**Chapter 1 Notes**

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

**I.** **Business Gross Income**

1. Gross Receipts – Small Business - $26 Million – Avg, 3 years
2. All events test

**II.** **Criteria for Business Deductions (5 Criteria)**

1. Ordinary

2. Necessary

1. Reasonable in Amount
2. Statutorily Limited
3. Books and Records – Cohan Rule (George M. - You’re a Grand Old Flag, 1930’s Circuit Court case)
4. Litigation/Controversy

Examples of ordinary and necessary expenses: In text – List

**Statutory Limitations on Deductions**

1. Against Public Policy – Fines/Penalties (Government only)
2. Related to Tax Exempt Income – Makes sense as income treatment – section 265
3. Capital Expenditures –
4. useful life over 12 months
5. organizational and start-up cost (intangible)
6. Personal Expenditure (Non-Deductible as not Ordinary/Necessary and Related to Business)
7. Mixed Use – Travel special rule – domestic vs. international
8. Travel – 2 methods
9. Limitations On Interest Deductions (Recent Law)
10. 30% vs, 50%
11. Limitations on Business Property Losses

**III. Accounting Periods and Methods**

*Accounting Periods*

Three types of tax years: Calendar, fiscal, 52-53 week

Tax Years and Entity Type

*Sole proprietorships*:

*Flow-through entities*:

*C corporations*:

How does a taxpayer select a tax year?

What if a taxpayer wants to change its accounting period?

*Accounting Methods*

The Internal Revenue Code recognizes three permissible accounting methods: 1) cash; 2) accrual; and 3) hybrid

Exception:

* Large corporations (average gross receipts for the three prior tax years in excess of $26 million) and large partnerships with C corporation partners are required to use the accrual method of accounting.

**Cash Method**

1. Income – recognize when constructively received

2. Expenses – deduct when paid

Exceptions to deduct when paid:

1. Prepaid interest

2. Expenses that create tangible or intangible assets

a. Exception: 12-month rule –

*12-month rule:*

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

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

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?

**Accrual Method**

All corporations and larger businesses use the accrual method.

*Income*

Accrual method taxpayers must satisfy the “**all events test**” to recognize income.

* + recognize income when:
  + all-events requirement is met on the ***earliest*** of when the:

Example: Erik, Inc., a calendar year taxpayer that uses the accrual method of accounting, was to receive a bonus equal to 10% of Bree, Inc.’s net income for its fiscal year ending each June 30. For the fiscal year ending June 30, 2019, Bree, Inc. had net income of $340,000, and for the six months ending December 31, 2019, the corporation’s net income was $250,000. How much will Erik, Inc. report in 2019?

*Deductions*

Accrual method taxpayers must satisfy the “all events test” and “**economic performance**” requirements to recognize tax deductions.

Example: On August 1, 2019 BSC Athletics, Inc. contracted with Bham Advertising, Inc. for one year to produce a radio ad campaign. Bham agreed that UAB Athletics would owe nothing under the contract unless football ticket sales increased by a minimum of 15% over the next six months. What amount, if any, may UAB Athletics deduct this year under the accrual method?

Economic performance

The nature of the liability determines when economic performance is met.

|  |  |
| --- | --- |
| **Economic Performance** | |
| **Taxpayer incurs liability from:** | **Economic performance occurs:** |
| Receiving goods and services *from* another person. | When the goods or services are provided to the taxpayer or with payment if the taxpayer reasonably expects actual performance within 3 ½ months. |
| Renting or leasing property *from* another person. | Ratably over the time period during which the taxpayer is entitled to use the property or money. |
| Providing goods and services *to* another person. | When the taxpayer incurs costs to satisfy the liability or provides the goods and services. |
| Activities creating “payment” liabilities. | When the business actually makes payment. |

Example: Panther, Inc., an accrual basis taxpayer, promoted a boxing match held in the company’s arena on December 31, 2018. CLN, Inc. had contracted to clean the arena for $7,000 but did not actually perform the work until January 1, 2019. Panther, Inc. did not pay the $7,000 until the year 2020. When should Panther, Inc. recognize the expense?

Example: Aggieland Corporation farms land owned by an individual. Aggieland’s contract to use the land is for three years, and at the end of three years, Aggieland agreed to apply lime to the farmland. The contract term expired in 2018, and Aggieland applied the lime in 2019. When is Aggieland permitted to recognize the deduction?

Adopting an Accounting Method

* overall methods of accounting: cash, accrual, hybrid.
* specific methods of accounting:
* for tax purposes, a business elects its accounting method on its tax return
* permissible accounting method –
* impermissible accounting method –

Changing an Accounting Method

What if a taxpayer wants to change its accounting method?

* A change of accounting method is NOT a correction of an error
* A change from an impermissible method to a permissible method:
  + a business adopts an impermissible method by using and reporting results (income and/or expense) on its tax return for two consecutive years.

Tax Consequences of Changing an Accounting Method

* business determines its taxable income for the year of change using the new method.
* **§481 Adjustment** –
  + if adjustment increases taxable income:
  + if adjustment decreases taxable income:

Example: Erin is considering switching her business from the cash method to the accrual method at the beginning of next year (year 1). Determine the amount and timing of her §481 adjustment assuming the IRS grants Erin’s request in the following alternative scenarios.

1. At the end of end of year 0/beginning of year 1, 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 year 0/beginning of year 1, Erin’s business reports $25,000 of accounts receivables and $9,000 of accounts payables that have not been recorded for tax purposes.