2021 NATIONAL INCOME TAX WORKBOOK

CHAPTER 3: BUSINESS TAX ISSUES

Land Grant University Tax Education Foundation

BUSINESS TAX ISSUES

PP. 81-129

MARIJUANA-RELATED BUSINESSES

PP. 82-88

- Still illegal under federal law
- See Fig. 3.1 for state legality – since publication recreational has become legal for Connecticut, and New Mexico and recreational and medical have become legal for Virginia.
- Large source of tax revenue

MARIJUANA-RELATED BUSINESSES

P. 84

- Practitioner Note on CBD
  - CBD is no longer on Controlled Substance List
  - Therapeutic use not approved by FDA
- Federal law overrides conflicting state law
- Taxation of federally illegal activity
  - Income is reportable
  - Expenses are not deductible
  - Cost of goods sold are allowed

➢ No specific guidance on “due diligence” – see 2018 workbook

INCOME, DEDUCTIONS AND CREDITS

P. 85

Income -

- ***Gross income*** must be reported
- I.R.C. §61 defines gross income as receipts in excess of COGS
- COGS:
  - *“expenditures necessary to acquire, construct, or extract a physical product that is to be sold”*
  - Capitalized and deductible only when product is sold

Deduction and Credits –

- IRC §280E states no deduction or credit for any amount paid or incurred carrying on any trade or business consisting of trafficking in controlled substances prohibited by federal or state law.
- Ordinary and necessary business expenses aren’t allowable
- Citations and court cases for no deductions, no credits

COST OF GOODS SOLD

PP. 86-87

- Practitioner Note – Indirect costs allocated under §263A barred under §280E
- Direct and indirect expenses allocated under §471 are allowed
- Additional indirect expenses if GAAP financials are produced

INABILITY TO OPEN CHECKING ACCOUNT

P. 87

- How to pay payroll taxes without EFTPS (Fig. 3.2)
- Request for penalty abatement for not using EFTPS
- Practitioner Note – a cash-based industry reminder!

BUSINESS-USE-OF-HOME DEDUCTION FOR DAY CARE PROVIDERS

PP. 89-94

- Losses more likely due to pandemic
  - Income ↓ due to capacity limitations
  - Expenses ↑ due to additional health and safety measures
- Day care for adults as well as children
- IRS Audit Technique Guide – day care providers often overstate the deduction for business use of the home

BUSINESS USE OF HOME GENERAL RULES FOR DEDUCTION

P. 89

- General rule - regular and exclusive use
- Meet at least one of three tests:
  - ***If within dwelling unit***
    - Principal place of business, <u>or</u>
    - must be used to meet or deal with patients, clients, or customers, <u>or</u>
  - ***If separate structure*** – used in connection with taxpayer's business
- Substantial administrative or management activities may suffice
- Separately identifiable space
- Practitioner Note (p. 90) – **<u>not</u>** for employee through 2025

DAY CARE EXCEPTION TO EXCLUSIVE USE RULE P. 90

- Day care for children, adults age 65 and older, or persons who are physically or mentally unable to care for themselves
- *"Available for day care use throughout each business day and is regularly used as part of the provider's routine provision of day care"*
- Occasional use for day care not included
- Occasional non-use for day care is permitted
- Used for custodial services not primarily educational or instructional services
- To qualify for business use of home deduction the provide must hold a current license, certification, registration or approval under state law

CALCULATING THE DEDUCTION P. 91

- General rule is allocation based on square footage
- Day care deduction is -

  actual expenses x (day care sq ft / total sq ft) x (day care hours / total hours in year)
- Deduction allowed only to the extent that income exceeds
  - direct expenses, and
  - Allocable home costs that would otherwise be deductible (interest and taxes)
- Ex. 3.2
  - Prep and cleanup time count in day care hours
  - Record-keeping crucial
  - No deduction for first phone line

CALCULATING DAYCARE SQ FT & HOURS P. 93

- Safe harbor method applies but limited to 300 square feet and time-use %
- Daycare square footage
  - Regularly used sq ft
  - ATG reminds auditors to include all living space (basement, maybe garage)
- Daycare time percentage
  - Time record keeping is important
  - Time outside of business hours can be counted, even if on the weekend
  - Record keeping time can also be included
- Food costs - Practitioner Note
  - Standard meal and snack rates available
  - Records must track number of children for each meal/snack

CALCULATING COST OF GOODS SOLD ON SCHEDULE C (FORM 1040)

PP. 94-95

- COGS
  - Cost to produce or acquire inventory
- Gross income under Treas. Reg. §1.61-3:
  - Total sales <u>less</u> COGS
- COGS Formula
  - Beginning Inventory
  - Plus: acquisition and production costs
  - Less: Ending Inventory
- Practitioner Note: Small Business Taxpayers - inventory exception

CALCULATING COST OF GOODS SOLD ON SCHEDULE C (FORM 1040)

PP. 94-95

- Beginning Inventory:
  - For merchant, cost of merchandise on hand at BOY
  - For manufacturer, cost of raw materials & supplies, WIP & finished goods on hand at BOY
- Purchases:
  - Raw materials, parts, and merchandise for resale
  - Net of returns or discounts and items withdrawn for personal/family use
- Labor Costs:
  - Includes both direct and indirect labor
  - Includes payroll taxes and fringe benefits
- Material and Supply Costs:
  - Direct materials that become an integral part of property produced
  - Indirect materials costs of materials that do not become an integral part of the property produced that are consumed during production that cannot be identified with a particular unit of property

CALCULATING COST OF GOODS SOLD ON SCHEDULE C (FORM 1040)

P. 95

Other Costs incurred in the resale or manufacturing activity:
- Shipping and handling
- Overhead costs allocable to the resale or manufacturing activity
- Maintenance and quality control

<u>Not</u> included:
- Marketing
- Advertising
- Selling

CALCULATING COST OF GOODS SOLD ON SCHEDULE C (FORM 1040)

P. 95

- Sch C, Part III (see Fig. 3.5)
- Taxpayer elects valuation method for year-end inventory:
  - Generally, cost
  - Could be lower of cost or market value
  - Explanation needed for any other method

MAXIMIZING THE QUALIFIED BUSINESS INCOME (QBI) DEDUCTION

PP. 96-106

- Starts as of 20% of QBI
- Limited by
  - 20% of taxable income
  - May be further limited by wage and capital limit (UBIA)
  - And specified service trade or business (SSTB) limit may apply
- I.R.C. §199A and regulations

DEFINITION OF QBI

P. 96

- Net income from a US trade or business
- Includes certain self-rentals
- Excludes:
  - Dividends
  - Interest not allocable to T/B
  - Capital gains and losses
  - Gains and losses of foreign PHCs
  - Annuity income
  - Wages and guaranteed payments
- Reduced by one-half SE tax, self employed health insurance deduction, and deduction for contributions to qualified retirement plans
- Net of these amounts times 20%

1ST LIMITATION - TAXABLE INCOME LIMIT P. 97

Start with initial QBI deduction calculation from previous slide

Limit it to 20% of taxable income before the QBI deduction

Taxable income for this limit does **not** include net capital gain

Net capital gain includes (basically anything that gets a capital gain tax rate)

- long term capital gain
- unrecaptured Sec 1250 gain
- collectibles gain
- Sec 1202 small business stock gain
- qualified dividends

2ND LIMITATION - W-2 WAGE AND CAPITAL LIMIT P. 97

The QBI deduction is limited to the greater of

- 50% of the W-2 wages with respect to the qualified trade or business; or
- 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the UBIA of all qualified property.

UBIA – **U**nadjusted **B**asis **I**mmediately after **A**cquisition

Limit applies above taxable income threshold:

FIGURE 3.7
QBI Phasein Ranges for 2021

	Single, HoH	MFJ	MFS
Threshold	$164,900	$329,800	$164,925
Phasein range	$164,901–$214,900	$329,801–$429,800	$164,926–$214,925
Fully phased in	> $214,900	> $429,800	> $214,925

EX. 3.5 INCOME ABOVE PHASEIN RANGE P. 98

- $200,000 wages and $75,000 QBI from S Corp
- $75,000 QBI x 20% = $15,000 tentative QBID
- Taxable income of $262,450 – $200,000 + $75,000 - $12,550
  - Taxable income limitation = $262,450 x 20% = $52,490
- Wage and capital limit
  - Allocable wages $15,000, UBIA $10,000
  - Wage and capital limit, the greater of
    - 50% x $15,000 = $7,500, or
    - 25% x $15,000 + 2.5% x $10,000 = $3,750 + $250 = $4,000
- Brian's QBID limited to $7,500
- Cross Reference – limitation is proportionate *within* the phasein range

SPECIFIED SERVICE TRADE OR BUSINESS

P. 98

- Above phasein: No QBI, qualified wages, or UBIA allowed from any SSTB
- Proportionate amounts allowed within phasein range
- No SSTB limitation below the phasein range
- See list of services considered SSTBs

SSTB – DE MINIMIS RULE (PRACTITIONER NOTE)

P. 99

- Gross receipts of $25M or less: SSTB receipts of less than 10% of total receipts
- Limit is 5% if gross receipts exceed $25M
- Ex. 3.6 Benefit of separating non-SSTB (dog food production) from SSTB (vet clinic)
  - $1,000,000 veterinary services
  - $2,000,000 from sale of organic dog food
  - Doesn't qualify for de minimus rule because it exceeds 10% of total income
  - Separate SSTB activity, otherwise, all LLC activity would be treated as SSTB

ANTIABUSE RULE

P. 99

- Treas. Reg. § 1.199A-5(c)(2)
- No splitting off a trade or business to create non-SSTB income by providing services or leasing property to a 50% commonly controlled SSTB
- Income received by non-SSTB from its related SSTB will be treated as SSTB income
- Related party defined under I.R.C. §§ 267(b) and 707(b)

SEPARATING BUSINESS ACTIVITIES

P. 100

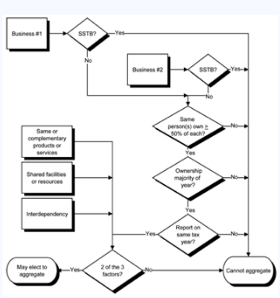
- Taxpayer with more than one T/B where one or more are SSTBs may wish to separate them
- Reasonable allocations based on all facts and circumstances
- Different reasonable methods can be used for different items of income, gain, deduction and loss
- Reasonable method must be applied consistently from year to year
- Practitioner Note: IRS requires
  - complete and separate books and records
  - each business would be allowed to choose a different method of accounting under Treas. Reg. § 1.446-1(d)(1)
- Ex. 3.7 separates non-SSTB income, wages, and expenses
  - ➢ and creates a $15,000 QBID (see Form 8995-A)

AGGREGATING BUSINESS ACTIVITIES

P. 102

- Aggregate to avoid the wage and capital limitation
- May increase QBI deduction when one business has QBI but no W-2 wages and another has W-2 wages
- Requirements:
  - Not an SSTB
  - Business relationship
  - Common ownership

FIG. 3.9



P. 103

ADDITIONAL GROUPING DETAILS

PP. 104-106

- Cross-Reference: attribution rules apply to determine common control
- Practitioner Note: Grouping under PAL rules may be different
- Ex. 3.8 Alice can aggregate catering and restaurant businesses
- Ex. 3.9 Common management of different businesses is *not enough*
- Ex. 3.10 Residential and commercial real estate are *not similar*
- Ex. 3.11Two non-SSTB businesses under common control
  - Shared boat ownership, accounting and administrative services, common customers
  - Rafting business has plenty of wages, fly fishing QBID limited by wages
  - Aggregation increases QBID by $100,000

CONSISTENCY AND REPORTING

P. 106

- Consistent grouping required in subsequent years
  - May add newly acquired or created business
  - Otherwise, regrouping requires
    - significant change in facts and circumstances
    - prior aggregation no longer qualifies
- Reporting – see requirements for attached statement *for year of grouping **and** each subsequent year*
  - IRS can disaggregate for failure to disclose
  - Disaggregation applies for subsequent 3 tax years