EA Review
Part 2: Businesses

May 1, 2025 - February 28, 2026

Testing Cycle

Joel Busch, CPA, JD

Christy Pinheiro, EA, ABA®

Thomas A. Gorczynski, EA, USTCP

Executive Editor: Joel Busch, CPA, JD

Contributors:

Joel Busch, CPA, JD

Christy Pinheiro, EA, ABA®

Thomas A. Gorczynski, EA, USTCP

PassKey Learning Systems EA Review Part 2 Businesses; Enrolled Agent Study Guide, May 1, 2025 - February 28, 2026 Testing Cycle

ISBN 13: ONLINE EDITION

First Printing. March 18, 2025.

Official company website: ***www.PassKeyOnline.com***

This study guide is designed for exam candidates who will take their exams in the May 1, 2025 to February 28, 2026 testing cycle.

Note: Prometric will NOT TEST on any legislation or court decisions passed after December 31, 2024. For exams taken between May 1, 2025 and February 28, 2026, all references on the examination are to the Internal Revenue Code, forms and publications, as amended through December 31, 2024. Also, unless otherwise stated, all questions relate to the calendar year 2024. Questions that contain the term 'current tax year' refer to calendar year 2024.

This page intentionally left blank

Table of Contents

This page intentionally left blank

Recent Praise for the PassKey EA Review Series

(Real customers, real names, public testimonials)

Passed all 3 Parts!
Kowani Collins
Thank you so much for providing this resource! I have passed all 3 parts of the SEE exam. PassKey allowed me to study on my own time and take the exam with confidence. Thank you for providing such thorough and easy-to-follow resources!

Perfect review book!
A. Bergman
The [PassKey] EA Review is great! Goes into detail and explains why. When you do the practice test, it actually tells you details of the answer for learning and retaining! Definitely recommend!

Easy to read and understand
Chrishun Etter
This book is good, especially if you have a hard time paying attention to a computer screen all the time. I would recommend this in addition to the subscription because the videos are very helpful as well.

Helped me to pass faster
Mohamed Helemish
I highly recommend Passkey if you are looking for something simple, and easy to understand, and if you want a good reference for your future career in taxes. I passed the exam with confidence and I used it with the three parts.

I highly recommend these materials.
Tosha H. Knelangeon
Using only the [PassKey] study guide and the workbook, I passed all three EA exams on my first try. I highly recommend these materials. As long as you put in the time to read and study all the information provided, you should be well-prepared.

I passed on the first try.
Jake Bavaro
I recently passed the first part of the EA exam using just the textbook and a separate practice test workbook. The textbook is very easy to read and understand. Although I have a background in accounting and tax, someone with little or no knowledge of either should be able to grasp all of the various topics covered in the book. I really do believe that it is a superior preparation resource.

Excellent explanations!
Janet Briggs
The best thing about these books is that each answer has a comprehensive explanation about why the answer is correct. I passed all three EA exams on the first attempt.

I passed all three parts the first time taking them.
Sheryl Reinecke
I passed all three parts the first time. I read each chapter and the review quiz at the end of each chapter. Before taking the real exam, I did the practice exams in the additional workbook. I feel the material adequately prepared me for success in passing the exam.

You can pass.
Vishnu Kali Osirion
I really rushed studying for this section. These authors make tax law relevant to your day-to-day experiences and understandable. You can pass the exam with just this as a resource. I do recommend purchasing the workbook as well, just for question exposure. The questions in the book and in the workbook are pretty indicative of what's on the exam. This is a must-buy. Cheers.

Absolute Best Purchase
Sharlene D.
This book was definitely worth the purchase. The layout was great, especially the examples! Reading the book from front to back allowed me to pass [Part 2]. I also recommend purchasing the workbook or subscribing to the material on their website for this section.

PassKey was the only study aid that I used
Stephen J Woodard, CFP, CLU, ChFC
The [PassKey] guides were an invaluable resource. They were concise and covered the subject matter succinctly with spot-on end-of-chapter questions that were very similar to what I encountered on the exams.

Amazing!
Sopio Svanishvilion
PassKey helped me pass all three parts of the Enrolled Agent exam. They are a "must-have" if you want to pass your EA exams.

I passed all three with Passkey.
Swathi B.R.
I went through the online membership, read the whole book, solved all the questions, and passed the EA exam on my first attempt. For all three [parts], I referred to Passkey EA Review. Wonderful books.

Fantastic textbooks and video resources.
Vino Joseph Philip
Comprehensive and accurate video lessons are available online, and testing is also available for each course. I passed all three exams on the first attempt after using Passkey's resources.

Introduction

Congratulations on taking the first step toward becoming an enrolled agent, a widely respected professional tax designation. The Internal Revenue Service licenses enrolled agents, known as EAs, after candidates pass a competency exam testing their knowledge of federal tax law. As an enrolled agent, you will have the same representation rights as a CPA, with the ability to represent taxpayers in IRS audits and appeals—an EA's rights are unlimited before all levels and offices of the IRS.

The PassKey study guide series is designed to help you study for the EA exam, which is formally called the *IRS Special Enrollment Examination* or "*SEE.*"

EA Exam Basics

The EA exam consists of three parts, which candidates may schedule separately and take in any order they wish. The computerized exam covers all aspects of federal tax law, with Part 1 testing the taxation of individuals; Part 2 testing the taxation of businesses, and Part 3 testing representation, practice, and procedures.

Each part of the EA exam features 100 multiple-choice questions, requiring no written answers. The exam will include some experimental questions that are not scored. You will not know which questions count toward your score and which do not.

Computerized EA Exam Format
Part 1: Individual Taxation–100 questions
Part 2: Business Taxation–100 questions
Part 3: Representation, Practice, and Procedures–100 questions

You will have 3.5 hours to complete each part of the exam. The actual seat time is four hours, which allows time for a pre-exam tutorial and a post-exam survey. An on-screen timer counts down the amount of time you have to finish. The testing company Prometric exclusively administers the EA exam at thousands of testing centers across the United States and certain other countries. You can find valuable information and register online at ***https://www.prometric.com/IRS***.

Prometric Testing Center Procedures

The testing center is designed to be a secure environment. The following are procedures you will need to follow on test day:

1. Check in about thirty minutes before your appointment time and bring a current, government-issued ID with a photo and signature. If you do not have a valid ID, you will be turned away and will have to pay for a new exam appointment. Prometric will not issue refunds if you forget to bring a proper ID with you.
2. The EA exam is a closed-book test, so you cannot bring any notes or reference materials into the testing room. The center supplies sound-blocking headphones if you want to use them.
3. No food, water, or other beverages are allowed in the testing room.
4. You will be given scratch paper and a pencil to use, which will be collected after the exam.

5. You can use an on-screen calculator during the exam, or Prometric will provide you with a handheld calculator. You cannot bring your own calculator into the examination room.
6. Before entering the testing room, you may be scanned with a metal detector wand.
7. You must sign in and out every time you leave the testing room.
8. You cannot talk or communicate with other test-takers in the exam room. Prometric continuously monitors the testing room via video, physical walk-throughs, and an observation window.

Important Note: Violating any of these procedures may result in the disqualification of your exam. In cases of cheating, the IRS says candidates are subject to consequences that include civil and criminal penalties.

Break Policy: The Special Enrollment Exam (SEE) now includes one scheduled 15-minute break. You may decline the scheduled break and continue testing. If you choose to take the scheduled break, you will leave the testing room, adhering to all security protocols. You can take additional unscheduled breaks; however, the exam clock will continue to count down during any unscheduled break.

Exam-takers who require special accommodations under the Americans with Disabilities Act (ADA) must contact Prometric directly to obtain an accommodation request. The test is administered in English; a language barrier is not considered a disability.

Exam Content

Each year, using questions based on the prior calendar year's tax law, the IRS introduces multiple new versions of each part of the EA exam. If you fail a particular part of the exam and need to retake it, do not expect to see identical questions the next time.

Prometric's website includes broad content outlines for each exam part. When you study, make sure you are familiar with the items listed, which are covered in detail in your PassKey study guides. Questions from older exams are available on the IRS website for review. Be aware that tax laws change yearly, so be familiar with recent updates.

Your PassKey study guides present an overview of all the major areas of federal taxation that enrolled agents typically encounter in their practices and are likely to appear on the exam. Although our guides are designed to be comprehensive, we suggest you also review IRS publications and try to learn as much as possible about tax law in general, so you are well-equipped to take the exam. In addition to this study guide, we highly recommend that all exam candidates read:

- **Publication 17,** *Your Federal Income Tax* (for Part 1 of the exam), and
- **Circular 230,** *Regulations Governing Practice before the Internal Revenue Service* (for Part 3 of the exam)

You may download these publications for free from the IRS website.

Note: Some exam candidates take *Part 3: Representation, Practice, and Procedures* first rather than taking the tests in order, since the material in Part 3 is considered less complicated. However, test-takers should know that several questions pertaining to taxation of *Individuals* (Part 1) and *Businesses* (Part 2) are often included on the Part 3 exam.

Exam Strategy

Each multiple-choice question has four answer choices. There are several different question formats. During the exam, you should read each question thoroughly to understand precisely what is being asked. Be particularly careful when the problem uses language such as “not” or “except.”

Format One–Direct Question
Which of the following entities are required to file Form 709, United States Gift Tax Return?
A. An individual B. An estate or trust C. A corporation D. All of the above

Format Two–Incomplete Sentence
Supplemental wages do not include payments for:
A. Accumulated sick leave B. Nondeductible moving expenses C. Vacation pay D. Travel reimbursements paid at the federal government’s per diem rate

Format Three–All of the Following Except
Five tests must be met for you to claim an exemption for a dependent. Which of the following is *not* a requirement?
A. Citizen or Resident Test B. Member of Household or Relationship Test C. Disability Test D. Joint Return Test

If you are unsure of an answer, you may mark it for review and return to it later. Try to eliminate clearly wrong answers from the four possible choices to narrow your odds of selecting the right answer. But be sure to answer every question, even if you have to guess, because all answers left incomplete will be marked as incorrect. Each question is weighted equally.

There may also be a limited number of questions that have four choices, with three incorrect statements or facts and only one with a correct statement or fact, which you would select as the right answer. With 3.5 hours allotted for each part of the exam, you have about two minutes per question. Try to answer the questions you are sure about quickly, so you can devote more time to those that include calculations or that you are unsure about. Allocate your time wisely. To familiarize yourself with the computerized testing format, you may take a tutorial on the Prometric website. The tutorial illustrates what the test screens look like.

Scoring Methods

The EA exam is not graded on a curve. The IRS determines scaled scores by calculating the number of questions answered correctly from the total number of questions in the exam and converting to a scale that ranges from 40 to 130. The IRS has set the scaled passing score at 105, which corresponds to the minimum level of knowledge deemed acceptable for EAs.

After you finish your exam and submit your answers, you will exit the testing room, and Prometric will send your results to your email, showing whether you passed or failed. Test results are automatically shared with the IRS, so you do not need to submit them yourself. Test scores are confidential and will be revealed only to you and the IRS. If you pass, your printed results will show a passing designation but not your actual score. The printout also will not indicate which specific questions you answered correctly or incorrectly.

If you fail, you will receive diagnostic information to help you know which subject areas to concentrate on when studying to retake the exam:

- Level 1: Area of weakness where additional study is necessary.
- Level 2: Might need additional study.
- Level 3: Clearly demonstrated an understanding of the subject area.

These diagnostic indicators correspond to various sections of each part of the exam. If necessary, you may take each part of the exam up to four times during the current testing window. You will need to re-register with Prometric and pay fees each time you take an exam part. Due to the global pandemic, the IRS extended the two-year carryover period to **three years** for passing all three parts of the exam.

Example: Randall, an EA exam candidate, successfully passed Part 1 on November 15, 2022. Subsequently, he passed Part 2 on February 15, 2023. Randall has until November 15, 2025, to pass the remaining part. Otherwise, he loses credit for Part 1. Randall has until February 15, 2026, to pass all other parts of the examination or he will lose credit for Part 2.

Applying for Enrollment

Once you have passed all three parts of the EA exam, you can apply to become an enrolled agent. The process includes an IRS review of your tax compliance history. Failure to file or pay personal income taxes in a timely manner can be grounds for denial of enrollment.

The IRS Return Preparer Office will review the circumstances of each case and make determinations on an individual basis. You may not practice as an EA until the IRS approves your application and issues you an enrollment card, a process that takes up to 60 days or more.

Successfully passing the EA exam can launch you into a fulfilling and lucrative new career. The exam requires intense preparation and diligence, but with the help of PassKey's comprehensive *EA Review*, you will have the tools you need to learn how to become an enrolled agent.

We wish you much success!

Ten Steps for the EA Exam

STEP 1: Learn

Learn more about the enrolled agent designation, and explore the career opportunities that await you after passing your EA exam. In addition to preparing income tax returns for clients, EAs can represent individuals and businesses before the IRS, just as attorneys and CPAs do. A college degree or professional tax background is not required to take the EA exam. Many people who use the PassKey study guides have had no prior experience preparing tax returns, but go on to rewarding new professional careers.

STEP 2: Gather Information

Gather more information before you launch into your studies. You will find valuable information about the exam itself on the Prometric testing website at www.prometric.com/IRS. Be sure to download the official Candidate Information Bulletin, which takes you step-by-step through the registration and testing process.

STEP 3: Obtain a PTIN

PTIN stands for "Preparer Tax Identification Number." Before you can register for your EA exam, you must obtain a PTIN from the IRS. The PTIN sign-up system can be found at www.irs.gov/ptin. You will need to create an account and provide personal information. Foreign-based candidates without a Social Security number are also required to have a PTIN to register to take the exam; they will need to submit additional paperwork with their Form W-12 (PTIN Application and Renewal).

STEP 4: Register with Prometric

Once you have your PTIN, you may register and schedule your exam on the Prometric website by creating an account to set up your user ID and password. Alternatively, you can schedule an appointment to take the exam by calling 800-306-3926 (toll-free) or 443-751-4193 (toll), Monday through Friday, between 8 a.m. and 9 p.m. (ET); or by submitting IRS Form 2587.

STEP 5: Schedule Your Test

After creating an account, you can complete the registration process by clicking on "Scheduling." Your exam appointment must be scheduled within one year from the registration date. You can choose a test site, time, and date that is convenient for you. Prometric has test centers in most major metropolitan areas of the United States, as well as in many other countries.

You may schedule your exam through the website or call Prometric directly Monday through Friday (some centers have Saturday testing). The testing fee is nonrefundable. Once you have scheduled, you will receive a confirmation number. Keep it for your records because you will need it to reschedule (which may incur a charge), cancel, or change your appointment.

STEP 6: Adopt a Study Plan

Focus on one exam part at a time and adopt a study plan that covers each unit of your PassKey guides. The period of time you'll need to prepare for each exam is truly unique to you, based on how much prior tax preparation experience you have and your current level of tax knowledge, how well you understand and retain the information you read, and how much time you have to study for each test.

For those without prior tax experience, a good rule of thumb is to study *at least* 60 hours for each of the three exam sections. Part 2: Businesses may require additional study preparation, as evidenced by the lower pass rates. One thing is true for all candidates: for each of the tests, start studying well in advance of your scheduled exam date.

STEP 7: Get Plenty of Rest and Good Nutrition

Get plenty of rest, exercise, and good nutrition before the EA exam. You will want to be at your best on exam day.

STEP 8: Test Day

Be sure to arrive early at the test site. Prometric advises arriving at least 30 minutes before your scheduled exam time. If you miss your appointment and cannot take the test, you will forfeit your fee and must pay for a new appointment. Remember to bring a government-issued ID with your name, photo, and signature. Your first and last name must exactly match the first and last name you used to register for the exam.

STEP 9: During the Exam

This is when your hard work finally pays off. Focus and don't worry if you don't know the answer to every question, but make sure you use your time well. Give your best answer to every question. All questions left blank will be marked as wrong.

STEP 10: Congratulations. You Passed!

After celebrating your success, you need to apply for your EA designation by filling out Form 23, *Application for Enrollment to Practice Before the Internal Revenue Service*. Once your application is approved, you will be issued an enrollment card and you will officially be a brand-new enrolled agent!

Essential Tax Law Figures for Businesses

Here is a quick summary of some important tax figures for the enrolled agent exam cycle that runs from May 1, 2025 to February 28, 2026.

Study Note: The IRS has stated in the most recent version of the official Prometric SEE Candidate Bulletin that candidates should not take into account any legislation or court decisions made after December 31, 2024.

Legislation Affecting the 2024 Tax Year:

- The ***SECURE Act 2.0*** was signed into law as part of the *Consolidated Appropriations Act of 2023.* The Act included dozens of provisions affecting retirement plans. Many of the provisions in the SECURE Act 2.0 went into effect in 2024.
    - **Emergency withdrawals:** SECURE 2.0 creates a new exception for distributions made in 2024 that are used for emergencies that are "unforeseeable or immediate financial needs relating to personal or family emergency expenses." Only one distribution of up to $1,000 is allowed per year.
    - **New early withdrawal exception for domestic abuse victims:** Victims of domestic abuse are also exempt from early withdrawal penalties. The maximum withdrawal allowed is the lesser of (1) $10,000 (inflation-adjusted) or (2) 50% of the account balance.
    - **529 Rollovers:** Beginning in 2024, owners of 529 plans can transfer unused funds directly to the plan beneficiary's Roth IRA without incurring federal tax or the 10% penalty for nonqualified withdrawals.
    - **New Roth Accounts:** Employers can offer their employees employer-sponsored Roth accounts, including Roth 401(k), Roth 403(b), and Roth 457 plans. These accounts must be funded with after-tax contributions.
    - **IRA catch-up contributions:** Previously, the limit on IRA catch-up contributions was set at $1,000. SECURE 2.0 authorizes indexing for inflation beginning in 2024.
- The ***Corporate Transparency Act ("CTA")*** Congress passed the Corporate Transparency Act ("CTA") on January 1, 2021, but the requirements to report beneficial ownership information (BOI) did not go into effect until January 1, 2024. On Sunday, March 2, 2025, the Treasury Department announced that it would not enforce the reporting rule against domestic reporting companies and plans to issue proposed regulations to revise it so that only foreign reporting companies must file a BOI report with the FinCEN. At the time of this book's printing, foreign entities still have a filing requirement. Note that the current EA exam specifications do not include these new BOI requirements.

FBAR: The official due date for the FBAR (FinCen 114) coincides with the filing of the federal tax return (normally April 15). However, an automatic extension is allowed until October 15.

2024 General Filing Deadlines

If a due date falls on a weekend or legal holiday, the deadline is pushed to the next business day.

- **Individual filing deadline:** April 15, 2025. This is the last day to file an individual extension (Form 4868). Extended due date: October 15, 2025.
- **Estates and Trusts Income Tax Return Deadline (Form 1041):** April 15, 2025 (extension period of 5½ months; due September 30 for a calendar-year entity).
- **Estate Tax Return Deadline (Form 706):** Due within nine months after the date of the decedent's death (a 6-month extension is available).
- **Partnership Deadline (Form 1065):** March 15, 2025 (extended due date: September 15, 2025), or the 15th day of the 3rd month after the end of the partnership's tax year, for fiscal-year filers.
- **S Corporation Deadline (Form 1120-S):** March 15, 2025 (extended due date: September 15, 2025) or by the 15th day of the 3rd month after the end of the tax year for fiscal year-filers.
- **C Corporation Deadline (Form 1120):** April 15, 2025 (extended due date: October 15, 2025), or the 15th day of the fourth month after the end of the corporation's tax year, in the case of most fiscal-year filers. For June 30 year-end corporations, the due date is September 15, 2025 (extended due date: April 15, 2026).
- **Exempt Entity Deadline (Form 990):** May 15 for a calendar-year exempt entity (extended due date: November 15).
- **Employee benefit plan (Form 5500 series):** Due the last day of the 7th calendar month after the end of the plan's tax year; July 31 for a calendar-year plan (an extension is available to October 15 for a calendar-year plan).

Estimated Tax Due Dates:

- **Individuals:** Quarterly estimated taxes are generally due by April 15, June 15, September 15, and January 15 of the following year.
- **Farmers and Fishermen:** January 15 (if *not* filing a return by March 1) or March 1 (if filing a tax return and paying all taxes due by March 1).
- **Corporations**: April 15, June 15, September 15, and December 15 (for calendar-year corporations).

2024 Maximum Compensation Subject to FICA

- 2024 Maximum Compensation Subject to FICA
- OASDI maximum wage base: $168,600
- Employee and employer portion: 7.65% (6.2% Social Security + 1.45% Medicare)
- Self-employed 15.30% (12.4% Social Security + 2.9% Medicare)
- Additional Medicare Tax: 0.9% on earned income exceeding the following thresholds:
  - Married filing jointly: $250,000
  - Married filing separately: $125,000
  - Single, HOH, and QSS: $200,000

2024 FUTA Wage Base: The FUTA tax rate is 6% on the first $7,000 paid to each employee. Only the employer pays FUTA tax. The tax is not withheld from the employee's wages.

2024 Net Investment Income Tax (NIIT): The tax is 3.8% of the *lesser* of:
- Net investment income, or
- The amount of modified adjusted gross income (MAGI) over $15,200 for estates and trusts.

2024 Excess Business Loss Limitation: In 2024, the threshold amount is $305,000 ($610,000 for joint filers). Excess losses over these amounts must be carried forward. Excess business losses that are disallowed are treated as a net operating loss carryover to the following taxable year. In the subsequent year, the NOL deduction is subject to an 80% taxable income limitation.

Form 1099 Deadlines: The deadline for distributing 1099s and W-2s to the payees is January 31.

Gross receipts threshold: For the 2024 tax year, the gross receipts threshold for using the cash method of accounting has increased to $30 million. This means businesses with average annual gross receipts of $30 million or less can use the cash method.

2024 Estate and Trust *Exemption* Amounts
- Estate Exemption Amount: $600
- Simple trust: $300
- Complex trust: $100
- Qualified disability trust: $5,050

2024 Estate and Gift Tax *Exclusion* Amounts
- Estate and gift tax (highest rate): 40%
- Combined estate tax and lifetime gift/GST exemption: $13,610,000 per recipient in 2024 ($27,220,000 per married couple)
- Gift tax annual exclusion: $18,000 ($19,000 in 2025)
- Annual exclusion for gifts to noncitizen spouse: $185,000

2024 Contribution Limits – Retirement Plans
- **Roth and traditional IRAs:** $7,000 ($8,000 for taxpayers age 50 or older)
- **SIMPLE IRA/SIMPLE 401(k):** $16,000 For those aged 50 and over, an additional $3,500 catch-up contributions is permitted.
- **Traditional 401(k)/403(b) plans:** The 2024 employee elective deferral limit is $23,000. For those age 50 and over, an additional $7,500 catch-up contributions is permitted.).
- **SEP-IRA contribution limits:** Up to 25% of compensation, up to a maximum contribution of $69,000 SEP-IRA contributions can be made up to the due date of the return, including extensions. No catch-up contributions are permitted in 2024.
- **Qualified plan contribution limits:** The limit on annual benefits for a participant in a defined benefit plan is $345,000 for 2024.

2024 Section 179 Expense:

- Maximum deduction amount: $1,220,000
- Beginning placed-in-service phaseout limitation: $ 3,050,000
- Spending cap: $4,270,000 (complete phaseout of the 179 election)
- Heavy SUV Limit: $30,500

2024 Bonus Depreciation: The former 100% bonus depreciation phases down to 60% in 2024. For 2025, the deduction will phase down to 40%.

2024 QBI deduction Limits: The Section 199A limitation modified taxable income threshold amounts are as follows:

- Married Filing Joint: $383,900 to $483,900
- All other filing statuses: $191,950 to $241,950

2024 Standard Mileage Rates:

- Business use: 67 cents a mile
- Medical and moving: 21 cents a mile
- Charitable: 14 cents a mile in service of charitable organizations

2024 Qualified Transportation Benefits:

- Commuter benefits/transit passes: $315 per month.
- Parking: $315 per month.

2024 HSA Limits: For 2024, the annual contribution limits on deductions for HSAs for individuals with self-only coverage is $4,150 and $8,300 for family coverage. There is an additional contribution amount of $1,000 for taxpayers who are age 55 or older. To qualify to contribute to a health savings account, the taxpayer must have a high-deductible health insurance policy.

2024 FSA Limits:

- Health Care FSA (HCFSA): $3,200
- Dependent Care FSA (DCFSA): $5,000 for unmarried filers and couples filing jointly, and $2,500 for MFS filers.

2024 QSEHRA Limits: Maximum payments and reimbursements through the QSEHRA are $6,150 for an employee only and $12,450 for an employee plus family.

2024 "Nanny Tax" on Household Employees: The nanny tax threshold is $2,700 in 2024. A household employer usually is obligated to withhold and pay federal FICA (Social Security and Medicare) taxes for any household employee above this threshold. A household employer is required to pay FUTA taxes if they paid a household employee $1,000 or more in a calendar quarter in the current or prior year. These thresholds are on a per-employee basis.

Tax Law Updates for Businesses

2024 Increase in penalty for failure to file: For tax years beginning in 2024, the penalty for failure to file a tax return that is more than 60 days shall not be less than the lesser of (1) $510 or (2) 100% of the tax due on the return. This penalty applies to Form 1120 and Form 1040 returns.

2024 Partnership and S corporation late filing penalties: Standard failure-to-file penalties are $245 per month, per partner or shareholder in a partnership or an S corporation for business returns filed in 2025 (for 2024 tax year returns).

2024 Form 1099-K Reporting Requirement: For the 2024 tax year, the Form 1099-K reporting requirements for businesses have been updated. The threshold for reporting third-party network transactions has been set to $5,000 for the provision of goods and services. This means that businesses must report payments made through third-party networks if they exceed $5,000 in aggregate payments for the year. Personal transfers between friends and family are exempt from this requirement, as clarified by the IRS.

2024 E-file Mandate: Starting January 1, 2024, businesses are now required to e-file if they file 10 or more Federal returns. Filers must aggregate almost all return types covered by the regulation to determine whether a filer meets the 10-return threshold, including information, income tax, employment tax, and excise tax returns. (previously, a 250-return threshold applied). A waiver may be requested in cases of undue hardship. Failure to e-file, when required, may result in penalties imposed on taxpayers and businesses who file their information returns on paper instead. The ten-return threshold does not make electronic filing mandatory for employment tax returns, such as Forms 940 and 941.

IRIS Platform for Form 1099 filings: Under the Taxpayer First Act, the IRS was tasked with creating an online portal for taxpayers to submit Form 1099 electronically. IRIS is available for free and may be particularly beneficial for small businesses that currently file paper forms with the IRS.

Corporate AMT: The Tax Cuts and Jobs Act permanently eliminated the graduated rates for C Corporations. All C corporations are now taxed at a flat rate of 21%. The TCJA also permanently repealed the prior corporate alternative minimum tax (AMT), but the *Inflation Reduction Act of 2022* reintroduced a new corporate AMT, but with major changes. This new corporate AMT applies only to certain corporations with average annual income over $1 billion from the prior three tax years.

2024 Credit for Small Employer Pension Plan Startup Costs: The SECURE 2.0 Act doubled the tax credit for new plans for small businesses with up to 50 employees to cover 100% of plan start-up costs. Eligible employers can claim a tax credit of up to $5,000 per year for the first three years. This credit covers 100% of the eligible start-up costs for employers with 50 or fewer employees and 50% of the eligible start-up costs for employers with 51 to 100 employees. In addition, SECURE 2.0 added a new sub-credit to subsidize employer contributions to employee retirement accounts. This credit is available for five years, starting in the tax year the employer establishes the plan. The maximum credit is $1,000 per employee per year.

Digital Asset Question for Entities: For the 2024 tax year, the IRS has included a question about digital assets on business entity tax forms, such as those for partnerships, corporations, S corporations, and estates and trusts. The question: *"At any time during 2024, did the [entity] (a) receive (as a reward, award, or payment for property or services), or (b) sell, exchange, or otherwise dispose of a digital asset (or financial interest in a digital asset)?"*

Unit 1: Business Entities and Requirements

More Reading:
Publication 334, Tax Guide for Small Business
Publication 505, Tax Withholding and Estimated Tax
Publication 1544, Reporting Cash Payments of Over $10,000

For Part 2 of the enrolled agent exam, you will be expected to know a broad range of information about tax provisions that affect various types of businesses.

You will need to understand the different types of businesses, including sole proprietorships, partnerships, limited liability companies, corporations, and farming businesses, as well as trusts and estates, retirement plans, tax-exempt organizations, and the special tax laws that apply to each.

For examinations delivered between May 1, 2025 and February 28, 2026, Part 2 of the exam is broken down into the following sections and corresponding percentages of questions:

1. **Business Entities – 30 questions**
2. **Business Financial Information – 37 questions**
3. **Specialized Returns and Taxpayers – 18 questions**[1]

We start with an overview of the different types of business entities. Each has its own drawbacks, risks, and benefits. Which entity a business should use is primarily a legal and financial decision, although there are other factors to consider. We briefly review each entity type in this chapter and will examine more complex entities in greater depth in later units.

Sole Proprietorships

A sole proprietorship is the simplest business type and also the easiest to start. An estimated 70% of businesses in the United States are sole proprietorships. A sole proprietorship is not a separate legal entity; it is an unincorporated business that is owned and controlled by one person.

A sole proprietorship may be a single-person business, or it may have several employees, but there is only one owner who accepts all the risk and liability of the business. A sole proprietorship cannot be passed on to a new owner as the same business entity because, by definition, a sole proprietorship is owned and operated by a single, specific individual. If a business operated as a sole proprietorship is sold, it must be operated by the new owner as either a different sole proprietorship or as a different type of business entity through a sale of assets of the business.

Sole proprietors often receive Form 1099-NEC from their business customers showing income they were paid for services. The amounts reported on Forms 1099-NEC, along with any other business income, are reported and taxed on the taxpayer's personal income tax return.

Income and expenses from the sole proprietorship are reported on Schedule C, *Profit or Loss from Business,* of Form 1040. A self-employed individual with net earnings of $400 or more from self-employment is required to pay self-employment tax by filing Schedule SE, *Self-Employment Tax*, with their Form 1040.

[1] These test specifications are listed in the current Special Enrollment Examination Candidate Information Bulletin, which is available for download on the Prometric website: https://www.prometric.com/sites/default/files/IRS/IRS-SEE-Candidate-Information-Bulletin.pdf

Example: Boyd works as an independent plumbing contractor for Texas Construction, Inc. Texas Construction sends Boyd a Form 1099-NEC that shows he received $25,000 for contract work. He also received payments of $7,000 from several individuals for contract work he completed on their homes. Although Boyd did not receive Forms 1099-NEC for the $7,000, he must include the payments as self-employment income, along with the $25,000 from Texas Construction, on his Schedule C.

Taxpayers do not need to have a full-time business to be considered self-employed. A part-time business can also count as self-employment, and may be classified as a sole proprietorship if owned by an individual taxpayer. For an activity to be considered a business, its main purpose must be for profit. Activities done as hobbies, without the intention of making a profit, do not qualify as businesses.

Example: Reggie loves woodworking and spends his weekends crafting furniture in his garage. He enjoys the process of designing and building pieces, often giving them away to friends and family as gifts. Occasionally, Reggie sells a few items at local craft fairs, but he prices them just high enough to cover the cost of materials. Reggie does not keep detailed records of his expenses or sales, and he does not actively market his work to make a profit. For Reggie, woodworking is a relaxing hobby, not a business venture. His main goal is to enjoy the creative process, not to earn a profit. Therefore, Reggie would not report his woodworking activity on Schedule C. Instead, he would report his hobby gross income (if any) on Schedule 1, Line 8j of his Form 1040, as "Activity not engaged in for profit income."

Partnerships

A partnership is a business relationship between two or more taxpayers who join together to carry on a trade or business. Each member contributes and shares in the profits and losses. A partnership can look very different depending on how it is structured—it can be anything from a small business run by a married couple to a complex business organization with thousands of general partners and limited partners. A partnership's annual tax return is filed on Form 1065, *U.S. Return of Partnership Income*, but the partnership itself does not pay income tax. Instead, any profits or losses "pass through" to its partners, who are then responsible for reporting their respective shares of the partnership's income or loss on their own returns.

Example: Brett and Leia Padgett are a father-daughter duo who co-own Padgett Accounting, LLP. Both are licensed CPAs actively involved in the business; they hold an equal 50% ownership stake. The partnership is required to file Form 1065 to report its annual income and losses, and must also issue a Schedule K-1 to each partner. In 2024, Padgett Accounting reported a net ordinary income of $204,000. Since Brett and Leia equally share in profits and losses, they will each report $102,000 (50% × $204,000) of self-employment income on their personal tax returns. Each partner's share of partnership income would be reported on page 2 of Schedule E, *Supplemental Income and Loss.*

The default legal classification for a partnership is a *general partnership* where all partners are *general* partners with each partner jointly and severally liable for the debts and obligations of the partnership. A partnership can have an unlimited number of partners and can have partners that are foreign or domestic. A partnership must always have at least one general partner whose actions legally bind the business and who is legally responsible for a partnership's debts and liabilities. However, a "joint undertaking" merely to share *expenses* is not automatically a partnership. For example, co-ownership of rental property is usually not considered a formal partnership unless the co-owners provide substantial services to the tenants.

Example: Cornell and Dolan are cousins who own a residential rental property together. The property is a passive rental with long-term tenants. Cornell and Dolan each own a 50% interest in the rental. Cornell takes care of any repairs, and Dolan collects and divides the rent. They do not have any other business with each other. The co-ownership of the rental property is not considered a partnership for tax purposes. Instead, they may divide the income and expenses based on their ownership percentages, and each would report his respective share on Schedule E on his individual return.

The IRS defines "substantial services" as services that are primarily for the tenant's convenience, such as daily cleaning, meals, or maid service. This would be something like a hotel or bed-and-breakfast. In that case, the rental activity would not be classified as a joint undertaking. Instead, it would be classified as a partnership and reported on Form 1065. If the activity includes substantial services and is owned by a single individual, it would be reported on Schedule C.

Example: Orlando and Suzanne are siblings. In 2024, they purchase a Victorian home in downtown New Orleans. They spend a substantial sum to divide the home into four separate units, which they then advertise as a bed-and-breakfast. They offer maid service and daily breakfast to all their guests. The IRS would classify their business as a hotel. Therefore, Orlando and Suzanne would be required to file a partnership return in order to report their earnings and profits.

Partners are not employees of the business, and they should not be issued a Form W-2**.** Instead, the partnership must furnish a copy of Schedule K-1 to each of its partners, showing the income and losses allocated to each partner. The return must show the name and address of each partner and the partner's share of taxable income. The return must be signed by a partner.

A **limited partnership (LP)** is a partnership that has at least one limited partner in addition to its general partner(s). A limited partnership allows an investor (the limited partner) to own an interest in a business without assuming personal liability or risk beyond the amount of their investment in the partnership.

Note: A Limited Partnership (LP) is a state-level entity. Unlike a general partnership (GP), which can be formed merely with a handshake between two persons. In order to form an LP, a Certificate of Limited Partnership or Certificate of Formation must generally be filed with the Secretary of State where the partnership chooses to do business. For example, in order to form an LP in California, a Certificate of Limited Partnership (Form LP–1) must be filed with the California Secretary of State, and the applicable filing fees must be paid.

A *limited partner* generally has no obligation to contribute additional capital to the partnership and, therefore, does not have an economic risk of loss for partnership liabilities. In most states, a limited partner is restricted regarding how active they can be in the management of the partnership.

Example: Carter wants to open a dance club. He approaches his aunt, Marisol, for the funds. Marisol agrees to invest in her nephew's business, but she does not want to be involved in the day-to-day running of the club. After consulting with an attorney, Carter and his aunt form Nightlife Ventures, LP, a limited partnership (LP). Per their partnership agreement, Marisol is a limited partner. She is an investor in the club and contributes $250,000 to establish the club. Carter is an experienced restaurateur and nightlife expert, so he runs the club. Carter is the general partner.

A **Limited Liability Partnership (LLP)** is an entity that is formed under state law and is generally used for specific professional services, such as those offered by a law firm or a CPA firm. Some professionals form an LLP because the option of an LLC may be prohibited in their state for their particular business type.[2]

For example, in California, LLCs cannot provide certain professional services. Attorneys, CPAs, architects, and other similar, licensed professionals cannot form an LLC for those particular business activities, but they *are* allowed to form an LLP and offer these professional services.

An LLP allows each partner to actively participate in management affairs but still provides limited liability protection to each partner. A partner in an LLP generally would not be personally liable for the partnership debts or the malpractice of other partners (or the employees under the management of other partners) and would only be at risk for their own malpractice and/or their interest in the partnership's assets.[3]

Example: Dylan and Farad are licensed attorneys in California who decide to go into business with each other. They form an LLP by registering their business with California's Secretary of State. Once they complete their registration, they open an office in San Diego, and begin accepting new clients. For tax purposes, their business will be taxed as a partnership, and they will be required to file a Form 1065 every year. In a limited liability partnership, the partners enjoy some protection against personal legal liability.

Married Couple Businesses and Qualified Joint Ventures

Often, a small business is operated by spouses without incorporating or creating a formal partnership agreement. The business is usually considered a partnership, whether or not there is a formal partnership agreement.

If both spouses materially participate as the only members of a jointly owned and operated business, the business may be treated as a *qualified joint venture*, or QJV.[4] This allows them to avoid the complexity of filing a partnership return but still allows each spouse to take credit for self-employment earnings from the business for Social Security purposes.

Items of business income, gain, loss, deduction, and credit are split between the spouses in accordance with their respective interests in the business. The spouses then file separate Schedules C and separate Schedules SE. This option is available only to married couples who file joint tax returns. A qualified joint venture (QJV) is available only to businesses owned and operated by spouses as co-owners and not in the name of a state law entity; spousal owners of a limited liability company or a limited partnership generally do not qualify.

---

[2] With regards to limited partnerships and limited liability partnerships, different states often have significantly different requirements for formation and legal liability. For example, most states restrict financial service providers, such as banks or brokerage firms, from forming LLCs. These businesses may need to operate under different legal structures, such a C corporation, in order to comply with industry regulations. In addition, healthcare providers like surgeons and doctors, may face restrictions on forming LLCs. They might be required to form professional corporations (PCs) or professional limited liability companies (PLLCs), instead.

[3] The laws regarding LPs, LLPs and LLCs vary greatly from state-to-state. Information is generally available online through a state's Secretary of State's office or the governor's office.

[4] Federal tax law makes many references to laws specific to a "husband and wife." These laws also apply to same-sex spouses who are legally married. However, couples that are in civil unions or registered domestic partnerships (RDPs) are not considered "married" for tax purposes. Therefore, these couples cannot elect a "qualified joint venture." They would be required to file a partnership tax return (Form 1065).

IRS regulations excludes state-approved entities (LLCs, LLPs) from filing as a qualified joint venture. However, married couples in community property states can file on two Schedules C, instead of on Form 1065, if they hold the LLC (or other non-corporate entity, such as an LP), as community property.[5]

Example: Jose and Johanna live in Hawaii, where they operate a small business together as husband and wife. Hawaii is not a community property state. They have always treated their business as a qualified joint venture. They file on two Schedule Cs. Later in the year, they decide to form a multi-member LLC for liability protection. They must now file a partnership return (Form 1065) for their business, starting with the date of formation of the LLC. They can no longer treat their business activity as a qualified joint venture, even if they file jointly.

Example: Grant and Evie are married and always file jointly. They live in Texas and run a small grocery store together as a qualified joint venture. During the year, they form a multi-member LLC for liability protection and hold the LLC as community property under Texas law. Since Texas is a community property state, they are allowed to continue reporting their income and loss on two Schedule Cs by making an election to be treated as a Qualified Joint Venture.

Centralized Partnership Audit Regime: The Centralized Partnership Audit Regime (CPAR) was introduced as part of the Bipartisan Budget Act of 2015. Under CPAR, if a partnership's tax return is audited and it is found to have underreported its taxable income, the partnership itself is responsible for paying any resulting tax, interest, and penalties.

Certain small partnerships with 100 or fewer eligible partners can elect out of CPAR. If they do so, any audit adjustments are made at the partner level, similar to the pre-CPAR rules.[6]

If eligible, a partnership can elect out of CPAR on Schedule B-2 (Form 1065). A partnership can *only* elect out of CPAR if it meets all the following requirements:

- Must have 100 or fewer partners during the year, and
- Has only “eligible” partners, which include:
    - Individuals (natural persons only, neither LLCs nor grantor trusts are considered eligible partners!)
    - C Corporations or foreign entities classified as corporations
    - S corporations
    - Estates of deceased partners (but *not* bankruptcy estates!)

Partnerships with just one non-qualified partner *cannot* opt-out of the centralized audit regime, even if the partnership has fewer than 100 partners.

[5] There are currently nine community property states: Louisiana, Arizona, California, Texas, Washington, Idaho, Nevada, New Mexico, and Wisconsin. See Rev. Proc. 2002-69, 2002-2 CB 831, for special rules applicable to married couple state law entities in community property states.

[6] CPAR aims to streamline the audit process for partnerships and make it easier for the IRS to assess and collect taxes on partnership adjustments. Under audit, the IRS calculates an "imputed underpayment" based on the adjustments made during the audit. This amount is assessed at the partnership level, rather than individually to the partners. Federal law defaults to CPAR for any partnership that does not, or cannot, opt out of CPAR, and requires the partnership to report and pay a tax deficiency resulting from adjustments to the partnership's tax return.

Example: Hannah, Anthony, and Tristan are partners who run Weeder's Ceramics, LLC a business that is operated as a partnership. Since the business only has three partners, Weeder's Ceramics, LLC has always opted-out of the centralized audit regime on Schedule B-2 of the partnership's Form 1065. However, in 2024, Tristan forms a grantor trust and transfers his partnership interest in Weeder's Ceramics into his newly-formed trust. The partnership can no longer opt-out of CPAR, because it now has an ineligible partner, namely, the trust that Tristan created to hold his partnership interest.

The CPAR requires partnerships to designate a "partnership representative" with the filing of their tax return,[7] but the representative is not required to be a partner. The representative can be either an individual or a business entity[8] and must have a substantial presence in the United States.[9] The partnership representative has the authority to make decisions for the partnership during the course of an audit, and decisions made by the representative are binding on the partnership and all of its partners.

Example: Libertad Energy, LP is a large oil and gas partnership focused on the exploration and production of crude oil and natural gas. Libertad Energy, LP is a large investment partnership with over 2,000 partners. Most of the partners are investors and do not actively work in the business. Libertad Energy cannot elect out of the centralized partnership audit regime, because it has more than 100 partners. Libertad Energy retains a well-known tax attorney, Benjamin Smith, Esq. to represent them in all tax matters. Benjamin Smith is not a partner, but he can be named as the partnership representative on Libertad Energy's tax return.

C Corporations

Most major companies are organized as C corporations. When forming a corporation, prospective shareholders provide money, property, or both in exchange for the issuance of the corporation's capital stock. A corporation conducts business, realizes net income or loss, and distributes profits to shareholders.

A corporation is considered an entity separate from its shareholders and must elect a board of directors who are responsible for oversight of the company. C corporations and S corporations (discussed next) are differentiated for tax purposes only. Legally, they are both simply corporations. For tax purposes, however, they are treated much differently.

A C corporation may have an unlimited number of shareholders and may be either foreign or domestic. A C corporation must file an annual tax return on Form 1120, *U.S. Corporation Income Tax Return,* to report its net income and losses, and pay tax on its income. Its after-tax profits may also be taxable income to its shareholders when distributed as dividends, resulting in double taxation.

---

[7] A "partnership representative" is the person that a partnership designates for the tax year as the partnership's representative, or the person the Internal Revenue Service has appointed to act as the federal partnership representative, pursuant to Section 6223(a) of the Internal Revenue Code. The partnership representative does not have to be an enrolled practitioner.

[8] If the representative is a business entity (such as a corporation), a designated individual of the entity must be named to act on the entity's behalf.

[9] A substantial presence is defined as a representative who meets all of the following requirements: (1) they have a U.S. taxpayer identification number; (2) they have a U.S. street address and a telephone number with a U.S. area code; and (3) the partnership representative or designated individual acting on behalf of an entity partnership representative makes themselves available to meet in person with the IRS in the United States at a reasonable time and place as determined by the IRS in accordance with Treasury Regulation § 301.7605-1.

A C corporation does not receive a tax deduction when it distributes dividends to shareholders, and shareholders cannot deduct any losses of the corporation. A corporation deducts its ordinary and necessary business expenses like any other business, but it is also allowed certain special deductions. C corporations are currently taxed at a flat rate of 21%.[10]

C Corporations are generally required to make estimated tax payments throughout the year. These payments are made quarterly and are based on the corporation's expected taxable income for the year (corporate taxation is covered in more detail later).

Example: Greentech Innovations, Inc. is an organic clothing company based in San Antonio, Texas. In 2024, it generated $500,000 in taxable income from the sales of its natural cotton clothes. As a C corporation, the company is subject to the flat corporate tax rate of 21%. The tax liability for Greentech Innovations Inc. would be $105,000 ($500,000 × 0.21), which would be the corporation's federal corporate income tax for the year. Greentech Innovations must pay this tax throughout the year by making estimated payments to avoid underestimated tax penalties.

S Corporations

An S corporation is a distinct form of entity, organized as a corporation for *legal* purposes, but *elected* with the IRS for tax purposes. For federal income tax purposes, an S corporation is generally not subject to tax; instead, its income, losses, deductions, and credits are passed through directly to its shareholders in a manner similar to a partnership. However, while not common, the S corporation itself may be responsible for income tax on certain built-in gains and passive investment income. We will cover these special taxes that apply to S corporations in a later chapter.

An S corporation is required to file an annual income tax return to report its income or loss using Form 1120-S, *U.S. Tax Return for an S Corporation.* It also reports each shareholder's applicable share of income or losses on Schedules K-1. The shareholders report the pass-through income or loss on their individual tax returns. As a result, the shareholders of S corporations are able to avoid double federal taxation on their corporate income. S corporations must meet the following requirements:

- Be a domestic corporation with 100 or fewer "permitted" shareholders (partnerships, C corporations,[11] and nonresident aliens are not eligible).
- Have only one class of stock (voting and nonvoting stock are not considered to be separate classes of stock, as long as they have identical rights to distribution and liquidation proceeds).
- Not be an ineligible type of corporation (certain financial institutions, insurance companies, and domestic international sales corporations are not eligible for S corporation status).

Limited Liability Companies (LLCs)

A **limited liability company (LLC)** is a type of business entity formed under state law by filing articles of organization. Depending upon whether it has a single owner or multiple owners, an LLC will be treated for federal tax purposes either as:

[10] The Tax Cuts and Jobs Act permanently eliminated the graduated rates for C Corporations. All C corporations are now taxed at a flat rate of 21%. There is no longer a separate tax rate for personal service corporations (PSC)—all C corporations are taxed at a 21% flat rate, regardless of their size or business activity.

[11] There is an exception for S corporations who own 100% of another S corporation under certain circumstances, as well as an exception for 501(c)(3) organizations that are organized as corporations. An exempt entity is allowed to own S corporation stock without jeopardizing the S corporation's status.

- A "disregarded entity," (as described later)
- As a partnership.
- A corporation; if the entity elects to be treated as a corporation.

Most LLCs in the United States are taxed as partnerships. Like the owners of S corporations and partnerships, the members of an LLC can avoid double taxation.

An LLC can provide the liability protection of a corporation with the tax benefits of a partnership. Unlike a partnership, none of the members of an LLC are personally liable for its debts. If a multi-member limited liability company (MMLLC) is treated as a partnership for tax purposes, it must file Form 1065 annually, and one of its owners/members must sign the return.

A **Professional Service Limited Liability Company**, or **PLLC** is a type of limited liability company that is owned and operated by licensed professionals, such as doctors, lawyers, engineers, and CPAs. PLLCs are not available in every state, and have ownership restrictions and can generally only offer services related to its profession.

Farmers

Farming businesses are primarily engaged in crop production, animal production, or forestry and logging. They may include stock, dairy, poultry, fish, fruit, and tree farms, as well as plantations, ranches, timber farms, and orchards. It is the nature of the activity, and not the entity type that determines whether a business qualifies as a farming business.

Congress has enacted many tax laws specific to farming. These laws provide special tax treatment and reflect the highly unpredictable nature of the business. For example, farmers have a different schedule for paying estimated taxes; they may postpone gain or income in certain cases that other businesses cannot; they can deduct a higher percentage of mileage expenses than other businesses, and they are given special tax considerations when disaster strikes.

Farming businesses operating as sole proprietorships report income and loss on Schedule F, *Profit or Loss from Farming*, of Form 1040. Farmers are typically self-employed if they operate a farm or rent farmland from others to engage in the business of farming. Self-employed farmers must also complete Schedule SE to determine self-employment taxes due.

A farming business may also be organized as a partnership or a corporation. Even if a farming business is organized as a partnership or corporation, there are many rules that apply to farm businesses that do not apply to any other entity type. Farmers are unique in that respect, and we have dedicated an entire unit to discussing many of the rules that apply specifically to farming activities.

Tax-Exempt Organizations (Nonprofit Entities)

IRS Code Section 501(c) outlines requirements for tax-exempt organizations. They must be operated exclusively for an exempt purpose and not benefit private individuals. Nonprofits can be organized as corporations, trusts, or associations, but <u>never</u> as partnerships or sole proprietorships.

To obtain tax-exempt status, most charitable organizations file Form 1023, *Application for Recognition of Exemption.* However, churches, including synagogues, temples, and mosques, are treated as tax-exempt by default and do not have to apply for formal exemption, although many do.

Most tax-exempt organizations must annually file Form 990, *Return of Organization Exempt from Income Tax,* to report its income and losses. Small tax-exempt organizations can file either a Form 990-

EZ or the 990-N (e-Postcard) in lieu of Form 990. In addition, Form 990-T*, Exempt Organization Business Income Tax Return,* is used by tax-exempt organizations to report and pay tax on their unrelated business income (UBI).

Example: Helping Hands Foundation is a nonprofit organization based in Denver, Colorado. The foundation's mission is to provide educational resources and support to underprivileged children in the local community. Throughout the year, Helping Hands Foundation receives donations from individuals and businesses, organizes fundraising events, and applies for grants to fund its programs. Total donations received were $725,000 for the year, and the organization is required to file a Form 990. Additionally, Helping Hands Foundation operates a small café within its community center, generating $17,400 in income from unrelated business activities. As a result, the foundation must also file Form 990-T, Exempt Organization Business Income Tax Return, to report and pay taxes on this unrelated business income.

Entity Classification Election Rules

Certain business entities may choose how they will be classified for tax purposes by filing Form 8832, *Entity Classification Election*. An LLC with a single member is classified as a "disregarded entity," or as not being separate from its owner for income tax purposes, unless the owner files Form 8832 and elects to be taxed as a corporation. Thus, a single-owner LLC conducting a trade or business activity owned by an individual is treated as a sole proprietorship, and the owner is subject to the tax on net earnings from self-employment.

Because it is a disregarded entity, a single-member LLC that is owned by a corporation or a partnership is included on the entity's tax return as if it were a division of the corporation or partnership.

A *single*-member LLC cannot be classified as a partnership, because a partnership must have at least two owners. An LLC with at least two members is classified as a partnership by default unless it files Form 8832 and elects to be treated as a corporation (an LLC that wishes to be taxed as an S corporation would file Form 2553, rather than Form 8832, to make both the corporation and S corporation elections simultaneously).

In general, an election to change an LLC's classification cannot take effect more than 75 days prior to the date the election is filed; nor can it take effect later than 12 months after the date the election is filed (although late elections are possible in some cases).

Once a business entity makes an election to change its classification, it generally cannot change the election again within five years (60 months). The 60-month limitation does not apply if the previous election was made by a newly formed eligible entity and was effective on the date of formation.

Example: Kiana and Garrick are siblings and own their own business, K&G LLC, which is taxed as a partnership. A year after they began business operations, they decide that they want to try and attract foreign investors to their business. They decide to change K&G's tax classification to be taxed as a C corporation, so they file Form 8832. The change is accepted by the IRS, and the business will now file as a C Corporation on Form 1120. At this point, if Kiana and Garrick change their minds and want their business to go *back* to being classified as a partnership again, they would have to wait at least 60 months (five years).

Recordkeeping for Businesses

Proper recordkeeping is essential for businesses to monitor operations, verify income and expenses, and file accurate tax returns. Records can be kept in any format as long as they clearly show the business's financial transactions, including gross income and deductions. Supporting documents such as sales slips, invoices, receipts, and bank statements must also be kept. Electronic records are acceptable if they are complete, accurate, and accessible to the IRS. Businesses should keep records until the statute of limitations for tax returns has expired.

Definition: A "**statute of limitation"** is a time period to review and analyze tax-related issues by the IRS. The Internal Revenue Code requires that the IRS must assess, refund, credit, and collect taxes within specific time limits known as the statute of limitations. When they expire, the IRS can no longer assess additional tax, allow a claim for refund by the taxpayer, or take collection action.

Generally, a business must keep records for at least **three years** from when a tax return was due or was filed, whichever is later. Employment tax records must be kept for at least **four years**. A business may need to keep records relating to the basis of property even longer since they may be important in determining the basis of replacement property. With regards to property, a business must keep records relating to property until the statute of limitations expires for the year in which the property is sold or otherwise disposed of.

Example: Summer Café is a small coffee shop in California that is organized as a partnership. Summer Café keeps its income tax returns, receipts, invoices, and bank statements for at least three years from the filing date or due date, whichever is later. The shop employs 10 people, so it also maintains payroll records, W-2 forms, and employment tax returns for at least four years to verify wages paid, taxes withheld, and employment tax deposits. By maintaining these records, Summer Café ensures compliance with IRS requirements and is prepared for any potential IRS audits.

Business funds should be kept separate from personal funds. The IRS is more likely to audit a business and deny deductions and losses if there is no clear separation between business and personal expenses. A separate bank account for business-related transactions is advisable, with business-related bills paid from it rather than from a personal account.

Financial Statements

Financial statements are the formal records of a business' financial activities. There are many types of financial statements, but the two most common ones used for tax reporting purposes are the income statement and the balance sheet.

Income Statement: The income statement is also called the "profit and loss" statement. It indicates the business's revenue, expenses, and net income or loss during a period, such as a month, quarter, or fiscal or calendar year.

Balance Sheet: The balance sheet is a summary of a business' assets, liabilities, and equity on a specific date, such as at the end of its fiscal year. A balance sheet provides a "snapshot" of the business's financial condition. Balance sheet accounts are carried forward from year to year, unlike income statement accounts, which are closed out at year-end and only reflect business operations within a specified period.