Chapter 9 Notes

Business Income, Deductions, and Accounting Methods

Everything in this chapter is on Schedule C. These are all FOR AGI deductions.

**I.** Business Gross Income

The rules for determining business gross income are generally the same as for determining gross income for individuals. Business income is equivalent to gross profit (revenue minus COGS) on sale of goods; also equal to revenue received for the provision of services.

Businesses can have income excluded (e.g., muni bond interest). Income concepts from Chapters 4 and 5 apply here.

**II.** Criteria for Business Deductions (IRC Section 162)

IRC Section 162 – businesses can deduct all ordinary and necessary expenses paid or incurred to carry on trade or business activities.

1. Ordinary

Normal, common, and accepted under regular business circumstances (depends on what’s “normal” for the type of business); an expense does not have to be recurring to be ordinary (ex: legal fees for lawsuit are considered ordinary).

2. Necessary

An expense that is appropriate and helpful to a taxpayer’s business; reasonable expectation that the expense will help the company make a profit (ex: KPMG sponsoring golf pro Phil Mickelson). The expenditure need not be essential.

3. Reasonable in Amount

Ordinary and necessary business expenses are deductible only to the extent to which they are also reasonable in amount, i.e., not extravagant. Arms-length price – If the amount of the expense is the amount typically charged in the market, then it is considered reasonable.

What if the expense is extravagant? The courts presume the excess amount is spent for personal rather than for business reasons, and is not deductible.

Examples of ordinary and necessary expenses: advertising, depreciation, insurance, legal fees, office expenses, rent, repairs, supplies, utilities, travel, wages, and interest.

**III.** Non-Deductible Business Expenses

There are limitations on business deductions. Just because you have a business doesn’t mean that every expense is deductible for tax purposes.

1. Expenditures against public policy

Bribes, kickbacks, or fines and penalties; disallowed under the rationale that allowing them would subsidize illegal activities.

2. Political contributions and/or lobbying costs

This is non-deductible to avoid the appearance of impropriety.

3. Capital expenditures

Expenses to purchase an asset with a useful life of more than one year; you have to capitalize these expenses and then deduct them over the useful life of the asset through depreciation (for tangible assets).

4. Expenses associated with the production of tax-exempt income

Makes sense from the standpoint that the government is already giving you a break by not taxing the income; you don’t get two breaks. Disallows deductions for interest on money borrowed to invest in tax-exempt bonds and also deductions for life insurance premiums paid for policies on key employees because both types of income are excludable from income when earned. Ex: Life insurance policies on key employees – Steve Jobs and Apple. If Apple had a key man life insurance policy on Steve Jobs (which it likely did), proceeds from the policy are not taxable income to Apple. Likewise, the premiums paid for the policy are not deductible to Apple.

5. Personal expenditures

Not deductible unless expressly authorized by the tax law.

- think expenses for food, clothing, and shelter are personal expenses and are not deductible.

- but expenses for uniforms that are not appropriate to wear outside of work are deductible business expenses.

**IV.** Mixed-Motive Expenses (See the text for this section too)

These have a business component and a personal component. You have incurred them for a business reason, but you still have a personal benefit from them. The rules for determining the amount of deductible mixed-motive expenditures depend on the type of expenditure.

1. Meals – food and beverages

Deductible if:

1. Associated with business

It is associated with business if (1) it builds a relationship that will translate to profit in the future (reasonably expect the activity to lead to profit in the future – e.g., taking a client out to dinner); and 2) must follow or precede a bonafide business discussion.

2. Ordinary, necessary, and reasonable

The amount must be reasonable under the circumstances (no $500 bottle of wine).

entertainment expenses: no longer deductible (TCJA) - Examples - country club dues and entertainment facilities; skyboxes.

3. Taxpayer or Employee is present

Either must be present when the meal is furnished.

How much is deductible?

Only 50%; they limit it because you do get a personal benefit.

Example: You own a small business and you take a client out for dinner and to a play. The meal costs $175 and the tickets for the play cost $125. What amount is a deductible business expense?

Meals expense = $175

Total meals deduction = $87.50 = ($175 x 50%)

Note: $125 tickets for play is a nondeductible entertainment expense.

2. Travel and Transportation Expenses – any expense you incur while traveling for business purposes (i.e., airfare, lodging, meals, incidentals – baggage fees and tips given to the baggage carriers at the airport, hotel staff.); however, meals are still only deductible at 50%.

Deductible if:

1. Away from home overnight

Home is the general area in which you conduct business. Overnight stay must be required when taxpayer is away long enough that the taxpayer requires sleep.

2. Expenses are for a legitimate business purpose

You are incurring these travel expenses because you reasonably expect them to help you earn a profit.

3. Sole purpose of trip is business

Taxpayer is allowed to deduct 100% of travel expenses – but meals are still only deductible at 50%.

4. Primary purpose of the trip is business

You are allowed to deduct 100% of transportation costs (e.g., airfare) and lodging, incidentals, and meals (50%) for business portion of the trip.

a. How is primary purpose defined?

If you spend more than 50% of the days of the trip on business.

b. What if the primary purpose is not business-related?

Transportation costs are not deductible, but you can deduct lodging, meals, and incidentals on the days that you are working (i.e., business portion of the trip).

Example: You are self-employed and you take a trip. The trip is 7 days total and 5 days are for business and 2 days are for personal vacation. You incur the following costs: airfare = $900, hotel (daily rate) = $185, meals (daily) = $60, and incidentals (daily) = $25.

How much is deductible?

Business percentage = 5 days/7 days = 71.43% > 50% - primary purpose is business

Airfare $900

Hotel 925 ($185\*5 days)

Meals 150 (60\*5 days)(50% limitation)

Incidentals 125 (25\*5 days)

**$2,100 Deductible amount for business travel**

What if 2 days were for business and 5 days were for personal reasons?

Business percentage = 2/7 = 28.57% < 50% - business is not the primary purpose

Airfare $ 0

Hotel 370 (185\*2 days)

Meals 60 (60\*2 days)(50% limitation)

Incidentals 50 (25\*2 days)

**$480 Deductible amount for business travel**

3. Mixed-use property expenses – property you use for both personal and business reasons. Distinguishing between business and personal expenses is difficult and subjective. Therefore, the IRS requires taxpayers to maintain specific, written, and contemporaneous records (of time, amount, and business purpose).

What types of property?

Cars (e.g., company car), computers, cell phones, etc. (listed property)

How much is deductible?

The amount of the expense multiplied by the ratio of the amount of business use to total use. You have to figure out the unit of analysis (i.e., days, miles, etc., depending on the property type).

Options for automobiles

1. Standard mileage method: 58 cents per mile plus tolls and parking – the 58 cents includes all expenses for operating and maintaining a vehicle (oil, gas, insurance, and depreciation)

What if you are self-employed?

You are allowed to deduct the business percentage of interest expense on your car loan and the business percentage of any property taxes on the car’s value (business percentage is a FOR AGI deduction and the personal percentage is a FROM AGI (itemized) deduction for the property taxes on a car - $10k cap).

2. Actual cost method: deduct the business percentage of the actual costs (depreciation, repairs, oil, licenses, etc.) plus tolls and parking

If you start with one method for the car, you are not able to switch to a different method during the life of the vehicle.

3. What qualifies as business use of an automobile?

a. Out-of-town travel

b. Drive to and from a temporary job (i.e., the client)

c. Drive from regular workplace to temporary work (i.e., the client)

d. From regular or temporary workplace to a second job (if you have two jobs)

Commuting from your home to your office is not deductible.

Example: Assume you are a self-employed taxpayer and incur the following expenses during the year:

Gas/oil - $4,500, car insurance - $800, interest on the auto loan - $1,200, automobile tax - $250, tolls to get to a client - $440, car depreciation - $6,500. You drive 20,000 miles for business purposes and 5,000 miles for personal reasons. What is your deduction if you use the standard mileage method? Actual cost method?

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Standard Mileage Method** |  | **Actual Cost Method** |
| 20,000 x $0.58 | $11,600 | Oil/gas | $ 4,500 |
| Tolls | 440 | Insurance | 800 |
| % business use\* | 20/25 = 0.8 | Interest | 1,200 |
| Interest | 960 [1,200 x 0.8] | Tax | 250 |
| Tax | 200 [250 x 0.8] | Depreciation | 6,500 |
| Total | $13,200 | Total | $13,250 (1) |
|  |  | % business use\* | 20/24 = 0.8 (2) |
|  |  |  | $10,600 (1) x (2) |
|  |  | Tolls | 440 |
| Total Deduction | $13,200 | Total Deduction | $11,040 |

\*% business use based on the business miles driven to total miles.

**V.** Specific Business Deductions

1. Start-up and organizational costs – discuss in Ch. 10

2. Losses on disposition of business property – discuss in Ch. 11

Completely and totally deductible; occurs when the asset’s tax basis exceeds the sale proceeds.

3. Business casualty losses

These occur when assets are stolen, damaged, or completely destroyed by events outside the control of the business.

(1) Complete loss – property is worth zero – the tax code prescribes that the taxpayer sold the asset for the amount of the insurance proceeds, if any

Loss = (insurance proceeds – asset’s adjusted tax basis).

(2) Partially damaged/destroyed:

Loss = insurance proceeds minus the lesser of i) decline in FMV; or 2) adjusted basis.

**VI.** Accounting Periods – affects when taxpayers determine their income and deductions.

Three types of tax years:

1. Calendar year – ends on December 31.

2. Fiscal year – ends on the last day of the month other than the month of December.

3. 52/53 week year – fiscal year that ends on the same day of the week every year.

For purposes of this course, assume all taxpayers are calendar year-end taxpayers (i.e., year-end is December 31st).

**VII.** Accounting Methods

**Cash Method**

Most individuals use this method and some small businesses.

1. Income – recognize when constructively received

Recognize means that you include it in taxable income and pay the tax (this is what we mean by recognize from now on).

2. Expenses – deduct when paid

Exceptions to deduct when paid:

1. Prepaid interest – deduct over the life of the loan

2. Expenses that create tangible or intangible assets – deduct over the life of the asset (this expense isn’t periodic so it makes sense to deduct it over the life of the asset (the government is being consistent here)

a. Exception: 12 month rule – prepaid business expenses related to intangible assets may be fully deductible in the current year if: (1) contract period does not last more than one year AND (2) contract period does not extend beyond the end of the next taxable year.

The government considers prepaid expenses to be intangible assets.

If the 12-month rule is violated, you recognize the expense over the life of the contract.

*12-month rule:* helps businesses determine whether to immediately capitalize or expense payments that create benefits for a relatively brief period of time, such as: insurance, security, rent, and warranty service contracts.

Example: Dean prepays Jim 12 months of rent on July 1, 2019 ($1,200 per month). How much rent can Dean deduct in 2019?

$14,400 = ($1,200 \* 12 months) in 2019.

- insurance coverage does not exceed 12 months and does not extend beyond the end of the next tax year.

How does the answer change if Dean pre-pays for 14 months?

Must recognize the pre-payment over the life of the contract because the contract is more than 12-months. Dean can deduct $7,200 in 2019 (6 months of rent). He would deduct the remaining $9,600 (8 months of rent) in 2020.

Suppose the rental contract was for 12 months but the contract ran from February 1 of next year, through January 31 of the following year. How much of the expenditure may Dean deduct this year?

$0. Even though the contract period does not exceed 12 months, Dean is required to capitalize the cost of the prepayment for the rental contract because the contract period extends beyond the end of next year.

**Accrual Method**

Corporations and larger businesses use the accrual method. It is designed to accelerate income and defer deductions because the IRS wants to raise revenue (opposite of accrual accounting for f/s).

We will not cover this method in this course.

Example: On August 1, 2019, Blazer Carving Company receives a $240,000 ($20,000 per month) prepayment to carve a miniature replica of UAB’s school mascot to place near the middle of campus. The project will take approximately 12 months. How much income should Blazer Carving Company recognize in 2019 under the cash method?

Must recognize all $240,000 (for the cash method it does not matter if you have earned it) – payment is constructively received.

Example: Dean is a sole proprietor and owns a local gym. He purchased new exercise equipment for the facility on July 1, 2019 and paid $24,000 for a 1-year warranty on the equipment. Under the cash method how much does Dean get to deduct? How does your answer change if the warranty is for two years?

(1) Deduct all $24,000 in 2019.

(2) If a two-year warranty, then the MSC can deduct 6 months worth ($6,000) in 2019 because they must follow the 12-month rule.