

# 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 \$31 million (2025).
    - iii) If the business has less than three years of experience, use the periods available including a short year adjusted to represent a 12-month period.
    - iv) 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 9-1 for Examples of Typical Ordinary and Necessary Business Expenses.
  - b) Reasonable in amount
    - i) Ordinary and necessary business expense are deductible only to the extent they are reasonable in amount.
    - ii) Limits on reasonableness are typically based on personal benefits.
- 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 unless related to specific exceptions (e.g., employee entertainment), 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) 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) This limit is not applied to firms passing the gross receipts test.
  - iv) 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.
  - v) 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.
  - vi) Calculating the interest limitation
    - (1) Adjusted taxable income is defined as taxable income allocable to the business computed without regard to any item of income, gain, deduction, or loss that is not properly allocable to a trade or business:
    - (2) Add back certain deductions:

- (a) any business interest expense or income,
  - (b) depreciation, amortization, and depletion (after 12/31/2024)
  - (c) qualified business income deductions under §199A, and
  - (d) any net operating loss deduction.
- (3) 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-incidentals or use the inventory method used for financial reporting purposes.
    - (2) Non-incidentals are accounted for as materials are used.
  - ii) Uniform capitalization
    - (1) The UNICAP rules require capitalization of most indirect costs of production unless the business qualifies as a small business under the gross income test.
      - (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.
    - (4) Small businesses (under the gross income test) can account for inventory using non-incidentals (expense as used) or using the method employed for financial accounting.
- 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 9-2 for Categories of Payment Liabilities and 9-3 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 9-4 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 9-5 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 non-incidentals, and
    - (3) ignore the UNICAP rules once the gross receipts test is satisfied.
  - iii) Refer to Exhibit 9-6 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.