

2021 NATIONAL INCOME TAX WORKBOOK

CHAPTER 3: BUSINESS TAX ISSUES



BUSINESS TAX ISSUES

PP. 81-129

- ✓ [Lisa Cochell, Instructor](#)
- ✓ Issue 1: [Marijuana](#)-Related Businesses
- ✓ Issue 2: Business-Use-of-Home Deduction for [Day Care](#) Providers
- ✓ Issue 3: Calculating [Cost of Goods Sold](#) on Schedule C (Form 1040)
- ✓ Issue 4: Maximizing the Qualified Business Income [\[QBI\] Deduction](#)
- ✓ [Mike L Hardin, Instructor](#)
- ✓ Issue 5: Partnership [Capital Account Reporting](#) Requirements
- ✓ Issue 6: [Like-Kind](#) Exchanges
- ✓ Issue 7: [Involuntary Conversions](#)

ISSUE 5: PARTNERSHIP CAPITAL ACCOUNT REPORTING REQUIREMENTS

PP. 107-114

- 3,946,342 partnership returns were filed (FY 2019). [Need for a Story](#)
- [IRS Improve Data for compliance](#) selection –Audits Coming
- As of [January 1, 2020](#), must report [tax basis](#) capital accounts
- [Prior reporting](#) may have been based on GAAP, book, or any other method
- Taxpayers may wish to maintain these [additional](#) capital account [records](#) for [other reasons](#)

BOOK CAPITAL ACCOUNTS

P. 107

- Required to meet safe harbor requirements for special allocations under I.R.C. §704(b), **Substantial Economic Effect**
- Increased by
 - Money contributed
 - FMV property contributed (net of any liabilities)
 - Allocated partnership income and gain
- Decreased by
 - Money distributed
 - FMV property distributed (net of any liabilities)
 - Allocated partnership deductions, losses and nondeductible expenditures

FMV (FAIR MARKET VALUE) CAPITAL ACCOUNTS

P. 107

- Start out the same as book capital accounts
- However, adjustments include changes in FMV not already reflected in book changes:
 - asset appreciation and
 - accrual transactions not yet reflected in the book income of a cash basis taxpayer

**TAX BASIS CAPITAL ACCOUNTS
TRANSACTIONAL APPROACH**

P. 108

- Similar to book but
 - Income and deductions based on income tax rules
 - Asset contributions are based on adjusted tax basis (ATB)
 - Asset distributions are generally based on ATB
 - Asset contributions to charity reduce tax basis capital by the asset's ATB
 - Tax exempt income also increases tax basis capital account
 - Nondeductible expenses and any foreign taxes paid will reduce capital account
 - Increased or decreased by any basis adjustments under I.R.C. §734(b)
- Practitioner Note – basis adjustments under I.R.C. §743(b) are not included

TAX BASIS CAPITAL ACCOUNTS COMPREHENSIVE EXAMPLES

PP. 108-110

Ex. 3.12 Initial Capital Accounts – 3 Flavors

FIGURE 3.12
Robert's Initial Capital Account in RPL, LLC

	Tax Basis	Book	FMV
Land	\$150,000	\$200,000	\$200,000
Debt	(50,000)	(50,000)	(50,000)
Capital account	\$100,000	\$150,000	\$150,000

Ex. 3.13 2021 Activity - Income and Distributions

FIGURE 3.13
Robert's Adjusted Tax Basis
Capital Account in RPL, LLC

	Tax Basis
Beginning capital account	\$100,000
Income	150,000
Distributions	(100,000)
Ending capital account	\$150,000

NEGATIVE TAX BASIS CAPITAL ACCOUNTS

PP. 109-110

- Tax basis capital accounts **may be negative if** the following **items exceed** partner's **Tax Basis Equity** in the partnership -
 - Allocated losses
 - Cash distributions
 - Contributions of debts (or assets subject to debt in **excess of the asset's ATB**)
- Practitioner Note – **Basis** in Partnership Interest:
 - Increased** by **partner's share of partnership liabilities** under I.R.C. §752
 - Basis** in partnership interest **cannot be negative**

NEGATIVE TAX BASIS CAPITAL ACCOUNTS

PP. 109-110

- Ex. 3.14 RPL shows loss on tax return, **tax basis capital account goes negative**

FIGURE 3.14
Robert's Negative Tax Basis
Capital Account in RPL, LLC

	Tax Basis
Beginning capital account	\$100,000
Income (loss)	(150,000)
Distributions	(100,000)
Ending capital account	(150,000)

- However, Partnership has **recourse liabilities** of \$600,000
- Robert's **allocated \$200,000 of liabilities Adds to Basis**, I.R.C. §752
- Basis** in partnership interest is therefore **\$50,000** (-\$150,000 + \$200,000)

Robert's
Schedule K-1
(Form 1065)

FIG. 3.15

P. 110

NOTICE 2020-43 TWO ALTERNATIVE METHODS P. 111-112

Methods to establish beginning tax basis capital account – If no better information

- Modified **Outside Basis** – Ex. 3.15, Page 111
 - Outside basis
 - Less: Partner debt share under I.R.C. § 752
 - Less: Partner's basis adjustments under I.R.C. § 743(b)
- Modified **Previously Taxed Capital** – Ex. 3.16, Page 112
 - Cash received by partner upon deemed liquidation at FMV
 - Plus: Any loss recognized upon liquidation disregarding I.R.C. § 743(b) adjustments
 - Less: Any gain recognized upon liquidation disregarding I.R.C. § 743(b) adjustments
 - [Note: Each partner is allocated prorata share of inside basis.]

EXCEPTION TO REPORTING REQUIREMENTS P. 112

Partnership does not have to report Item L, partner tax capital accounts if:

- Total receipts less than \$250,000
- Total assets at the end of the tax year less than \$1,000,000
- Timely filed and furnished Schedules K-1
- The partnership is not required to file Schedule M-3 (Form 1065)
- Schedule B, Form 1065, Question 4

PENALTIES – 2020 RELIEF ONLY

P. 113

- **Penalty for failure** to timely file complete and accurate **Schedule K-1** (I.R.C. § 6698)
- **Penalty relief for 2020** under Notice 2021-13
 - No penalty for **error on beginning tax basis capital account**
 - No penalty for **error on ending tax basis capital account due to incorrect beginning**
 - **"Exercise Ordinary and prudent business care"** standard is applied

ISSUE 6: LIKE-KIND EXCHANGES

PP. 114-124

- I.R.C. 1031, Gain (loss) **not recognized**, If Qualified Like-Kind Property
- **Gain not recognized** until taxpayer disposes property acquired in exchange
- **Loss recognized, not deferred**
- TCJA **eliminated** like-kind exchanges of **personal property**
- This Section:
 - **Final regulations** issued December 2, 2020, [T.D. 9935] **clarify what is real property**
 - **Taxation** of Like-Kind Exchanges
 - **Recapture Rules** cause Income Recognition
 - **Definitions** – Important for Understanding

REQUIREMENTS LIKE-KIND REAL PROPERTY

P. 115

- Generally, all **real property** is **considered like-kind**
- **Property Relinquished**, or Given Up, and **Replacement**, Property Received, **must be**
 - Used in a **trade or business**, or Held for **investment** purposes
 - **Not Personal**, Not held primarily for sale, (i.e., Inventory)
- Property outside the US **is not like-kind** with property in the US
- Cross-Reference 2017 NITW, Pages 40-41: very **broad qualification of like-kind**

IDA 9935 REAL PROPERTY

P. 115

- Final regulations define real property as:
 - Land *and improvements to land*
 - Unsevered Natural **Products of Land**: Growing Crops, plant, and Timber
 - Water and airspace** – if superjacent to the land
 - Fee Ownership, Leaseholds, Easements or Options to Acquire
 - Other property defined** as real property under **state or local law**
 - Note**: **federal definition** as real property **supersedes** contrary law defining as personal

INHERENTLY PERMANENT STRUCTURES

PP. 115-116

- Lengthy list in regulations** & Col. 2, page 115
- May be permanently **affixed by weight**
- If not on the list**, apply 5 criteria, page 116, Col. 1
 - How **affixed** to real property
 - Designed to be removed**
 - Damage caused by removal** to item or property
 - Indication that **it won't remain affixed**
 - Time and expense of removal**
- Practitioner Note Machinery & Equipment, **Page 116** – **OK to produce income**

STRUCTURAL COMPONENTS

P. 116

Regulations list structural components

If not on the list, apply 4 criteria:

- Time and **cost to install and remove**
- Designed to be removed**
- Damage caused by removal**
- Whether installed during construction

See **Ex. 3.17 and 3.18** (P. 117) – sculpture, 3D printer, and generator are real property

INTANGIBLE ASSETS

P. 117

- Considered real property if:
 - **derives its value from** real property, and
 - **is inseparable from** the real property
- Includes:
 - **Easements, Leasehold or options to acquire**
 - stock in a cooperative housing corporation
 - certain **shares** in a mutual ditch, reservoir, or irrigation company (**Prop. Regs. were more restrictive**)
 - Practitioner Note (p. 118) licenses and permits to **use** or rights to **enjoy** property
- **Note:** other corporate stock and partnership interests, or **license to operate do not qualify as real property**

INCIDENTAL PROPERTY RULE

P. 118

Allows certain personal property to be **included in LKE**:

- Property is **typically** included with the real property in a standard commercial transaction, **and**
- If the aggregate FMV of the incidental property **does not exceed 15%** of the FMV of the real property.
- **Ex. 3.19:** apartment FMV 1.1M, ATB, 400K exchanged for Office Bldg. 1M and Furniture, FMV, 100K, < 15%, meets incidental rule, disregarded for Like-Kind exchange.
- However, **100K** less than 700K gain (1.1M-400K ATB) **recognized**, 1031 (b)

TAXATION OF LIKE-KIND EXCHANGES

PP. 118-119

- Simplest LKE
 - **No gain recognized**
 - **Basis** of exchange property **carries over to** replacement property
- Practitioner Note **PP. 118** – Related party exchanges okay – **watch 2-year trigger**
- Gain is recognized to the **extent of boot received** (cash, unlike property)
- Practitioner Note **PP. 119:** QI may **hold cash and acquire** replacement property
- **Ex. 3.20** – Gain recognized **lesser of gain or boot received**
 - Rob realizes **gain of \$40,000** but **only recognizes gain of \$5,000**.
 - **Basis of new property** is Rob's **carryover basis (\$10,000)**

OTHER BOOT ISSUES

P. 119

- Payment of Boot
 - Does not trigger gain or loss to transferor
 - Increases basis of the replacement property
- Receipt of Boot
 - May trigger gain
- Assumption of liabilities by transferee
 - Considered boot received by transferor
 - If debt is assumed as well as given up, only net is considered boot (paid or received)

RECAPTURE RULES STILL APPLY

P. 120

- Same recapture property exchanged
- Any gain recognized will be ordinary up to recapture amount
 - Any remaining recapture potential carries over to replacement property
 - Ex. 3.21
 - Exchanged green house and received a greenhouse plus \$5,000 cash
 - Realized gain of \$27,355, all ordinary due to accumulated depreciation of \$37,355.
 - Recognized gain of \$5,000 due to boot received – all ordinary
 - Remaining recapture potential of \$22,355 carries over to replacement property
 - \$62,645 ATB of exchange property also carries over to replacement property

FIG. 3.19

P. 122

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: If you transferred and received (a) more than one group of like-kind properties or (b) cash or other not like-kind property, see Reporting of multi-asset exchanges in the instructions.

Note: Complete lines 12 through 14 only if you gave up property that was not like-kind. Otherwise, go to line 15.

12	Fair market value (FMV) of other property given up	12	
13	Adjusted basis of other property given up	13	
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale.	14	
<i>Caution: If the property given up was used previously or partly as a home, see Property used as home in the instructions.</i>			
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions.	15	5,000
16	FMV of like-kind property you received	16	85,000
17	Add lines 15 and 16	17	90,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15. See instructions.	18	62,645
19	Realized gain or (loss). Subtract line 18 from line 17	19	27,355
20	Enter the smaller of line 15 or line 19, but not less than zero	20	5,000
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16. See instructions.	21	5,000
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions.	22	0
23	Recognized gain. Add lines 21 and 22	23	5,000
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions.	24	22,355
25	Basis of like-kind property received. Subtract line 15 from the sum of lines 18 and 23	25	67,645

All ordinary

DIFFERENT RECAPTURE PROPERTY RECEIVED

P. 123

- Different recapture rules
- Gain **recognized** will be realized as ordinary **even without boot received**
- **Ex. 3.23 Different property recapture rules**

INVOLUNTARY CONVERSIONS

PP. 124-129

- **No gain recognized** if involuntarily converted to similar property.
- Applies to **personal use property, business use, and investment property.**
- If cash is received, and taxpayer purchases similar or related property, taxpayer may **elect to defer gain.**
- Gain is **recognized** to the **extent** proceeds are **not reinvested.**
- Loss must be **unexpected and unusual** but need **not be sudden.**
- **Ex. 3.24:** sale of **trees dying** after a Pine Beetle infestation
- Not applicable if damaged **property could be repaired** – Ex. 3.25 fire damage
- **Condemnation** is the most typical non-casualty involuntary conversion

CONDEMNATIONS

PP. 125-126

- **Government acquires** under **right of eminent domain** for public use
- Government pays a condemnation award **treated as sales price.**
- Taxpayer can also **sell to third party under a threat** of condemnation
- Calculate **gain as usual** – deducting any expense of litigating award amount
- Gain can be **deferred by reinvesting proceeds**
 - Note: Cost of restoring remaining part of property to former usefulness qualifies
- **Ex. 3.26** Straight up condemnation for \$25,000, \$15,000 gain

OTHER AFFECTED PROPERTY

P. 126

- Planning Pointer – **voluntary sale of related property may qualify**
- Severance Damages
 - Decrease in value to **remaining** (non-condemned) **property**
 - **Reduce basis** of remaining property
 - Payments in **excess of basis create gain** but are eligible for deferral

SIMILAR REPLACEMENT PROPERTY

PP. 126-127

- Property must be **similar or related in use**
- A **controlling interest** ($\geq 80\%$) in a corporation owning such property qualifies
- **Business or investment real property** meeting the **LKE property requirements** qualifies
- Any tangible property held for **productive use in a trade or business** qualifies in a federally **declared disaster area**
- **Ex. 3.27** **Not** personal residence for grocery store
- **Basis** of replacement property **reduced by gain** deferred (**Ex. 3.28**)

REPLACEMENT PERIOD

P. 127

- Replacement period **begins on the date of disposition** or on any earlier threat or imminence of condemnation.
- Replacement period generally **ends 2 years after the end of the tax year in which any gain is realized**.
 - **4 years** for personal residence and contents **in federal disaster area**
 - **Extension can be requested**
 - Generally limited to 1 additional year
 - Replacement property still under construction may justify
- Different **rules for livestock**

PRINCIPAL RESIDENCE

P. 128

- Gain is **reduced by available exclusion** under I.R.C. § 121
- Taxpayer may **defer any remaining gain**
- **Proceeds in excess** of exclusion amount **must be reinvested**
- **Ownership and use period** of converted residence **lack on** to replacement residence

REPORTING

P. 129

- **No reporting** is required if taxpayer receives property
- **Receipt of cash triggers** reporting
 - Report taxable gain on Schedule D or Form 4797
 - With reinvestment and election defer gain, attach statement of details to return

FIGURE 3.21
Election to Defer Gain**Election to Defer Gain under I.R.C. § 1033**

On February 8, 2021, the taxpayers realized a gain from the condemnation of their principal residence. The taxpayers elect to postpone this casualty gain and have purchased replacement property that is similar or related in use.

Condemnation award received	\$700,000
Adjusted tax basis	(150,000)
Gain realized	\$550,000
Gain excluded under I.R.C. § 121	(500,000)
Gain deferred	(50,000)
Gain recognized	\$0
Cost of replacement property (principal residence)	\$600,000
Gain deferred	(50,000)
Cost of replacement property	\$750,000
	(amount realized)



Any
Questions


