McGraw Hills Taxation of Business Entities 2021 Edition 12th edition Spilker Solutions Manual

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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 discusses the 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 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.

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			

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			

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.

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) 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), 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.
  v) This limit is not applied to firms passing the gross receipts test.
  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
      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)
      (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 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.
        (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:

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.