**Chapter 1**

**Business Income, Deductions, and Accounting Methods**

INSTRUCTOR’S MANUAL

### Learning Objectives

1. Identify common business deductions.
2. Determine the limits on deducting business expenses.
3. Identify special business deductions specifically permitted under the tax laws.
4. Describe accounting periods available to businesses.
5. 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 discusses general rules for business expenses 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 special limitations of which the mixed use 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.

###### Assignment Matrix

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | Learning Objectives | | | | | Text Feature | | |
|  |  | Difficulty | LO1 | LO2 | LO3 | LO4 | LO5 | Research | Planning | Tax Forms |
| DQ1-1 | 20 min. | Medium | X |  |  |  |  |  |  |  |
| DQ1-2 | 20 min. | Medium | X |  |  |  |  |  |  |  |
| DQ1-3 | 20 min. | Medium | X |  |  |  |  |  |  |  |
| DQ1-4 | 20 min. | Medium | X |  |  |  |  |  | X |  |
| DQ1-5 | 20 min. | Medium |  | X |  |  |  |  | X |  |
| DQ1-6 | 20 min. | Medium |  | X |  |  |  |  | X |  |
| DQ1-7 | 20 min. | Medium |  | X |  |  |  |  | X |  |
| DQ1-8 | 20 min. | Medium |  | X |  |  |  |  | X |  |
| DQ1-9 | 20 min. | Medium |  | X |  |  |  |  | X |  |
| DQ1-10 | 20 min. | Medium |  | X |  |  |  |  | X |  |
| DQ1-11 | 20 min. | Medium | X | X |  |  |  |  | X |  |
| DQ1-12 | 10 min. | Medium |  | X |  |  |  |  |  |  |
| DQ1-13 | 10 min. | Medium |  | X |  |  |  |  | X |  |
| DQ1-14 | 10 min. | Medium |  | X |  |  |  |  | X |  |
| DQ1-15 | 25 min. | Hard |  |  | X |  |  |  | X |  |
| DQ1-16 | 25 min. | Hard |  |  | X |  |  |  | X |  |
| DQ1-17 | 25 min. | Hard |  |  |  | X |  |  | X |  |
| DQ1-18 | 20 min. | Hard |  |  |  | X |  |  | X |  |
| DQ1-19 | 20 min. | Hard |  |  |  | X |  |  |  |  |
| DQ1-20 | 20 min. | Hard |  |  |  | X |  |  |  |  |
| DQ1-21 | 20 min. | Hard |  |  |  | X |  |  | X |  |
| DQ1-22 | 20 min. | Hard |  |  |  |  | X |  | X |  |
| DQ1-23 | 20 min. | Hard |  |  |  |  | X |  | X |  |
| DQ1-24 | 20 min. | Hard |  |  |  |  | X |  |  |  |
| DQ1-25 | 20 min. | Hard |  |  |  |  | X |  |  |  |
| DQ1-26 | 25 min. | Hard |  |  |  |  | X |  | X |  |
| DQ1-27 | 25 min. | Hard |  |  |  |  | X |  | 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 |  |  |  |
| 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 |  |  |  |
| P1-43 | 10 min. | Easy | X |  |  |  |  |  |  |  |
| P1-44 | 10 min. | Easy | X | X |  |  |  |  |  |  |
| P1-45 | 20 min. | Easy | X | X |  |  |  |  |  |  |
| P1-46 | 20 min. | Easy |  | X |  |  |  |  |  |  |
| P1-47 | 30 min. | Medium |  | X |  |  |  |  |  |  |
| P1-48 | 30 min. | Medium |  | X |  |  |  |  |  |  |
| P1-49 | 30 min. | Medium |  | X |  |  |  |  |  |  |
| P1-50 | 20 min. | Medium | X | X |  |  |  |  | X |  |
| P1-51 | 15 min. | Easy |  | X |  |  |  |  |  |  |
| P1-52 | 20 min. | Medium | X | X |  |  |  |  | X |  |
| P1-53 | 30 min. | Hard |  | X |  |  |  |  |  |  |
| P1-54 | 25 min. | Medium |  |  | X |  |  |  |  |  |
| P1-55 | 20 min. | Medium |  |  | X |  |  |  |  |  |
| P1-56 | 25 min. | Medium |  |  |  |  | X |  | X |  |
| P1-57 | 25 min. | Medium |  |  |  |  | X |  |  |  |
| P1-58 | 25 min. | Medium |  |  |  |  | X |  |  |  |
| P1-59 | 25 min. | Medium |  |  |  |  | X |  |  |  |
| P1-60 | 15 min. | Easy |  |  |  |  | X |  |  |  |
| P1-61 | 20 min. | Medium |  |  |  |  | X |  |  |  |
| P1-62 | 20 min. | Medium |  |  |  |  | X |  |  |  |
| P1-63 | 25 min. | Medium |  |  |  |  | X |  |  |  |
| P1-64 | 25 min. | Medium |  |  |  |  | X |  |  |  |
| P1-65 | 25 min. | Medium |  |  |  |  | X |  |  |  |
| P1-66 | 20 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 | X |  |  |
| P1-72 | 30 min. | Medium |  |  |  |  | X |  |  |  |
| P1-73 | 30 min. | Medium |  |  |  |  | X |  |  |  |
| P1-74 | 20 min. | Medium |  |  |  |  | X |  |  |  |
| P1-75 | 30 min. | Medium |  |  |  |  | X |  |  |  |
| P1-76 | 30 min. | Medium |  |  |  |  | X |  |  |  |
| P1-77 | 30 min. | Medium |  |  |  |  | X |  |  |  |
| CP1-78 | 45 min. | Medium | X | X | X | X | X |  |  |  |
| CP1-79 | 45 min. | Medium | X | X | X | X | X |  |  |  |
| CP1-80 | 60 min. | Hard | X | X | X | X | X |  |  |  |
| CP1-81 | 60 min. | Hard | X | X | X | X | X |  |  |  |
| CP1-82 | 75 min. | Hard | X | X | X | X | X |  |  |  |
| CP1-83 | 35 min. | Medium | X | X | X | X | X |  |  |  |

**Lecture Notes**

1. Business Deductions
   1. Provision authorizing business deduction
      1. IRC §162, the provision authorizing business deductions is relatively broad and ambiguous:

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

* + - 1. Business expenses must be incurred in pursuit of profits, not personal goals.
  1. Ordinary and necessary
     1. A deduction must be ordinary and necessary (i.e. appropriate and helpful).
     2. An ordinary expense is an expense that is normal or appropriate for the business under the circumstance.
     3. A necessary expense is an expense that is helpful or conducive to the business activity, but the expenditure need not be essential or indispensable.
     4. Refer to Exhibit 1-1 for Examples of Typical Ordinary and Necessary Business Expenses.
     5. Work through Example 1-1.
  2. Reasonable in amount
     1. Ordinary and necessary business expense are deductible only to the extent they are reasonable in amount.
     2. Work through Example 1-2.

1. Limitations on Business Deductions
   1. Expenditures against public policy
      1. No business deductions for expenditures against public policy (illegal bribes, fines, penalties or illegal kickbacks)
   2. Political contributions and lobbying costs
      1. To avoid the perception that the federal government subsidizes taxpayer efforts to influence politics, there are no deductions for political contributions and lobbying costs.
      2. Work through Example 1-3.
   3. Capital expenditures
      1. Businesses must capitalize expenditures for tangible assets (i.e., assets or properties which have a useful life for more than one year) that are generally recovered through depreciation.
      2. Businesses must also capitalize the cost to create or acquire intangible assets that are generally recovered through amortization or upon disposition of the assets.
   4. Expenses associated with the production of tax-exempt income
      1. Expenses that do not help businesses generate taxable income are not allowed to offset taxable income.
      2. Work through Example 1-4.
   5. Personal expenditures
      1. Taxpayers are not allowed to deduct personal expenses unless the expenses are “expressly” authorized by a provision in the law.
      2. There are inevitable exceptions when personal items are specially adapted to business use.
      3. Work through Example 1-5.
   6. Mixed-motive expenditures
      1. Businesses often make expenditures that are motivated by both personal and business concerns.
      2. The amount of mixed-motive expenditures depends on the type of the expenditure.
      3. Special limits are imposed on expenditures that have both personal and business benefits.
      4. Contemporaneous written records of business purpose are required.
      5. Meals
         1. Only 50% of business meals and entertainment are deductible.
         2. To deduct any portion of cost of the meal as a business expense,
            1. the amount must be reasonable,
            2. the taxpayer or the taxpayer’s employee must be present when the meal is furnished, and
            3. the meal must be directly associated with active conduct of taxpayer’s business.
            4. Work through Example 1-6.
      6. Travel and transportation
         1. Standard mileage rate is indexed for inflation and reset each year, but taxpayers can also choose to deduct actual cost.
         2. Work through Examples 1-7 and 1-8.
      7. Property use
         1. Work through Example 1-9.
      8. Record keeping and other requirements
   7. Business interest limitation
      1. The Tax Cuts and Jobs Act in 2017 added IRC §163(j) that imposed an overall limitation on the deduction of interest expense allocable to a business activity (regardless of the form or structure of the entity).
      2. The deduction is imposed on interest paid or accrued on indebtedness allocable to a trade or business.
      3. The limit is 30 percent of *adjusted taxable income* plus interest income allocable to the trade or business.
      4. Adjusted taxable income is defined as taxable income allocable to the business computed without regard to:
         1. business interest income,
         2. business interest expense,
         3. deductions allowable for depreciation, amortization or depletion, and
         4. net operating loss deduction.
      5. Any business interest disallowed by the limitation is carried forward indefinitely.
      6. The limitation does not apply to a real property trade or business or any taxpayer with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that does not exceed $25 million.
2. Specific Business Deductions
   1. Losses on disposition of business property
      1. Work through Example 1-11.
   2. Business casualty losses
      * 1. Casualty losses are events when business 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:
           1. Completely destroyed or stolen
           2. 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:
           1. The asset’s tax basis
           2. The decline in the value of the asset due to the casualty

Work through Example 1-12.

1. Accounting Periods
   1. Individuals and proprietorships account for income on a calendar year.
   2. Corporations are allowed to choose a calendar year, a fiscal year, or a 52/53-week year.
   3. Partnerships and other flow-through entities generally use a required year.
      1. Work through Example 1-13.
2. Accounting Methods
   1. Taxpayer’s accounting methods determine the tax year in which a business recognizes a particular item of income or deduction.
   2. Financial and tax accounting methods
      1. Businesses have incentives to select accounting methods permissible under GAAP that accelerate income and defer deductions.
      2. For tax planning purposes, businesses have incentives to choose accounting methods that defer income and accelerate deductions.
   3. Overall accounting method
      * 1. Cash method
           1. Work through Example 1-14.
           2. The cash method can be elected by any taxpayer with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that does not exceed $25 million.
        2. Accrual method
   4. Accrual income
      1. Businesses using the accrual method of accounting generally recognize income when they meet the all-events test.
      2. All-events test for income requires that businesses recognize income when
         1. all events have occurred that determine or fix their right to receive the income and
         2. the amount of the income can be determined with reasonable accuracy.
         3. Work through Example 1-15.
      3. Taxation of advance payments of income (prepaid income)
         1. Advance payment for services
            1. Income is recognized when earned (all-events) or received (if earlier).
            2. The all-events test requires that the business has the right to income.
            3. Taxpayers can generally elect to defer recognition of prepaid income for services (for one year) and goods.
      4. Advance payment for goods
         1. Businesses may account for the prepayment for tax purposes under the full-inclusion method or the deferral method.
            1. Full-inclusion method immediately recognizes the advance payment as income.
            2. Deferral method recognize advance payments for goods by the earlier of

when the business would recognize the income for tax purposes if it had not received the advance payment or

when it recognizes the income for financial reporting purposes.

Work through Example 1-16.

* + 1. Inventories
       1. Businesses must use the accrual method to account for substantial inventories.
       2. The UNICAP rules require capitalization of most indirect costs of production.
       3. The LIFO method is allowed if also used for financial reporting purposes.
       4. Uniform capitalization
          1. Tax laws require businesses to capitalize in the cost of inventory certain direct and indirect costs associated with inventories.
          2. Work through Example 1-17.
       5. 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

First-in, first-out (FIFO),

Last-in, first-out (LIFO), and

Specific identification.

* + - * 1. Tax laws require that a business can use LIFO for tax purposes only if it also uses LIFO for financial reporting purposes.
        2. Work through Example 1-18.
  1. Accrual deductions
     1. To record an expense and the corresponding deduction for tax purposes, the business must meet both the all events test and economic performance.
        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.
        2. Work through Example 1-19.
     2. Economic performance (exceedingly complex material for many students)
        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:
           1. Receiving goods or services from another party

Work through Example 1-20.

* + - * 1. Renting or leasing property from another party

Work through Examples 1-21 and 1-22 .

* + - * 1. Providing goods or services to another party

Work through Example 1-23.

* + - 1. Certain activities creating payment liabilities

Refer to Exhibit 1-3 for Categories of Payment Liabilities and 1-4 for Economic Performance.

Work through Example 1-24.

* + - 1. The recurring item exception is an accounting method election for accrued expenses that meet several requirements:

Recurring

Better match with current revenue or not material

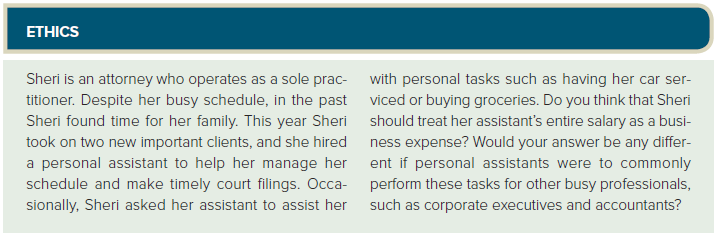
Economic performance reasonably expected prior to filing return (including extensions). This is why this exception is sometimes called the 8½-month rule.

* + 1. Bad debt expense
       1. Work through Example 1-25.
    2. Limitations on accrued related parties
       - 1. Family members, including parents, siblings, and spouses
         2. Shareholders and C corporations when the shareholder owns more than 50 percent of the corporation’s stock
         3. Owners of partnerships and S corporations no matter the ownership percentage
         4. Work through Example 1-26.
  1. Comparison of accrual and cash methods
     + 1. Refer to Exhibit 1-5 for Comparison of Cash and Accrual Methods.
       2. Work through Example 1-27.
  2. Adopting an accounting method
     1. Refer to Exhibit 1-6 for Green Acres’ Net Business Income and 1-7 for Green Acres 2016 Schedule C.
  3. Changing accounting methods
     1. Tax consequences of changing accounting method
     2. Work through Example 1-28.

1. Conclusion
2. Summary
3. Key Terms

**Ethics Discussion**

From page 1-3:



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.

###### Suggested 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.