complete below. <input checked="" type="checkbox"/> No																					
(Other than paid preparer)	Designee's name ▶	Phone no. ▶	Personal identification number (PIN) ▶ <table border="1" style="display: inline-table; text-align: center; width: 100px;"><tr><td> </td><td> </td><td> </td><td> </td><td> </td><td> </td></tr></table>																		
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																		
	Spouse's signature. If a joint return, both must sign.		Date																		
	Your occupation Retired		If the IRS sent you an Identity Protection PIN, enter it here (see inst.) <table border="1" style="display: inline-table; text-align: center; width: 100px;"><tr><td> </td><td> </td><td> </td><td> </td><td> </td><td> </td></tr></table>																		
Spouse's occupation		If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.) <table border="1" style="display: inline-table; text-align: center; width: 100px;"><tr><td> </td><td> </td><td> </td><td> </td><td> </td><td> </td></tr></table>																			
Phone no.		Email address																			
Paid Preparer Use Only	Preparer's name	Preparer's signature	Date																		
	Firm's name ▶	PTIN	Check if: <input type="checkbox"/> 3rd Party Designee <input type="checkbox"/> Self-employed																		
	Firm's address ▶	Phone no.	Firm's EIN ▶																		

Go to www.irs.gov/Form1040SR for instructions and the latest information.

Form **1040-SR** (2019)

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For Example 16

SCHEDULE 1 (Form 1040 or 1040-SR)

Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

► Attach to Form 1040 or 1040-SR.

► Go to www.irs.gov/Form1040 for instructions and the latest information.

OMB No. 1545-0074

2019

Attachment
Sequence No. **01**

Name(s) shown on Form 1040 or 1040-SR

Eppie Landers

Your social security number

355-55-5556

At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency? ☐ Yes ☒ No

Part I Additional Income

1	Taxable refunds, credits, or offsets of state and local income taxes	1	
2a	Alimony received	2a	
b	Date of original divorce or separation agreement (see instructions) ►		
3	Business income or (loss). Attach Schedule C	3	
4	Other gains or (losses). Attach Form 4797	4	
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	5	
6	Farm income or (loss). Attach Schedule F	6	
7	Unemployment compensation	7	
8	Other income. List type and amount ► Not for Profit Activity Income 15,000	8	15,000
9	Combine lines 1 through 8. Enter here and on Form 1040 or 1040-SR, line 7a	9	15,000

Part II Adjustments to Income

10	Educator expenses	10	
11	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	11	
12	Health savings account deduction. Attach Form 8889	12	
13	Moving expenses for members of the Armed Forces. Attach Form 3903	13	
14	Deductible part of self-employment tax. Attach Schedule SE	14	
15	Self-employed SEP, SIMPLE, and qualified plans	15	
16	Self-employed health insurance deduction	16	
17	Penalty on early withdrawal of savings	17	
18a	Alimony paid	18a	
b	Recipient's SSN		
c	Date of original divorce or separation agreement (see instructions) ►		
19	IRA deduction	19	
20	Student loan interest deduction	20	
21	Tuition and fees. Attach Form 8917	21	
22	Add lines 10 through 21. These are your adjustments to income . Enter here and on Form 1040 or 1040-SR, line 8a	22	

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 71479F

Schedule 1 (Form 1040 or 1040-SR) 2019

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EXAMPLES

In this section, detailed fact patterns taken from real-life scenarios are presented for participants to consider.

Example 17. Dorothy is 80 years old and does not see or hear well. Her daughter, Karen, accompanies her to her tax preparation appointment. Dorothy hands the preparer a Form 1099-MISC from Company X, showing \$2,000 in other income. Karen tells the preparer that her mom is a multi-level marketer for a supplier of health, home, and beauty aids. She explains that all of Dorothy's purchases of supplements and beauty aids are deductible as advertising because her glowing health proves the products work. Karen also provides the preparer with a list of home office expenses and a copy of materials supplied by Company X advocating the tax advantages of writing off otherwise personal expenses as part of the operations of the home-based business.

What questions should the tax preparer ask?

Example 18. Ray is an accomplished automobile mechanic. He invests a substantial amount of his personal savings into a new production race car. He hires a master builder to make all the required race-legal modifications to the car and assist him in recruiting a top-rated driver. Ray's expenses for the car and driver total approximately \$150,000, but he is focused on the possibility of placing in the top three in the car's racing category. This would provide winnings in the range of \$300,000 to \$900,000. Despite fierce competition, Ray believes his acumen as a mechanic with assistance from the master builder gives him some advantages over other cars, especially with the top-rated driver he is able to employ. Winning would easily offset his substantial expenses and place him in a significant profit position after recouping his investment.

What questions should the tax preparer ask?

Example 19. Raven is a 16-year-old high-school student. She makes funny how-to videos for makeovers on her home computer. Her viral videos have received 1 million views. Raven received a Form 1099-NEC from YouTube for \$5,000 of nonemployee compensation.

What questions should the tax preparer ask?

Example 20. Glen works full-time as a project manager. He also referees high-school basketball games and is a member of the state officials' association. He gets paid \$50 per game. After taking into account the costs of uniforms, travel, and dues, he is not generating any profit.

What questions should the tax preparer ask?

S CORPORATION IRC §183 ISSUES

As discussed previously, S corporations are subject to the hobby loss limitation rules of §183. In 2011, in *Morton v. U.S.*,⁴³ the taxpayer claimed the “unified business enterprise” theory allowed him to take deductions for the use of aircraft that furthered the business purposes of a restaurant chain, hotels, and casinos that were operated as separate S corporations. The Court of Federal Claims concluded that the taxpayer’s S corporation activities all had the same business purpose and were profit motivated. The court determined that the taxpayer’s losses from the S corporation’s activities were sufficiently intertwined with other profitable ventures to support the taxpayer’s intent to create profit. Thus, for §183 purposes, the court established a standard allowing losses generated by S corporations to be aggregated with the taxpayer’s other activities, even those conducted individually or through commonly controlled entities.

In 2017, the IRS Chief Counsel issued an advice memorandum in which they concluded that the *Morton* case “is an aberration that the Service should not follow...”⁴⁴ The Chief Counsel Advice (CCA) offered two alternative frameworks to use instead of the broad unified business theory.

1. A corporation is an entity separate from its owner for federal tax purposes. Accordingly, only the actions of the corporation should be considered in determining profit motive.
2. The unified business theory should only be applied when the shareholder owns at least a majority, if not substantially more, of the entities sought to be combined **and** those same entities have significant business integration.

The CCA is consistent with an IRS field service advice memorandum issued in 2000,⁴⁵ in which the IRS determined that an unprofitable S corporation’s activities could **not** be aggregated with that of its sole customer, a C corporation owned by the same taxpayer, for the purposes of determining the profit motive of the S corporation.

The courts have addressed several situations involving S corporations and profit motive.

- In several cases, the requisite profit motive was missing from the S corporation’s activities, and the S corporation’s deductible losses were denied based on the hobby loss rules.⁴⁶
- An S corporation with certain farming activities was subjected to the hobby loss limits, and the loss was disallowed at the corporate level.⁴⁷
- An S corporation was not able to claim research and experimentation expenses as deductible items. The S corporation was not involved in any trade or business and was thus not allowed a deduction for any expenses. The losses were not deductible under IRC §§174(a) or 162(a).⁴⁸

⁴³ *Morton v. U.S.*, 98 Fed. Cl. 596 (2011).

⁴⁴ CCA 201747006 (Oct. 24, 2017).

⁴⁵ FSA 200042001 (Mar. 1, 2000).

⁴⁶ *Ballard v. Comm’r*, TC Memo 1996-68 (Feb. 20, 1996); *Hilliard v. Comm’r*, TC Memo 1995-473 (Oct. 3, 1995); *Lucid v. Comm’r*, TC Memo 1997-247 (Jun. 2, 1997).

⁴⁷ *Westbrook v. Comm’r*, TC Memo 1993-634 (Dec. 29, 1993), *aff’d* 68 F.3d 868 (1995).

⁴⁸ *Estate of George B. Cook v. Comm’r*, TC Memo 1993-581 (Dec. 9, 1993).

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WORKSHEET

The following worksheet can be used to help analyze whether an activity is a business or a hobby. No one factor is determinative. Comments should be entered as to why a decision was made. This worksheet should be kept with the taxpayer's records in case of an IRS challenge.

		Place a Checkmark in the Applicable Box		
Test	Description	Profit Motive	No Profit Motive	Comments For or Against
1	Manner in which the taxpayer carried on the activity			
2	The expertise of the taxpayer or their advisors			
3	The time and effort expended by the taxpayer in carrying on the activity			
4	Expectation that assets used in the business may appreciate in value			
5	The success of the taxpayer in carrying on similar or dissimilar activities			
6	The taxpayer's history of income and losses with respect to the activity			
7	The amount of occasional profits, if any, which are earned			
8	The financial status of the taxpayer			
9	Elements of personal pleasure or recreation			

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Taxpayer/Business Name:		Type of Business:		Year Business Started:	
Year	20__	20__	20__	20__	20__
Gross Income					
Expenses (Other than depreciation)					
Depreciation					
Gain or (Loss)					

Year	Reasons for the loss in a year.

DEATH OF A BUSINESS OWNER

The death of a business owner, particularly a sole proprietor, highlights the interrelationship of state law regarding business and probate and of federal tax law regarding the administrative responsibilities and tax liabilities for the deceased business owner, the deceased business owner's estate, and the successor in interest of the business.

The focus of this section is on the tax aspects of the administration and disposition of the business owner's assets and liabilities. This section is not a comprehensive treatment of business or estate administration. The objective here is to assist the tax practitioner in identifying potential issues when working with the representatives of a deceased business owner.

DETERMINE WHO THE CLIENT IS

If the deceased business owner was a client, then the practitioner may still owe a duty of confidentiality to the client under state law, the state licensing board, and other governing standards depending upon the practitioner's licensure, certification, and status.

IRC §7525 extends a limited privilege between clients and federally authorized tax practitioners (certified public accountants (CPAs), enrolled agents (EAs), attorneys, and others recognized by Circular 230) for tax advice provided in noncriminal matters.

Some states, but not all, allow for an accountant-client privilege, which is generally more limited than attorney-client privilege. For example, Colorado Revised Statutes §13-90-107(1)(f)(I) extends the privilege only to CPAs, and only to the extent the client does not waive the privilege.



Practitioner Planning Tip

Malpractice, errors and omissions, and professional liability insurance carriers often offer hotlines for the insured to call for guidance, as well as suggested language for use in engagement letters.

A practitioner working with a client who is a business owner should consider adding the owner's express authorization to the engagement letter to permit continued communication with authorized representatives after the owner's incapacity or death.

Practitioners may consult their business attorney about best practices regarding client confidentiality and about working with decedents' estates and trusts in their jurisdiction.

In addition, state CPA societies and other organizations offer continuing education on these issues.

If the business entity was a client, then the entity continues to be the practitioner's client after the owner's death. The practitioner continues under the same constrictions regarding what they may reveal to external parties about the financial position of the entity or of any individual owner.

Practitioners should follow IRS procedures and not disclose information until they have obtained documentation that the person making the inquiry has the appropriate authority.

DOCUMENTATION FOR BUSINESS INTEREST

Following is a list of some of the items the tax practitioner should obtain from a new or existing client who is a business owner.

1. A description of the purpose of the business, where and how it is conducted (e.g., single or multiple states, any online activity), the number of employees, the ownership and management structures, and any business continuation or succession plans
2. The choice of entity for the business
3. Financial information
4. Articles of incorporation/organization or partnership/operating agreements (if applicable)
5. Buy-sell agreements and/or documents that govern the transfer of the business
6. Bylaws
7. Filings with secretaries of state
8. Federal employer identification number (FEIN)
9. Account numbers for state departments of revenue and unemployment insurance
10. Tax returns for prior years

Note. The decedent's prior years' tax returns provide information about how the deceased business owner perceived and reported the business activity, as well as depreciation schedules and net operating losses (NOLs). For a detailed discussion of depreciation issues, see the *2020 University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Depreciation. For more information about NOLs, see the *2020 University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Net Operating and Excess Business Losses.

Caution. Documents provided by the business owner to the practitioner (e.g., wills, partnership/operating agreements, business succession plans) can provide necessary information; however, the practitioner should make sure that the documents are current and have not been changed. In addition, the practitioner may need to work with a licensed attorney if interpretations of the documents are necessary.

Some legal issues that the business owner should discuss with an attorney include the following.

- Establishment and licensing of the business
- Protection of intellectual property
- Proper conduct of corporate governance
- Advice regarding business operations
- Ensuring the owner's business planning is consistent with the owner's personal estate planning

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DOCUMENTS GOVERNING DISPOSITION OF THE BUSINESS INTEREST

A deceased business owner may have a will, a trust, and/or governing documents for the business. This may also include documents such as operating agreements and/or bylaws. It is important to determine who owns the business and who owns the business assets.

Other claims may be made against the decedent's estate or business interest. State law governs the probate process, which includes the adjudication of claims and the schedule of asset distribution.⁴⁹ Thus, the document that governs the disposition of the business interest may be a court order.

Caution. No matter how well the practitioner knew the deceased business owner and the financial position of the business entity, unless the practitioner is a licensed attorney, their interpretation of documents may constitute the unauthorized practice of law in their jurisdiction.

Unless the practitioner is duly appointed by a court, a trust instrument, or an entity's governing document (e.g., corporate bylaws, partnership or operating agreement), they do not have the legal authority to operate the business, transfer its assets, or resolve its liabilities.

Moreover, unless the person with the legal authority to operate the business, transfer its assets, or resolve its liabilities is a client, they must be careful to distinguish between **providing information** to authorized individuals and **advising** other parties.

Decedent's Intended Disposition of Business Interests or Assets

The decedent's wishes regarding the disposition of business interests and/or assets are paramount; however, problems may arise from the estate planning documents or from circumstances at the business owner's death.

Estate Planning Documents. The practitioner should discuss the following issues with a business owner client.

- The business owner should regularly review and update all estate planning documents.
- All the assets that the trust instrument is supposed to govern should be titled in the name of the trust.
- Regarding the disposition of a business interest, the will and/or trust should expressly refer to governing documents for the business entity. In addition, the business entity should have governing documents that clearly address what is to happen to the owner's business interest if the owner is incapacitated or dies.

Realistically, anything can happen. Depending upon the content of the documents, the titling of assets, human error, and other facts and circumstances, the probate court may be asked to review all of the decedent's interests — including nonprobate transfers.⁵⁰ The result may be a reclassification of the business interest or assets that were supposed to pass outside of probate.

⁴⁹ See, generally, IRM 5.5.2.2 (2011).

⁵⁰ For example, the Colorado Supreme Court held that "A district court sitting in probate 'has jurisdiction over all subject matter vested by article VI of the [Colorado] constitution and by articles 1 to 10 of title 13, C.R.S.' ... The court thus has the authority 'to impose or raise a trust with respect to any of the property of the decedent or any property in the name of the decedent, individually or in any other capacity, in any case in which the demand for such relief arises in connection with the administration of the estate of a decedent.'" *Sandstead-Corona v. Sandstead*, 415 P.3d 310, 317 (Colo. 2018).

Thirty-five states have enacted their own version of the Uniform Trust Code (UTC).⁵¹ The UTC provides default provisions to use when a trust instrument is silent. For example, §202 of the UTC addresses jurisdiction over the trustee and the beneficiary. A comment to UTC §202 states:

*The jurisdiction conferred over the trustee and beneficiaries by this section does not preclude jurisdiction by courts elsewhere on some other basis. Furthermore, the fact that the courts in a new State acquire jurisdiction under this section following a change in a trust's principal place of administration does not necessarily mean that the courts of the former principal place of administration lose jurisdiction, particularly as to matters involving events occurring prior to the transfer.*⁵²

UTC §1005 addresses the limitation on actions against a trustee.⁵³ Trusts, and actions by trustees — even for a seemingly simple revocable trust — may be subject to judicial review in multiple jurisdictions, each with its own law.

Note. For an in-depth discussion of trusts, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Trust Essentials.

Circumstances at the Business Owner's Death. No matter how thorough the planning, the following circumstances may exist at the time of the business owner's death.

- The business and/or the business owner might be insolvent at death.
- State law may allow a surviving spouse to claim certain allowances under statute or to elect more of the decedent's estate than provided under the will.
- A party may make a claim that the business is part of the deceased owner's estate.

Conclusions

As stated earlier, a practitioner who is not an attorney should not engage in the unauthorized practice of law by interpreting documents for clients. The practitioner may not have all of the documents or the latest version of each document and may not be aware of what is being filed with the court. No matter how well the practitioner knew the deceased business owner or the financial position of the business entity, they should not make any assumptions. The practitioner should recognize the limits on what they do know and work with the authorized representative of the deceased business owner's estate or trust regarding the tax aspects of the administration and disposition of the business owner's assets and liabilities.

⁵¹ *Trust Code*. Uniform Law Commission. [www.uniformlaws.org/committees/community-home?CommunityKey=193ff839-7955-4846-8f3c-ce74ac23938d] Accessed on Jul. 5, 2020.

⁵² *Uniform Trust Code (Last Revised or Amended in 2010)*. Apr. 10, 2020. Uniform Law Commission. [www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=3d7d5428-dfc6-ac33-0a32-d5b65463c6e3] Accessed on Jul. 5, 2020.

⁵³ *Ibid.*

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TAX REPORTING OF BUSINESS ENTITY

Income tax and filing responsibilities change during the business's transition periods.

1. **Business owner's life** — The decedent's final Form 1040 covers the period through the date prior to the decedent's date of death and includes any revocable trusts.⁵⁴
2. **Business owner's estate administration** — The estate's Form 1041, *U.S. Income Tax Return for Estates and Trusts*, commences with the decedent's date of death⁵⁵ through the termination of estate administration.⁵⁶

Note. Under IRC §645, the executor of the estate and the successor trustee of a revocable trust may agree to treat the trust as part of the estate and file one Form 1041 for up to two years after the decedent's date of death. This merging election of the estate and trust allows the executor to file one return and elect a fiscal year. For more information, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Trust Essentials.

3. **Business successor interest** — A successor's interest is reflected on the appropriate returns of the successor.

ESTATE ADMINISTRATION AND THE PROBATE PROCESS

Federal (and state) tax considerations coincide with estate administration and the probate process.

Caution. If the decedent's survivors approach the practitioner for advice, tax practitioners cannot discuss the business owner's information. The practitioner must get the appropriate documentation related to the appointed designated fiduciary before any discussion. It is important to be aware of a potential criminal IRC §7216 violation for improper disclosure of client information.

Executor

Delaying estate administration or the opening of probate does not excuse delays in tax filings or payments on behalf of the decedent, the estate, or the business because, pursuant to IRC §2203, the executor is the administrator of the decedent's estate. If there is no executor or administrator appointed, then any person in actual or constructive possession of any property of the decedent is deemed the executor.⁵⁷

Note. If no executor or administrator was appointed, the person in actual or constructive possession of the decedent's property should check box 1d on Form 56, *Notice Concerning Fiduciary Relationship* (shown later).

Timeliness for Completing Estate Administration

Estate administration cannot languish without providing an explanation to the IRS. Treas. Reg. §1.641(b)-3(a) states in part, "However, the period of administration of an estate cannot be unduly prolonged."

The instructions for Form 1041 state that if the decedent's estate has been open for more than two years, an explanation for the delay in closing the estate must be attached. Litigation will likely delay closing the estate.

⁵⁴ IRS Pub. 559, *Survivors, Executors, and Administrators*.

⁵⁵ IRC §1(e); Instructions for Form 1041.

⁵⁶ Treas. Reg. §1.641(b)-3(a).

⁵⁷ IRC §2203.

Inventory: Gross Estate vs. Probate Estate

An executor must determine the value of the decedent's gross estate as defined in IRC §2031, *et seq.*, in order to determine whether an estate tax under IRC §2001 is likely to be owed.

Note. For more information about the estate tax and Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Trust and Estate Taxation. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

The value of the gross estate includes the value of the decedent's interest in all property at the time of their death.⁵⁸ Thus, the value of the decedent's **gross estate** includes all property, including that which passes by operation of law (e.g., titled with a joint owner, designated beneficiary, or in a contract).

The **probate estate** contains only those assets titled in the decedent's name alone and for which no beneficiary was designated. The executor's scope of authority is to administer and account for the probate estate.

The executor, upon examining the decedent's tax transcripts, personal documents, or public records may find that the federal government has already imposed a federal tax lien. IRS Pub. 4235, *Collection Advisory Group Numbers and Addresses*, provides the contact information for requesting the IRS file a proof of claim in a probate proceeding.⁵⁹

Transferee Liability (Premature Distributions)

Under 31 USC §3713(b), "A representative of a person or an estate (except a trustee acting under title 11) paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government." This federal law corresponds to state laws holding executors personally liable for premature (i.e., prior to tax liabilities and claims being satisfied) distributions of estate assets.

If the decedent's property is distributed prior to resolving tax liabilities and claims, then the IRS may pursue the transferee of the property for satisfaction of tax liabilities.⁶⁰ IRC §6901 addresses transferred assets, specifically imposing potential transferee liability on the recipient of the decedent's assets as well as on the fiduciary (i.e., executor).

IRC §6901(h) provides that the term "transferee" includes a donee, heir, legatee, devisee, and distributee. Thus, successors in interest have an incentive to wait until the estate is probated prior to assuming legal title of any distributions.

Liquidate, Operate, or Distribute?

Factors such as the inventory of the probate estate, the requirements of estate administration, and claims against the decedent and the estate must be taken into account in the executor's decision to liquidate, operate, or distribute business assets and liabilities.

Liquidation of Interest in an Entity (Corporation, limited liability corporation (LLC), or Partnership). Entities must perform their own internal accounting as of the decedent's date of death. The corporate bylaws, LLC operating agreement, or partnership agreement may give the entity the right to purchase a decedent's interest from the estate. Alternatively, the corporate bylaws, LLC operating agreement, or partnership agreement may give the decedent the right to direct the disposition of the decedent's interest to the decedent's estate (to become part of the residue) or to one or more specific beneficiaries.

The decedent's interest is usually the right to receive income from, but not to vote or to participate in the management of, the LLC or the partnership unless voted in by the surviving members or partners.

⁵⁸ IRC §2033.

⁵⁹ See also IRM 5.5.4 (2011) regarding proof of claim procedures in decedents' estate, and IRM 5.17.13 (2012) regarding insolvencies and decedents' estates.

⁶⁰ IRC §6901.

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The estate must distribute the interest as part of the residue either according to the terms of the will or by the state's intestacy statute. This potential loss of control over who receives income usually prompts LLCs and partnerships to offer to buy out the decedent's interest.

Specific gifts are subject to the state's laws regarding abatement of gifts to satisfy a decedent's liabilities.

Liquidation of Sole Proprietorship. The executor must wind up the business activities of a sole proprietorship by selling assets, settling receivables and payables, and dismissing any employees. Net proceeds go to the estate. If there are insufficient business assets to satisfy business liabilities and a satisfaction and accord cannot be negotiated by the executor, then creditors of the business must file claims against the estate. If there was accrued payroll, the employees become employees of the newly established estate and should be paid by the estate.

Continue Business Operations When a Buy-Sell Agreement Exists. A properly drafted buy-sell agreement will usually be honored during the administration of the probate estate. Until the business transfer occurs, the probate estate assumes all liability for business filings and taxes.

Continue Business Operations by the Estate. Estate administration is based largely on the facts and circumstances of each case, and on communication and negotiation of claims and an acceptable schedule of distribution. The liquidity of the estate is a principal concern for the executor. Therefore, if the business is generating a profit, the executor may choose to operate the business during estate administration before selling or distributing it. However, the estate and the executor then assume all of the tax administration and liabilities.

Distribution of Business Assets (and Liabilities). If the business assets (and liabilities) are readily identifiable and their fair market value (FMV) as of the decedent's date of death is ascertainable and the estate is unlikely to need to liquidate or operate the business, the executor may distribute the business assets (and liabilities). These are distributed either to the specific legatee(s) named in the will or to one or more beneficiaries pursuant to an agreement among all beneficiaries.

Tentative Schedule of Distribution. The executor's tentative schedule of distribution is based on the inventory of the probate estate, accounting for inflows and outflows, requirements of estate administration, the terms of the will or intestacy statute, and agreements negotiated with claimants and beneficiaries. Fiduciary duty and 31 USC §3713(b) hold the executor personally liable for premature distributions made prior to resolving tax issues of the decedent and of the estate.

TAX ADMINISTRATION AND LIABILITIES

Federal Employer Identification Number

Under IRC §6109 and Treas. Reg. §31.6011(b)-1, most employers are required to obtain an FEIN and to include it on wage reports filed with the Social Security Administration. A sole proprietor is not required to obtain an FEIN if they do not pay wages to employees or file a pension or excise tax return.⁶¹

Estates and irrevocable trusts are also required to obtain their own FEINs.⁶² If the estate or a trustee on behalf of a trust operates a business, it must obtain a new FEIN for the business, regardless of whether the business owner already obtained an FEIN for the business.⁶³ Likewise, a change of ownership, such as to a successor in interest, necessitates obtaining a new FEIN.⁶⁴

⁶¹ 20 CFR §422.112(a).

⁶² Treas. Reg. § 301.6109-1(a)(1)(ii)(C).

⁶³ *Do You Need a New EIN?* Jan. 16, 2020. IRS. [www.irs.gov/businesses/small-businesses-self-employed/do-you-need-a-new-ein] Accessed on Apr. 30, 2020.

⁶⁴ See *Employer ID Numbers*. Feb. 4, 2020. IRS. [www.irs.gov/businesses/small-businesses-self-employed/employer-id-numbers] Accessed on April 30, 2020; and IRS Pub. 1635, *Employer Identification Number; Understanding your EIN*.

Basis

For the business owner, the basis in property is generally its net book value.⁶⁵ For the estate or for a revocable trust, the basis in the decedent's property is stepped up or down to FMV as of the business owner's date of death, except for income in respect of a decedent (IRD) and S or C corporation ownership.⁶⁶ For S or C corporate ownership, the basis of the stock for the beneficiaries is generally its FMV.

For the successor in interest pursuant to a buy-sell agreement or other purchase arrangement, under IRC §2703(a), the value of the property is determined without regard to any agreement. In addition, under §2703(b), the terms of the buy-sell agreement or other purchase arrangement must be comparable to an arms' length transaction.

Under IRC §643(e), the basis of property received by a beneficiary in a distribution from an estate or trust is the estate's or trust's adjusted basis immediately before the distribution, adjusted for any gain or loss recognized to the estate or trust on the distribution.

Income in Respect of a Decedent (IRD)

IRD is defined at Treas. Reg. §1.691(a)-1(b) as income to which a decedent was entitled that was not properly includable in calculating the decedent's taxable income for the tax year ending with the date of death or for a previous tax year under the decedent's method of accounting.

Under IRC §691, IRD must be included in the income of one of the following.

1. The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent
2. The person who, because of the decedent's death, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent
3. The person who acquires the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution of such right by the decedent's estate

The estate may also be eligible for a deduction under §691(c)(1) for the portion of IRD that is distributed to beneficiaries.

Deductions in Respect of a Decedent

Under §691(b), certain expenses, interest, and taxes for which the decedent was liable that were not allowable as a deduction prior to the decedent's death are allowed as a deduction to one of the following when paid.⁶⁷

- The estate
- If the estate was not liable to pay such obligation, as a deduction by the person who by bequest, devise, or inheritance from the decedent or because of the decedent's death acquires, subject to such obligation, an interest in the decedent's property

Qualified Business Income Deduction

A business owner whose business is not a C corporation is eligible for the QBID under IRC §199A(a).

Treas. Reg. §1.199A-6(d)(3) provides the calculation of the QBID for an estate. The deduction may be taken by the estate or distributed to beneficiaries.

⁶⁵ IRC §1012.

⁶⁶ IRC §1014.

⁶⁷ Treas. Reg. §1.691(b)-1; IRS Pub. 559, *Survivors, Executors, and Administrators*.

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The successor must determine the successor's eligibility for the QBID depending upon the choice of entity and other circumstances.

Note. For more information about the QBID for trusts and estates, see the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: QBID Update and the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues. The 2018 chapter can be found at uofi.tax/arc [tax-school.illinois.edu/taxbookarchive].

IRS FORM 56

The IRS requires Form 56 to be filed, along with evidence of the fiduciary's authority to act, before the IRS will share any information pertaining to the decedent. A copy of this form follows.

Form 56 (Rev. December 2019) Department of the Treasury Internal Revenue Service	Notice Concerning Fiduciary Relationship (Internal Revenue Code Sections 6036 and 6903) ▶ Go to www.irs.gov/Form56 for instructions and the latest information.	OMB No. 1545-0013
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Part I Identification

Name of person for whom you are acting (as shown on the tax return)	Identifying number	Decedent's social security no.
Address of person for whom you are acting (number, street, and room or suite no.)		
City or town, state, and ZIP code (If a foreign address, see instructions.)		
Fiduciary's name		
Address of fiduciary (number, street, and room or suite no.)		
City or town, state, and ZIP code	Telephone number (optional) ()	

Section A. Authority

- 1** Authority for fiduciary relationship. Check applicable box:
- a** ☐ Court appointment of testate estate (valid will exists)
 - b** ☐ Court appointment of intestate estate (no valid will exists)
 - c** ☐ Court appointment as guardian or conservator
 - d** ☐ Fiduciary of intestate estate
 - e** ☐ Valid trust instrument and amendments
 - f** ☐ Bankruptcy or assignment for the benefit of creditors
 - g** ☐ Other. Describe ▶
- 2a** If box 1a, 1b, or 1d is checked, enter the date of death ▶
- b** If box 1c, 1e, 1f, or 1g is checked, enter the date of appointment, taking office, or assignment or transfer of assets ▶

Section B. Nature of Liability and Tax Notices

- 3** Type of taxes (check all that apply): ☐ Income ☐ Gift ☐ Estate ☐ Generation-skipping transfer ☐ Employment ☐ Excise ☐ Other (describe) ▶
- 4** Federal tax form number (check all that apply): **a** ☐ 706 series **b** ☐ 709 **c** ☐ 940 **d** ☐ 941, 943, 944
e ☐ 1040 or 1040-SR **f** ☐ 1041 **g** ☐ 1120 **h** ☐ Other (list) ▶
- 5** If your authority as a fiduciary does not cover all years or tax periods, check here ▶ ☐
and list the specific years or periods ▶

For Paperwork Reduction Act and Privacy Act Notice, see separate instructions.

Cat. No. 16375I

Form **56** (Rev. 12-2019)

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Form 56 (Rev. 12-2019)

Page **2**

Part II Revocation or Termination of Notice

Section A—Total Revocation or Termination

- 6** Check this box if you are revoking or terminating all prior notices concerning fiduciary relationships on file with the Internal Revenue Service for the same tax matters and years or periods covered by this notice concerning fiduciary relationship ☐ Reason for termination of fiduciary relationship. Check applicable box:
- a** ☐ Court order revoking fiduciary authority
- b** ☐ Certificate of dissolution or termination of a business entity
- c** ☐ Other. Describe ☐

Section B—Partial Revocation

- 7a** Check this box if you are revoking earlier notices concerning fiduciary relationships on file with the Internal Revenue Service for the same tax matters and years or periods covered by this notice concerning fiduciary relationship ☐
- b** Specify to whom granted, date, and address, including ZIP code.
- ☐

Section C—Substitute Fiduciary

- 8** Check this box if a new fiduciary or fiduciaries have been or will be substituted for the revoking or terminating fiduciary and specify the name(s) and address(es), including ZIP code(s), of the new fiduciary(ies) ☐
- ☐

Part III Court and Administrative Proceedings

Name of court (if other than a court proceeding, identify the type of proceeding and name of agency)		Date proceeding initiated	
Address of court		Docket number of proceeding	
City or town, state, and ZIP code	Date	Time <input type="checkbox"/> a.m. <input type="checkbox"/> p.m.	Place of other proceedings

Part IV Signature

Please Sign Here	Under penalties of perjury, I declare that I have examined this document, including any accompanying statements, and to the best of my knowledge and belief, it is true, correct, and complete.		
	Fiduciary's signature	Title, if applicable	Date

Form **56** (Rev. 12-2019)

A box in section A of Form 56 should be checked under the following circumstances.⁶⁸

- **Box 1(a)** — This box is checked if the person who files the form is the executor of a decedent who died testate (i.e., with a valid will) and has been authorized to serve by a court of appropriate jurisdiction. A court issues letters testamentary or a court certificate to the person administering the decedent's estate pursuant to the will.
- **Box 1(b)** — This box is checked if the person filing the form has been appointed as the administrator or representative of an estate of a decedent who died intestate (i.e., without a valid will). A court issues letters testamentary or a court certificate as proof of the court appointment.
- **Box 1(c)** — This box is checked if a court appointed the person filing the form as the guardian, custodian, or conservator over the interests of another person or entity.
- **Box 1(d)** — This box is checked if the person filing the form is the fiduciary of a decedent who died intestate and there is no court-appointed administrator or representative for the decedent's estate. The fiduciary is the person in possession of the decedent's assets.

⁶⁸ Instructions for Form 56.

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- **Box 1(e)** — This box is checked if the person filing the form was named a trustee under a valid trust instrument (and amendments, if any). A certificate of trust may also be provided as evidence of the trust without revealing the detailed contents of the trust. The certificate of trust usually contains the names of the trust, the grantor/settlor of the trust, the trustee, and successor trustee(s).
- **Box 1(f)** — This box is checked if the person filing the form is a bankruptcy trustee or an assignee for the benefit of creditors.
- **Box 1(g)** — This box is checked if the person filing the form is acting in a fiduciary capacity under circumstances different from those listed for lines 1(a) through 1(f).

Under section B, items 3 (type of taxes) and 4 (federal tax form number) define the extent of the fiduciary's authority. For example, if the business owner was a sole proprietor with employees, then the executor or personal representative of the business owner's estate should check that employment taxes were current as of the owner's death. To do this, the executor must inquire not only about the owner's individual income taxes reported on Form 1040, *U.S. Individual Income Tax Return*, but also about employment taxes reported on employment tax forms (e.g., Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return* and Form 941, *Employer's Quarterly Federal Tax Return*).

If the fiduciary's authority is limited to specific tax years, the box in item 5 should be checked and the specific years or periods listed. This is in contrast to Form 2848, *Power of Attorney and Declaration of Representative*, where item 3 also refers to the type of taxes and federal form numbers, but "years or periods" is not open-ended as it is on Form 56. Form 2848 limits the representative's authority to the years specified and no more than three years past December 31 of the year in which the Form 2848 is received by the IRS.⁶⁹

EXAMPLES

The rules discussed in this section are illustrated in the following examples.

Example 21. The testate estate. Jack died on December 31, 2019. He had a valid will that is uncontested and that creates a testamentary trust. The trust is funded by \$100,000 cash and real property that Jack inherited during his lifetime. The trust is for the benefit of Jack's two children. The will nominates his surviving spouse, Jill, as executor and as trustee.

Jack and Jill held all assets in joint tenancy with right of survivorship. Jill had signed a waiver of all rights to any of Jack's business interests.

Jack was one of five owners of a C corporation, which was duly registered and in good standing with the secretary of state. The C corporation has bylaws stating that the interest (shares) of any deceased owner will be apportioned equally among the surviving shareholders. Jack had earned \$50,000 in salary from the C corporation that he had not received at the time of his death.

Jill files a Form 56 as executor of the estate and another Form 56 as trustee of the trust. The basis of the testamentary trust is the \$100,000 cash and the FMV of the real property as of Jack's date of death.

Assets titled in joint tenancy with right of survivorship pass by operation of law, not probate. Jill can file the 2019 tax return as married filing jointly.

The C corporation continues to operate according to its bylaws, and files its own Form 1120, *U.S. Corporation Income Tax Return*. The \$50,000 of wages earned by Jack is IRD payable to his estate and reported on the estate's Form 1041. (If the right to receive the \$50,000 had been distributed by the estate to a beneficiary, the beneficiary would have reported the \$50,000 on Form 1040.) If IRD wages are paid during the year of death, they are subject to withholding of social security and Medicare tax. The wages would be reported in box 5 and 7 of form W-2 but not box 1. If paid in a subsequent year, federal taxes are withheld.⁷⁰

⁶⁹ Instructions for Form 2848.

⁷⁰ IRS Pub. 559, *Survivors, Executors, and Administrators*.

Example 22. The intestate estate. Josie died on January 15, 2020. She had no will or trust and all her assets, which include a bank account with a \$100,000 balance, are titled in her name without any designated beneficiaries.

Josie obtained a divorce and remarried three years ago. She had two adult children with the first spouse and one minor child with her current spouse. She also had a single-member LLC (SMLLC) that the two adult children want to take over.

Josie's personal assets, bank account, and SMLLC interest must be probated. The residue after expenses and claims are paid will be distributed according to the intestacy statute of the state in which she resided.

SMLLCs are disregarded entities for tax purposes. Whether Josie's estate operates, liquidates, sells, or distributes the SMLLC depends upon the nature of the business. A sale must be at arms' length, and the basis in any of the SMLLC's property distributed to the adult children is the FMV.

Example 23. Fiduciary in possession of assets. Nick had no will and no trust, but had designated beneficiaries on all his assets and accounts. He was single and had no children when he died. He was a sole proprietor with a single employee.

Nick's representative, whose eligibility and priority of appointment are determined by state law, must file a final Form 1040 with a Schedule C reporting the income and expenses for the business and Schedule SE, *Self-Employment Tax*, reporting SE taxes through Nick's date of death.

In addition, the representative winding up the business must file final Forms 940 and 941.

Example 24. Valid trust. Rose had a valid revocable trust and no will when she died. She had contributed assets to a partnership that was titled in the name of the trust.

The administration of her assets is pursuant to the trust instrument. The assets included in Rose's estate (from the revocable trust) receive a step up in basis.

The trust can pay the income tax or distribute the income and take a distribution deduction. Under the latter alternative, the beneficiaries pay the income tax.

Note. For 2020, the top trust tax rate of 37% starts at \$12,951 of taxable income. For individuals, the top rate starts at \$518,401 for single taxpayers and \$622,051 for joint filers.⁷¹ As a result, shifting the income tax liability to the beneficiaries will likely result in a lower tax burden.

Example 25. Comprehensive. Yoder Family Fine Furniture has been in operation for more than 150 years. Muriel Hathaway, who is a fourth generation owner, inherited the store from her family 50 years ago. Muriel is widowed and has two grown children, Mandy and Mark. Mandy has worked in the business since she was a teenager, while Mark worked in the business when he was younger but moved to California in 1990. Muriel is elderly and wants to slow down but she feels that Mandy might not be ready to take over the business operation. There are five other store employees who are not related to Muriel.

The furniture store has always operated as a sole proprietorship. During an appointment in early 2019, Muriel met with Frieda Balance, her tax professional. At that meeting, Muriel expressed concern that she may be the last generation of the family to run the business and wonders what will happen when she passes away.

Muriel passed away on April 30, 2019. Her daughter, Mandy, contacted Frieda asking what to do. Frieda's first suggestion was for all parties to meet with the family attorney.

⁷¹ Rev. Proc. 2019-44, 2019-47 IRB 1093.

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Mandy, Mark, and Frieda were present at the meeting with the family attorney. The attorney stated that Muriel left a very cursory will. The will stated her desire for Yoder Family Fine Furniture to continue to be a family-owned business. She left all assets to be divided equally between Mandy and Mark and stated that they can work out the details themselves. Muriel's will expressed a desire for the two of them to mend a decades-long rift between them and working out their inheritance is one way to get them to work together.

When Muriel passed, Mandy began running the business and assured the employees and the public that the business would continue as a family-owned enterprise. Mark stated that he wanted nothing to do with the business and merely wants his share of his mother's estate.

The attorney recommends the following steps.

1. Obtain an FEIN for the Muriel Hathaway estate. The estate will operate the business during the period of estate administration and probate.
2. Obtain an appraisal for all of Muriel's assets. Her assets consist of her residence, which is owned free of any mortgage, the building that operates Yoder Family Fine Furniture, and an extensive inventory at the store. The building was fully depreciated.
3. Mandy should begin to gather data for Frieda to file the final Form 1040 for Muriel.
4. Frieda should prepare the tax returns for 2019.

Muriel's assets are appraised as follows.

FMV of the personal residence	\$ 350,000
FMV of the furniture store building	750,000
Yoder Family Fine Furniture market value of inventory	215,000
Goodwill value of the business	1,500,000
Total assets	<u>\$2,815,000</u>

Mark told the family attorney he wants to be bought out and asked when he can get the check for his half. Mandy wants to continue the business according to her mother's wishes and does not know where she is going to get the money to buy her brother out.

Luckily for Frieda, her firm has handled the bookkeeping on a monthly basis for Yoder Family Fine Furniture, so she is familiar with the operation.

For 2019 the following returns will need to be filed.

1. Form 1040 for Muriel for the short tax year ending April 29, 2019 — Even though Muriel has passed away, the tax return was still due on July 15, 2020.⁷²
2. Form 1041 for the estate — All of Muriel's assets passed into the estate, with the attorney as executor. Frieda obtained an FEIN for the estate. The attorney, as executor, **elected to file** the return on a calendar-year basis.

The Final 1040. Frieda needs to obtain (or allocate) income amounts for Muriel for the period January 1 through April 29, 2019. As mentioned earlier, Frieda provides bookkeeping services on a monthly basis for the business. Therefore, she is reasonably able to determine the income for the period January 1 through April 29, 2019. The net income of Yoder Family Furniture for this period is \$89,657. This is Muriel's only source of income for her final 1040 (which is shown later in this section).

⁷² *Deceased Persons — Filing the Final Return(s) of a Deceased Person.* Mar. 27, 2020. IRS. [www.irs.gov/businesses/small-businesses-self-employed/deceased-taxpayers-filing-the-final-returns-of-a-deceased-taxpayer] Accessed on Jul. 14, 2020.

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Estate Form 1041. Frieda makes the following notes with regard to the estate.

1. The business passed to the estate upon Muriel's death, and Frieda chooses to prepare the financial results for the period April 30 through December 31, 2019.
2. Because the assets of the furniture store were owned by Muriel as a sole proprietor, the estate received the building and inventory at the FMV on the date of Muriel's death.⁷³ According to the appraisal, the depreciable basis of the building is now \$750,000 (less an allocation for land, which the appraiser indicated was \$50,000). The inventory cost on the books for the estate is \$215,000, which is the FMV as of the date of death according to the appraisal.
3. The appraised value of the furniture store as a going concern (goodwill) becomes an asset of the estate and is eligible to be amortized over 15 years.
4. The estate will pay any taxes owed, with distributions to occur after all parties are in agreement.
5. All parties have a goal of wrapping up the estate by December 31, 2019.

5

The results for the short-year return ending December 31, 2019, are illustrated later in this section.

After completing Muriel's personal tax returns, Frieda meets with the attorney along with Mandy and Mark to discuss the situation moving forward. Mandy wants to continue the business as owner. To this end, she, the attorney (executor), and Frieda met with Mandy's banker and obtained approval for a \$1.5 million line of credit, using the furniture store building and inventory as collateral for the loan. The purpose of the loan is to buy Mark's share of the furniture business.

During the period of estate administration, Muriel's home was sold for the appraised value of \$350,000.

On December 31, 2019, the estate distributed full ownership of the furniture store to Mandy and distributed cash of \$1,407,500 to Mark.

Distribution to Mandy

Goodwill value of the furniture business	\$1,500,000
Inventory value at Muriel's date of death	215,000
Building value	750,000
Cash proceeds of home sale	350,000
Total	\$2,815,000
Less: debt assumed by Mandy	(1,500,000)
Loan proceeds not used for buyout	92,500
Net value to Mandy	\$1,407,500

Distribution to Mark

Cash	\$1,407,500
------	-------------

⁷³ IRS Pub. 551, *Basis of Assets*.

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Observations.

1. All assets received a step up to FMV as of the date of death because the assets were owned by Muriel. If the furniture store was an S or C corporation, there would have been no step up in the value of the store. Mandy and Mark would “step into the shoes” of the corporate operation, although the stock they would inherit would be valued based on the value of the underlying assets at the date of death.
2. Mandy was not required to buy her brother out. She made this decision based on what she perceived to be her mother’s wishes and perhaps her own desire to continue the business.
3. The executor’s job could have been to liquidate the assets and distribute cash to the heirs. This may have been the outcome if there was a dispute between Mandy and Mark, or if Mandy could not obtain a loan.
4. The taxes owed for Muriel’s final Form 1040 and the estate return (including legal and professional fees) were paid from cash balances Muriel had in her personal bank accounts as of her date of death.
5. The estate was not subject to the net investment income tax (NIIT) because the estate operated the furniture store as a business.
6. An estate is not typically opened and closed within the same calendar year. In most situations, when the FEIN is obtained, a fiscal year is elected (in this case, beginning April 2019 and ending March 30, 2020). This election provides additional time (if needed) to wrap up the affairs of the estate within the fiscal year.
7. If Muriel’s attorney had recommended she hold her assets in a grantor (revocable) trust, the period of probate could have been avoided.

Note. For a more in-depth discussion of trusts and trust issues, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Trust Essentials.

8. Once the estate is settled, additional meetings between Frieda, Mandy, and the attorney may be warranted to discuss future arrangements. These may include insurance on key employees, determining alternative legal structures for the business, etc. Although the estate of Muriel Hathaway may be settled, estate planning for Mandy has just begun.

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For Example 25

Form	1040-SR	Department of the Treasury—Internal Revenue Service (99)	2019	OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.																																																															
Filing Status <input checked="" type="checkbox"/> Single <input type="checkbox"/> Married filing jointly <input type="checkbox"/> Married filing separately (MFS) <input type="checkbox"/> Head of household (HOH) <input type="checkbox"/> Qualifying widow(er) (QW) <small>Check only one box.</small> If you checked the MFS box, enter the name of spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent. ▶																																																																				
Your first name and middle initial Muriel Hathaway		Last name		Your social security number 348 59 7892																																																																
If joint return, spouse's first name and middle initial		Last name		Spouse's social security number																																																																
Home address (number and street). If you have a P.O. box, see instructions. 1602 State Route 45				Apt. no.																																																																
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Champaign, IL 61820				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. <input type="checkbox"/> You <input type="checkbox"/> Spouse																																																																
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If more than four dependents, see inst. and ✓ here ▶ <input type="checkbox"/>																																																																				
Standard Deduction Someone can claim: <input type="checkbox"/> You as a dependent <input type="checkbox"/> Your spouse as a dependent <input type="checkbox"/> Spouse itemizes on a separate return or you were a dual-status alien																																																																				
Age/Blindness You: <input checked="" type="checkbox"/> Were born before January 2, 1955 <input type="checkbox"/> Are blind Spouse: <input type="checkbox"/> Was born before January 2, 1955 <input type="checkbox"/> Is blind																																																																				
Dependents (see instructions): <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 40%;">(1) First name Last name</th> <th style="width: 10%;">(2) Social security number</th> <th style="width: 15%;">(3) Relationship to you</th> <th style="width: 15%;">(4) ✓ if qualifies for (see inst.): Child tax credit</th> <th style="width: 20%;">Credit for other dependents</th> </tr> </thead> <tbody> <tr><td> </td><td> </td><td> </td><td><input type="checkbox"/></td><td><input type="checkbox"/></td></tr> <tr><td> </td><td> </td><td> </td><td><input type="checkbox"/></td><td><input type="checkbox"/></td></tr> <tr><td> </td><td> </td><td> </td><td><input type="checkbox"/></td><td><input type="checkbox"/></td></tr> <tr><td> </td><td> </td><td> </td><td><input type="checkbox"/></td><td><input type="checkbox"/></td></tr> </tbody> </table>						(1) First name Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see inst.): Child tax credit	Credit for other dependents				<input type="checkbox"/>	<input type="checkbox"/>				<input type="checkbox"/>	<input type="checkbox"/>				<input type="checkbox"/>	<input type="checkbox"/>				<input type="checkbox"/>	<input type="checkbox"/>																																						
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<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td rowspan="10" style="width: 10%; vertical-align: middle;"> Attach Schedule B if required. </td> <td style="width: 15%;">1</td> <td style="width: 45%;">Wages, salaries, tips, etc. Attach Form(s) W-2</td> <td style="width: 10%;">1</td> <td style="width: 30%;"></td> </tr> <tr> <td>2a</td> <td>Tax-exempt interest</td> <td>2a</td> <td></td> </tr> <tr> <td>3a</td> <td>Qualified dividends</td> <td>3a</td> <td></td> </tr> <tr> <td>4a</td> <td>IRA distributions</td> <td>4a</td> <td></td> </tr> <tr> <td>c</td> <td>Pensions and annuities</td> <td>4c</td> <td></td> </tr> <tr> <td>5a</td> <td>Social security benefits</td> <td>5a</td> <td></td> </tr> <tr> <td>6</td> <td>Capital gain or (loss). Attach Schedule D if required. If not required, check here . ▶ <input type="checkbox"/></td> <td>6</td> <td></td> </tr> <tr> <td>7a</td> <td>Other income from Schedule 1, line 9</td> <td>7a</td> <td style="text-align: right;">89,657</td> </tr> <tr> <td>b</td> <td>Add lines 1, 2b, 3b, 4b, 4d, 5b, 6, and 7a. This is your total income ▶</td> <td>7b</td> <td style="text-align: right;">89,657</td> </tr> <tr> <td>8a</td> <td>Adjustments to income from Schedule 1, line 22</td> <td>8a</td> <td style="text-align: right;">6,334</td> </tr> <tr> <td colspan="2">b Subtract line 8a from line 7b. This is your adjusted gross income ▶</td> <td>8b</td> <td style="text-align: right;">83,323</td> </tr> <tr> <td rowspan="3" style="width: 10%; vertical-align: middle;"> Standard Deduction See <i>Standard Deduction Chart</i> below. </td> <td>9</td> <td>Standard deduction or itemized deductions (from Schedule A)</td> <td>9</td> <td style="text-align: right;">13,850</td> </tr> <tr> <td>10</td> <td>Qualified business income deduction. Attach Form 8995 or Form 8995-A</td> <td>10</td> <td style="text-align: right;">13,895</td> </tr> <tr> <td>11a</td> <td>Add lines 9 and 10</td> <td>11a</td> <td style="text-align: right;">27,745</td> </tr> <tr> <td colspan="2">b Taxable income. Subtract line 11a from line 8b. If zero or less, enter -0-</td> <td>11b</td> <td style="text-align: right;">55,578</td> <td></td> </tr> </table>						Attach Schedule B if required.	1	Wages, salaries, tips, etc. Attach Form(s) W-2	1		2a	Tax-exempt interest	2a		3a	Qualified dividends	3a		4a	IRA distributions	4a		c	Pensions and annuities	4c		5a	Social security benefits	5a		6	Capital gain or (loss). Attach Schedule D if required. If not required, check here . ▶ <input type="checkbox"/>	6		7a	Other income from Schedule 1, line 9	7a	89,657	b	Add lines 1, 2b, 3b, 4b, 4d, 5b, 6, and 7a. This is your total income ▶	7b	89,657	8a	Adjustments to income from Schedule 1, line 22	8a	6,334	b Subtract line 8a from line 7b. This is your adjusted gross income ▶		8b	83,323	Standard Deduction See <i>Standard Deduction Chart</i> below.	9	Standard deduction or itemized deductions (from Schedule A)	9	13,850	10	Qualified business income deduction. Attach Form 8995 or Form 8995-A	10	13,895	11a	Add lines 9 and 10	11a	27,745	b Taxable income. Subtract line 11a from line 8b. If zero or less, enter -0-		11b	55,578	
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	5a	Social security benefits	5a																																																																	
	6	Capital gain or (loss). Attach Schedule D if required. If not required, check here . ▶ <input type="checkbox"/>	6																																																																	
	7a	Other income from Schedule 1, line 9	7a	89,657																																																																
	b	Add lines 1, 2b, 3b, 4b, 4d, 5b, 6, and 7a. This is your total income ▶	7b	89,657																																																																
	8a	Adjustments to income from Schedule 1, line 22	8a	6,334																																																																
b Subtract line 8a from line 7b. This is your adjusted gross income ▶		8b	83,323																																																																	
Standard Deduction See <i>Standard Deduction Chart</i> below.	9	Standard deduction or itemized deductions (from Schedule A)	9	13,850																																																																
	10	Qualified business income deduction. Attach Form 8995 or Form 8995-A	10	13,895																																																																
	11a	Add lines 9 and 10	11a	27,745																																																																
b Taxable income. Subtract line 11a from line 8b. If zero or less, enter -0-		11b	55,578																																																																	
Standard Deduction Chart* Add the number of boxes checked in the "Age/Blindness" section of <i>Standard Deduction</i> . . . ▶																																																																				
<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 20%;">IF your filing status is . . .</th> <th style="width: 10%;">AND the number of boxes checked is . . .</th> <th style="width: 15%;">THEN your standard deduction is . . .</th> <th style="width: 20%;">IF your filing status is . . .</th> <th style="width: 10%;">AND the number of boxes checked is . . .</th> <th style="width: 15%;">THEN your standard deduction is . . .</th> </tr> </thead> <tbody> <tr> <td rowspan="2">Single</td> <td>1</td> <td>13,850</td> <td rowspan="2">Head of household</td> <td>1</td> <td>20,000</td> </tr> <tr> <td>2</td> <td>15,500</td> <td>2</td> <td>21,650</td> </tr> <tr> <td rowspan="4">Married filing jointly or Qualifying widow(er)</td> <td>1</td> <td>25,700</td> <td rowspan="4">Married filing separately</td> <td>1</td> <td>13,500</td> </tr> <tr> <td>2</td> <td>27,000</td> <td>2</td> <td>14,800</td> </tr> <tr> <td>3</td> <td>28,300</td> <td>3</td> <td>16,100</td> </tr> <tr> <td>4</td> <td>29,600</td> <td>4</td> <td>17,400</td> </tr> </tbody> </table>						IF your filing status is . . .	AND the number of boxes checked is . . .	THEN your standard deduction is . . .	IF your filing status is . . .	AND the number of boxes checked is . . .	THEN your standard deduction is . . .	Single	1	13,850	Head of household	1	20,000	2	15,500	2	21,650	Married filing jointly or Qualifying widow(er)	1	25,700	Married filing separately	1	13,500	2	27,000	2	14,800	3	28,300	3	16,100	4	29,600	4	17,400																													
IF your filing status is . . .	AND the number of boxes checked is . . .	THEN your standard deduction is . . .	IF your filing status is . . .	AND the number of boxes checked is . . .	THEN your standard deduction is . . .																																																															
Single	1	13,850	Head of household	1	20,000																																																															
	2	15,500		2	21,650																																																															
Married filing jointly or Qualifying widow(er)	1	25,700	Married filing separately	1	13,500																																																															
	2	27,000		2	14,800																																																															
	3	28,300		3	16,100																																																															
	4	29,600		4	17,400																																																															
*Don't use this chart if someone can claim you (or your spouse if filing jointly) as a dependent, your spouse itemizes on a separate return, or you were a dual-status alien. Instead, see instructions.																																																																				

For Example 25

Form 1040-SR (2019)

Page 2

12a Tax (see instructions). Check if any from:			
1 <input type="checkbox"/> Form(s) 8814	2 <input type="checkbox"/> Form 4972	3 <input type="checkbox"/> _____	12a 8,085
b Add Schedule 2, line 3, and line 12a and enter the total			12b 8,085
13a Child tax credit or credit for other dependents		13a	
b Add Schedule 3, line 7, and line 13a and enter the total			13b
14 Subtract line 13b from line 12b. If zero or less, enter -0-			14 8,085
15 Other taxes, including self-employment tax, from Schedule 2, line 10			15 12,668
16 Add lines 14 and 15. This is your total tax			16 20,753
17 Federal income tax withheld from Forms W-2 and 1099			17
18 Other payments and refundable credits:			
a Earned income credit (EIC)		18a	
b Additional child tax credit. Attach Schedule 8812		18b	
c American opportunity credit from Form 8863, line 8		18c	
d Schedule 3, line 14		18d	
e Add lines 18a through 18d. These are your total other payments and refundable credits			18e
19 Add lines 17 and 18e. These are your total payments			19 0
Refund		20	
20 If line 19 is more than line 16, subtract line 16 from line 19. This is the amount you overpaid			20
21a Amount of line 20 you want refunded to you . If Form 8888 is attached, check here <input type="checkbox"/>			21a
Direct deposit? <input type="checkbox"/> See instructions.	b Routing number	c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings	
	d Account number		
22 Amount of line 20 you want applied to your 2020 estimated tax			22
Amount You Owe		23	
23 Amount you owe. Subtract line 19 from line 16. For details on how to pay, see instructions			23 20,753
24 Estimated tax penalty (see instructions)			24
Third Party Designee			
Do you want to allow another person (other than your paid preparer) to discuss this return with the IRS? See instructions. <input type="checkbox"/> Yes. Complete below. <input checked="" type="checkbox"/> No			
(Other than paid preparer)	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
	Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation
	Phone no.	Email address	
Paid Preparer Use Only			
Firm's name		Phone no.	
Firm's address		Firm's EIN	

Go to www.irs.gov/Form1040SR for instructions and the latest information.

Form **1040-SR** (2019)

2020 Workbook

For Example 25

SCHEDULE 2 (Form 1040 or 1040-SR)

Department of the Treasury
Internal Revenue Service

Additional Taxes

► Attach to Form 1040 or 1040-SR.
► Go to www.irs.gov/Form1040 for instructions and the latest information.

OMB No. 1545-0074

2019
Attachment
Sequence No. **02**

Name(s) shown on Form 1040 or 1040-SR

Muriel Hathaway

Your social security number

348-59-7892

Part I Tax

1	Alternative minimum tax. Attach Form 6251	1	0
2	Excess advance premium tax credit repayment. Attach Form 8962	2	
3	Add lines 1 and 2. Enter here and include on Form 1040 or 1040-SR, line 12b	3	0

Part II Other Taxes

4	Self-employment tax. Attach Schedule SE	4	12,668
5	Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 8919	5	
6	Additional tax on IRAs, other qualified retirement plans, and other tax-favored accounts. Attach Form 5329 if required	6	
7a	Household employment taxes. Attach Schedule H	7a	
b	Repayment of first-time homebuyer credit from Form 5405. Attach Form 5405 if required	7b	
8	Taxes from: a <input type="checkbox"/> Form 8959 b <input type="checkbox"/> Form 8960 c <input type="checkbox"/> Instructions; enter code(s)	8	
9	Section 965 net tax liability installment from Form 965-A	9	
10	Add lines 4 through 8. These are your total other taxes . Enter here and on Form 1040 or 1040-SR, line 15	10	12,668

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 71478U

Schedule 2 (Form 1040 or 1040-SR) 2019

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2020 Workbook

For Example 25

SCHEDULE SE (Form 1040 or 1040-SR)

Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

► Go to www.irs.gov/ScheduleSE for instructions and the latest information.
► Attach to Form 1040, 1040-SR, or 1040-NR.

OMB No. 1545-0074

2019

Attachment
Sequence No. **17**

Name of person with self-employment income (as shown on Form 1040, 1040-SR, or 1040-NR)

Muriel Hathaway

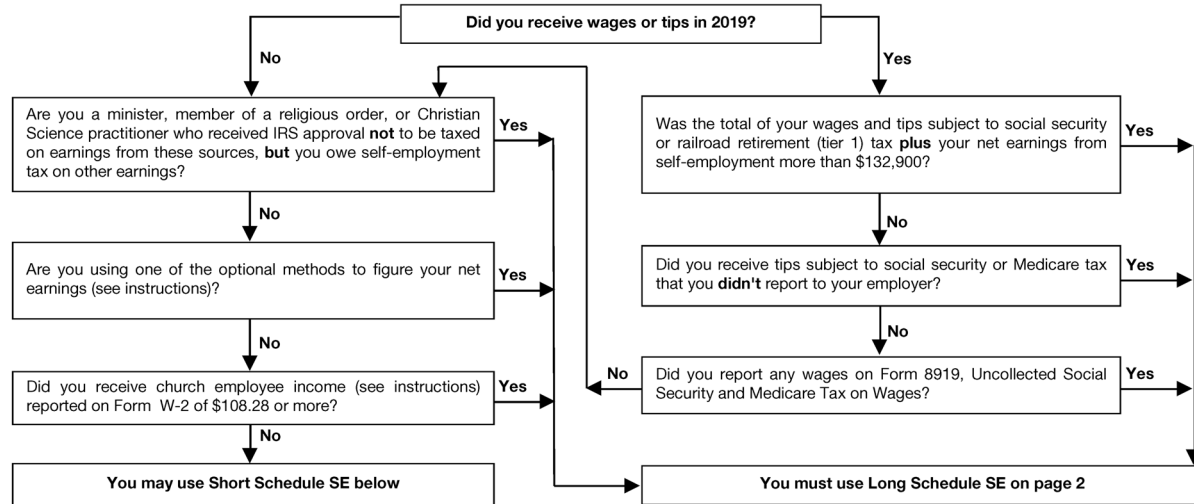
Social security number of person
with self-employment income ►

348-59-7892

Before you begin: To determine if you must file Schedule SE, see the instructions.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note: Use this flowchart **only** if you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.



Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.

1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a	
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AH	1b	()
2	Net profit or (loss) from Schedule C, line 31; and Schedule K-1 (Form 1065), box 14, code A (other than farming). Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report	2	89,657
3	Combine lines 1a, 1b, and 2	3	89,657
4	Multiply line 3 by 92.35% (0.9235). If less than \$400, you don't owe self-employment tax; don't file this schedule unless you have an amount on line 1b ►	4	82,798
5	Self-employment tax. If the amount on line 4 is: • \$132,900 or less, multiply line 4 by 15.3% (0.153). Enter the result here and on Schedule 2 (Form 1040 or 1040-SR), line 4, or Form 1040-NR, line 55. • More than \$132,900, multiply line 4 by 2.9% (0.029). Then, add \$16,479.60 to the result. Enter the total here and on Schedule 2 (Form 1040 or 1040-SR), line 4, or Form 1040-NR, line 55 .	5	12,668
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (0.50). Enter the result here and on Schedule 1 (Form 1040 or 1040-SR), line 14, or Form 1040-NR, line 27	6	6,334

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11358Z

Schedule SE (Form 1040 or 1040-SR) 2019

2020 Workbook

For Example 25

Form 8995 Department of the Treasury Internal Revenue Service	Qualified Business Income Deduction Simplified Computation ► Attach to your tax return. ► Go to www.irs.gov/Form8995 for instructions and the latest information.	OMB No. 1545-0123 <div style="font-size: 2em; font-weight: bold;">2019</div> Attachment Sequence No. 55
Name(s) shown on return Muriel Hathaway		Your taxpayer identification number 348-59-7892
1	(a) Trade, business, or aggregation name	(b) Taxpayer identification number
i	Yoder Family Fine Furniture	36-1254369
ii		
iii		
iv		
v		
2	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	2 83,323
3	Qualified business net (loss) carryforward from the prior year	3 (0)
4	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	4 83,323
5	Qualified business income component. Multiply line 4 by 20% (0.20)	5 16,665
6	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	6 0
7	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	7 (0)
8	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	8 0
9	REIT and PTP component. Multiply line 8 by 20% (0.20)	9 0
10	Qualified business income deduction before the income limitation. Add lines 5 and 9	10 16,665
11	Taxable income before qualified business income deduction	11 69,473
12	Net capital gain (see instructions)	12 0
13	Subtract line 12 from line 11. If zero or less, enter -0-	13 69,473
14	Income limitation. Multiply line 13 by 20% (0.20)	14 13,895
15	Qualified business income deduction. Enter the lesser of line 10 or line 14. Also enter this amount on the applicable line of your return ►	15 13,895
16	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-	16 (0)
17	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-	17 (0)

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 37806C Form **8995** (2019)

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2020 Workbook

For Example 25

SCHEDULE C (Form 1040 or 1040-SR)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business (Sole Proprietorship)

► Go to www.irs.gov/ScheduleC for instructions and the latest information.

► Attach to Form 1040, 1040-SR, 1040-NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2019

Attachment
Sequence No. **09**

Name of proprietor

Muriel Hathaway

Social security number (SSN)

348-59-7892

A Principal business or profession, including product or service (see instructions)

Retail Sales

B Enter code from instructions

► **442110**

C Business name. If no separate business name, leave blank.

Yoder Family Fine Furniture

D Employer ID number (EIN) (see instr.)

361254369

E Business address (including suite or room no.) ► **14 High Street**

City, town or post office, state, and ZIP code **Champaign IL**

F Accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) ►

G Did you "materially participate" in the operation of this business during 2019? If "No," see instructions for limit on losses ☒ Yes ☐ No

H If you started or acquired this business during 2019, check here ☐

I Did you make any payments in 2019 that would require you to file Form(s) 1099? (see instructions) ☒ Yes ☐ No

J If "Yes," did you or will you file required Forms 1099? ☒ Yes ☐ No

Part I Income

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked <input type="checkbox"/>	1	489,041
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	489,041
4	Cost of goods sold (from line 42)	4	149,654
5	Gross profit. Subtract line 4 from line 3	5	339,387
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7	Gross income. Add lines 5 and 6	7	339,387

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8	25,601	18	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		a	Vehicles, machinery, and equipment	20a	
12	Depreciation	12		b	Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13		21	Repairs and maintenance	21	
14	Employee benefit programs (other than on line 19)	14		22	Supplies (not included in Part III)	22	
15	Insurance (other than health)	15		23	Taxes and licenses	23	18,604
16	Interest (see instructions):			24	Travel and meals:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel	24a	
b	Other	16b		b	Deductible meals (see instructions)	24b	
17	Legal and professional services	17		25	Utilities	25	
26				26	Wages (less employment credits)	26	203,767
27a				27a	Other expenses (from line 48)	27a	1,758
27b				b	Reserved for future use	27b	

28 **Total expenses** before expenses for business use of home. Add lines 8 through 27a **28** **249,730**

29 Tentative profit or (loss). Subtract line 28 from line 7 **29** **89,657**

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

31 **Net profit or (loss).** Subtract line 30 from line 29.

• If a profit, enter on both **Schedule 1 (Form 1040 or 1040-SR), line 3** (or **Form 1040-NR, 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.

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 **Schedule 1 (Form 1040 or 1040-SR), line 3** (or **Form 1040-NR, 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 the separate instructions.

Cat. No. 11334P

Schedule C (Form 1040 or 1040-SR) 2019

2020 Workbook

For Example 25

Schedule C (Form 1040 or 1040-SR) 2019

Page **2**

Part III Cost of Goods Sold (see instructions)

33	Method(s) used to value closing inventory:	a <input checked="" type="checkbox"/> Cost	b <input type="checkbox"/> Lower of cost or market	c <input type="checkbox"/> Other (attach explanation)
34	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No			
35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	62,500	
36	Purchases less cost of items withdrawn for personal use	36	302,154	
37	Cost of labor. Do not include any amounts paid to yourself	37		
38	Materials and supplies	38		
39	Other costs	39		
40	Add lines 35 through 39	40	364,654	
41	Inventory at end of year	41	215,000	
42	Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on line 4	42	149,654	

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.

43	When did you place your vehicle in service for business purposes? (month, day, year)	/ /	
44	Of the total number of miles you drove your vehicle during 2019, enter the number of miles you used your vehicle for:		
	a Business	b Commuting (see instructions)	c Other
45	Was your vehicle available for personal use during off-duty hours? <input type="checkbox"/> Yes <input type="checkbox"/> No		
46	Do you (or your spouse) have another vehicle available for personal use? <input type="checkbox"/> Yes <input type="checkbox"/> No		
47a	Do you have evidence to support your deduction? <input type="checkbox"/> Yes <input type="checkbox"/> No		
	b If "Yes," is the evidence written?	<input type="checkbox"/> Yes <input type="checkbox"/> No	

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.

Accounting	897
Bank Charges	861
48 Total other expenses. Enter here and on line 27a	1,758

Schedule C (Form 1040 or 1040-SR) 2019

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2020 Workbook

For Example 25

Form	1041	Department of the Treasury—Internal Revenue Service U.S. Income Tax Return for Estates and Trusts ▶ Go to www.irs.gov/Form1041 for instructions and the latest information.	2019	OMB No. 1545-0092
A Check all that apply: <input checked="" type="checkbox"/> Decedent's estate <input type="checkbox"/> Simple trust <input type="checkbox"/> Complex trust <input type="checkbox"/> Qualified disability trust <input type="checkbox"/> ESBT (S portion only) <input type="checkbox"/> Grantor type trust <input type="checkbox"/> Bankruptcy estate—Ch. 7 <input type="checkbox"/> Bankruptcy estate—Ch. 11 <input type="checkbox"/> Pooled income fund		For calendar year 2019 or fiscal year beginning 4/30 , 2019, and ending 12/31 , 20 19 C Employer identification number 62-1596203 D Date entity created 4/30/2019 E Nonexempt charitable and split-interest trusts, check applicable box(es). See instructions. <input type="checkbox"/> Described in sec. 4947(a)(1). Check here if not a private foundation . . . ▶ <input type="checkbox"/> <input type="checkbox"/> Described in sec. 4947(a)(2)		
B Number of Schedules K-1 attached (see instructions) ▶		F Check applicable boxes: <input checked="" type="checkbox"/> Initial return <input checked="" type="checkbox"/> Final return <input type="checkbox"/> Amended return <input type="checkbox"/> Net operating loss carryback <input type="checkbox"/> Change in trust's name <input type="checkbox"/> Change in fiduciary <input type="checkbox"/> Change in fiduciary's name <input type="checkbox"/> Change in fiduciary's address		
G Check here if the estate or filing trust made a section 645 election . . . ▶ <input type="checkbox"/> Trust TIN ▶				
Income	1 Interest income	1		
	2a Total ordinary dividends	2a		
	b Qualified dividends allocable to: (1) Beneficiaries (2) Estate or trust			
	3 Business income or (loss). Attach Schedule C (Form 1040 or 1040-SR)	3	232,583	
	4 Capital gain or (loss). Attach Schedule D (Form 1041)	4		
	5 Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040 or 1040-SR)	5		
	6 Farm income or (loss). Attach Schedule F (Form 1040 or 1040-SR)	6		
	7 Ordinary gain or (loss). Attach Form 4797	7		
	8 Other income. List type and amount	8		
9 Total income. Combine lines 1, 2a, and 3 through 8 ▶	9	232,583		
Deductions	10 Interest. Check if Form 4952 is attached ▶ <input type="checkbox"/>	10		
	11 Taxes	11		
	12 Fiduciary fees. If only a portion is deductible under section 67(e), see instructions	12		
	13 Charitable deduction (from Schedule A, line 7)	13		
	14 Attorney, accountant, and return preparer fees. If only a portion is deductible under section 67(e), see instructions	14		
	15a Other deductions (attach schedule). See instructions for deductions allowable under section 67(e)	15a		
	b Net operating loss deduction. See instructions	15b		
	16 Add lines 10 through 15b ▶	16		
	17 Adjusted total income or (loss). Subtract line 16 from line 9	17	232,583	
	18 Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18		
19 Estate tax deduction including certain generation-skipping taxes (attach computation)	19			
20 Qualified business income deduction. Attach Form 8995 or 8995-A	20	46,397		
21 Exemption	21	600		
22 Add lines 18 through 21 ▶	22	46,997		
Tax and Payments	23 Taxable income. Subtract line 22 from line 17. If a loss, see instructions	23	185,586	
	24 Total tax (from Schedule G, Part I, line 9)	24	67,025	
	25 2019 net 965 tax liability paid from Form 965-A, Part II, column (k), line 3	25		
	26 Total payments (from Schedule G, Part II, line 17)	26		
	27 Estimated tax penalty. See instructions	27		
	28 Tax due. If line 26 is smaller than the total of lines 24, 25, and 27, enter amount owed	28	67,025	
	29 Overpayment. If line 26 is larger than the total of lines 24, 25, and 27, enter amount overpaid	29		
	30 Amount of line 29 to be: a Credited to 2020 ▶ ; b Refunded ▶	30		
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 fiduciary or officer representing fiduciary _____ Date _____ EIN of fiduciary if a financial institution _____			
Paid Preparer Use Only	Print/Type preparer's name _____		Preparer's signature _____ Date _____	
	Firm's name ▶ _____		Check <input type="checkbox"/> if self-employed PTIN _____	
	Firm's address ▶ _____		Firm's EIN ▶ _____ Phone no. _____	

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11370H

Form **1041** (2019)

HOME OFFICE REFRESHER

Note. The TCJA suspends miscellaneous itemized deductions for tax years beginning after 2017 and before 2026.⁷⁴ Therefore, the use of a home office by an **employee** of a business is not deductible. However, **self-employed taxpayers** are still eligible for this deduction.



Practitioner Planning Tip

Because of stay-at-home orders due to COVID-19, many employees in 2020 worked from home. For employees who qualify for a deduction for home office use, seeking reimbursement from their employer for home-office related expenses incurred is advisable.

5

TWO METHODS FOR HOME OFFICE DEDUCTION

A deduction for the use of a home office (whether the home is rented or owned) is available to taxpayers who meet certain requirements. Before 2013, utilizing the home office deduction required the calculation, allocation, and substantiation of allowable expenses using the **actual expense method**, which often proved to be a complex and burdensome task. To alleviate this burden, for tax years starting on or after January 1, 2013, taxpayers may elect to use a **safe harbor method**⁷⁵ (discussed later) to determine the amount of deductible expenses for their home offices.

Claiming a deduction for business use of the home **using either method** requires that a portion of the home be used for conducting a trade or business. The business area of the home must meet **one** of the following requirements.⁷⁶

- Used **exclusively and regularly** as the principal place of business
- Used **exclusively and regularly** as a place to meet or deal with patients, clients, or customers in the normal course of the trade or business
- In the case of a separate structure not attached to the home, used in connection with the trade or business
- Used regularly as a storage unit for the taxpayer's inventory, but only if the dwelling unit is the sole fixed location of that trade or business

Actual Expense Method⁷⁷

To claim the home office deduction using the actual expense method, the **business percentage** must be calculated.

The business percentage determines the amount of household expenses that can be deducted because they are attributable to the business area of the home. The taxpayer may use any reasonable method to determine the business percentage. A typical method is to compare the area (square footage) of the business-use portion with the total area of the home.

⁷⁴ PL 115-197, §11045.

⁷⁵ Rev. Proc. 2013-13, 2013-6 IRB 478.

⁷⁶ IRC §280A(c).

⁷⁷ IRS Pub. 587, *Business Use of Your Home*.

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Home office expenses are **fully deductible** without any limitation if gross business revenue exceeds:

- The regular business operating expenses not related to the home (excluding the 50% SE tax deduction), plus
- The business portion of expenses related to the home.

If the home office and other business expenses exceed gross revenue, the deduction for home office expenses is **limited**. When this limitation applies, the taxpayer's business expenses are applied against the business's profits using a set of ordering rules. To understand how these ordering rules apply, it is useful to categorize the taxpayer's home office expenses into three classes, although the term classes is not mentioned in the instructions for Form 8829, *Expenses for Business Use of Home*.

Class	Description	Examples
Class 1	The business portion of home expenses that the taxpayer could deduct as itemized expenses on Schedule A even if the taxpayer did not have a business	<ul style="list-style-type: none">• Mortgage interest• Property taxes• Mortgage insurance premium
Class 2	Expenses attributable to the home office, not including depreciation	<ul style="list-style-type: none">• Insurance• Utilities• Repairs and maintenance• Rent (if the residence is rented and not owned)
Class 3	Depreciation	<ul style="list-style-type: none">• Depreciation on the business portion of the home

Once the taxpayer's home office expenses are categorized into these three classes, the following ordering rules apply in the calculation of the home office deduction on Form 8829.

1. **Class 1 expenses** (Form 8829, lines 9, 10 and 11) are deducted fully from the business's net income, even if this results in a loss. The deduction limit does not affect class 1 expenses. These deductions can create a loss or increase the entity's loss. However, the treatment of class 1 expenses is not as clear during the TCJA years. The changes made by the TCJA are discussed later in this section.

Note. If a taxpayer deducts the business portion of mortgage interest and property taxes as part of a home office deduction and itemizes deductions on Schedule A, the amounts claimed on Schedule A are **reduced** by the amounts claimed as a home office deduction. This prevents the home-office portion from being deducted twice.

2. **Class 2 expenses** (Form 8829, lines 16 through 22) are deducted up to the amount of any net income remaining after deducting class 1 expenses. Deduction of class 2 expenses **cannot create a loss**, and any amount not deducted is **carried forward** to the following year. The same limitation applies in the following year for class 2 expenses.
3. **Class 3 expenses** (Form 8829, lines 29 and 30) are deducted up to the amount of any remaining net income. Deduction of depreciation **cannot create a loss**, and any depreciation that cannot be deducted is **carried forward** to the following year.

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Example 26. Josie Young, single, is a tax preparer. In January 2019, she began using one room in her residence exclusively and regularly to meet with clients, provide accounting services, and prepare tax returns. She qualifies to claim a home office deduction. Josie has a 340 square foot room she uses for her business. This is 20% of her 1,700 square foot home ($340 \div 1,700$).

In 2019, Josie's business income and general business expenses (expenses not related to her home) are as follows.

Gross income		\$15,000
Expenses:		
Advertising	\$ 400	
Business telephone	700	
Office expense	1,700	
Professional license	300	
Equipment rental	400	
Supplies	1,500	
Legal fees	1,500	
Total expenses	\$6,500	(6,500)
Net income		\$ 8,500

Her home office and household expenses are as follows.

Expense	Total Amount	Class
Mortgage interest	\$20,000	1
Real estate tax	3,000	1
House insurance	600	2
Home repairs	1,200	2
Utilities	1,100	2

Josie uses the following information to calculate her depreciation.

FMV of home	\$225,000
Cost basis of home and lot	150,000
Cost basis of lot	50,000

Josie calculates and reports her business expenses and home office expenses as follows.

1. Because Josie is a sole proprietor, she reports her business income and general business expenses on Schedule C. Before deducting the expenses for the business use of her home, she has a net profit of \$8,500.
2. Josie's business percentage for her home (20%) is shown in part I of Form 8829.
3. The business portion of Josie's mortgage interest and property taxes (class 1 expenses) is calculated in part II of Form 8829 by multiplying these expenses by her business percentage, which results in \$4,600 ($(\$20,000 + \$3,000) \times 20\%$). This amount is subtracted from her \$8,500 profit (from item 1), leaving \$3,900. This amount can be used for deducting class 2 and 3 expenses.

Note. Josie can deduct the remainder of the mortgage interest and property taxes on Schedule A, assuming she is eligible to itemize deductions.

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4. Josie's class 2 expenses consist of insurance, home repairs, and utilities. These are indirect expenses because they relate to her entire house and not just the business portion of the house. Accordingly, the business percentage is applied to these expenses, which are entered in column b of part II of Form 8829. After deducting these indirect expenses, there is \$3,320 ($\$3,900 - ((\$600 + \$1,200 + \$1,100) \times 20\%)$) of profit remaining for class 3 expenses.
5. If Josie had expenses that related only to the business portion of her home, these amounts would be considered direct expenses and reported in column a of part II of Form 8829.
6. Part III of Form 8829 shows the depreciation calculation for the business portion of Josie's home. The business percentage is applied to the basis of the building only, because land cannot be depreciated. Josie refers to the instructions for Form 8829 to find the depreciation percentage for line 41. Because she used the home for all of 2019, the applicable depreciation percentage is 2.461%. The table from the instructions for line 41 is shown here.

Line 41

IF you first used your home for business in the following month in 2019...	THEN enter the following percentage on line 41*...
January	2.461%
February	2.247%
March	2.033%
April	1.819%
May	1.605%
June	1.391%
July	1.177%
August	0.963%
September	0.749%
October	0.535%
November	0.321%
December	0.107%

* **Exception.** If the business part of your home was Indian reservation property that met the requirements of section 168(j) when placed in service, see Pub. 946 to figure the depreciation.

The depreciation deduction is calculated as follows:

$$((\$150,000 \text{ total cost basis} - \$50,000 \text{ basis of lot}) \times 20\%) \times 2.461\% = \$492$$

7. Josie's total home office deduction of \$5,672 is calculated on Form 8829. This is shown on line 36 and is also entered on her Schedule C, line 30. After the applicable home office deduction, Josie's business net income is \$2,828, which is shown on line 31 of Schedule C. This amount is then entered on her Schedule 1, line 3.

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For Example 26

Form 8829 Department of the Treasury Internal Revenue Service (99)	Expenses for Business Use of Your Home ▶ File only with Schedule C (Form 1040 or 1040-SR). Use a separate Form 8829 for each home you used for business during the year. ▶ Go to www.irs.gov/Form8829 for instructions and the latest information.	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold; text-align: center;">2019</div> Attachment Sequence No. 176
Name(s) of proprietor(s) Josie Young		Your social security number 333-22-4444

Part I Part of Your Home Used for Business			
1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)	1	340
2	Total area of home	2	1,700
3	Divide line 1 by line 2. Enter the result as a percentage	3	20.00 %
For daycare facilities not used exclusively for business, go to line 4. All others, go to line 7.			
4	Multiply days used for daycare during year by hours used per day	4	hr.
5	If you started or stopped using your home for daycare during the year, see instructions; otherwise, enter 8,760	5	hr.
6	Divide line 4 by line 5. Enter the result as a decimal amount	6	.
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3	7	20.00 %

Part II Figure Your Allowable Deduction			
8	Enter the amount from Schedule C, line 29, plus any gain derived from the business use of your home, minus any loss from the trade or business not derived from the business use of your home (see instructions)	8	8,500
See instructions for columns (a) and (b) before completing lines 9-22.			
		(a) Direct expenses	(b) Indirect expenses
9	Casualty losses (see instructions)	9	
10	Deductible mortgage interest (see instructions)	10	20,000
11	Real estate taxes (see instructions)	11	3,000
12	Add lines 9, 10, and 11	12	23,000
13	Multiply line 12, column (b), by line 7	13	
14	Add line 12, column (a), and line 13	14	4,600
15	Subtract line 14 from line 8. If zero or less, enter -0-	15	3,900
16	Excess mortgage interest (see instructions)	16	
17	Excess real estate taxes (see instructions)	17	
18	Insurance	18	600
19	Rent	19	
20	Repairs and maintenance	20	1,200
21	Utilities	21	1,100
22	Other expenses (see instructions)	22	
23	Add lines 16 through 22	23	2,900
24	Multiply line 23, column (b), by line 7	24	580
25	Carryover of prior year operating expenses (see instructions)	25	0
26	Add line 23, column (a), line 24, and line 25	26	580
27	Allowable operating expenses. Enter the smaller of line 15 or line 26	27	580
28	Limit on excess casualty losses and depreciation. Subtract line 27 from line 15	28	3,320
29	Excess casualty losses (see instructions)	29	
30	Depreciation of your home from line 42 below	30	492
31	Carryover of prior year excess casualty losses and depreciation (see instructions)	31	
32	Add lines 29 through 31	32	492
33	Allowable excess casualty losses and depreciation. Enter the smaller of line 28 or line 32	33	492
34	Add lines 14, 27, and 33	34	5,672
35	Casualty loss portion, if any, from lines 14 and 33. Carry amount to Form 4684 (see instructions)	35	
36	Allowable expenses for business use of your home. Subtract line 35 from line 34. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions	36	5,672

Part III Depreciation of Your Home			
37	Enter the smaller of your home's adjusted basis or its fair market value (see instructions)	37	150,000
38	Value of land included on line 37	38	50,000
39	Basis of building. Subtract line 38 from line 37	39	100,000
40	Business basis of building. Multiply line 39 by line 7	40	20,000
41	Depreciation percentage (see instructions)	41	2.461 %
42	Depreciation allowable (see instructions). Multiply line 40 by line 41. Enter here and on line 30 above	42	492

Part IV Carryover of Unallowed Expenses to 2020			
43	Operating expenses. Subtract line 27 from line 26. If less than zero, enter -0-	43	
44	Excess casualty losses and depreciation. Subtract line 33 from line 32. If less than zero, enter -0-	44	

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For Example 26

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	6,500
29	Tentative profit or (loss). Subtract line 28 from line 7				29	8,500
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	5,672
31	Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Schedule 1 (Form 1040 or 1040-SR), line 3 (or Form 1040-NR, 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	2,828
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 Schedule 1 (Form 1040 or 1040-SR), line 3 (or Form 1040-NR, 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	<input type="checkbox"/> All investment is at risk.
				32b	<input type="checkbox"/> Some investment is not at risk.	

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11334P Schedule C (Form 1040 or 1040-SR) 2019

Safe Harbor Method

For tax years starting on or after January 1, 2013, Rev. Proc. 2013-13 provides an optional safe harbor method (also referred to as the “simplified” method) that taxpayers can use to determine the amount of deductible expenses attributable to the business use of a residence.⁷⁸ The safe harbor deduction is limited to **\$5 per square foot of home office space, up to a maximum of 300 square feet**. Therefore, **the deduction is limited to \$1,500 per year**.

Note. If the actual office in home square footage is less than 300 square feet, the taxpayer must use the actual square footage. If the actual square footage used is more than 300 square feet, the taxpayer is limited under the safe harbor method to 300 square feet.

The deduction may not exceed the gross income from the business. Any excess deduction **cannot be carried forward** to the following year.

One advantage of the safe harbor method is that the home mortgage interest and real estate taxes are not reduced for the business percentage and remain deductible as an itemized deduction assuming the taxpayer is eligible to itemize. Also, taxpayers are **not** required to substantiate the expenses incurred for their home. Another advantage is that there is no depreciation to recapture.

The election to use the safe harbor method is an annual election that must be made on a timely filed original return using Schedule C. The election is made by using the simplified method on the return. However, once made, **the election is irrevocable for that tax year**.

⁷⁸ Rev. Proc. 2013-13, 2013-6 IRB 478.

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Example 27. Use the same facts as **Example 26**, except Josie Young uses the safe harbor method to determine the amount of her home office deduction. She completes the following worksheet from the Schedule C instructions. The relevant portion of her Schedule C follows the worksheet.

Simplified Method Worksheet

Keep for Your Records



1. Enter the amount of the gross income limitation. See the Instructions for the Simplified Method Worksheet	1.	8,500
2. Allowable square footage for the qualified business use. Do not enter more than 300 square feet. See the Instructions for the Simplified Method Worksheet	2.	300
3. Simplified method amount		
a. Maximum allowable amount	3a.	\$5
b. For daycare facilities not used exclusively for business, enter the decimal amount from the Daycare Facility Worksheet; otherwise, enter 1.0	3b.	1.0
c. Multiply line 3a by line 3b and enter result to 2 decimal places	3c.	5
4. Multiply line 2 by line 3c	4.	1,500
5. Allowable expenses using the simplified method. Enter the smaller of line 1 or line 4 here and include that amount on Schedule C, line 30. If zero or less, enter -0-	5.	1,500
6. Carryover of unallowed expenses from a prior year that are not allowed in 2019.		
a. Operating expenses. Enter the amount from your last Form 8829, line 43 (line 42 if before 2018). See the Instructions for the Simplified Method Worksheet	6a.	0
b. Excess casualty losses and depreciation. Enter the amount from your last Form 8829, line 44 (line 43 if before 2018). See the Instructions for the Simplified Method Worksheet	6b.	0

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Instructions for the Simplified Method Worksheet

Use this worksheet to figure the amount of expenses you may deduct for a qualified business use of a home if you are electing to use the simplified method for that home. If you are not electing to use the simplified method, use Form 8829.

Line 1. If all gross income from your trade or business is from this qualified business use of your home, figure your gross income limitation as follows.

A. Enter the amount from Schedule C, line 29	8,500
B. Enter any gain derived from the business use of your home and shown on Form 8949 (and included on Schedule D) or Form 4797	0
C. Add lines A and B	8,500
D. Enter the total amount of any losses (as a positive number) shown on Form 8949 (and included on Schedule D) or Form 4797 that are allocable to the business, but not allocable to the business use of the home	0
E. Gross income limitation. Subtract line D from line C. Enter the result here and on line 1	8,500

If some of the income is from a place of business other than your home, you must first determine the part of your gross income (Schedule C, line 7, and gains from Form 8949, Schedule D, and Form 4797) from the business use of your home. In making this determination, consider the amount of time you spent at each location as well as other facts. After determining the part of your gross income from the business use of your home, subtract from that amount the total expenses shown on Schedule C, line 28, plus any losses shown on Form 8949 (and included on Schedule D) or Form 4797 that are allocable to the business in which you use your home but that are not allocable to the business use of the home. Enter the result on line 1.

Note: If you had more than one home in which you conducted this business during the year, include only the income earned and the deductions attributable to that income during the period you owned the home for which you elected to use the simplified method.

Line 2. If you used the same area for the entire year, enter the smaller of the square feet you actually used or 300. If you and your spouse conducted the business as a qualified joint venture, split the square feet between you and your spouse in the same manner you split your other tax attributes. If you shared space with someone else, used the home for business for only part of the year, or the area you used changed during the year, see *Figuring your allowable expenses for business use of the home* before entering an amount on this line. Do not enter more than 300 square feet or, if applicable, the average monthly allowable square footage on this line. See *Part-year use or area changes (for simplified method only)*, later, for more information on how to figure your average monthly allowable square footage.

Line 3b. If your qualified business use is providing daycare, you may need to account for the time that you used the same part of your home for other purposes. If you used the part of your home exclusively and regularly for providing daycare, enter 1.0 on line 3b. If you did not use the part of your home exclusively for providing daycare, complete the *Daycare Facility Worksheet* to figure what number to enter on line 3b.

Line 6. Since you are using the simplified method this year, you cannot deduct the amounts you entered on lines 6a and 6b this year. If you file Form 8829 next year for your qualified business use of this home, you will be able to include these expenses when you figure your deduction.

- 6a.** If you did not file a 2018 Form 8829, then your carryover of prior year operating expenses is the amount of operating expenses shown in Part IV of the last Form 8829, if any, that you filed to claim a deduction for business use of the home.
- 6b.** If you did not file a 2018 Form 8829, then your carryover of prior year excess casualty losses and depreciation is the amount of excess casualty losses and depreciation shown in Part IV of the last Form 8829, if any, that you filed to claim a deduction for business use of the home.

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For Example 27

17	Legal and professional services	17	b	Reserve for future use	27b	
28	Total expenses before expenses for business use of home. Add lines 8 through 27a				28	6,500
29	Tentative profit or (loss). Subtract line 28 from line 7				29	8,500
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: 1,700 and (b) the part of your home used for business: 340. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30				30	1,500
31	Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Schedule 1 (Form 1040 or 1040-SR), line 3 (or Form 1040-NR, 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	7,000
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 Schedule 1 (Form 1040 or 1040-SR), line 3 (or Form 1040-NR, 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	<input type="checkbox"/> All investment is at risk.
				32b	<input type="checkbox"/> Some investment is not at risk.	

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11334P Schedule C (Form 1040 or 1040-SR) 2019

By using the safe harbor method instead of the actual expense method, Josie's net Schedule C income is increased by \$4,172 (\$7,000 – \$2,828). However, she can potentially deduct the full amount of her mortgage interest and real estate taxes on Schedule A.

Practitioner Planning Tip

The safe harbor (simplified method) does not allow for the carryover of unused expenses from one year to the next. However, practitioners are advised to review tax returns from prior years to determine if the actual expense method was used previously. A taxpayer who uses the actual expense method following a year in which they used the simplified method must consider any expense carryovers from the year(s) in which they used the actual expense method.

Depreciation Issues. Taxpayers who use the safe harbor method **cannot** deduct any depreciation for the qualified home office for that tax year.

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** for the property. This is true regardless of whether the taxpayer used an optional depreciation table to calculate depreciation for the property in the year it was placed in service. The optional depreciation tables for modified accelerated recovery system (MACRS) property are provided in IRS Pub. 946, *How To Depreciate Property*. Selecting the appropriate optional depreciation table depends on the depreciation system, depreciation method, recovery period, and convention applicable to the property when it was placed into service.

The allowable depreciation deduction in the subsequent year is calculated 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 (e.g., year 1, year 2) is based on the property's placed-in-service date.

IMPACT OF TCJA ON THE HOME OFFICE DEDUCTION

As mentioned earlier, because the deduction for miscellaneous itemized deductions is eliminated, the deduction for office use of a home by employees during the TCJA years is also eliminated. There is an additional impact of the TCJA on the home office deduction, which is more subtle and affects taxpayers who take the standard deduction or itemize deductions. The instructions for Form 8829 in 2018 and 2019 illustrate this change.

Taxpayers claiming the standard deduction. If you claim the standard deduction, you will not include any mortgage interest, mortgage insurance premiums, or real estate taxes on lines 10 and 11; instead, you will claim the entire business use of the home portion of those expenses using lines 16 and 17.

This change impacts taxpayers in several ways.

1. Mortgage interest, mortgage insurance premiums, and real estate taxes are now class 2 expenses instead of class 1 expenses for taxpayers who choose the standard deduction on their Form 1040.
2. Taxpayers with a business loss cannot increase the loss by the business percentage of mortgage interest, mortgage insurance premiums, and real estate taxes because using the standard deduction moves these expenses from class 1 to class 2.
3. The TCJA limitation on deductible state taxes on Schedule A⁷⁹ causes class 1 expenses for real estate taxes to be limited to \$10,000 (\$5,000 if married filing separately). The instructions for Form 8829 explain these changes.

Real estate taxes reported on line 11. If you are claiming the standard deduction, do not report an amount on line 11. If you itemize your deductions, figure the amount to include on line 11 as follows.

Step 1. If the total of your state and local income (or, if elected on your Schedule A, general sales) taxes, real estate taxes, and personal property taxes is not more than \$10,000 (\$5,000 if married filing separately), enter all the real estate taxes attributable to the home in which you conducted business in column (b) of line 11.

Step 2. If you do not meet the condition of Step 1, use the following worksheet to figure the amount to include in column (a) of line 11.

Note. The worksheet for line 11 is shown as part of the next example.

⁷⁹ PL 115-97, §11042(a)(6)(B).

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Example 28. Mark Malfoy, a single taxpayer, operates as a sole proprietor. His Schedule C for 2019 reports a profit of \$9,542, before consideration of expenses for home office use. Mark's office where he meets with clients is 742 square feet and the total square footage of his house is 2,460. Therefore, his business percentage is 30.16%.

Because Mark itemizes his deductions and has a Schedule C profit, he reports the mortgage interest as a class 1 expense on line 10(b) of Form 8829. His total property taxes for 2019 were \$5,412. Mark allocates \$1,632 of the taxes ($\$5,412 \times 30.16\%$) to his business use of the home. During 2019, Mark pays total state and local income taxes of \$7,183.

He calculates on worksheet 11 that \$963 of his real estate taxes exceed the \$10,000 limitation and are allowed as a direct expense on Form 8829, line 11(a) as a class 1 expense. He reports his remaining deduction for real estate taxes of \$669 ($\$1,632 - \963) as class 2 expenses on line 17(a) as a direct expense.

The worksheet for line 11 and Mark's Form 8829 and Schedule A follow.

Line 11 Worksheet

1. Enter your state and local income taxes (or, if you elect on Schedule A, your state and local general sales taxes) that are personal expenses	1. <u>7,183</u>
2. Enter all the state and local real estate taxes you paid on the home in which you conducted business . . .	2. <u>5,412</u>
3. Enter any other state and local real estates taxes you paid that are a personal expense and not included in line 2	3. <u>0</u>
4. Enter your state and local personal property taxes that are a personal expense	4. <u>0</u>
5. Add lines 1 through 4	5. <u>12,595</u>
6. Multiply line 2 by the percentage on Form 8829, line 7	6. <u>1,632</u>
7. Subtract line 6 from line 5	7. <u>10,963</u>
8. Subtract line 7 from \$10,000 (\$5,000 if married filing separately). If zero or less, enter -0-	8. <u>963</u>
9. Real estate taxes reported on line 11. Enter the smaller of line 6 or line 8 here and in column (a) of Form 8829, line 11	9. <u>963</u>
10. Excess real estate taxes reported on line 17. Subtract line 9 from line 6	10. <u>669</u>

Note. The purpose of this worksheet is to determine if the Schedule A \$10,000 limitation for taxes was already met with state and local taxes, such as payroll withholding and the personal part of real estate taxes. If the limitation is already met, the worksheet calculates an allowable expense for the business portion of real estate taxes.

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For Example 28

Form 8829 Department of the Treasury Internal Revenue Service (99)	Expenses for Business Use of Your Home ► File only with Schedule C (Form 1040 or 1040-SR). Use a separate Form 8829 for each home you used for business during the year. ► Go to www.irs.gov/Form8829 for instructions and the latest information.	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold; text-align: center;">2019</div> Attachment Sequence No. 176
Name(s) of proprietor(s) Mark Malfoy		Your social security number 337-06-2274
Part I Part of Your Home Used for Business		
1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)	1 742
2	Total area of home	2 2,460
3	Divide line 1 by line 2. Enter the result as a percentage	3 30.16 %
For daycare facilities not used exclusively for business, go to line 4. All others, go to line 7.		
4	Multiply days used for daycare during year by hours used per day	4 hr.
5	If you started or stopped using your home for daycare during the year, see instructions; otherwise, enter 8,760	5 hr.
6	Divide line 4 by line 5. Enter the result as a decimal amount	6 .
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3	7 30.16 %
Part II Figure Your Allowable Deduction		
8	Enter the amount from Schedule C, line 29, plus any gain derived from the business use of your home, minus any loss from the trade or business not derived from the business use of your home (see instructions)	8 9,542
See instructions for columns (a) and (b) before completing lines 9-22.		
9	Casualty losses (see instructions)	9
10	Deductible mortgage interest (see instructions)	10 6,396
11	Real estate taxes (see instructions)	11 963
12	Add lines 9, 10, and 11	12 963 6,396
13	Multiply line 12, column (b), by line 7	13 1,929
14	Add line 12, column (a), and line 13	14 2,892
15	Subtract line 14 from line 8. If zero or less, enter -0-	15 6,650
16	Excess mortgage interest (see instructions)	16
17	Excess real estate taxes (see instructions)	17 669
18	Insurance	18 2,378
19	Rent	19
20	Repairs and maintenance	20 929
21	Utilities	21 5,956
22	Other expenses (see instructions)	22
23	Add lines 16 through 22	23 669 9,263
24	Multiply line 23, column (b), by line 7	24 2,794
25	Carryover of prior year operating expenses (see instructions)	25
26	Add line 23, column (a), line 24, and line 25	26 3,463
27	Allowable operating expenses. Enter the smaller of line 15 or line 26	27 3,463
28	Limit on excess casualty losses and depreciation. Subtract line 27 from line 15	28 3,187
29	Excess casualty losses (see instructions)	29
30	Depreciation of your home from line 42 below	30 908
31	Carryover of prior year excess casualty losses and depreciation (see instructions)	31
32	Add lines 29 through 31	32 910
33	Allowable excess casualty losses and depreciation. Enter the smaller of line 28 or line 32	33 910
34	Add lines 14, 27, and 33	34 7,265
35	Casualty loss portion, if any, from lines 14 and 33. Carry amount to Form 4684 (see instructions)	35
36	Allowable expenses for business use of your home. Subtract line 35 from line 34. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions	36 7,265
Part III Depreciation of Your Home		
37	Enter the smaller of your home's adjusted basis or its fair market value (see instructions)	37 147,567
38	Value of land included on line 37	38 25,000
39	Basis of building. Subtract line 38 from line 37	39 122,567
40	Business basis of building. Multiply line 39 by line 7	40 36,966
41	Depreciation percentage (see instructions)	41 2.461 %
42	Depreciation allowable (see instructions). Multiply line 40 by line 41. Enter here and on line 30 above	42 910
Part IV Carryover of Unallowed Expenses to 2020		
43	Operating expenses. Subtract line 27 from line 26. If less than zero, enter -0-	43 0
44	Excess casualty losses and depreciation. Subtract line 33 from line 32. If less than zero, enter -0-	44 0

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 13232M

Form 8829 (2019)

2020 Workbook

For Example 28

SCHEDULE A
(Form 1040 or 1040-SR)
(Rev. January 2020)
Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

► Go to www.irs.gov/ScheduleA for instructions and the latest information.
► Attach to Form 1040 or 1040-SR.

OMB No. 1545-0074

2019

Attachment
Sequence No. **07**

Caution: If you are claiming a net qualified disaster loss on Form 4684, see the instructions for line 16.

Name(s) shown on Form 1040 or 1040-SR

Your social security number

Mark Malfoy

337-06-2274

Medical and Dental Expenses	Caution: Do not include expenses reimbursed or paid by others.		
1	Medical and dental expenses (see instructions)	1	
2	Enter amount from Form 1040 or 1040-SR, line 8b 2		
3	Multiply line 2 by 7.5% (0.075)	3	
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4	
Taxes You Paid	5 State and local taxes.		
	a State and local income taxes or general sales taxes. You may include either income taxes or general sales taxes on line 5a, but not both. If you elect to include general sales taxes instead of income taxes, check this box <input type="checkbox"/>	5a	7,183
	b State and local real estate taxes (see instructions)	5b	3,780
	c State and local personal property taxes	5c	
	d Add lines 5a through 5c	5d	10,963
	e Enter the smaller of line 5d or \$10,000 (\$5,000 if married filing separately)	5e	10,000
	6 Other taxes. List type and amount ►	6	
	7 Add lines 5e and 6	7	10,000
Interest You Paid	8 Home mortgage interest and points. If you didn't use all of your home mortgage loan(s) to buy, build, or improve your home, see instructions and check this box <input type="checkbox"/>		
	a Home mortgage interest and points reported to you on Form 1098. See instructions if limited	8a	4,467
	b Home mortgage interest not reported to you on Form 1098. See instructions if limited. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address	8b	
	c Points not reported to you on Form 1098. See instructions for special rules	8c	
	d Mortgage insurance premiums (see instructions)	8d	
	e Add lines 8a through 8d	8e	4,467
	9 Investment interest. Attach Form 4952 if required. See instructions.	9	
	10 Add lines 8e and 9	10	4,467
Gifts to Charity	11 Gifts by cash or check. If you made any gift of \$250 or more, see instructions	11	
	12 Other than by cash or check. If you made any gift of \$250 or more, see instructions. You must attach Form 8283 if over \$500.	12	
	13 Carryover from prior year	13	
	14 Add lines 11 through 13	14	
Casualty and Theft Losses	15 Casualty and theft loss(es) from a federally declared disaster (other than net qualified disaster losses). Attach Form 4684 and enter the amount from line 18 of that form. See instructions	15	
Other Itemized Deductions	16 Other—from list in instructions. List type and amount ►	16	
Total Itemized Deductions	17 Add the amounts in the far right column for lines 4 through 16. Also, enter this amount on Form 1040 or 1040-SR, line 9	17	14,467
	18 If you elect to itemize deductions even though they are less than your standard deduction, check this box <input type="checkbox"/>		

For Paperwork Reduction Act Notice, see the Instructions for Forms 1040 and 1040-SR. Cat. No. 17145C Schedule A (Form 1040 or 1040-SR) 2019

Caution. The TCJA changes prevent taxpayers from obtaining a double benefit, i.e., a higher standard deduction and also a direct deduction for the business percentage of real estate taxes and mortgage interest.

Taxpayers with profitable business activities before consideration of the deduction for home office use may be less affected by the TCJA change for reasons such as the following.

1. Taxpayers could elect to use the safe harbor (simplified method), thereby avoiding the additional calculations and complexity.
2. As a deduction effectively connected with a trade or business, any allowable home office expense reduces the QBID for the entity.

Example 29. Use the same facts as **Example 26**, except Josie is married. Her husband Joe earned \$40,000 as a zookeeper. During 2019, Josie placed into service equipment that cost \$10,000.

The entire \$10,000 was expensed using bonus depreciation, creating a business loss of \$1,500 (\$8,500 original profit – \$10,000 bonus depreciation). Josie's forms, included below, illustrate the treatment of mortgage interest and real estate taxes as class 2 expenses. Therefore, Josie receives no home office deduction and any calculated expenses under the actual expense method are carried forward to future years.

Note. For an in-depth discussion of depreciation options available to taxpayers, see the 2020 *University of Illinois Federal Tax School Workbook*, Volume A, Chapter 2: Depreciation.

Observation. Because Josie had a Schedule C loss of \$1,500 before consideration of the home's office use, she is not permitted to use the safe harbor (simplified method) for home office expenses.

2020 Workbook

For Example 29

Form 8829 Department of the Treasury Internal Revenue Service (99)	Expenses for Business Use of Your Home ▶ File only with Schedule C (Form 1040 or 1040-SR). Use a separate Form 8829 for each home you used for business during the year. ▶ Go to www.irs.gov/Form8829 for instructions and the latest information.	OMB No. 1545-0074 <div style="border: 1px solid black; padding: 5px; text-align: center;"> 2019 Attachment Sequence No. 176 </div>
Name(s) of proprietor(s) Josie Young		Your social security number 333-22-4444
Part I Part of Your Home Used for Business		
1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)	1 340
2	Total area of home	2 1,700
3	Divide line 1 by line 2. Enter the result as a percentage	3 20.00 %
For daycare facilities not used exclusively for business, go to line 4. All others, go to line 7.		
4	Multiply days used for daycare during year by hours used per day	4 hr.
5	If you started or stopped using your home for daycare during the year, see instructions; otherwise, enter 8,760	5 hr.
6	Divide line 4 by line 5. Enter the result as a decimal amount	6 .
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3	7 20.00 %
Part II Figure Your Allowable Deduction		
8	Enter the amount from Schedule C, line 29, plus any gain derived from the business use of your home, minus any loss from the trade or business not derived from the business use of your home (see instructions). See instructions for columns (a) and (b) before completing lines 9-22.	8 (1,500)
9	Casualty losses (see instructions)	9
10	Deductible mortgage interest (see instructions)	10
11	Real estate taxes (see instructions)	11
12	Add lines 9, 10, and 11	12
13	Multiply line 12, column (b), by line 7	13
14	Add line 12, column (a), and line 13	14
15	Subtract line 14 from line 8. If zero or less, enter -0-	15 0
16	Excess mortgage interest (see instructions)	16 20,000
17	Excess real estate taxes (see instructions)	17 3,000
18	Insurance	18 600
19	Rent	19
20	Repairs and maintenance	20 1,200
21	Utilities	21 1,100
22	Other expenses (see instructions)	22
23	Add lines 16 through 22	23 25,900
24	Multiply line 23, column (b), by line 7	24 5,180
25	Carryover of prior year operating expenses (see instructions)	25
26	Add line 23, column (a), line 24, and line 25	26 5,180
27	Allowable operating expenses. Enter the smaller of line 15 or line 26	27
28	Limit on excess casualty losses and depreciation. Subtract line 27 from line 15	28
29	Excess casualty losses (see instructions)	29
30	Depreciation of your home from line 42 below	30 492
31	Carryover of prior year excess casualty losses and depreciation (see instructions)	31
32	Add lines 29 through 31	32 492
33	Allowable excess casualty losses and depreciation. Enter the smaller of line 28 or line 32	33
34	Add lines 14, 27, and 33	34
35	Casualty loss portion, if any, from lines 14 and 33. Carry amount to Form 4684 (see instructions)	35
36	Allowable expenses for business use of your home. Subtract line 35 from line 34. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions	36 0
Part III Depreciation of Your Home		
37	Enter the smaller of your home's adjusted basis or its fair market value (see instructions)	37 150,000
38	Value of land included on line 37	38 50,000
39	Basis of building. Subtract line 38 from line 37	39 100,000
40	Business basis of building. Multiply line 39 by line 7	40 20,000
41	Depreciation percentage (see instructions)	41 2.461 %
42	Depreciation allowable (see instructions). Multiply line 40 by line 41. Enter here and on line 30 above	42 492
Part IV Carryover of Unallowed Expenses to 2020		
43	Operating expenses. Subtract line 27 from line 26. If less than zero, enter -0-	43 5,180
44	Excess casualty losses and depreciation. Subtract line 33 from line 32. If less than zero, enter -0-	44 492

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 13222M

Form 8829 (2019)

2020 Workbook

For Example 29

28		
29	Tentative profit or (loss). Subtract line 28 from line 7.	(1,500)
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.	
31	Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Schedule 1 (Form 1040 or 1040-SR), line 3 (or Form 1040-NR, 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.	
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 Schedule 1 (Form 1040 or 1040-SR), line 3 (or Form 1040-NR, 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 <input type="checkbox"/> All investment is at risk. 32b <input type="checkbox"/> Some investment is not at risk.

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11334P Schedule C (Form 1040 or 1040-SR) 2019

5

SALE OF PERSONAL RESIDENCE WITH HOME OFFICE

IRC §121 permits taxpayers to exclude from gross income any gain up to \$500,000 for married couples filing jointly and \$250,000 for other filing statuses when their principal residence is sold, as long as they meet the rules for exclusion under §121.⁸⁰

- The property was not acquired through a like-kind exchange in the past five years.
- The taxpayer is not subject to the expatriate tax.
- The home was owned for two of the last five years, and the taxpayer(s) lived in the home for two (one if the taxpayer became disabled) of the last five years leading up to the date of the sale.
- For the two years before the date of the current sale, the taxpayer(s) did not sell another home on which the exclusion was claimed.
- The sale does not involve the transfer of vacant land or a remainder interest.

If these conditions are not met, the home sale may still qualify for a partial exclusion. The sale must involve one of the following events experienced by the taxpayer, the taxpayer's spouse, or a co-owner.⁸¹

- Work-related move
- Health-related move
- Death
- Divorce
- Pregnancy with multiple children
- Change in employment status
- Change in unemployment compensation eligibility
- Other unusual event

⁸⁰ IRS Pub. 523, *Selling Your Home*.

⁸¹ Ibid.

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If a bona fide business was conducted from the personal residence, then gain upon the sale may be subject to taxation and or depreciation recapture. The issue as to the potential taxability of gain depends on whether the home office was within the living area or was an appurtenant structure detached from the home.

IRS Pub. 523, *Selling Your Home*, states:⁸²

Space within the living area.(emphasis added). *If the space you used for business or rental purposes was within the living area of the home, then your usage doesn't affect your gain or loss calculations. Examples of spaces within the living area include a rented spare bedroom and an attic space used as a home office. In contrast, business or rental spaces not within the living area (emphasis added) affect your gain/loss calculations. Examples of space not within the living area include a first-floor storefront with an attached residence; a rented apartment in a duplex; or a working farm with a farmhouse on the property.*

Home Office Within the Living Area

Depreciation, allowed or allowable after May 6, 1997, is subject to recapture under IRC §1250.⁸³ The recapture amount is taxed at the ordinary tax rates as unrecaptured §1250 gain but not to exceed 25%.⁸⁴

Example 30. Willie, a single taxpayer, lived in his home for eight years. He had a home office in a separate bedroom, which equaled 15% of the home's square footage. In 2019, Willie sold his home for a profit of \$50,000. Because the office was within his home's living area, his entire gain qualifies for the \$250,000 §121 exclusion.

Willie had **allowed or allowable** depreciation deductions of \$2,000 for his home office use. He must pay tax on the \$2,000, subject to ordinary income tax rates, not to exceed a maximum tax rate under §1250 of 25% (or \$500).

Home Office in a Separate (Appurtenant) Structure

If the home office was not located inside the home (such as a detached garage used as an office), profit from the sale must be allocated between the living and office portions of the home.⁸⁵

Example 31. Use the same facts as in **Example 30**, except Willie has the home office in an unattached converted garage, which represents 15% of the total square footage of his home. Because the home office was not within the home's living space, the \$50,000 of profit on the sale of the residence must be allocated between the main home (which will likely qualify for the §121 exclusion) and the separate office. Willie has a taxable gain of \$7,500 ($\$50,000 \times 15\%$), which is attributable to his office.

Sale of the Appurtenant Structure Eligible for a Like-Kind Exchange.⁸⁶ If a taxpayer purchases another property used as a principal residence that has an appurtenant structure to be used for a home office, a taxpayer may be able to defer reporting the gain on the business-use portion of a personal residence by utilizing a like-kind exchange.⁸⁷ This is because the appurtenant structure is considered a property held for business or investment purposes and not a personal residence.⁸⁸

Note. These types of properties are often referred to as being "mixed use." The allocation between the principal residence and the office portion should not be a difficult undertaking because the business-use portion of the property was already determined for the home office deduction.

⁸² Ibid.

⁸³ Ibid.

⁸⁴ IRC §1250.

⁸⁵ Treas. Reg. §1.121-1(e)(1).

⁸⁶ Rev. Proc. 2005-14, 2005-7 IRB 528.

⁸⁷ *Like-Kind Exchanges - Real Estate Tax Tips*. May 22, 2020. IRS. [www.irs.gov/businesses/small-businesses-self-employed/like-kind-exchanges-real-estate-tax-tips] Accessed on Jul. 10, 2020.

⁸⁸ IRC §1031.