Taxation of Business Entities

McGraw Hill's

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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 wife Mindy; sons Tyler, Braden, and Connor; and parents Kent and Wendy.

Troy Lewis

JES, Tommy, and Laura.

John Robinson

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

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, Issues in Accounting Education, Accounting Horizons, Journal of Accounting Education, Journal of Corporate Taxation, Journal of Accountancy,* and *The Tax Adviser*.


Courtesy of 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 of 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 U.S. 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 of John Barrick

Courtesy of Troy K Lewis

Troy K. Lewis (CPA, CGMA, MAcc, Brigham Young University, 1995) is an associate teaching professor in the School of Accountancy at Brigham Young University—Marriott School of Business. He teaches graduate and undergraduate courses in introductory taxation, property transactions, pass-through entity taxation, advanced individual taxation, and accounting for income taxes. He is the past chair of the Tax Executive Committee of the American Institute of CPAs (AICPA) in Washington, D.C., as well as the president of the Utah Association of CPAs (UACPA). He has testified six times before the U.S. Senate Finance Committee and the House Committee on Small Business. Prior to joining the faculty at BYU, he was a tax manager at Arthur Andersen and KPMG in Salt Lake City, Utah. In addition, he was employed for over a decade as the CERMO and Tax Director of Heritage Bank in St. George, Utah. He is the recipient of the AICPA Tax Section Distinguished Service Award, the BYU Marriott Ethics Teaching Award, and the UACPA Distinguished Service Award. Troy researches and publishes in professional tax journals in the areas of individual and pass-through taxation, qualified business income deduction, and property transactions as well as professional tax practice standards. His work has been published in journals such as *Practical Tax Strategies, Journal of Accountancy, Issues in Accounting Education,* and *The Tax Adviser*.

Courtesy of 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 2015–2016 president of the ATA. 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 JD (*Cum Laude*) from the University of Michigan in 1979, and he teaches courses on individual and corporate taxation and advanced accounting.

Courtesy of Connie Weaver

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 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 an editor of *The Accounting Review* and has served as the senior editor of *The Journal of the American Taxation Association* and on the editorial board of *Contemporary Accounting Research*.

Courtesy of Ron Worsham

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 program 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*.

In Memoriam

Courtesy Ed Outslay

On May 20, 2019, we lost one of our beloved authors, Edmund (Ed) Outslay, aged 67. During his tenure at Michigan State University from 1980 to 2019, Ed was known as a passionate academic, impactful mentor, and devoted community volunteer.

Over the course of his long and distinguished career, Ed gathered a remarkable list of accomplishments. He coauthored three tax textbooks, testified before the U.S. Senate Finance Committee, and presented to the Treasury, the IRS, and the Office of Tax Analysis. He won numerous awards from the Eli Broad College of Business at MSU, including the Distinguished Faculty Award, the Presidential Award for Outstanding Community Service, the Withrow Teacher-Scholar Award, and the Curricular Service-Learning and Civic Engagement Award, in addition to numerous departmental teaching and research awards.

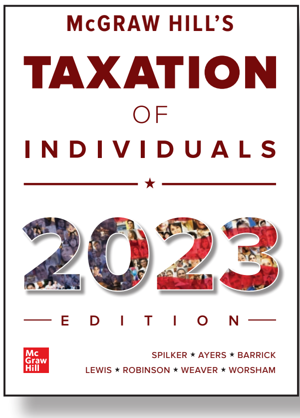
Ed enjoyed volunteering his time and was involved in many community programs, such as Lansing's Meals on Wheels program and MSU's Volunteer Income Tax Assistance (VITA) program. He was also an assistant baseball coach at East Lansing High School.

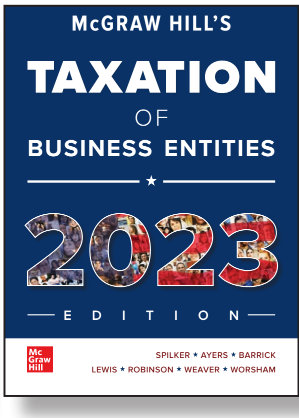
Ed was an avid reader and enjoyed visiting baseball parks and the zoo; he enjoyed coaching baseball and celebrating Halloween.

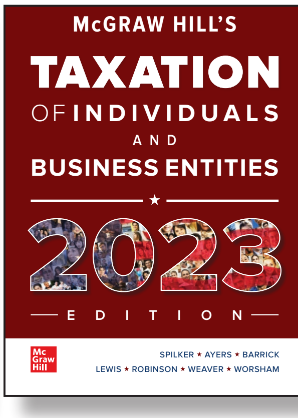
He earned his bachelor's degree from Furman University in Greenville, South Carolina, and his MBA and PhD from the University of Michigan.

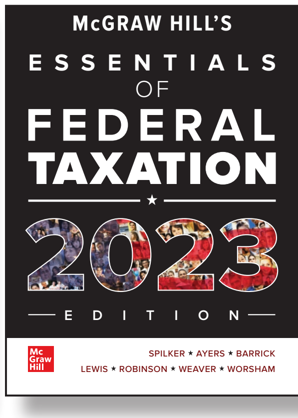
Ed's guidance, energy, and contributions will be deeply missed.

TEACHING THE CODE IN CONTEXT









The bold, innovative approach used by McGraw Hill's Taxation *series has become the most popular choice of course materials among instructors and students—a remarkable achievement in just over 10 years since first publishing. 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. 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.

A STORYLINE APPROACH THAT RESONATES WITH STUDENTS

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Storyline Summary

Elise Brandon (she/her/hers)

Employment status:	Tax associate for a large public accounting firm.

Assigned to prepare the federal income tax provision and income-tax-related balance sheet accounts and footnote disclosures for Premiere Computer Corporation, a nonaudit client.

Premiere Computer Corporation
Medium-sized publicly traded company.
Manufactures and sells computers and computer-related equipment. Calendar-year taxpayer.

Tax rate:	21 percent.

Elise felt a great sense of accomplishment when she completed her review of the federal income tax return for Premiere Computer Corporation (PCC). She was glad the return was filed on time and did not need to be extended. With the tax return filed, Elise was assigned to help the PCC tax department compute the federal **income tax provision** (financial income tax expense) for the company's soon-to-be-published income statement and to determine the correct amounts in the company's

Elise was aware that, as a result of the stringent independence requirements imposed by the Sarbanes-Oxley Act, her colleagues in the tax group were getting a lot of engagements to help prepare the income tax provision for nonaudit clients. In fact, her firm considered accounting for income taxes to be a "core competency" for all tax staff and prepared a training course for everyone. Having recently attended the firm's training on the subject, Elise was eager to apply her new knowledge to an actual client

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.

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 1-2

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?

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 a *Hard Fork* a taxable event?

A hard fork refers to a radical change to the protocols of a blockchain network. In simple terms, a hard fork splits a single cryptocurrency into two. On August 1, 2017, Bitcoin experienced a hard fork, and a second cryptocurrency, called Bitcoin Cash, was created. Every holder of a unit of Bitcoin received the same number of Bitcoin Cash units.

In 2021, the IRS concluded that the Bitcoin hard fork is a taxable event if the taxpayer had control over the resulting second cryptocurrency. Hence, a taxpayer who held 1 Bitcoin unit with a private key was subject to tax in 2017 on the value of the Bitcoin Cash unit received in the hard fork.

In contrast, another taxpayer owned Bitcoin through an account at CEX, a cryptocurrency sole control over the private key to 100 units of Bitcoin. The taxpayer owned one unit of the 100 total Bitcoin units held by CEX. Because CEX was uncertain of Bitcoin Cash's security and viability, it chose not to support Bitcoin Cash at the time of the hard fork. As a result, the taxpayer was unable to access any Bitcoin Cash through the account with CEX. The taxpayer was only subject to tax in 2018 on the value of the Bitcoin Cash unit after CEX initiated support for Bitcoin Cash in 2018, allowing the taxpayer to buy, sell, send, receive, transfer, or exchange the 1 unit in their account. The IRS noted that the character of the gain depended on whether the virtual currency is a capital asset in the hands of the taxpayer.

The Key Facts

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

Inventories

When producing, buying, or selling goods is an income-producing activity, taxpayers are required to keep inventories of goods, including raw materials and work in process, to determine the cost of goods sold. In addition, taxpayers who are required to keep inventory records also must use the accrual method of accounting for purchases and sales.[43] This requirement applies regardless of whether the taxpayer uses the cash or the accrual method as the overall method of accounting. Hence, the cost of inventory must include the purchase price of raw materials (minus any discounts), direct costs (manufacturing), shipping costs, and any indirect costs allocated to the inventory under the **uniform cost**

THE KEY FACTS

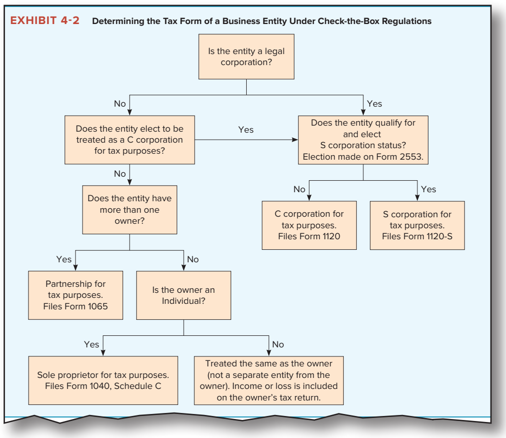
Inventories

- C corporations and partnerships with C corporation partners must use the accrual method to account for inventories unless they qualify as a small business under the gross receipts test. Small busi-

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 4-2 Determining the Tax Form of a Business Entity Under Check-the-Box Regulations



Top: Imageroller/Alamy Stock Photo; Bottom left: Jill Braaten/McGraw Hill

> "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

PRACTICE MAKES PERFECT WITH A WIDE VARIETY OF ASSIGNMENT MATERIAL

Summary

LO 3-1 Calculate the amount of gain or loss recognized on the disposition of assets used in a trade or business.

- Dispositions occur in the form of sales, trades, or other realization events.
- Gain realized is the amount realized less the adjusted basis of an asset.
- Amount realized is everything of value received in the transaction less any selling costs.
- Adjusted basis is the historical cost or initial basis of an asset less any cost recovery deductions applied against the asset.
- Gain realized on asset dispositions is not always recognized.

LO 3-2 Describe the general character types of gain or loss recognized on property dispositions.

- Recognized gains must be characterized as ordinary, capital, or §1231. An asset's character is a function of the asset's use and holding period.
- Ordinary assets are derived from normal transactions of the business (revenues and accounts receivable), the sale of short-term trade or business assets, and depreciation recapture.
- Capital assets are assets that are held either for investment or for personal use (a taxpayer's principal residence).

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 3-1 Calculate the amount of gain or loss recognized on the disposition of assets used in a trade or business.

LO 3-2 Describe the general character types of gain or loss recognized on property dispositions.

LO 3-3 Calculate depreciation recapture.

LO 3-4 Describe the tax treatment of unrecaptured §1250 gains.

LO 3-5 Describe the tax treatment of §1231 gains or losses, including the §1231 netting process.

LO 3-6 Explain common deferral exceptions to the general rule that realized gains and losses are recognized currently.

DISCUSSION QUESTIONS

Discussion Questions are available in Connect®. McGraw Hill connect

LO 4-1 1. What are the most common legal entities used for operating a business? How are these entities treated similarly and differently for state law purposes?

LO 4-1 2. How do business owners create legal entities? Is the process the same for all entities? If not, what are the differences?

LO 4-1 3. What is an operating agreement for an LLC? Are operating agreements required for limited liability companies? If not, why might it be important to have one?

LO 4-1 4. Explain how legal business entities differ in terms of the liability protection they provide their owners.

LO 4-1 5. Why is it a nontax advantage for corporations to be able to trade their stock on the stock market?

Discussion Questions

Discussion questions, 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.

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 5-1 33. LNS Corporation reports book revenue of $2,000,000. Included in the $2,000,000 is $15,000 of tax-exempt interest income. LNS reports $1,345,000 in ordinary and necessary business expenses. What is LNS Corporation's taxable income for the year?

LO 5-1 34. ATW Corporation currently uses the FIFO method of accounting for its inventory for book and tax purposes. Its beginning inventory for the current year was

Tax Form Problems

Tax form problems are a set of requirements included in the end-of-chapter material of the 2023 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, with select problems available in both static and algorithmic format. Each tax form problem includes an icon to differentiate it from regular problems.

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.

60. Mustafa, Mickayla, and Taylor are starting a new business (MMT). To get the business started, Mustafa is contributing $200,000 for a 40 percent ownership interest, Mickayla is contributing a building with a value of $200,000 and a tax basis of $150,000 for a 40 percent ownership interest, and Taylor is contributing legal services for a 20 percent ownership interest. What amount of gain or income is each owner required to recognize under each of the following alternative situations? [*Hint:* Look at §§351 and 721.] LO 4-3 research

a) MMT is formed as a C corporation.

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.

14. Daria is considering investing in one of two partnerships that will build, own, and operate a hotel. One is located in Canada and one is located in Arizona. Assuming both investments will generate the same before-tax rate of return, which entity should Daria invest in when considering the after-tax consequences of the investment? Assume Daria's marginal tax rate is 37 percent, she will be a passive investor in the business, and she will report the flow-through income from either entity on her tax return. Explain (ignore any foreign tax credit issues). LO 4-3 planning

15. Is business income allocated from a flow-through business entity to its owner's self-employment income? Explain. LO 4-3

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. **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.**

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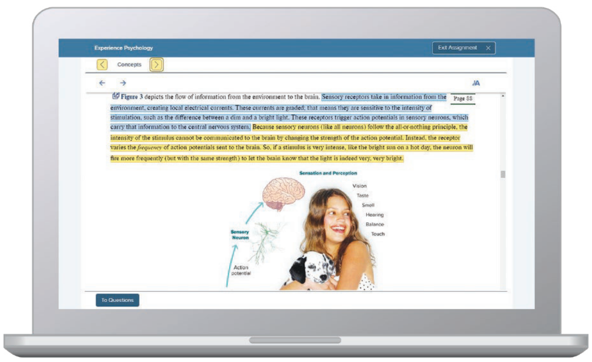

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>
> - Jordan Cunningham, Eastern Washington University

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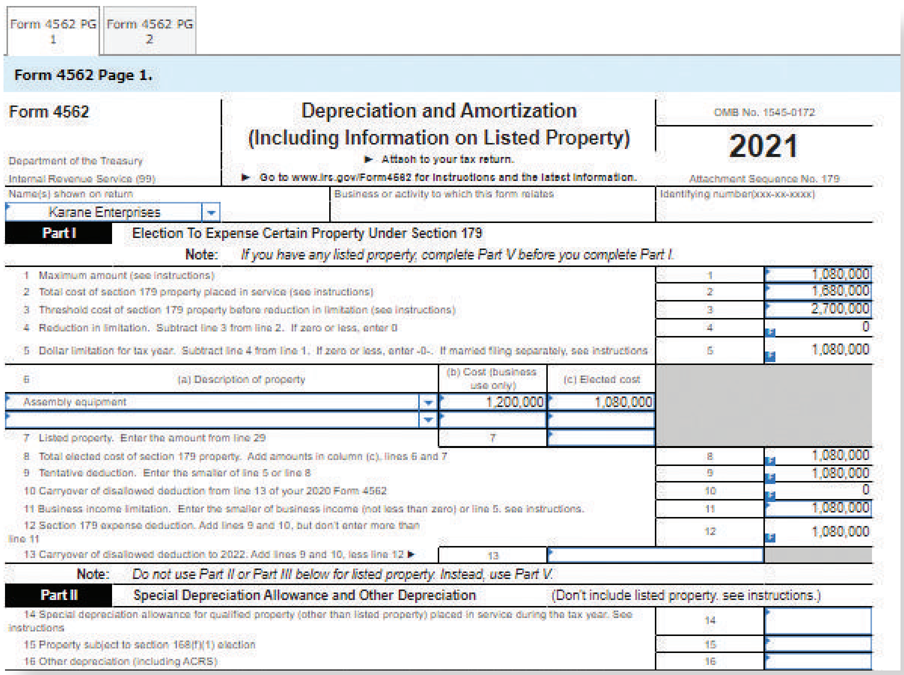
> Jason W. Stanfield
> – Ball State University

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.

Auto-Graded Tax Forms

The auto-graded **Tax Forms,** also called the Comprehensive Problems—Static (Tax Form) 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.



Form 4562 PG 1 | Form 4562 PG 2

Form 4562 Page 1.

Form 4562 — Department of the Treasury, Internal Revenue Service (99)

Depreciation and Amortization (Including Information on Listed Property)

► Attach to your tax return.

► Go to www.irs.gov/Form4562 for instructions and the latest information.

OMB No. 1545-0172 — **2021** — Attachment Sequence No. 179

Name(s) shown on return	Business or activity to which this form relates	Identifying number(xxx-xx-xxxx)
Karane Enterprises		

Part I Election To Expense Certain Property Under Section 179

Note: *If you have any listed property, complete Part V before you complete Part I.*

1 Maximum amount (see instructions)	1	1,080,000
2 Total cost of section 179 property placed in service (see instructions)	2	1,680,000
3 Threshold cost of section 179 property before reduction in limitation (see instructions)	3	2,700,000
4 Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter 0	4	0
5 Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	1,080,000

6 (a) Description of property	(b) Cost (business use only)	(c) Elected cost
Assembly equipment	1,200,000	1,080,000
7 Listed property. Enter the amount from line 29	7	

8 Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	1,080,000
9 Tentative deduction. Enter the smaller of line 5 or line 8	9	1,080,000
10 Carryover of disallowed deduction from line 13 of your 2020 Form 4562	10	0
11 Business income limitation. Enter the smaller of business income (not less than zero) or line 5. see instructions.	11	1,080,000
12 Section 179 expense deduction. Add lines 9 and 10, but don't enter more than line 11	12	1,080,000
13 Carryover of disallowed deduction to 2022. Add lines 9 and 10, less line 12 ►	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II Special Depreciation Allowance and Other Depreciation (Don't include listed property. see instructions.)

14 Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year. See instructions	14	
15 Property subject to section 168(f)(1) election	15	
16 Other depreciation (including ACRS)	16	

Source: irs.gov.

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.

Tableau Dashboard Activities

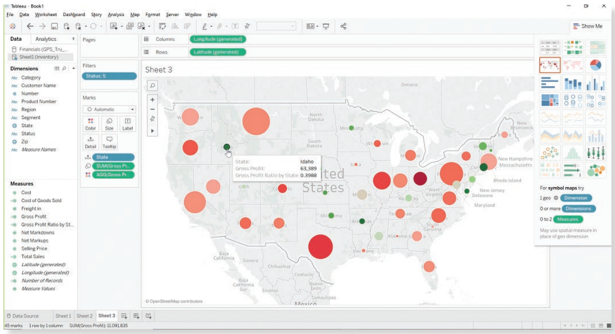
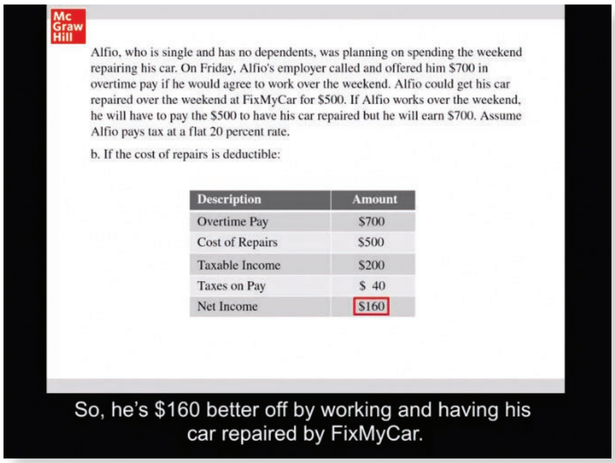


Tableau Dashboard Activities allow students to explore live Tableau dashboards directly integrated into Connect through interactive filters and menus as well as auto-graded questions focused on both calculations and analysis. Students can check their understanding and apply what they are learning within the framework of analytics and critical thinking.

TaxACT®



McGraw Hill's Taxation features an integrated software package from TaxAct, one of the leading preparation software companies in the market today. TaxAct features in-depth form instructions that supplement *Individuals* and *Business Entities,* making it easier than ever to integrate software into the classroom. Students are provided with the latest tax forms via the Check for Updates from the Online tab in the program so that at the start of the semester, each student will be prepared to work with the most up-to-date information available. With over 120 tax forms, schedules, and worksheets, TaxAct is sure to have the course materials you will need throughout the semester.

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 CPA

McGraw Hill has partnered with Roger CPA Review (Powered by UWorld), 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. Accordingly, students using these McGraw Hill materials will have access to Roger CPA Review multiple choice questions supported by explanations written by CPAs focused on exam preparation. McGraw Hill 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.

McGraw Hill Customer Experience Group Contact Information

At McGraw Hill, we understand that getting the most from new technology can be challenging. That's why our services don't stop after you purchase our products. You can contact our Product Specialists 24 hours a day to get product training online. Or you can search the knowledge bank of Frequently Asked Questions on our support website. For Customer Support, call **800-331-5094,** or visit www.mhhe.com/support. One of our Technical Support Analysts will be able to assist you in a timely fashion.

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

McGraw Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *McGraw Hill's Taxation* recognizes the curriculum guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the text and the test bank to the general knowledge and skill guidelines in the revised AACSB standards.

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.

Tegrity: Lectures 24/7

Tegrity in Connect is a tool that makes class time available 24/7 by automatically capturing every lecture. With a simple one-click start-and-stop process, you capture all computer screens and corresponding audio in a format that is easy to search, frame by frame. Students can replay any part of any class with easy-to-use, browser-based viewing on a PC, Mac, iPod, or other mobile device.

Educators know that the more students can see, hear, and experience class resources, the better they learn. In fact, studies prove it. Tegrity's unique search feature helps students efficiently find what they need, when they need it, across an entire semester of class recordings. Help turn your students' study time into learning moments immediately supported by your lecture. With Tegrity, you also increase intent listening and class participation by easing students' concerns about note-taking. Using Tegrity in Connect will make it more likely you will see students' faces, not the tops of their heads.

Test Builder in Connect

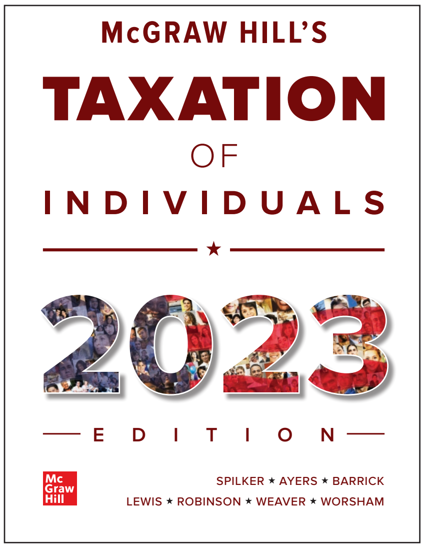
Available within Connect, Test Builder is a cloud-based tool that enables instructors to format tests that can be printed or administered within an LMS. Test Builder offers a modern, streamlined interface for easy content configuration that matches course needs, without requiring a download.

Test Builder allows you to:

- access all test bank content from a particular title.
- easily pinpoint the most relevant content through robust filtering options.
- manipulate the order of questions or scramble questions and/or answers.
- pin questions to a specific location within a test.
- determine your preferred treatment of algorithmic questions.
- choose the layout and spacing.
- add instructions and configure default settings.

Test Builder provides a secure interface for better protection of content and allows for just-in-time updates to flow directly into assessments.

Four Volumes to Fit Four Course Approaches



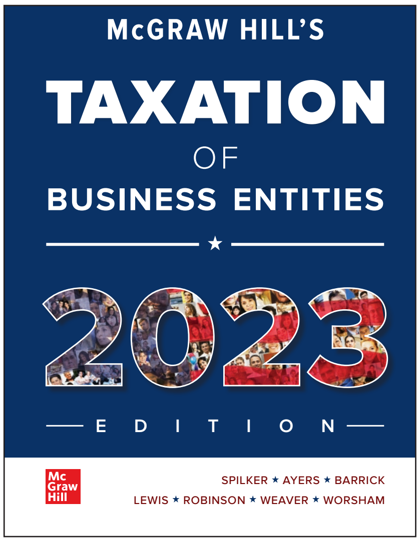
McGraw Hill's Taxation of Individuals is organized to emphasize topics that are most important to undergraduates taking their first tax course. The first three chapters provide an introduction to taxation and then carefully guide students through tax research and tax planning. Part II discusses the fundamental 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



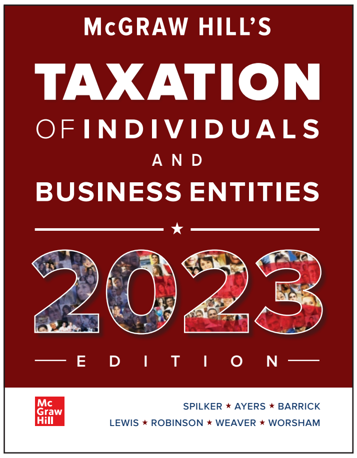
McGraw Hill's Taxation of Business Entities begins with the process for determining gross income and deductions for businesses, and the tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). Part II provides a comprehensive overview of entities 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.

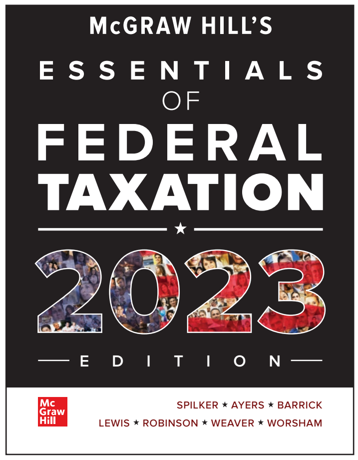
Part I: Business-Related Transactions
1. Business Income, Deductions, and Accounting Methods
2. Property Acquisition and Cost Recovery
3. Property Dispositions

Part II: Entity Overview and Taxation of C Corporations
4. Business 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





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.

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.

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 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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We are especially grateful to J. T. Eagan for his contributions to the Tableau Dashboard Activities and Guided Examples, as well as Temple University instructors Wayne Williams, David Jones, and Ronald Unger for their assistance developing the Data Analytics Problems.

We also appreciate the expert attention given to this project by the staff at McGraw Hill Education, especially Tim Vertovec, Managing Director; Kathleen Klehr, Executive Portfolio Manager; Sarah Wood and Katie Ward, Freelance Product Developers; Brian Nacik and Jill Eccher, Content Project Managers; Beth Blech, Designer; Natalie King, Marketing Director; Claire McLemore, Marketing Manager; and Sue Culbertson, Senior Buyer.

Changes in *Taxation of Business Entities,* 2023 Edition

For the 2023 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 2022.** In addition, **chapter content** throughout the text has been **updated to reflect tax law changes through February 8, 2022.**

Other notable changes in the 2023 edition include:

Chapter 1

- Updated tax forms from 2020 to 2021.
- Updated examples and problems for changes in inflation limit on gross receipts test.
- Added new Taxes in the Real World on whether cost of goods sold is subject to the test for economic performance.
- Clarified exception for prohibition of expense deduction by cannabis businesses.
- Explained and illustrated new small business accounting regulations.
- Integrated gross receipts test into accounting limitations.
- Added explanations of new regulations limiting entertainment and travel deductions including revised examples.
- Described and illustrated accounting for nonincidental material.
- Updated mileage deductions for travel in 2022.
- Added new Taxes in the Real World on Cryptocurrency and Income from a Hard Fork.

Chapter 2

- Updated Exhibit 2-2 for Weyerhaeuser's 2020 assets.
- Updated tax rates to 2022 rates.
- Revised section on §179 amounts to reflect the inflation adjustments for 2022.
- Updated examples for 2022 §179 amounts.
- Updated discussion and Exhibit 2-10 relating to automobile depreciation limits.
- Updated §179 amount for SUVs for 2022 inflation amount changes.
- Updated tax forms to 2021.
- Updated and revised end-of-chapter problems for §179 amounts and bonus depreciation rules.
- Revised discussion of research and experimentation expenditures to reflect disallowance of the immediate expensing option in 2022.
- Added new Taxes in the Real World: The Case of How Sports Owners Pay Lower Tax Rates Than the Stadium Beer Server.

Chapter 3

- Updated tax rates for 2022.
- Updated tax forms from 2020 to 2021 forms.
- Added new Taxes in the Real World: Buyer Beware.

Chapter 4

- Added discussion and new example illustrating double taxation of C corporations and single taxation of flow-through entities (including basis in ownership interest in entity).
- Added discussion on the qualified business income (QBI) deduction, including two new examples.
- Enhanced QBI-related problems to include limitations.
- Added discussion and new example on self-employment tax.
- Added discussion relating to tax-exempt organizations.
- Added new discussion question dealing with tax-exempt organizations.
- Added new exhibit comparing tax characteristics by tax entity type.
- Added discussion and new example on owner compensation when owners provide services.
- Added new Taxes in the Real World dealing with unreasonable compensation paid to S corporation shareholder/employees.
- Updated Social Security wage base limitation for 2022, including related calculations.
- Updated inflation-adjusted numbers for excess business loss threshold and gross receipts test to reflect 2022 numbers.
- Added and/or revised several discussion questions and problems, including adding a new comprehensive problem.
- Updated tax forms to 2021 in problem solutions.

Chapter 5

- Revised section dealing with book–tax difference on an investment held for trading.
- Added summary of temporary book–tax differences for installment sales and like-kind exchanges.

- Added example on the book-tax differences associated with organizational expenditures.
- Revised net operating loss discussion.
- Added new Taxes in the Real World about whether large corporations are paying enough taxes.
- Added note to Exhibit 5-6 to mention that NOL deductions may be limited when there is an ownership change.
- Revised charitable deduction limitation discussion and example to reflect differences in charitable contribution limit between 2021 and 2022.
- Updated the gross receipts test for the cash method to reflect the inflation-adjusted threshold for 2022.
- Updated dates in examples and problems from 2021 to 2021.
- Updated tax forms to 2022.

Chapter 6

- Added new discussion of ASC 740 objectives.
- Added new Examples 6-1 and 6-2 to illustrate the importance of ASC 740 and its objectives.
- Revised net operating loss discussion in the valuation allowance section to describe tax law changes relating to net operating losses under the CARES Act.
- Updated text discussion for tax law changes introduced by the Consolidated Appropriations Act (CAA), 2021, signed on December 27, 2020. This includes updating the deductibility of the cost of meals purchased at a restaurant and updating the income percentage limitation for qualified charitable contributions.
- Updated examples and problems to reflect the tax law changes introduced by the CAA.
- Revised and streamlined the Tax Provision Process to five steps.
- Added new Exhibit 6-6 for the current tax expense formula.
- Revised discussion of the calculation of the current income tax expense.
- Revised discussion of the determination of the deferred tax assets and liabilities.
- Added new Exhibit 6-7 to illustrate taxable and deductible temporary differences.
- Added new Exhibit 6-8 to provide PCC's tax basis balance sheet.
- Added new discussion of tax basis liabilities and the balance sheet method of determining the deferred tax assets and liabilities.
- Revised Examples 6-7 through 6-13 to illustrate the balance sheet approach.
- Added formula for the total tax expense.
- Revised the discussion of the required journal entries to book the current and deferred income tax expense or benefit.
- Expanded the discussion of the journal entries related to the valuation allowance.
- Added discussion of journal entries related to uncertain tax positions.
- Updated dates in examples and problems from 2021 to 2022.
- Updated the Subsequent Events discussion for uncertain tax benefits.
- Updated Exhibit 6-9 for Microsoft uncertain tax benefit footnote disclosure.
- Added new Taxes in the Real World: Material Weaknesses in Tax Reporting.

Chapter 7

- Modified examples and discussion to clarify distinction between calculating accumulated and current earnings and profits.
- Added new Taxes in the Real World describing the importance of record keeping in calculating the tax basis of shares of corporate stock.
- Clarified examples of stock attribution from entities to owners or beneficiaries.
- Added new Taxes in the Real World illustrating the substance-over-form doctrine.
- Clarified homework problems on calculation of current earnings and profits.

Chapter 8

- Clarified discussion and example of receipt of stock for services in §351.
- Modified version of ethics question on accommodation transfers.
- Revised explanation of corporate basis calculation when shareholders receive boot in a §351 transaction.
- Clarified that merger negotiations must simultaneously consider both the form and the price of a corporate acquisition.
- Added new Taxes in the Real World on reverse Special Purpose Acquisition Company (SPAC) mergers.
- Added new alternatives to corporate liquidation problems.

Chapter 9

- Updated discussion on excess business loss limitation to reflect inflation adjustments of threshold amounts.
- Updated discussion on the availability of the cash method to partnerships with corporate partners to

reflect inflation adjustments to the average annual gross receipts test.

- Updated discussion on the applicability of the limitation on business interest expense to partners and partnerships to reflect inflation adjustments to the average annual gross receipts test.
- Added new discussion of forms K-2 and K-3 filed by partnerships.
- Added a new discussion of how passive activity losses carried forward are used when a partner sells their interest in a partnership.
- Updated tax forms to 2021.
- Revised end-of-chapter problems to reflect inflation adjustments.

Chapter 10

- Updated Form 1065 late filing penalty amounts.
- Added a new Taxes in the Real World item describing how owners of sports franchises utilize special basis adjustments available to partners to deduct a substantial amount of their purchase price.
- Added a new discussion of partnership terminations and their implications.

Chapter 11

- Updated excess business loss limitation for 2022.
- Added a new Taxes in the Real World on S corporation elections and venture capital.
- Updated Social Security tax wage base for 2022.
- Updated tax forms to 2021.

Chapter 12

- Updated economic sales tax nexus for updates related to *South Dakota v. Wayfair, Inc.*
- Updated nexus discussion to reflect sales tax nexus and income tax nexus being different.

Chapter 13

- Updated the discussion on the OECD base erosion and profit-shifting project to reflect the recent adoption by OECD countries of a worldwide minimum tax rate.
- Updated the discussion on the level of foreign investment in the U.S and the level of U.S. investment in foreign countries.
- Updated tax forms to 2021.

Chapter 14

- Revised text and Exhibit 14-2 for changes in the applicable exclusion amount.
- Revised for inflation adjustment for annual gift tax exclusion.
- Explained and illustrated calculation of applicable credit in event that the applicable exclusion amount is reduced in the future.
- Explained and illustrated calculation of deceased spousal unused exclusion (DSUE) for changes in the applicable exclusion amount at the death of the surviving spouse.
- Added new homework problem on use of the DSUE portability election.
- Modified homework problem on calculation of estate tax in a contemplation of death transfer.
- Clarified and illustrated shortcut method to calculate transfer taxes.
- Updated 2020 tax forms with 2021 forms.

As We Go to Press

The 2023 Edition includes tax law enacted as part of the Consolidated Appropriations Act, 2021 (CAA), signed into law on December 27, 2020, and the American Rescue Plan Act of 2021 (ARP), signed into law on March 11, 2021. The 2023 Edition is current through February 8, 2022. You can visit the *Connect Library* for updates that occur after this date.

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6 Accounting for Income Taxes

7 Corporate Taxation: Nonliquidating Distributions

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** Describe accounting periods available to businesses.
- **LO 1-4** Apply cash and accrual methods to determine business income and expense deductions.

Tony Anderson/DigitalVision/Getty Images

Storyline Summary

Taxpayer:	Rick Grime (he/him/his)
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 has been employed by a landscape architect in Dallas. Nearly every day Rick 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 to San Antonio. Once in town, Rick discovered a lot of things are necessary to start a business. First, Rick registered his new business name (Green Acres Landscaping, LLC) and established a bank account for the business. Next, Rick rented a used sport utility vehicle (SUV) and a shop for the place of business. Rick didn't know much about accounting for business activities, so a CPA, Jane Bronson, was hired to advise Rick. Jane and Rick decided that Green Acres would operate as a sole proprietorship, but Jane suggested that as the business grew, Rick might want to consider organizing it as a different type of legal entity. Operating as a corporation, for instance, would allow Rick to invite new investors or business partners to help fund future expansion. Rick formally started his business on May 1. Initially, Rick spent a lot of time attracting new customers, and figured he would hire employees as needs warranted.

(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 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.

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 1120-S, 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 (i.e., 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. Unlike wage earners, businesses can be subject to complex rules and limitations discussed later in this chapter. However, most *small* businesses are exempt from these rules as determined under a gross receipts test.

Gross Receipts Test for Determining Small Businesses

A business that qualifies as a *small* business under a **gross receipts test** is exempt from certain complex accounting provisions (discussed later in the chapter) for each year in which it meets the test. A business meets the gross receipts test for 2022 if its average annual gross receipts for the three prior taxable years does not exceed $27 million.[3] For example, if a corporation reported gross receipts of $26 million, $25 million, and $29 million in 2019, 2020, and 2021, respectively, it would meet the gross receipts test for 2022 ($26.7 million in average gross receipts over the prior three years). However, if it reported $32 million of gross receipts in 2021, rather than $29 million, it would fail the gross receipts test for 2022 ($27.7 million in average gross receipts over the prior three years) and would not qualify as a small business for 2022. For purposes of the test, gross receipts includes total sales (net of returns and allowances but not cost of goods sold), amounts received for services, and income from investments (including tax-exempt interest).[4] When the business has not been in existence for three prior tax years, the test is conducted for the years that it was in existence. Also, in the case of a taxable year of less than 12 months (a *short* year), the amount of gross receipts must be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

[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. The choice of the organizational form for a business is a complex decision that is beyond the scope of this chapter.

[2]§61(a).

[3]§448(c). The gross receipts threshold amount is indexed for inflation. The gross receipts threshold was $25 million for 2018 and $26 million for 2019 through 2021.

[4]Temp. Reg. §1.448-1T(f)(2)(iv)(A). Gross receipts from the sale of a capital asset is reduced by the adjusted basis in the asset.

The gross receipts test is an annual test. It is possible a business might qualify under the the gross receipts test in year 1 but experience a surge in gross receipts and not qualify in year 2. Hence, businesses that experience volatile gross receipts may find that they qualify in one year but not the next if gross receipts vary substantially around the $27 million cutoff.

Example 1-1

What if: Suppose that Green Acres is a C corporation and a calendar-year taxpayer. Suppose further that Green Acres reported gross receipts of $20 million in 2019, $25 million in 2020, and $30 million in 2021. In 2022, is Green Acres a small business under the gross receipts test?

Answer: Yes. The average of gross receipts for the previous three-tax-year period is $25 million ($75 million divided by 3). Because average gross receipts doesn't exceed $27 million, Green Acres qualifies as a small business under the gross receipts test in 2022.

What if: Suppose that Green Acres began business operations on January 1, 2020, and reported $22 million in gross receipts for that year. In 2021, Green Acres reported $30 million in gross receipts. Is Green Acres a small business in 2022 under the gross receipts test?

Answer: Yes. The average of gross receipts for the two-tax-year period in which Green Acres conducted business is $26 million ($52 million divided by 2). Because average gross receipts doesn't exceed $27 million, Green Acres qualifies as a small business in 2022.

What if: Suppose that Green Acres began business operations on July 1, 2021, and reported $15 million in gross receipts for the six months of 2021, a short year. Does Green Acres qualify as a small business in 2022 under the gross receipts test?

Answer: No. For purposes of the gross receipts test, the gross receipts for the six-month 2021 tax year is annualized by multiplying $15 million by 12 and dividing the result by 6 (the number of months in the short period 2021). Thus, gross receipts for Green Acres in 2021 is $30 million ($180 million divided by 6). Because average gross receipts is more than $27 million, Green Acres is not considered to be a small business in 2022.

TAXES IN THE REAL WORLD Is a *Hard Fork* a taxable event?

A hard fork refers to a radical change to the protocols of a blockchain network. In simple terms, a hard fork splits a single cryptocurrency into two. On August 1, 2017, Bitcoin experienced a hard fork, and a second cryptocurrency, called Bitcoin Cash, was created. Every holder of a unit of Bitcoin received the same number of Bitcoin Cash units.

In 2021, the IRS concluded that the Bitcoin hard fork is a taxable event if the taxpayer had control over the resulting second cryptocurrency. Hence, a taxpayer who held 1 Bitcoin unit with a private key was subject to tax in 2017 on the value of the Bitcoin Cash unit received in the hard fork.

In contrast, another taxpayer owned Bitcoin through an account at CEX, a cryptocurrency exchange. Rather than the taxpayer, CEX had sole control over the private key to 100 units of Bitcoin. The taxpayer owned one unit of the 100 total Bitcoin units held by CEX. Because CEX was uncertain of Bitcoin Cash's security and viability, it chose not to support Bitcoin Cash at the time of the hard fork. As a result, the taxpayer was unable to access any Bitcoin Cash through the account with CEX. The taxpayer was only subject to tax in 2018 on the value of the Bitcoin Cash unit after CEX initiated support for Bitcoin Cash in 2018, allowing the taxpayer to buy, sell, send, receive, transfer, or exchange the 1 unit in their account. The IRS noted that the character of the gain depended on whether the virtual currency is a capital asset in the hands of the taxpayer.

Source: Chief Counsel Advice CCA 202114020.

BUSINESS DEDUCTIONS

LO 1-1

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

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.

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. . . .[5]

Taxpayers can deduct expenses for "trade or business" activities, but the law does not define the phrase "trade or business."[6] 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.

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.[7] 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 repair would require 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 1-2

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?

[5]§162(a). It is important to note that the cost of goods sold is not a deduction. Instead, it automatically reduces gross income from sales and requires no statutory authority. See *Doyle v. Mitchell Brothers Co.,* 247 U.S. 179 (1918), *aff'g* 235 Fed. 686 (6th Cir. 1916).

[6]§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.

[7]*Welch v. Helvering,* 290 U.S. 111 (1933).

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 a busy schedule, in the past Sheri found time for family. This year Sheri took on two new important clients and hired a personal assistant to help manage Sheri's schedule and make timely court filings. Occasionally, Sheri asked the assistant to assist with personal tasks such as buying groceries. Do you think that Sheri should treat the 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?

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.[8] 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 1-3

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 $20 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 $21,000 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 $35 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 $3,500 from Rick. What amount can Rick deduct for the compensation he paid to his employees?

Answer: $23,000. Rick can deduct the entire $21,000 paid to the four part-time employees. However, he can only deduct $20 an hour for Tom's compensation because the extra $15 per hour Rick paid Tom is unreasonable in amount.[9] 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 [$21,000 + ($20 × 100)].

(*continued on page 1-6*)

[8]§162(a); *Comm'r v. Lincoln Elec. Co.*, 176 F.2d 815 (6th Cir. 1949).

[9]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 $20 an hour, but perhaps not as much as $35 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.

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 $3,500 under these circumstances?

Answer: $3,500. Rick can now deduct an additional $1,500 because Tom's quality of work justifies twice the salary paid to other employees.

LO 1-2

LIMITATIONS ON BUSINESS DEDUCTIONS

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.

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.

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.[10] 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 (i.e., 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.[11] Of course, the IRS is probably more concerned that many illegal businesses fail to report *any* income than that illegal businesses overstate deductions.[12]

Example 1-4

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.

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.[13]

[10]§162(c); 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.

[11]*Comm'r v. Sullivan,* 356 U.S. 27 (1958). 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.

[12]§280E explicitly prohibits dealers in illegal drugs from deducting any business expenses associated with this "business" activity. This prohibition remains on marijuana producers despite the legalization of marijuana under some state laws. However, drug dealers and marijuana producers are still able to deduct cost of goods sold because cost of goods sold is technically a reduction in gross income (return of capital) and not a business expense. See Reg. §1.61-3(a).

[13]§162(e).

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).[14] For tax purposes, businesses recover the cost of capitalized tangible assets (other than land) either by immediate expensing (when allowed by law) or through depreciation.

Businesses also capitalize the cost to create or acquire *intangible* assets such as patents, purchased goodwill, start-up costs, and organizational expenditures.[15] 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.[16] 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 1-5

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 Joan is over 60 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?

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.[17] 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.

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

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

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

[17]§262(a).

Example 1-6

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.

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.
- For 2022, the cost of business meals provided by restaurants is 100 percent deductible. Other business meals are typically 50 percent deductible.
- Contemporaneous written records of business purpose are required.

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 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.

Like personal expenses, entertainment expenditures are generally not deductible as business expenses. Entertainment is defined in the regulations as any activity that is of a type generally considered to constitute entertainment, amusement, or recreation. Activities at night clubs, theaters, country clubs, and sporting events are all considered entertainment.[18] Two notable exceptions to the ban on deducting entertainment expenses include expenditures primarily for the benefit of the taxpayer's employees and entertainment expenses designed and treated as compensation. For example, an employer could deduct as compensation an all-expense paid holiday provided to an outstanding employee.

Some business expenditures are deductible despite being related to personal, living, or family needs of an individual; for example, the cost of a hotel room maintained by an employer for lodging of his employees while in business travel status. Another example is the cost for using an automobile in the active conduct of trade or business even though the auto might also be used for routine personal purposes such as commuting to and from work.

Because everyone needs to eat, meals also contain a significant personal element. In addition, meals are also often associated with entertainment activities. However, the cost or a portion of the cost of a meal can sometimes qualify as a business expense. To qualify as a business expense, the cost of food and beverages must meet several requirements. First, as with all business expenses, a meal must be ordinary and necessary under the circumstances and the amount must be reasonable (not extravagant). Second, the taxpayer or an employee must be present when the meal is furnished, and the meal must be provided to a current or potential client or business contact. Finally, if the meal is provided during or at an entertainment activity, the meal must be purchased separately from the entertainment or the cost stated separately on invoices or receipts.[19]

[18]Reg. §§1.274-2(b) and 1.274-11.

[19]§274(k), (n); Notices 2018-76 and 2021-25; Prop. Reg. §1.274-11(b)(ii).

Business deductions for food and beverages are generally limited to 50 percent of the cost. However, for 2022 (and 2021) the cost of food and beverages for business meals is 100 percent deductible as long as the expense is for food or beverages provided by a *restaurant* (presumably including take-out and delivery).[20] Also fully deductible are the costs of food and beverages when the amounts paid are treated as employee compensation.[21] For example, when a business rewards a high-performing salesperson with an all-inclusive vacation, the cost of the vacation including food and beverages is fully deductible. Likewise, the cost of food and beverages provided during employee recreational activities is fully deductible when the activity is not limited to highly compensated individuals. For example, the cost of meals and beverages would be fully deductible for a buffet and open bar at a holiday party for employees.

Example 1-7

Rick invited two prospective clients to a professional basketball game. Rick purchased tickets to attend the game in a suite where food and beverages would be provided by a wine and cheese specialty store that does not qualify as a restaurant. Rick paid $850 for the tickets and $540 for the food and beverages. Assuming that these amounts were not extravagant, what amount can Rick deduct as a business expense?

Answer: Rick can deduct $270 [$540 × 50%] as a business expense because the cost of the food was stated separately from the cost of the tickets. The cost of the tickets to the game is a nondeductible entertainment expense. If the food and beverages were provided by a restaurant, then Rick could deduct their full cost ($540).

What if: Suppose that Rick purchased the tickets for $1,500 and that the cost of the tickets included food and beverages. What amount of the expenditures can Rick deduct as a business expense?

Answer: Zero. The cost of meals must be stated separately from the cost of the entertainment.

What if: Suppose that Rick invited all of his employees to a company picnic where he paid $1,250 for food and beverages. What amount of the expenditures can Rick deduct as a business expense?

Answer: $1,250. The cost of food and beverages is fully deductible for employee recreational events that are not limited to highly compensated employees.

What if: Suppose Rick took a prospective client to his favorite restaurant and paid $200 for a meal. What amount could Rick deduct as a business expense?

Answer: $200 if the meal was not extravagant. For 2022, the entire cost of a business meal is deductible when provided by a restaurant.

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 remote business sites. In contrast, 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).[22] For 2022, the standard mileage rate is 58.5 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.

[20]Section 210 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 amends Code Sec. 274(n)(2) to allow for 100 percent deduction of expenses for food and beverages paid to or incurred at a restaurant after December 31, 2020, and prior to January 1, 2023. Notice 2021-15 defines restaurant to mean a business that sells food or beverages to retail customers for immediate consumption regardless of whether the food or beverages are consumed on the business's premises.

[21]§274(e)(20) and Reg. §1.274-12(c). Importantly, the cost of food and beverages is only 50 percent deductible for breakroom snacks because this benefit does not qualify as compensation or recreational activities.

[22]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 actual cost method including depreciation for determining automobile deductions, the taxpayer is not allowed to switch to the standard mileage rate method. If the taxpayer uses the mileage method, they can switch to the cost method in a subsequent year but must compute depreciation using the straight-line method.

Example 1-8

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. Because Rick uses the SUV in his business activities, he can deduct (1) the $5,335 cost of operating and leasing the SUV or (2) $4,739 for the 8,100 business miles driven this year (58.5 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. However, by choosing to deduct the actual operating expense, Rick will forgo the option of using the mileage rate in the future.

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 unless provided by a restaurant), 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 unless provided by a restaurant). 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 unless provided by a restaurant), lodging, and incidental expenditures are limited to those incurred during the business portion of the travel.[23] 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 (limited to 50 percent unless provided by a restaurant), 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 ratio of the proportion of personal days to total days (travel days count as business days).[24]

Example 1-9

Rick paid a $300 registration fee for a three-day course in landscape design. The course was held in upstate New York (Rick paid $625 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 at restaurants, and $70 a day for a rental car. What amount of these travel-related expenditures may Rick deduct as business expenses?

[23]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.

[24]Foreign transportation expense is deductible without prorating under special circumstances detailed 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	$ 625	Primary purpose is business
Lodging	450	3 business days × $150 a day
Meals	150	3 business days × $50 a day
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 $810 for the lodging, meals, and rental car and $300 for business education. Rick would not be able to deduct the $625 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	150	3 business days × $50 a day
Rental car	210	3 business days × $70 a day
Total business travel expenses	**$810**	

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 $1,995 for travel (computed below) and $300 for business education.

Deductible Travel Costs

Description	Amount	Explanation
Airfare to London	$ 375	6 business days/10 total days × $625
Lodging in London	900	6 business days × $150 a day
Meals	300	6 business days × $50 a day
Rental car	420	6 business days × $70 a day
Total business travel expenses	**$1,995**	

Rick is allowed to deduct $375 of the $625 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.[25] However, because expenses relating to these assets are deductible only to the extent the assets are used for business purposes, taxpayers 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%).

[25]These types of assets are referred to as "listed property." However, cell phones and computers are specifically exempted from the definition of listed property under §280F(d)(4)(A).

Example 1-10

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 500 miles for business activities and 10,000 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 [500 business miles/10,000 total miles]). Hence, Rick will deduct 5 percent of $6,120, or $306, as business travel. Alternatively, Rick could use the business mileage rate of 58.5 cents a mile to determine his business travel expense.

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, the cost of business meals is deductible (limited to 50% unless provided by a restaurant), but only if the taxpayer can properly document the five requirements described above.[26]

Limitation on Business Interest Deductions

The deduction of interest paid or accrued on indebtedness allocable to a trade or business is subject to limitation. The purpose of this limitation is to limit the extent to which a business utilizes debt to avoid income taxes. Specifically, business interest is broadly 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 includable in gross income that is properly allocable to a trade or business. The limitation does not apply to a business that qualifies as a small business under the $27 million gross receipts test discussed in the gross income section of the chapter.

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.
- The business interest limitation does not apply to businesses qualifying as small businesses under the $27 million gross receipts test.
- 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.

Calculating the Interest Limitation Adjusted taxable income represents the 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 that 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; (4) deductions allowable for depreciation, amortization, or depletion; and (5) any deduction for qualified business income under §199A.[27]

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 or bonds 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 $27 million indexed for inflation, then the interest (including any carryforwards) becomes fully deductible (i.e., it is no longer subject to the business interest limitation).

[26]§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. Comm'r,* 39 F.2d 540 (2d Cir. 1930)].

[27]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 before 2022, adjusted taxable income was also reduced for depreciation, amortization, and depletion.

Example 1-11

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 other deductible expenses (excluding interest expense and $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 $27 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: $6,900. Green Acres generated $23,000 of adjusted taxable income. Adjusted taxable income is the amount of revenue less expense before interest expense and after adding back depreciation ($70,000 − ($47,000)). The 2022 business interest limitation is 30 percent of the $23,000 of adjusted taxable income, or $6,900. The $2,100 of disallowed interest expense from 2022 would be carried over to 2023.

Losses on Dispositions of Business Property

Businesses are generally allowed to deduct losses incurred when selling or disposing of business assets. 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. To prevent businesses and related persons from working together to defer taxes, the tax laws generally limit the deduction of business losses when property is sold to a related person. For this purpose, related persons generally include family members, partnerships, and controlled corporations. Related persons are discussed in more detail in the next section of this chapter, and the calculation of the loss limitation is discussed in the Property Dispositions chapter.

Example 1-12

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.)

What if: Suppose that Rick sold the trailer to a parts shop owned by his father. What amount can Rick deduct as a loss from the trailer sale?

Answer: Zero. However, Rick's father may be able to utilize Rick's loss if the trailer is later sold by the father.

Business Casualty Losses

Businesses can also incur deductible losses when their assets are stolen, damaged, or completely destroyed by a force outside the control of the business. These events are called casualties.[28] Businesses 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

[28]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.

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 1-13

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 tax basis, $5,000. The calculation follows:

Insurance proceeds	$ 1,000
Minus decline in value	−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 tax basis, $5,000.

LO 1-3

ACCOUNTING PERIODS

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 taxable income and the tax liability of the business.[29]

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 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).[30]

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.

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 on their tax returns.[31]

[29]§443. Discussion of tax consequences associated with these short years is beyond the scope of this text.
[30]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.
[31]Virtually all individual taxpayers use a calendar-year tax year.

- *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.[32] 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 1-14

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 formed Green Acres as a C corporation for tax purposes at the time he began his business. What tax year could Green Acres adopt?

Answer: If Green Acres were 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).

ACCOUNTING METHODS

LO 1-4

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 especially important for taxpayers considering a timing strategy to defer taxable income or accelerate deductions.[33]

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 generally require businesses to use the same accounting methods for tax purposes that they use for

[32]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.

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

financial accounting purposes, a *consistency* requirement. In other words, in many circumstances, if businesses want to defer taxable income, they must also defer book income.[34]

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.[35] The two overall methods of accounting are the cash method and the accrual method. Although businesses are generally free to choose either the cash or accrual method, C corporations and partnerships with C corporation partners are generally required to use the accrual method if they do not qualify as a small business under the gross receipts test discussed previously.[36] Businesses that qualify under the gross receipts test do not need to request the consent of the IRS to elect the cash method. Businesses also may choose to keep some accounts on the cash method and others on the accrual method. This method is sometimes called a hybrid or mixed accounting method, but technically the method is still classified as a form of cash 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 than 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 using either the cash or accrual method must 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.[37] If the prepaid expense does not meet both these

[34]§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.

[35]§446(b).

[36]Businesses that are defined as tax shelters cannot qualify for the cash method under §448(a). A business on the cash basis that fails the gross receipts test must change to the accrual method of accounting. However, if the same business qualifies under the gross receipts test in a subsequent year, the business may elect to use the cash basis again.

[37]§263(a).

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.[38]

Example 1-15

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. Hence, he will amortize the cost beginning 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.

(*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. Rick believed 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 must choose 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 Method Businesses using the accrual method to determine taxable income follow rules similar to GAAP with two basic differences. 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.

[38] Reg §1.263(a)-4(f). 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 Accrual Deductions section.

Accrual Income

Businesses using the accrual method of accounting generally recognize income when they meet the *all-events test.* This test is sometimes referred to as the fixed and determinable 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.[39] 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 (AFS), even if it has yet to satisfy any of the above three criteria.[40]

Example 1-16

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.

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 earned when the business has the right to receive payment or when recognized in the applicable financial statement, if earlier.
- Taxpayers can generally elect to defer recognition of prepaid (unearned) income if the income is also deferred for financial accounting purposes.
- However, the deferral of income is an accounting method election and deferred income must be recognized in the year after deferral (e.g., the tax deferral only lasts for one year).

Taxation of Advance Payments of Income (Unearned Income)

In some cases, taxpayers receive income payments before they actually earn the income.[41] Taxpayers using the cash method include these payments in gross income in the year the payment is received. When an accrual-method taxpayer must include unearned income in gross income depends, in part, on the type of income. For example, all taxpayers must recognize interest and rental income immediately upon receipt (i.e., the income is taxable when received even if is not yet earned).

For other types of income, accrual-method businesses can elect to defer recognition of unearned income for one year. Specifically, businesses using the accrual method may elect to defer recognizing advance payments for goods or services until the next tax year.[42] This one-year deferral method does not apply if the income is actually earned by the end of the year of receipt or if the unearned income is recognized for financial reporting purposes. In addition, this is an accounting method election that once elected can only be revoked with the permission of the Commissioner.

[39] Reg. §1.451-1(a).
[40] §451(b). Applicable financial statements are described in §451(b)(3).
[41] Unlike advance payments, businesses are not required to recognize security deposits as income because there is an obligation to return the deposit [*Comm'r v. Indianapolis Power & Light Co.,* 493 U.S. 203 (1990)].
[42] §451(c).

Example 1-17

In late November 2022, Rick received a $7,200 payment in advance from a client for monthly landscaping services from December 1, 2022, through November 30, 2024 ($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 2022. In 2023, he would recognize the remaining $6,900 (rather than only the $3,600 related to 2022) 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 2022. Under the cash method, Rick would recognize the entire prepayment, $7,200, as income upon receipt in 2022.

What if: Suppose that rather than receiving payment in advance for services, Rick's client paid $7,200 in 2022 for landscape supplies that Rick purchased in 2022 and provided in 2023. 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 2022 because none of the income had been earned in 2022. Rick would then recognize the entire $7,200 (less the cost of goods sold) in 2023. If Rick did not elect the deferral method, he would recognize the entire $7,200 (less the cost of the goods) in 2022. Under the cash method, Rick would recognize the entire $7,200 (less the cost of goods sold) in 2022.

Inventories

When producing, buying, or selling goods is an income-producing activity, taxpayers are required to keep inventories of goods, including raw materials and work in process, to determine the cost of goods sold. In addition, taxpayers who are required to keep inventory records also must use the accrual method of accounting for purchases and sales.[43] This requirement applies regardless of whether the taxpayer uses the cash or the accrual method as the overall method of accounting. Hence, the cost of inventory must include the purchase price of raw materials (minus any discounts), direct costs (manufacturing), shipping costs, and any indirect costs allocated to the inventory under the **uniform cost capitalization (UNICAP) rules** (discussed next).[44]

However, under §471(c), small businesses qualifying under the gross receipts test discussed previously can opt to account for goods as nonincidental materials or use the accounting method that conforms to the taxpayer's financial accounting treatment of inventory. Generally, nonincidental materials are tracked on the taxpayer's books and records, either through records of consumption or by periodic physical inventory. Amounts paid to acquire or produce nonincidental materials are generally deductible in the tax year in which the materials are used in the taxpayer's operations or are consumed in the taxpayer's operations. The IRS interprets "used or consumed" to mean that nonincidental materials are deductible when taxpayers sell the inventory.

For example, suppose a company stores machine repair parts for which it keeps records of purchases and consumption. The company can choose to treat the parts either under the method conforming to its financial accounting or as nonincidental materials. If the parts are treated as nonincidental materials and the parts are used in the business, the company can deduct the costs of parts in the tax year the part is removed from storage. If, however, the parts are a component of a finished good, then the cost of the part can only be deducted at the time the taxpayer incurs the cost or delivers the finished goods, whichever is later.[45]

THE KEY FACTS

Inventories

- C corporations and partnerships with C corporation partners must use the accrual method to account for inventories unless they qualify as a small business under the gross receipts test. Small businesses can account for inventories either as nonincidental materials or use the inventory method used for financial reporting.
- The UNICAP rules require capitalization of most indirect costs of production, but businesses that qualify as a small business under the gross receipts test are exempt from UNICAP.
- The LIFO method is allowed if it is also used for financial reporting purposes (a conformity rule).

[43] Reg. §1.446-1(c)(2).

[44] 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.

[45] Reg. §1.162-3(a)(1); Prop. Reg. §1.471-1(b)(4). Note that nonincidental materials can only be accounted for using the first-in, first-out (FIFO); specific identification; or average cost methods. The last-in, first-out (LIFO) method and the lower of cost or market method may not be used.