# *McGraw Hills Taxation of Business Entities 2022 Edition 13th edition Spilker Solutions Manual*

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# Chapter 1
# Business Income, Deductions, and Accounting Methods

## SOLUTIONS MANUAL

## Discussion Questions

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

   *"Ordinary" and "necessary" imply that an expense must be customary and helpful, respectively. Because these terms are subjective, the tests are ambiguous. However, ordinary is interpreted by the courts as including expenses which may be unusual for a specific taxpayer (but not unusual for that type of business) and necessary is not interpreted as only essential expenses. These limits can be contrasted with the reasonable limit on amounts and the bona fide requirement for profit motivation.*

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

   *Under the return of capital principle, cost of goods sold represents a reduction in gross income rather than a business expense. For example, if a taxpayer sells inventory for $100,000 and reports a cost of goods sold of $40,000, the business's gross income is $60,000 ($100,000 – 40,000) not $100,000.*

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

   *Reasonableness is an issue of fact and circumstance, and extravagance is difficult to determine because of the subjectivity and multitude of factors involved in determining price. Reasonableness is most likely to be an issue when a payment is made to a related individual or the taxpayer enjoys some personal benefit incidental to the expenditure.*

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

   *A common test for reasonableness is whether the expenditure is comparable to an arm's length amount – a price charged by objective (unrelated) individuals who do not receive any incidental personal benefits. Hence, the IRS is most likely to challenge the cost of the dog food if Jake's relatives control or own the local pet food company and was benefiting from the increased price.*

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

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*The Code lists bribes, kickbacks, and "other" illegal payments as nondeductible. Congress didn't want the tax benefits associated with deductions to benefit or subsidize wrongdoing. Of course, this rationale doesn't really explain the prohibition against deducting political contributions which is probably better explained by the potential perception that political efforts are being subsidized by taxpayers.*

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

   *Two common examples are interest expense associated with debt used to purchase municipal bonds and life insurance premiums paid on key man insurance. If this prohibition were repealed, then taxpayers would have an incentive to borrow to invest in municipal bonds or borrow to invest in employee life insurance. This former practice would lead to higher demand for municipal bonds (less yield) and less revenue for the government. The latter practice would lead to higher demand for insurance (higher premiums?) and less revenue for the government. Both practices could lead to a perception of inequity between those taxpayers able to utilize the tax arbitrage to reduce taxes and those who could not use the practice.*

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

   *Taxpayers may deduct the cost of uniforms or special clothing they use in their business when the clothing is not appropriate to wear as ordinary clothing outside the place of business. In Peggy's case, the clown clothes are analogous to special uniforms or protective garments and could be deductible. See D. Techner, TC Memo 1997-498. Erhard Seminar Training, TC Memo 1986-526 provides an example of clothes that were not deductible because they were appropriate for normal wear. However, the cost of clothing would not likely be deductible if the clothes were unacceptable solely because of the taxpayer's sense of fashion.*

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

   *Jimmy might be trying to reduce his bank charges by using one account for both personal and business expenditures, but he could also be trying to disguise personal expenditures as business expenses. By commingling business and personal expenditures, Jimmy will need to separate personal and business expenditures before claiming any business deductions.*

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

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

*To deduct 100 percent of the cost of meals as a business expense, the meals must be ordinary and necessary to Troy's business, provided by a restaurant, and the amount must be reasonable under the circumstances. In addition, Troy or an employee must be present when the meal is furnished, and the meal must be furnished to an actual or potential business associate. Finally, the cost of the meals must be separately stated (by invoice) from the cost of the entertainment (the cost of the entertainment is not deductible). If the meals and beverages are not provided by a restaurant, then only 50 percent is deductible (assuming all of the other requirements are met).*

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

*Because only the expense relating to business use is deductible, the taxpayer must allocate the expenses between the business and personal use portions. A common method of allocation is relative use. In this instance Jenny would calculate the business portion based upon the ratio of business miles to total miles (11/20 or 55 percent). She would then deduct the costs of operating the vehicle for business purposes plus depreciation on the business portion (55 percent) of the vehicle's tax basis. Alternatively, in lieu of deducting these costs, Jenny may elect to deduct a standard amount for each business mile she drives. The standard mileage rate (56 cents per mile for 2021) represents the per-mile cost of operating an automobile (including depreciation or lease payments). Once Jenny has made this election, she must continue to use it throughout the life of the auto.*

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

*If the taxpayer has both business and personal motives for a trip, but the primary or dominant motive is business, the taxpayer may deduct the transportation costs to get to the place of business, but she may deduct only meals (50% or 100% if provided by a restaurant), lodging, transportation on site, and incidental expenditures for the business portion of the travel. If the taxpayer's primary purpose for the trip is personal, the taxpayer may not deduct transportation costs to travel to and from the location but the taxpayer may deduct meals (50% or 100% if provided by a restaurant), lodging, transportation, and incidental expenditures for the business portion of the trip. For international travel in excess of one week, the taxpayer must allocate the cost of the transportation between personal (nondeductible) and business (deductible) activities. Taxpayers generally determine the nondeductible portion of the transportation costs by multiplying the travel costs by a ratio of personal activity days to total days travelling. Finally, remember that travel days are considered business activity days for both domestic and international travel.*

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

    *Besides the cost of transportation, the deduction for travel expenses includes meals (50% or 100% if provided by a restaurant), lodging, and incidental expenses. However, travel expenses are only deductible if the taxpayer is away from home overnight while traveling. For this purpose, a taxpayer is considered to be away from home overnight if the trip is of sufficient duration to require sleep or rest. It's likely that Clyde's trip will not satisfy this condition and that he will not be able to deduct costs for meals and lodging.*

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

    *Taxpayers must keep specific, written, contemporaneous records of time, amount of the expenditure, and business purpose of the travel. No deductions are allowed absent sufficient records to document business purpose. Records of the expenditure amount, however, may not be necessary if the taxpayer claims per diem amounts.*

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

    *The deduction of business interest expense is limited to the sum of business interest income plus 30 percent of the business's adjusted taxable income. Business interest is defined as any interest paid on debt allocable to a trade or business activity, and adjusted taxable income is taxable income allocable to the business activity computed before deductions for interest, depreciation, amortization, or depletion. Disallowed business interest can be carried forward indefinitely.*

15. [LO 2] Describe the gross receipts test and identify how this test relates to the business interest deduction.

    *The gross receipts test is an annual test designed to identify small businesses that Congress intended to exempt from some of the more complex and onerous provisions of the law, such as the business interest deduction. As the name implies, size is measures by whether average gross receipts exceeds a threshold amount, and businesses whose gross receipts do not exceed the threshold in any tax year are not subject to this limitation in that year. This amount was originally set at $25 million, but since it is indexed for inflation, the amount in 2021 is set at $26 million. The average gross receipts is determined using the previous three years of receipts (after subtracting sales returns and allowances). When the business has not been in existence for three prior tax years, the test is conducted using 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.*

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16. [LO 2] Explain the difference between calculating a loss deduction for a business asset that was partially damaged in an accident and a loss deduction for a business asset that was stolen or completely destroyed in an accident.

    *When a business asset is completely destroyed or stolen, the amount of the business's loss is calculated as though the business sold the asset for the insurance proceeds, if any (i.e., insurance proceeds minus adjusted basis). If the asset is damaged but not completely destroyed, the amount of the loss is the amount of the insurance proceeds minus the lesser of (1) the asset's tax basis or (2) the decline in the value of the asset due to the casualty.*

17. [LO 2] How does a casualty loss on a business asset differ when the asset is stolen as opposed to destroyed in a fire?

    *The difference between a fire and a theft is that the casualty loss from the fire is measured and deducted in the year of the casualty whereas the loss from the theft is measured and deducted in the year the theft is discovered.*

18. [LO 3] What is the difference between a full tax year and a short tax year? Describe circumstances in which a business may have a short tax year.

    *A full tax year consists of 12 months while short years are less than 12 months. A business may report income on 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).*

19. [LO 3] Explain why a taxpayer might choose one tax year-end over another if given a choice.

    *A business might use a calendar year (ends on December 31), a fiscal year (ends on the last day of a month other than December) or a 52/53 week fiscal year end (ends on the same day of the week every year). Not all types of tax years are available to all types of businesses. The rules for determining the tax years available to the business depends on whether the business is a sole proprietorship, a flow-through entity, or C corporation. If allowed an unfettered choice, taxpayers with a flow-through business might choose a tax year other than a calendar year to postpone the recognition of business income into the next calendar year (based upon when income flows through the business to its owners). Also, a retail business might choose a 52/53 week fiscal year to avoid inventory counts on busy day sales. Further, a business might choose a fiscal year end that coincides with the end of the season.*

20. [LO 3] Compare and contrast the different year-ends available to sole proprietorships, flow-through entities, and C corporations.

    *C corporations are generally allowed to select a calendar, fiscal, or 52/53 week year-end whereas other business entities generally must adopt tax years consistent with the owners' tax years.*

21. [LO 3] Why does the law generally require partnerships to adopt a tax year consistent with the year used by the partners?

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*The tax laws impose the tax year consistency requirement to minimize income tax deferral opportunities for the owners. To illustrate the deferral, suppose that a partner's tax year-end is December 31, year 1 and her partnership's tax year-end is January 31, year 2. In year 2, the partner is treated as though she earned the entire amount of her share of the partnership's income on January 31, year 2. Thus, even though 11/12ths of the partnership's income was actually earned in year 1 (February through December of year 1), for purposes of paying taxes on the income, the partner gets to defer this income until year 2.*

22. [LO 3] How does an entity choose its tax year? Is it the same process no matter the type of tax year-end the taxpayer adopts?

*A business adopts its 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.*

23. [LO 4] Explain when an expenditure should be "capitalized" based upon accounting principles. From time to time, it is suggested that all business expenditures should be deducted when incurred for tax purposes. Do you agree with this proposition, and if so, why?

*Under accounting principles an expenditure should be "capitalized" when the benefits from the expenditure occur in two different periods. The cost is spread across the applicable periods through a periodic charge such as depreciation or amortization. The tax law differs from accounting principles, but the rationale for the tax rules is based upon the same matching principle, expenditures should be recognized in the period that revenues are generated. The proposition to deduct all business expenditures is usually defended on the grounds of simplification, encouraging capital investment, and lack of bias (at least over the long run) and criticized on the grounds of potential economic bias (at least in the short run) and revenue loss by the government.*

24. [LO 4] Describe the 12-month rule for determining whether and to what extent businesses should capitalize or immediately deduct prepaid expenses such as insurance or security contracts. Explain the apparent rationale for this rule.

*A business expenditure or business liability may be immediately deducted (rather than capitalized) if the expenditure or liability relates to a business expense where the contract period (1) does not last more than a year and (2) does not extend beyond the end of the taxable year following the tax year in which the taxpayer makes the payment. The rule could be rationalized as an attempt to simplify the deduction for expenditures that merely span tax years and would not likely result in material differences in taxable income should the expenditure be capitalized across both periods.*

25. [LO 4] Explain why Congress sometimes mandates that businesses use particular accounting methods while other times Congress is content to require businesses to use the same accounting methods for tax purposes that they use for financial accounting purposes.

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*The natural tension between financial reporting incentives and tax reporting incentives may be the reason the tax laws indicate that as a general rule, businesses must use the same accounting methods for tax purposes that they use for financial accounting purposes. That is, businesses that want to accelerate book income (or delay taxable income) are also required to accelerate taxable income (or delay financial income). Thus, using the same method for both tends to neutralize incentives to stretch numbers in one direction or the other. Congress specifies that businesses are required to use other, presumably more appropriate, accounting methods for tax purposes when financial accounting methods do not "clearly reflect income" for tax purposes or when dictated by policy or administrative concerns.*

26. [LO 4] Why is it not surprising that specific rules differ between tax accounting and financial accounting?

*Tax policy objectives often differ from the objectives motivating financial accounting rules. Tax accounting attempts to maximize revenue for the government while financial accounting attempts to minimize overstatements that might mislead investors and creditors. Hence, for policy and administrative reasons, the tax laws identify several circumstances when businesses must use specific tax accounting methods to determine taxable income no matter what accounting method they use for financial reporting purposes.*

27. [LO 4] The cash method of accounting is generally preferred by taxpayers. Describe two types of businesses that are not allowed to use the cash method.

*Unless they qualify under the gross receipts test, businesses organized as C corporations or partnerships with C corporations as partners cannot use the cash method. Also, tax shelters are not allowed to use the cash method of accounting.*

28. [LO 4] Fred is considering using the accrual method for his next business venture. Explain to Fred the conditions for recognizing income for tax purposes under the accrual method.

*A taxpayer must recognize income if (1) all the events have occurred that are necessary to fix the right to receive a payment and (2) the amount of the payment can be determined with reasonable accuracy.*

29. [LO 4] Describe the all-events test for determining income and describe how to determine the date on which the all-events test has been met.

*The all events test requires a taxpayer to recognize income if the taxpayer has a fixed right to receive a payment and the amount of the payment can be determined with reasonable accuracy. The all-events test is typically met on the earliest of the following three dates: (1) the date the business provides the service or transfers goods, (2) the date payment is due, or (3) the date payment is received.*

30. [LO 4] Compare and contrast the tax treatment for rental income received in advance with advance payments for goods and services.

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*For tax purposes, businesses must immediately recognize prepaid rental or interest income (it is recognized before it is earned). The all-events test generally requires businesses receiving advance payments for services to recognize the income when they receive the payment rather than when they perform the services. The IRS provides that businesses receiving advance payments for services may defer recognizing the prepayment as income until the tax year following the year they receive the payment. This one-year deferral does not apply if (or the extent to which) the income is actually earned by the end of the year of receipt, if the prepayment was included in financial reporting income, or if the prepayment was for rent (unless rental receipts are bundled with goods or services, prepayments are taxed on receipt).*

31. [LO 4] {Research} Jack operates a large home repair business as a sole proprietorship. Besides providing services, Jack also sells home repair supplies to homeowners. However, these sales constitute a relatively small portion of Jack's income. Describe the conditions under which Jack would need to account for sales and purchases of plumbing supplies using the accrual method. (*Hint*: Read §471(c) and Reg. §1.471-1.)

*Generally, inventories taken at the beginning and end of each taxable year are necessary when the production, purchase, or sale of merchandise is an income-producing factor. However, under §471(c) if Jack satisfies the gross receipts test, he can account for the purchase of home repair supplies either as nonincidental materials or using the method employed for financial reporting. The business would need to report average gross receipts of $26 million or less for the three-tax year period ending with the prior tax year. The determination of what is "merchandise" and what amount of inventory sales constitute a "material" income-producing factor is determined by facts and circumstances on a case-by-case basis. One likely characteristic is the level of sales and another is the income generated by sales of inventory relative to the overall income of the business. Reg. §1.162-3(a) allows taxpayers to deduct the costs of buying nonincidental materials in the year of use (assuming taxable income is clearly reflected).*

32. [LO 4] Describe why Congress enacted the UNICAP rules and describe an exception to these rules.

*Congress enacted these rules primarily for two reasons. First, the rules accelerate tax revenues for the government by deferring deductions for the capitalized costs until the business sells the associated inventory. Second, Congress enacted these "uniform" rules to reduce variation in the costs businesses include in inventory. These rules place a burden on taxpayers for record-keeping (identifying an allocation method and keeping records of indirect costs). However, the UNICAP rules do not apply to businesses that qualify under the gross receipts test.*

33. [LO 4] Compare and contrast financial accounting rules with the tax rules under UNICAP (§263A). Explain whether the UNICAP rules tend to accelerate or defer income relative to the financial accounting rules.

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*Under GAAP, businesses generally include in inventory only those costs incurred within their production facility. In contrast, the UNICAP rules require businesses to allocate to inventory the costs they incur not only inside the production facility but also the costs they incur outside the facility to support production (or inventory acquisition) activities. Uniform capitalization requires that both direct and certain indirect costs be capitalized into inventories (full absorption costing). Hence, businesses generally capitalize more costs to inventory for tax purposes than they capitalize under financial accounting rules. This rule tends to accelerate income for tax purposes (compared to financial accounting purposes).*

34. [LO 4] Compare and contrast the tests for accruing income and those for accruing deductions for tax purposes.

*To record an expense and the corresponding deduction for tax purposes, the business must meet (1) an all-events test for the liability and (2) an economic performance test with respect to the liability. While the all-events test for recognizing deductions is similar to the all-events test for recognizing income, the additional economic performance requirement makes the deduction recognition rules more stringent than the income recognition rules. The deduction rules generally preclude businesses from deducting estimated expenses or reserves.*

35. [LO 4] Compare and contrast when taxpayers are allowed to deduct the cost of warranties provided by others to the taxpayer (i.e., purchased by the taxpayer) and when taxpayers are allowed to deduct the costs associated with warranties they provide (sell) to others.

*Insurance, warranties, and service contracts provided to the taxpayer are payment liabilities and accrual method taxpayers that prepay business expenses for payment liabilities (insurance contracts, warranties, and product service contracts provided to the taxpayer) are allowed to immediately deduct the prepayments subject to the 12-month rule for prepaid expenses. A warranty provided by the taxpayer to others is deductible as the taxpayer incurs costs associated with these liabilities.*

36. [LO 4] Describe when economic performance occurs for the following expenses:

a) Workers' compensation,
b) Rebates and refunds
c) Insurance, warranties, and service contracts provided *to* the business
d) Taxes

*Workers' compensation, rebates, refunds, and service contracts are payment liabilities and economic performance occurs upon payment regardless of actual performance. Taxes are also payment liabilities, but under §461 accrual-method taxpayers that pay certain real estate taxes are allowed to elect to deduct tax payments ratably over the tax accrual period.*

37. [LO 4] On December 31 of the current year, a taxpayer prepays an advertising company to provide advertising services for the next 10 months. Using the 12-month rule and the economic performance rules, contrast when the taxpayer would be able to deduct the

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expenditure if the taxpayer uses the cash method of accounting versus if the taxpayer uses the accrual method of accounting.

*Under economic performance an accrual-method taxpayer can deduct the cost of advertising as the services are provided to the taxpayer or with payment if the taxpayer reasonably expects actual performance within 3 ½ months. A cash-method business that prepays businesses expenses may immediately deduct the prepayment if the contract period (1) does not last more than a year and (2) does not extend beyond the end of the taxable year following the tax year in which the taxpayer makes the payment.*

38. [LO 4] Compare and contrast how bad debt expense is determined for financial accounting purposes and how the deduction for bad debts is determined for accrual-method taxpayers. How do cash-method taxpayers determine their bad debt expense for accounts receivable?

*For financial reporting purposes, the business estimates the amount of the bad debt, debits bad debt expense, and credits an allowance for doubtful accounts. However, for tax purposes, accrual-method taxpayers are only allowed to deduct bad debt expense in the tax year when an account receivable or debt becomes worthless. Cash-method taxpayers do not create accounts receivable for sales on credit so no bad debt deductions are ever claimed.*

39. [LO 4] Describe the related-person limitation on accrued deductions. What tax savings strategy is this limitation designed to thwart?

*An accrual-method business is not allowed to deduct amounts they accrue for expenses payable to related persons until the related person includes the payment in income. When a business accrues an expense payable to a related person at year end, and the related person is a cash-method taxpayer, the business is not allowed to deduct the expense until the next year when the related person receives the payment and includes it in income. This limit prevents businesses and related persons from working to accelerate a tax deduction into the earlier year and the related person from deferring the income until the later year.*

40. [LO 4] What are the relative advantages of the cash and accrual methods of accounting?

*The two primary advantages of the cash method over the accrual method are that (1) the cash method provides the business with more flexibility to time income and deductions by accelerating or deferring payments and (2) the ease of bookkeeping. The primary advantage of the accrual method over the cash method is that it better matches revenues and expenses.*

41. [LO 4] Describe how a business adopts a permissible accounting method. Explain whether a taxpayer can adopt an impermissible accounting method.

*A business adopts a permissible accounting method by using and reporting the results of the method for at least one year. A business adopts an impermissible method by using and reporting the results of the method for two consecutive years.*

42. [LO 4] Describe why the IRS might be skeptical of permitting requests for changes in accounting method without a good business purpose.

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*The reluctance of the IRS probably stems from the possibility that taxpayers will manipulate accounting methods to defer taxable income. For example, a taxpayer might use LIFO in a period of rising costs, but want to switch to FIFO in a period of stable or declining costs.*

43. [LO 4] Describe two specific accounting methods that are treated as initiated by the taxpayer without any need for consent of the IRS when the business qualifies under the gross receipts test.

*Businesses qualifying under the gross receipts test can elect to use the cash method and account for inventories as non-incidental materials. Neither of these elections require the consent of the Secretary. In addition, these businesses will not be subject to the UNICAP rules or the business interest limitation.*

44. [LO 4] What is a §481 adjustment, and what is the purpose of this adjustment?

*When a business changes an accounting method, the business is required to make a §481 adjustment that represents the cumulative difference between the accounting method the business was using and the accounting method the taxpayer is changing to. The adjustment prevents the duplication or omission of items of income or deduction due to a change in accounting method. If the adjustment increases income, the taxpayer includes 25 percent of the adjustment (beginning in the year of adjustment) in income for four years. If the adjustment reduces taxable income, the taxpayer recognizes the entire adjustment in the year of change.*

## Problems

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

*Only reasonable amounts of compensation are deductible ($40,000), and the remainder would be reclassified probably as a gift to his brother.*

46. [LO 1, LO 2] Michelle operates several food trucks. Indicate the amount (if any) that she can deduct as an ordinary and necessary business deductions in each of the following situations and explain your solution.

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

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

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

d) Michelle realized a $1,200 loss when she sold one of her food trucks to her father, a related party.

*a) No deduction for the fine, but the legal advice is fully deductible.*

*b) The cost of the reserve parking ($750) is deductible, but the cost of the tickets is likely personal and not deductible.*

*c) No deduction for expenditures for political purposes (in cash or in kind).*

*d) No current deduction for a business loss on a sale to a related party.*

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

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

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

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

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

*a) $0. The interest expense is not deductible (expense associated with tax-exempt income).*

*b) $0. Capital expenditures are not deductible.*

*c) Only $10,000 is deductible and the remaining $5,000 is either unreasonable in amount or against public policy (as a bribe).*

*d) $0. The amount paid to install a machine is capitalized because the cost benefits the useful life of the machine.*

48. [LO 2] {Research} Ralph operates a business that acts as a sales representative for firms that produce and sell precious metals to electronic manufacturers. Ralph contacts

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manufacturers and convinces them to sign contracts for delivery of metals. Ralph's company earns a commission on the sales. This year, Ralph contacted a jeweler to engrave small lapel buttons for each of his clients. Ralph paid $20 each for the lapel buttons and the jeweler charged Ralph an additional $7 for engraving. The electronic manufacturers, however, prohibit their employees from accepting gifts related to sales contracts. Can Ralph deduct the cost of the lapel buttons as business gifts?

*§274(b) denies business deductions for gifts that exceed $25 in amount, but Reg. §1.274-3(c) indicates that "the term expense for a gift means the cost of the gift to the taxpayer, other than incidental costs such as for customary engraving on jewelry." Hence, it would appear that the amount of the gift ($27) is likely deductible. It might also be argued that the expenditure is not deductible because it violates the §162(c) prohibition against deducting expense against illegal bribes and kickbacks. However, in Arthur E. Bondy, TC Memo 1991-545, the Tax Court found similar gifts deductible as business expenses as long as the payments were not illegal under state or federal law.*

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

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

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

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

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

*a) Since business was the primary reason for the trip, Melissa can deduct $1,900 of business expenses [$250 registration + $400 airfare + $900 lodging + $200 meals + $150 cab fare]*

*b) None of the costs of sightseeing is deductible. However, because her primary purpose for the trip appears to be business (3 days business vs. 2 days personal) she is allowed*

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*to deduct her airfare to San Francisco and her other expenses in part (a) relating to the business portion of the trip.*

*c) If the purpose of the trip is primarily personal, then none of the air fare is deductible and only those direct costs associated with the conference ($1,400) can be deducted (the registration, lodging, meals, and cab fare).*

*d) Melissa would be allowed to deduct the registration fee for the conference of $250 and she could deduct $56 (in 2021) for the 100 miles she drove to and from the conference (56 cents per mile × 100 miles) and the parking fee of $90. However, because her travel did not require her to be away from home overnight, she is not allowed to deduct the cost of her meals going to and coming from the conference each day.*

50. [LO 2] Kimberly is a self-employed taxpayer. She recently spent $1,000 for airfare to travel to Italy. What amount of the airfare is deductible in each of the following alternative scenarios?

a) Her trip was entirely for personal purposes.

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

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

d) Her trip was entirely for business purposes.

*a) $0 since the sole purpose of the trip was for personal purposes.*

*b) $0 since the primary purpose of the trip appears to be personal.*

*c) $700 ($1,000 × 7/10). Since the primary purpose of the trip appears to be business, she may deduct the portion of the airfare allocated to the business trip (prorated because this is foreign travel). Using the number of days of business activities to total days of travel, she may deduct 70 percent (7/10ths) of the cost (conversely, she may not deduct 30 percent (3/10ths) of the cost.*

*d) $1,000 since the sole purpose of the trip is business, she may deduct the entire airfare.*

51. [LO 2] Ryan is self-employed. This year Ryan used his personal auto for several long business trips. Ryan paid $1,500 for gasoline on these trips. His depreciation on the car if he was using it fully for business purposes would be $3,000. During the year, he drove his car a total of 12,000 miles (combination of business and personal travel).

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

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

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*a) Ryan can claim the direct cost of these trips, including gas ($1,500) and depreciation on the auto. However, the deduction for auto use is limited to direct costs (such as gas and oil) and the pro-rata portion of indirect costs (such as depreciation). The pro rata portion would be calculated as the business percentage of total mileage ($3,000 × [3,000/12,000]) or $750. Hence, Ryan could deduct $2,250. Alternatively, Ryan can claim a standard mileage rate, and based on the standard mileage rate of 56¢ per mile (in 2021), he can deduct $1,680 (i.e., 3,000 × 56¢).*

*b) Ryan is allowed to deduct the cost of using his personal auto in his business activities only if he can substantiate the business use. If he has records to substantiate the business use, Ryan can claim the direct cost of these trips including depreciation on the auto (for the business portion of the total mileage). Ryan's total expense deduction would consist of depreciation and expenses calculated as follows: [(820/12,000)* $3,000] + [(820/1300)*$1,500] = $205 + $946 = $1,151. Alternatively, Ryan can claim a standard mileage rate. Ryan can only substantiate 820 miles, and based on the standard mileage rate of 56¢ per mile, he can deduct $459.20 (i.e., 820 × 56¢).*

52. [LO 1, LO 2] Christopher is a self-employed cash-method, calendar-year taxpayer, and he made the following cash payments related to his business this year. Calculate the after-tax cost of each payment assuming Christopher has a 37 percent marginal tax rate.

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

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

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

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

*a) $500 – not deductible.*

*b) $252 = ($800 × 50%) × (1-.37) Half of the interest is not deductible because it was used to purchase tax-exempt securities.*

*c) $378 = $600*(1-.37) – all deductible since used within the next year.*

*d) $450 – not deductible.*

53. [LO 2] Heather in an attorney who paid $15,000 to join a country club in order to meet potential clients. This year she also paid $4,300 in greens fees when golfing with clients and an additional $1,700 paid by Heather for meals with clients in the clubhouse. Under what circumstances, if any, can Heather deduct all or part of the $21,000 paid to the country club this year?

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*§274(a) denies deductions for amounts paid or incurred for entertainment including membership in any club organized for business, pleasure, recreation, or other social purpose. Hence, the country club dues and golf fees are nondeductible. However, 50% of the cost of the meals with prospective clients ($850) could be deductible as long as the meals are ordinary and necessary, the amounts were reasonable and not lavish, and the costs of the meals are stated and invoiced separately from the entertainment. The entire cost of the meals could be deductible if the club is classified as a restaurant.*

54. [LO 1, LO 2] Sarah is a cash-method calendar-year taxpayer, and she is considering making the following cash payments related to her business. Calculate the after-tax cost of each payment assuming she has a 37 percent marginal tax rate.

a) $2,000 payment for next year's property taxes on her place of business.

b) $800 to reimburse the cost of meals at restaurants incurred by employees while traveling for the business.

c) $1,200 for football tickets to entertain out-of-town clients during contract negotiations.

d) $500 contribution to the mayor's reelection campaign.

*a) $1,260 = $2,000*(1-.37) – all of the payments are deductible under the 12-month rule. Note that property taxes are generally deductible as paid (subject to 12-month rule) unless an election is made under §461(c) to deduct them as accrued.*

*b) $504 = ($800 × (1-.37))*

*c) $1,200 - the entertainment is not deductible.*

*d) $500 – the political contribution is not deductible*

55. [LO 2] Red Inc. is a C corporation and a calendar year taxpayer. Red reports sales of $24 million in 2018, $28.3 million in Year 2019, and $32 million in 2020.

a) Is Red subject to the business interest limitation in 2021?

b) Suppose that besides sales, Red also reports sales returns of $3.1 million in each year - 2018-2020. Is Red subject to the business interest limitation in 2021?

c) Suppose that Red began business on January 1. 2019 and reported gross receipts of $25.3 million in 2019 and $28.9 million in 2020. Is Red subject to the business interest limitation in 2021?

d) Suppose that Red began business operations on October 1, 2020 and reported $6.2 million in gross receipts for the three-month 2020 short year. Is Red subject to the business interest limitation in 2021?

*a) Yes because Red's average gross receipts exceed $26 million. The average of Red's gross receipts for the three-year period prior to this year is $28.1 million calculated as $84.3 million divided by 3 ($84.3=$24 +$28.3 +$32).*

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*b) No because Red's average gross receipts do not exceed $26 million. Gross receipts is calculated after subtracting sales returns so for the three-year period prior to this year is $28.1 million calculated as $75 million divided by 3 ($75=$20.9 +$25.2 +$28.9).*

*c) Yes because Red's average gross receipts exceed $26 million. The average of Red's gross receipts for the two-year period prior to this year is $27.1 million calculated as $54.2 million divided by 2 ($54.2=$25.3 +$28.9).*

*d) No because Red's average gross receipts exceed $26 million. The average of Red's gross receipts for the three-month short year is $24.8 million calculated as $6.2 million divided by 3 and multiplied by 12 ($24.8=$6.2 [12/3).*

56. [LO 2] Renee operates a proprietorship selling collectibles over the web, and last year she purchased a building for $24 million for her business. This year, Renee's proprietorship reported revenue of $95.5 million and incurred total expenses of $88.6 million. Her expenses included cost of goods sold of $48.5 million, sales commissions paid of $16.9 million, $10.5 million of interest paid on the building mortgage, and $12.7 million of depreciation.

a) What is Renee's adjusted taxable income for purposes of calculating the limitation on business interest expense?

b) What is the maximum amount of business interest expense that Renee can deduct this year, and how is the disallowed interest expense (if any) treated?

c) Suppose that Renee's revenue includes $5 million of business interest income. What is the maximum amount of business interest expense that could be deducted this year under the business interest limitation?

*a) $30.1 million. Renee's adjusted taxable income on her business is computed by adding back depreciation and interest to the taxable income attributed to the business. In this case, Renee's allocable taxable income is $6.9 million ($95.5M - $88.6M) and her adjusted taxable income is $30.1 million ($6.9M + $10.5M + $12.7M).*

*b) Renee can deduct a maximum of $9.03 million of business interest this year ($30.1M × 30%). Since she paid $10.5M of business interest, $1.47 million of interest is disallowed and would be carried forward into the next year.*

*c) Renee's adjusted taxable income is now reduced by the amount of interest income to $25.1M ($30.1M - $5.M) but the limit is increased by the amount of interest income. Hence, Renee's interest deduction limit would now be increased to $12.53 million ($5 million + (30% × $25.1 million)). Since the interest paid was less than the limit, Renee can deduct the $10.5M of business interest she paid.*

57. [LO 2] This year, Amy purchased $2,000 of equipment for use in her business. However, the machine was damaged in a traffic accident while Amy was transporting the equipment to her business. Note that because Amy did not place the equipment into service during the year, she does not claim any depreciation or cost recovery expense for the equipment.

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a) After the accident, Amy had the choice of repairing the equipment for $1,800 or selling the equipment to a junk shop for $300. Amy sold the equipment. What amount can Amy deduct for the loss of the equipment?

b) Suppose that after the accident, Amy repaired the equipment for $800. What amount can Amy deduct for the loss of the equipment?

c) Suppose that after the accident, Amy could not replace the equipment so she had the equipment repaired for $2,300. What amount can Amy deduct for the loss of the equipment?

*a) For the complete destruction of a business asset, Amy can claim a casualty loss deduction for the tax basis of the machine less any insurance recovery. Hence, Amy can claim a casualty deduction for $1,700 ($2,000-$300)*

*b) For partial destruction of a business asset, Amy can claim a casualty loss deduction for the lesser of the economic loss (the cost of repair) or the tax basis of the machine. In this case, Amy can deduct $800.*

*c) For partial destruction of a business asset, Amy can claim a casualty loss deduction for the lesser of the economic loss (the cost of repair) or the tax basis of the machine. In this case Amy can deduct $2,000.*

58. [LO 3] [Tax Forms] In July of this year Stephen started a proprietorship called ECR (which stands for electric car repair). ECR uses the cash method of accounting and Stephen has produced the following financial information for this year:

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

ECR has made the following expenditures:

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

The interest paid relates to interest accrued on a $54,000 loan made to Stephen in July of this year. Stephen used half of the loan to pay for 18 months of shop rent and the remainder he used to upgrade his personal wardrobe. In July Stephen purchased 12 months of liability insurance to protect against liability should anyone be injured in the shop. ECR has only one employee (the remaining workers are contract labor), and this employee thoroughly understands how to repair an electric propulsion system. On

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November 1 of this year Stephen purchased a 12-month term-life policy that insures the life of this "key" employee. Stephen paid Gecko Insurance Company $1,800, and in return Gecko promises to pay Stephen a $40,000 death benefit if this employee dies any time during the next 12 months.

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

*Under the cash method, revenues are recorded as value is received whether the revenues are earned or not. Revenues are not, however, recorded for accounts receivable. Hence, ECR will only recognize $84,200 of revenue in the first six months of this year.*

*Regarding deductions, ECR can only deduct $625 of the interest expense (the portion of the loan proceeds used for business purposes). Likewise, ECR can only deduct $9,000 of the shop rent relating to this year because the lease extends over 24 months (it does not qualify for the 12-month rule). There are no apparent problems with deducting the payments for contract labor, utilities, or compensation. The liability insurance payment relates to the last 6 months of this year and the first 6 months of next year. However, this entire payment is deductible under the 12-month rule. The premiums paid on the life insurance policy of the key employee are not deductible. Deductions are not allowed for premiums on policies that cover the lives of officers or other key employees and compensate the business for the disruption and lost income they may experience due to the death of a key employee.*

*Stephen's completed Schedule C for 2020 would be filled in as follows:*

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**SCHEDULE C (Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

# Profit or Loss From Business

(Sole Proprietorship)

▶ Go to *www.irs.gov/ScheduleC* for instructions and the latest information.

▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

**2020**

Attachment Sequence No. 09

| Name of proprietor | Social security number (SSN) |
|---|---|
| STEPHEN | 000-00-0000 |

A Principal business or profession, including product or service (see instructions): CAR REPAIR

B Enter code from instructions ▶ 9 1 1 1 1 0

C Business name. If no separate business name, leave blank.: ELECTRIC CAR REPAIR (ERC)

D Employer ID number (EIN) (see instr.)

E Business address (including suite or room no.) ▶

City, town or post office, state, and ZIP code

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

G Did you "materially participate" in the operation of this business during 2020? If "No," see instructions for limit on losses . ☑ Yes ☐ No

H If you started or acquired this business during 2020, check here . . . ▶ ☑

I Did you make any payments in 2020 that would require you to file Form(s) 1099? See instructions . ☐ Yes ☑ No

J If "Yes," did you or will you file required Form(s) 1099? . ☐ Yes ☐ No

## Part I Income

| | | | |
|---|---|---|---|
| 1 | Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked ▶ ☐ | 1 | 84,200 |
| 2 | Returns and allowances | 2 | |
| 3 | Subtract line 2 from line 1 | 3 | 84,200 |
| 4 | Cost of goods sold (from line 42) | 4 | |
| 5 | **Gross profit.** Subtract line 4 from line 3 | 5 | 84,200 |
| 6 | Other income, including federal and state gasoline or fuel tax credit or refund (see instructions) | 6 | |
| 7 | **Gross income.** Add lines 5 and 6 ▶ | 7 | 84,200 |

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

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 8 | Advertising | 8 | | 18 | Office expense (see instructions) | 18 | |
| 9 | Car and truck expenses (see instructions) | 9 | | 19 | Pension and profit-sharing plans | 19 | |
| 10 | Commissions and fees | 10 | | 20 | Rent or lease (see instructions): | | |
| 11 | Contract labor (see instructions) | 11 | 8,250 | a | Vehicles, machinery, and equipment | 20a | |
| 12 | Depletion | 12 | | b | Other business property | 20b | 9,000 |
| 13 | Depreciation and section 179 expense deduction (not included in Part III) (see instructions) | 13 | | 21 | Repairs and maintenance | 21 | |
| 14 | Employee benefit programs (other than on line 19) | 14 | | 22 | Supplies (not included in Part III) | 22 | |
| 15 | Insurance (other than health) | 15 | 4,200 | 23 | Taxes and licenses | 23 | |
| 16 | Interest (see instructions): | | | 24 | Travel and meals: | | |
| a | Mortgage (paid to banks, etc.) | 16a | 625 | a | Travel | 24a | |
| b | Other | 16b | | b | Deductible meals (see instructions) | 24b | |
| 17 | Legal and professional services | 17 | | 25 | Utilities | 25 | 1,075 |
| | | | | 26 | Wages (less employment credits) | 26 | 21,100 |
| | | | | 27a | Other expenses (from line 48) | 27a | |
| | | | | b | **Reserved for future use** | 27b | |

| | | | |
|---|---|---|---|
| 28 | **Total expenses** before expenses for business use of home. Add lines 8 through 27a ▶ | 28 | 44,250 |
| 29 | Tentative profit or (loss). Subtract line 28 from line 7 | 29 | 39,950 |
| 30 | Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method. See instructions. **Simplified method filers only:** Enter the total square footage of (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30 | 30 | |
| 31 | **Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Schedule 1 (Form 1040), line 3,** and on **Schedule SE, line 2.** (If you checked the box on line 1, see instructions). Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32. | 31 | 39,950 |
| 32 | If you have a loss, check the box that describes your investment in this activity. See instructions. • If you checked 32a, enter the loss on both **Schedule 1 (Form 1040), line 3,** and on **Schedule SE, line 2.** (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on **Form 1041, line 3.** • If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited. | 32a ☑ All investment is at risk. 32b ☐ Some investment is not at risk. | |

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59. [LO 4] {Planning} Nicole is a calendar-year taxpayer who accounts for her business using the cash method. On average, Nicole sends out bills for about $12,000 of her services at the first of each month. The bills are due by the end of the month, and typically 70 percent of the bills are paid on time and 98 percent are paid within 60 days.

    a) Suppose that Nicole is expecting a 2 percent reduction in her marginal tax rate next year. Ignoring the time value of money, estimate the tax savings for Nicole if she postpones mailing of bills for December until January 1 of next year.

    b) Describe how the time value of money affects your calculations.

    c) Would this tax savings strategy create any additional business risks? Explain.

    *a) On average Nicole would delay $8,400 (70 percent of the average monthly billings of $12,000) of collections thereby shifting this income into the next year (assuming that the accounts remained collectible and that clients didn't pay in advance). Hence, if her business is profitable, Nicole's tax savings would be $168 ($8,400 * .02).*

    *b) The time value of money impacts the calculation in two opposite ways. First, Nicole would be saving the time value on the estimated taxes on the December income because they would be postponed until January. Second, Nicole would lose the time value of the December collections because the clients would not pay until January. On the whole, the effect of the time value of money would be negative because the tax savings are a fraction of the total collections.*

    *c) There are two business risks created with this strategy. First, the strategy assumes that clients will be equally willing (and able) to pay if Nicole delays sending bills. If this is not true, then Nicole's uncollectible accounts could rise. Second, if the tax reduction applies to the clients as well as to Nicole and if the payments are deductible for the clients (two big "ifs") , it's possible that clients might be more willing to pay in December in order to deduct the payments under the higher tax rate this year. Hence, delaying the collections could risk alienating clients and perhaps losing an opportunity to collect the receivable.*

60. [LO 4] Jeremy is a calendar-year taxpayer who sometimes leases his business equipment to local organizations. He recorded the following receipts this year. Indicate the extent to which these payments are taxable income to Jeremy this year if Jeremy is (1) a cash-method taxpayer and (2) an accrual-method taxpayer.

    a) $1,000 deposit from the Ladies' Club, which want to lease a trailer. The club will receive the entire deposit back when the trailer is returned undamaged.

    b) $800 from the Ladies' Club for leasing the trailer from December of this year through March of next year ($200 per month).

    c) $300 lease payment received from the Men's Club this year for renting Jeremy's trailer last year. Jeremy billed them last year but recently he determined that the Men's Club would never pay him so he was surprised when he received the check.

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*a) $0 income under both cash method and accrual method. A deposit is not taxable income unless it can be applied toward rent.*

*b) $800 of income under both the cash method and the accrual method (advance payments of rent and interest are always taxable when received).*

*c) $300 of income under the cash method. Under the accrual basis, the income would have been recognized in the prior year. The write-off of the apparent bad debt this year would be offset by the subsequent recovery. Hence, no change in taxable income.*

61. [LO 4] Brown Thumb Landscaping is a calendar-year, accrual-method taxpayer. In September, Brown Thumb negotiated a $14,000 contract for services it would provide to the city in November of the current year. The contract specifies that Brown Thumb will receive $4,000 in October as a down payment for these services and it will receive the remaining $10,000 in January of next year.

a) How much income from this $14,000 contract will Brown Thumb recognize in the current year? Explain.

b) How much income from this $14,000 contract will Brown Thumb recognize in the current year if it uses the cash method of accounting?

c) Suppose that the total amount to be paid under the contract with the city is estimated at $14,000 but may be adjusted to $12,000 next year during the review of the city budget. What amount from the contract, if any, should Brown Thumb recognize as income this year? Explain.

d) Suppose that in addition to the basic contract, Brown Thumb will be paid an additional $3,000 if its city landscape design wins the annual designer competition next year. Should Brown Thumb accrue $3,000 revenue this year? Why or why not?

*a) Accrual-method taxpayers must recognize income when the all-events test is met and the amount can be estimated with reasonable accuracy. Under the all-events test income is realized upon the earliest of three dates: (1) when the required performance takes place, (2) when payment is due, or (3) when payment is received. Hence, Brown Thumb will recognize $14,000 this calendar year because it provided the services this year.*

*b) Under the cash method, Brown Thumb would recognize only the $4,000 received this year.*

*c) Accrual-method taxpayers must recognize income when the all-events test is met and the amount can be estimated with reasonable accuracy. Because $14,000 appears to be a reasonable estimate (at most it could be off by $2,000), Brown Thumb should accrue $14,000 of income this year. If the estimate differs from the actual amounts received next year, Brown Thumb would make an adjustment next year to reconcile to the actual amount of income.*

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*Income estimates are sometimes confused with a condition precedent or condition subsequent. A condition precedent means that no liability (or right to income) exists until the precedent is met. A condition subsequent means the liability or right to income may be extinguished by subsequent events. In the first instance, no liability (or income) is realized until the condition is met. In the latter instance, a liability (or income) exists, but the amount is subsequently adjusted. The facts in this problem suggest that the amount of the income is uncertain, but another interpretation could be that review by the city council is either a condition precedent or subsequent. The determination of whether this review is a condition would be done by looking at the contract. For example, suppose that Brown Thumb billed $14,000 but the contract stipulates that no payments are made over $12,000 without council approval (and approval is uncertain). This would likely be a condition precedent. On the other hand, suppose that Brown Thumb billed $14,000 but the council retains the right to review the work and reduce the payment for substandard results. This would likely be a condition subsequent.*

*d) No income, under the all-events test, accrual method taxpayers are not required to recognize income if their right to the income is not fixed (it is contingent upon future events).*

62. [LO 4] In January of year 0, Justin paid $4,800 for an insurance policy that covers his business property for accidents and casualties. Justin is a calendar-year taxpayer who uses the cash method of accounting. What amount of the insurance premium may Justin deduct in year 0 in each of the following alternative scenarios?

a) The policy covers the business property from April 1 of year 0 through March 31 of year 1.

b) The policy begins on February 1 of year 1 and extends through January 31 of year 2.

c) Justin pays $6,000 for a 24-month policy that covers the business from April 1, year 0 through March 31, year 2.

d) Instead of paying an insurance premium, Justin pays $4,800 to rent his business property from April 1 of year 0 through March 31 of year 1.

*a) The entire premium of $4,800 is deductible under the 12-month rule because the insurance coverage does not exceed 12 months and does not extend beyond the end of next year.*

*b) No deduction this year. Even though the contract period is 12 months or fewer, Justin is required to capitalize the cost of the prepayment for the insurance policy because the contract period extends beyond the end of next year.*

*c) Because the length of the insurance coverage lasts longer than 12 months, Justin may only deduct the portion of the premium pertaining to this year. Justin can deduct $2,250 of the $6,000 insurance premium payment (9 months / 24 months times $6,000).*

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*d) Deduct $4,800 rent. The 12-month rule for capitalizing expenditures applies to rent (but not interest) payments for a cash method taxpayer. In contrast, for an accrual method taxpayer both rent and interest are deducted over the period relating to the lease or loan term because of economic performance.*

63. [LO 4] {Tax Forms} Ben teaches golf lessons at a country club under a business called Ben's Pure Swings (BPS). He operates this business as a sole proprietorship on the accrual basis of accounting. Use the following accounting information for BPS to complete the firm's Schedule C:

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

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

BPS has accrued the following expenses (explained below):

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

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

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

*Under the accrual method, revenues are generally recorded under the all-events test as earned or received. Hence, unless the deferral method election has been made, BPS will recognize $101,200 of lesson revenue ($86,700 plus $14,500) this year. BPS will only recognize $17,000 of driving range revenue because the remaining amount of the income is not "fixed and determinable" due to the dispute.*

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*Regarding deductions, BPS cannot claim a deduction for estimated uncollectible accounts because direct write-off is the method dictated by the Code. BPS paid $600 of insurance premiums and is liable for $600 of the remaining premiums. However, insurance is a payment liability and only payment satisfies economic performance. Unless BPS has elected to account for the insurance as a recurring item, the deduction is limited to $600 (the insurance would only qualify for the 12-month rule if economic performance has been met under the recurring item exception). Under the accrual method and economic performance rent is deducted over the term of the lease. Hence, BPS can only deduct the club rents relating to the current year ($100 × 52). Finally, it would appear that half of the cost of supplies is not deductible because it is unreasonable in amount. There are no apparent problems with deducting the payments for advertising, membership fees, or accounting fees.*

*Schedule C for 2020 would be filled in as follows:*

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**Part I Income**

| | | | |
|---|---|---|---|
| 1 | Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked ▶ ☐ | 1 | 118,200 |
| 2 | Returns and allowances | 2 | |
| 3 | Subtract line 2 from line 1 | 3 | 118,200 |
| 4 | Cost of goods sold (from line 42) | 4 | |
| 5 | **Gross profit.** Subtract line 4 from line 3 | 5 | 118,200 |
| 6 | Other income, including federal and state gasoline or fuel tax credit or refund (see instructions) | 6 | |
| 7 | **Gross income.** Add lines 5 and 6 ▶ | 7 | 118,200 |

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

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 8 | Advertising | 8 | 13,150 | 18 | Office expense (see instructions) | 18 | |
| 9 | Car and truck expenses (see instructions) | 9 | | 19 | Pension and profit-sharing plans | 19 | |
| 10 | Commissions and fees | 10 | 860 | 20 | Rent or lease (see instructions): | | |
| 11 | Contract labor (see instructions) | 11 | | a | Vehicles, machinery, and equipment | 20a | |
| 12 | Depletion | 12 | | b | Other business property | 20b | 5,200 |
| 13 | Depreciation and section 179 expense deduction (not included in Part III) (see instructions) | 13 | | 21 | Repairs and maintenance | 21 | |
| 14 | Employee benefit programs (other than on line 19) | 14 | | 22 | Supplies (not included in Part III) | 22 | 2,360 |
| 15 | Insurance (other than health) | 15 | 600 | 23 | Taxes and licenses | 23 | |
| 16 | Interest (see instructions): | | | 24 | Travel and meals: | | |
| a | Mortgage (paid to banks, etc.) | 16a | | a | Travel | 24a | |
| b | Other | 16b | | b | Deductible meals (see instructions) | 24b | |
| 17 | Legal and professional services | 17 | 8,820 | 25 | Utilities | 25 | |
| | | | | 26 | Wages (less employment credits) | 26 | |
| | | | | 27a | Other expenses (from line 48) | 27a | |
| | | | | b | **Reserved for future use** | 27b | |

| | | | |
|---|---|---|---|
| 28 | **Total expenses** before expenses for business use of home. Add lines 8 through 27a ▶ | 28 | 30,990 |
| 29 | Tentative profit or (loss). Subtract line 28 from line 7 | 29 | 87,210 |
| 30 | Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). **Simplified method filers only:** enter the total square footage of: (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30 | 30 | |
| 31 | **Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Schedule 1 (Form 1040 or 1040-SR), line 3** (or **Form 1040-NR, line 13**) and on **Schedule SE, line 2**. (If you checked the box on line 1, see instructions). Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32. | 31 | 87,210 |
| 32 | If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both **Schedule 1 (Form 1040 or 1040-SR), line 3** (or **Form 1040-NR, line 13**) and on **Schedule SE, line 2.** (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on **Form 1041, line 3.** • If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited. | 32a ☑ All investment is at risk.<br>32b ☐ Some investment is not at risk. | |

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64. [LO 4] Stephanie began her consulting business this year, and on April 1 Stephanie received a $9,000 payment for full payment on a three-year service contract (under the contract Stephanie is obligated to provide advisory services for the next three years). Stephanie has elected to use the accrual method of accounting for her business.

a) What is the minimum amount of income should Stephanie recognize for tax purposes this year if she recognizes $2,250 of income from the for financial accounting purposes?

b) What is the minimum amount of income will Stephanie recognize next year for tax purposes?

*a) Under the deferral method Stephanie will recognize $2,250 of income in this year for tax purposes. This is the amount of the income she earned this year for financial reporting purposes calculated as follows: ([$9,000/3 years] × 9/12). Otherwise, Stephanie must recognize the entire $9,000 or the amount recognized for financial reporting purposes.*

*b) Stephanie must recognize the remaining $6,750 next year because under the deferral method she may only defer prepaid income for one year.*

65. [LO 4] This year, Amber purchased a business that processes and packages landscape mulch. Approximately 20 percent of management time, space, and expenses are spent on this manufacturing process.

| | | Costs | Inventory |
|---|---|---|---|
| Material: | Mulch and packaging | $ 500,000 | ? |
| | Administrative supplies | 25,000 | ? |
| Salaries: | Factory labor | 1,200,000 | ? |
| | Sales & advertising | 350,000 | ? |
| | Administration | 520,000 | ? |
| Property taxes: | Factory | 460,000 | ? |
| | Offices | 270,000 | ? |
| Depreciation: | Factory | 800,000 | ? |
| | Offices | 150,000 | ? |

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

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

*a) $315,300 calculated below. The costs of selling, advertising, and research are not required to be allocated to inventory under UNICAP. Direct costs (material, labor, taxes, and depreciation) are allocated to inventory according to the level of ending*

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*inventory (10%). In contrast, indirect costs (administration) are first allocated by time spent (20%) and then according to the level of ending inventory.*

| | | *Costs* | *Percent* | *Tax Inventory* |
|---|---|---|---|---|
| *Material:* | *Mulch and packaging* | *$ 500,000* | *10* | *$ 50,000* |
| | *Administrative supplies* | *25,000* | *2* | *500* |
| *Salaries:* | *Factory labor* | *$1,200,000* | *10* | *120,000* |
| | *Sales & advertising* | *350,000* | *0* | *0* |
| | *Administration* | *520,000* | *2* | *10,400* |
| *Property taxes:* | *Factory* | *$ 460,000* | *10* | *46,000* |
| | *Offices* | *270,000* | *2* | *5,400* |
| *Depreciation:* | *Factory* | *$ 800,000* | *10* | *80,000* |
| | *Offices* | *150,000* | *2* | *3,000* |
| *Total Inventory Costs* | | | | *$315,300* |

*b) Amber can avoid UNICAP if the average annual gross receipts from the business for the prior three years do not exceed $26 million.*

66. [LO 4] Suppose that David has elected to account for inventories and has adopted the last-in, first-out (LIFO) inventory-flow method for his business inventory of widgets (purchase prices below).

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

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

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

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

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

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

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

*a) Under the LIFO method, this year David should record a cost of goods sold of $2,400 and an ending inventory of $4,550.*

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*b) Under LIFO, David would be deemed to sell widgets #5 and #6 so his cost of goods sold next year would be $4,660 and his ending inventory would consist of widgets #1, #2, and #4 for a total ending inventory of $7,150.*

*c) Under the FIFO method, for part a, David's cost of goods sold this year would be $2,200 and his ending inventory would be $4,750. Under FIFO for part b, David would be deemed to sell widgets #2 and #3 so his cost of goods sold next year would be $4,750 and his ending inventory would consist of widgets #4, #5, and #6 for a total ending inventory of $7,260.*

*d) The §481 adjustment will require David to recognize income or expense as though he initially had adopted the FIFO method. Under the FIFO method, his cost of goods sold in the first year would have been $2,200 instead of $2,400. Hence, David's §481 adjustment will be +$200, effectively increasing his beginning inventory for the next year from $4,550 under LIFO to $4,750 under FIFO. The adjustment would be spread over four years.*

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

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

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

*a) and b) $750 under either cash or accrual method of accounting. This year Jaxon can only deduct two months of interest ([$4,500/12] × 2) because prepaid interest is not deductible under either method of accounting.*

68. [LO 4] Matt hired Apex Services to repair his business equipment. On November 1, of this year, Matt paid $2,000 for the repairs that he expects to begin in early March of next year.

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

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

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

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

*a) The $2,000 cost of repairs is deductible this year because Matt is a cash-method taxpayer and this is a routine repair that meets the 12-month rule.*

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*b) The $2,000 cost of the repairs is not deductible this year but rather next year because economic performance occurs when the services are performed.*

*c) $2,000 deductible this year (the year of payment). Because Matt paid for the service this year and he can reasonably expect that the work will be done within 3 and ½ months of payment he is allowed to deduct the payment this year under the accrual method.*

*d) The $2,000 cost of repairs is deductible this year because he meets the 12-month rule.*

69. [LO 4] Circuit Corporation (CC) is a calendar-year, accrual-method taxpayer. CC manufactures and sells electronic circuitry. On November 15 of this year, CC enters into a contract with Equip Corp (EC) that provides CC with exclusive use of EC's specialized manufacturing equipment for the five-year period beginning on January 1 of next year. Pursuant to the contract, CC pays EC $100,000 on December 30 of this year. How much of this expenditure is CC allowed to deduct this year and next year?

*$0 this year and $20,000 next year. Because CC is leasing property from EC, economic performance on the contract occurs ratably over the five-year period from January 1 of next year through December 31 of year 5. Consequently, CC is not allowed to deduct any of the expenditure this year and is allowed to deduct one-fifth of the contract price next year (and in each of the four succeeding years).*

70. [LO 4] This year Elizabeth agreed to a three-year service contract with an engineering consulting firm to improve efficiency in her factory. The contract requires Elizabeth to pay the consulting firm $1,500 for each instance that Elizabeth requests its assistance. The contract also provides that Elizabeth only pays the consultants if their advice increases efficiency as measured 12 months from the date of service. This year Elizabeth requested advice on three occasions and she has not yet made any payments to the consultants.

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

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

*a) Zero. Because the liability is contingent on a future event (increase in efficiency) occurring after the end of the year, the liability is not fixed. Therefore, as an accrual-method business, Elizabeth is not allowed to recognize any deduction for this contract this year even though the consultants have provided services on three different occasions by the end of the year.*

*b) Zero. Under the cash-method, Elizabeth would only deduct payments made to the consultants by the end of the year. In this situation, she had not paid the consultants anything by year end, so she would not deduct any expense associated with the contract.*

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71. [LO 4] Travis is a professional landscaper. He provides his clients with a one-year (12-month) warranty for retaining walls he installs. In June of this year, Travis installed a wall for an important client, Sheila. In early November, Sheila informed Travis that the retaining wall had failed. To repair the wall, Travis paid $700 cash for additional stone that he delivered to Sheila's location on November 20 of this year. Travis also offered to pay a mason $800 to repair the wall. Due to some bad weather and the mason's work backlog, the mason agreed to begin the work by the end of January of the next year. Even though Travis expected the mason to finish the project by end of February, Travis informed the mason that he would only pay the mason the $800 when he completed the job.

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

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

    *a) $700. Under the accrual method, economic performance occurs as Travis incurs costs associated with providing goods and services to another person. Hence, Travis can deduct the $700 cost of the stone this year. However, because Travis is hiring another (the mason) to provide a service that Travis is liable to perform, economic performance occurs as the mason performs the services. Consequently, Travis will not be allowed to deduct the cost for the mason until next year when the mason performs the services.*

    *b) The timing and amount of the deductions under the cash method is the same as it is under the accrual method.*

72. [LO 4] {Research} Adam elects the accrual method of accounting for his business. What amount of deductions does Adam recognize this year for the following transactions?

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

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

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

    *a) No deduction this year - economic performance only occurs for refunds upon payment.*

    *b) Deduct $40 for portion of services provided to Adam (one month) this year. Note the economic performance rules (deductible as receives services from other person)*

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*c) Deduct $240 if recurring item exception is elected. Otherwise, taxes can only be deducted upon payment. The amount is immaterial, this is the first time encountered, and payment is expected within the date for filing a return or 8.5 months, thus, Reg. §1.461-5 provides a "recurring items" exception to the economic performance rules.*

73. [LO 4] Rebecca is a calendar-year taxpayer who operates a business. She made the following business-related expenditures in December of this year. Indicate the amount of these payments that she may deduct this year under both the cash method of accounting and the accrual method of accounting.

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

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

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

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

*a) $2,000 under the cash method. Likely $2,000 under the accrual method. Rebecca paid for the accounting services in advance and as long as she reasonably expected that the accountant would finish the services within 3 ½ months after the payment, she may treat payment as economic performance. Here, since she made the payment in December and the accountant provided the services a month later, it is likely that she would qualify for the deduction this year. Otherwise, she would need to deduct the $2,000 of year when the accountant provided the services.*

*b) $0 under both the cash and accrual method. In this case, economic performance takes place as when the goods are provided to her. However, because the asset will provide a benefit for more than 12 months, she must capitalize the expenditure and she will begin depreciating it next year when she places the asset in service.*

*c) $3,000 under both the cash method and accrual method. Taxes are a payment liability and are therefore, absent a special election, deductible only when paid. However, §461(c) allows businesses to elect to accrue the deduction for real property taxes ratably over the tax period instead of deducting them when they actually pay them.*

*d) $600 (the interest allocable to November and December) under both the cash method and the accrual method. Even under the cash method taxpayers may not deduct interest expense in excess of the amount of accrued interest.*

74. [LO 4] BCS Corporation is a calendar-year, accrual-method taxpayer. BCS was formed and started its business activities on January 1 of this year. It reported the following information for the year. Indicate BCS's deductible amount for this year in each of the following alternative scenarios.

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

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

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

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

e) On December 1 of this year, BCS acquired equipment from Equip Company. As part of the purchase, BCS signed a separate contract which provided that Equip would warranty the equipment for two years (starting in December 1 of this year). The extra cost of the warranty was $12,000 which BCS finally paid to Equip in January of next year.

*a) Because the accrued $200,000 warranty expense is an estimate (it is not a fixed and determinable liability) BCS is not allowed to deduct any of the $200,000 accrual this year. However, BCS is allowed to deduct the $30,000 it actually spent this year repairing its product under the warranty.*

*b) Because employer liabilities under the workers compensation act are payment liabilities, BCS is allowed to deduct only the $10,000 it actually paid this year for workers compensation-related liabilities.*

*c) Because tort liabilities such as this are payment liabilities, BCS is not allowed to deduct any of the $500,000 expense it accrued this year for the expected lawsuit loss.*

*d) Same answer as c. BCS is not allowed to deduct the $500,000 until it is actually paid to the customer. Payment to the escrow account is not payment to the customer because BCS will get the money back if it wins the case next year.*

*e) Warranties provided to the taxpayer are payment liabilities. However, this prepaid expense is also subject to the 12-month rule. BCS cannot deduct any amounts until it has made payment and it meets the requirements of the 12- month rule. In this situation, BCS would not be allowed to deduct anything this year because it had not paid anything by year end. Further, even though it paid Equip on January 1 next year, it is subject to the 12-month rule because the contract period is longer than 12 months. Consequently, BCS may deduct $6,500 next year (for December of this year*

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*and all of next year). It can also deduct $5,500 in the last year of the warranty (January through November of that year).*

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

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

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

    *a) Under the accrual method, §166 provides that William can claim a bad debt deduction for the account receivable if it is partially or completely uncollectible. Because William does not expect to collect for his services and he has written off the receivable, he is allowed to deduct the full $4,200 of services that he has included in income under the accrual method.*

    *b) Under the cash method, William would not be able to claim a bad debt expense deduction because, under this method he has not yet recognized the income for his services.*

76. [LO 4] Dustin has a contract to provide services to Dado Enterprises. In November of this year, Dustin billed Dado $10,000 for the services he rendered during the year. Dado is an accrual-method proprietorship that is owned and operated by Dustin's father.

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

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

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

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

    *a) Dustin recognizes the $10,000 payment as revenue this year when he receives it, and Dado accrues and deducts a $10,000 expense this year.*

    *b) Dustin accrues $10,000 revenue this year and Dado accrues the $10,000 expense this year.*

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*c) Because Dustin and Dado are related persons, Dado may only deduct the accrual when Dustin recognizes the associated income. Since, under the cash method of accounting, Dustin recognizes the payment as revenue next year when he receives it, Dado cannot deduct the $10,000 expense until next year.*

*d) As an accrual-method taxpayer, Dustin accrues the $10,000 of revenue this year. Consequently, under the related-person rule, Dado may deduct the $10,000 of accrued expense this year (the same year that Dustin recognizes the revenue for tax purposes).*

77. [LO 4] Nancy operates a business that uses the accrual method of accounting. In December, Nancy asked her brother, Hank, to provide her business with consulting advice. Hank billed Nancy for $5,000 of consulting services in year 0 (a reasonable amount), but Nancy was only able to pay $3,000 of the bill by the end of this year. However, Nancy paid the remainder of the bill in the following year.

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

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

*a) Under the cash method of accounting, Hank includes the $3,000 payment he received in his income. Hank is Nancy's brother, so Nancy and Hank are "related" persons for tax purposes. Under the related person rules, because Nancy uses the accrual method and Hank the cash method, Nancy will only be able to deduct this year the $3,000 she actually pays to Hank this year. Consequently, Nancy will deduct the remaining $2,000 expense next year when Hank includes it in income.*

*b) Under the accrual method of accounting, Hank includes the $5,000 of services in income this year because that is when he earned it. Also, because she uses the accrual method of accounting, Nancy is allowed to accrue and deduct the entire $5,000 of consulting services this year.*

78. [LO 4] Erin is considering switching her business from the cash method to the accrual method at the beginning of next year. Determine the amount and timing of her §481 adjustment for next year assuming the IRS grants Erin's request in the following alternative scenarios.

a) At the end of this year, Erin's business has $15,000 of accounts receivables and $18,000 of accounts payables that have not been recorded for tax purposes.

b) At the end of this year, Erin's business reports $25,000 of accounts receivables and $9,000 of accounts payables that have not been recorded for tax purposes.

*a) Erin would be required to make a §481 adjustment to ensure that she does not omit receivables and payables from taxable income under the accrual method of accounting that she is switching to. Her net §481 adjustment is to decrease net*

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*income by $3,000 ($15,000 receivables minus the $18,000 payables). Because this is an income decreasing adjustment, Erin would deduct the full adjustment amount in the next year.*

*b) Erin's net §481 adjustment is to increase net income by $16,000 ($25,000 receivables minus the $9,000 payables). Because this is an income increasing adjustment, Erin would include 25 percent of the net adjustment ($4,000) in taxable income in each of the next four years beginning with next year.*

## Comprehensive Problems

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

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

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

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

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

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

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

g) Joe uses his BMW (a personal auto) to travel to and from his residence to his factory. However, he switches to a business vehicle if he needs to travel after he reaches the factory. In September of this year, the business vehicle broke down and he was forced to use the BMW both to travel to and from the factory and to visit work sites. He

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drove 120 miles visiting work sites and 46 miles driving back and forth between the factory and his home. Joe uses the standard mileage rate to determine his auto-related business expenses.

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

*a) $0 income. Joe does not include any income this year from his contract with the city because the sale is contingent upon a future event. Consequently, Joe does not have a fixed right to the income.*

*b) $0 deduction. Entertainment is not a deductible business expense.*

*c) $0 deduction. The insurance premiums on a key-man policy are not deductible because any life insurance proceeds paid to Joe would be tax exempt. Hence, key-man life insurance premiums are an expense associated with the production of tax exempt income.*

*d) $9,000 increase in income. The receivables will be reflected in sales thereby increasing income by $9,000. However, no bad debt expense can be deducted this year because Joe only "expects" that that some will be uncollectible. Those that are identified as partially or completely uncollectible can be deducted next year.*

*e) Under the economic performance rules, Joe will deduct the cost of the lease over the lease term. Thus, he will deduct $1,000 this year and the remaining $2,000 next year.*

*f) Joe is allowed to deduct the full cost of the airfare ($300) and lodging ($350) as an ordinary and necessary business expense. Joe is also allowed to deduct the $250 cost of meals (assuming Joe's employee provides proper substantiation for the meals).*

*g) While the 46 miles from his home to the factory is personal and not deductible, Joe can either deduct the business portion of the operating costs of his car, or a standard amount (56 cents in 2021) for each mile driven. If he elects the standard usage rate, Joe is entitled to a $67.20 (56¢ × 120) deduction.*

*h) The primary purpose of Joe's trip was to visit relatives, so only the expenses directly related to business are deductible. Hence, Joe can deduct $25 for meals (the trip is away from home overnight but the meals were not provided by a restaurant), $20 for cab fare, and $50 for the cost of the symposium.*

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

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following financial information for the year (assume GJ reports on a calendar year, uses the accrual method of accounting, and elects to account for inventory).

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

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

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

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

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

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

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

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

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

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

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

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

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

n) Jack lives 12 miles from the office. He carefully tracked his mileage and drove his truck 6,280 miles between the office and his home. He also drove an additional 7,200 miles between the office and traveling to client sites. Jack did not use the truck for

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any other purposes. He did not keep track of the specific expenses associated with the truck. However, while traveling to a client site, Jack received a $150 speeding ticket. GJ reimbursed Jack for business mileage and for the speeding ticket.

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

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

q) GJ had a client who needed Jack to perform work in Florida. Because Jack had never been to Florida before, he booked an extra day and night for sightseeing. Jack spent $400 for airfare and booked a hotel for 3 nights ($120/night). (Jack stayed two days for business purposes and one day for personal purposes.) He also rented a car for $45 per day. The client provided Jack's meals while Jack was doing business, but GJ paid all expenses.

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

**Required:**

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

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

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

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

*a) Geo-Jack's taxable income for the year is $189,118 computed as gross income of $277,100 less deductible business expenses of $87,982 as follows:*

| ***Description*** | ***Amount*** | ***Explanation*** |
|---|---|---|
| *b) Sales and service revenue* | *$290,000* | |
| *r) Cost of goods sold* | *(15,000)* | |
| *c) Interest income* | *2,100* | *$50 of municipal bond interest is excluded from income.* |
| *Gross income* | *$277,100* | |
| *a) Rent* | *(3,000)* | *$4,000 is a deposit and nondeductible. Only the rent for the current year ($3,000) is deductible because rent is deducted ratably under economic performance.* |
| *d) Depreciation expense* | *(6,540)* | |
| *e) Season tickets* | *0* | *Not an ordinary and necessary business expense for GJ* |
| *f) Compensation paid to Jack's father* | *(6,000)* | *Paid $10,000 but amounts above $6,000 likely not reasonable given the circumstances.* |

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| | | |
|---|---|---|
| *g) Advertising expense* | *(22,000)* | *Ordinary and necessary business expense* |
| *h) Office rent expense* | *(27,000)* | *Ordinary and necessary business expense* |
| *r) Employee compensation* | *(10,000)* | *Ordinary and necessary business expense* |
| *i) Theft loss* | *(3,500)* | *$2,000 insurance proceeds minus 5,500 adjusted basis* |
| *j) Fine for unauthorized digging* | *0* | *Fines not deductible* |
| *k) Lobbying costs* | *0* | *Lobbying costs generally not deductible* |
| *l) Insurance policy* | *(600)* | *Under 12-month rule, may only deduct portion of cost attributable to current year (6 months)* |
| *m) Deductible interest* | *(1,080)* | *$1,200 total interest - $120 interest related to generation of nontaxable income that is not deductible.* |
| *n) Automobile expense* | *(4,032)* | *7,200 business miles × 56¢ = $4,032. The fine is not deductible.* |
| *o) Baseball tickets* | *0* | *(entertainment is nondeductible)* |
| *p) Business meals* | *(3,500)* | *meals at restaurants are fully deductible* |
| *q) Overnight travel expenses* | *(730)* | *Primary purpose of trip was business so may deduct airfare, two nights' lodging, rental car for two days ($400 + 240 lodging + 90 for rental car).* |
| *Total deductions* | *$87,982* | |
| ***Taxable income*** | ***$189,118*** | |

*b) As a C corporation, Geo-Jack could choose the last day of any month including December 31 (even though it didn't start its business until February) or it could select a 52/53 week year.*

*c) As a sole proprietorship Geo-Jack would have a calendar year end, December 31, the same as its proprietor, Jack.*

*d) As an S corporation Geo-Jack would have a calendar yearend, December 31, unless it can show a business purpose for adopting a different year end.*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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values) covering the period December 1 of last year, through November 30 of this year.

*BAM's business income is $133,198 computed as gross income of $166,250 less deductible business expenses of $32,252 as follows:*

| ***Description*** | ***Accrual*** | ***Explanation*** |
|---|---|---|
| *b) Sale to HRU* | *75,000* | |
| *c) Prepayment of goods from HRU* | *12,000* | *Using the deferral method for accrual, only amount earned is recognized (2 mos. × $12 per unit × 500 units). The remaining payment will be recognized next year.* |
| *d) Sale at sci-fi convention* | *11,000* | |
| *e) Sale of figurines on credit* | *$120,000* | *Under the accrual method included income at time of sale Note: Gross receipts for schedule C is $218,000 [(b) + (c) + (d) + (e)]* |
| *f) Cost of goods sold* | *(54,000)* | |
| *Gross Profit* | *$164,000* | |
| *a) 481 adjustment cash to accrual method* | *2,250* | *14,000 AR – 5,000 AP = 9,000; 9,000 × 25% = $2,250 A positive adjustment is included over 4 years (25% a year).* |
| ***Gross Income*** | *$166,250* | |
| *e) and a) Bad debt expense* | *2,000* | *Can only deduct amounts actually written off as uncollectible.* |
| *g) Travel costs* | *835* | *$350 airfare + $100 convention fee + $210 lodging + $65 cab fare + $110 meals* |
| *h) Insurance expense* | *3,600* | *This prepayment qualifies under the 12-month rule and it is a payment liability so it meets the economic performance test when it pays to the insurance company in August.* |
| *i) Depreciation* | *8,200* | |
| *j) Rent expense* | *13,200* | *Economic performance for rent expense occurs over the rental period. Because no expenditure is accrued, the 12 month rule is inapplicable. Rex may only deduct rent for 11 months it was renting the property (11 mos. × $1,200).* |
| *k) Amortization—start-up costs* | *1,667* | *30,000 – 5,000 expensed immediately = 25,000; 25,000 / 180 mos. = 138.89;138.89 × 12 mos. = $1,667* |
| *l) Advertising* | *250* | *$5,000 is not deductible because the liability is not fixed. Economic performance for the $3,000 occurs as AWU provides services. Thus, BAM may only deduct the portion of this expense that relates to December (3,000 × 1/12)* |
| *m) Property taxes* | *2,500* | *Taxes are payment liabilities so economic performance and the deduction occurs when BAM pays the taxes.* |
| ***Total Deductions*** | ***32,252*** | |
| ***Business income*** | ***$133,198*** | *Schedule C income* |

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

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

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

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

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

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

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

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

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WPA wasn't able to complete the job until April 1of next year, at which time IDC paid the remaining $1,500.

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

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

*Bryan's taxable income is $47,003 under the cash method of accounting and $137,330 under the accrual method of accounting computed as follows:*

| ***Description*** | ***Cash*** | ***Accrual*** | ***Explanation*** |
|---|---|---|---|
| *a) Prepaid carpeting services* | *$0* | *$80,000* | *The $80,000 was received in the prior year and would have been included in gross income when it was received.* |
| *b) Carpeting services* | *220,000* | *240,000* | *Income not recognized until received for cash method.* |
| *c) Cleaning services* | *8,640* | *1,440* | *For accrual, only amount earned is recognized (6 mos. × $240).* |
| *Sale of Inventory:* | | | |
| *d) Stain remover sales* | *500* | *500* | |
| ***Gross Income*** | *$229,140* | *$321,940* | |
| *a) Carpet supplies* | *50,000* | *50,000* | *Economic performance under the accrual method requires that IDC provide the goods (carpet) to the homebuilder in order to deduct the cost. The home was finished in the current year.* |
| *b) materials needed for contracts* | *130,000* | *130,000* | |
| *d) Stain remover* | *337* | *335* | *Cash method may deduct cost in year paid (August purchase of $140 + July purchased of $85 + February purchase of $112 = $337). Accrual method: $127 for first sale (35 bottles from February + 5 bottles from November last year) and $208 from second sale (40 bottles from August + 20 bottles from July).* |
| *Supplies* | *180,337* | *180,335* | *Bryan no longer needs to account for inventory except as misc. supplies* |
| ***Gross Profit*** | *$48,803* | *$141,605* | |
| | | | |
| *b) Bad debt* | *0* | *3,000* | *Cash method not deductible because bad debt was never included in income.* |

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| | | | |
|---|---|---|---|
| *e) Prepaid rent* | *$900* | *$375* | *For accrual, economic performance occurs over lease period (5 months this year). 12-month rule applies for cash method.* |
| *f) Prepaid paint job* | *500* | *500* | *Because IDC expects completion within 3½ months of payment, they may deduct amount paid this year under the accrual method.* |
| *g) Compensation to Aiden* | *0* | *0* | *Not deductible until paid to the related cash-method recipient (Aiden)* |
| *h) Prepaid interest* | *400* | *400* | *Not deductible until interest accrues (2 months this year).* |
| *Total Deductions* | *1,800* | *4,275* | |
| ***Taxable Income*** | ***$47,003*** | ***$137,330*** | |

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

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

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

- A small minority of HW clients complained about the catering service. To mitigate these complaints, Hank's policy is to refund dissatisfied clients 50 percent of the catering fee. By the end of the first year, only two HW clients had complained but had not yet been paid refunds. The expected refunds amount to $1,700, and Hank reduced the reported catering fees for the first year to reflect the expected refund.
- In the first year, HW received a $6,750 payment from a client for catering a monthly breakfast for 30 consecutive months beginning in December. Because the payment didn't relate to last year Hank excluded the entire amount when he calculated catering revenues.

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

**Required:**

a) Hank files his personal tax return on a calendar year, but he has not yet filed last year's personal tax return nor has he filed a tax return reporting HW's results for the first year of operations. Explain when Hank should file the tax return for HW and calculate the amount of taxable income generated by HW last year.

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b) Determine the taxable income that HW will generate if Hank chooses to account for the business under the accrual method.

c) Describe how your solution might change if Hank incorporated HW before he commenced business last year.

*a) Hank should report HW's results on a Schedule C filed with his personal tax return which is due by the 15th day of April. HW's taxable income is $116,550 calculated as follows:*

| *Revenue:* | *Balance* | *Adjust* | *Correct* |
|---|---|---|---|
| *Donut sales* | *252,000* | | *252,000* |
| *Catering revenues* | *71,550* | *1,700* | *80,000* |
| | | *6,750* | |
| *Total Revenue* | *323,550* | | *332,000* |
| *Expenditures:* | | | |
| *Donut supplies* | *124,240* | | *124,240* |
| *Catering expense* | *27,910* | *-9,250* | *18,660* |
| *Salaries to shop employees* | *52,500* | | *52,500* |
| *Rent expense* | *40,050* | *-2,000* | *16,800* |
| | | *-21,250* | |
| *Accident insurance premiums* | *8,400* | *-6,650* | *1,750* |
| *Other business expenditures* | *6,850* | *-250* | *1,500* |
| | | *-5,100* | |
| *Total Expenses* | *259,950* | | *215,450* |
| *Net Income* | *63,600* | *52,950* | *116,550* |

| *Adjustments under the cash method* | |
|---|---|
| *refunds cannot be deducted from revenue until paid* | *1,700* |
| *prepaid income is recognized in the period received* | *6,750* |
| *a fine is nondeductible* | *250* |
| *only 5 months are deductible 8,400-(8,400 × 5/24)* | *6,650* |
| *deposits are not deductible* | *2,000* |
| *deduct 7 months of equip lease 30,000-(1,250x7)* | *21,250* |
| *last month cater expense unpaid at year end* | *9,250* |
| *key person insurance premium is not deductible* | *5,100* |
| *no change under the cash method* | |
| *Total adjustments under cash method* | *52,950* |
| *Net income under cash method* | *116,550* |

*b) Taxable income for HW under the accrual method is $110,290- computed as follows:*

| *Revenue:* | *Balance* | *Adjust* | *Correct* |
|---|---|---|---|
| *Donut sales* | *252,000* | | *252,000* |
| *Catering revenues* | *71,550* | *1,700* | *80,575* |

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| | | | |
|---|---|---|---|
| | | *225* | |
| | | *7,100* | |
| *Total Revenue* | *323,550* | | *332,575* |
| *Expenditures:* | | | |
| *Donut supplies* | *124,240* | | *124,240* |
| *Catering expense* | *27,910* | | *27,910* |
| *Salaries to shop employees* | *52,500* | | *52,500* |
| *Rent expense* | *40,050* | *-2,000* | *14,385* |
| | | *-21,250* | |
| | | *-2,415* | |
| *Accident insurance premiums* | *8,400* | *-6,650* | *1,750* |
| *Other business expenditures* | *6,850* | *-250* | *1,500* |
| | | *-5,100* | |
| *Total Expenses* | *259,950* | | *222,285* |
| *Net Income* | *63,600* | *46,690* | *110,290* |

| | |
|---|---|
| *Adjustments under the accrual method* | |
| *refunds are a payment liability so no deduction* | *1,700* |
| *prepaid income ($6,750/30x1) is deferred one year* | *225* |
| *a fine is nondeductible* | *250* |
| *only 5 months are deductible 8,400-(8,400x5/24)* | *6,650* |
| *deposits are not deductible* | *2,000* |
| *Deduct 7 months of shop lease 8,050-(805x7)* | *2,415* |
| *Deduct 7 months of equip lease 30,000-(1,250x7)* | *21,250* |
| *catering expense is accrued properly* | |
| *key person insurance premium is not deductible* | *5,100* |
| *no change under the cash method* | *7,100* |
| *Total adjustments under cash method* | *46,690* |
| *Net income under cash method* | *$110,290* |

c) *If HW was incorporated at the time business commences, then last year's results would be reported on a form 1120 which is due by the 15th day of the third month following year end. HW would have the opportunity to treat legal fees associated with incorporation as organizational expenditures. Otherwise, if HW was incorporated, Hank would have the option of electing (on the first return) to use a fiscal year for reporting HW's results. This election would, obviously, influence the calculation of taxable income as well as the due date of HW's tax return.*

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

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***MEMO***

***Key Facts:***

*R.E.M., a calendar year corporation and Athens, Georgia, band, recently sold tickets ($20,000,000) for concerts scheduled in the United States for next year and the following two years. For financial statement purposes, R.E.M. will recognize the income from the ticket sales when it performs the concerts, and R.E.M is obligated to return the ticket payments should a concert be cancelled. For tax purposes, it uses the accrual method and would prefer to defer the income from the ticket sales until after the concerts are performed.*

*This is the first time that it has sold tickets one or two years in advance. Michael Stipe has asked your advice. Write a memo to Michael explaining your findings.*

***Question:***

*Should R.E.M. include in current income advance sales of tickets for concerts scheduled in future years?*

***Relevant Authorities:***

*§451(c) and §446*

*Tampa Bay Devil Rays, Ltd., 84 TCM 394 (2002).*

*Artnell Co. v. Comm. (7 Cir., 1968), 68-2 USTC par. 9593, rev'g and rem'g 48 TC 411 (1967).*

*Schlude v. Comm. (S. Ct., 1963), 63-1 USTC par. 9284, aff'g, rev'g and rem'g (8 Cir., 1962), 62-1 USTC par. 9137, aff'g 32 TC 1271 (1959).*

*American Automobile Association v. U.S. (367 US 687), 61-2 USTC par. 9517, aff'g (Ct. Cl., 1960), 60-1 USTC par. 9301.*

*Auto. Club of Michigan v. Comm. (353 US 180), 57-1 USTC par. 9593, aff'g (6 Cir., 1956), 56-1 USTC par. 9296, aff'g 20 TC 1033 (1953).*

***Conclusion:***

*There is authority to support R.E.M.'s deferred recognition of the ticket sales income until the amounts are earned (i.e., until the concerts are performed). Thus, the ticket sale income for the concerts will be recognized in the year of the performance.*

***Synopsis:*** *The general rule for prepaid service income is to recognize it in the year of receipt. §451(c) allows only a one-year elective deferral for prepaid services. However, there is judicial authority (Artnell Co. and Tampa Bay Devil Rays, Ltd.) that indicates that deferring the income until actual performance more clearly reflects income in this particular setting (concerts are scheduled to be played over time according to fixed schedule and taxpayer is required to refund deposits. Moreover, the primary expenses of the concerts are not incurred until the time of the concert, and the taxpayer knows exactly when the performance will take place. If, for example, the prepaid services were for "services on demand" like dance lessons, consulting services, etc., the most likely tax treatment would be the one-year elective deferral.*

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# Chapter 1
# Business Income, Deductions, and Accounting Methods

# INSTRUCTOR'S MANUAL

## Learning Objectives

1-1. Identify common business deductions.
1-2. Determine the limits on deducting business expenses.
1-3. Describe accounting periods available to businesses.
1-4. Apply cash and accrual methods to determine business income and expense deductions.

## Teaching Suggestions

Congress intended for taxable income to reflect the net increase in wealth from a business, so it is only fair that businesses be allowed to deduct expenses incurred to generate business income. This chapter focuses on business deductions from a proprietor's perspective, but the rules generally apply to all types of business entities including sole proprietorships, partnerships, S corporations, and C corporations. While Congress provides specific statutory rules authorizing deductions, IRC §162 is relatively broad and ambiguous. Hence, understanding the deductibility of business expenses is a critical component of a tax practitioner's skill set.

The chapter reiterates the general rules for business expenses introduced in Chapter 7 and then proceeds to describe the four types of expenditures that are not deductible (against public policy, capital, associated with tax-exempt income, and personal). The chapter introduces several specific limitations of which the mixed-motive and business interest limitations are the most complex.

The last two sections of the chapter plunge into accounting periods and methods, and these are details that some instructors may prefer to cover in a more advanced class.

Section 1-4 describes the options for different tax years, and this topic is primarily applicable to corporations. The last section (1-5) describes the rules for accounting for taxable income, specifically which items of income and deductions must be recognized during a particular year. It is important to stress that accounting methods are very important because they affect when a taxpayer is allowed or required to report income and deductions. The material on economic performance is among the most complex in the text.

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# Assignment Matrix

| Number | Time Estimate | Difficulty | LO1 | LO2 | LO3 | LO4 | Research | Planning | Tax Forms |
|---|---|---|---|---|---|---|---|---|---|
| DQ1-1 | 20 min. | Easy | X | | | | | | |
| DQ1-2 | 20 min. | Easy | X | | | | | | |
| DQ1-3 | 20 min. | Medium | X | | | | | | |
| DQ1-4 | 20 min. | Medium | X | | | | | | |
| DQ1-5 | 20 min. | Easy | | X | | | | | |
| DQ1-6 | 20 min. | Easy | | X | | | | | |
| DQ1-7 | 20 min. | Easy | | X | | | X | | |
| DQ1-8 | 20 min. | Medium | | X | | | | | |
| DQ1-9 | 20 min. | Medium | | X | | | | | |
| DQ1-10 | 20 min. | Medium | | X | | | | | |
| DQ1-11 | 20 min. | Medium | X | X | | | | | |
| DQ1-12 | 10 min. | Medium | | X | | | | | |
| DQ1-13 | 10 min. | Medium | | X | | | | | |
| DQ1-14 | 10 min. | Medium | | X | | | | | |
| DQ1-15 | 10 min. | Medium | | X | | | | | |
| DQ1-16 | 25 min. | Easy | | X | | | | | |
| DQ1-17 | 25 min. | Easy | | X | | | | | |
| DQ1-18 | 25 min. | Easy | | | X | | | | |
| DQ1-19 | 20 min. | Easy | | | X | | | | |
| DQ1-20 | 20 min. | Medium | | | X | | | | |
| DQ1-21 | 20 min. | Medium | | | X | | | | |
| DQ1-22 | 20 min. | Medium | | | X | | | | |
| DQ1-23 | 20 min. | Medium | | | | X | | | |
| DQ1-24 | 20 min. | Medium | | | | X | | | |
| DQ1-25 | 20 min. | Hard | | | | X | | | |
| DQ1-26 | 20 min. | Hard | | | | X | | | |
| DQ1-27 | 25 min. | Hard | | | | X | | | |
| DQ1-28 | 25 min. | Hard | | | | X | | | |
| DQ1-29 | 25 min. | Hard | | | | X | | | |
| DQ1-30 | 25 min. | Hard | | | | X | | | |
| DQ1-31 | 25 min. | Hard | | | | X | X | | |
| DQ1-32 | 25 min. | Hard | | | | X | | | |
| DQ1-33 | 25 min. | Hard | | | | X | | | |
| DQ1-34 | 25 min. | Hard | | | | X | | | |
| DQ1-35 | 25 min. | Hard | | | | X | | | |
| DQ1-36 | 25 min. | Hard | | | | X | | | |
| DQ1-37 | 25 min. | Hard | | | | X | | | |
| DQ1-38 | 25 min. | Hard | | | | X | | | |
| DQ1-39 | 25 min. | Hard | | | | X | | | |
| DQ1-40 | 25 min. | Hard | | | | X | | | |
| DQ1-41 | 25 min. | Hard | | | | X | | | |
| DQ1-42 | 25 min. | Hard | | | | X | | | |

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| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| DQ1-43 | 25 min. | Hard | | | | X | | | |
| DQ1-44 | 25 min. | Hard | | | | X | | | |
| P1-45 | 10 min. | Easy | X | | | | | | |
| P1-46 | 10 min. | Easy | X | X | | | | | |
| P1-47 | 20 min. | Easy | X | X | | | | | |
| P1-48 | 20 min. | Easy | | X | | | X | | |
| P1-49 | 30 min. | Medium | | X | | | | | |
| P1-50 | 30 min. | Medium | | X | | | | | |
| P1-51 | 30 min. | Medium | | X | | | | | |
| P1-52 | 20 min. | Medium | X | X | | | | X | |
| P1-53 | 15 min. | Easy | | X | | | | | |
| P1-54 | 20 min. | Medium | X | X | | | | | |
| P1-55 | 30 min. | Hard | | X | | | | | |
| P1-56 | 30 min. | Hard | | X | | | | | |
| P1-57 | 25 min. | Medium | | X | | | | | |
| P1-58 | 20 min. | Medium | | | X | | | | X |
| P1-59 | 25 min. | Medium | | | | X | | X | |
| P1-60 | 25 min. | Medium | | | | X | | | |
| P1-61 | 25 min. | Medium | | | | X | | | |
| P1-62 | 25 min. | Medium | | | | X | | | |
| P1-63 | 15 min. | Easy | | | | X | | | X |
| P1-64 | 20 min. | Medium | | | | X | | | |
| P1-65 | 25 min. | Medium | | | | X | | | |
| P1-66 | 25 min. | Medium | | | | X | | | |
| P1-67 | 20 min. | Medium | | | | X | | | |
| P1-68 | 20 min. | Medium | | | | X | | | |
| P1-69 | 20 min. | Medium | | | | X | | | |
| P1-70 | 20 min. | Medium | | | | X | | | |
| P1-71 | 20 min. | Medium | | | | X | | | |
| P1-72 | 20 min. | Medium | | | | X | X | | |
| P1-73 | 30 min. | Medium | | | | X | | | |
| P1-74 | 30 min. | Medium | | | | X | | | |
| P1-75 | 20 min. | Medium | | | | X | | | |
| P1-76 | 30 min. | Medium | | | | X | | | |
| P1-77 | 30 min. | Medium | | | | X | | | |
| P1-78 | 30 min. | Medium | | | | X | | | |
| CP1-79 | 45 min. | Medium | X | X | X | X | | | |
| CP1-80 | 45 min. | Medium | X | X | X | X | | | |
| CP1-81 | 60 min. | Hard | X | X | X | X | | | |
| CP1-82 | 60 min. | Hard | X | X | X | X | | | |
| CP1-83 | 75 min. | Hard | X | X | X | X | X | | |

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# Lecture Notes

1) Business Gross Income
   a) Gross receipts test for determining small businesses
      i) A business that qualifies as a "small" business under a gross receipts test is exempt from certain complex tax law provisions (discussed later in the chapter) for each year in which it meets the test.
      ii) A business meets the gross receipts test for a particular year if its average annual gross receipts for the three prior taxable years does not exceed $26 million.
      iii) For purposes of the test, gross receipts include 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).
2) Business Deductions
   a) Ordinary and necessary
      i) A deduction must be ordinary and necessary (i.e., appropriate and helpful).
      ii) An ordinary expense is an expense that is normal or appropriate for the business under the circumstances.
      iii) A necessary expense is an expense that is helpful or conducive to the business activity, but the expenditure need not be essential or indispensable.
      iv) Refer to Exhibit 1-1 for Examples of Typical Ordinary and Necessary Business Expenses.
      v) Work through Example 1-2.
   b) Reasonable in amount
      i) Ordinary and necessary business expense are deductible only to the extent they are reasonable in amount.
      ii) Work through Example 1-3.
3) Limitations on Business Deductions
   a) Expenditures against public policy
      i) No business deductions for expenditures against public policy (illegal bribes, fines, penalties or illegal kickbacks).
   b) Political contributions and lobbying costs
      i) 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.
   c) Capital expenditures
      i) Businesses must capitalize expenditures for tangible assets (i.e., assets or properties that have a useful life for more than one year) that are generally recovered through depreciation.
      ii) Businesses must also capitalize the cost to create or acquire intangible assets that are generally recovered through amortization (when the tax laws allow them to do so) or upon disposition of the assets.
   d) Expenses associated with the production of tax-exempt income
      i) Expenses that generate tax-exempt income are not allowed to offset taxable income.
   e) Personal expenditures
      i) Taxpayers are not allowed to deduct personal expenses unless the expenses are "expressly" authorized by a provision in the law.
      ii) There are inevitable exceptions when personal items are specially adapted to business use.
   f) Mixed-motive expenditures
      i) Businesses often make expenditures that are motivated by both personal and business concerns.

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ii) 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.
iii) Thus, deductions for business expenditures accompanied by personal benefits are closely monitored and restricted.
iv) The rules for determining the amount of deductible mixed-motive expenditures depend on the type of expenditure.
v) Entertainment and meals
(1) Only 50 percent of business meals and entertainment are deductible.
(2) For 2021 and 2022, Section 210 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 amended §274(n)(2) to allow for full deduction of expenses for food and beverages paid or incurred to a restaurant.
(3) To deduct any portion of cost of the meal as a business expense,
(a) the amount must be ordinary, necessary, and reasonable in amount,
(b) the taxpayer or an employee must be present when the meal is furnished,
(c) the meal must be provided to a current or potential client or business contact, and
(d) 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.
vi) Travel and transportation
(1) Transportation expenses relate to the direct cost of transporting the taxpayer to and from business sites.
(2) 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 at a restaurant), lodging, and incidental expenses.
vii) Property use
(1) Several types of property may be used for both business and personal purposes.
(2) 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.
viii) Record keeping and other requirements
(1) 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.
(2) Under these provisions, taxpayers must maintain specific, written, contemporaneous records (of time, amount, and business purpose) for mixed-motive expenses.

g) Limitation on business interest deductions
i) Starting in 2018 Congress limited the deduction of interest paid or accrued on indebtedness allocable to a trade or business.
ii) The purpose of this limitation is to limit the extent to which a business utilizes debt to avoid income taxes.
iii) Business interest is defined as an amount that is paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement.
iv) 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 (50 percent for 2019 and 2020).
v) This limit is not applied to firms passing the gross receipts test.

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vi) Calculating the interest limitation
(1) Adjusted taxable income is defined as taxable income allocable to the business computed without regard to:
(a) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business,
(b) any business interest expense or income,
(c) deductions allowable for depreciation, amortization, or depletion, and
(d) any net operating loss deduction.
(2) Any business interest disallowed by the limitation is carried forward indefinitely.

h) Losses on dispositions of business property
i) Losses on sales of business assets are generally deductible.
ii) Losses on sales of a business asset to a related party are not deductible by the seller.

i) Business casualty losses
(1) Casualty losses are events when businesses incur losses in selling or when their assets are stolen, damaged, or completely destroyed by a force outside the control of the business.
(2) The amount of the loss deduction depends on whether the asset is:
(a) Completely destroyed or stolen
(b) Only partially destroyed
(3) If the asset is damaged but not completely destroyed, the amount of the loss is the amount of the insurance proceeds minus the lesser of:
(a) The asset's adjusted tax basis
(b) The decline in the value of the asset due to the casualty

4) Accounting Periods
a) Individuals and proprietorships account for income on a calendar year.
b) C corporations are allowed to choose a calendar year, a fiscal year, or a 52/53-week year.
c) 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.

5) Accounting Methods
a) The taxpayer's accounting methods determine the tax year in which a business recognizes a particular item of income or deduction.
b) Financial and tax accounting methods
i) In reporting financial statement income, businesses have incentives to select accounting methods permissible under GAAP that accelerate income and defer deductions.
ii) For tax planning purposes, businesses have incentives to choose accounting methods that defer income and accelerate deductions.
c) Overall accounting method
i) Cash method
(1) The cash method can be elected by any taxpayer that qualifies under the gross receipts test.
(2) Businesses that qualify under the gross receipts test do not need to request the consent of the IRS to elect the cash method.
ii) Accrual method
(1) Businesses using the accrual method to determine taxable income follow rules similar to GAAP with two basic differences.
(a) The requirements for recognizing taxable income tend to be structured to recognize income earlier than the recognition rules for financial accounting.
(b) The requirements for accruing tax deductions tend to be structured to recognize less accrued expenses than the recognition rules for financial reporting purposes.
d) Accrual income

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i) Businesses using the accrual method of accounting generally recognize income when they meet the all-events test.
ii) All-events test for income
(1) This test requires that businesses recognize income when:
(a) all events have occurred that determine or fix their right to receive the income and
(b) the amount of the income can be determined with reasonable accuracy.

e) Taxation of advance payments of income (unearned income)
i) In some cases, taxpayers receive income payments before they actually earn the income (e.g., unearned income or advance payments).
ii) Taxpayers using the cash method include these payments in gross income in the year the payment is received.
iii) When an accrual-method taxpayer must include unearned income in gross income depends, in part, on the type of income.
(1) 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).
iv) For other types of income, accrual-method businesses can elect to defer recognition of unearned income for one year.
(1) Specifically, businesses using the accrual method may elect to defer recognizing advance payments for goods or services until the next tax year.
v) 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.

f) Inventories
i) Businesses must use the accrual method to account for inventories if sales are an income-producing activity.
(1) Businesses qualifying under the gross receipts test can elect to treat goods as non-incidental materials or use the inventory method used for financial reporting purposes.
(2) Non-incidental materials are accounted for as materials are used.
ii) Uniform capitalization
(1) The UNICAP rules require capitalization of most indirect costs of production.
(a) Businesses qualifying under the gross receipts test can ignore UNICAP adjustments.
(b) Tax laws require businesses to capitalize in the cost of inventory certain direct and indirect costs associated with inventories.
iii) Inventory cost-flow methods
(1) Once a business determines the cost of its inventory, it must use an inventory cost-flow method to determine its cost of goods sold.
(2) Three primary cost-flow methods are
(a) First-in, first-out (FIFO),
(b) Last-in, first-out (LIFO), and
(c) Specific identification.
(3) Tax laws require that a business can use LIFO for tax purposes only if it also uses LIFO for financial reporting purposes.

g) Accrual deductions
i) To claim a tax deduction for an accrued expense, the expense must meet both an all-events test and an economic performance test.
(1) The all-events test for deductions requires that events have occurred to establish both that a liability to pay exists and that the amount of the liability is determinable with reasonable accuracy.
ii) Economic performance (exceedingly complex material for many students)

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(1) Economic performance generally requires that the activity generating the liability has occurred in order for the associated expense to be deductible (e.g., the service has been performed or the goods have been delivered).
(2) Specific requirements for the economic performance test differ based on whether the liability arose from:
  (a) Receiving goods or services from another party.
  (b) Renting or leasing property from another party.
  (c) Providing goods or services to another party
  (d) Certain activities creating payment liabilities
(3) Receiving goods and (or) services from another person
  (a) When a business receives goods or services from another person, the business deducts the expense associated with the liability when the other person provides the goods or services (assuming the all-events test is met for the liability).
  (b) However, there is an exception when a business actually pays the liability before the other person provides the goods or services.
    (i) In this circumstance, the business can elect to treat the actual payment as economic performance as long as it reasonably expects the other person to provide the goods or the services within three and one-half months after the payment.
(4) Renting or leasing property from another person
  (a) When a business enters into an agreement to use property (rent or lease property) from another person, economic performance occurs over the term of the lease.
  (b) Thus, the business is allowed to deduct the rental expense over the term of the lease.
(5) Providing goods and services to another person
  (a) Businesses liable for providing goods and services to other persons meet the economic performance test as they provide the goods or services that satisfy the liability.
(6) Payment liabilities
  (a) Economic performance occurs for certain liabilities only when the business actually pays the liability.
  (b) Thus, accrual-method businesses incurring payment liabilities are essentially on the cash method for deducting the associated expenses.
  (c) Refer to Exhibit 1-2 for Categories of Payment Liabilities and 1-3 for Economic Performance.
(7) Recurring item exception
  (a) This exception is designed to reduce the administrative cost of applying economic performance to expenses that occur on a regular basis.
  (b) Under this exception, accrual-method taxpayers can deduct certain accrued expenses even if economic performance has not occurred by year-end.
  (c) A recurring item is a liability that is expected to recur in future years and either the liability is not material in amount or deducting the expense more properly matches with revenue.
  (d) In addition, the all-events test must be satisfied at year-end and actual economic performance of the item must occur within a reasonable time after year-end (but prior to the filing of the tax return, which could be up to 8½ months after year-end with an extension).
  (e) The recurring item exception does not apply to workers' compensation or tort liabilities.

iii) Bad debt expense
(1) When accrual method businesses sell a product or a service on credit, they debit accounts receivable and credit sales revenue for both financial and tax purposes. However, because

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businesses usually are unable to collect the full amount of their accounts receivable, they incur bad debt expense (a customer owes them a debt that the customer will not pay).
(2) For financial reporting purposes, the business estimates the amount of the bad debt and creates a reserve account, the allowance for doubtful accounts.
(3) However, for tax purposes, businesses are only allowed to deduct bad debt expense when the debt actually becomes worthless within the taxable year.
(4) Consequently, for tax purposes, when businesses determine which specific debts are uncollectible, they are entitled to a deduction. This method of determining bad debt expense for tax purposes is called the direct write-off method.
(5) In contrast, the method used for financial reporting purposes is called the allowance method.

iv) Limitations on accruals to related persons
(1) To prevent businesses and related persons from working together to defer taxes, the tax laws prevent an accrual-method business from accruing (and deducting) an expense for a liability owed to a related person using the cash method until the related person recognizes the income associated with the payment.
(2) For this purpose, related persons include:
(a) Family members, including parents, siblings, and spouses.
(b) Shareholders and C corporations when the shareholder owns more than 50 percent of the corporation's stock.
(c) Owners of partnerships and S corporations no matter the ownership percentage.

h) Comparison of accrual and cash methods
i) The two primary advantages of adopting the cash method over the accrual method are that
(1) the cash method provides the business with more flexibility to time income and deductions by accelerating or deferring payments (timing tax planning strategy) and
(2) bookkeeping for the cash method is easier.
ii) The primary advantage of the accrual method over the cash method is that it better matches revenues and expenses.
iii) Refer to Exhibit 1-4 for Comparison of Cash and Accrual Methods.

i) Adopting an accounting method
i) Businesses generally elect their accounting methods by using them on their tax returns.
ii) However, when the business technically adopts a method depends on whether it is a permissible accounting method or an impermissible accounting method.
iii) Refer to Exhibit 1-5 for Green Acres's Net Business Income.

j) Changing accounting methods
i) Once a business has adopted an accounting method, it must generally receive permission to change the method, regardless of whether it is a permissible or an impermissible method.
ii) There are three important exceptions to this general rule that apply to businesses that qualify under the gross receipts test:
(1) Businesses are allowed to switch to use the cash method,
(2) treat inventories as nonincidental materials, and
(3) ignore the UNICAP rules once the gross receipts test is satisfied.
iii) Refer to Exhibit 1-6 for Green Acres Schedule C.
iv) Tax consequences of changing accounting method
(1) When a business changes from one accounting method to another, the business determines its taxable income for the year of change using the new method.
(2) Furthermore, the business must make an adjustment to taxable income that effectively represents the cumulative difference, as of the beginning of the tax year, between the amount of income (or deductions) recognized under the old accounting method and the amount that would have been recognized for all prior years if the new method had been applied.

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(3) This adjustment is called a §481 adjustment, and it prevents the duplication or omission of items of income or deduction due to a change in accounting method.

6) Conclusion
7) Summary
8) Key Terms

# Class Activities

## 1. Suggested class activities

When discussing advanced payments, a nice case that demonstrates the importance of the issue is *Tampa Bay Devil Rays*, TC Memo 2002-281. The primary issue in this case is whether deposits a partnership received on advance season tickets and on private suite reservations for Major League Baseball games (expected to be played in 1998) are to be included in the income of the partnership when received, or in 1998 when the advance season tickets and the private suite reservations would be used.

A good review activity is to work through a problem by using the trial balance of a business to convert reported income into taxable income. Problem 1-82 can be assigned to all students and then a class period can be invested into working through the trial balances. This chapter provides a great introduction into deriving a Schedule M-3 and calculating taxable income for corporations (for later in the term or in an advanced course).

One of the most difficult aspects of economic performance is the interaction of accrual expenses and the 12-month rule. As depicted in the slides, economic performance is a prerequisite to the application of the 12-month rule. To facilitate understanding, compare prepayment for 12 months of insurance with a prepayment for 12 months of rent. The cash-basis taxpayer can deduct both under the 12-month rule (assuming the rent is not typically renewed and neither prepayment extends beyond the end of the next tax year). However, an accrual-basis taxpayer can only deduct the insurance prepayment because economic performance does not occur for the rent until the property is used. In contrast, payment is sufficient for economic performance with the insurance because it is a payment liability.

Another difficult topic is the recurring item exception, and some instructors may want to discuss this exception in depth. Rev. Rul. 2012-1, 2012-02 IRB provides a nice explanation and an illustration of this rule that supplements the material in the text.

## 2. Ethics discussion

From page 1-4:

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**ETHICS**

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

Discussion points:

- "Ordinary and necessary" is the phrase that likely applies to Sheri's deduction of the personal assistant's salary, and the deduction would be evaluated according to the facts and circumstances in each particular instance.
- Sheri would need to demonstrate the extent to which this use of the personal assistant is helpful and conducive to her business. Factors such as new (demanding) clients would certainly work in Sheri's favor.
- Other facts that suggest this use of a personal assistant is common in Sheri's profession would also support the deduction.
- The likely ethical issue here is whether Sheri is *really* using her personal assistant to promote the business or just to make her life easier. It is likely that only Sheri will know the answer to that question.

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