McGRAW-HILL'S

TAXATION OF BUSINESS ENTITIES

2020 EDITION

McGraw Hill

SPILKER ★ AYERS ★ BARRICK
OUTSLAY ★ ROBINSON ★ WEAVER ★ WORSHAM

McGraw-Hill's

Taxation of Business Entities

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Dedications

We dedicate this book to:

My family and to Professor Dave Stewart for his great example and friendship.

Brian Spilker

My wife, Marilyn, daughters Margaret Lindley and Georgia, son Benjamin, and parents Bill and Linda.

Ben Ayers

My wife, Jill, and my children Annika, Corinne, Lina, Mitch, and Connor.

John Barrick

My family, Jane, Mark, Sarah, Chloe, Lily, Jeff, and Nicole, and to Professor James E. Wheeler, my mentor and friend.

Ed Outslay

JES, Tommy, and Laura.

John Robinson

My family: Dan, Travis, Alix, Alan, and Anna.

Connie Weaver

My wife, Anne, sons Matthew and Daniel, and daughters Whitney and Hayley.

Ron Worsham

About the Authors

Brian C. Spilker (PhD, University of Texas at Austin, 1993) is the Robert Call/Deloitte Professor in the School of Accountancy at Brigham Young University. He teaches taxation at Brigham Young University. He received both BS (Summa Cum Laude) and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Arthur Young & Co. (now Ernst & Young). After his professional work experience, Brian earned his PhD at the University of Texas at Austin. He received the Price Waterhouse Fellowship in Tax Award and the American Taxation Association and Arthur Andersen Teaching Innovation Award for his work in the classroom. Brian has also been awarded for his use of technology in the classroom at Brigham Young University. Brian researches issues relating to tax information search and professional tax judgment. His research has been published in journals such as *The Accounting Review, Organizational Behavior and Human Decision Processes, Journal of the American Taxation Association, Behavioral Research in Accounting, Journal of Accounting Education, Journal of Corporate Taxation,* and *Journal of Accountancy.*


Courtesy Brian Spilker

Ben Ayers (PhD, University of Texas at Austin, 1996) holds the Earl Davis Chair in Taxation and is the dean of the Terry College of Business at the University of Georgia. He received a PhD from the University of Texas at Austin and an MTA and BS from the University of Alabama. Prior to entering the PhD program at the University of Texas, Ben was a tax manager at KPMG in Tampa, Florida, and a contract manager with Complete Health, Inc., in Birmingham, Alabama. He is the recipient of 11 teaching awards at the school, college, and university levels, including the Richard B. Russell Undergraduate Teaching Award, the highest teaching honor for University of Georgia junior faculty members. His research interests include the effects of taxation on firm structure, mergers and acquisitions, and capital markets and the effects of accounting information on security returns. He has published articles in journals such as *The Accounting Review, Journal of Finance, Journal of Accounting and Economics, Contemporary Accounting Research, Review of Accounting Studies, Journal of Law and Economics, Journal of the American Taxation Association,* and *National Tax Journal*. Ben was the 1997 recipient of the American Accounting Association's Competitive Manuscript Award, the 2003 and 2008 recipient of the American Taxation Association's Outstanding Manuscript Award, and the 2016 recipient of the American Taxation Association's Ray M. Sommerfeld Outstanding Tax Educator Award.


Courtesy Ben Ayers

John Barrick (PhD, University of Nebraska at Lincoln, 1998) is currently an associate professor in the Marriott School at Brigham Young University. He served as an accountant at the United States Congress Joint Committee on Taxation during the 110th and 111th Congresses. He teaches taxation in the graduate and undergraduate programs at Brigham Young University. He received both BS and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Price Waterhouse (now PricewaterhouseCoopers). After his professional work experience, John earned his PhD at the University of Nebraska at Lincoln. He was the 1998 recipient of the American Accounting Association, Accounting, Behavior, and Organization Section's Outstanding Dissertation Award. John researches issues relating to tax corporate political activity. His research has been published in journals such as *Organizational Behavior and Human Decision Processes, Contemporary Accounting Research,* and *Journal of the American Taxation Association*.


Courtesy John Barrick

Courtesy Ed Outslay

Ed Outslay (PhD, University of Michigan, 1981) is a professor of accounting and the Deloitte/Michael Licata Endowed Professor of Taxation in the Department of Accounting and Information Systems at Michigan State University, where he has taught since 1981. He received a BA from Furman University in 1974 and an MBA and PhD from the University of Michigan in 1977 and 1981. Ed currently teaches graduate classes in corporate taxation, multiunit enterprises, accounting for income taxes, and international taxation. In February 2003, Ed testified before the Senate Finance Committee on the Joint Committee on Taxation's Report on Enron Corporation. MSU has honored Ed with the Presidential Award for Outstanding Community Service, the Distinguished Faculty Award, the John D. Withrow Teacher-Scholar Award, the Roland H. Salmonson Outstanding Teaching Award, the Senior Class Council Distinguished Faculty Award, the MSU Teacher-Scholar Award, and MSU's 1st Annual Curricular Service-Learning and Civic Engagement Award in 2008. Ed received the Ray M. Sommerfeld Outstanding Tax Educator Award in 2004 and the Lifetime Service Award in 2013 from the American Taxation Association. He has also received the ATA Outstanding Manuscript Award twice, the ATA/Deloitte Teaching Innovations Award, and the 2004 Distinguished Achievement in Accounting Education Award from the Michigan Association of CPAs. In 2017, Ed received the American Accounting Association / J. Michael and Mary Ann Cook Prize given in "foremost recognition of an individual who consistently demonstrates the attributes of a superior teacher in the discipline of accounting." Ed has been recognized for his community service by the Greater Lansing Chapter of the Association of Government Accountants, the City of East Lansing (Crystal Award), and the East Lansing Education Foundation. He received a National Assistant Coach of the Year Award in 2003 from AFLAC and was named an Assistant High School Baseball Coach of the Year in 2002 by the Michigan High School Baseball Coaches Association.

Courtesy John Robinson

John Robinson (PhD, University of Michigan, 1981) is the Patricia '77 and Grant E. Sims '77 Eminent Scholar Chair in Business. Prior to joining the faculty at Texas A&M, John was the C. Aubrey Smith Professor of Accounting at the University of Texas at Austin, Texas, and he taught at the University of Kansas where he was the Arthur Young Faculty Scholar. In 2009–2010 John served as the Academic Fellow in the Division of Corporation Finance at the Securities and Exchange Commission. He has been the recipient of the Henry A. Bubb Award for outstanding teaching, the Texas Blazer's Faculty Excellence Award, and the MPA Council Outstanding Professor Award. John also received the 2012 Outstanding Service Award from the American Taxation Association (ATA) and in 2017 was named the Ernst & Young and ATA Ray Sommerfeld Outstanding Educator. John served as the 2014–2015 president (elect) of the ATA and was the ATA's president for 2015–2016. John conducts research in a broad variety of topics involving financial accounting, mergers and acquisitions, and the influence of taxes on financial structures and performance. His scholarly articles have appeared in *The Accounting Review*, *The Journal of Accounting and Economics, Journal of Finance*, *National Tax Journal*, *Journal of Law and Economics*, *Journal of the American Taxation Association*, *The Journal of the American Bar Association*, and *The Journal of Taxation*. John's research was honored with the 2003 and 2008 ATA Outstanding Manuscript Awards. In addition, John was the editor of *The Journal of the American Taxation Association* from 2002–2005. Professor Robinson received his J.D. (*Cum Laude*) from the University of Michigan in 1979, and he teaches courses on individual and corporate taxation and advanced accounting.

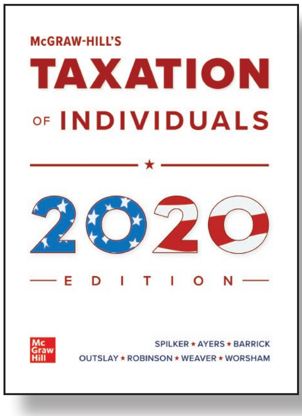
Connie Weaver (PhD, Arizona State University, 1997) is the KPMG Professor of Accounting at Texas A&M University. She received a PhD from Arizona State University, an MPA from the University of Texas at Arlington, and a BS (chemical engineering) from the University of Texas at Austin. Prior to entering the PhD Program, Connie was a tax manager at Ernst & Young in Dallas, Texas, where she became licensed to practice as a CPA. She teaches taxation in the Professional Program in Accounting and the Executive MBA program at Texas A&M University. She has also taught undergraduate and graduate students at the University of Wisconsin–Madison and the University of Texas at Austin. She is the recipient of several teaching awards, including the 2006 American Taxation Association/Deloitte Teaching Innovations award, the David and Denise Baggett Teaching award, and the college and university level Association of Former Students Distinguished Achievement award in teaching. Connie's current research interests include the effects of tax and financial incentives on corporate decisions and reporting. She has published articles in journals such as *The Accounting Review, Contemporary Accounting Research, Journal of the American Taxation Association, National Tax Journal, Accounting Horizons, Journal of Corporate Finance,* and *Tax Notes*. Connie is the senior editor of *The Journal of the American Taxation Association* and she serves on the editorial board of *Contemporary Accounting Research*.

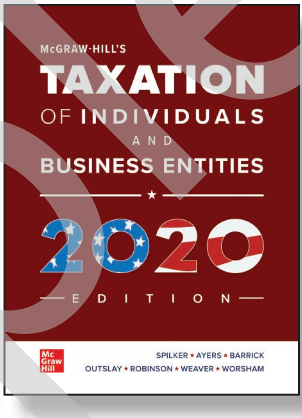

Courtesy Connie Weaver

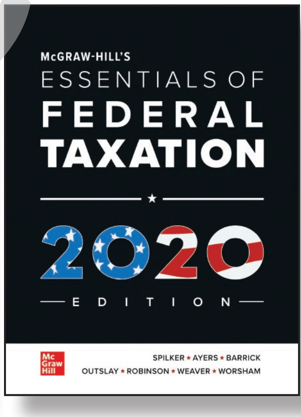
Ron Worsham (PhD, University of Florida, 1994) is an associate professor in the School of Accountancy at Brigham Young University. He teaches taxation in the graduate, undergraduate, MBA, and Executive MBA programs at Brigham Young University. He has also taught as a visiting professor at the University of Chicago. He received both BS and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Arthur Young & Co. (now Ernst & Young) in Dallas, Texas. While in Texas, he became licensed to practice as a CPA. After his professional work experience, Ron earned his PhD at the University of Florida. He has been honored for outstanding innovation in the classroom at Brigham Young University. Ron has published academic research in the areas of taxpayer compliance and professional tax judgment. He has also published legal research in a variety of areas. His work has been published in journals such as *Journal of the American Taxation Association, The Journal of International Taxation, The Tax Executive, Tax Notes, The Journal of Accountancy,* and *Practical Tax Strategies*.


Courtesy Ron Worsham

TEACHING THE CODE IN CONTEXT







The bold innovative approach used by McGraw-Hill's Taxation series is quickly becoming the most popular choice of course materials among instructors and students. It's apparent why the clear, organized, and engaging delivery of content, paired with the most current and robust tax code updates, has been adopted by more than 650 schools across the country.

McGraw-Hill's Taxation is designed to provide a unique, innovative, and engaging learning experience for students studying taxation. The breadth of the topical coverage, **the storyline approach to presenting the material,** the emphasis on the tax and nontax consequences of multiple parties involved in transactions, and the integration of financial and tax accounting topics make this book ideal for the modern tax curriculum.

> "Do you want the best tax text? This is the one to use. It has a storyline in each chapter that can relate to real life issues."
>
> Leslie A. Mostow
> – University of Maryland, College Park

> "This text provides broad coverage of important topics and does so in a manner that is easy for students to understand. The material is very accessible for students."
>
> Kyle Post
> – Tarleton State University

Since the first manuscript was written in 2005, 450 professors have contributed 500 book reviews, in addition to 30 focus groups and symposia. Throughout this preface, their comments on the book's organization, pedagogy, and unique features are a testament to the **market-driven nature of *Taxation's* development.**

> "I think this is the best book available for introductory and intermediate courses in taxation."
>
> Shane Stinson
> – University of Alabama

A MODERN APPROACH FOR TODAY'S STUDENT

McGraw-Hill's Taxation series was built around the following five core precepts:

1. **Storyline Approach:** Each chapter begins with a storyline that introduces a set of characters or a business entity facing specific tax-related situations. Each chapter's examples are related to the storyline, providing students with opportunities to **learn the code in context.**

2. **Integrated Examples:** In addition to providing examples in-context, we provide **"What if"** scenarios within many examples to **illustrate how variations in the facts might or might not change the answers.**

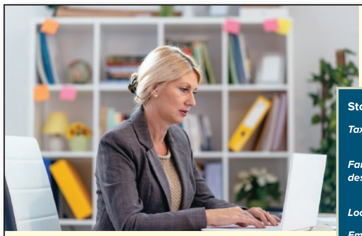
3. **Conversational Writing Style:** The authors took special care to write *McGraw-Hill's Taxation* in a way that fosters a friendly dialogue between the content and each individual student. The tone of the presentation is intentionally conversational—creating the impression of ***speaking with* the student,** as opposed to *lecturing to* the student.

4. **Superior Organization of Related Topics:** *McGraw-Hill's Taxation* provides two alternative topic sequences. In the *McGraw-Hill's Taxation of Individuals and Business Entities* volume, the individual topics generally follow the tax form sequence, with an individual overview chapter and then chapters on income, deductions, investment-related issues, and the tax liability computation. The topics then transition into business-related topics that apply to individuals. This volume then provides a group of specialty chapters dealing with topics of particular interest to individuals (including students), including separate chapters on home ownership, compensation, and retirement savings and deferred compensation. This volume concludes with a chapter covering the taxation of business entities. Alternatively, in the *Essentials of Federal Taxation* volume, the topics follow a more traditional sequence, with topics streamlined (no specialty chapters) and presented in more of a life-cycle approach.

5. **Real-World Focus:** Students learn best when they see how concepts are applied in the real world. For that reason, real-world examples and articles are included in **"Taxes in the Real World"** boxes throughout the book. These vignettes demonstrate current issues in taxation and show the relevance of tax issues in all areas of business.

> "The in-text examples of how to complete tax returns (is a strength of this text). These help students improve their overall understanding of the material as it moves from something abstract to something tangible the student can produce."
>
> Christine Cheng
> – Louisiana State University

A STORYLINE APPROACH THAT RESONATES WITH STUDENTS



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Storyline Summary

Taxpayers:	Courtney Wilson, age 40, and Courtney's mother Dorothy "Gram" Weiss, age 70
Family description:	Courtney is divorced with a son, Deron, age 10, and a daughter, Ellen, age 20. Gram is currently residing with Courtney.
Location:	Kansas City, Missouri
Employment status:	Courtney works as an architect for EWD. Gram is retired.
Filing status:	Courtney is head of household. Gram is single.
Current situation:	Courtney and Gram have computed their taxable income. Now they are trying to determine their tax liability, tax refund, or additional taxes due and whether they owe any payment-related penalties.

Courtney has already determined her taxable income. Now she's working on computing her tax liability. She knows she owes a significant amount of regular income tax on her employment and business activities. However, she's not sure how to compute the tax on the qualified dividends she received from General Electric and is worried that she may be subject to the alternative minimum tax this year. Finally, Courtney knows she owes some self-employment taxes on her business income. Courtney would like to determine whether she is eligible to claim any tax credits, such as the child tax credit for her two children and education credits, because she paid for a portion of her daughter Ellen's tuition at the University of Missouri–Kansas City this year. Courtney is hoping that she has paid enough in taxes during the year to avoid underpayment penalties. She's planning on filing her tax return and paying her taxes on time.

Gram's tax situation is much more straightforward. She needs to determine the regular income tax on her taxable income. Her income is so low she knows she need not worry about the alternative minimum tax, and she believes she doesn't owe any self-employment tax. Gram didn't prepay any taxes this year, so she is concerned that she might be required to pay an underpayment penalty. She plans to file her tax return and pay her taxes by the looming due date.

Each chapter begins with a storyline that introduces a set of characters facing specific tax-related situations. This revolutionary approach to teaching tax emphasizes real people facing real tax dilemmas. Students learn to apply practical tax information to specific business and personal situations. As their situations evolve, the characters are brought further to life.

"Excellent text! Very readable, easy for students to read and understand. Storyline approach and integrated examples make it easy for students to relate to taxpayers and their tax situations."

Sandra Owen
– Indiana State University, Bloomington

Examples

Examples are the cornerstone of any textbook covering taxation. For this reason, *McGraw-Hill's Taxation* authors took special care to create clear and helpful examples that relate to the storyline of the chapter. Students learn to refer to the facts presented in the storyline and apply them to other scenarios—in this way, they build a greater base of knowledge through application. Many examples also include "What if?" scenarios that add more complexity to the example or explore related tax concepts.

Example 2-1

Bill and Mercedes file their 2015 federal tax return on September 6, 2016, after receiving an automatic extension to file their return by October 15, 2016. In 2019, the IRS selects their 2015 tax return for audit. When does the statute of limitations end for Bill and Mercedes's 2015 tax return?

Answer: Assuming the six-year and "unlimited" statute of limitation rules do not apply, the statute of limitations ends on September 6, 2019 (three years after the later of the actual filing date and the *original* due date).

What if: When would the statute of limitations end for Bill and Mercedes for their 2015 tax return if the couple filed the return on March 22, 2016 (before the original due date of April 15, 2016)?

Answer: In this scenario the statute of limitations would end on April 15, 2019, because the later of the actual filing date and the original due date is April 15, 2016.

"I enjoy teaching from the McGraw-Hill Spilker taxation textbook. Students too have commented that they prefer it over other texts they have learned taxation from. The ancillaries, LearnSmart and Connect help in my mission to present the material in a logical, reader-friendly manner."

Cheryl Crespi – Central Connecticut State University

THE PEDAGOGY YOUR STUDENTS NEED TO PUT THE CODE IN CONTEXT

Taxes in the Real World

Taxes in the Real World are short boxes used throughout the book to demonstrate the real-world use of tax concepts. Current articles on tax issues, the real-world application of chapter-specific tax rules, and short vignettes on popular news about tax are some of the issues covered in Taxes in the Real World boxes.

TAXES IN THE REAL WORLD Is It a Deductible State Tax Payment, Charitable Contribution, or Neither?

In recent years, it has become popular for state and local governments to provide state or local tax credits for contributions to certain qualified charities (for example, local hospitals, certain scholarship funds, etc.). While there was no "official" IRS guidance on the federal tax treatment of these contributions, in "unofficial" guidance, the IRS Office of Chief Counsel (see Chief Counsel Advice Memorandum 201105010) advised that a payment to a state agency or charitable organization in return for a tax credit might be characterized as either a deductible charitable contribution or a deductible state tax payment. The 2010 CCA advised that taxpayers could take a charitable deduction for the full amount of the contribution without subtracting the value of the state tax credit received. Hence, for federal tax purposes, the taxpayer could take a charitable contribution deduction for an amount that otherwise was used to reduce the taxpayer's state tax liability. Because individuals deduct both state taxes and charitable contributions as itemized deductions, the IRS was not too concerned with these types of state tax credit programs.

As you might expect, the IRS's laissez-faire stance changed in 2018 with the enactment of the $10,000 limit on the itemized deduction for state, local, and foreign taxes. Specifically, the IRS revisited the federal tax consequences of state and local tax credit programs out of concern that taxpayers may use these programs to bypass the $10,000 limit on state, local, and foreign tax deductions. After further review, the news was not favorable for taxpayers. In Prop. Reg. §1.170A-1(h)(3), the IRS stated that, effective for contributions after August 27, 2018, taxpayers making payments or transferring property to an entity eligible to receive tax-deductible contributions will have to reduce their charitable contribution deductions by the amount of any state or local tax credit received (or expected to be received). Thus, after August 27, 2018, if a taxpayer receives a dollar-for-dollar state tax credit for a contribution to a qualified charity, the charitable contribution deduction is reduced to zero for federal tax purposes (i.e., the contribution is neither a deductible state tax payment or deductible charitable contribution).

Sources: Prop. Reg. §1.170A-1(h)(3); REG-112176-18.

> "This is the best text I have found for both my students and myself. Easier to read than other textbooks I have looked at, good examples, and, as mentioned before, I appreciate the instructor resources."
>
> – Esther Ehrlich, CPA, The University of Texas at El Paso

The Key Facts

The Key Facts provide quick synopses of the critical pieces of information presented throughout each chapter.

The **tax base** defines what is actually taxed and is usually expressed in monetary terms, whereas the **tax rate** determines the level of taxes imposed on the tax base and is usually expressed as a percentage. For example, a sales tax rate of 6 percent on a purchase of $30 yields a tax of $1.80 ($1.80 = $30 × .06).

Federal, state, and local jurisdictions use a large variety of tax bases to collect tax. Some common tax bases (and related taxes) include taxable income (federal and state income taxes), purchases (sales tax), real estate values (real estate tax), and personal property values (personal property tax).

Different portions of a tax base may be taxed at different rates. A single tax applied

THE KEY FACTS

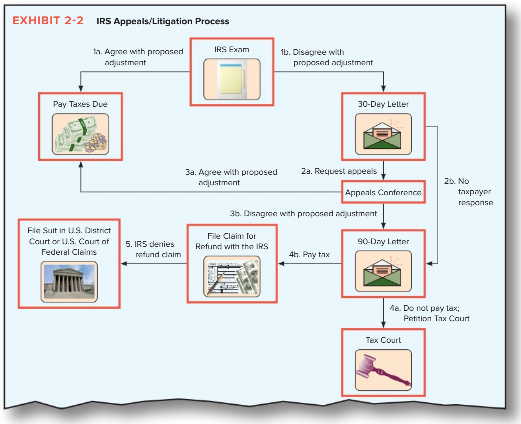
How to Calculate a Tax

- Tax = Tax base × Tax rate
- The tax base defines what is actually taxed and is usually expressed in monetary terms.
- The tax rate determines

Exhibits

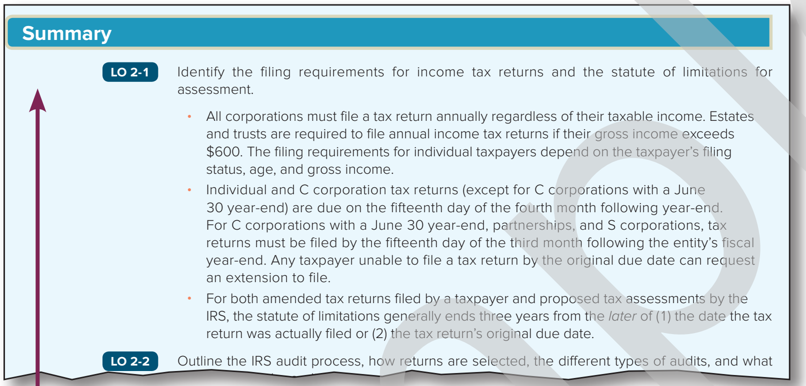
Today's students are visual learners, and *McGraw-Hill's Taxation* understands this student need by making use of clear and engaging charts, diagrams, and tabular demonstrations of key material.

EXHIBIT 2-2 IRS Appeals/Litigation Process



> "It is easily accessible to students as it is written in easy-to-understand language, and contains sufficient examples to illustrate complicated tax concepts and calculations."
>
> Machiavelli Chao
> – University of California, Irvine: The Paul Merage School of Business

PRACTICE MAKES PERFECT WITH A WIDE



Summary

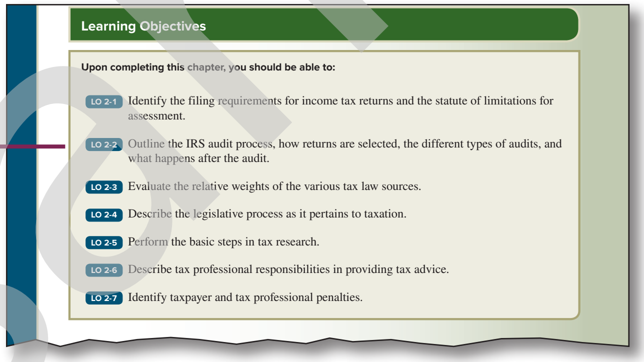
LO 2-1 Identify the filing requirements for income tax returns and the statute of limitations for assessment.

- All corporations must file a tax return annually regardless of their taxable income. Estates and trusts are required to file annual income tax returns if their gross income exceeds $600. The filing requirements for individual taxpayers depend on the taxpayer's filing status, age, and gross income.
- Individual and C corporation tax returns (except for C corporations with a June 30 year-end) are due on the fifteenth day of the fourth month following year-end. For C corporations with a June 30 year-end, partnerships, and S corporations, tax returns must be filed by the fifteenth day of the third month following the entity's fiscal year-end. Any taxpayer unable to file a tax return by the original due date can request an extension to file.
- For both amended tax returns filed by a taxpayer and proposed tax assessments by the IRS, the statute of limitations generally ends three years from the *later* of (1) the date the tax return was actually filed or (2) the tax return's original due date.

LO 2-2 Outline the IRS audit process, how returns are selected, the different types of audits, and what

Summary

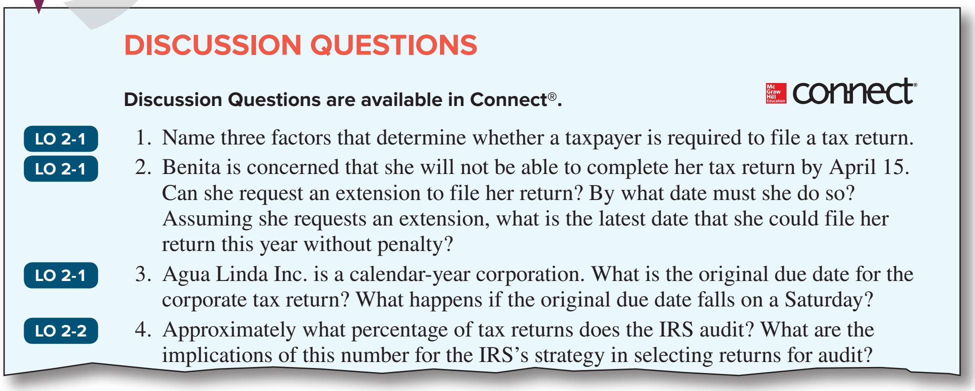
A unique feature of *McGraw-Hill's Taxation* is the end-of-chapter summary organized around learning objectives. Each objective has a brief, bullet-point summary that covers the major topics and concepts for that chapter, including references to critical exhibits and examples. All end-of-chapter material is tied to learning objectives.



Learning Objectives

Upon completing this chapter, you should be able to:

- LO 2-1 Identify the filing requirements for income tax returns and the statute of limitations for assessment.
- LO 2-2 Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.
- LO 2-3 Evaluate the relative weights of the various tax law sources.
- LO 2-4 Describe the legislative process as it pertains to taxation.
- LO 2-5 Perform the basic steps in tax research.
- LO 2-6 Describe tax professional responsibilities in providing tax advice.
- LO 2-7 Identify taxpayer and tax professional penalties.



DISCUSSION QUESTIONS

Discussion Questions are available in Connect®.

LO 2-1 1. Name three factors that determine whether a taxpayer is required to file a tax return.

LO 2-1 2. Benita is concerned that she will not be able to complete her tax return by April 15. Can she request an extension to file her return? By what date must she do so? Assuming she requests an extension, what is the latest date that she could file her return this year without penalty?

LO 2-1 3. Agua Linda Inc. is a calendar-year corporation. What is the original due date for the corporate tax return? What happens if the original due date falls on a Saturday?

LO 2-2 4. Approximately what percentage of tax returns does the IRS audit? What are the implications of this number for the IRS's strategy in selecting returns for audit?

Discussion Questions

Discussion questions, now available in *Connect*, are provided for each of the major concepts in each chapter, providing students with an opportunity to review key parts of the chapter and answer evocative questions about what they have learned.

VARIETY OF ASSIGNMENT MATERIAL

Problems

Problems are designed to test the comprehension of more complex topics. Each problem at the end of the chapter is tied to one of that chapter's learning objectives, with multiple problems for critical topics.

> **PROBLEMS**
>
> **Select problems are available in Connect®.** connect
>
> LO 2-1 43. Ahmed does not have enough cash on hand to pay his taxes. He was excited to hear that he can request an extension to file his tax return. Does this solve his problem? What are the ramifications if he doesn't pay his tax liability by April 15?
>
> LO 2-1 44. Molto Stancha Corporation had zero earnings this fiscal year; in fact, it lost money. Must the corporation file a tax return?

Tax Forms Problems

Tax forms problems are a set of requirements included in the end-of-chapter material of the 2020 edition. These problems require students to complete a tax form (or part of a tax form), providing students with valuable experience and practice with filling out these forms. These requirements—and their relevant forms—are also included in *Connect*. Each tax form problem includes an icon to differentiate it from regular problems.

> LO 6-1 tax forms 28. Betty operates a beauty salon as a sole proprietorship. Betty also owns and rents an apartment building. This year Betty had the following income and expenses. Determine Betty's AGI and complete page 2 (through line 7) and Schedule 1 of Form 1040 for Betty. You may assume that Betty will owe $2,502 in self-employment tax on her salon income, with $1,251 representing the employer portion of the self-employment tax. You may also assume that her divorce from Rocky was finalized in 2016.
>
> | | |
> |---|---|
> | Interest income | $11,255 |
> | Salon sales and revenue | 86,360 |

Research Problems

Research problems are special problems throughout the end-of-chapter assignment material. These require students to do both basic and more complex research on topics outside of the scope of the book. Each research problem includes an icon to differentiate it from regular problems.

> LO 6-2 research 35. This year Tim is age 45 and is considering enrolling in an insurance program that provides for long-term care insurance. He is curious about whether the insurance premiums are deductible as a medical expense and, if so, what the maximum amount is that can be deducted in any year.
>
> LO 6-2 research 36. Doctor Bones prescribed physical therapy in a pool to treat Jack's broken back. In response to this advice (and for no other reason), Jack built a swimming pool in his backyard and strictly limited use of the pool to physical therapy. Jack paid $25,000 to build the pool, but he wondered if this amount could be deducted as a medical

Planning Problems

Planning problems are another unique set of problems included in the end-of-chapter assignment material. These require students to test their tax planning skills after covering the chapter topics. Each planning problem includes an icon to differentiate it from regular problems.

> 57. The IRS recently completed an audit of Shea's tax return and assessed $15,000 additional tax. Shea requested an appeals conference but was unable to settle the case at the conference. She is contemplating which trial court to choose to hear her case. Provide a recommendation based on the following alternative facts: LO 2-2 planning
>
> a) Shea resides in the 2nd Circuit, and the 2nd Circuit has recently ruled against the position Shea is litigating.
>
> b) The Federal Circuit Court of Appeals has recently ruled in favor of Shea's position.
>
> c) The issue being litigated involves a question of fact. Shea has a very appealing

Comprehensive and Tax Return Problems

Comprehensive and tax return problems address multiple concepts in a single problem. Comprehensive problems are ideal for cumulative topics; for this reason, they are located at the end of all chapters. In the end-of-book Appendix C, we include tax return problems that cover multiple chapters. **Additional tax return problems are also available in *Connect* and *Instructor Resource Center*. These problems range from simple to complex and cover individual taxation, corporate taxation, partnership taxation, and S corporation taxation.**

> **COMPREHENSIVE PROBLEMS**
>
> **Select problems are available in Connect®.** connect
>
> tax forms 54. Marc and Michelle are married and earned salaries this year of $64,000 and $12,000, respectively. In addition to their salaries, they received interest of $350 from municipal bonds and $500 from corporate bonds. Marc contributed $2,500 to an individual retirement account, and Marc paid alimony to a prior spouse in the amount of $1,500. Marc and Michelle have a 10-year-old son, Matthew, who lived with them throughout the entire year. Thus, Marc and Michelle are allowed to claim a $2,000 child tax credit for Matthew. Marc and Michelle paid $6,000 of expenditures that qualify as itemized deductions and they had a total of $3,500 in federal income taxes withheld from their paychecks during the course of the year.

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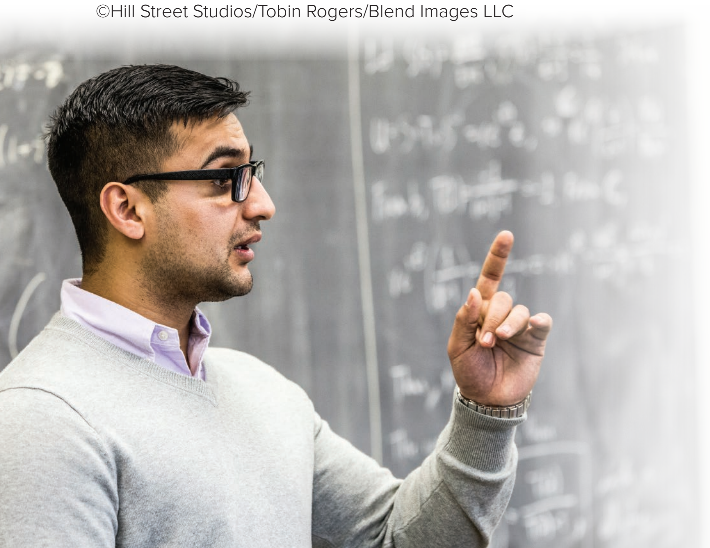

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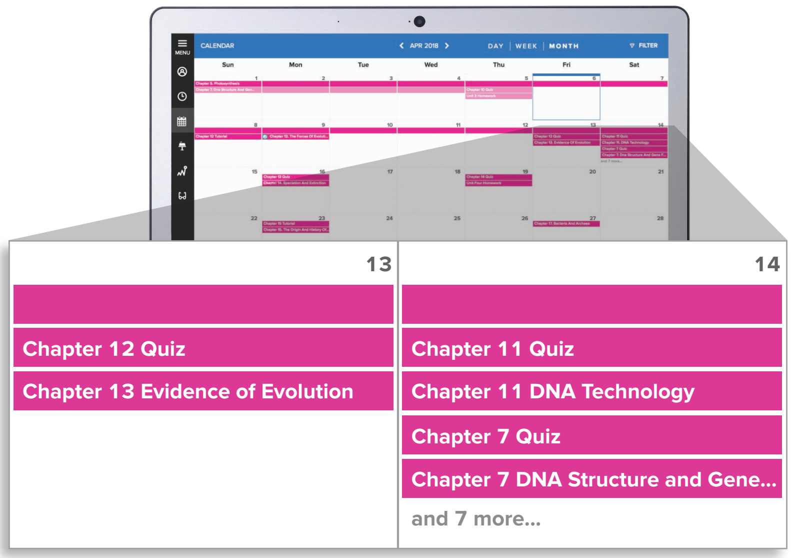

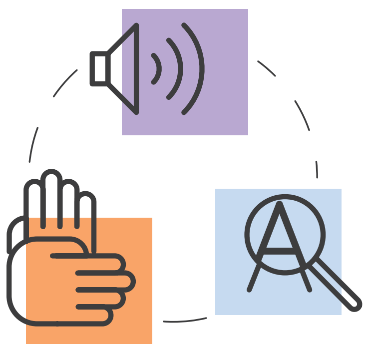

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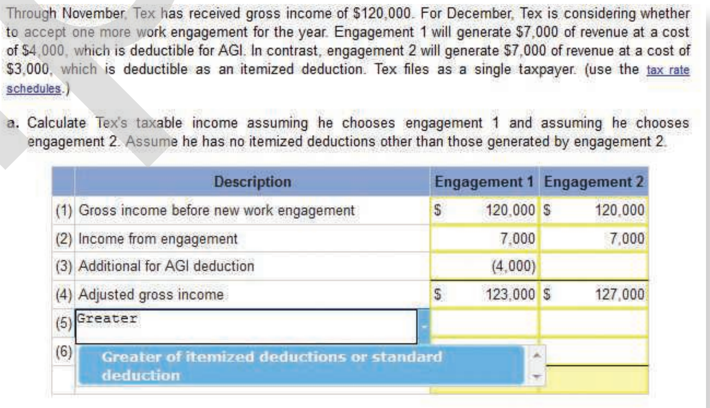
DIGITAL LEARNING ASSETS TO IMPROVE STUDENT OUTCOMES

> "The quality of the online materials in Connect and Learnsmart are market-leading and unmatched in the tax arena."
>
> Jason W. Stanfield
> – Ball State University

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes problems, comprehensive problems (available as auto-graded tax forms), and discussion questions. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.



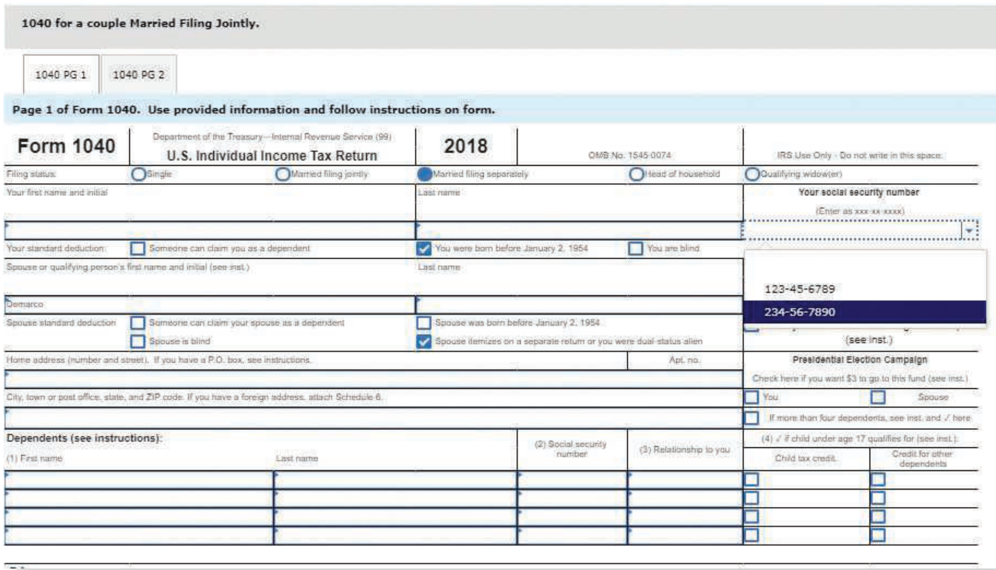
Through November, Tex has received gross income of $120,000. For December, Tex is considering whether to accept one more work engagement for the year. Engagement 1 will generate $7,000 of revenue at a cost of $4,000, which is deductible for AGI. In contrast, engagement 2 will generate $7,000 of revenue at a cost of $3,000, which is deductible as an itemized deduction. Tex files as a single taxpayer. (use the tax rate schedules.)

a. Calculate Tex's taxable income assuming he chooses engagement 1 and assuming he chooses engagement 2. Assume he has no itemized deductions other than those generated by engagement 2.

	Description	Engagement 1	Engagement 2
(1)	Gross income before new work engagement	$ 120,000	$ 120,000
(2)	Income from engagement	7,000	7,000
(3)	Additional for AGI deduction	(4,000)	
(4)	Adjusted gross income	$ 123,000	$ 127,000
(5)	Greater		
(6)	Greater of itemized deductions or standard deduction		

Auto-Graded Tax Forms

The auto-graded **Tax Forms** in Connect provide a much-improved student experience when solving the tax-form based problems. The tax form simulation allows students to apply tax concepts by completing the actual tax forms online with automatic feedback and grading for both students and instructors.



1040 for a couple Married Filing Jointly.

1040 PG 1 | 1040 PG 2

Page 1 of Form 1040. Use provided information and follow instructions on form.

Form 1040 Department of the Treasury—Internal Revenue Service (99) U.S. Individual Income Tax Return 2018 OMB No. 1545-0074 IRS Use Only - Do not write in this space.

Filing status: Single | Married filing jointly | Married filing separately | Head of household | Qualifying widow(er)

Your first name and initial | Last name | Your social security number (Enter as xxx-xx-xxxx)

Your standard deduction: Someone can claim you as a dependent | You were born before January 2, 1954 | You are blind

Spouse or qualifying person's first name and initial (see inst.) | Last name

Demarco

123-45-6789

234-56-7890

Spouse standard deduction: Someone can claim your spouse as a dependent | Spouse was born before January 2, 1954 | Spouse is blind | Spouse itemizes on a separate return or you were dual-status alien | (see inst.)

Home address (number and street). If you have a P.O. box, see instructions. | Apt. no. | Presidential Election Campaign

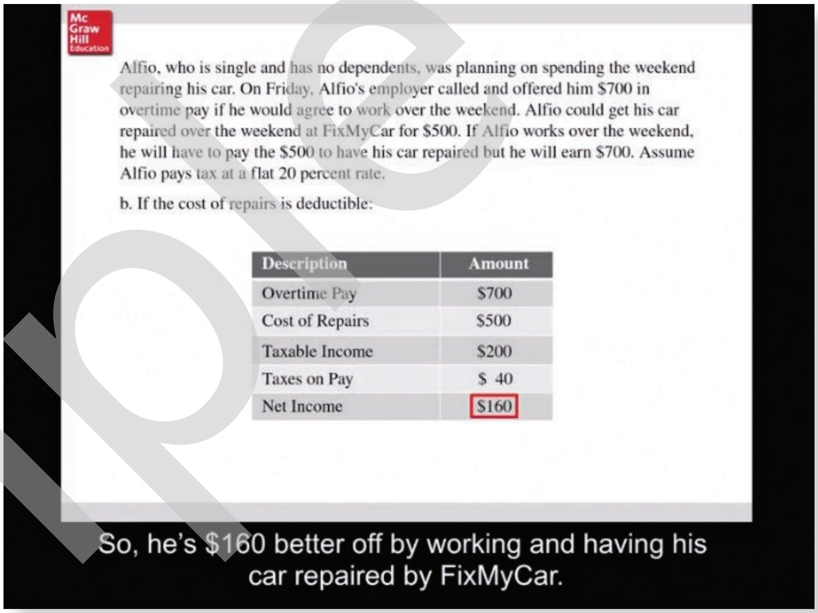
Check here if you want $3 to go to this fund (see inst.) You | Spouse

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6. | If more than four dependents, see inst. and ✓ here

Dependents (see instructions): (1) First name | Last name | (2) Social security number | (3) Relationship to you | (4) ✓ if child under age 17 qualifies for (see inst.): Child tax credit | Credit for other dependents

Guided Examples

The **Guided Examples,** or "hint" videos, in Connect provide a narrated, animated, step-by-step walk-through of select problems similar to those assigned. These short presentations can be turned on or off by instructors and provide reinforcement when students need it most.



TaxACT®

TaxAct Professional *McGraw-Hill's Taxation* can be packaged with tax software from TaxACT, one of the leading preparation software companies in the market today. The 2018 edition includes availability of both *Individuals* and *Business Entities* software, including the 1040 Forms and TaxACT Preparer's Business 3-Pack (with Forms 1065, 1120, and 1120S).

Please note, TaxACT is only compatible with PCs and not Macs. However, we offer easy-to-complete licensing agreement templates that are accessible within Connect and the Instructor Resources Center to enable school computer labs to download the software onto campus hardware for free.

Roger's CPA

ROGER | CPA Review McGraw-Hill Education has partnered with Roger CPA Review, a global leader in CPA Exam preparation, to provide students a smooth transition from the accounting classroom to successful completion of the CPA Exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA Exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing the CPA Exam.

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McGraw-Hill Education and Roger CPA Review are dedicated to supporting every accounting student along their journey, ultimately helping them achieve career success in the accounting profession. For more information about the full Roger CPA Review program, exam requirements, and exam content, visit www.rogercpareview.com.

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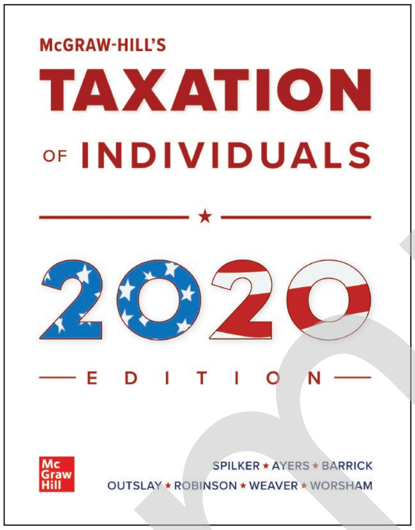

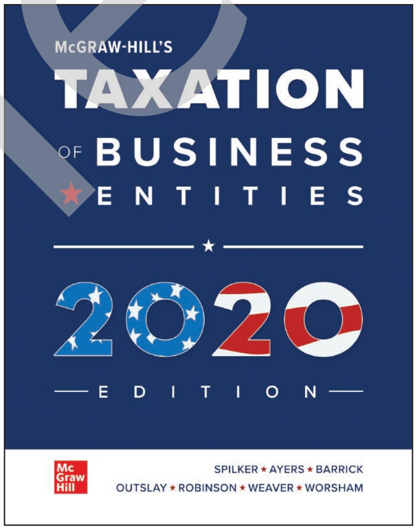

McGraw-Hill's Taxation of Individuals is organized to emphasize topics that are most important to undergraduates taking their first tax course. The first three chapters provide an introduction to taxation and then carefully guide students through tax research and tax planning. Part II discusses the fundamental elements of individual income tax, starting with the tax formula in Chapter 4 and then proceeding to more discussion on income, deductions, investments, and computing tax liabilities in Chapters 5–8. Part III then discusses tax issues associated with business-related activities. Specifically, this part addresses business income and deductions, accounting methods, and tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). Part IV is unique among tax textbooks; this section combines related tax issues for compensation, retirement savings, and home ownership.

Part I: Introduction to Taxation
1. An Introduction to Tax
2. Tax Compliance, the IRS, and Tax Authorities
3. Tax Planning Strategies and Related Limitations

Part II: Basic Individual Taxation
4. Individual Income Tax Overview, Dependents, and Filing Status
5. Gross Income and Exclusions
6. Individual Deductions
7. Investments
8. Individual Income Tax Computation and Tax Credits

Part III: Business-Related Transactions
9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

Part IV: Specialized Topics
12. Compensation
13. Retirement Savings and Deferred Compensation
14. Tax Consequences of Home Ownership

McGraw-Hill's Taxation of Business Entities begins with the process for determining gross income and deductions for businesses, and the tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). Part II provides a comprehensive overview of entities and the formation, reorganization, and liquidation of corporations. Unique to this series is a complete chapter on accounting for income taxes, which provides a primer on the basics of calculating the income tax provision. Included in the narrative is a discussion of temporary and permanent differences and their impact on a company's book "effective tax rate." Part III provides a detailed discussion of partnerships and S corporations. The last part of the book covers state and local taxation, multinational taxation, and transfer taxes and wealth planning.

Part I: Business-Related Transactions
1. Business Income, Deductions, and Accounting Methods
2. Property Acquisition and Cost Recovery
3. Property Dispositions

Part II: Entity Overview and Taxation of C Corporations
4. Entities Overview
5. Corporate Operations
6. Accounting for Income Taxes
7. Corporate Taxation: Nonliquidating Distributions
8. Corporate Formation, Reorganization, and Liquidation

Part III: Taxation of Flow-Through Entities
9. Forming and Operating Partnerships
10. Dispositions of Partnership Interests and Partnership Distributions
11. S Corporations

Part IV: Multijurisdictional Taxation and Transfer Taxes
12. State and Local Taxes
13. The U.S. Taxation of Multinational Transactions
14. Transfer Taxes and Wealth Planning

Four Course Approaches

McGraw-Hill's Taxation of Individuals and Business Entities covers all chapters included in the two split volumes in one convenient volume. See Table of Contents.

Part I: Introduction to Taxation
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Part VI: Taxation of Flow-Through Entities
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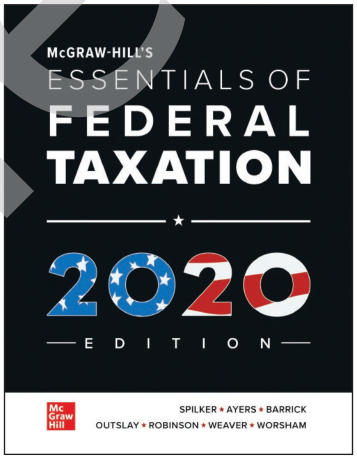
22. S Corporations

Part VII: Multijurisdictional Taxation and Transfer Taxes
23. State and Local Taxes
24. The U.S. Taxation of Multinational Transactions
25. Transfer Taxes and Wealth Planning



McGraw-Hill's Essentials of Federal Taxation is designed for a one-semester course, covering the basics of taxation of individuals and business entities. To facilitate a one-semester course, *McGraw-Hill's Essentials of Federal Taxation* folds the key topics from the investments, compensation, retirement savings, and home ownership chapters in *Taxation of Individuals* into three individual taxation chapters that discuss gross income and exclusions, *for* AGI deductions, and *from* AGI deductions, respectively. The essentials volume also includes a two-chapter C corporation sequence that uses a life-cycle approach covering corporate formations and then corporate operations in the first chapter and nonliquidating and liquidating corporate distributions in the second chapter. This volume is perfect for those teaching a one-semester course and for those who struggle to get through the 25-chapter comprehensive volume.

Part I: Introduction to Taxation
1. An Introduction to Tax
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3. Tax Planning Strategies and Related Limitations

Part II: Individual Taxation
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5. Gross Income and Exclusions
6. Individual *For* AGI Deductions
7. Individual *From* AGI Deductions
8. Individual Income Tax Computation and Tax Credits

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14. Corporate Nonliquidating and Liquidating Distributions

Part V: Taxation of Flow-Through Entities
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16. Dispositions of Partnership Interests and Partnership Distributions
17. S Corporations

SUPPLEMENTS FOR INSTRUCTORS

Assurance of Learning Ready

Many educational institutions today are focused on the notion of *assurance of learning*, an important element of many accreditation standards. *McGraw-Hill's Taxation* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful, solution.

Each chapter in the book begins with a list of numbered learning objectives, which appear throughout the chapter as well as in the end-of-chapter assignments. Every test bank question for *McGraw-Hill's Taxation* maps to a specific chapter learning objective in the textbook. Each test bank question also identifies topic area, level of difficulty, Bloom's Taxonomy level, and AICPA and AACSB skill area.

AACSB Statement

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The statements contained in *McGraw-Hill's Taxation* are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *McGraw-Hill's Taxation* and the teaching package make no claim of any specific AACSB qualification or evaluation, we have, within the text and test bank, labeled selected questions according to the eight general knowledge and skill areas.

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TestGen is a complete, state-of-the-art test generator and editing application software that allows instructors to quickly and easily select test items from McGraw Hill's TestGen testbank content and to organize, edit, and customize the questions and answers to rapidly generate paper tests. Questions can include stylized text, symbols, graphics, and equations that are inserted directly into questions using built-in mathematical templates. With both quick-and-simple test creation and flexible and robust editing tools, TestGen is a test generator system for today's educators.

A HEARTFELT THANKS TO THE MANY COLLEAGUES WHO SHAPED THIS BOOK

The version of the book you are reading would not be the same book without the valuable suggestions, keen insights, and constructive criticisms of the list of reviewers below. Each professor listed here contributed in substantive ways to the organization of chapters, coverage of topics, and use of pedagogy. We are grateful to them for taking the time to read chapters or attend reviewer conferences, focus groups, and symposia in support of the development for the book:

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Mingjun Zhou, *DePaul University*

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Changes in *Taxation of Business Entities,* 2020 Edition

For the 2020 edition of McGraw-Hill's *Taxation of Business Entities,* many changes were made in response to feedback from reviewers and focus group participants:

- All **tax forms** have been **updated for the latest available tax form as of March 2019**. In addition, **chapter content** throughout the text has been **updated to reflect tax law changes through March 2019.**

Other notable changes in the 2019 edition include:

Chapter 1

- Updated tax forms from 2017 to 2018.
- Updated definition of interest for the business interest limitation to conform with proposed regulations.
- Added a new Taxes in the Real World on the all-events test for rebate payments.
- Added two new research problems.
- Added a description of the latest IRS position on the deduction of business meals in conjunction with nondeductible entertainment.
- Added example and homework problems on the deduction of business meals.
- Revised examples and text discussion for updated 2018 mileage rates.
- Expanded description of accounting exceptions for small businesses (average annual gross receipts of $26 million or less in prior three years).

Chapter 2

- Updated Exhibit 2-2 for Weyerhaeuser's 2017 assets.
- Updated tax rates for 2019.
- Revised section on §179 amounts to reflect the inflation adjustments for 2019.
- Updated examples for 2019 §179 amounts.
- Clarified treatment of bonus depreciation for AMT purposes.
- Updated discussion and Exhibit 2-10 relating to automobile depreciation limits.
- Updated §179 amount for SUVs for 2019 inflation amount changes.
- Updated tax forms from 2017 to 2018.
- Updated and revised end-of-chapter problems for §179 amounts and bonus depreciation rules.

Chapter 3

- Updated tax rates for 2019.
- Updated Exhibit 3-6 for changes to recapture.
- Clarified discussion of §1250 recapture as it applies to qualified improvement property placed in service prior to 2018.
- Modified discussion of §1239 gains.
- Modified discussion on like-kind exchanges to clarify purpose of a third-party deferred like-kind exchange.
- Updated discussion of boot given in like-kind exchange.
- Added definition of condemnation.

Chapter 4

- Revised section describing the self-employment tax and the additional Medicare tax.
- Updated the discussion on specified service trades or businesses for purposes of the deduction for qualified business income and included reference to new regulation dealing with what constitutes a specified trade or business.
- Updated Social Security wage base limitation for 2019, including related calculations.
- Revised numbers in Example 4-4.
- Eliminated detailed discussion about pre-2018 individual and corporate tax rates.
- Eliminated discussion about pre-2018 dividends received deduction percentages.
- Included more discussion relating to the dividends received deduction.
- Replaced discussion question 5.

Chapter 5

- Updated the discussion on stock option compensation.
- Revised Taxes in the Real World for Facebook stock options.
- Updated the compliance section for new year-end filing.

Chapter 6

- Updated the Taxes in the Real World saga of Weatherford.
- Updated chapter material to incorporate the new FASB rules on disclosures of deferred tax assets and liabilities.

- Updated the Microsoft uncertain tax benefit footnote disclosure.
- Updated the FASB's projects involving accounting for income taxes.

Chapter 7

- Condensed the facts of the story.
- Clarified explanation of the ordering of E&P distributions.
- Introduced a research problem illustrating the calculation of E&P when distributions include both dividends and stock redemptions.

Chapter 8

- Clarified some definitions and terms throughout the chapter.
- Revised explanation of basis calculation when shareholders receive boot in a §351 transaction.
- Revised illustration of a gain or loss calculation for a §351 transaction with boot.
- Added two problems illustrating basis and gain and loss calculation for §351 transactions.

Chapter 9

- Updated discussion on the new rule dealing with the availability of the cash method of accounting for partnerships to reflect inflation adjustment.
- Updated discussion on new excess business loss limitation and how it interacts with other loss limitation rules to reflect inflation adjustments.
- Updated tax forms from 2017 to 2018.
- Revised Taxes in the Real World example.
- Revised end of chapter problems to reflect inflation adjustments.

Chapter 10

- Revised Taxes in the Real World example.
- Added new end of chapter problem on Section 754 basis step-ups.

Chapter 11

- Updated excess business loss limitation for 2019.
- Updated Social Security tax wage base for 2018.
- Updated tax forms from 2017 to 2018.

Chapter 12

- Substantially revised sales and use tax discussion.
- Updated sales tax nexus for *Wayfair* vs. South Dakota.
- Substantially revised the discussion of income tax nexus.
- Substantially revised the discussion of Public Law 86-272.

Chapter 13

- Updated the discussion on the OECD base erosion and profit-shifting project.
- Updated the proposals for international tax reform.
- Updated the discussion on inversions.

Chapter 14

- Revised text and Exhibit 14-2 for changes in the exemption equivalent.
- Revised calculations, text descriptions, and examples to reflect inflation changes.
- Added new problem illustrating incomplete gifts.
- Replaced Exhibit 14-5 with 2018 Form 709.
- Replaced Exhibit 14-8 with 2019 Form 706.
- Included a new Taxes in the Real World discussing the role of wills in the estate tax.
- Added illustration reconciling the gift and estate tax formulas.
- Clarified the description and illustration of retained estates.

As We Go to Press

The 2020 Edition is current through March, 2019. You can visit the *Connect Library* for updates that occur after this date.

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McGraw-Hill's

Taxation of Business Entities

chapter

1 Business Income, Deductions, and Accounting Methods

Learning Objectives

Upon completing this chapter, you should be able to:

- **LO 1-1** Identify common business deductions.
- **LO 1-2** Determine the limits on deducting business expenses.
- **LO 1-3** Identify special business deductions specifically permitted under the tax laws.
- **LO 1-4** Describe accounting periods available to businesses.
- **LO 1-5** Apply cash and accrual methods to determine business income and expense deductions.

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Storyline Summary

Taxpayer:	Rick Grime
Location:	San Antonio, Texas
Family description:	Unmarried
Employment status:	Rick quit his landscaping job in Dallas and moved to San Antonio to start a business as a self-employed landscaper.

Rick Grime graduated from Texas A&M University with a degree in agronomy, and for the past few years he has been employed by a landscape architect in Dallas. Nearly every day that Rick went to work, he shared ideas with his employer about improving the business. Rick finally decided to take his ideas and start his own landscaping business in his hometown of San Antonio, Texas. In mid-April, Rick left his job and moved his belongings to San Antonio. Once in town, Rick discovered he had to do a lot of things to start his business. First, he registered his new business name (Green Acres Landscaping, LLC) and established a bank account for the business. Next, he rented a used sport utility vehicle (SUV) and a shop for his place of business. Rick didn't know much about accounting for business activities, so he hired a CPA, Jane Bronson, to help him. Jane and Rick decided that Green Acres would operate as a sole proprietorship, but Jane suggested that as the business grew, he might want to consider organizing it as a different type of legal entity. Operating as a corporation, for instance, would allow him to invite new investors or business partners to help fund future expansion. Rick formally started his business on May 1. He spent a lot of time attracting new customers, and he figured he would hire employees as he needed them.

to be continued . . .

This chapter describes the process for determining income for *businesses*. Keep in mind that the concepts in this chapter generally apply to all types of tax entities, including sole proprietorships (such as Rick's company, Green Acres), partnerships, entities taxed as partnerships (such as LLCs), S corporations, and C corporations.[1] Because Rick is a sole proprietor, our examples emphasize business income and deductions from his personal perspective. Proprietors report business income on Schedule C of their individual income tax returns. However, the choice of the organizational form is a complex decision that is not described in this chapter.

Schedule C income is subject to both individual income and self-employment taxes. Entities, other than sole proprietorships, report income on tax forms separate from the owners' tax returns. For example, partnerships report taxable income on Form 1065, S corporations report taxable income on Form 1120S, and C corporations report taxable income on Form 1120. Of all these entity types, generally only C corporations pay taxes on their income.

BUSINESS GROSS INCOME

In most respects, the rules for determining business gross income are the same as for determining gross income for individuals. Gross income includes "all income from whatever source derived."[2] Generally speaking, income from a business includes gross profit from inventory sales (sales minus cost of goods sold), income from services provided to customers, and income from renting property to customers. Just like individuals, a business is allowed to exclude certain types of realized income from gross income, such as municipal bond interest.

LO 1-1

BUSINESS DEDUCTIONS

THE KEY FACTS

Business Expenses

- Business expenses must be incurred in pursuit of profits, not personal goals.
- A deduction must be ordinary and necessary (appropriate and helpful).
- Only reasonable amounts are allowed as deductions.

Because Congress intended for taxable income to reflect the *net* increase in wealth from a business, it is only fair that a business is allowed to deduct expenses incurred to generate business income. Typically, Congress provides *specific* statutory rules authorizing deductions. However, as you can see from the following excerpt from §162, the provision authorizing business deductions is relatively broad and ambiguous:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .[3]

Taxpayers can deduct expenses for "trade or business" activities but the law does not define the phrase "trade or business."[4] However, it is implicit that the primary objective of a "business" activity is to make a profit. Thus, the law requires that a business expense be made in the pursuit of profit rather than the pursuit of other, presumably personal, motives. When an activity does not meet the "for profit" requirement, it is treated as a "hobby" which is an activity motivated by personal objectives.

[1]S corporations are treated as flow-through entities (S corporation income is taxed to its owners) while C corporations are taxed as separate taxable entities.

[2]§61(a).

[3]§162.

[4]§212 contains a sister provision to §162 allowing deductions for ordinary and necessary expenses incurred for the production of income ("investment expenses") and for the management and maintenance of property (including expenses incurred in renting property in situations when the rental activity is not considered to be a trade or business). A business activity, sometimes referred to as a trade or business, requires a relatively high level of involvement or effort from the taxpayer. Unlike business activities, investments are profit-motivated activities that don't require a high degree of taxpayer involvement or effort.

Ordinary and Necessary

Business expenditures must be both **ordinary and necessary** to be deductible. An *ordinary* expense is an expense that is normal or appropriate for the business under the circumstances.[5] To be considered ordinary, an expense need *not* be typical or repetitive in nature. For example, a business could deduct the legal fees it expends to defend itself in an antitrust suit. Although an antitrust suit would be atypical and unusual for most businesses, defending the suit would probably be deemed ordinary because it would be expected under the circumstances. A *necessary* expense is an expense that is helpful or conducive to the business activity, but the expenditure need not be essential or indispensable. For example, a deduction for metric tools would qualify as ordinary and necessary even if there was only a small chance that a repairman might need these tools. The "ordinary and necessary" requirements are applied on a case-by-case basis, and while the deduction depends on individual circumstances, the IRS is often reluctant to second-guess business decisions. Exhibit 1-1 presents examples of expenditures that are ordinary and necessary for typical businesses.

EXHIBIT 1-1 **Examples of Typical Ordinary and Necessary Business Expenses**

• Advertising	• Office expenses
• Car and truck expenses	• Rent
• Depreciation	• Repairs
• Employee compensation and benefits	• Supplies
• Insurance	• Travel
• Interest	• Utilities
• Legal fees	• Wages

Example 1-1

Rick provides a small waiting room for clients. Rick paid $50 for several books to occupy clients while waiting for appointments. These are hardcover books with photographs and illustrations of landscape designs. Rick believes that the books will inspire new designs and alleviate boredom for potential clients. Can Rick deduct the $50 cost as a business expense?

Answer: Yes, the $50 is ordinary and necessary. The phrase *ordinary and necessary* is interpreted as *helpful or conducive to business activity*. In Rick's situation, it seems highly unlikely that the IRS or a court would conclude that the cost of these books is not ordinary and necessary.

What if: Suppose that Rick's hobby was pre-Columbian art. Would Rick be able to deduct the cost of a new treatise on determining provenance of this art if he placed this book in his waiting room?

Answer: No. It seems unlikely that Rick's prospective clients would share Rick's interest in pre-Columbian art much less how to determine provenance. Hence, it seems highly likely that the IRS or a court would conclude that Rick purchased the treatise for personal rather than business reasons and that the cost of this book is not ordinary and necessary.

ETHICS

Sheri is an attorney who operates as a sole practitioner. Despite her busy schedule, in the past Sheri found time for her family. This year Sheri took on two new important clients, and she hired a personal assistant to help her manage her schedule and make timely court filings. Occasionally, Sheri asked her assistant to assist her with personal tasks such as having her car serviced or buying groceries. Do you think that Sheri should treat her assistant's entire salary as a business expense? Would your answer be any different if personal assistants were to commonly perform these tasks for other busy professionals, such as corporate executives and accountants? How would the cost of a personal assistant differ from the cost of having groceries delivered?

[5] *Welch v. Helvering* (1933), 290 US 111.

Reasonable in Amount

Ordinary and necessary business expenses are deductible only *to the extent* they are **reasonable in amount.** The courts have interpreted this requirement to mean that an expenditure is not reasonable when it is extravagant or exorbitant.[6] If the expenditure is extravagant in amount, the courts presume the excess amount is spent for personal rather than business reasons and is not deductible.

Determining whether an expenditure is reasonable is not an exact science, and not surprisingly, taxpayers and the IRS may have different opinions. Generally, the courts and the IRS test for extravagance by comparing the amount of the expense to a market price or an **arm's length amount.** An amount is reasonable if it is within the range of amounts typically charged in the market by unrelated persons. When an amount exceeds this range, the underlying issue becomes *why* a profit-motivated taxpayer would make an excessive payment. Hence, reasonableness is most likely to be an issue when a payment is made to an individual related to the taxpayer or when the taxpayer enjoys some incidental benefit from the expenditure.

Example 1-2

During the busy part of the year, Rick could not keep up with all the work. Therefore, he hired four part-time employees and paid them the market rate of $10 an hour to mow and trim lawns. When things finally slowed down in late fall, Rick released his four part-time employees. Rick paid a total of $22,000 in compensation to the four employees.

Rick still needed some extra help now and then, so he hired his brother, Tom, on a part-time basis. Tom performed the same duties as the prior part-time employees. However, Rick paid Tom $25 per hour because Tom is a college student and Rick wanted to provide some additional support for Tom's education. At year-end, Tom had worked a total of 100 hours and received $2,500 from Rick. What amount can Rick deduct for the compensation he paid to his employees?

Answer: $23,000. Rick can deduct the entire $22,000 paid to the four part-time employees. However, he can only deduct $10 an hour for Tom's compensation because the extra $15 per hour Rick paid Tom is unreasonable in amount.[7] The remaining $15 per hour is considered a personal (nondeductible) gift from Rick to Tom. Hence, Rick can deduct a total of $23,000 for compensation expense this year [$22,000 + ($10 × 100)].

What if: Suppose that Tom was able to mow twice as many lawns as other employees in the same amount of time and also provide the same quality of work. What is the deductible amount of the $2,500 under these circumstances?

Answer: $2,000. Rick can now deduct an additional $1,000 because Tom's quality of work justifies twice the salary paid to other employees.

TAXES IN THE REAL WORLD Web Sales and the Cohan Rule

Thomas began collecting coins in 1958 and later inherited his father's coin collection. He wasn't employed during 2013, so he actively engaged in buying and selling coins and related items (such as silver ingots and items issued by the Franklin Mint) on eBay using PayPal. At year-end, PayPal filed a Form 1099-K reporting sales of $37,013 by Thomas during 2013. However, Thomas failed to report these sales on his return, and because he didn't report these sales, Thomas also didn't claim the costs he incurred in making his eBay sales. The IRS subsequently assessed a tax deficiency of $12,905 based on unreported income of $37,013.

The law generally requires the Tax Court to presume that the deficiency determined by the IRS is correct, and hence, Thomas had the

[6]§162(a) and *Comm. v. Lincoln Electric Co.* (CA-6, 1949), 176 F.2d 815.

[7]In practice, this distinction is rarely cut and dried. Rick may be able to argue for various reasons that Tom's work is worth more than $10 an hour but perhaps not as much as $25 per hour. We use this example to illustrate the issue of reasonable expenses and not to discuss the merits of what actually is reasonable compensation to Tom.

burden of proving it wrong. At trial the IRS conceded that Thomas was engaged in a "trade or business" with the intent to earn a profit. However, Thomas was still required to substantiate expenses for any deductions by producing records sufficient to enable the court to determine the correct tax liability. Unfortunately, Thomas maintained no records of any kind to establish his cost or other bases in the coins and related items that he sold on eBay.

Despite a continuance at trial, Thomas was unable to present any documentation to establish his cost of goods. Rather, he submitted eBay records of his sales and coin catalogs tracking the market prices during 2010–2013. Thomas testified that he turned over his inventory fairly quickly and the sales records provided some support for this contention. On the other hand, Thomas also sold some of the coins he had previously collected or inherited.

If a taxpayer with inadequate business records testifies credibly that he incurred certain expenses, under the Cohan rule the Court can estimate the amount of deductions. This rule originated with George M. Cohan, who was a Broadway star in the early 1900s. He was audited by the IRS, which disallowed many of his business- and entertainment-related expenses. The IRS argued that without receipts, the expenses were nondeductible despite Cohan's credible testimony in court. The 2nd Circuit Court of appeals agreed with Cohan and forced the IRS to accept estimates of his expenses. (See *Cohan v. Commissioner,* 39 F. 2d 540 [2d Cir. 1930].)

Under the Cohan rule, the Court is not required to guess at a number but must have some basis for an estimate. In Thomas's case, the Tax Court evaluated his testimony and decided that Thomas substantiated a cost of goods sold of $12,000 (a nice round number) and expense deductions of $4,430 for PayPal fees, Internet charges, and postage. As a side note, Thomas was also assessed an accuracy-related penalty because he did not make a good-faith effort to determine his tax correctly.

Source: Thomas R. Huzella, TC Memo 2017–20.

LIMITATIONS ON BUSINESS DEDUCTIONS

LO 1-2

For a variety of reasons, Congress specifically prohibits or limits a business's ability to deduct certain expenditures that appear to otherwise meet the general business expense deductibility requirements.

THE KEY FACTS

Limitations on Business Deductions

- No business deductions are allowable for expenditures that are against public policy (bribes) or are political contributions.
- Expenditures that benefit a period longer than 12 months generally must be capitalized.
- No deductions are allowable for expenditures associated with the production of tax-exempt income.
- Personal expenditures are not deductible.

Expenditures against Public Policy

Businesses occasionally incur fines and penalties and may even pay illegal bribes and kickbacks. However, these payments are not deductible for tax purposes.[8] Congress disallows these expenditures under the rationale that allowing them would subsidize illegal activities and frustrate public policy. Interestingly enough, businesses conducting an illegal activity (selling stolen goods or conducting illegal gambling) are allowed to offset gross income with the cost of the illegal goods (the cost of goods sold) and deduct other ordinary and necessary business expenses incurred in conducting the illegal business activity. However, they are not allowed to deduct fines, penalties, bribes, or illegal kickbacks.[9] Of course, the IRS is probably more concerned that many illegal businesses fail to report *any* income than that illegal businesses overstate deductions.[10]

[8]§162(c) and Reg. §1.162-21. This prohibition applies to fines and penalties imposed by a government or governmental unit unless the taxpayer establishes that the payment is either restitution, remediation, or required to come into compliance with the law. Fines and penalties imposed by other organizations, such as a fine levied by NASCAR or the NFL, would be fully deductible if the payment otherwise qualified as an ordinary and necessary business expense.

[9]*Comm. v. Sullivan* (1958), 356 US 27. In addition, no deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or abuse if the payments are subject to a nondisclosure agreement.

[10]§280E explicitly prohibits drug dealers from deducting any business expenses associated with this "business" activity. However, drug dealers are able to deduct cost of goods sold because cost of goods sold is technically a reduction in gross income and not a business expense. See Reg. §1.61-3(a).

Political Contributions and Lobbying Costs

Perhaps to avoid the perception that the federal government subsidizes taxpayer efforts to influence politics, the tax laws prohibit deductions for political contributions and most lobbying expenses.[11]

Example 1-3

In July, the city fined Rick $200 for violating the city's watering ban when he watered a newly installed landscape. Later, Rick donated $250 to the mayor's campaign for reelection. Can Rick deduct these expenditures?

Answer: No. Rick cannot deduct either the fine or the political contribution as a business expense because the tax laws specifically prohibit deductions for these expenditures.

Capital Expenditures

Whether a business uses the cash or the accrual method of accounting, it must capitalize expenditures for *tangible* assets such as buildings, machinery and equipment, furniture and fixtures, and similar property that have useful lives of more than one year (12 months).[12] For tax purposes, businesses either recover the cost of capitalized tangible assets (other than land) by immediate expensing (when allowed by law) or through depreciation.

Businesses also capitalize the cost to create or acquire *intangible* assets such as patents, goodwill, start-up costs, and organizational expenditures.[13] They recover the costs of capitalized intangible assets either through amortization (when the tax laws allow them to do so) or upon disposition of the assets.[14] Prepaid expenses are also subject to capitalization, but there is a special exception that we discuss under accounting methods later in this chapter.

Expenses Associated with the Production of Tax-Exempt Income

Expenses that generate *tax exempt* income are not allowed to offset taxable income. For example, this restriction disallows interest expense deductions for businesses that borrow money and invest the loan proceeds in municipal (tax-exempt) bonds. It also disallows deductions for life insurance premiums businesses pay on policies that cover the lives of officers or other key employees and compensate the business for the disruption and lost income related to a key employee's death. Because the death benefit from the life insurance policy is not taxable, a business is not allowed to deduct the insurance premium expense associated with this nontaxable income.

Example 1-4

Rick employs Joan, an arborist who specializes in trimming trees and treating local tree ailments. Joan generates a great deal of revenue for Rick's business, but she is in her mid-60s and suffers from MS. In November, Rick purchased a "key employee" term life-insurance policy on Joan's life. Rick paid $720 in premiums for a policy that pays Rick (Green Acres) a $20,000 death benefit if Joan passes away during the next 12 months. Can Rick deduct the life insurance premium?

[11]§162(e).

[12]Reg. §1.263(a)-2(d)(4). The act of recording the asset is sometimes referred to as *capitalizing* the expenditure.

[13]Reg. §1.263(a)-4(b). The extent to which expenditures for intangible assets must be capitalized is explored in *Indopco v. Comm.* (1992), 503 US 79.

[14]See §195, §197, and §248 for provisions that allow taxpayers to amortize the cost of certain intangible assets such as start-up costs and goodwill.

Answer: No. Rick cannot deduct the $720 premium on the life insurance policy because the life insurance proceeds from the policy are tax-exempt.

What if: Suppose Rick purchased the life insurance policy on Joan's life and allowed Joan to name the beneficiary. Again Rick paid a $720 premium for a policy that pays the beneficiary a $20,000 death benefit if Joan dies in the next 12 months. What amount of life insurance policy premium can Rick deduct?

Answer: $720. In this scenario, Rick can deduct the entire premium of $720 as a *compensation* expense because the benefit of the policy inures to Joan (she names the beneficiary), and not to Rick's business.

Personal Expenditures

Taxpayers are not allowed to deduct **personal expenses** unless the expenses are "expressly" authorized by a provision in the law.[15] While the tax laws do not expressly define what constitutes a *personal* expense, the statute identifies "personal, living, or family expenses" as nondeductible examples. Hence, at a minimum, the costs of food, clothing, and shelter are assumed to be personal and nondeductible. Of course, there are the inevitable exceptions when otherwise personal items are specially adapted to business use. For example, taxpayers may deduct the cost of uniforms or special clothing they purchase for use in their business, if the clothing is not appropriate to wear as ordinary clothing outside the place of business. However, when the clothing is adaptable as ordinary clothing, the cost of the clothing is a nondeductible personal expenditure.

Example 1-5

Rick spent $500 to purchase special coveralls that identify his landscaping service and provide a professional appearance. How much of the cost for the clothing can Rick deduct as a business expense?

Answer: $500. While the cost of clothing is inherently personal, Rick can deduct the $500 cost of the coveralls because, due to the design and labeling on the coveralls, they are not suitable for ordinary use.

Many business owners, particularly small business owners such as sole proprietors, may be tempted to use business funds to pay for items that are entirely personal in nature. For example, a sole proprietor could use the business checking account to pay for family groceries. These expenditures, even though funded by the business, are not deductible.

Educational expenses constitute another exception. Expenditures made by a taxpayer for business education, including tuition and books, may be motivated by business aspirations. However, educational expenditures are not deductible as business expenses unless the taxpayer is self-employed and the education *maintains or improves skills* required by the individual in an *existing* trade or business. Education expenses necessary to meet minimum requirements for an occupation are not deductible. For example, tuition payments for courses to satisfy the education requirement to sit for the CPA exam are not deductible. These courses would qualify the taxpayer for a *new* trade or business rather than improving his skills in an existing trade or business.

Mixed-Motive Expenditures

Business owners in general, and owners of small or closely held businesses in particular, often make expenditures that are motivated by *both* business and personal concerns. These **mixed-motive expenditures** are of particular concern to lawmakers and the IRS

[15]§262(a).

THE KEY FACTS

Mixed-Motive Expenditures

- Special limits are imposed on expenditures that have both personal and business benefits.
- Entertainment expenses are generally not deductible.
- Only 50 percent of business meals are deductible.
- Contemporaneous written records of business purpose are required.

because of the tax incentive to disguise nondeductible personal expenses as deductible business expenses. Thus, deductions for business expenditures accompanied by personal benefits are closely monitored and restricted. The rules for determining the amount of *deductible* mixed-motive expenditures depend on the type of expenditure. The most common restrictions determine the deductible portion of mixed-motive expenditures for meals, travel and transportation, and the use of property for both business and personal purposes.

Entertainment and Meals Entertainment expenses are generally not deductible as business expenses. However, certain entertainment expenses are deductible. For example, entertainment expenses primarily for the benefit of the taxpayer's employees and entertainment expenses designed as compensation are deductible as business expenses. Because everyone needs to eat, even business meals contain a significant personal element. To allow for this personal element, taxpayers may deduct only 50 percent of actual business meals.[16]

To deduct any portion of the cost of food or beverages (a meal) as a business expense: (1) the meal must be ordinary and necessary under the circumstances, (2) the amount must be reasonable (not extravagant), (3) the taxpayer (or an employee) must be present when the meal is furnished, (4) the meal must be provided to a current or potential client or business contact, and (5) if the meal is provided during or at an entertainment activity, the meal must be purchased separately from the entertainment and the cost stated separately on invoices or receipts.[17]

Example 1-6

Rick went out to dinner with prospective clients to discuss Rick's ideas for landscaping several business properties. After dinner, Rick and the prospective clients attended the theater. Rick paid $540 for the meal and $850 for the tickets, amounts that were reasonable under the circumstances. What amount of these expenditures can Rick deduct as a business expense?

Answer: Rick can deduct $270 [$540 × 50%] as a business expense if the meal was not lavish and the expenditure was separate from the cost of the tickets. The cost of the tickets to the theater is a nondeductible entertainment expense.

What if: Suppose that Rick did not discuss business with the clients either before, during, or after the meal. What amount of the expenditures can Rick deduct as a business expense?

Answer: $270. Business discussions are not required in order to deduct part of the cost of meals per the five deduction requirements listed above.

Travel and Transportation Under certain conditions, sole proprietors and self-employed taxpayers may deduct the cost of travel and transportation for business purposes. *Transportation* expenses relate to the direct cost of transporting the taxpayer to and from business sites. However, the cost of commuting between the taxpayer's home and regular place of business is personal and, therefore, not deductible. If the taxpayer uses a vehicle for business, the taxpayer can deduct the costs of operating the vehicle plus depreciation on the vehicle's tax basis. Alternatively, in lieu of deducting these costs, the taxpayer may simply deduct a standard amount for each business mile driven. The standard mileage rate represents the per-mile cost of operating an automobile (including depreciation or lease payments).[18] For 2019, the standard mileage rate has been set at 58 cents per mile. To be deductible, the transportation must be for business reasons. If the transportation is primarily for personal purposes, the cost is not deductible.

[16]§§274(k) and (n) provide these restrictions. This section also provides some exceptions to the 50 percent reduction for meals, such as meals provided as employee compensation. Taxpayers can also use a *per diem* rate (an automatic, flat amount per meal) in lieu of actual expenditures to determine the amount of the deduction.

[17]In Notice 2018-76.

[18]This mileage rate is updated periodically (sometimes more than once a year) to reflect changes in the cost of operating a vehicle. Once a taxpayer uses the mileage rate for determining the cost of using an automobile, the taxpayer is not allowed to switch to the actual cost method.

Example 1-7

Rick decided to lease an SUV to drive between his shop and various work sites. Rick carefully documents the business use of the SUV (8,100 miles this year) and his operating expenses ($5,335 this year, including $3,935 for gas, oil, and repairs and $1,400 for lease payments). At no time does Rick use the SUV for personal purposes. What amount of these expenses may Rick deduct as business expenses?

Answer: $5,335. Since Rick uses the SUV in his business activities, he can deduct (1) the $5,335 cost of operating and leasing the SUV or (2) $4,698 for the 8,100 business miles driven this year (58 cents per mile × 8,100 miles). Assuming Rick chooses to deduct operating expenses and lease payments in lieu of using the mileage rate, he can deduct $5,335. Once Rick chooses his method of computing business auto expenses, he cannot later switch methods.

In contrast to transportation expenses, *travel* expenses are only deductible if the taxpayer is *away from home* overnight while traveling. This distinction is important because, besides the cost of transportation, the deduction for **travel expenses** includes the cost of meals (limited to 50 percent), lodging, and incidental expenses. A taxpayer is considered to be away from home overnight if the travel is away from the primary place of business and of sufficient duration to require sleep or rest (typically this will be overnight).

When a taxpayer travels solely for business purposes, *all* of the costs of travel are deductible (but only 50 percent of meals). When the travel has both business and personal aspects, the deductibility of the transportation costs depends upon whether business is the *primary* purpose for the trip. If the primary purpose of a trip is business, the transportation costs are fully deductible, but meals (50 percent), lodging, and incidental expenditures are limited to those incurred during the business portion of the travel.[19] If the taxpayer's primary purpose for the trip is personal, the taxpayer may not deduct *any* transportation costs to arrive at the location but may deduct meals (50 percent), lodging, transportation, and incidental expenditures for the *business* portion of the trip. The primary purpose of a trip depends upon facts and circumstances and is often the subject of dispute.

The rule for business travel is modified somewhat if a trip abroad includes both business and personal activities. Like the rule for domestic travel, if foreign travel is primarily for personal purposes, then only those expenses directly associated with business activities are deductible. However, unlike the rule for domestic travel, when foreign travel is primarily for business purposes, a portion of the round-trip transportation costs is not deductible. The nondeductible portion is typically computed based on a time ratio such as the proportion of personal days to total days (travel days count as business days).[20]

Example 1-8

Rick paid a $300 registration fee for a three-day course in landscape design. The course was held in upstate New York (Rick paid $700 for airfare to attend) and he spent four days away from home. He spent the last day sightseeing. During the trip, Rick paid $150 a night for three nights' lodging, $50 a day for meals, and $70 a day for a rental car. What amount of these travel-related expenditures may Rick deduct as business expenses?

(*continued on page 1-10*)

[19]Note that travel days are considered business days. Also, special limitations apply to a number of travel expenses that are potentially abusive, such as luxury water travel, foreign conventions, conventions on cruise ships, and travel expenses associated with taking a companion.

[20]Foreign transportation expense is deductible without prorating under special circumstances authorized in §274(c). For example, the cost of getting abroad is fully deductible if the travel is for one week or less or if the personal activity constitutes less than one-fourth of the travel time.

Answer: $1,435 for business travel and $300 for business education. The primary purpose for the trip appears to be business because Rick spent three days on business activities versus one day on personal activities. He can deduct travel costs, computed as follows:

Deductible Travel Costs

Description	Amount	Explanation
Airfare	$ 700	Primary purpose is business
Lodging	450	3 business days × $150 a day
Meals	75	3 business days × $50 a day × 50% limit
Rental car	210	3 business days × $70 a day
Total business travel expenses	**$ 1,435**	

What if: Assume Rick stayed in New York for 10 days, spending 3 days at the seminar and 7 days sightseeing. What amount could he deduct?

Answer: In this scenario Rick can deduct $735 for business travel and $300 for business education. Rick would not be able to deduct the $700 cost of airfare because the trip is primarily personal, as evidenced by the seven days of personal activities compared to only three days of business activities.

Deductible Travel Costs

Description	Amount	Explanation
Airfare	$ 0	Primary purpose is personal
Lodging	450	3 business days × $150 a day
Meals	75	3 business days × $50 a day × 50% limit
Rental car	210	3 business days × $70 a day
Total business travel expenses	**$735**	

What if: Assume the original facts in the example except Rick traveled to London (rather than upstate New York) for 10 days, spending 6 days at the seminar and 4 days sightseeing. What amount could he deduct?

Answer: In this scenario Rick can deduct $1,890 for travel (computed below) and $300 for business education.

Deductible Travel Costs

Description	Amount	Explanation
Airfare to London	$ 420	6 business days/10 total days × $700
Lodging in London	900	6 business days × $150 a day
Meals	150	6 business days × $50 a day × 50% limit
Rental car	420	6 business days × $70 a day
Total business travel expenses	**$1,890**	

Rick is allowed to deduct $420 of the $700 airfare (60 percent) because he spent 6 of the 10 days on the trip conducting business activities.

Property Use Several types of property may be used for both business and personal purposes. For example, business owners often use automobiles, computers, or cell phones for both business and personal purposes.[21] However, because expenses relating to these assets are deductible only to the extent the assets are used for business purposes, taxpayers

[21]These types of assets are referred to as "listed property." However, cell phones and computers are specifically exempted from the definition of listed property [§280F(d)(4)(A)], as amended by the 2010 Small Business Act §2043(a).

must allocate the expenses between the business and personal use portions. For example, if a full year's expense for a business asset is $1,000, but the asset is only used for business purposes 90 percent of the time, then only $900 of expense can be deducted ($1,000 × 90%).

Example 1-9

Rick occasionally uses his personal auto (a BMW) to drive to interviews with prospective clients and to drive back and forth between his shop and various work sites. This year Rick carefully recorded that the BMW was driven 750 miles for business activities and 15,000 miles in total. What expenses associated with the BMW may Rick deduct if Rick incurred $6,120 in operating costs for his BMW?

Answer: $306. Rick can deduct the business portion (of his total operating costs based upon the percentage of business miles driven to total miles driven [750 business miles/15,000 total miles]). Hence, Rick will deduct 5 percent of $6,120 or $306 as business travel.

Record Keeping and Other Requirements Because distinguishing business purposes from personal purposes is a difficult and subjective task, the tax laws include provisions designed to help the courts and the IRS determine the business element of mixed-motive transactions. Under these provisions, taxpayers must maintain specific, written, contemporaneous records (of time, amount, and business purpose) for mixed-motive expenses. For example, 50 percent of the cost of business meals is deductible but only if the taxpayer can properly document the five requirements described above.[22]

Limitation on Business Interest Deductions

Starting in 2018 Congress limits the deduction of interest paid or accrued on indebtedness allocable to a trade or business. The purpose of this limitation is to limit the extent to which a business utilizes debt to avoid income taxes. However, the limit applies only to taxpayers with average annual gross receipts in excess of $26 million for the prior three taxable years.

Specifically, business interest is defined as an amount that is paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement. The amount of the deduction is, in general, limited to the sum of (1) *business interest income* and (2) 30 percent of the *adjusted taxable income* of the taxpayer for the taxable year. As a matter of equity, Congress allows business interest deductions to offset business interest income. The latter is defined as the amount of interest income includible in gross income which is properly allocable to a trade or business.

Adjusted taxable income represents all of the other taxable income allocable to the business activity. This income is defined as taxable income of the taxpayer computed without regard to (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; (2) any business interest expense or business interest income; (3) the amount of any net operating loss deduction; and (4) deductions allowable for depreciation, amortization, or depletion.[23]

THE KEY FACTS

Business Interest Limitation

- The deduction of business interest expense is limited to business interest income plus 30 percent of the business's adjusted taxable income for taxpayers with average annual gross receipts in excess of $26 million.
- Adjusted taxable income is taxable income allocable to the business computed without interest income and before depreciation and interest expense deductions.
- Disallowed business interest expense can be carried forward indefinitely.

[22]§274 requires substantiation of all elements of travel, including sufficient corroborating evidence. Although there are a few exceptions to this rule, approximations and estimates are generally not sufficient. Also, taxpayers must maintain records to deduct the business portion of mixed-use assets such as cars used for both business and personal purposes. Note that when the taxpayer is unable to substantiate other deductions, the court may estimate the deductible amount under the Cohan rule [*George Cohan v. Com.,* (1930, CA2), 39 F2d 540].

[23]Adjusted taxable income of the taxpayer cannot be less than zero. Under §163(j) the interest expense disallowance is determined at the filer level but special rules apply to pass-through entities. For years after 2021, adjusted taxable income is not reduced for depreciation, amortization, and depletion.

When computing the limit, business interest expense does not include investment interest expense, and business interest income does not include investment income. For example, business interest expense would include interest paid on a loan used to purchase business equipment, but it would not include interest paid on a loan to purchase stock for investment purposes. The amount of any business interest expense not allowed as a deduction for any taxable year is carried forward indefinitely. If the average gross receipts of the business in any given year falls below a three-year average of $26 million indexed for inflation, then the interest (including any carryforwards) become fully deductible (no longer subject to the business interest limitation).

Example 1-10

What if: Suppose that at the beginning of the year Rick borrowed $300,000 to provide liquidity for starting up Green Acres. Suppose further that at year-end Rick had reported $9,000 in interest expense on the business loan. In addition, Green Acres reported $70,000 of revenue from services and incurred $47,000 of deductible expenses (other than interest expense). The deductible expenses included $5,000 of depreciation. What amount of interest can Rick deduct as a business expense for Green Acres?

Answer: $9,000. Green Acres is not subject to the business interest expense limitation because Rick's gross receipts do not exceed the $26 million average gross receipts test.

What if: Suppose the interest expense limitation applies to Green Acres. What amount of business interest expense could Rick deduct for Green Acres?

Answer: $8,400. Green Acres generated $28,000 of adjusted taxable income. Adjusted taxable income is the amount of revenue less expense before interest and depreciation ($70,000 – $42,000). The 2019 business interest limitation is 30 percent of the adjusted taxable income or $8,400. The $600 of disallowed interest from 2019 is carried over to 2020.

LO 1-3

SPECIFIC BUSINESS DEDUCTIONS

As we discussed above, the tax code provides general guidelines for determining whether business expenditures are deductible. We learned that to be deductible, business expenditures must be ordinary, necessary, and reasonable in amount. In some cases, however, the tax laws identify specific items businesses are allowed to deduct. We discuss several of these deductions below.

Losses on Dispositions of Business Property

Businesses are generally allowed to deduct losses incurred when selling or disposing of business assets.[24] The calculation of losses from business property dispositions can be complex, but the main idea is that businesses realize and recognize a loss when the asset's tax basis exceeds the sale proceeds.

Example 1-11

What if: Assume that in late October, Rick purchased a used trailer to transport equipment to work sites. Rick bought the trailer for what he thought was a bargain price of $1,000. However, shortly after Rick acquired it, the axle snapped and was not repairable. Rick was forced to sell the trailer to a parts shop for $325. What amount can Rick deduct as a loss from the trailer sale?

Answer: $675 is deductible as a business loss because the trailer was a business asset. The loss is calculated as the amount realized of $325 minus adjusted basis of $1,000. (Note that Rick is not allowed to deduct depreciation on the trailer because he disposed of it in the same year he acquired it.)

[24] In most circumstances businesses may *not* deduct losses on assets sold to related persons. We describe who qualifies as a related person later in this chapter.

Business Casualty Losses

Businesses can incur losses when their assets are stolen, damaged, or completely destroyed by a force outside the control of the business. These events are called casualties.[25] Businesses may deduct casualty losses in the year the casualty occurs or, in the case of theft, the year the theft is discovered. The amount of the loss deduction depends on whether the asset is completely destroyed or only partially destroyed. When its asset is *completely* destroyed (or stolen), the business calculates the loss by substituting the insurance proceeds, if any, for the amount realized. That is, the loss is the amount of insurance proceeds minus the adjusted tax basis of the asset. If the asset is damaged but not completely destroyed, the amount of the loss is the amount of the insurance proceeds minus the *lesser* of (1) the asset's adjusted tax basis or (2) the decline in the value of the asset due to the casualty. For individuals, business casualty losses and casualty losses associated with rentals and royalties are deducted *for* AGI.

Example 1-12

What if: Suppose Rick acquires business equipment this year for $5,000 but a fire damages the equipment shortly after it is acquired and before it can be placed in service. After the fire the equipment was worth $3,500 and insurance reimbursed Rick for $1,000. What would be the amount of his business casualty loss?

Answer: $500. The loss is the insurance proceeds ($1,000) reduced by the lesser of the decline in value, $1,500 (computed as $5,000 − $3,500) or the adjusted basis, $5,000. The calculation follows:

Insurance proceeds	$ 1,000
Minus adjusted tax basis	−1,500
Casualty loss deduction	**$ (500)**

What if: Suppose that the fire completely destroyed the equipment. What would be the amount of Rick's business casualty loss?

Answer: $4,000. The loss is the insurance proceeds ($1,000) reduced by the adjusted basis, $5,000.

ACCOUNTING PERIODS

LO 1-4

After identifying a business's taxable income and deductible business expenses, it is necessary to identify the period in which income and deductions are to be measured. Businesses must report their income and deductions over a fixed **accounting period** or **tax year.** A full tax year consists of 12 full months. A tax year can consist of a period less than 12 months (a short tax year) in certain circumstances. For instance, a business may report income for such a short year in its first year of existence (for example, it reports income on a calendar year-end and starts business after January 1) or in its final year of existence (for example, a calendar-year business ends its business before December 31). Short tax years in a business's initial or final year are treated the same as full years. A business also may have a short year when it changes its tax year, and this can occur when the business is acquired by new owners. In these situations, special rules may apply for computing the tax liability of the business.[26]

There are three types of tax years, each with different year-ends:

1. A calendar year ends on December 31.
2. A **fiscal year** ends on the last day of a month other than December.
3. A 52/53-week year. This is a fiscal year that ends on the same day of the week that is the last such day in the month or on the same day of the week nearest the end of

THE KEY FACTS

Accounting Periods

- Individuals and proprietorships generally account for income using a calendar year-end.
- Corporations are allowed to choose a fiscal year.
- Partnerships and other flow-through entities generally use a tax year consistent with their owners' tax years.

[25] Casualties are unexpected events driven by forces outside the control of the taxpayer that damage or destroy a taxpayer's property. §165 lists "fire, storm, and shipwreck" as examples of casualties.

[26] §443. Discussion of tax consequences associated with these short years is beyond the scope of this text.

the month. For example, a business could adopt a 52/53-week fiscal year that (1) ends on the last Saturday in July each year or (2) ends on the Saturday closest to the end of July (although this Saturday might be in August rather than July).[27]

Not all types of tax years are available to all types of businesses. The rules for determining the tax years available to the business depend on whether the business is a sole proprietorship, a **flow-through entity,** or a C corporation. These rules are summarized as follows:

- *Sole proprietorships*: Because individual proprietors must report their business income on their individual returns, proprietorships use a calendar year-end to report their business income.[28]
- *Flow-through entities*: Partnerships and S corporations are flow-through entities (partners and S corporation owners report the entity's income directly on their own tax returns), and these entities generally must adopt tax years consistent with the owners' tax years.[29] Because owners are allocated income from flow-through entities on the last day of the entity's taxable year, the tax laws impose the tax year consistency requirement to minimize income tax deferral opportunities for the owners.
- *C corporations*: C corporations are generally allowed to select a calendar, fiscal, or 52/53-week year-end.

A business adopts a calendar year-end or fiscal year-end by filing its initial tax return. In contrast, a business adopts a 52/53-week year-end by filing a special election with the IRS. Once a business establishes its tax year, it generally must receive permission from the IRS to change.

Example 1-13

Rick is a calendar-year taxpayer. What tax year must Rick use to report income from Green Acres?

Answer: Calendar year. This is true even though Rick began his business in May of this year. He will calculate income and expense for his landscaping business over the calendar year and include business income and deductions from May through December of this year on Schedule C of his individual tax return.

What if: Suppose that Rick incorporated Green Acres at the time he began his business. What tax year could Green Acres adopt?

Answer: If Green Acres was operated as a C corporation, it could elect a calendar year-end, a fiscal year-end, or a 52/53-week year-end. If it were an S corporation, it likely would use a calendar year-end. If Rick opted to have Green Acres adopt a calendar year-end, the first tax return for Green Acres would only cover the eight months from May through December (a short year).

LO 1-5

ACCOUNTING METHODS

Once a business adopts a tax year, it must determine which items of income and deduction to recognize during a particular year. Generally speaking, the taxpayer's **accounting methods** determine the tax year in which a business recognizes a particular item of income or deduction. Because accounting methods affect the *timing* of when a taxpayer reports income and deductions, these methods are very important for taxpayers using a timing tax strategy to defer income or accelerate deductions.[30]

[27]Businesses with inventories, such as retailers, can benefit from 52/53-week year-ends. These year-ends can facilitate inventory counts (e.g., the store is closed, such as over a weekend) and financial reporting.

[28]Virtually all individual taxpayers use a calendar-year tax year.

[29]See §706 for the specific restrictions on year-ends for partnerships and §1378 for restrictions on S corporations. If they can show a business purpose (a difficult task), both partnerships and S corporations can adopt year-ends other than those used by their owners.

[30]Accounting methods determine *when* income or deduction is recognized, but do not determine *whether* an item of income is taxable or an expense is deductible.

Financial and Tax Accounting Methods

Many businesses are required to generate financial statements for nontax business reasons. For example, publicly traded corporations must file financial statements with the Securities and Exchange Commission (SEC) based on generally accepted accounting principles (GAAP). Also, privately owned businesses borrowing money from banks are often required to generate financial statements under GAAP, so that the lender can evaluate the business's creditworthiness. In reporting financial statement income, businesses have incentives to select accounting methods permissible under GAAP that *accelerate income* and *defer deductions*.

In contrast, for tax planning purposes, businesses have incentives to choose accounting methods that *defer income* and *accelerate deductions*. This natural tension between financial reporting incentives and tax reporting incentives may be the reason the tax laws sometimes require businesses to use the same accounting methods for tax purposes that they use for financial accounting purposes. In other words, in many circumstances, if businesses want to defer taxable income, they must also defer book income.[31]

Sometimes the tax laws require businesses to use specific accounting methods for tax purposes regardless of what accounting method is used for financial reporting purposes. With certain restrictions, businesses first select their *overall* accounting method and then choose accounting methods for *specific* items or transactions.

Overall Accounting Method

Businesses must choose an overall method of accounting to track and report their business activities for tax purposes. The overriding requirement for all tax accounting methods is that the method must "clearly reflect income" and be applied consistently.[32] The two primary overall methods are the cash method and the accrual method. Although businesses are generally free to choose either the cash or accrual method, large C corporations (average gross receipts for the three prior years in excess of $26 million indexed for inflation) and large partnerships with C corporation partners are generally required to use the accrual method.[33] Businesses also may choose a hybrid method (some accounts on the cash method and others on the accrual method).

Cash Method A business using the cash method of accounting recognizes revenue when property or services are actually or constructively received. This is generally true no matter when the business sells the goods or performs the service that generates the revenue. Keep in mind that a cash-method business receiving payments in *noncash* form (as property or services) must recognize the noncash payments as gross income when the goods or services are received.

Likewise, a business adopting the cash method generally recognizes deductions when the expense is paid. Thus, the timing of the liability giving rise to the expense is usually irrelevant. For example, a cash method business would deduct office supply expense when payment is made rather when the supplies are ordered or received. Also, in certain circumstances, a business expending cash on ordinary and necessary business expenses may not be allowed to *currently* deduct the expense at the time of the payment. For example, cash-method taxpayers (and accrual-method taxpayers) are not allowed to deduct expenditures that create future benefits. Hence, a business must

[31]§446(a). Businesses that use different accounting methods for book and tax income must typically file a Schedule M-1 or Schedule M-3 that reconciles the results from the two accounting methods.

[32]§446(b).

[33]§448(c)(4) indexes for inflation the amount of average gross receipts for purposes of electing the cash method of accounting. Large C corporations and large partnerships with C corporation partners are generally required to use the accrual method. For purposes of this rule, any business that is not defined as a tax shelter can elect the cash method if average gross receipts do not exceed $26 million (discussed above) for the three-tax-year period ending with the prior tax year.

generally capitalize prepaid interest and other prepayments that create tangible or intangible assets.

However, it can be difficult and time-consuming for small businesses to capitalize the multitude of prepaid expenditures that create benefits for a relatively brief period of time. For this reason, regulations provide a **12-month rule** that simplifies the process of determining whether to capitalize or immediately expense payments that create benefits for a relatively brief period of time, such as insurance, security, rent, and warranty service contracts. When a business prepays business expenses, it may *immediately* deduct the prepayment if (1) the contract period does not last more than a year *and* (2) the contract period does not extend beyond the end of the taxable year following the tax year in which the taxpayer makes the payment.[34] If the prepaid expense does not meet both these criteria, the business must capitalize the prepaid amount and amortize it over the length of the contract whether the business uses the cash or accrual method of accounting.[35]

Example 1-14

On July 1 of this year, Rick paid $1,200 for a 12-month insurance policy that covers his business property from accidents and casualties from July 1 of this year through June 30 of next year. How much of the $1,200 expenditure may Rick deduct this year if he uses the cash method of accounting for his business activities?

Answer: $1,200. Because the insurance coverage does not exceed 12 months and does not extend beyond the end of next year, Rick is allowed to deduct the entire premium payment under the 12-month rule.

What if: Suppose the insurance policy was for 12 months but the policy ran from February 1 of next year, through January 31 of the following year. How much of the expenditure may Rick deduct this year if he uses the cash method of accounting for his business activities?

Answer: $0. Even though the contract period is 12 months or less, Rick is required to capitalize the cost of the prepayment for the insurance policy because the contract period extends beyond the end of next year.

What if: Suppose Rick had paid $1,200 for an *18-month* policy beginning July 1 of this year and ending December 31 of next year. How much may he deduct this year if he uses the cash method of accounting for his business activities?

Answer: $400. In this scenario, because the policy exceeds 12 months, Rick is allowed to deduct the portion of the premium pertaining to this year. Hence, this year, he would deduct $400 [(6 months/18 months) × $1,200]. He would deduct the remaining $800 in the next year.

Accrual Method Businesses using the accrual method to determine taxable income follow rules similar to GAAP with two basic differences.[36] First, the requirements for recognizing taxable income tend to be structured to recognize income earlier than the recognition rules for financial accounting. Second, the requirements for accruing tax deductions tend to be structured to recognize less accrued expenses than the recognition rules for financial reporting purposes. These differences reflect the underlying objectives of financial accounting income and taxable income. The objective of financial accounting is to provide useful information to stakeholders such as creditors, prospective investors, and shareholders. Because financial accounting methods are designed to guard against businesses overstating their profitability to these users, financial accounting tends to bias against *overstating* income. In contrast, the government's main objective for writing tax laws is to collect revenues. Thus, tax accounting rules for accrual-method businesses tend to bias against *understating* income.

[34]§263(a).

[35]This 12-month rule applies to both cash-method and accrual-method taxpayers. However, for accrual-method taxpayers to deduct prepaid expenses, they must meet both the 12-month rule requirements and the economic performance requirements discussed in the next section.

[36]Reg. §1.263(a)-4(f).

continued from page 1-1 . . .

Rick's CPA, Jane, informed him that he needs to select an overall method of accounting for Green Acres to compute its taxable income. Jane advised Rick to use the cash method. However, Rick wanted to prepare GAAP financial statements and use the accrual method of accounting. He decided that if Green Acres was going to become a big business, it needed to act like a big business. Finally, after much discussion, Rick and Jane reached a compromise. For the first year, they decided they would track Green Acres's business activities using both the cash *and* the accrual methods. In addition, they would also keep GAAP-based books for financial purposes. When filing time comes, Rick will need to decide which method to use in reporting taxable income. Jane told Rick that he could wait until he filed his tax return to select the overall accounting method for tax purposes. ■

Accrual Income

Businesses using the accrual method of accounting generally recognize income when they meet the all-events test.

All-Events Test for Income The all-events test requires that businesses recognize income when (1) all events have occurred that determine or fix their right to receive the income and (2) the amount of the income can be determined with reasonable accuracy.[37] Assuming the amount of income can be determined with reasonable accuracy, businesses meet the all-events requirement on the *earliest* of the following three dates:

1. When they complete the task required to earn the income. Businesses earn income for services as they provide the services, and they generally earn income from selling property when the title of the property passes to the buyer.
2. When the payment for the task is due from the customer.
3. When the business receives payment for the task.

Alternatively, the all-events test is deemed to be satisfied when an income item is recognized on an applicable financial statement, even if it has yet to satisfy any of the above three criteria.[38]

Example 1-15

In early fall, Rick contracted with a dozen homeowners to landscape their yards. Rick agreed to do the work for an aggregate of $11,000. Rick and his crew started in the fall and completed the jobs in December of this year. However, he didn't mail the bills until after the holidays and didn't receive any payments until the following January. When must Rick recognize the income from this work?

Answer: Under the accrual method, Rick would recognize the entire $11,000 as income this year because his right to the income is fixed at year-end, when Rick and his crew complete the work. Under the cash method, however, Rick would not recognize the $11,000 as income until next year, when he receives it.

Taxation of Advance Payments of Income (Unearned Income)

In some cases, businesses receive income payments *before* they actually earn the income (they receive a prepayment). When the business must recognize a prepayment as income depends on the type of income. The rule for interest and rental income is relatively strict. Businesses must recognize unearned rental and unearned interest income *immediately* upon receipt (the income is recognized before it is earned). However, businesses are not required to recognize security deposits received from rental customers because there is an

[37] Reg. §1.451-1(a).
[38] §451(b).

obligation to return unearned deposits.[39] The income recognition rules are less strict when businesses receive advance payments for services or goods.

> **THE KEY FACTS**
>
> **Revenue Recognition Under the Accrual Method**
>
> - Income is recognized when earned (all-events) or received (if earlier).
> - Under the all-events test, income is recognized when the business has the right to receive payment.
> - Taxpayers can generally elect to defer recognition of prepaid (unearned) income for goods and services, but the deferral only lasts for one year.

Advance Payments for Goods and Services For financial reporting purposes, a business does not immediately recognize income on payments it receives for services or goods to be provided in the future. The business recognizes the *financial* income from the services or sales as it performs the services or provides the goods. In contrast, for tax purposes, the all-events test generally requires businesses receiving advance payments for goods or services to recognize the income when they receive the payment, rather than when they deliver the goods or perform the services. This rule is sometimes called the full inclusion method.

The law provides an exception to immediate recognition. Specifically, businesses receiving advance payments for goods or services may elect to defer recognizing the advance payment as income until the tax year following the year they receive the payment.[40] This one-year deferral method does *not* apply (1) if (or to the extent to which) the income is actually earned by the end of the year of receipt, (2) to the extent that the advance payment was included in financial reporting income, or (3) if the advance payment was for interest or rent (taxpayers must recognize unearned interest and rental income upon receipt).

Example 1-16

In late November 2018, Rick received a $7,200 payment in advance from a client for monthly landscaping services from December 1, 2019, through November 30, 2021 ($300 a month for 24 months). When must Rick recognize the income from the advance payment for services?

Answer: Under the accrual method, if Rick elects the deferral method to account for advance payments, he would initially recognize the $300 income he earned in December 2019. In 2020, he would recognize the remaining $6,900 (rather than only the $3,600 related to 2020) because he is not allowed to defer the prepayments for more than a year. If Rick does not elect the deferral method, he would recognize the entire prepayment of $7,200 as income upon receipt in 2019. Under the cash method, Rick would recognize the entire prepayment, $7,200, as income upon receipt in 2019.

What if: Suppose that rather than receiving payment in advance for services, Rick's client paid $7,200 in 2019 for landscape supplies that Rick purchased and provided in 2020. When must Rick recognize the income from the advance payment for goods?

Answer: Using the accrual method, if Rick elects the deferral method to account for advance payments, he would not recognize any income in 2019 because none of the income had been earned in 2019. Rick would then recognize the entire $7,200 (less the cost of the goods) in 2020. If Rick did not elect the deferral method, he would recognize the entire $7,200 in 2019. Under the cash method, Rick would recognize the entire $7,200 in 2019.

Inventories

Many businesses generate income by selling products they acquire for resale or products they manufacture. When selling inventory is a material income-producing factor, larger businesses generally must account for gross profit (sales minus cost of goods sold) using the accrual method, even if the business is a cash-method taxpayer. However, taxpayers need not use the accrual method to account for inventory if they report average gross receipts of $26 million (indexed for inflation) or less for the three-tax-year period ending with the prior tax year. Instead, under §471(c)(1)(B) these taxpayers can generally treat purchases of goods for sale as non-incidental materials and deduct the cost as the materials are used. Alternatively, taxpayers can use an accounting method that conforms to the taxpayer's financial accounting treatment of inventory.

Businesses that account for inventory must determine their inventory costs to accurately compute taxable income. This requires businesses to maintain records of balances

[39] *Comm. v. Indianapolis Power & Light Co*. (1990), 493 US 203. In this case, it was determined that customer deposits required by a public utility weren't taxable income because the right to keep the deposits depended on events outside of the taxpayer's control, such as the decision to have the deposit applied to future bills.

[40] §451(c)(1)(B). Prior to 2018, this exception was provided under Rev. Proc. 2004-34.

for finished goods inventory and, if applicable, for partially finished goods and raw materials. Inventory costs include the purchase price of raw materials (minus any discounts), shipping costs, and any indirect costs it allocates to the inventory under the **uniform cost capitalization (UNICAP) rules.**[41]

THE KEY FACTS

Inventories

- Businesses with three-year average annual gross receipts in excess of $26 million must use the accrual method to account for substantial inventories.
- The UNICAP rules require capitalization of most indirect costs of production.
- The LIFO method is allowed if also used for financial reporting purposes.

Uniform Capitalization

The tax laws require large businesses that account for inventories to capitalize certain direct and indirect costs associated with inventories.[42] Congress enacted these rules primarily for two reasons. First, the rules accelerate tax revenues for the government by deferring deductions for the capitalized costs until the business sells the associated inventory. Thus, there is generally a one-year lag between when businesses initially capitalize the costs and when they deduct them. Second, Congress designed the "uniform" rules to reduce variation in the costs businesses include in inventory and Congress intended these provisions to apply to large manufacturers and resalers.[43]

Under these uniform cost capitalization rules, large businesses are generally required to capitalize more costs to inventory for tax purposes than they capitalize under financial accounting rules. Under GAAP, businesses generally include in inventory only those costs incurred within their production facility. In contrast, the UNICAP rules require businesses to allocate to inventory the costs they incur inside the production facility and the costs they incur outside the facility to support production (or inventory acquisition) activities. For example, under the UNICAP provisions, a business must capitalize at least a portion of the compensation paid to employees in its purchasing department, general and administrative department, and even its information technology department, to the extent these groups provide support for the production process. In contrast, businesses immediately expense these items as period costs for financial accounting purposes. The regulations provide guidance on the costs that must be allocated to inventory. Selling, advertising, and research are specifically identified as costs that do not have to be allocated to inventory under the UNICAP provisions.[44]

Example 1-17

What if: Green Acres sells trees but Rick anticipates selling flowers, shrubs, and other plants in future years. Ken is Rick's employee in charge of purchasing inventory. Ken's compensation this year is $30,000, and Rick estimates that Ken spends about 5 percent of his time acquiring inventory and the remaining time working on landscaping projects. Assuming Rick was required to apply the UNICAP rules, how would he allocate Ken's compensation under the UNICAP rules?

Answer: If the UNICAP rules applied to Green Acres, Rick would allocate $1,500 ($30,000 × 5%) of Ken's compensation to the cost of the inventory Green Acres acquired this year. In contrast, Ken's entire salary would be expensed as a period cost for financial accounting purposes. (Note, however, because Green Acres's average annual gross receipts are under $26 million for the prior three years, it is not *required* to apply the UNICAP rules.)

Inventory Cost-Flow Methods

Once a business determines the cost of its inventory, it must use an inventory cost-flow method to determine its cost of goods sold. Three primary cost-flow methods are (1) the **first-in, first-out (FIFO) method,** (2) the **last-in, first-out (LIFO) method,** and (3) the **specific identification method.** Businesses might be inclined to use FIFO or LIFO methods when they sell similar, relatively low-cost, high-volume products such as cans of soup or barrels of oil. These methods simplify inventory accounting because the business need not track the individual cost of each item it sells. In contrast, businesses that sell distinct, relatively high-cost, low-volume products might be more likely to adopt the specific identification method. For example, jewelry

[41]Inventory valuation allowances are generally not allowed, but taxpayers can adopt the lower of cost or market method of inventory valuation. In addition, under certain conditions specific goods not salable at normal prices can be valued at bona fide selling prices less direct cost of disposition.

[42]§263A(a). Large is defined using the gross receipts test.

[43]Like the rule for electing cash method accounting and inventory accounting, a business need not employ UNICAP to adjust inventory costs if it reports average gross receipts of $26 million or less for the three-tax-year period ending with the prior tax year.

[44]Reg. §1.263A–1(e)(3)(iii).

and used-car businesses would likely use the specific identification method to account for their cost of sales. In general terms, when costs are increasing, a business using the FIFO method will report a higher gross margin than if it used the LIFO method. The opposite is true if costs are decreasing.

Example 1-18

In late August, Rick purchased 10 oak saplings (immature trees) for a total purchase price of $3,000. In September, he purchased 12 more for a total price of $3,900, and in late October, he purchased 15 more for $5,000. The total cost of each lot of trees was determined as follows:

Purchase Date	Trees	Direct Cost	Other Costs	Total Cost
August 20	10	$ 3,000	$200	$ 3,200
September 15	12	3,900	300	4,200
October 22	15	5,000	400	5,400
Totals	37	$11,900	$900	$12,800

Before the end of the year, Green Acres sold 20 of the oak saplings (5 from the August lot, 5 from the September lot, and 10 from the October lot) for cash. To illustrate the effects of inventory accounting, assume that Rick prefers to keep inventory records (recall that taxpayers are not required to keep inventories for tax purposes if their average annual gross receipts are under $26 million for the prior three years). What is Green Acres's gross profit from sales of oak saplings if the sales revenue totaled $14,000 (all collected by year-end), and what is its ending oak sapling inventory under the FIFO, LIFO, and specific identification cost-flow methods?

Answer: Under the accrual method, Green Acres's gross profit from sapling sales and its ending inventory balance for the remaining oak saplings under the FIFO, LIFO, and specific identification cost-flow methods is as follows:

	FIFO	LIFO	Specific ID
Sales	$14,000	$14,000	$14,000
Cost of goods sold	−6,700	−7,150	−6,950
Gross profit	$ 7,300	$ 6,850	$ 7,050
Ending inventory:			
August 20 trees	$ 0	$ 3,200	$ 1,600
September 15 trees	700	2,450	2,450
October 22 trees	5,400	0	1,800
Total ending inventory	**$ 6,100**	**$ 5,650**	**$ 5,850**

Because Green Acres is a small business, it is allowed to elect to deduct the cost of purchases as nonincidental materials and supplies. Hence, Rick could deduct the $12,800 as the materials are used. However, if Rick elects to keep an inventory of his trees for financial accounting purposes, he would be entitled to choose his inventory method (LIFO, FIFO, or specific identification) and use the same method to calculate the cost of goods sold for tax purposes.

When costs are subject to inflation over time, a business would get the best of both worlds if it adopted the FIFO method for financial reporting purposes and the LIFO method for tax purposes. Not surprisingly, the tax laws require that a business can use LIFO for tax purposes only if it also uses LIFO for financial reporting purposes.[45] While this "conformity" requirement may not matter to entities not required to generate financial reports, it can be very restrictive to publicly traded corporations.

Accrual Deductions

Generally, when accrual-method businesses incur a liability relating to a business expense, they account for it by crediting a liability account (or by crediting cash if they pay the liability at the time they incur it) and debiting an expense account. However, to claim

[45] §472(c).

a tax deduction for the expense, the expense must meet (1) an **all-events test** *and* (2) an **economic performance test.**[46] While the all-events test for recognizing deductions is similar to the all-events test for recognizing income, the additional economic performance requirement makes the deduction recognition rules more stringent than the income recognition rules. As a result, businesses are generally prohibited from deducting estimated expenses or reserves.

For a business to recognize a deduction, the events that establish the liability giving rise to the deduction must have occurred, and the amount of the liability must be determinable with reasonable accuracy.[47]

All-Events Test for Deductions

TAXES IN THE REAL WORLD The All-Events Test and Rebates

In a Technical Advice Memorandum (TAM 201223015), an IRS field agent requested advice on applying the all-events test. The taxpayer was a manufacturer who paid rebates to customers under a special rule for premium coupons issued with sales, and the question was whether the rebates were deductible at the time of the sale or later when the rebate was paid. Under the sales agreements, customers agreed to pay the list price of a product, and the manufacturer agreed to pay the customers trade promotion rebates (the coupons) based on the number of products purchased. The manufacturer used a computer software system to track the coupons, but most customers had to request the rebates in writing. Furthermore, customers had one year from the date of an invoice to claim a rebate, and the sales agreements contained a minimum purchase requirement to qualify for the rebates.

The manufacturer argued that the rebate liabilities were fixed and determinable when customers purchased the goods. In contrast, the IRS field agent asserted that the rebate liabilities were not fixed and determinable until customers submitted claim forms and substantiation to the manufacturer to request the rebate. The agent argued that the requirement to file a claim is a condition precedent that delays satisfaction of the all-events test. The courts have been divided on this issue, with some courts holding that the filing of a claim is a mere technicality that does not prevent a deduction at the time of sale. Other times courts have required a claim because rebates are not required until the terms of the sales contract are met.

In this situation, the IRS national office noted that the manufacturer had paid rebates to customers who submitted claims after the one-year deadline and paid rebates to customers even if they did not meet the minimum purchase amounts. This practice indicated that the submission of claim forms was a ministerial act, a mere technicality. Further, the IRS determined that the amount of the manufacturer's rebate liabilities was determinable with reasonable accuracy at the time the customers purchased the goods because the manufacturer had all of the information it needed to calculate the rebates. Hence, the national office ruled that the manufacturer's liability to pay the rebates arose when the customers purchased the goods and the estimated rebates met the all-events test.

Example 1-19

On November 1st of this year, Rick agreed to a one-year $6,000 contract with Ace Advertising to produce a radio ad campaign. Ace agreed that Rick would owe nothing under the contract unless his sales increase a minimum of 25 percent over the next six months. What amount, if any, may Rick deduct this year for this contract under the accrual and cash methods?

Answer: Under the accrual method, Green Acres is not allowed to recognize *any* deduction this year for the liability. Even though Ace will have completed two months of advertising for Green Acres by the end of the year, the guarantee means that Rick's liability is not fixed until and unless his sales increase by 25 percent. Under the cash method, Rick would not deduct any of the cost of the campaign this year because he has not paid anything to Ace.

[46]§461(h).
[47]§461.

THE KEY FACTS

Accrual of Business-Expense Deductions

- Both all-events and economic performance are required for deducting accrued business expenses.
- The all-events test requires that the business be liable for the payment.
- Economic performance generally requires that the underlying activity generating the liability has occurred in order for the associated expense to be deductible.

Economic Performance Even when businesses meet the all-events test, they still must clear the economic performance hurdle to recognize the tax deduction. Congress added the economic performance requirement because in some situations taxpayers claimed current deductions and delayed paying the associated cash expenditures for years. Thus, the delayed payment reduced the real (present value) cost of the deduction. This requirement specifies that businesses may not recognize a deduction for an expense until the underlying activity generating the associated liability has occurred. Thus, an accrual-method business is not allowed to deduct a prepaid business expense even if it qualifies to do so under the 12-month rule (discussed above) unless it also has met the economic performance test with respect to the liability associated with the expense.

The specific requirements for the economic performance test differ based on whether the liability has arisen from:

- Receiving goods or services *from* another person.
- Use of property (renting or leasing property *from* another person).
- Providing goods or services *to* another person.
- Certain activities creating **payment liabilities.**

Receiving goods and (or) services from another person. When a business receives goods or services from another person, the business deducts the expense associated with the liability only when the other person provides the goods or services (assuming the all-events test is met for the liability). An exception to this general rule occurs when a business hires another person to provide goods or services and the business actually pays the liability before the other person provides the goods or services. In this circumstance, the business may treat the actual payment as economic performance as long as it reasonably expects the other person to provide the goods or the services within three and one-half months after the payment.[48]

Example 1-20

On December 15, 2019, Rick hires Your New Fence LLC (YNF) to repair a concrete wall for one of his clients by paying $1,000 of the cost as a down payment and agreeing to pay the remaining $7,000 when YNF finishes the wall. YNF was not going to start working on the wall until early 2020, so as of the end of the year Rick has not billed his client for the wall. Rick expects YNF to finish the repairs by the end of April. What amount associated with his liability to YNF is Rick allowed to deduct in 2019 and 2020?

Answer: Under the accrual method, Rick is not entitled to a deduction in 2019. Rick will deduct his full $8,000 cost of the wall in 2020 when YNF repairs the wall, because economic performance occurs as YNF provides the services, even though Rick paid for part of the goods and services in 2019. Under the cash method, Rick would deduct $1,000 (his down payment) in 2019 and the remainder in 2020 when he pays the remainder on the contract.

What if: Assume that Rick expected YNF to finish repairing the wall by the end of January 2020. What amount associated with this liability to YNF is Rick allowed to deduct in 2019 and 2020?

Answer: Under the accrual method, Rick is allowed to deduct $1,000 in 2019 because Rick actually paid this amount in 2019 and he reasonably expected YNF to finish its work on the wall within 3½ months after he made the payment to YNF on December 15. Rick would deduct the remaining $7,000 cost of the wall in 2020 when YNF builds the wall. Under the cash method, Rick deducts the $1,000 down payment in 2019 and the remaining $7,000 when he makes the payment in 2020.

Renting or leasing property from another person. When a business enters into an agreement to use property (rent or lease property) from another person, economic performance occurs over the term of the lease. Thus, the business is allowed to deduct the rental expense over the term of the lease.

[48]Reg. §1.461-4(d)(6).

Example 1-21

On May 1, 2019, Rick paid $7,200 in advance to rent his shop for 12 months ($600 per month). What amount may Rick deduct for rent in 2019 if he accounts for his business activities using the accrual method?

Answer: $4,800 ($600 × 8 months use). Even though the rent is a prepaid business expense under the 12-month rule (the contract period is for 12 months and the contract period does not extend beyond 2020), he must deduct the rent expense over the term of the lease because that is when economic performance occurs.

What if: Assuming the original facts, what amount of the $7,200 rental payment may Rick deduct in 2019 if he is using the cash method of accounting for his business?

Answer: $7,200. In this case, Rick may deduct the expense under the 12-month rule. He does not have to meet the economic performance requirement to deduct the expense because the economic performance requirements apply to accrual-method taxpayers, but not cash-method taxpayers.

Example 1-22

On November 1, 2019, Rick paid $2,400 to rent a trailer for 24 months. What amount of this payment may Rick deduct and when may he deduct it?

Answer: Under the accrual method, even though Rick paid the entire rental fee in advance, economic performance occurs over the 24-month rental period. Thus, Green Acres deducts $200 for the trailer rental in 2019, $1,200 in 2020, and $1,000 in 2021. Because the rental period exceeds 12 months, the amount and timing of the deductions are the same under the cash method.

Providing goods and services to another person. Businesses liable for providing goods and services to other persons meet the economic performance test as they provide the goods or services that satisfy the liability.

Example 1-23

In the summer, Rick landscaped a city park. As part of this service, Rick agreed to remove a fountain from the park at the option of the city parks committee. In December 2019, the committee decided to have Rick remove the fountain. Rick began the removal in December and paid an employee $850 on December 31 for working the last two weeks of 2019. Rick completed the removal work in the spring of 2020 and paid an employee $685 on March 31. What amounts will Rick deduct for the removal project and when may he deduct them?

Answer: Under the accrual method, Rick is allowed to deduct his costs as he provides the services. Consequently, in 2019 Rick can deduct $850 for the cost of the services provided by his employee in 2019. In 2020, Rick can deduct the remaining $685 cost of the services provided by his employee in 2020. Under the cash method, the amount and timing of his deductions would be the same as under the accrual method.

Payment liabilities. Economic performance occurs for certain liabilities only when the business actually pays the liability. Thus, accrual-method businesses incurring payment liabilities are essentially on the cash method for deducting the associated expenses. Exhibit 1-2 describes different categories of these payment liabilities.

EXHIBIT 1-2 Categories of Payment Liabilities

Economic performance occurs when the taxpayer pays liabilities associated with:

- Workers' compensation, tort, breach of contract, or violation of law.
- Rebates and refunds.
- Awards, prizes, and jackpots.
- Insurance, warranties, and service contracts provided *to* the business. (*Note:* This relates to insurance, warranties, and product service contracts that cover the taxpayer and *not* a warranty that the taxpayer provides to others.)
- Taxes.[49]
- Other liabilities not provided for elsewhere.

[49]While taxes are generally not deducted until they are paid, §461(c) allows businesses to elect to accrue the deduction for real property taxes ratably over the tax period instead of deducting them when they actually pay them.

Accrual-method taxpayers that prepay business expenses for payment liabilities (insurance contracts, warranties, and product service contracts provided to the taxpayer) that qualify as recurring items are allowed to immediately deduct the prepayments subject to the 12-month rule for prepaid expenses. Thus, the deductible amounts for Rick's prepaid insurance contracts in Example 1-14 are the same for both the cash method and accrual method of accounting. Exhibit 1-3 describes the requirements for economic performance for the different types of liabilities.

EXHIBIT 1-3 **Economic Performance**

Taxpayer incurs liability from	Economic performance occurs
Receiving goods and services *from* another person.	When the goods or services are provided to the taxpayer or with payment if the taxpayer reasonably expects actual performance within 3½ months.
Renting or leasing property *from* another person.	Ratably over the time period during which the taxpayer is entitled to use the property or money.
Providing goods and services *to* another person.	When the taxpayer incurs costs to satisfy the liability or provide the goods and services.
Activities creating "payment" liabilities.	When the business actually makes payment.
Interest expense.	As accrued. This technically does not fall within the economic performance rules but it is a similar concept.

Recurring item exception. One of the most common exceptions to economic performance is the **recurring item** exception. This exception is designed to reduce the administrative cost of applying economic performance to expenses that occur on a regular basis. Under this exception, accrual method taxpayers can deduct certain accrued expenses even if economic performance has not occurred by year-end.[50] A recurring item is a liability that is expected to recur in future years and is either not material in amount or deducting the expense more properly matches with revenue. Payment liabilities, such as insurance, rebates, and refunds, are deemed to meet the matching requirement.[51] In addition, the all-events test must be satisfied at year-end and actual economic performance of the item must occur within a reasonable time after year-end (but prior to the filing of the tax return, which could be up to 8½ months after year end with an extension). As a final note, the recurring item exception does not apply to workers' compensation or tort liabilities.

Example 1-24

If clients are not completely satisfied with Green Acres's landscaping work, Rick offers a $200 refund with no questions asked. Near the end of 2019, Rick had four clients request refunds. Rick incurred the liability for the refunds this year. However, Rick was busy during the holiday season, so he didn't pay the refunds until January 2020. When should Rick deduct the customer refunds?

Answer: Because refunds are payment liabilities, economic performance does not occur until Rick actually pays the refunds. Consequently, Rick deducts the $800 of refunds in 2020 even though the liability for the refunds met the all-events test in 2019. Under the cash method, Rick would not deduct the refunds until he paid them in 2020.

What if: Suppose that Rick received $800 of refund requests at year-end. Under what conditions could Rick deduct the refunds in 2019 if he elects to use accrual accounting?

Answer: To claim $800 of deductions for the refunds in 2019, either the accrued refunds must not be material in amount or a 2019 deduction must better match 2019 revenue than 2020 revenue. Rick doesn't need to worry about the matching requirement. Under the regulations, refunds are deemed to meet the matching requirement for purposes of the recurring item exception. Also, actual economic performance (payment) must occur within a reasonable time after year-end (but not longer than 8½ months or the filing of the tax return). Note also that Rick must elect to deduct the refunds in 2019 using the recurring item exception and then follow this method in future periods.

[50]§461(h)(3).

[51]Reg §1.461-5(b)(5)(ii).

Bad Debt Expense When accrual method businesses sell a product or a service on credit, they debit accounts receivable and credit sales revenue for both financial and tax purposes. However, because businesses usually are unable to collect the full amount of their accounts receivable, they incur bad debt expense (a customer owes them a debt that the customer will not pay). For financial reporting purposes, the business estimates the amount of the bad debt, debits bad debt expense, and credits an allowance for doubtful accounts. However, for tax purposes, businesses are allowed to deduct bad debt expense only when the debt actually becomes worthless within the taxable year.[52] Consequently, for tax purposes, businesses determine which debts are uncollectible and write them off by debiting bad debt expense and directly crediting the actual account receivable account that is uncollectible. This required method of determining bad debt expense for tax purposes is called the **direct write-off method.** In contrast, the method used for financial reporting purposes is called the **allowance method.** Businesses reporting taxable income on the cash method of accounting are *not* allowed to deduct bad debt expenses, because they do not include receivables in taxable income (they do not credit revenue until they actually receive payment).

Example 1-25

At year-end, Rick estimates that about $900 of the receivables from his landscaping services will be uncollectible, but he has identified only one client, Jared, who will definitely not pay his bill. Jared, who has skipped town, owes Rick $280 for landscaping this fall. What amount of bad debt expense may Rick deduct for the year?

Answer: For financial reporting purposes, Rick recognizes a $900 bad debt expense. However, for tax purposes, under the accrual method, Rick can deduct only $280—the amount associated with specifically writing off Jared's receivable. Under the cash method, Rick would not be able to claim any deduction, because he did not receive a payment from Jared and thus did not recognize income on the amount Jared owed him.

Limitations on Accruals to Related Persons To prevent businesses and related persons from working together to defer taxes, the tax laws prevent an accrual-method business from accruing (and deducting) an expense for a liability owed to a related person using the cash method until the related person recognizes the income associated with the payment.[53] For this purpose, related persons include:

- Family members, including parents, siblings, and spouses.
- Shareholders and C corporations when the shareholder owns more than 50 percent of the corporation's stock.[54]
- Owners of partnerships and S corporations no matter the ownership percentage.[55]

This issue frequently arises in situations in which a business employs the owner or a relative of an owner. The business is not allowed to deduct compensation expense owed to the related person until the year in which the related person includes the compensation in income. However, this related-person limit extends beyond compensation to any accrued expense the business owes to a related cash-method taxpayer.

Example 1-26

In December, Rick asked his retired father, Lee, to help him finish a landscaping job. By the end of 2019, Rick owed Lee $2,000 of (reasonable) compensation for his efforts, which he paid in January 2020. What amount of this compensation may Rick deduct and when may he deduct it?

(*continued on page 1-26*)

[52]§166(a).
[53]§267(a).
[54]Certain constructive ownership rules apply in determining ownership percentages for this purpose. See §267(c).
[55]See §267(b) for related-person definitions.

Answer: If Rick uses the accrual method and Lee the cash method, Rick will not be able to deduct the $2,000 compensation expense until 2020. Rick is Lee's son, so Rick and Lee are "related" persons for tax purposes. Consequently, Rick can deduct the compensation only when Lee includes the payment in his taxable income in 2020. If Rick uses the cash method, he will deduct the expense when he pays it in January 2020.

Comparison of Accrual and Cash Methods

From a business perspective, the two primary advantages of adopting the cash method over the accrual method are that (1) the cash method provides the business with more flexibility to time income and deductions by accelerating or deferring payments (timing tax planning strategy) and (2) bookkeeping for the cash method is easier. For example, a cash-method taxpayer could defer revenue by waiting to bill clients for goods or services until after year-end, thereby increasing the likelihood that customers would send payment after year-end. There are some concerns with this tax strategy. For example, delaying the bills might increase the likelihood that the customers will not pay their bills at all.

The primary advantage of the accrual method over the cash method is that it better matches revenues and expenses. For that reason, external financial statement users who want to evaluate a business's financial performance prefer the accrual method. Consistent with this idea, the cash method is not allowed for financial reporting under GAAP.

Although the cash method is by far the predominate accounting method among sole proprietors, it is less common in other types of businesses. As we noted previously, tax laws generally prohibit large C corporations and large partnerships with corporate partners from using the cash method of accounting.[56] Exhibit 1-4 details the basic differences in accounting for income and deductions under the accrual and cash methods of accounting.

EXHIBIT 1-4 Comparison of Cash and Accrual Methods

Income or Expense Item	Cash Method	Accrual Method
Income recognition.	Actually or constructively received.	Taxable once the all-events test is satisfied.
Unearned rent and interest income.	Taxable on receipt.	Taxable on receipt.
Advance payment for goods and services.	Taxable on receipt.	Taxed when received or taxpayers can elect to be taxed in the following year of receipt if not earned by end of year of receipt.
General deduction recognition.	Deduct when paid; economic performance does not apply.	Deduct once all-events test and economic performance test are both satisfied.
Expenditures for tangible assets with a useful life of more than one year.	Capitalize and apply cost recovery.	Same as the cash method.
Expenditures for intangible assets other than prepaid business expenses.	Capitalize and amortize if provision in code allows it.	Same as the cash method.
Prepaid business expenses.	Immediately deductible. However, amortize if contract period exceeds 12 months or extends beyond the end of the next taxable year.	Same as cash method for payment liabilities; otherwise, apply all-events and economic performance tests to ascertain when to capitalize and amortize.
Prepaid interest expense.	Not deductible until interest accrues.	Same as the cash method.
Bad debt expense.	Not deductible because sales on account not included in income.	Deduct under direct write-off method.

[56]Recall that these entities are able to adopt the cash method if their average annual gross receipts for the three tax years ending with the prior tax year do not exceed $26 million (indexed for inflation, see §448(c)).

Example 1-27

At year-end, Rick determined that Green Acres had collected a total of $78,000 of service revenue and $12,575 in other expenses (not described elsewhere in examples but listed in Exhibit 1-5). Rick is debating whether to adopt the cash or accrual method. To help him resolve his dilemma, Jane calculates Green Acres's taxable income under the cash and accrual methods assuming that Rick elects not to maintain an inventory (summarized in Exhibit 1-5). What are the differences between the two calculations?

Answer: Jane provided the following summary of the differences between taxable income under the cash method and taxable income under the accrual method:

Description	(1) Accrual	(2) Cash	(1) − (2) Difference	Example
Revenue:				
Credit sales	11,000	0	+11,000	1-15
Prepaid revenue	300	7,200	−6,900	1-16
Expenses:				
Prepaid services	0	−1,000	+1,000	1-20
Prepaid rent expense	−4,800	−7,200	+2,400	1-21
Bad debts	−280	0	−280	1-25
Total difference (accrual income > cash income)			**+ 7,220**	

After comparing the revenue and expenses recognized under the two accounting methods, Jane explains that the selection of the accrual method for Green Acres means that Rick will be taxed on an additional $7,220 of income this year.

The business income for Green Acres under the accrual and cash methods is summarized in Exhibit 1-5. After reflecting on these numbers and realizing that he would recognize $7,220 more taxable income (and self-employment income subject to self-employment tax) this year under the accrual method, Rick determined that it made sense to instead adopt the cash method of accounting for Green Acres's first tax return. Meanwhile, he knew he had to include Green Acres's business income on Schedule C of his individual tax return. Exhibit 1-6 presents Rick's Schedule C for Green Acres using the cash method of accounting.

Adopting an Accounting Method

We've seen that businesses use overall accounting methods (cash, accrual, or hybrid) and many specific accounting methods (inventory cost-flow assumption, methods of accounting for prepaid income for goods and services, and methods for accounting for prepaid expenses, among other methods) to account for their business activities. For tax purposes, it's important to understand how and when a business technically adopts an accounting method, because once it does so, it must get the IRS's permission to change the method.

Businesses generally elect their accounting methods by using them on their tax returns. However, when the business technically adopts a method depends on whether it is a **permissible accounting method** or an **impermissible accounting method.** So far, our discussion has emphasized accounting methods permissible under the tax laws. A business adopts a permissible accounting method by using and reporting the tax results of the method for at least one year. However, businesses may unwittingly (or intentionally) use impermissible accounting methods. For example, a business using the allowance method for determining bad debt expense for tax purposes is using an impermissible accounting method because the tax laws prescribe the use of the direct write-off method for determining bad debt expense. A business adopts an impermissible method by using and reporting the results of the method for two consecutive years.

EXHIBIT 1-5 **Green Acres's Net Business Income**

Description	Cash	Accrual	Example
Income			
Service revenue:			
Landscaping revenue	$78,000	$ 78,000	1-27
December landscape service	0	11,000	1-15
Prepaid landscape services	7,200	300	1-16
Sales of inventory:			
Tree sales	14,000	14,000	1-18
Gross Profit	**$99,200**	**$103,300**	
Nonincidental materials and supplies	$12,800	$ 12,800	1-18
Car and truck expense:			
SUV operating expense	5,335	5,335	1-7
BMW operating expense	306	306	1-9
Insurance	1,200	1,200	1-14
Rent:			
Shop	7,200	4,800	1-21
Trailer	200	200	1-22
Travel and business meals:			
Travel to NY seminar	1,435	1,435	1-8
Business dinner with clients	270	270	1-6
Wages and subcontractor fees:			
Part-time employees	23,000	23,000	1-2
Full-time employee (Ken)	30,000	30,000	1-17
Fountain removal (part-time employee)	850	850	1-23
Fence installation (prepaid subcontractor)	1,000	0	1-20
Other expenses:			
Books for waiting room	50	50	1-1
Education—seminar	300	300	1-8
Uniforms	500	500	1-5
Bad debts	0	280	1-25
Other expenses (not in examples):			
Advertising	1,160	1,160	
Depreciation	4,000	4,000	
Interest	300	300	
Legal and professional services	1,040	1,040	
Office expense	1,500	1,500	
Repairs and maintenance	1,975	1,975	
Taxes and licenses	400	400	
Utilities	2,200	2,200	
Total deductions	**$97,021**	**$ 93,901**	
Net Business Income	**$ 2,179**	**$ 9,399**	

Changing Accounting Methods

Once a business has adopted an accounting method, it must generally receive permission to change the method, regardless of whether it is a permissible or an impermissible method.[57] A taxpayer requests permission to change accounting methods by filing Form 3115 with the IRS. The IRS automatically approves certain types of accounting method

[57]For tax years beginning after 2017, there is a special exception for taxpayers who change accounting methods under the $26 million (indexed for inflation) average gross receipts test either by switching to the cash method or who opt to treat purchases of goods for sale as non-incidental materials. These changes in accounting method are treated as initiated by the taxpayer and no longer need the consent of the Secretary.

EXHIBIT 1-6 Green Acres Schedule C

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)

▶ **Go to *www.irs.gov/ScheduleC* for instructions and the latest information.**
▶ **Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.**

OMB No. 1545-0074
2018
Attachment Sequence No. **09**

Name of proprietor: RICK GRIME
Social security number (SSN): 000-00-0000

A Principal business or profession, including product or service (see instructions): LANDSCAPING
B Enter code from instructions ▶ 5 7 1 6 3 0

C Business name. If no separate business name, leave blank.: GREEN ACRES LANDSCAPING
D Employer ID number (EIN) (see instr.): 0 0 0 0 0 0 0 0 0

E Business address (including suite or room no.) ▶ BUCKSNORT STREET
City, town or post office, state, and ZIP code: SAN ANTONIO, TX 78208

F Accounting method: **(1)** ☑ Cash **(2)** ☐ Accrual **(3)** ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2018? If "No," see instructions for limit on losses . ☑ **Yes** ☐ **No**

H If you started or acquired this business during 2018, check here ▶ ☑

I Did you make any payments in 2018 that would require you to file Form(s) 1099? (see instructions) ☐ **Yes** ☑ **No**

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

Part I Income

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked ▶ ☐	1	99,200
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	99,200
4	Cost of goods sold (from line 42)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	99,200
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	99,200

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

8	Advertising	8	1,160	18	Office expense (see instructions)	18	1,500
9	Car and truck expenses (see instructions)	9	5,641	19	Pension and profit-sharing plans	19	
				20	Rent or lease (see instructions):		
10	Commissions and fees	10		a	Vehicles, machinery, and equipment	20a	7,400
11	Contract labor (see instructions)	11	1,000	b	Other business property	20b	
12	Depletion	12		21	Repairs and maintenance	21	1,975
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	4,000	22	Supplies (not included in Part III)	22	12,800
				23	Taxes and licenses	23	400
				24	Travel and meals:		
14	Employee benefit programs (other than on line 19)	14		a	Travel	24a	1,435
15	Insurance (other than health)	15	1,200	b	Deductible meals (see instructions)	24b	270
16	Interest (see instructions):			25	Utilities	25	2,200
a	Mortgage (paid to banks, etc.)	16a	300	26	Wages (less employment credits)	26	53,850
b	Other	16b		27a	Other expenses (from line 48)	27a	850
17	Legal and professional services	17	1,040	b	**Reserved for future use**	27b	

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27a ▶	28	97,021
29	Tentative profit or (loss). Subtract line 28 from line 7	29	2,179
30	Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). **Simplified method filers only:** enter the total square footage of: (a) your home: ______ and (b) the part of your home used for business: ______ . Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Schedule 1 (Form 1040), line 12** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2**. (If you checked the box on line 1, see instructions). Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32.	31	2,179

32 If you have a loss, check the box that describes your investment in this activity (see instructions).

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

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

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11334P **Schedule C (Form 1040) 2018**

Source: Form 1040.

changes, but for others the business must provide a good business purpose for the change and pay a fee. The IRS also requires permission when a business must change from using an impermissible method; this requirement helps the IRS to certify that the business properly makes the transition to a permissible method. In essence, the IRS requires the business to report its own noncompliance. Why would a business do so? Besides complying with the tax laws, a business might report its own noncompliance to receive leniency from the IRS. Without getting into the details, the IRS is likely to assess fewer penalties and less interest expense for noncompliance when the business reports the noncompliance before the IRS discovers it on its own.

Tax Consequences of Changing Accounting Methods When a business changes from one accounting method to another, the business determines its taxable income for the year of change using the new method. Furthermore, the business must make an adjustment to taxable income that effectively represents the cumulative difference, as of the beginning of the tax year, between the amount of income (or deductions) recognized under the old accounting method and the amount that would have been recognized for all prior years if the new method had been applied. This adjustment is called a **§481 adjustment.** The §481 adjustment prevents the duplication or omission of items of income or deduction due to a change in accounting method. If the §481 adjustment increases taxable income, the taxpayer recognizes the total adjustment spread evenly over four years beginning with the year of the change (25 percent of the full adjustment each year).[58] If the adjustment decreases taxable income, the taxpayer recognizes it entirely in the year of change.[59]

Example 1-28

What if: Suppose that at the end of 2019, Green Acres has $24,000 of accounts receivable. Assuming Green Acres uses the cash method of accounting in 2019, it would not include the $24,000 of receivables in income in determining its 2019 taxable income. Suppose further that Rick decides to switch Green Acres to the accrual method of accounting in 2020 by filing a Form 3115 and receiving permission from the IRS. What is Rick's annual adjustment for his change in accounting method from the cash to the accrual method?

Answer: $24,000 increase to income and because this adjustment is income-increasing, the total is spread evenly over four years ($6,000 in 2020 and each of the subsequent three years). Since Rick would use the accrual method in 2020, he would *not* include payments he receives for the $24,000 receivables as income because he earned this income in 2019 (not 2020). Instead, Rick would be required to make a §481 adjustment to ensure that he does not *omit* these items from taxable income. His total §481 adjustment is to increase income by $24,000. Because this is an income-increasing adjustment, Rick includes $6,000 of the adjustment (25 percent) in Green Acres's taxable income in 2020. He would likewise include a $6,000 income-increasing annual adjustment in each of the subsequent three years.

What if: Suppose that at the end of 2019, Green Acres has $4,000 of accounts payable instead of $24,000 of accounts receivable. What is Rick's annual adjustment for his change in accounting method from the cash to the accrual method in 2020?

Answer: In this instance Green Acres would have a negative (income-decreasing) §481 adjustment of $4,000 because the $4,000 of expenses would have accrued in 2019 but would not have been deducted. Hence, Green Acres would be entitled to deduct the full $4,000 as a negative §481 adjustment amount in 2020.

[58]Taxpayers with positive §481 adjustments less than $25,000 can elect to recognize the entire amount in the year of change. Rev. Proc. 2002-19.

[59]Taxpayers changing accounting methods under the Tax Cuts and Jobs Act will need to make §481 adjustments for those changes.

CONCLUSION

This chapter discusses issues relating to business income and deductions. We learned that the income rules for businesses are very similar to those for individuals and that businesses may deduct only ordinary and necessary business expenses and other business expenses specifically authorized by law. We also described several business expense limitations and discussed the accounting periods and methods businesses may use in reporting taxable income to the IRS. The issues described in this chapter are widely applicable to all types of business entities, including sole proprietorships, partnerships, S corporations, and C corporations.

Summary

Identify common business deductions. **LO 1-1**

- Ordinary and necessary business expenses are allowed as deductions to calculate net income from activities entered into with a profit motive.
- Only reasonable amounts are allowed as business expense deductions. Extravagant or excessive amounts are likely to be characterized by personal motives and are disallowed.

Determine the limits on deducting business expenses. **LO 1-2**

- The law specifically prohibits deducting expenses that are against public policy (such as fines or bribes) and expenses that produce tax-exempt income.
- Expenses benefiting more than 12 months must be capitalized and special limits and record-keeping requirements are applied to business expenses that may have personal benefits, such as meals.
- The deduction of business interest expense is limited for large businesses (average annual gross receipts in excess of $26 million for the three prior years and indexed for inflation). Business interest can only be deducted to the extent of business interest income plus 30 percent of the business's adjusted taxable income. Adjusted taxable income is taxable income before depreciation and interest deductions allocable to the business activity. Disallowed business interest expense can be carried forward indefinitely.

Identify special business deductions specifically permitted under the tax laws. **LO 1-3**

- Special calculations are necessary for deductions such as the deduction for casualty losses. The deduction when an asset is damaged (not destroyed) is limited to the lesser of the reduction in value or the adjusted tax basis of the asset.

Describe accounting periods available to businesses. **LO 1-4**

- Accounting periods and methods are chosen at the time of filing the first tax return.
- There are three types of tax years—calendar year, fiscal year, and 52/53-week year—and each tax year is distinguished by year-end.

Apply cash and accrual methods to determine business income and expense deductions. **LO 1-5**

- Under the cash method, taxpayers recognize revenue when they actually or constructively receive property or services and they recognize deductions when they actually pay the expense. C corporations and partnerships with C corporation partners but not tax shelters, can elect to use the cash method if the C corporation and/or the partnership (and any C corporation partner) report average annual gross receipts for the three prior years of $26 million or less.
- Under the accrual method, the all-events test requires that income be recognized when all the events have occurred that are necessary to fix the right to receive payments and the amount of the payments can be determined with reasonable accuracy.
- Except for taxpayers who meet the $26 million gross receipts test, the accrual method must be used to account for sales and purchases for businesses where inventories are an income-producing factor.

- Under the accrual method, accrued expenses can be deducted only when the all-events test and the economic performance test both have been met. The application of the economic performance test depends, in part, on the type of business expense.
- Changes in accounting method or accounting period typically require the consent of the IRS and a §481 adjustment to taxable income. A negative adjustment is included in income for the year of change, whereas a positive adjustment is spread over four years.

KEY TERMS

12-month rule (1-16)
accounting methods (1-14)
accounting period (1-13)
all-events test (1-21)
allowance method (1-25)
arm's length amount (1-4)
direct write-off method (1-25)
economic performance test (1-21)
first-in, first-out (FIFO) method (1-19)
fiscal year (1-13)
flow-through entities (1-14)
impermissible accounting method (1-27)
last-in, first-out (LIFO) method (1-19)
mixed-motive expenditures (1-7)
ordinary and necessary (1-3)
payment liabilities (1-22)
permissible accounting method (1-27)
personal expenses (1-7)
reasonable in amount (1-4)
recurring item (1-24)
§481 adjustment (1-30)
specific identification method (1-19)
tax year (1-13)
travel expenses (1-9)
uniform cost capitalization (UNICAP) rules (1-19)

DISCUSSION QUESTIONS

Discussion Questions are available in Connect®.

LO 1-1
1. What is an "ordinary and necessary" business expenditure?

LO 1-1
2. Explain how cost of goods is treated when a business sells inventory.

LO 1-1
3. Whether a business expense is "reasonable in amount" is often a difficult question. Explain why determining reasonableness is difficult, and describe a circumstance where reasonableness is likely to be questioned by the IRS.

LO 1-1
4. Jake is a professional dog trainer who purchases and trains dogs for use by law enforcement agencies. Last year Jake purchased 500 bags of dog food from a large pet food company at an average cost of $30 per bag. This year, however, Jake purchased 500 bags of dog food from a local pet food company at an average cost of $45 per bag. Under what circumstances would the IRS likely challenge the cost of Jake's dog food as unreasonable?

LO 1-2
5. What kinds of deductions are prohibited as a matter of public policy? Why might Congress deem it important to disallow deductions for expenditures that are against public policy?

LO 1-2
6. Provide an example of an expense associated with the production of tax-exempt income, and explain what might happen if Congress repealed the prohibition against deducting expenses incurred to produce tax-exempt income.

LO 1-2
research
7. Peggy is a rodeo clown, and this year she expended $1,000 on special "funny" clothes and outfits. Peggy would like to deduct the cost of these clothes as work-related because she refuses to wear the clothes unless she is working. Under what circumstances can Peggy deduct the cost of her clown clothes?

LO 1-2
8. Jimmy is a sole proprietor of a small dry-cleaning business. This month Jimmy paid for his groceries by writing checks from the checking account dedicated to the dry-cleaning business. Why do you suppose Jimmy is using his business checking account rather than his personal checking account to pay for personal expenditures?

LO 1-2
9. Troy operates an editorial service that often entertains prospective authors to encourage them to use Troy's service. This year Troy paid $3,000 for the cost of meals

and $6,200 for the cost of entertaining authors. Describe the conditions under which Troy can deduct a portion of the cost of the meals as a business expense.

10. Jenny uses her car for both business and personal purposes. She purchased the auto this year and drove 11,000 miles on business trips and 9,000 miles for personal transportation. Describe how Jenny will determine the amount of deductible expenses associated with the auto. LO 1-2

11. What expenses are deductible when a taxpayer combines both business and personal activities on a trip? How do the rules for international travel differ from the rules for domestic travel? LO 1-1 LO 1-2

12. Clyde lives and operates a sole proprietorship in Dallas, Texas. This year Clyde found it necessary to travel to Fort Worth (about 25 miles away) for legitimate business reasons. Is Clyde's trip likely to qualify as "away from home"? Why would this designation matter? LO 1-2

13. Describe the record-keeping requirements for deducting business expenses, including mixed-motive expenditures. LO 1-2

14. Describe the computation of the limit placed on the business interest deduction. Is the disallowed interest ever deductible? LO 1-2

15. Explain the difference between calculating a loss deduction for a business asset that was partially damaged in an accident and calculating a loss deduction for a business asset that was stolen or completely destroyed in an accident. LO 1-3

16. How does a casualty loss on a business asset differ when the asset is stolen as opposed to destroyed in a fire? LO 1-3

17. What is the difference between a full tax year and a short tax year? Describe circumstances in which a business may have a short tax year. LO 1-4

18. Explain why a taxpayer might choose one tax year-end over another if given a choice. LO 1-4

19. Compare and contrast the different year-ends available to sole proprietorships, flow-through entities, and C corporations. LO 1-4

20. Why does the law generally require partnerships to adopt a tax year consistent with the year used by the partners? LO 1-4

21. How does an entity choose its tax year? Is it the same process no matter the type of tax year-end the taxpayer adopts? LO 1-4

22. Explain when an expenditure should be "capitalized" based upon accounting principles. From time to time, it is suggested that all business expenditures should be deducted when incurred for tax purposes. Do you agree with this proposition, and if so, why? LO 1-5

23. Describe the 12-month rule for determining whether and to what extent businesses should capitalize or immediately deduct prepaid expenses such as insurance or security contracts. Explain the apparent rationale for this rule. LO 1-5

24. Explain why Congress sometimes mandates that businesses use particular accounting methods while other times Congress is content to require businesses to use the same accounting methods for tax purposes that they use for financial accounting purposes. LO 1-5

25. Why is it not surprising that specific rules differ between tax accounting and financial accounting? LO 1-5

26. Fred is considering using the accrual method for his next business venture. Explain to Fred the conditions for recognizing income for tax purposes under the accrual method. LO 1-5

27. Describe the all-events test for determining income and describe how to determine the date on which the all-events test has been met. LO 1-5

LO 1-5 28. Compare and contrast the tax treatment for rental income received in advance and advance payments for goods and services.

LO 1-5 29. Compare and contrast the rules for determining the tax treatment of advance payments for services versus advance payments for goods.

LO 1-5 research 30. Jack operates a large home repair business as a sole proprietorship. Besides providing services, Jack also sells home repair supplies to homeowners. However, these sales constitute a relatively small portion of Jack's income. Describe the conditions under which Jack would need to account for sales and purchases of plumbing supplies using the accrual method. (*Hint:* Read §471(a) and Reg. §1.471-1.)

LO 1-5 31. Explain why Congress enacted the UNICAP rules and describe the burdens these rules place on taxpayers.

LO 1-5 32. Compare and contrast financial accounting rules with the tax rules under UNICAP (§263A). Explain whether the UNICAP rules tend to accelerate or defer income relative to the financial accounting rules.

LO 1-5 33. Compare and contrast the tests for accruing income and those for accruing deductions for tax purposes.

LO 1-5 34. Compare and contrast when taxpayers are allowed to deduct the cost of warranties provided by others to the taxpayer (i.e., purchased by the taxpayer) and when taxpayers are allowed to deduct the costs associated with warranties they provide (sell) to others.

LO 1-5 35. Describe when economic performance occurs for the following expenses:

a) Workers' compensation

b) Rebates and refunds

c) Insurance, warranties, and service contracts provided *to* the business

d) Taxes

LO 1-5 36. On December 31 of the current year, a taxpayer prepays an advertising company to provide advertising services for the next 10 months. Using the 12-month rule and the economic performance rules, contrast when the taxpayer would be able to deduct the expenditure if the taxpayer uses the cash method of accounting versus if the taxpayer uses the accrual method of accounting.

LO 1-5 37. Compare and contrast how bad debt expense is determined for financial accounting purposes and how the deduction for bad debts is determined for accrual-method taxpayers. How do cash-method taxpayers determine their bad debt expense for accounts receivable?

LO 1-5 38. Describe the related-person limitation on accrued deductions. What tax savings strategy is this limitation designed to thwart?

LO 1-5 39. What are the relative advantages of the cash and accrual methods of accounting?

LO 1-5 40. Describe how a business adopts a permissible accounting method. Explain whether a taxpayer can adopt an impermissible accounting method.

LO 1-5 41. Describe why the IRS might be skeptical of permitting requests for changes in accounting method without a good business purpose.

LO 1-5 42. What is a §481 adjustment, and what is the purpose of this adjustment?

PROBLEMS

Select problems are available in Connect®.

LO 1-1 43. Manny hired his brother's firm to provide accounting services to his business. During the current year, Manny paid his brother's firm $82,000 for services even though other firms were willing to provide the same services for $40,000. How much of this expenditure, if any, is deductible as an ordinary and necessary business expenditure?

44. Michelle operates a food truck. Indicate the amount (if any) that she can deduct as an ordinary and necessary business deduction in each of the following situations and explain your solution. LO 1-1 LO 1-2

a) Michelle moves her food truck between various locations on a daily rotation. Last week, Michelle was stopped for speeding. She paid a fine of $125 for speeding, including $80 for legal advice in connection with the ticket.

b) Michelle paid $750 to reserve a parking place for her food truck for the fall football season outside the local football arena. Michelle also paid $95 for tickets to a game for her children.

c) Michelle provided a candidate with free advertising painted on her truck during the candidate's campaign for city council. Michelle paid $500 to have the ad prepared and an additional $200 to have the ad removed from the truck after the candidate lost the election.

45. Indicate the amount (if any) that Josh can deduct as an ordinary and necessary business deduction in each of the following situations and explain your solution. LO 1-1 LO 1-2

a) Josh borrowed $50,000 from First State Bank using his business assets as collateral. He used the money to buy City of Blanksville bonds. Over the course of a year, Josh paid interest of $4,200 on the borrowed funds, but he received $3,500 of interest on the bonds.

b) Josh purchased a piece of land for $45,000 in order to get a location to expand his business. He also paid $3,200 to construct a new driveway for access to the property.

c) This year Josh paid $15,000 to employ the mayor's son in the business. Josh would typically pay an employee with these responsibilities about $10,000 but the mayor assured Josh that after his son was hired, some city business would be coming his way.

d) Josh paid his brother, a mechanic, $3,000 to install a robotic machine for Josh's business. The amount he paid to his brother is comparable to what he would have paid to an unrelated person to do the same work. Once the installation was completed by his brother, Josh began calibrating the machine for operation. However, by the end of the year, he had not started using the machine in his business.

46. Ralph operates a business that acts as a sales representative for firms that produce and sell precious metals to electronics manufacturers. Ralph contacts manufacturers and convinces them to sign contracts for the delivery of metals. Ralph's company earns a commission on the sales. This year, Ralph contacted a jeweler to engrave small lapel buttons for each of his clients. Ralph paid $20 each for the lapel buttons and the jeweler charged Ralph an additional $7 for engraving. The electronics manufacturers, however, prohibit their employees from accepting gifts related to sales contracts. Can Ralph deduct the cost of the lapel buttons as business gifts? LO 1-2 research

47. Melissa recently paid $400 for round-trip airfare to San Francisco to attend a business conference for three days. Melissa also paid the following expenses: $250 fee to register for the conference, $300 per night for three nights lodging, $200 for meals, and $150 for cab fare. LO 1-2

a) What amount of the travel costs can Melissa deduct as business expenses?

b) Suppose that while Melissa was on the coast, she also spent two days sightseeing the national parks in the area. To do the sightseeing, she paid $1,000 for transportation, $800 for lodging, and $450 for meals during this part of her trip, which she considers personal in nature. What amount of the travel costs can Melissa deduct as business expenses?

c) Suppose that Melissa made the trip to San Francisco primarily to visit the national parks and only attended the business conference as an incidental benefit of being present on the coast at that time. What amount of the airfare can Melissa deduct as a business expense?

d) Suppose that Melissa's permanent residence and business was located in San Francisco. She attended the conference in San Francisco and paid $250 for the registration fee. She drove 100 miles over the course of three days and paid $90 for parking at the conference hotel. In addition, she spent $150 for breakfast and dinner over the three days of the conference. She bought breakfast on the way to the conference hotel and she bought dinner on her way home each night from the conference. What amount of these costs can Melissa deduct as business expenses?

LO 1-2

48. Kimberly is a self-employed taxpayer. She recently spent $1,000 for airfare to travel to Italy. What amount of the airfare is deductible in each of the following alternative scenarios?

a) Her trip was entirely for personal purposes.

b) On the trip, she spent eight days on personal activities and two days on business activities.

c) On the trip, she spent seven days on business activities and three days on personal activities.

d) Her trip was entirely for business purposes.

LO 1-2

49. Ryan is self-employed. This year Ryan used his personal auto for several long business trips. Ryan paid $1,500 for gasoline on these trips. His depreciation on the car if he was using it fully for business purposes would be $3,000. During the year, he drove his car a total of 12,000 miles (a combination of business and personal travel).

a) Ryan can provide written documentation of the business purpose for trips totaling 3,000 miles. What business expense amount can Ryan deduct (if any) for these trips?

b) Ryan estimates that he drove approximately 1,300 miles on business trips, but he can only provide written documentation of the business purpose for trips totaling 820 miles. What business expense amount can Ryan deduct (if any) for these trips?

LO 1-1 LO 1-2

50. Christopher is a self-employed cash-method, calendar-year taxpayer, and he made the following cash payments related to his business this year. Calculate the after-tax cost of each payment assuming Christopher has a 37 percent marginal tax rate.

a) $500 fine for speeding while traveling to a client meeting.

b) $800 of interest on a short-term loan incurred in September and repaid in November. Half of the loan proceeds were used immediately to pay salaries and the other half was invested in municipal bonds until November.

c) $600 for office supplies in May of this year. He used half of the supplies this year and he will use the remaining half by February of next year.

d) $450 for several pairs of work boots. Christopher expects to use the boots about 80 percent of the time in his business and the remainder of the time for hiking. Consider the boots to be a form of clothing.

LO 1-2

51. Heather is an attorney who paid $15,000 to join a country club in order to meet potential clients. This year she also paid $4,300 in greens fees when golfing with clients and paid an additional $1,700 for meals with clients in the clubhouse. Under what circumstances, if any, can Heather deduct all or part of the $21,000 paid to the country club this year?

52. Assume Sarah is a cash-method, calendar-year taxpayer, and she is considering making the following cash payments related to her business. Calculate the after-tax cost of each payment assuming she is subject to a 37 percent marginal tax rate. **LO 1-1** **LO 1-2**
   a) $2,000 payment for next year's property taxes on her place of business.
   b) $800 to reimburse the cost of meals incurred by employees while traveling for the business.
   c) $1,200 for football tickets to entertain out-of-town clients during contract negotiations.
   d) $500 contribution to the mayor's reelection campaign.

53. Renee operates a proprietorship selling collectibles over the web, and last year she purchased a building for $24 million for her business. This year, Renee's proprietorship reported revenue of $85 million and incurred total expenses of $78.1 million. Her expenses included cost of goods sold of $48.5 million, sales commissions paid of $6.4 million, $10.5 million of interest paid on the building mortgage, and $12.7 million of depreciation. **LO 1-2**
   a) What is Renee's adjusted taxable income for purposes of calculating the limitation on business interest expense?
   b) What is the maximum amount of business interest expense that Renee can deduct this year, and how is the disallowed interest expense (if any) treated?
   c) Suppose that Renee's revenue includes $5 million of business interest income. What is the maximum amount of business interest expense that could be deducted this year under the business interest limitation?

54. This year Amy purchased $2,000 of equipment for use in her business. However, the machine was damaged in a traffic accident while Amy was transporting the equipment to her business. Note that because Amy did not place the equipment into service during the year, she does not claim any depreciation or cost recovery expense for the equipment. **LO 1-3**
   a) After the accident, Amy had the choice of repairing the equipment for $1,800 or selling the equipment to a junk shop for $300. Amy sold the equipment. What amount can Amy deduct for the loss of the equipment?
   b) After the accident, Amy repaired the equipment for $800. What amount can Amy deduct for the loss of the equipment?
   c) After the accident, Amy could not replace the equipment so she had the equipment repaired for $2,300. What amount can Amy deduct for the loss of the equipment?

55. In July of this year, Stephen started a proprietorship called ECR (which stands for electric car repair). ECR uses the cash method of accounting and Stephen has produced the following financial information for this year: **LO 1-3** **tax forms**

   - ECR collected $81,000 in cash for repairs completed during the year and an additional $3,200 in cash for repairs that will commence after year-end.
   - Customers owe ECR $14,300 for repairs completed this year, and while Stephen isn't sure which bills will eventually be paid, he expects to collect all but about $1,900 of these revenues next year.

   ECR has made the following expenditures:

Interest expense	$ 1,250
Shop rent ($1,500 per month)	27,000
Utilities	1,075
Contract labor	8,250
Compensation	21,100
Liability insurance premiums ($350 per month)	4,200
Term life insurance premiums ($150 per month)	1,800

The interest paid relates to interest accrued on a $54,000 loan made to Stephen in July of this year. Stephen used half of the loan to pay for 18 months of shop rent, and the remainder he used to upgrade his personal wardrobe. In July, Stephen purchased 12 months of liability insurance to protect against liability should anyone be injured in the shop. ECR has only one employee (the remaining workers are contract labor), and this employee thoroughly understands how to repair an electric propulsion system. On November 1 of this year, Stephen purchased a 12-month term-life policy that insures the life of this "key" employee. Stephen paid Gecko Insurance Company $1,800; in return, Gecko promises to pay Stephen a $40,000 death benefit if this employee dies any time during the next 12 months.

Fill out a draft of the front page of Stephen's Schedule C.

LO 1-5
planning

56. Nicole is a calendar-year taxpayer who accounts for her business using the cash method. On average, Nicole sends out bills for about $12,000 of her services at the first of each month. The bills are due by the end of the month, and typically 70 percent of the bills are paid on time and 98 percent are paid within 60 days.
    a) Suppose that Nicole is expecting a 2 percent reduction in her marginal tax rate next year. Ignoring the time value of money, estimate the tax savings for Nicole if she postpones mailing the December bills until January 1 of next year.
    b) Describe how the time value of money affects your calculations.
    c) Would this tax savings strategy create any additional business risks? Explain.

LO 1-5

57. Jeremy is a calendar-year taxpayer who sometimes leases his business equipment to local organizations. He recorded the following receipts this year. Indicate the extent to which these payments are taxable income to Jeremy this year if Jeremy is (1) a cash-method taxpayer and (2) an accrual-method taxpayer.
    a) $1,000 deposit from the Ladies' Club, which wants to lease a trailer. The club will receive the entire deposit back when the trailer is returned undamaged.
    b) $800 from the Ladies' Club for leasing the trailer from December of this year through March of next year ($200 per month).
    c) $300 lease payment received from the Men's Club this year for renting Jeremy's trailer last year. Jeremy billed the club last year but recently he determined that the Men's Club would never pay him, so he was surprised when he received the check.

LO 1-5

58. Brown Thumb Landscaping is a calendar-year, accrual-method taxpayer. In September, Brown Thumb negotiated a $14,000 contract for services it would provide to the city in November of the current year. The contract specifies that Brown Thumb will receive $4,000 in October as a down payment for these services and it will receive the remaining $10,000 in January of next year.
    a) How much income from this $14,000 contract will Brown Thumb recognize in the current year? Explain.
    b) How much income from this $14,000 contract will Brown Thumb recognize in the current year if it uses the cash method of accounting?
    c) Suppose that the total amount to be paid under the contract with the city is estimated at $14,000 but may be adjusted to $12,000 next year during the review of the city budget. What amount from the contract, if any, should Brown Thumb recognize as income this year? Explain.
    d) Suppose that in addition to the basic contract, Brown Thumb will be paid an additional $3,000 if its city landscape design wins the annual design competition next year. Should Brown Thumb accrue $3,000 revenue this year? Why or why not?

LO 1-5

59. In January of year 0, Justin paid $4,800 for an insurance policy that covers his business property for accidents and casualties. Justin is a calendar-year taxpayer

who uses the cash method of accounting. What amount of the insurance premium may Justin deduct in year 0 in each of the following alternative scenarios?

a) The policy covers the business property from April 1 of year 0 through March 31 of year 1.
b) The policy begins on February 1 of year 1 and extends through January 31 of year 2.
c) Justin pays $6,000 for a 24-month policy that covers the business from April 1, year 0, through March 31, year 2.
d) Instead of paying an insurance premium, Justin pays $4,800 to rent his business property from April 1 of year 0 through March 31 of year 1.

60. Ben teaches golf lessons at a country club under a business called Ben's Pure Swings (BPS). He operates this business as a sole proprietorship on the accrual basis of accounting. Use the following accounting information for BPS to complete the firm's Schedule C: LO 1-5 tax forms

This year BPS billed clients for $86,700 and collected $61,000 in cash for golf lessons completed during the year. In addition, BPS collected an additional $14,500 in cash for lessons that will commence after year-end. Ben hopes to collect about half of the outstanding billings next year but the rest will likely be written off.

Besides providing private golf lessons, BPS also contracted with the country club to staff the driving range. This year, BPS billed the country club $27,200 for the service. The club paid $17,000 of the amount but disputed the remainder. By year-end, the dispute had not been resolved, and while Ben believes he is entitled to the money, he has still not collected the remaining $10,200.

BPS has accrued the following expenses (explained below):

Advertising (in the clubhouse)	$13,150
Pro golf teachers' membership fees	860
Supplies (golf tees, balls, etc.)	4,720
Club rental	6,800
Malpractice insurance	2,400
Accounting fees	8,820

The expenditures were all paid for this calendar year, with several exceptions. First, Ben initiated his golfer's malpractice insurance on June 1 of this year. The $2,400 insurance bill covers the last six months of this calendar year and the first six months of next year. At year-end, Ben had only paid $600, but he has assured the insurance agent he will pay the remaining $1,800 early next year. Second, the amount paid for club rental ($100 per week) represents rental charges for the last 6 weeks of the previous year, the 52 weeks in this calendar year, and the first 10 weeks of next year. Ben has also mentioned that BPS only pays for supplies that are used at the club. Although BPS could buy the supplies for half the cost elsewhere, Ben likes to "throw some business" to the golf pro shop because it is operated by his brother.

Fill out a draft of Parts I and II on the front page of a Schedule C for BPS.

61. On April 1 of year 0 Stephanie received a $9,000 payment for full payment on a three-year service contract (under the contract Stephanie is obligated to provide advisory services for the next three years). LO 1-5

a) What amount of income should Stephanie recognize in year 0 if she uses the accrual method of accounting? (She recognized $2,250 for financial accounting purposes.)
b) What amount of income will Stephanie recognize in year 1 if she uses the accrual method of accounting?

c) What amount of income will Stephanie recognize in year 2 if she uses the accrual method of accounting?

d) What amount of income will Stephanie recognize in year 0 if she recognizes $5,000 of income from the contract for financial statement purposes?

LO 1-5

62. In October of year 0, Janine received a $6,000 payment from a client for 25 months of security services she will provide starting on November 1 of year 0. This amounts to $240 per month.

a) When must Janine recognize the income from the $6,000 advance payment for services if she uses the cash method of accounting?

b) When must Janine recognize the income from the $6,000 advance payment for services if she uses the accrual method of accounting?

c) Suppose that instead of services, Janine received the payment for a security system (inventory) that she will deliver and install in year 2. When would Janine recognize the income from the advance payment for the inventory sale if she uses the accrual method of accounting and she elects to use the deferral method for reporting income from advance payments? For financial accounting purposes, she reports the income when the inventory is delivered.

d) Suppose that instead of services, Janine received the payment for inventory to be delivered next year. When would Janine recognize the income from the advance payment for sale of goods if she uses the accrual method of accounting and she does not elect to use the deferral method for advance payments?

LO 1-5

63. Nicole's business uses the accrual method of accounting and accounts for inventory with specific identification. In year 0, Nicole received a $4,500 payment with an order for inventory to be delivered to the client early next year. Nicole has the inventory ready for delivery at the end of year 0 (she purchased the inventory in year 0 for $2,300).

a) When does Nicole recognize the $2,200 of gross profit ($4,500 revenue minus $2,300 cost of the inventory) if she does not elect to use the deferral method?

b) When does Nicole recognize the $2,200 of gross profit from the inventory sale if she elects to use the deferral method?

c) How would Nicole account for the inventory-related transactions if she uses the cash method of accounting and her annual sales are usually less than $100,000?

d) How would Nicole account for the inventory-related transactions if she uses the cash method of accounting and her annual sales are usually over $50 million per year?

LO 1-5

64. This year Amber purchased a factory to process and package landscape mulch. Approximately 20 percent of management time, space, and expenses are spent on this manufacturing process.

		Costs (in thousands)	Tax Inventory
Material:	Mulch and packaging	$ 5,000	?
	Administrative supplies	250	?
Salaries:	Factory labor	12,000	?
	Sales & advertising	3,500	?
	Administration	5,200	?
Property taxes:	Factory	4,600	?
	Offices	2,700	?
Depreciation:	Factory	8,000	?
	Offices	1,500	?

a) At the end of the year, Amber's accountant indicated that the business had processed 10 million bags of mulch but only 1 million bags remained in the ending inventory. What is Amber's tax basis in her ending inventory if the UNICAP rules are used to allocate indirect costs to inventory? (Assume direct costs are allocated to inventory according to the level of ending inventory. In contrast, indirect costs are first allocated by time spent and then according to level of ending inventory.)

b) Under what conditions could Amber's business avoid having to apply UNICAP rules to allocate indirect costs to inventory for tax purposes?

65. Suppose that David has elected to account for inventories and has adopted the last-in, first-out (LIFO) inventory-flow method for his business inventory of widgets (purchase prices below). LO 1-5

Widget	Purchase Date	Direct Cost	Other Costs	Total Cost
#1	August 15	$2,100	$100	$2,200
#2	October 30	2,200	150	2,350
#3	November 10	2,300	100	2,400

In late December, David sold one widget and next year David expects to purchase three more widgets at the following estimated prices:

Widget	Purchase Date	Estimated Cost
#4	Early spring	$2,600
#5	Summer	2,260
#6	Fall	2,400

a) What cost of goods sold and ending inventory would David record if he elects to use the LIFO method this year?

b) If David sells two more widgets next year, what will be his cost of goods sold and ending inventory next year under the LIFO method?

c) How would you answer (a) and (b) if David had initially selected the first-in, first-out (FIFO) method instead of LIFO?

d) Suppose that David initially adopted the LIFO method, but wants to apply for a change to FIFO next year. What would be his §481 adjustment for this change, and in what year(s) would he make the adjustment?

66. On November 1 of year 0, Jaxon borrowed $50,000 from Bucksnort Savings and Loan for use in his business. In December, Jaxon paid interest of $4,500 relating to the 12-month period from November of year 0 through October of year 1. LO 1-5

a) How much interest, if any, can Jaxon deduct in year 0 if his business uses the cash method of accounting for tax purposes?

b) How much interest, if any, can Jaxon deduct in year 0 if his business uses the accrual method of accounting for tax purposes?

67. Matt hired Apex Services to repair his business equipment. On November 1 of year 0, Matt paid $2,000 for the repairs that he expects to begin in early March of year 1. LO 1-5

a) What amount of the cost of the repairs can Matt deduct in year 0 if he uses the cash method of accounting for his business?

b) What amount of the cost of the repairs can Matt deduct in year 0 if he uses the accrual method of accounting for his business?

c) What amount of the cost of the repairs can Matt deduct in year 0 if he uses the accrual method and he expects the repairs to be done by early February?

d) What amount of the cost of the repairs can Matt deduct in year 0 if he uses the cash method of accounting and he expects the repairs to be done by early February?

LO 1-5

68. Circuit Corporation (CC) is a calendar-year, accrual-method taxpayer. CC manufactures and sells electronic circuitry. On November 15, year 0, CC enters into a contract with Equip Corp (EC) that provides CC with exclusive use of EC's specialized manufacturing equipment for the five-year period beginning on January 1 of year 1. Pursuant to the contract, CC pays EC $100,000 on December 30, year 0. How much of this expenditure is CC allowed to deduct in year 0 and in year 1?

LO 1-5

69. This year (year 0) Elizabeth agreed to a three-year service contract with an engineering consulting firm to improve efficiency in her factory. The contract requires Elizabeth to pay the consulting firm $1,500 for each instance that Elizabeth requests its assistance. The contract also provides that Elizabeth only pays the consultants if their advice increases efficiency as measured 12 months from the date of service. This year Elizabeth requested advice on three occasions and she has not yet made any payments to the consultants.

a) How much should Elizabeth deduct in year 0 under this service contract if she uses the accrual method of accounting?

b) How much should Elizabeth deduct in year 0 under this service contract if she uses the cash method of accounting?

LO 1-5

70. Travis is a professional landscaper. He provides his clients with a one-year (12-month) warranty for retaining walls he installs. In June of year 1, Travis installed a wall for an important client, Sheila. In early November, Sheila informed Travis that the retaining wall had failed. To repair the wall, Travis paid $700 cash for additional stone that he delivered to Sheila's location. Travis also offered to pay a mason $800 to repair the wall on November 20 of year 1. Due to some bad weather and the mason's work backlog, the mason agreed to finish the work by the end of January of year 2. Even though Travis expected the mason to finish the project by the end of February, Travis informed the mason that he would pay the mason the $800 when he completed the job.

a) Assuming Travis is an accrual-method taxpayer, how much can he deduct in year 1 from these activities?

b) Assuming Travis is a cash-method taxpayer, how much can he deduct in year 1 from these activities?

LO 1-5

research

71. Adam elects the accrual method of accounting for his business. What amount of deductions does Adam recognize in year 0 for the following transactions?

a) Adam guarantees that he will refund the cost of any goods sold to a client if the goods fail within a year of delivery. In December of year 0, Adam agreed to refund $2,400 to clients, and he expects to make payment in January of year 1.

b) On December 1 of year 0, Adam paid $480 for a one-year contract with CleanUP Services to clean his store. The agreement calls for services to be provided on a weekly basis.

c) Adam was billed $240 for annual personal property taxes on his delivery van. Because this was the first time Adam was billed for these taxes, he did not make payment until January. However, he considers the amounts immaterial.

LO 1-5

72. Rebecca is a calendar-year taxpayer who operates a business. She made the following business-related expenditures in December of year 0. Indicate the amount of these payments that she may deduct in year 0 under both the cash method of accounting and the accrual method of accounting.

a) $2,000 for an accountant to evaluate the accounting system of Rebecca's business. The accountant spent three weeks in January of year 1 working on the evaluation.

b) $2,500 for new office furniture. The furniture was delivered on January 15, year 1.

c) $3,000 for property taxes payable on her factory.

d) $1,500 for interest on a short-term bank loan relating to the period from November 1, year 0, through March 31, year 1.

73. BCS Corporation is a calendar-year, accrual-method taxpayer. BCS was formed and started its business activities on January 1, year 0. It reported the following information for year 0. Indicate BCS's deductible amount for year 0 in each of the following alternative scenarios. **LO 1-5**

a) BCS provides two-year warranties on products it sells to customers. For its year 0 sales, BCS estimated and accrued $200,000 in warranty expense for financial accounting purposes. During year 0, BCS actually spent $30,000 repairing its product under the warranty.

b) BCS accrued an expense for $50,000 for amounts it anticipated it would be required to pay under the workers' compensation act. During year 0, BCS actually paid $10,000 for workers' compensation–related liabilities.

c) In June of year 0, a display of BCS's product located in its showroom fell and injured a customer. The customer sued BCS for $500,000. The case is scheduled to go to trial next year. BCS anticipates that it will lose the case and accrued a $500,000 expense on its financial statements.

d) Assume the same facts as in (c) except that BCS was required to pay $500,000 to a court-appointed escrow fund in year 0. If BCS loses the case in year 1, the money from the escrow fund will be transferred to the customer suing BCS.

e) On December 1 of year 0, BCS acquired equipment from Equip Company. As part of the purchase, BCS signed a warranty agreement with Equip so that Equip would warranty the equipment for two years (from December 1 of year 0 through November 30 of year 2). The cost of the warranty was $12,000. BCS paid Equip for the warranty in January of year 1.

74. This year William provided $4,200 of services to a large client on credit. Unfortunately, this client has recently encountered financial difficulties and has been unable to pay William for the services. Moreover, William does not expect to collect for his services. William has "written off" the account and would like to claim a deduction for tax purposes. **LO 1-5**

a) What amount of deduction for bad debt expense can William claim this year if he uses the accrual method?

b) What amount of deduction for bad debt expense can William claim this year if he uses the cash method?

75. Dustin has a contract to provide services to Dado Enterprises. In November of year 0, Dustin billed Dado $10,000 for the services he rendered during the year. Dado is an accrual-method proprietorship that is owned and operated by Dustin's father. **LO 1-5**

a) What amount of revenue must Dustin recognize in year 0 if Dustin uses the cash method and Dado remits payment for the services in December of year 0? What amount can Dado deduct in year 0?

b) What amount of revenue must Dustin recognize in year 0 if Dustin uses the accrual method and Dado remits payment for the services in December of year 0? What amount can Dado deduct in year 0?

c) What amount of revenue must Dustin recognize in year 0 if Dustin uses the cash method and Dado remits payment for the services in January of year 1? What amount can Dado deduct in year 0?

d) What amount of revenue must Dustin recognize in year 0 if Dustin uses the accrual method and Dado remits payment for the services in January of year 1? What amount can Dado deduct in year 0?

LO 1-5

76. Nancy operates a business that uses the accrual method of accounting. In December, Nancy asked her brother, Hank, to provide her business with consulting advice. Hank billed Nancy for $5,000 of consulting services in year 0 (a reasonable amount), but Nancy was only able to pay $3,000 of the bill by the end of year 0. However, Nancy paid the remainder of the bill in year 1.

a) How much of the $5,000 consulting services will Hank include in his income in year 0 if he uses the cash method of accounting? What amount can Nancy deduct in year 0 for the consulting services?

b) How much of the $5,000 consulting services will Hank include in his income in year 0 if he uses the accrual method of accounting? What amount can Nancy deduct in year 0 for the consulting services?

LO 1-5

77. Erin is considering switching her business from the cash method to the accrual method at the beginning of next year (year 1). Determine the amount and timing of her §481 adjustment assuming the IRS grants Erin's request in the following alternative scenarios.

c) At the end of year 0/beginning of year 1, Erin's business has $15,000 of accounts receivable and $18,000 of accounts payable that have not been recorded for tax purposes.

d) At the end of year 0/beginning of year 1, Erin's business reports $25,000 of accounts receivable and $9,000 of accounts payable that have not been recorded for tax purposes.

COMPREHENSIVE PROBLEMS

Select problems are available in Connect®.

78. Joe operates a business that locates and purchases specialized assets for clients, among other activities. Joe uses the accrual method of accounting but he doesn't keep any significant inventories of the specialized assets that he sells. Joe reported the following financial information for his business activities during year 0. Determine the effect of each of the following transactions on the taxable business income.

a) Joe has signed a contract to sell gadgets to the city. The contract provides that sales of gadgets are dependent upon a test sample of gadgets operating successfully. In December, Joe delivers $12,000 worth of gadgets to the city that will be tested in March. Joe purchased the gadgets especially for this contract and paid $8,500.

b) Joe paid $180 for entertaining a visiting out-of-town client. The client didn't discuss business with Joe during this visit, but Joe wants to maintain good relations to encourage additional business next year.

c) On November 1, Joe paid $600 for premiums providing for $40,000 of "key man" insurance on the life of Joe's accountant over the next 12 months.

d) At the end of year 0, Joe's business reports $9,000 of accounts receivable. Based upon past experience, Joe believes that at least $2,000 of his new receivables will be uncollectible.

e) In December of year 0, Joe rented equipment to complete a large job. Joe paid $3,000 in December because the rental agency required a minimum rental of three months ($1,000 per month). Joe completed the job before year-end, but he returned the equipment at the end of the lease.

f) Joe hired a new sales representative as an employee and sent her to Dallas for a week to contact prospective out-of-state clients. Joe ended up reimbursing his employee $300 for airfare, $350 for lodging, and $250 for meals (Joe provided adequate documentation to substantiate the business purpose for the meals). Joe requires the employee to account for all expenditures in order to be reimbursed.

g) Joe uses his BMW (a personal auto) to travel to and from his residence to his factory. However, he switches to a business vehicle if he needs to travel after he reaches the factory. Last month, the business vehicle broke down and he was forced to use the BMW both to travel to and from the factory and to visit work sites. He drove 120 miles visiting work sites and 46 miles driving to and from the factory from his home. Joe uses the standard mileage rate to determine his auto-related business expenses.

h) Joe paid a visit to his parents in Dallas over the Christmas holidays. While he was in the city, Joe spent $50 to attend a half-day business symposium. Joe paid $200 for airfare, $50 for meals during the symposium, and $20 on cab fare to the symposium.

79. Jack, a geologist, had been debating for years whether or not to venture out on his own and operate his own business. He had developed a lot of solid relationships with clients and he believed that many of them would follow him if he were to leave his current employer. As part of a New Year's resolution, Jack decided he would finally do it. Jack put his business plan together and, on January 1 of this year, Jack opened his doors for business as a C corporation called Geo-Jack (GJ). Jack is the sole shareholder. Jack reported the following financial information for the year (assume GJ reports on a calendar year, uses the accrual method of accounting, and elects to account for inventory).

a) In January, GJ rented a small business office about 12 miles from Jack's home. GJ paid $10,000, which represented a damage deposit of $4,000 and rent for two years ($3,000 annually).

b) GJ earned and collected $290,000 performing geological-related services and selling its specialized digging tool [see part (i)].

c) GJ received $50 interest from municipal bonds and $2,100 interest from other investments.

d) GJ purchased some new equipment in February for $42,500. It claimed depreciation on these assets during the year in the amount of $6,540.

e) GJ paid $7,000 to buy luxury season tickets for Jack's parents for State U football games.

f) GJ paid Jack's father $10,000 for services that would have cost no more than $6,000 if Jack had hired any other local business to perform the services. While Jack's dad was competent, he does not command such a premium from his other clients.

g) In an attempt to get his name and new business recognized, GJ paid $7,000 for a one-page ad in the *Geologic Survey*. It also paid $15,000 in radio ads to be run through the end of December.

h) GJ leased additional office space in a building downtown. GJ paid rent of $27,000 for the year.

i) In November, Jack's office was broken into and equipment valued at $5,000 was stolen. The tax basis of the equipment was $5,500. Jack received $2,000 of insurance proceeds from the theft.

j) GJ incurred a $4,000 fine from the state government for digging in an unauthorized digging zone.

k) GJ contributed $3,000 to lobbyists for their help in persuading the state government to authorize certain unauthorized digging zones.

l) On July 1, GJ paid $1,800 for an 18-month insurance policy for its business equipment. The policy covers the period July 1 of this year through December 31 of next year.

m) GJ borrowed $20,000 to help with the company's initial funding needs. GJ used $2,000 of funds to invest in municipal bonds. At the end of the year, GJ paid the $1,200 of interest expense that accrued on the loan during the year.

n) Jack lives 12 miles from the office. He carefully tracked his mileage and drove his truck 6,280 miles between the office and his home. He also drove an additional 7,200 miles between the office and traveling to client sites. Jack did not use the truck for any other purposes. He did not keep track of the specific expenses associated with the truck. However, while traveling to a client site, Jack received a $150 speeding ticket. GJ reimbursed Jack for business mileage and for the speeding ticket.

o) GJ purchased two season tickets (20 games) to attend State U baseball games for a total of $1,100. Jack took existing and prospective clients to the games to maintain contact and find further work. This was very successful for Jack as GJ gained many new projects through substantial discussions with the clients following the games.

p) GJ paid $3,500 for meals when sales employees met with prospective clients.

q) GJ had a client who needed Jack to perform work in Florida. Because Jack had never been to Florida before, he booked an extra day and night for sightseeing. Jack spent $400 for airfare and booked a hotel for three nights ($120/night). (Jack stayed two days for business purposes and one day for personal purposes.) He also rented a car for $45 per day. The client arranged for Jack's meals while Jack was doing business, but GJ paid all expenses.

r) GJ paid a total of $10,000 of wages to employees during the year and cost of goods sold was $15,000.

Required:

a) What is GJ's net business income for tax purposes for the year?

b) As a C corporation, does GJ have a required tax year? If so, what would it be?

c) If GJ were a sole proprietorship, would it have a required tax year-end? If so, what would it be?

d) If GJ were an S corporation, would it have a required tax year-end? If so, what would it be?

80. Rex loves to work with his hands and is very good at making small figurines. Three years ago, Rex opened Bronze Age Miniatures (BAM) for business as a sole proprietorship. BAM produces miniature characters ranging from sci-fi characters (his favorite) to historical characters like George Washington (the most popular). Business has been going very well for him, and he has provided the following information relating to his business. Calculate the business taxable income for BAM assuming that BAM elects to account for its inventory of miniatures.

a) Rex received approval from the IRS to switch from the cash method of accounting to the accrual method of accounting effective January 1 of this year. At the end of last year, BAM reported accounts receivable that had not been included in income under the accrual method of $14,000 and accounts payable that had not been deducted under the accrual method of $5,000.

b) In March, BAM sold 5,000 miniature historical figures to History R Us Inc. (HRU), a retailer of historical artifacts and figurines, for $75,000.

c) HRU was so impressed with the figurines that it purchased in March that it wanted to contract with BAM to continue to produce the figurines for it for the next three years. HRU paid BAM $216,000 ($12 per figurine) on October 30 of this year, to produce 500 figurines per month for 36 months beginning on November 1 of this year. BAM delivered 500 figurines on November 30 and again on December 30. Rex elects to use the deferral method to account for the transaction.

d) Though the sci-fi figurines were not quite as popular, BAM sold 400 figurines at a sci-fi convention in April. Rex accepted cash only and received $11,000 for these sales.

e) In January, BAM determined that it would not be able to collect on $2,000 of its beginning-of-the-year receivables, so it wrote off $2,000 of specific receivables. BAM sold 100,000 other figurines on credit for $120,000. BAM estimates that it will be unable to collect 5 percent of the sales revenue from these sales but it has not been able to specifically identify any accounts to write off.

f) Assume that BAM correctly determined that its cost of goods sold using an appropriate inventory method is $54,000 this year.

g) The sci-fi convention in April was held in Chicago, Illinois. Rex attended the convention because he felt it was a good opportunity to gain new customers and to get new ideas for figurines. He paid $350 round-trip airfare, $100 for entrance to the convention, $210 for lodging, $65 for cab fare, and $110 for meals during the trip. He was busy with business activities the entire trip.

h) On August 1, BAM purchased a 12-month insurance policy that covers its business property for accidents and casualties through July 31 of next year. The policy cost BAM $3,600.

i) BAM reported depreciation expense of $8,200 for this year.

j) Rex had previously operated his business out of his garage, but in January he decided to rent a larger space. He entered into a lease agreement on February 1 and paid $14,400 ($1,200 per month) to possess the space for the next 12 months (February of this year through January of next year).

k) Before he opened his doors for business, Rex spent $30,000 investigating and otherwise getting ready to do business. He expensed $5,000 immediately and is amortizing the remainder using the straight-line method over 180 months.

l) In December, BAM agreed to a 12-month, $8,000 contract with Advertise-With-Us (AWU) to produce a radio ad campaign. BAM paid $3,000 up front (in December of this year) and AWU agreed that BAM would owe the remaining $5,000 only if BAM's sales increased by 15 percent over the 9-month period after the contract was signed.

m) In November of this year, BAM paid $2,500 in business property taxes (based on asset values) covering the period December 1 of this year through November 30 of next year. In November of last year, BAM paid $1,500 for business property taxes (based on asset values) covering the period December 1 of last year through November 30 of this year.

81. Bryan followed in his father's footsteps and entered into the carpet business. He owns and operates I Do Carpet (IDC). Bryan prefers to install carpet only, but in order to earn additional revenue, he also cleans carpets and sells carpet-cleaning supplies. Compute his taxable income for the current year considering the following items:

a) IDC contracted with a homebuilder in December of last year to install carpet in 10 new homes being built. The contract price of $80,000 includes $50,000 for materials (carpet). The remaining $30,000 is for IDC's service of installing the carpet. The contract also stated that all money was to be paid up front. The homebuilder paid IDC in full on December 28 of last year. The contract required IDC to complete the work by January 31 of this year. Bryan purchased the necessary carpet on January 2 and began working on the first home January 4. He completed the last home on January 27 of this year.

b) IDC entered into several other contracts this year and completed the work before year-end. The work cost $130,000 in materials and IDC elects to immediately deduct supplies. Bryan billed out $240,000 but only collected $220,000 by year-end. Of the $20,000 still owed to him, Bryan wrote off $3,000 he didn't expect to collect as a bad debt from a customer experiencing extreme financial difficulties.

c) IDC entered into a three-year contract to clean the carpets of an office building. The contract specified that IDC would clean the carpets monthly from July 1 of this year through June 30 three years hence. IDC received payment in full of $8,640 ($240 a month for 36 months) on June 30 of this year.

d) IDC sold 100 bottles of carpet stain remover this year for $5 per bottle (it collected $500). Rex sold 40 bottles on June 1 and 60 bottles on November 2. IDC had the following carpet-cleaning supplies on hand for this year, and IDC has elected to use the LIFO method of accounting for inventory under a perpetual inventory system:

Purchase Date	Bottles	Total Cost
November last year	40	$120
February this year	35	112
July this year	25	85
August this year	40	140
Totals	140	$457

e) On August 1 of this year, IDC needed more room for storage and paid $900 to rent a garage for 12 months.

f) On November 30 of this year, Bryan decided it was time to get his logo on the sides of his work van. IDC hired We Paint Anything Inc. (WPA) to do the job. It paid $500 down and agreed to pay the remaining $1,500 upon completion of the job. WPA indicated it wouldn't be able to begin the job until January 15 of next year, but the job would only take one week to complete. Due to circumstances beyond its control, WPA wasn't able to complete the job until April 1 of next year, at which time IDC paid the remaining $1,500.

g) In December, Bryan's son, Aiden, helped him finish some carpeting jobs. IDC owed Aiden $600 (reasonable) compensation for his work. However, Aiden did not receive the payment until January of next year.

h) IDC also paid $1,000 for interest on a short-term bank loan relating to the period from November 1 of this year through March 31 of next year.

82. Hank started a new business, Hank's Donut World (HW for short), in June of last year. He has requested your advice on the following specific tax matters associated with HW's first year of operations. Hank has estimated HW's income for the first year as follows:

Revenue:		
Donut sales	$252,000	
Catering revenues	71,550	$323,550
Expenditures:		
Donut supplies	$124,240	
Catering expense	27,910	
Salaries to shop employees	52,500	
Rent expense	40,050	
Accident insurance premiums	8,400	
Other business expenditures	6,850	−259,950
Net income		$ 63,600

HW operates as a sole proprietorship and Hank reports on a calendar year. Hank uses the cash method of accounting and plans to do the same with HW (HW has no inventory of donuts because unsold donuts are not salable). HW does not purchase donut supplies on credit nor does it generally make sales on credit. Hank has provided the following details for specific first-year transactions.

- A small minority of HW clients complained about the catering service. To mitigate these complaints, Hank's policy is to refund dissatisfied clients

50 percent of the catering fee. By the end of the first year, only two HW clients had complained but had not yet been paid refunds. The expected refunds amount to $1,700, and Hank reduced the reported catering fees for the first year to reflect the expected refund.

- In the first year, HW received a $6,750 payment from a client for catering a monthly breakfast for 30 consecutive months beginning in December. Because the payment didn't relate to last year, Hank excluded the entire amount when he calculated catering revenues.
- In July, HW paid $1,500 to ADMAN Co. for an advertising campaign to distribute fliers advertising HW's catering service. Unfortunately, this campaign violated a city code restricting advertising by fliers, and the city fined HW $250 for the violation. HW paid the fine, and Hank included the fine and the cost of the campaign in "other business" expenditures.
- In July, HW also paid $8,400 for a 24-month insurance policy that covers HW for accidents and casualties beginning on August 1 of the first year. Hank deducted the entire $8,400 as accident insurance premiums.
- In May of the first year, Hank signed a contract to lease the HW donut shop for 10 months. In conjunction with the contract, Hank paid $2,000 as a damage deposit and $8,050 for rent ($805 per month). Hank explained that the damage deposit was refundable at the end of the lease. At this time, Hank also paid $30,000 to lease kitchen equipment for 24 months ($1,250 per month). Both leases began on June 1 of the first year. In his estimate, Hank deducted these amounts ($40,050 in total) as rent expense.
- Hank signed a contract hiring WEGO Catering to help cater breakfasts. At year-end, WEGO asked Hank to hold the last catering payment for the year, $9,250, until after January 1 (apparently because WEGO didn't want to report the income on its tax return). The last check was delivered to WEGO in January after the end of the first year. However, because the payment related to the first year of operations, Hank included the $9,250 in last year's catering expense.
- Hank believes that the key to the success of HW has been hiring Jimbo Jones to supervise the donut production and manage the shop. Because Jimbo is such an important employee, HW purchased a "key-employee" term-life insurance policy on his life. HW paid a $5,100 premium for this policy and it will pay HW a $40,000 death benefit if Jimbo passes away any time during the next 12 months. The term of the policy began on September 1 of last year and this payment was included in "other business" expenditures.
- In the first year, HW catered a large breakfast event to celebrate the city's anniversary. The city agreed to pay $7,100 for the event, but Hank forgot to notify the city of the outstanding bill until January of this year. When he mailed the bill in January, Hank decided to discount the charge to $5,500. On the bill, Hank thanked the mayor and the city council for their patronage and asked them to "send a little more business our way." This bill is not reflected in Hank's estimate of HW's income for the first year of operations.

Required:

a) Hank files his personal tax return on a calendar year, but he has not yet filed last year's personal tax return nor has he filed a tax return reporting HW's results for the first year of operations. Explain when Hank should file the tax return for HW and calculate the amount of taxable income generated by HW last year.
b) Determine the taxable income that HW will generate if Hank chooses to account for the business under the accrual method.
c) Describe how your solution might change if Hank incorporated HW before he commenced business last year.

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83. R.E.M., a calendar-year corporation and Athens, Georgia, band, recently sold tickets ($20,000,000) for concerts scheduled in the United States for next year and the following two years. For financial statement purposes, R.E.M. will recognize the income from the ticket sales when it performs the concerts, and R.E.M is obligated to return the ticket payments should a concert be cancelled. For tax purposes, R.E.M. uses the accrual method and would prefer to defer the income from the ticket sales until after the concerts are performed. This is the first time that it has sold tickets one or two years in advance. Michael Stipe has asked your advice. Write a memo to Michael explaining your findings.

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