

SYSTEM TEN

TAX ASPECTS OF THE SELF-EMPLOYED

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PREFACE

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SUMMARY FOR THE TAX ASPECTS OF THE SELF EMPLOYED

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LEARNING OBJECTIVES – SYSTEM 10

TAX ASPECTS OF THE SELF-EMPLOYED

Course knowledge – basic

Prerequisites – some basic knowledge and experience

Chapter 1 – Starting the Business – Learn about

- How to apply for an EIN
- Business license's
- Bookkeeping and recordkeeping systems

Chapter 2 – Accounting Periods – Learn about

- Tax years – Fiscal vs. Calendar
- Changes in accounting periods

Chapter 3 – Accounting Methods – Learn about

- The cash and accrual methods
- Changing the accounting method

Chapter 4 – Business Assets – Learn about

- Kinds of capital expenses
- Types of business assets
- Going into business costs
- Business start-up costs
- Costs you can choose to deduct or capitalize

Chapter 5 – Basis of Business Assets – Learn about

- The cost basis
- Types of assets
- Adjusted basis

Chapter 6 – Business Income – Learn about

- Accounting for your income
- Prepaid income
- Advance income from sales

Chapter 7 – Costs of Goods Sold – Learn about

- Figuring cost of goods sold
- Different types of inventory
- Valuing inventory

Chapter 8 – Business Deductions – Learn about

- The different types
- Employee benefit programs
- Meals and lodging for employees
- Rent expenses
- Methods of treating business bad debts
- Interest expenses
- Taxes

Chapter 9 – Travel, Meals, and Entertainment Expenses – Learn about

- The standard meal allowance
- Types of entertainment expenses and which ones are deductible
- The directly related test vs. the associated test
- Recordkeeping

Chapter 10 – Depreciation – Learn about

- Amortizations of certain intangible assets
- MACRS
- The section 179 expense deduction
- Listed property including automobiles

Chapter 11 – Self-Employment Taxes – Learn about

- Employee's vs. employer's taxes

Chapter 12 – Sale of a Business – Learn about

- Classification of assets
- Nontaxable exchanges

Chapter 13 – SIMPLE IRA Plans for Small Businesses – Learn about

- Advantages of the SIMPLE IRA
- Operating and establishing the plan
- Terminating the plan.

**Chapter 14 - Section 199A Deduction for Qualified Business Income -
Learn about**

- Who and who cannot claim the deduction
- What is a qualified business or trade
- What is qualified business income
- How to calculate the deduction

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TAX ASPECTS OF THE SELF-EMPLOYED

IN GENERAL

Once you have decided to start a business, you must decide what type of business entity to use. Your decision will depend on legal and tax considerations. Normally, a business is conducted in the form of a sole proprietorship, partnership or corporation.

A sole proprietorship is the simplest form of business organization. The business has no existence apart from you, the owner. Its liabilities are your personal liabilities, and your ownership (proprietary) interest ends when you die. You undertake the risks of business to the extent of all your assets, whether used in the business or used personally.

Example. You are the sole proprietor of a small retail shop that a customer may be able to sue for monetary damages. If monetary damages are awarded and the assets of your retail shop are not sufficient to cover the award, your personal assets unrelated to the business may be attached to pay the damage award. (This assumes you do not have liability insurance.)

A sole proprietorship is an unincorporated business that **one individual** owns. Generally, if two or more individuals join efforts to operate a business, a **partnership** is created. As far as the tax laws are concerned, it doesn't matter if there is no partnership agreement, verbal or written. If two or more individuals are involved in the same business venture, it is **not** a sole proprietorship. It is a partnership. A partnership return must be filed allocating income and expenses among the partners. An exception to this is where there is co-ownership of real estate or other property that is leased or rented.

Example. Tom and Ted leased a building and opened an auto repair shop. They jointly paid the rent, utilities and other overhead expenses. They split the net income 50/50. Tom and Ted are not allowed to file, each, as sole proprietors. They must, instead, file a partnership return and allocate the net income to themselves.

Addendum A at the end of this text contains a comparison of the advantages and disadvantages of a sole proprietorship to partnerships, corporations and limited liability companies.

REPORTING YOUR INCOME AND EXPENSES

If you are a sole proprietor, you report your income and expenses on Schedule C or, in some limited circumstances, on Schedule C-EZ.

If you operate more than one sole proprietorship, you must complete a **separate** Schedule C for each business and attach them to your return. If you do not prepare a separate Schedule C for each business, you can be assessed a penalty for not properly reporting your income and expenses.

Schedule C-EZ. Schedule C-EZ is a "short-form" Schedule C. There are a number of restrictions on its use. To use C-EZ:

1. Your business expenses must be \$5,000 or less,
2. You must use the cash method of accounting,
3. You cannot have had any inventory at any time,
4. You cannot have a net loss from your business,
5. You must have had only one business either as a sole proprietor, qualified joint venture, or statutory employee,
6. You cannot have any employees during the year,
7. You cannot be required to file Form 4562 to report depreciation,
8. You cannot qualify to deduct expenses for the business use of your home, **and**
9. You cannot have prior year unallowed passive activity losses from your business.

As indicated, there are some limitations to the use of Form C-EZ!

Cash Withdrawals From Profits of the Business. One of the most common misunderstood aspects of a sole proprietorship is the effect of withdrawing a "salary" from the business. The withdrawing of money from profits (or from a general fund) from the business by a sole proprietor has no tax effect whatsoever.

In an oversimplification, at the end of the business tax year, the operating expenses (**not including** any proprietor withdrawals) are **subtracted** from the gross income of the business. The **result** is the net profit generated by the sole proprietorship. The sole

proprietor is required to include this amount as income on line 12 of Form 1040.

Now, it does not matter how much the sole proprietor has withdrawn. The amount he or she has withdrawn may be less than, more than or exactly the same as, the profits of the business. The withdrawal may be labeled as a salary but it is not subject to either income tax or self-employment tax. Only the net profit on Schedule C or C-EZ is subject to tax.

FAMILY MEMBERS EMPLOYED BY SOLE-PROPRIETORS

It is not uncommon for a sole proprietor to employ either his or her spouse and or his or her children. Special rules cover these situations. These rules follow.

One Spouse Employed by Another. The wages for the services of an individual who works for his or her spouse in a trade or business **are subject to** income tax withholding and social security and Medicare taxes, but **not to** federal unemployment taxes. **However**, the services of one spouse employed by another in **other than** a trade or business, such as domestic service in a private home, **are not** subject to social security, Medicare, and federal unemployment taxes.

Children Employed by Parents. Payments for the services of a child under the age of 18 who works for his or her parent (or a partnership in which each partner is a parent of the child) in a trade or business is not subject to social security and Medicare taxes. If these services are for work other than in a trade or business, such as domestic work in the parent's private home, they are not subject to social security and Medicare taxes until the child reaches 21.

Payments for the services of a child under the age of 21 who works for his or her parent whether or not in a trade or business are not subject to federal unemployment taxes.

The above rules apply even if the child is paid regular wages. The wages for these services are not subject to Social Security, Medicare, and federal unemployment taxes. But they may still be subject to income tax withholding.

CHAPTER 1

STARTING THE BUSINESS

One of the first decisions to make when establishing a sole proprietorship is regarding the employer identification number.

A sole proprietor can use his or her regular social security number when completing Schedule C ***unless*** he or she meets one of the following conditions.

1. Have employees,
2. Have a qualified retirement plan, or
3. File any of these tax returns:
 - a. Employment,
 - b. Excise,
 - c. Fiduciary, or
 - d. Alcohol, tobacco and firearms.

If you meet any of the situations above, you ***cannot use*** your social security number, but instead, must obtain an ***employer identification number*** (EIN).

HOW TO APPLY FOR AN EIN

To apply for an EIN, file Form SS-4, ***Application for Employer Identification Number***, with the IRS Center for your area listed in the instructions to Form SS-4. You can get an updated copy of Form SS-4 at IRS or Social Security Administration (SSA) offices.

When to Apply. You should apply for an EIN early enough to receive the number by the time you must file a return or statement or make a tax deposit. If you apply by mail, file Form SS-4 at least 4 to 6 weeks before you need an EIN. If you apply by telephone or through the IRS website, you can get an EIN immediately. If you apply by fax, you can get an EIN within 5 business days.

If you do not receive your EIN by the time a return is due, file your return anyway. Write “applied for” and the date you applied for the number in the space for the EIN. Do not use your social security number as a substitute for your EIN on your tax returns.

How to Use an EIN. You must include your taxpayer identification number (SSN or EIN) on all returns or other documents you send to the IRS. You must also furnish your number to other persons who use your identification number on any returns or documents they send to the IRS. This includes returns or documents they file to report:

1. Interest, dividends, royalties, etc., paid to you, or
2. Amounts paid to you (in your business) that total \$600 or more for the year.

Change in Ownership. You must get a **new** EIN if you purchase or inherit an existing business that you will operate as a sole proprietor. (You cannot use the EIN of the former owner, even if he or she is your spouse.)

Individual Taxpayer Identification Number (ITIN). The IRS will issue an ITIN if you are a **nonresident or resident alien** and you do not have and are not eligible to get an SSN. In general, if you need to obtain an ITIN, you must attach **Form W-7**, Application for IRS Individual Taxpayer Identification Number, with your signed, original, completed tax return and any other required documentation and mail them to the following address.

Internal Revenue Service
ITIN Operation
PO Box 149342
Austin, TX 78714-9342

The exceptions are covered in detail in the instructions for Form W-7. If you must include another person's SSN on your return and that person does not have and cannot get an SSN, enter that person's ITIN. The application is also available in Spanish.

Note: An ITIN is for tax use only. It does not entitle the holder to social security benefits or change the holder's employment or immigration status.

BUSINESS LICENSE

With some limited exceptions, the IRS does not require that you have a business license from state or local jurisdictions. Their only concern is that you accurately report your gross income from your business activity and report only your expenses for which you have documentation. (One exception to this IRS position is Day Care providers. In order to deduct expenses, Day Care providers must be licensed by state or local jurisdictions as applicable.)

Independent Contractor. People such as doctors, dentists, veterinarians, lawyers, accountants, contractors, subcontractors, public stenographers, or auctioneers who are in an independent trade, business, or profession in which they offer their services to the general public are generally independent contractors. However, whether they are independent contractors or employees depend on the facts in each case. The general

rule is that an individual is an independent contractor if the payer has the right to control or to direct only the result of the work and not how it will be done. The earnings of a person who is working as an independent contractor are subject to self-employment tax.

Statutory Employee. A statutory employee has a checkmark in box 13 of his or her Form W-2, Wage and Tax Statement. Statutory employees use Schedule C or C-EZ to report their wages and expenses.

Limited Liability Company (LLC). A limited liability company (LLC) is an entity formed under state law by filing articles of organization. Generally, a single-member LLC is disregarded as an entity separate from its owner and reports its income and deductions on its owner's federal income tax return. An owner who is an individual may use Schedule C or C-EZ.

Husband and Wife Business. If you and your spouse jointly own and operate an unincorporated business and share in the profits and losses, you are partners in a partnership, whether or not you have a formal partnership agreement. Do not use Schedule C or C-EZ. Instead, file Form 1065, U.S. Return of Partnership Income.

Exception – Community Income. If you and your spouse wholly own an unincorporated business as community property under the community property laws of a state, foreign country, or U.S. possession, you can treat the business either as a sole proprietorship or a partnership. The only states with community property laws are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. A change in your reporting position will be treated as a conversion of the entity.

Exception – Qualified Joint Venture. If you and your spouse each materially participate as the only members of a jointly owned and operated business, and you file a joint return for the tax year, you can make a joint election to be treated as a qualified joint venture instead of a partnership for the tax year. Making this election will allow you to avoid the complexity of Form 1065 but still give each spouse credit for social security earnings on which retirement benefits are based. For an explanation of “material participation,” see the Instructions for Schedule C, line G.

To make this election, you must divide all items of income, gain, loss, deduction, and credit attributable to the business between you and your spouse in accordance with your respective interests in the venture. Each of you must file a separate Schedule C or C-EZ and a separate SE.

RECORDKEEPING

Everyone in business must keep records. Good records will help you prepare accurate tax returns so that you pay only the amount of tax you owe. Good records are also needed for good management.

Good records can save you time and money. You need good records to show the progress of your business operations, to prepare credit applications, and to support items of income and expense reported on your tax return.

Identify Source of Receipts. You will receive money or property from many sources. Your records can identify the source of your receipts. You need this information to separate **business** from **nonbusiness** receipts and taxable from nontaxable income.

Figuring Depreciation Allowance. You should record the assets you can depreciate in a permanent record. You need a record of the cost and other information on your assets to figure your depreciation deductions. If you sell the assets or make capital improvements to them, only a permanent record shows how much of their cost you have recovered.

Record Details of Assets. Good, complete records show the date you acquired an asset, the percentage of its business use, and any changes in the basis of each asset. You need this information to figure (and to know how to report) gain or loss if you sell, trade, or otherwise dispose of it, or it is destroyed.

Determine Earnings for Self-Employment Tax Purposes. The self-employment tax is the means for providing social security coverage for people who work for themselves. The social security benefits you receive when you retire, if you are disabled, or the benefits your family receives when you die, depend on how much you earn. Self-employment tax also provides you with medical insurance (Medicare) benefits. Your records should show how much self-employment tax you pay on your earnings.

Support Items Reported on Tax Returns. If the IRS examines any of your tax returns, you may be asked to explain the items reported. A complete set of records will speed up the examination. You support adequate and complete records with sales slips, invoices, receipts, deposit slips, canceled checks, certain financial account statements, and other documents.

Financial Account Statements as Proof of Payment. If you cannot provide a canceled check to prove payment of an expense item, you may be able to prove payment with certain financial account statements. This includes account statements prepared by a third party who is under contract to prepare statements for the financial institution. Acceptable account statements include:

1. An account statement showing a check clearing is accepted as proof (depending on your method of accounting) if it shows the:
 - a. Check number,
 - b. Amount,
 - c. Payee name, and

- d. Date the check amount was posted to the account by the financial institution.
- 2. An account statement prepared by a financial institution showing an electronic funds transfer is accepted as proof if it shows the:
 - a. Amount transferred,
 - b. Payee name, and
 - c. Date the transfer was posted to the account by the financial institution.
- 3. An account statement prepared by a financial institution showing a credit card charge (an increase to the cardholder's loan balance) is accepted as proof if it shows the:
 - a. Amount charged,
 - b. Payee name, and
 - c. Date charged (transaction date).

These account statements must show a high degree of legibility and readability. For this purpose, legibility is the quality of a letter or number that allows it to be identified positively excluding all other letters and numbers. Readability is the quality of a group of letters or numbers that allows it to be recognized as words or complete numbers. However, this does not mean the information must be typed or printed. For example, the IRS will accept an account statement that reproduces the required information in the account holder's own handwriting from checks or charge slips.

However, proof of payment of an amount alone does not establish that you are entitled to a tax deduction.

RECORDS REQUIRED

The law does not require any special kind of records. You may choose any system suited to your business to clearly show your income.

Your permanent books, including inventory records, must show your gross income, as well as your deductions and credits. In addition, you must keep any other records and data necessary to support the entries in your books and on your tax and information returns. File paid bills, canceled checks, etc., that support entries in your books in an orderly fashion and keep them in a safe place. For most small businesses, the business checkbook is the main source for entries in the business records.

BOOKKEEPING SYSTEM

You must decide whether to use a single or double-entry bookkeeping system. The single-entry system of bookkeeping is the simplest to maintain, but it may not be suitable for everyone. You may find the double-entry system better because it has built-in checks and balances to assure accuracy and control.

Single-Entry. A single-entry system is based on the income statement (profit or loss statement). It can be a simple and practical system if you are starting a small business. For tax purposes, the system records the flow of income and expenses through the use of:

1. A daily summary of cash receipts.
2. Monthly summaries of cash receipts and disbursements.

Double-Entry. A double-entry bookkeeping system uses journals and ledgers. Transactions are first entered in a journal and then posted to ledger accounts. These accounts show income, expenses, assets (property a business owns), liabilities (debts of a business), and net worth (excess of assets over liabilities). You close income and expense accounts at the end of each accounting period. You keep asset, liability, and net worth accounts open on a permanent basis.

In the double-entry system, each account has a left side for debits and a right side for credits. It is self-balancing because you record every transaction as a debit entry in one account and as a credit entry in another.

Under this system, the total debits must equal the total credits after you post the journal entries to the ledger accounts. If the amounts do not balance, you have made an error and you must find and correct it.

At the end of each accounting period, you prepare financial statements. These are generally the income statement and the balance sheet. The income statement reflects current operations for the year. The balance sheet shows the financial position of the business in terms of assets, liabilities, and net worth on a given date.

RECORDKEEPING SYSTEM

You do not have to keep your records in bound books. Records are adequate if they show current income on the basis of an annual accounting period.

A recordkeeping system for a small business might include the following:

- Business Checkbook
- Daily Summary of Cash Receipts
- Monthly Summary of Cash Receipts
- Check Disbursements Journal
- Depreciation Worksheet
- Employee Compensation Record

Computerized System. There are computer software systems that you can use for recordkeeping. These can be purchased on various online sites or retail locations.

If you use a computer software system, you must be able to produce sufficient records to support and verify entries made on the return and determine the proper tax liability. The records on the computer must reconcile with your books and return. These records must provide enough detail to identify the source documents.

You must also keep all computer records and a complete description of the software portion of your recordkeeping system. The documentation must be sufficiently detailed to show all of the following items.

- Functions being performed as the data flows through the system.
- Controls used to ensure accurate and reliable processing.
- Controls used to prevent the unauthorized addition, alteration, or deletion of retained records.
- Charts of accounts and detailed account descriptions.

How Long to Keep Records. You must keep your records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Keep records that support an item of income or deduction on a return until the period of limitations for that return runs out. Usually, the period of limitations for an income tax return is **3 years after** the return is due or filed, **or 2 years** from the date the tax is paid, whichever is later.

If you have employees, you must keep all employment tax records for at least 4 years after the date the tax becomes due or is paid, whichever is later.

Keep records that verify your basis in property for as long as they are needed to figure the basis of the original or replacement property. Also, new laws may provide tax benefits to taxpayers who can prove from their records they are entitled to the benefits.

Copies of Tax Returns. You should keep copies of your filed tax returns. They help in preparing future tax returns and making computations if you later file a claim for refund. They may also be helpful to the executor or administrator of your estate, or to the IRS, if your original return is not available.

THE BUSINESS CHECKBOOK

The business checkbook is your basic source of information for recording your business expenses. You should deposit all daily receipts in your business checking account. You should check your account for errors by reconciling it.

Consider using a checkbook that allows enough space to identify the source of deposits as business income, personal funds, or loans. You should also note on the deposit slip the source of the deposit and keep copies of all slips.

You may need a petty cash fund for small expenses. You must clearly support all business expenses paid by cash with documents that show their business purpose.

You should make all payments by check to document business expenses. Write checks payable to yourself only when making withdrawals from your business for personal use. Avoid writing checks payable to cash. If you must write a check for cash to pay a business expense, include the receipt for the cash payment in your records. If you cannot get a receipt for a cash payment, you should make an adequate explanation in your records at the time of payment.

REVIEW QUESTIONS

CHAPTER 1 – STARTING THE BUSINESS

1. Which one of the following statements is **incorrect** in regard to a sole proprietor being allowed to use their social security number (SS#) when completing a Schedule C. Form 1040?
 - A. They can use their SS# if they have 6 or fewer employees.
 - B. They can use their SS# if they have 4 or fewer employees.
 - C. They can use their SS# if they have 2 or fewer employees.
 - D. They cannot use their SS# under any circumstances.
2. Which one of the following statements is **incorrect** in regard to obtaining an employer identification number?
 - A. It can be obtained by mail.
 - B. It can be obtained through the IRS website.
 - C. It can be obtained by telephone.
 - D. If you have not received it by your filing deadline, you can use your SS# as a temporary number.
3. Which one of the following statements is **correct** in regard to an Individual Taxpayer Identification Number (ITIN)?
 - A. The IRS will issue an ITIN only to **resident** aliens.
 - B. The IRS will not issue an ITIN to a **nonresident** alien.
 - C. The IRS will issue an ITIN to either “A” or “B” if they are not eligible to obtain a SSN.
 - D. To obtain an ITIN, you must complete Form W-8.

RESPONSES TO REVIEW QUESTIONS

CHAPTER 1 – STARTING THE BUSINESS

1.
 - A. **Correct.** They cannot use their S.S. # if they have **any** employees.
 - B. **Correct.** They cannot use their S.S. # if they have **any** employees.
 - C. **Correct.** An employer cannot use their S.S. # if they have **any** employees.
 - D. **Incorrect.** An employer can use their S.S. # if they, (1) have no employees, (2) does not have a qualified retirement plan, nor they do not (3) file any **employment** tax returns.

2.
 - A. **Correct.** It also can be obtained by phone or the IRS website.
 - B. **Correct.** It can also be obtained by mail or phone.
 - C. **Correct.** It can also be obtained through the IRS website.
 - D. **Incorrect.** If you have not received your EIN number by the due date of your return, write “applied for” in the space indicated for your EIN number. **Do not** use your social security number.

3.
 - A. **Incorrect.** The IRS will issue an ITIN number to **either** a nonresident or resident alien.
 - B. **Incorrect.** The IRS will issue an ITIN number to a nonresident alien who is not eligible to get a SSN.
 - C. **Correct.** The IRS will issue an ITIN number if either they do not have one or are unable to get one.
 - D. **Incorrect.** To obtain an ITIN, you must complete Form W-7.

CHAPTER 2

ACCOUNTING PERIODS

Every taxpayer (business or individual) must figure taxable income and file a tax return on the basis of an **annual** accounting period. The term "tax year" is the annual accounting period you use for keeping your records and reporting your income and expenses. The accounting periods you can use are:

1. A calendar year, or
2. A fiscal year.

You adopt a tax year when you file **your first** income tax return. You must adopt your first tax year by the due date (not including extensions) for filing a return for that year.

The due date for individuals is the 15th day of the 4th month after the end of the tax year. Individuals include sole proprietors.

This chapter discusses: the calendar tax year; the fiscal tax year (including a period of 52 or 53 weeks); the short tax year (including a change in accounting period), and improper tax years.

Note. **Employment taxes** are figured on a **calendar year** basis. You must use the calendar quarter for withheld income tax and social security and Medicare taxes. You must use the calendar year for federal unemployment tax.

TAX YEAR

Your regular accounting period is **either** a calendar tax year **or** a fiscal tax year.

CALENDAR TAX YEAR

If you adopt the calendar year for your annual accounting period, **you must** maintain your books and records and report your income and expenses for the period from January 1 through December 31 of each year.

If you filed your first return using the calendar tax year, and you later begin business as a sole proprietor, you **must continue** to use the calendar tax year unless you get permission to change. See **Change in Accounting Period**, later. You must report your income from all sources, including your sole proprietorship, salaries, partnership income, and dividends, using the same tax year.

You **must** adopt the calendar tax year if:

1. You do not keep adequate records,
2. You have no annual accounting period, or
3. Your present tax year does not qualify as a fiscal year.
4. You are required to use a calendar year by a provision of the Internal Revenue Code or the Income Tax Regulations.

FISCAL TAX YEAR

A regular fiscal tax year is 12 consecutive months ending on the last day of **any month** except December. A 52-53 week year is a fiscal tax year that varies from 52 to 53 weeks.

If you adopt a fiscal tax year, you must maintain your books and records and report your income **and** expenses using the same tax year.

52-53 WEEK TAX YEAR

You can elect to use a 52-53 week tax year if you keep your books and records and report your income on that basis. If you make this election, your tax year will always be either 52-53 weeks long, and will always end on the same day of the week. You may choose to have your year always end on either:

1. The date a specified day of the week last occurs in a particular month,
or
2. The date that day of the week occurs nearest to the last day of a particular month.

For example, you may elect a tax year that always ends on the last Monday in March, even though the **calendar date** will change from year to year. Likewise if you elect a tax year that ends on the Friday **nearest the end** of January, it must always end on Friday even though the **calendar date** will change from year to year.

You make the election by filing your tax return for the 52-53 week year and attaching to it a statement showing;

1. The day of the week on which the tax year will always end,
2. Whether it will end on the last such day of the week in the calendar month or on the date such day of the week occurs nearest the end of the month, and

3. The month in which or with reference to which the tax year will end.

Change to a 52-53 Week Tax Year. You may change to a 52-53 week year that ends with reference to the end of the same month with which your present tax year ends, ***without*** first getting permission from the IRS. You must attach the statement, just discussed, to the tax return for the year for which the election is made.

Example. If you ***now*** use a calendar year and want to ***change*** to a 52-53 week year ending on the Friday closest to December 31, prior approval is ***not*** needed. You make the election to change by filing the statement described above with your return.

Approval Required. If you want to change to a 52-53 week tax year that ends with reference to the end of a month that is not the same month in which your old tax year ended, you must first get approval from the IRS, as explained later in ***Change in Accounting Period.***

For example, if you use a calendar year and want to change to a 52-53 week year ending on the Saturday nearest to the end of November, you must first get approval from the IRS.

To change from a 52-53 week year to any other tax year, including another 52-53 week year, you must first get approval from the IRS.

SHORT TAX YEAR

A short tax year is a tax year of less than 12 months. There are two situations that can result in a short tax year. The first occurs when you (as a taxable entity) are not in existence for an entire tax year. The second occurs when you change your accounting period. Each situation results in a different way of figuring tax for the short tax year.

NOT IN EXISTENCE ENTIRE YEAR

A tax return is required for the short period during which you were in existence. Requirements for filing the return and paying the tax generally are the same as if the return were for a full tax year of 12 months that ended on the last day of the short tax year.

Death of Individual. When a individual dies, a tax return must be filed for the decedent by the 15th day of the 4th month ***after*** the close of the individual's ***regular*** tax year.

Example. "X" was a single, calendar year taxpayer. She died on March 6. Her last tax return for the period of January 1, through March 6, must be filed by April 15, of the year following her death.

CHANGE IN ACCOUNTING PERIOD

If you change your accounting period, you figure your tax for the short tax year by placing your taxable income for the short period on an annual basis.

IRS Approval. You must, with certain exceptions, get approval from the IRS **to change** your tax year. To get this approval, you must file a current Form 1128. This form must be filed by the 15th day of the **2nd calendar month** after the close of the short tax year. This short tax year **begins** on the first day after the end of your present tax year **and ends** on the day before the first day of your new tax year.

Example. John Adams, a sole proprietor, filed his return using a calendar tax year. For business purposes, he wanted to change to a fiscal year ending June 30. John will have a short tax year for the period January 1 to June 30. John must file Form 1128 by August 15, the 15th day of the 2nd calendar month after the close of the short tax year.

Extension to File. If you file Form 1128 after the due date, it is late and will be considered only if you can show good cause for filing late. However, applications received within 90 days of the date required may qualify for an automatic extension.

Husband and Wife. A husband and wife who have different tax years **may not** file a **joint** return. If the husband and wife want the same tax year so they can file a joint return, the method of changing a tax year depends on **whether** or not they are newly married.

Improper Tax Year. If you begin your business on a date other than the first day of a calendar month and end it exactly 12 months from the date it began and this ending date is other than the last day of the month, you have not satisfied the requirements for establishing a calendar year or a fiscal year. Nor does the adoption of an accounting period ending exactly 12 months from the date your business began satisfy the requirements for a 52-53 week tax year. Because you have not satisfied the requirements for either a calendar or a fiscal year, you have adopted an improper tax year. You must either file an amended income tax return on the basis of a calendar year, or, if you want to use a tax year other than the calendar year, you must get approval from the IRS to change your tax year.

Amended Return. To file an amended return to correct an improper tax year, you must attach a completed Form 1128 to your amended income tax return that is filed on a calendar year basis. Write "FILED UNDER REV. PROC. 85-15," at the top of your Form 1128. The form and your amended return should be filed with the Internal Revenue Service Center where you filed your original return.

REVIEW QUESTION

CHAPER TWO – ACCOUNTING PERIODS

1. Which one of the following statements is **correct** in regard to accounting periods?
 - A. Adopting an accounting period ending exactly 12 months from the date the business began satisfies the requirements for an accounting period.
 - B. You do not need approval from the IRS to change your tax year.
 - C. You must attach Form 1128 to the amended return if you are correcting an improper tax year.
 - D. A husband and wife who have different tax years can file a joint return.

RESPONSES TO REVIEW QUESTION

CHAPTER 2 – ACCOUNTING PERIODS

1.

- A. **Incorrect.** If your ending date for your accounting period is not the last day of the month you have not met the requirements for establishing a calendar or fiscal year accounting period.
- B. **Incorrect.** In order to change your accounting period you do need approval from the IRS.
- C. **Correct.** When filing an amended return to correct an improper tax year you must attach Form 1128.
- D. **Incorrect.** A husband and wife who have different tax years may not file a joint return.

CHAPTER 3

ACCOUNTING METHODS

An accounting method is a set of rules used to determine when and how income and expenses are reported. The term "accounting method" includes not only the overall method of accounting you use, but also the accounting treatment you use for any material item.

You choose your accounting method when you file ***your first*** tax return. After that, if you want to change your accounting method, you must first get ***consent*** from the IRS. See ***Change in Accounting Method***, later.

No single accounting method is required of taxpayers. You simply must use a system that clearly shows your income and expenses and you must maintain records that will enable you to file a correct return. In addition to your permanent books of account, you must keep any other records necessary to support the entries on your books and tax returns.

You must use the ***same method*** from year to year. Any accounting method that shows the consistent use of generally accepted accounting principles for your trade or business generally is considered to clearly show income. An accounting method clearly shows income only if all items of gross income and all expenses are treated the same from year to year.

If you do not regularly use an accounting method that clearly shows your income, your income will be figured under the method that, in the opinion of the IRS, clearly shows your income.

Methods You May Use. Generally, you may figure your taxable income under ***any*** of the following accounting methods:

1. Cash method,
2. Accrual method,
3. Special methods of accounting for certain items of income and expenses, and
4. Combination (hybrid) method using elements of (1), (2), or (3).

Combination (Hybrid) Method. Generally, you may use any combination of cash, accrual, and special methods of accounting if the combination clearly shows income and you use it consistently. However, the following restrictions apply:

1. If inventories are necessary to account for your income, you ***must use*** an ***accrual*** method for purchases and sales. You can use the cash method for all other items of income and expenses.
2. If you use the cash method for figuring your ***income***, you must use the cash method for reporting your ***expenses***.
3. If you use an accrual method for reporting your expenses, you must use an accrual method for figuring your income.

Any combination that includes the cash method is treated as the cash method, subject to the limitations applied to that method.

However, the following taxpayers can use the cash method of accounting even if they produce, purchase, or sell merchandise. These taxpayers can also account for inventorable items as materials and supplies that are not incidental.

Qualifying Taxpayer. You are a qualifying taxpayer if:

- Your average annual gross receipts for each prior tax year ending on or after December 17, 1998, is \$1 million or less. (Your average annual gross receipts for a tax year is figured by adding the gross receipts for the tax year and the 2 preceding tax years and dividing by 3.)
- Your business is not a tax shelter, as defined under section 448(d)(3) of the Internal Revenue Code.

Qualifying Small Business Taxpayer. You are a qualifying small business taxpayer if:

- Your average annual gross receipts for each prior tax year ending on or after December 31, 2000, is more than \$1 million but not more than \$10 million ***is no longer in effect as of tax year 2018***. Under Sec 13102 in the Tax Cut and Jobs Act you are a small business taxpayer if your average gross receipts are ***\$25 million or less for the last three years***.
- You are not prohibited from using the cash method under section 448 of the Internal Revenue Code.

Business Not Owned or Not In Existence For 3 Years. If you did not own your own business for all of the 3-tax-year period used in figuring your average annual gross receipts, include the period of the predecessor. If your business has not been in existence for the 3-tax-year period, base your average on the period it has existed including any short tax years, annualizing your short tax year's gross receipts.

Items Included in Inventory. If you are required to account for inventories, include the following items when accounting for your inventory.

- Merchandise or stock in trade.
- Raw materials.
- Work in process.
- Finished products.
- Supplies that physically become a part of the item intended for sale.

Donation of Inventory. If you contribute inventory (property that you sell in the course of your business), the amount you can claim as a contribution deduction is the smaller of the fair market value on the day you contributed it or its basis. The basis of donated inventory is any cost incurred for the inventory in an earlier year that you would otherwise include in your opening inventory for the year of the contribution. You must remove the amount of your contribution deduction from your opening inventory. It is not part of the cost of goods sold.

Two or More Businesses. If you operate *more than* one business, you generally may use a *different* accounting method for each separate and distinct business if the method you use for each clearly shows your income. For example, if you operate a personal service business and a manufacturing business, you may use the cash method for the personal service business but you must use an accrual method for the manufacturing business.

No business will be considered separate and distinct if you do not keep a complete and separate set of books and records for that business.

CASH METHOD

The cash method of accounting is used by most individuals and many small businesses *with no* inventories. However, if inventories are necessary in accounting for your income, *you must use* an *accrual* method for your sales and purchases. If you are not required to keep inventories, you usually will use the cash method.

INCOME

With the cash method, you include in your gross income all items of income you actually or constructively receive during the year. You must include property and services you receive in your income at their fair market value.

Constructive Receipt. You have constructive receipt of income when an amount is credited to your account or made available to you ***without*** restriction. You do not need to have possession of it. If you authorize someone to be your agent and receive income for you, you are treated as having received it when your agent received it.

Example 1. You have interest credited to your bank account in December. You must include it in your gross income for the year ending December 31 and ***not for the following year*** when you withdraw it or enter it in your passbook.

Example 2. You have interest coupons that mature and are payable in the current year, but you do not cash them until the following year. You must include them in income for the current year. You must include this matured interest in your gross income even though you later exchange the coupons for other property instead of cashing them.

Delaying Receipt of Income. You ***cannot*** hold checks or postpone taking possession of similar property ***from one tax year to another*** to avoid paying the tax on the income. You must report the income in the year the check or property is made available to you without restriction.

EXPENSES

Usually, you must deduct expenses in the tax year in which you actually pay them. However, expenses you pay in advance can be deducted only in the year to which they apply. In addition, if the uniform capitalization rules apply, you may have to capitalize certain costs.

Example. You are a calendar year taxpayer and you pay \$1,000 for a business insurance policy that is effective on July 1, for a one-year period. You may deduct \$500 in that year and \$500 in the following year.

ACCRUAL METHOD

Under an accrual method of accounting, income generally is reported ***in the year earned***, and expenses are deducted or capitalized in the year ***incurred***. The purpose of an accrual method of accounting is to match your income and your expenses in the correct year.

INCOME

All items of income are generally included in your gross income when you earn them, even though you may receive payment in another tax year. All events that fix your right to receive the income must have happened, and you must be able to figure the amount with reasonable accuracy.

Example. You are a calendar year accrual basis taxpayer. You sold a television on December 28. You billed the customer in the first week of January of the following year, but you did not receive payment until February. You must include the amount of the sale in your income in the previous year because you earned the income in December.

Advance Income. Special rules dealing with an accrual method of accounting for advance payments to you are discussed in Chapter 6 under ***Prepaid Income***.

Estimating Income. When you include an amount in gross income on the basis of a reasonable estimate, and you later determine the exact amount, the difference, if any, is taken into account in the tax year in which the determination is made.

Change in Payment Schedule for Services. If you contract to perform services for a basic rate, you must include the basic rate in your income as it accrues. You must accrue the basic rate ***even if***, as a matter of convenience, you agree to receive payments at a ***lower rate*** until you complete your services, at which time you will receive the difference between the basic rate and the amount actually paid to you.

Accounts Receivable for Services. You may not have to accrue all of your accounts receivable if, based on your experience; you will not collect all of these accounts. This is called the ***nonaccrual-experience method***.

EXPENSES

You deduct or capitalize business expenses when you become liable for them, whether or not you pay them in the same year.

All Events Test. Before you can deduct or capitalize the expenses, all events that set the amount of the liability ***must have happened***, and you must be able to figure the amount with reasonable accuracy.

Economic Performance Rule. Generally, you ***cannot deduct or capitalize*** business expenses ***until*** economic performance occurs. If your expense is for property or services provided to you, or for use of property by you, economic performance occurs as the property or services are provided or as the property is used. If your expense is for property ***or*** services that you provide to others, economic performance occurs ***as you provide*** the property or services.

Example. You are a calendar year taxpayer and in December you buy office supplies. You received the supplies and are billed for them in December, but you pay for the supplies in January of the following year. You can deduct the expense in the year you bought them because all events that set the amount of liability and economic performance occurred in that year.

Your office supplies may qualify as a recurring expense. In that case, you may be able to deduct the expense in the year purchased even if economic performance (delivery of the supplies to you) did not occur until the following year.

Inventories. Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If inventories are **necessary to show** income correctly, **only** an accrual accounting method can be used for purchases and sales.

Reallocation of Income and Deductions. Where it is necessary to clearly show income or to prevent **evasion of taxes**, the IRS may reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

CHANGE IN ACCOUNTING METHOD

When you file your first return, you may, without consent from the IRS, choose any permitted accounting method. The method you choose must clearly show your income and this same method must be used from year to year.

After your first return is filed, if you want to change your accounting method, you must **first get consent** from the IRS. This is necessary to notify the IRS that a change is being made and to prevent you from gaining an unlawful tax advantage.

The IRS will consider the need for consistency in the accounting area against your reason for wanting to change your accounting method when the method from which you are changing clearly shows your income.

If you request a change in accounting method (such as from an improper to a proper method), the absence of IRS consent to the change **does not prevent** the IRS from imposing any penalty or addition to tax, nor diminish the amount of the penalty or the addition to tax.

A change in your accounting method includes a change **not only** in your overall system of accounting but also in the treatment of any material item. Some examples of changes that **require** consent are:

1. A change from the cash method to an accrual method or vice versa (unless you must change to an accrual method and you make the change automatically),
2. A change in the method or basis used to value inventories, and
3. A change in the method of figuring depreciation (except certain changes to the straight line method).

Form 3115. In general, you must file a current Form 3115 to request a change in either an overall accounting method or the accounting treatment of any item. There are some cases when you can obtain automatic consent from the IRS to change to certain accounting methods.

REVIEW QUESTIONS

CHAPTER 3 – ACCOUNTING METHODS

1. Which one of the following statements is **incorrect** in regard to accounting methods?
 - A. You may use the cash method.
 - B. You may use the accrual method.
 - C. You cannot use a combination of the cash method and the accrual method.
 - D. You must use the same accounting method from year to year.

2. Frank, a sole proprietor, owns a small business that requires inventories to operate the business. Which one of the following statements is **correct** in regard to his accounting method?
 - A. Frank must use an accrual method for both his purchases and sales of the inventories.
 - B. Frank may use the accrual method for his inventory purchases and a cash method for figuring his income from the sales.
 - C. Frank has the option of using the cash method for both his inventories purchases and inventory sales.
 - D. Frank is allowed to use the cash method for figuring his income and the accrual method for figuring his expenses.

RESPONSES TO REVIEW QUESTIONS

CHAPTER 3 – ACCOUNTING METHODS

1.
 - A. **Correct.** You may use either the cash method or the accrual method but you must use the same method from year to year.
 - B. **Correct.** You may use either the cash method or the accrual method but you must use the same method from year to year.
 - C. **Incorrect.** You may use a combination of the cash method and the accrual method.
 - D. **Correct.** You may use the cash method, the accrual method or a combination method, but you must use the same method from year to year.
2.
 - A. **Correct.** Because Frank has inventories, he must use an accrual method for both his purchases and income from the sale of those purchases.
 - B. **Incorrect.** Frank is required to use the accrual method for both his purchases and income from the sale of those purchases.
 - C. **Incorrect.** Frank ***does not*** have an option. He must use the accrual method for both of his purchases and income from the sale of those purchases.
 - D. **Incorrect.** If Frank had no inventories, he would be allowed to account for ***both*** his ***sales*** and ***expenses*** by using the cash accounting method.

CHAPTER 4

BUSINESS ASSETS

You must capitalize, ***rather than*** deduct, some costs. These costs are considered a part of your investment in your business and are called "capital expenses." There are, in general, three types of costs that ***must be capitalized***:

1. Going into business costs,
2. Business assets, and
3. Improvements.

KINDS OF CAPITAL EXPENSES

Going Into Business Costs. The costs of getting started in business, ***before*** you actually begin business operations, ***are all capital expenses***. This may include the cost of such things as advertising, travel, utilities, repairs, and employees' wages. These are often the same kind of expenses that ***you could deduct*** if you incurred them ***after you opened*** for business. The costs of going into business are discussed later in this chapter.

Business Assets. The cost of any asset that you will use in your business for ***more than one year*** is a capital expense. There are many different kinds of business assets--- for example, land, buildings, machinery, trucks, books, furniture, patents, and franchise rights. You must capitalize the full cost of the asset, ***including*** freight and installation charges. Business assets are discussed later in this chapter.

Improvements. The costs of making improvements to a business asset are also capital expenses if the improvements ***add to the value*** of the asset, appreciably lengthen the time you can use it, or adapt it to a different use. However, ***normal repair costs*** are deducted as business expenses and are not capitalized. Ordinarily, add the cost of the improvement to the basis of the improved property. The cost of the improvement is recovered through annual depreciation deductions.

Examples of improvements are new electric wiring, a new floor, new plumbing, bricking up windows to strengthen a wall, and lighting improvements.

Cost of Goods Sold. If your business **manufactures** products **or** purchases them for **resale**, some of your costs are for the products you sell. You use these expenses to figure the cost of goods you sold during the year. Subtract cost of goods sold from total sales to figure gross profit for the year. If you use an expense to figure cost of goods sold, you cannot deduct it again as a business expense.

Business Expenses. Most of the other operating costs of your business **can be deducted** from gross profit when figuring income or loss for the year. These operating costs are known as business expenses. Some of the business expenses that are deductible are advertising, office supplies, insurance premiums, employee wages, utilities, rent, and property taxes. **Deductible** business expenses will be discussed in a subsequent chapter.

Restoration Plan. Capitalize the cost of reconditioning, improving, or altering your property as part of a **general restoration plan** to make it suitable for your business. This applies even if some of the work would by itself be classified as repairs. See the discussion of "**Replacements**," later.

Basis. When you make a capital expense, **your cost** becomes a part of "basis." Basis is a way of measuring your investment in your business and its assets for tax purposes. It is used in many ways--to figure gain or loss on a sale, to figure the amount of a casualty loss, to figure depreciation deductions, etc.

Your **original basis** in an asset is the amount you must spend **to acquire** it. But even if it does not cost you anything to acquire a business asset--for example, if you inherit it or get it as a gift--you will still have a basis in the asset. While you own the asset, various events may take place that will change your basis in the property. Some events, such as improvements or additions, increase basis. Others, such as casualty losses or depreciation deductions, decrease basis. Basis will be discussed in detail in a subsequent chapter.

Recovery. Although you generally cannot directly deduct a capital expense, you can often "recover" your cost (i.e., subtract it from income) one part at a time over a number of years. This is done by deducting a percentage of basis each year under one of the following methods:

1. **Depreciation.** Depreciation is used to recover capital expenses for most tangible business assets.
2. **Amortization.** Amortization is used to recover **only certain kinds** of capital expenses, such as some research costs, business start-up costs, and the cost of pollution control facilities.
3. **Depletion.** Depletion is used to recover the cost of an economic interest in timber, minerals, and other natural resources.

You can choose to deduct in **one tax year** a limited amount of what you spend to acquire certain tangible property for use in a trade or business **instead of** treating this amount as a capital expense. The maximum amount you can deduct is limited. See **Section 179 Deduction** in a subsequent chapter.

If you do not **completely recover** a capital expense through depreciation, amortization, or depletion, you can usually recover the balance **when you sell** or otherwise give up ownership of your business assets. Basis is subtracted from the amount you realize on a sale to figure gain or loss. Basis is also the starting point for figuring gain or loss if a business asset is stolen or destroyed. If you abandon the asset, you also use basis to figure your loss. See **Dispositions** in a subsequent chapter.

Replacements. Like the cost of improvements, you may not deduct the cost of a replacement that stops deterioration and adds to the life of your property. It should be capitalized and depreciated.

Treat amounts you pay to replace parts of a machine that only keep it in a normal operating condition like repairs. You can deduct them as business expenses. However, if your equipment has a **major overhaul**, you capitalize and depreciate the expense.

Capital Expenses or Deductible Expenses. To help you distinguish between capital expenses and deductible expenses, several different items are discussed next.

Business Motor Vehicles. You usually capitalize the cost of a motor vehicle you buy to use in your business. You can recover its cost through annual deductions for depreciation.

There are dollar limits on the amount of depreciation you may claim each year for passenger automobiles you place in service for your business. Repairs you make to your business vehicle are deductible. However, amounts you pay for reconditioning and overhaul of business vehicles are capital expenses.

Roads and Driveways. The cost of building a private road on your business property and the cost of replacing a gravel driveway with a concrete one are capital expenses which you may be able to depreciate. The cost of maintaining a private road on your business property is deductible as an ordinary and necessary business expense.

Tools. Unless the uniform capitalization rules apply, amounts spent for tools used in your business are deductible expenses if the tools wear out **and** are thrown away **within one year** from the date of purchase.

Machinery. Unless the uniform capitalization rules apply, the cost of replacing short-lived parts of a machine to keep it in good working condition **and not** to add to its life is deductible as an ordinary and necessary expense. The uniform capitalization rules will be discussed later.

Heating Equipment. The cost of changing from one heating system to another is a capital expense and **not** a deductible one.

TYPES OF BUSINESS ASSETS

A business usually owns property that it uses, directly or indirectly, to earn its income. Property that is used in this way is a business asset. Business assets are classified as tangible or intangible, real or personal.

All the costs of getting a business asset that is ordinarily used for **more than** one year are capital expenses. This **includes** the cost of freight, installation, and testing. It also includes the costs of building an asset yourself.

Tangible and Intangible Property. A business asset **may be tangible** property--such as a warehouse, lathe, desk, truck, or tool--**or** it may be **intangible** property--such as a trademark, customer list, franchise, promissory note, or goodwill. Tangible property is property that **can be felt** or touched. Its physical features are what make it useful to you. Intangible property is property that is not tangible. Documents that are merely **representations of value** (such as stock certificates) or evidence of rights (such as patents) **are intangible** property.

Real and Personal Property. Tangible business assets are further classified as either real **or** personal property. Real property **is land** and anything fixed to the land--for example, fences, parking lots, buildings, or trees. **Everything else** is personal property--for example, furniture, office equipment, vehicles, and supplies. Components of buildings--such as air conditioning, plumbing, and furnaces--may be real or personal property, depending on state law.

GOING INTO BUSINESS

When you get ready to go into business, you probably will have a number of different costs. For example, you may:

1. Travel to look over various business possibilities, or to find customers and suppliers,
2. Conduct market surveys, or begin to advertise your business,
3. Retain a lawyer to help organize your business, or an accountant to set up a record keeping system,
4. Begin to hire and train employees, or
5. Analyze available facilities, labor, supplies, etc.

However, because your business has not yet started active operations, you are **not allowed** to deduct these kinds of costs **as expenses**. These costs, start-up costs, must be **amortized**. To be amortizable, a start-up cost must meet the following tests:

1. It must be a cost that you could deduct if it were paid or incurred to operate an existing trade or business.
2. It must be paid or incurred by you before you actually begin business operations.

If You Buy Business Assets. The costs connected with **acquiring** a business asset becomes **part of your basis** in the asset. For example, a lawyer's fee for negotiating a lease becomes **part of your basis** in the lease. The cost of a land survey for real estate you plan to buy becomes a **part of your basis** in the property once you acquire it.

If your attempt to acquire a business asset is **not successful**, you can deduct, **as a capital loss**, the costs you had in the attempt. You can take this loss **whether or not** you eventually go into business. However, the deductible amount is limited to \$3,000 under the normal capital loss rules.

If You Fail to Go Into Business. If your attempt to go into business **is not successful**, the expenses you had in trying to establish yourself in business fall into two categories:

1. The costs you had **before** making a decision to acquire or begin a specific business. These costs are personal and nondeductible. They include any costs incurred in the course of a general search for, or a preliminary investigation of, a business or investment possibility.

Example. Pete traveled to a distant city to investigate the prospects of opening a retail business. He paid for a survey to determine the number of potential customers for his type of business. He stayed three days in a hotel while waiting for the survey to be completed. In the end he decided it was not a suitable location to open his business. Pete can neither deduct nor capitalize his travel, hotel and survey costs.

2. The costs you had in your attempt **to acquire or begin** a specific business. These costs are capital expenses and can be deducted as a capital loss.

Example. Kay decided to open a retail business. She hired an attorney to review the proposed lease agreement. She paid an architect to draw plans for modification of the interior of the building. In the end Kay and the landlord could not reach agreement on the lease. Kay's expenses for the architect and the attorney can be deducted only as a capital loss and are subject to the normal \$3,000 per year limitation.

The costs of any assets you **acquired** during your **unsuccessful** attempt to go into business are a part of **your basis** in the assets. You cannot take a deduction for these costs.

Example. Sal decided to open a candy store. He located a building that was available to lease. He paid \$4,000 for a candy-making machine. Sal was unable to negotiate a lease with the landlord. Sal can neither deduct nor depreciate his machine. His basis in the machine is his cost, \$4,000. If he sells the machine for more than his basis, he will have a capital gain. If he sells it for less than his basis, he will have a capital loss, deductible with the normal deductible limitation. If he can neither sell it nor find a location for a candy store, his money is simply "tied up."

BUSINESS START-UP COSTS

Business start-up costs are the expenses you incur before you actually begin business operations. Your business start-up costs will depend on the type of business you are starting. They may include costs for advertising, travel, surveys, and training. These costs are generally capital expenses.

You usually recover costs for a particular asset (such as machinery or office equipment) through depreciation (discussed later). You can elect to deduct up to \$5,000 of business start-up costs and \$5,000 of organizational costs paid or incurred. The \$5,000 deduction is reduced by the amount your total start-up costs or organizational costs exceed \$50,000. Any remaining costs must be amortized. These remaining costs that cannot be deducted currently may be amortized ratably over 180 months.

Example. Kim incurred \$7,000 start-up business costs prior to the opening of her new business. Kim can currently deduct \$5,000 of the costs and deduct \$2,000 over the next 180 months.

Start-up costs **include** what you pay for both investigating a prospective business and getting the business started. For example, they may include costs of items such as the following:

- A survey of potential markets,
- An analysis of available facilities, labor, supplies, etc.,
- Advertisements for the opening of the business,
- Salaries and wages for employees who are being trained, and their instructors,
- Travel and other necessary expenses for securing prospective distributors, suppliers, or customers, and

- Salaries and fees for executives and consultants, or for other professional services.

Start-up costs **do not include** deductible interest, taxes, and research and experimental costs.

Business Sold. If you completely dispose of your business before the end of the amortization period selected, any deferred start-up costs for your business that you **have not deducted** can be deducted to the extent they qualify **as a loss** from a trade or business.

COST OF ACQUIRING A LEASE

You may either enter into a new lease with the lessor of the property or acquire an existing lease from another lessee. Very often when you acquire an existing lease from another lessee, **in addition**, to paying the rent on the lease, **you must pay** the previous lessee a sum of money **to acquire** that lease.

If you **acquire** an existing lease on property or equipment for your business, you **must amortize** any amount you pay to acquire that lease over the **remaining term** of the lease.

Example. Les needed a large centrally located building in which to open his sole proprietorship business. A certain building that he desired was already leased to another individual with 6 years remaining on the lease. Les offered and the lessee accepted \$6,000 to give up his lease and allow Les to open his business in the building. (Of course, Les had to negotiate with the landlord to complete the takeover.)

Option to Renew. The term of the lease for amortization **will include** all renewal options if less than 75% of the cost is attributable to the term of the lease remaining on the purchase date. In determining the term of the lease remaining on the purchase date, you do not include any period for which the lease may be renewed, extended, or continued under an option exercisable by the lessee.

Generally, allocation of the lease cost to the original term and any option term is based on the facts and circumstances.

Example 1. You paid \$10,000 to acquire a lease with 20 years remaining on it and two options to renew for 5 years each. Of this cost, \$7,000 was paid for the original lease and \$3,000 was applied to the renewal options. Since \$7,000 is less than 75% of the total cost of the lease of \$10,000, you must amortize the \$10,000 over 30 years, the remaining life of your present lease plus the periods for renewal.

Example 2. If in Example 1, the amount applicable to the original lease had been \$8,000, then you would have been allowed to amortize the entire \$10,000 over the 20-year remaining life of the original lease because the \$8,000 cost of acquiring the original lease was not less than 75% of the total cost of the lease.

Cost of a Modification Agreement. If you have to pay an additional "rent" amount over part of the lease period in order to change certain provisions in your lease, you must capitalize these payments and amortize them over the remaining period of the lease. You **cannot deduct** the payments as **additional rent** even if they are described as rent in the agreement.

Example. You are a calendar year taxpayer and sign a 20-year lease to rent part of a building starting on January 1. However, **before** you occupy it, you decide that you really need **less** space. The lessor agrees to reduce your rent from \$7,000 to \$6,000 per year and to release the excess space from the original lease. In exchange, you agree to pay an additional rent amount of \$3,000 payable in 60 monthly installments of \$50 each.

You **must** capitalize the \$3,000 and amortize it **over the 20-year term** of the lease. Your amortization deduction each year will be \$150 ($\$3,000 \div 20$). You **cannot** deduct the \$600 that you will **actually pay** during each of the first 5 years as rent.

Commission, Bonuses, and Fees. Commissions, bonuses, fees, and other amounts that you pay to obtain a lease on property you use in your business are capital costs. You **must amortize** these costs over the term of the lease.

Loss on Merchandise and Fixtures. If you sell merchandise and fixtures that you bought solely to acquire a lease and you have a loss on the sale, the loss is a cost of acquiring the lease. You must **capitalize the loss** and amortize it over the **remaining term** of the lease.

Improved Leased Property. If you lease property with a building or other improvement already on it, you are entitled to amortize **only** your cost of **acquiring** the lease. You cannot claim a deduction for depreciation on the building or other improvements.

COSTS YOU CAN CHOOSE TO DEDUCT OR TO CAPITALIZE

If you **deduct** a cost as an **expense**, you "recover" it **in full** by subtracting it from **your current year's** income.

If you capitalize a cost, you may be able to "recover" it through a section 179 deduction or periodic deductions for depreciation, amortization, or depletion. The section 179 deduction is discussed in the chapter on depreciation. In that material, we will suggest

strategies that can allow sole proprietors to work "magic" in tax savings by applying the section 179 deduction.

The costs that you can choose to deduct or to capitalize include:

- Certain carrying charges on property (unless the uniform capitalization rules apply),
- Research and experimental costs,
- "Intangible" drilling and development costs for oil, gas, and geothermal wells,
- Exploration costs for new mineral deposits,
- Mine development costs for a new mineral deposit,
- Costs of increasing the circulation of a newspaper or a periodical, and
- Costs of removing architectural and transportation barriers to people with disabilities and the elderly.

For sole proprietors most of the costs are listed above, **except** carrying charges and costs of removing architectural and transportation barriers to disabled and elderly people **are adjustments** or **tax preference** items. These items are **subject to** the alternative minimum tax **if** they are deducted on your tax return.

Now, admittedly, the above list is not exactly your "average" type of deductions. But no text would be complete without a discussion of these items.

Carrying Charges. Carrying charges are the taxes and interest you pay to carry **or** develop **real property or** to carry, transport, and install **personal** property. Certain carrying charges must be capitalized under the uniform capitalization rules.

In addition, you can choose to capitalize carrying charges **not subject to** the uniform capitalization rules, but only if they are otherwise deductible.

You can make a separate choice to capitalize carrying charges for each project you have and for each type of carrying charge. For unimproved and unproductive real property, your choice is good for only one year. You must make a new choice each year the property remains unimproved and unproductive. For other property, your choice to capitalize carrying charges remains in effect until construction, development, or installation is completed (or, for personal property, the date you first use it, if later).

How to Make the Choice. To make the choice to capitalize a carrying charge, write a statement saying which charges you choose to capitalize. Attach it to your original tax return for the year the choice is to be effective.

Research and Experimental Costs. The cost of research and experimentation that is reasonable is generally a capital expense. However, you can choose to deduct some of these costs as a current business expense.

This choice applies to the reasonable costs of research and development arising from laboratory or experimental procedures. It includes the cost of developing or improving a product, a formula, an invention, a plant process, an experimental or pilot model, or something similar. It also includes the cost of any research or experimental work carried on for you by someone else (such as a research institute, foundation, engineering company, or similar contractor). It **does not apply** to market research, management surveys, or normal product testing. It also **does not apply** to the costs of acquiring or improving land or depreciable property.

The choice you make applies **to all** your research and experimental costs. You **cannot choose** to deduct some of these expenses and capitalize others.

However, if you do not choose to deduct your research and experimental costs currently, you have other choices. You can choose to treat certain research and development costs as deferred expenses and amortize them over a period of at least 60 months, beginning with the month that you first receive an economic benefit from the research. You **can also choose** to deduct them over the 10-year period beginning with the tax year they were paid or incurred. This optional write-off will be discussed later in this chapter.

***Future Tax Considerations with Research and Experimental Costs.** For these expenditures paid or incurred after December 31, 2021 the Tax Cut and Jobs Act will apply these new rules:

- Costs must be capitalized and amortized over five years (15 years for research conducted outside the U.S.) and
- The start date for amortization of all such costs throughout the year is the midpoint of the year (June 30 for calendar year taxpayers.)

How to Make the Choice. To choose to deduct research and experimental costs currently, claim them as an expense deduction on your income tax return **for the year** in which you first have them.

Research Credit. You may qualify for a credit on some or all of your research and experimental costs **no matter how** you treat them. You must reduce the amount you deduct or capitalize by the amount of the credit, unless you choose to take a reduced credit.

Drilling and Development Costs. The costs of developing oil, gas, or geothermal wells are **ordinarily** capital expenses. They can usually be recovered through depreciation or depletion. However, **you can choose** to deduct **as current business expenses** certain drilling and development costs for wells located in the United States in which you hold an **operating or working** interest.

Exploration Costs. If the costs of determining the existence, location, extent, or quality of any mineral deposit lead to the development of a mine, they ordinarily are capital expenses. You can recover these costs through depletion as the mineral is removed from the ground. However, **you can choose** to deduct the costs of exploration in the United States (except those for oil, gas, and geothermal wells) if you paid or incurred them before the development stage began.

If you do not choose to deduct your exploration costs currently, you can choose to deduct them over the 10-year period beginning with the tax year they were paid or incurred.

Development Costs. You can deduct costs paid or incurred during the tax year for developing a mine or any other natural deposit (other than an oil or gas well) located in the United States if the costs are paid or incurred after the discovery of ores or minerals in commercially marketable quantities. Development costs include those incurred by a contractor on your behalf. They do not include costs for depreciable improvements.

Costs of Removing Barriers to Disabled and Elderly People. The cost of an improvement to a business asset is normally a capital expense. However, **you can choose** to deduct up to \$15,000 of the cost of improvements that make a building, public transportation vehicle or other facility **more accessible** to elderly and disabled people.

As stated earlier, except for carrying charges and "disabled barriers," any costs that are eligible for either current deduction or 60-month amortization **are considered** tax preference items for the alternative minimum tax. However, you can **prevent** these items from being treated as tax preference items. You do this by depreciating these items using the Modified Accelerated Cost Recovery System (MACRS).

OPTIONAL WRITE-OFF METHOD

3-Year Write-Off. You can choose to deduct the cost of increasing the circulation of a newspaper or periodical in equal installments over a 3-year period.

60-Month Write-Off. You can choose to deduct intangible drilling and development costs in equal installments over a 60-month period beginning with the month the costs were paid or incurred. These costs must have been paid or incurred in a tax year beginning **after** 1989.

10-Year Write-Off. The costs you can choose to deduct in equal installments over a 10-year period are:

- Research and experimental costs,
- Mining exploration and development costs, and
- Intangible drilling and development costs incurred in tax years beginning before 1990.

Choosing the Optional Write-Off. You must choose the optional write-off ***by the due date*** (including extensions) of your income tax return for the year for which you are making the choice. Attach a statement to your return that includes:

1. Your name, address, and social security number,
2. The specific write-off you are choosing,
3. A notation that you are making this choice under section 59(e) of the Internal Revenue Code,
4. The year for which you are making the choice, and
5. The tax preference item to which it applies.

You can use **Form 4562, *Depreciation and Amortization***, to choose the optional write-off. Once you select the optional write-off for any qualified expenditure, your choice may be revoked only with the consent of the Internal Revenue Service.

REVIEW QUESTIONS

CHAPTER 4 – BUSINESS ASSETS

1. Dan was starting a business. He incurred certain expenses before he began business operations. Which one of the following statements is **correct** in regard to those expenses?
 - A. Dan must capitalize all of his expenses.
 - B. Dan must deduct advertising expenses as ordinary expenses.
 - C. Dan must deduct utility costs as ordinary expenses.
 - D. Dan must deduct travel expenses as ordinary expenses.
2. The cost of making improvements to a business asset is a capital asset. Which one of the following statements is **incorrect** in this regard?
 - A. An improvement that adds to the value of the asset is a capital expense.
 - B. An improvement that adds to the value of the asset increases the basis of the asset.
 - C. An improvement to a business asset that adapts the asset to a different use is a capital asset.
 - D. The costs of improvements to a business asset are recovered as ordinary expenses over a 5-year period.
3. Which one of the following statements is **correct** in regard to amortization?
 - A. Amortization is used to recover research costs.
 - B. Amortization is used to recover capital expenses for most tangible business assets.
 - C. Amortization is used to recover an economic interest in timber and minerals.
 - D. Amortization may **not** be used to recover business start-up costs.
4. If you attempt to acquire a business asset for opening a new business and are not successful, you can deduct the cost you had in the attempt whether or **not** you ultimately go into business. Which one of the statements is **correct** in this regard?
 - A. The cost must be amortized.
 - B. The cost must be depreciated, using an allowable MACRS method.
 - C. The cost must be deducted as a capital loss subject to the \$3,000 annual limit.
 - D. The cost can be deducted as an ordinary expense.

5. Business start-up costs are currently deductible in an amount up to \$5,000. Any remaining costs may be amortized over a certain minimum amount of time. What is that time?
- A. 24 months
 - B. 60 months
 - C. 120 months
 - D. 180 months
6. Which one of the following statements is ***incorrect*** regarding business start-up costs?
- A. Salaries and wages for employees being trained qualify as start-up costs.
 - B. Travel and other necessary expenses for securing prospective customers qualify as start-up costs.
 - C. Research and experimental costs do not qualify as start-up costs.
 - D. Deductible interest qualifies as a start-up cost.

RESPONSES TO REVIEW QUESTIONS

CHAPTER 4 – BUSINESS ASSETS

1.
 - A. **Correct.** Dan must capitalize all of his start-up expenses because they were all incurred **before** he began business operations.
 - B. **Incorrect.** Advertising expenses incurred before business operations began must be capitalized.
 - C. **Incorrect.** Like advertising expenses, utility costs incurred before a business begins must be capitalized.
 - D. **Incorrect.** Dan must capitalize his travel expenses and all other normal business expenses that he incurs before the beginning of his business operations.
2.
 - A. **Correct.** An improvement that either adds to the value of an asset or adapts it to a different business use qualifies as a capital asset.
 - B. **Correct.** The cost of an improvement to an asset increases the basis of asset.
 - C. **Correct.** Also, if an improvement substantially lengthens the useful business life of an asset, it qualifies as a capital asset.
 - D. **Incorrect.** The cost of an improvement to an asset is recovered through depreciation, **not** as an ordinary expense.
3.
 - A. **Correct.** Amortization is used to recover the cost of certain kinds of capital expenses such as business start-up costs and some intangible assets such as research costs.
 - B. **Incorrect.** Amortization is used to recover capital expenses from most **intangible** business assets.
 - C. **Incorrect.** **Depletion** is used to recover the cost of an **economic** interest in timber and minerals.
 - D. **Incorrect.** **Depreciation** is used to recover the cost of tangible assets.
4.
 - A. **Incorrect.** You must deduct these costs as capital loss.
 - B. **Incorrect.** The cost cannot be depreciated or amortized. They must be deducted as a capital loss.
 - C. **Correct.** The costs must be deducted as a capital loss subject to the normal \$3,000 annual limitation for capital losses.
 - D. **Incorrect.** The costs cannot be deducted as an ordinary expense.

5.

- A. **Incorrect.** The costs in excess of \$5,000 must be amortized ratably over a period of 180 months (15 years).
- B. **Incorrect.** The first \$5,000 of costs may be currently deducted. Any amount in excess of \$50,000 reduces your \$5,000 deduction by that amount.
- C. **Incorrect.** The costs over \$5,000 must be amortized (within limitations) of a period of 180 months (15 years).
- D. **Correct.** However, the first \$5,000 is currently deductible. Any amount in excess of \$50,000 reduces the \$5,000 amount by that excess. Then, any remaining amount may be amortized over 180 months.

6.

- A. **Correct.** The costs qualify as start-up costs you incur before you began business operations.
- B. **Correct.** The cost of travel for securing prospective customers qualifies as business start-up costs when they are incurred **before** you begin business operations.
- C. **Correct.** Research and experimental costs **do not** qualify as business start-up costs.
- D. **Incorrect.** Deductible interest and deductible taxes do not qualify as start-up costs.

CHAPTER 5

BASIS OF BUSINESS ASSETS

A sole proprietor's basis is his or her investment in property for income tax purposes. Use the basis of property to figure gain or loss from the sale or disposition of property. Also use it to figure the deduction for depreciation, amortization, depletion, and casualty losses.

This chapter is divided into three sections:

1. Cost Basis,
2. Adjusted Basis, and
3. Other Basis.

The basis of property **you buy** is its cost. If you use the asset in a trade or business or an activity conducted for profit, capitalize (add to basis) many direct and indirect costs.

Your original basis in property is increased or decreased (adjusted) for certain events. If you make improvements to the property, this increases your basis. If you take deductions for depreciation or casualty losses, this reduces your basis.

You cannot determine your basis in some assets by cost. This includes property you receive as a gift or inheritance. It also applies to property received in an involuntary exchange, and certain other circumstances.

If you sell or exchange your property, figure your gain or loss on the transaction. Compare the amount realized from the sale or exchange to the adjusted basis of the property you transferred. The amount realized is the money you received, plus the fair market value of any other property you received.

If any of your debts were cancelled by a creditor, or were discharged because you became bankrupt, the basis of your assets might be affected.

COST BASIS

The basis of property you buy is usually its cost. The cost is the amount you pay in cash or in other property or debt obligation. Your cost includes amounts you pay for:

1. Sales tax,
2. Freight,

3. Installation and testing,
4. Excise taxes,
5. Legal fees (when required to be capitalized),
6. Revenue stamps,
7. Recording fees, and
8. Real estate taxes (if assumed for the seller).

In addition, the cost basis of real estate and business assets may include other items.

Loans With Low or No Interest. If you buy business or investment property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price, less the amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable Federal rate. These rates are published monthly in the Internal Revenue Bulletin (I.R.B.).

BUSINESS ASSETS

If you purchase property to use in your business, your basis usually is its actual cost to you. However, if you construct, build, or otherwise produce property, you may be subject to the uniform capitalization rules to determine the basis of the property.

Example 1. Dale White is an independent contractor. He purchased a building for his business. He used it to store his construction equipment. His basis in the building ***is its cost*** to him.

Example 2. Assume the same facts as in example 1 except instead of purchasing the building; Dale had his employees construct the building. He must determine his basis in the building under the ***uniform capitalization rules***.

INTANGIBLE ASSETS

Intangible assets include goodwill, patents, copyrights, trademarks, trade names, and franchises. The basis of an intangible asset is usually its cost. If you acquire multiple assets for a lump-sum, for example a going business, determine your basis in the individual assets by making an allocation. This allocation is the total purchase price spread among the individual assets. If you bought a business, see ***Allocating the Basis***, later.

Goodwill. The basis of goodwill is usually its cost if you bought it. When you buy a going business you intend to continue, the price may include goodwill. See ***Allocating the Basis***, later.

Agreement Not to Compete. Usually, the basis of an agreement not to compete (also called a covenant not to compete) is the amount you pay for it. If you buy a going business, however, a part of the price may be for an agreement not to compete.

Patents. The basis of a patent you buy is the amount you pay for it. If you get a patent for your invention, however, the basis is the cost of development, such as research and experimental expenditures, drawings, working models, and attorney's and governmental fees. If you deduct the research and experimental expenditures as current business expenses, you cannot include them in the cost of the patent. The value of the time spent on an invention is not part of the basis.

Copyrights. When you buy a copyright, the basis is the amount you pay for it. However, if you are an author, your basis usually will be your cost of getting the copyright, plus copyright fees, attorney's fees, clerical assistance, and the cost of plates that remain in your possession. Do not include in the basis the value of your time as the author, or any other person's time for which you did not pay.

Franchises, Trademarks, and Trade Names. If you buy a franchise, trademark, or trade name, the basis is its cost.

Land and Buildings. If you buy buildings and the land on which they stand for your business and you pay a lump sum, allocate the basis of the whole property among the land and the buildings so you can figure the depreciation allowable on the building.

When you allocate your cost between land and buildings or among the lots, the amount used as the basis of each asset is the ratio of the fair market value of that asset to the fair market value of the whole property at the time you get it. If you are not certain of the fair market values of land and buildings, you may allocate the cost among them based on their assessed values for real estate tax purposes

Demolition of Building. Add demolition costs and other losses incurred for the demolition of any building to the basis of the land on which the demolished building was located. Do not claim it as a ***current*** deduction.

ALLOCATING THE BASIS

If you buy multiple assets for a lump sum, allocate the amount you pay to each of the assets you receive. Make this allocation to figure your basis for depreciation and gain or loss on a later disposition of any of these assets.

Group of Assets Acquired. If you buy multiple assets for a lump sum, you and the seller may agree ***to a specific allocation*** of the purchase price to ***each*** asset in the sales contract. If this allocation is based on the value of each asset, ***and*** the sale is an arm's-length transaction, the allocation will generally be accepted. However, see ***Trade or Business Acquired***, next.

Trade or Business Acquired. If you acquire a group of assets that is a trade or business to which goodwill or going concern value could attach, you ***must*** use the following method to allocate the purchase price to the various assets acquired.

Allocate the purchase price to:

1. Cash, demand deposits, and similar accounts, and then
2. Allocate the remaining purchase price to the following assets by allocating each asset an amount proportionate to, ***but not in excess of***, its FMV in the following order:
 - a. Certificates of deposit, U.S. Government securities, readily marketable stock or securities, and foreign currency, and
 - b. All other assets except goodwill and going concern value.

Any remainder of your purchase price, after you make these allocations, ***is your basis in goodwill*** and going concern.

Example 1. Fred purchased a small construction company. He paid \$100,000, and he received the following assets:

1. A \$40,000 certificate of deposit,
2. A road paving machine with a fair market value of \$60,000, and
3. A bulldozer with a fair market value of \$15,000.

For determining basis, Fred must reduce the purchase price by the value of the cash-equivalent assets he received, in this case, the \$40,000 certificate of deposit. So this leaves \$60,000 (\$100,000 purchase price less \$40,000 C.D.), to be allocated to the remaining assets.

Since the road paving machine has an 80% ratio of FMV of total remaining assets (\$60,000 ÷ \$75,000), the basis for the road paving machine is \$48,000 (80% x \$60,000 total depreciable assets).

Similarly the basis for depreciating the bulldozer is \$12,000 (20% x \$60,000).

In “Fred’s” Example 1, after the \$40,000 certificate of deposit is deducted from the purchase price, the fair market value of the remaining assets (\$75,000) **is in excess** of the balance of the purchase price (\$60,000). So there is **no amount remaining** to allocate to goodwill or going concern value.

Example 2. Let’s assume the same facts are the same as in Example 1 **except** that the fair market value of Fred’s road paving machine **is \$30,000**.

To determine basis in this example, Fred again subtracts the \$40,000 certificate of deposit from the \$100,000 purchase price leaving \$60,000 to be allocated by the IRS formula.

Next, Fred subtracts the \$45,000 combined fair market value of the road paving machine (\$30,000) and the bulldozer (\$15,000) from the \$60,000 balance after the certificate of deposit reduction. This leaves \$15,000, which becomes the amount that is allocated to goodwill. (The amortization of goodwill is discussed later.)

If you and the seller agree **in writing** to allocate the consideration, or to allocate the fair market value of any asset, the agreement **is binding** on both you and the seller **unless** the IRS determines either to be inappropriate.

If you are a buyer or seller of a group of assets that is a trade or business, file Form 8594 with your income tax return for the year of sale.

Exchange of Businesses. Exchanging one business’ assets for another business’ assets is a **multiple asset exchange**. A multiple asset exchange cannot be treated as a disposition of a **single property**. Check the various assets that comprise each business **to determine which** are like-kind exchanges.

The assets treated as transferred in exchange for like-kind property **are excluded** for the allocation rules. However, property that is **not like-kind property** is subject to the allocation rules.

ADJUSTED BASIS

Before figuring any gain or loss on a sale, exchange, or other disposition of property **or** figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) **to the basis** of the property. The result of these adjustments to the basis **is the adjusted basis**.

INCREASES TO BASIS

If you make additions or improvements to business property, keep separate accounts for them. Also, depreciate the basis of each according to the depreciation rules in effect when you place the addition or improvement in service.

Increase the basis of any property by all items properly added to a capital account. This includes the cost of any improvements having a useful life of more than one year and amounts spent after a casualty to restore the damaged property. The following are also additions to basis:

1. The cost of extending utility lines to the property.
2. Impact fees.
3. Legal fees for defending and perfecting title.
4. Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements.
5. Zoning costs.
6. The capitalized value of a redeemable ground rent.

DECREASES TO BASIS

You decrease the basis of your property by items that represent a return of capital. These include:

1. The section 179 deduction,
2. The deduction for clean-fuel vehicles and clean-fuel refueling property,
3. Deductions previously allowed (or allowable) for amortization, depreciation, and depletion,
4. Exclusions from income of subsidies for energy conservation measures,
5. Credit for qualified electric vehicles,
6. Investment credit (part or all of credit) taken,
7. Casualty and theft losses, and

8. Certain cancelled debt excluded from income.

Section 179 Deduction. If you elect to take section 179 deduction for any part of the cost of property, decrease the basis of the property by the amount of the section 179 deduction.

Example. Sue paid \$25,000 for a qualified machine for use in her sole proprietorship business. She took the maximum allowable section 179 expense deduction. Sue's basis in the machine for depreciation and for gain or loss if she sells her business is the result of \$25,000 minus the section 179 deduction. (The section 179 deduction is discussed in Chapter 11).

Exclusion From Income of Subsidies for Energy Conservation Measures. If you received a subsidy from a public utility company for the purchase or installation of any energy conservation measure, you can exclude it from income. ***If you exclude*** the subsidy from income, ***reduce*** the basis of the property on which you received the subsidy by the amount of the subsidy.

Diesel-Powered Vehicle. If you received an income ***tax credit*** or refund for buying a diesel-powered highway vehicle, ***reduce*** your basis in that vehicle by the amount of credit or refund allowable.

Credit for Qualified Electric Vehicle. If you claim the credit for qualified electric vehicles you must ***reduce the basis*** of the property on which you claimed the credit.

Deduction for Clean-Fuel Vehicles and Clean-Fuel Vehicle Refueling Property. If you take either the deduction for clean-fuel vehicles or clean-fuel vehicle refueling property, or both, you must ***decrease the basis*** of the property by the amount of the deduction.

Gas-Guzzler Tax. Decrease the basis in your car by the gas-guzzler (fuel economy) tax if you begin using the car within 1 year of the date of its first sale for ultimate use. This rule applies to someone who later buys and begins using it not more than 1 year after the original sale for ultimate use. If the car is imported, the one-year period begins on the date of entry or withdrawal of the car from the warehouse if that date is later than the date of the first sale for ultimate use.

Depreciation. Decrease the basis of your property by the amount of depreciation you could have deducted on your tax returns under the method of depreciation you selected. If you deducted more depreciation than you should have, decrease your basis as follows. Decrease it by an amount equal to the depreciation you should have deducted as well as by the part of the excess depreciation you deducted that actually reduced your tax liability for any year. If you took less depreciation than you could have, decrease your basis by the amount you could have deducted.

In decreasing your basis for depreciation, take into account the amount deducted on your tax returns as depreciation expense, and any depreciation you must capitalize under the uniform capitalization rules.

ADJUSTED BASIS EXAMPLE

In January, five years ago, you paid \$80,000 for real property to be used as a factory. You also paid commissions of \$2,000 and title search and legal fees of \$600. You allocated the total cost of \$82,600 between the land and the building--\$10,325 for the land and \$72,275 for the building. Immediately, you spent \$20,000 in remodeling the building before you placed it in service. You were allowed a total combined amount of depreciation of \$14,526 for the year you purchased the property **and** the following four years. In the third year of ownership you had a \$5,000 casualty loss from a fire in the building.

This loss was not covered by insurance and was claimed as a deduction. You spent \$5,500 to repair the fire damages. The adjusted basis of the building at the beginning of the sixth year is figured as follows:

		<u>Building</u>
Original cost of building, including fees and commission.....		\$72,275
Adjustments to basis:		
Add:		
Improvements.....	20,000	
Repair of fire damages.....	<u>5,500</u>	
		\$97,775
Subtract:		
Depreciation.....	\$14,526	
Casualty loss.....	<u>5,000</u>	<u>\$19,526</u>
Adjusted basis at the beginning		
of the sixth year of ownership:.....		<u>\$78,249</u>

The basis of the land, \$10,325 remains unchanged. It is not affected by any of the above adjustments, which affect only the basis of the building.

OTHER BASIS

There are many times when you cannot use cost as a basis. In these cases, the fair market value of the property, or the adjusted basis of certain property may be important.

Fair Market Value (FMV). FMV is the price at which the property would change hands between a buyer and seller, neither being required to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property, on or about the same date, may be helpful in figuring the FMV of the property.

Property for Services. If you receive property for services, ***include*** the property's FMV ***in income***. The amount you include in income ***becomes your basis***.

REVIEW QUESTIONS

CHAPTER 5 – BASIS OF BUSINESS ASSETS

1. Which one of the following statements is **incorrect** regarding a sole proprietor's basis in his or her assets?
 - A. The basis is used to figure gain or loss.
 - B. The basis of property you buy is its cost.
 - C. Deductions for depreciation increase your basis.
 - D. Deductions taken for casualty losses reduce your basis in property.
2. The basis of business property you buy is usually its cost. Which one of the following statements is **incorrect** in this regard?
 - A. Freight is included in your basis.
 - B. Excise taxes are included in your basis.
 - C. Recording fees are included in your basis.
 - D. Sales tax is not included in your basis.
3. The basis of an intangible asset is its cost. Which one of the following statements is **incorrect** in this regard?
 - A. Goodwill is an intangible asset.
 - B. Patents are intangible assets.
 - C. Copyrights are intangible assets.
 - D. Franchises are not intangible assets.
4. Al paid \$6,000 to have an old building demolished that stood on a lot he owned. Which one of the following statements is **correct** in this regard?
 - A. Al can currently deduct the \$6,000.
 - B. Al must add the \$6,000 to his basis in the land.
 - C. Al is allowed to take a \$3,000 capital loss and carry over the remaining \$3,000 as a capital loss to the following year.
 - D. Al can recover his cost by amortizing the \$6,000 over 5 years.

5. Sue purchased a candy store. She paid \$25,000 and received the following assets: (1), A \$5,000 certificate of deposit. (2), A candy making machine with a fair market value of \$15,000 (3), a candy wrapping machine with a fair market value of \$10,000. Assuming there is no buyer/seller agreement to allocate basis of the assets, what is Sue's basis for depreciating the candy wrapping machine?
- A. \$10,000
 - B. \$8,000
 - C. \$4,000
 - D. \$5,000
6. Certain costs can either increase or decrease the basis of property. Which one of the following statements is **correct** in this regard?
- A. The section 179 deduction increases the basis.
 - B. The deduction for clean-fuel vehicles increases the basis.
 - C. The deduction of a casualty loss increases the basis.
 - D. The exclusion from income of subsidies for energy concept measures decreases the basis.

RESPONSES TO REVIEW QUESTIONS

CHAPTER 5 – BASIS OF BUSINESS ASSETS

1.

- A. **Correct.** Basis is used to figure your gain or loss on the sale of property. It is also used to figure depreciation, amortization, depletion and casualty losses.
- B. **Correct.** The basis of property you buy is its cost. This basis may be increased by any improvements you add to the original cost.
- C. **Incorrect.** Deductions for depreciation **decrease** your basis. Example: Your cost of an asset is \$1,000. Over a period of time you depreciate (recover the cost) of \$300 of the cost. Your new basis is \$700. If you later sell the asset for \$900, you have a gain of \$200 (\$900 selling price less \$700 basis).
- D. **Correct.** A deduction for an unreimbursed casualty loss reduces your basis in the asset.

2.

- A. **Correct.** The cost of freight is included in your cost basis.
- B. **Correct.** Excise taxes along with any real estate taxes (if paid by the seller) are added to your cost basis.
- C. **Correct.** Recording fees and revenue stamps are included in your basis.
- D. **Incorrect.** Sales tax **is** included in your basis.

3.

- A. **Correct.** Goodwill is an intangible asset. It is the additional value of your business in excess of the value of the assets added to the value of your net accounts receivable.
- B. **Correct.** Patents are intangible assets. Its basis is the amount you pay for it. However, the time spent on a patent or an invention is not part of the basis.
- C. **Correct.** Copyrights are intangible assets. You cannot include any value of your time in the basis.
- D. **Incorrect.** Franchises are intangible assets. The physical business activity allowed by the franchise **is** a tangible asset.

4.

- A. **Incorrect.** The \$6,000 AI paid is not currently deductible, nor is it depreciable over a number of years.
- B. **Correct.** AI must add the \$6,000 to the basis of the land. AI must wait until he sells the property to recover the cost of the demolition.
- C. **Incorrect.** AI cannot take either a capital loss or currently deduct the \$6,000. He must add the \$6,000 to the basis of the land.
- D. **Incorrect.** AI cannot amortize, depreciate or currently deduct the cost. He must add the \$6,000 to the basis of the land and recover his cost when the property is sold.

5.

- A. **Incorrect.** For determining her depreciable basis, Sue must first subtract the \$5,000 certificate of deposit from the \$25,000 purchase price leaving a depreciable basis of \$20,000. She then must make an allocation of the relative value of the fair market value of the two machines which are 60% for the candy making machine and 40% for the candy wrapping machine. 40% of \$20,000 is \$8,000, so A is incorrect.
- B. **Correct.** Applying the formula in "A" above, 40% x \$20,000 is \$8,000.
- C. **Incorrect.** Neither 40% nor 60% times \$20,000 equals \$4,000.
- D. **Incorrect.** Subtracting the \$15,000 candy making machine from the total \$20,000 basis is **not** the method for determining the depreciable value.

6.

- A. **Incorrect.** The section 179 deduction is a recovery of cost (or other basis) and thereby **decreases** the original basis.
- B. **Incorrect.** In the deduction of either the cost of clean-fuel vehicles or the clean-vehicle refueling property, you must **decrease** the basis of the asset(s).
- C. **Incorrect.** The deduction of an **unreimbursed** casualty loss **decreases** the basis. If you later receive a reimbursement for part or all of the loss, you must increase the basis of the amount received.
- D. **Correct.** The exclusion from income of subsidies for energy concept measures decreases the basis.

CHAPTER 6

BUSINESS INCOME

Sole proprietors must report any income they receive from their trade or business or any other source unless it is excluded by law. The income may be in the form of cash, property, or services. Some types of income are:

1. Interest, dividends, rents, royalties.
2. Payment for services, including fees, commissions, fringe benefits, and similar items.
3. Gains from dealings in property.
4. Income from the discharge of indebtedness.
5. Distributive shares of partnership gross income.

Business Income. Business income is income you receive when you sell your product or services. Interest is business income to a lending company. Fees are business income to a professional person. Rents are business income to a person in the real estate business. Dividends generally are business income to a dealer in securities.

Assignment of Income. All income you earn is taxable to you. You cannot avoid the tax by having the income paid to a third party.

Example. You rent out your property and the rental agreement directs the tenant to pay the rent to your son. The amount paid to your son is gross income to you.

Property or Services (Bartering). An exchange of property or services for your property or services is sometimes called ***bartering***. Income received in the form of property or services must be included in income at its fair market value on the date received. If you receive the goods or services of another in return for your goods or services and you both have definitely agreed ahead of time as to the value of the goods or services, that value will be accepted as fair market value, unless the value can be shown to be otherwise.

Example 1. You perform legal services for a client, a small corporation. In payment for your services, you receive shares of stock in the corporation. You ***must include*** the fair market value of the shares in income.

Example 2. Both you and a house painter are members of a barter club, an organization that each year gives its members a directory of members and the services each member provides. Members get in touch with other members directly and bargain for the value of the services to be performed.

In return for accounting services you provided for the house painter's business, the house painter painted your home. The **fair market value** of the services you received from the house painter **must be included** in your income, and the fair market value of your accounting services **must be included** in the house painter's income.

Example 3. You are a member of a barter club that uses credit units to credit or debit members' accounts for goods or services provided or received. As soon as units are credited to a member's account, the member may use them to buy goods or services or may sell or transfer the units to other members.

The value of credit units received **must be included** in your gross income for the tax year in which the units are credited to your account.

Canceled Debt. A canceled debt is generally **income to the debtor**. If you settled a debt by delivering to your creditor property that cost you less than the amount owed, the difference is income to you--unless you are insolvent. If you are **insolvent** before the cancellation but solvent after the cancellation, you realize income to the extent the transaction makes you solvent. This is the amount by which the fair market value of your assets is more than your liabilities after the cancellation. If you are insolvent before the cancellation, and remain insolvent or have no excess of assets over liabilities after the cancellation, you realize no income.

Kickbacks. Any kickbacks that you receive **are included** in your income. However, do not include them in your income if you properly treat them as a reduction of a related expense item, cost of goods sold, or a capital expenditure.

Recovery of Items Previously Deducted. If you recover a bad debt, prior tax, or any item deducted in a previous year, **include** the recovery in your income. However, if all or part of the deduction in earlier years **did not reduce your tax**, you may not have to include the entire recovered amount in your income.

Consignments. Consignments of merchandise to others to sell for you are **not sales**. The title of merchandise remains with you, the consignor, even after the consignee possesses the merchandise. Therefore, if you ship goods on consignment, you have no profit or loss **until** the merchandise has been sold by the consignee. Merchandise that you have shipped out on consignment is included **in your inventory** until it is sold.

Merchandise that you **receive** on consignment is **never included** in your inventory. Your profit or commission on merchandise consigned to you is included in your income when you sell the merchandise or when you receive your profit or commission, depending upon the method of accounting you use.

ACCOUNTING FOR YOUR INCOME

Accounting for your income for income tax purposes differs at times from accounting for financial purposes. This section discusses some of the more common differences that may affect business transactions.

The income from your business is figured on the basis of a tax year and according to your regular method of accounting. If the sale of a product is an income-producing factor in your business, the use of inventories usually is required to clearly show your income. Dealers in real estate are prohibited from using inventories.

Cash Discounts. These are amounts that the seller permits sole proprietors to deduct from the invoice price for prompt payment. For income tax purposes you may use either of these two methods to account for cash discounts. You may:

1. Deduct the cash discount from purchases, or
2. Credit the cash discount to a discount income account.

You must use the method you select every year for all your purchase discounts.

If the second method is used, the credit balance in the account at the end of your tax year is business income. Under this method, the cost of goods sold **is not reduced** by the cash discounts you received. When valuing your closing inventory, you may not reduce the invoice price of merchandise on hand at the close of the tax year by the average or estimated discounts received on the merchandise.

Trade Discounts. These are reductions from list or catalog prices and usually are not written into the invoice or charged to the customer. These discounts are not entered on your books of account. Only the net amount is included for purchases.

Constructive Receipt. Income is constructively received when it is **credited to your account** or set apart in a way that makes it available to you. You do not need to have physical possession of it. If you use the cash method of accounting, report the income in the year it is constructively received.

Example. Frances Jones, a service contractor, was entitled to receive a \$10,000 payment on a contract in December. She was told in December that her payment was available. At her request, she was not paid until January of the following year. She **must include** this payment in her

income in the year it was available because it was **constructively** received in that year.

Checks. A valid check received **before** the close of the tax year is constructive receipt of income **in that year**, even though you do not cash or deposit the check until the following year.

Example. Dr. Redd received a check for \$500 on December 31, from a patient. This check was not deposited in her business account until January 2, of the following year. This fee must be included in her income for the year the check was actually received.

Agents. An agent is someone who engages in business transactions for you. Income is constructively received by you **in the year** your agent receives it.

Insurance Proceeds. If a sole proprietor receives dividends from business insurance and he or she deducted the insurance premiums in prior years, part of the dividends is income.

Sales Returns and Allowances. Credits you allow customers for returned merchandise and any other allowances you make on sales **are deductions** from gross sales in figuring net sales.

PREPAID INCOME

Prepaid income is generally included in your gross income **in the year** that it is received. However, the amount received is not income unless it is subject to your free and unrestricted use. Prepaid income must be treated this way **whether** you use the cash or an accrual method of accounting. But, if you use an accrual method and meet the conditions explained in **Advance Income for Services**, next, you may be able to postpone including these amounts in income until the year you earn them.

If you must repay any part or all of the prepaid income in a later year, you may ordinarily deduct the repayment **in the year** you make the repayment.

Advance Income for Services. If you use an accrual method of accounting and, under an agreement, you receive advance payments for services to be performed by the end of the next tax year; you can make an election to postpone including the advance payments in income until you earn them. However, you may not postpone including them beyond the year after the year you received them.

Service Agreements. You may postpone reporting in income the advance payments you receive under service agreements (including agreements providing for incidental replacement of parts or materials) for property that you offer to sell, lease, build, or install without service agreements in the normal course of business.

Guarantees and Warranties. You generally ***may not*** postpone reporting as income amounts that you receive under guarantee or warranty contracts.

Postponement Not Allowed. Usually you may not postpone income including advance payments for services if, under the agreement:

1. You are to perform any part of the services after the end of the tax year immediately following the year you receive the advance payments, or
2. You are to perform any part of the services at any unspecified future date that may be after the end of the tax year immediately following the year you receive the advance payment.

Any advance payment that you include in gross receipts in the tax year you receive the payment ***may not be less than*** the amount of the payment you include as gross receipts in gross income in your books and records and all your reports (including consolidated financial statements) to shareholders, partners, and other proprietors or beneficiaries, and in reports you prepare for credit purposes.

If you want to change your method of reporting advance payments, you must first get consent from the IRS.

Example 1. You manufacture, sell, and service television sets. You received payment for a one-year contingent service contract on a television set you sold. You ***may postpone*** including this payment in income if you offer the television sets for sale without the contingent service contracts in the normal course of your business.

Example 2. You are in the television repair business. You received payments for one-year contracts under which you agree to repair or replace certain parts that fail to function properly in television sets that were sold by an unrelated party. You may include the payments in gross income ***as you earn them*** over the period of the contract.

Example 3. You own a dance studio. On November 2, you received payment for a one-year contract beginning on that date and providing for 48 one-hour lessons. You gave eight lessons through December of that year. Under this method of including advance payments, you ***must include*** one-sixth of the payment in income for the year, and five-sixths of the payment in the following year, even ***if you cannot give*** all the lessons by the end of the following year.

ADVANCE INCOME FROM SALES

If you use an accrual method of accounting, any advance payments you receive for future sales or other dispositions of goods **are included** in your income **under special rules**. Under these rules, advance payments include those you receive under an agreement for future sales of goods you hold primarily for sale to your customers in the ordinary course of your trade or business. They also include payments received under agreements for building, installing, or manufacturing items if you do not complete the agreement in the tax year.

If the advance payments are for contracts involving both sale and service of goods, it may be necessary to treat them as two agreements. An agreement also means a gift certificate that can be redeemed for goods. Amounts that are **due and payable** are treated as received.

Inclusion in Income. You may choose when to report the advance payments in income. You may include them in income in the tax year in which you receive them. Under an **alternative method**, you may include them in income in the **earlier** of the:

1. Tax year in which you include the advance payments in gross receipts under the method of accounting that you use for tax purposes, or
2. Tax year in which you include any part of the advance payments in any of your financial reports under the method of accounting used for those reports.

Your financial reports include consolidated financial statements; reports to shareholders, partners, beneficiaries, and other proprietors; and reports you prepare for credit purposes.

Example 1. You are a retailer who uses an accrual method of accounting under which you account for your sales of goods when you ship the goods. You use this method for both tax and reporting purposes. Therefore, **you must include** advance payments you receive in gross receipts for tax purposes either in the tax year you receive the payments or in the tax year you ship the goods. However, see **Exception for Inventory Goods**, later.

Example 2. You are a calendar year taxpayer who makes household furniture. You use an accrual method of accounting. Under your method of accounting, you accrue income for your financial reports when you ship the furniture. For tax purposes, you do not accrue income until the furniture has been delivered and accepted.

In November, you received an advance payment of \$8,000 from a customer for an order of furniture to be made for a total price of \$20,000. You shipped the furniture to your customer in December, but it was not delivered and accepted until January of the following year.

You must include the entire \$8,000 advance payment in your gross income for tax purposes in the year it was received. You include the remaining \$12,000 of the contract price in your gross income, for tax purposes, in the following year.

Exception for Inventory Goods. If you receive advance payments under an agreement for the sale of goods that are included in your inventory or under an agreement, such as a gift certificate, that can be satisfied with goods or a type of goods that cannot be identified in the year of sale, you may be able to postpone including the advance payments in income in the year of receipt. However, you may postpone including these payments until no later than the end of the second tax year following the end of a tax year in which you received an advance payment if, on the last day of your tax year, you meet the following conditions:

1. You account for advance payments under the alternative method, discussed earlier in ***Inclusion in Income***, and
2. You have received substantial advance payments, discussed later, on the agreement, ***and***
3. You have on hand or available to you through your normal source of supply in that year enough substantially similar goods to satisfy the agreement.

If you meet these conditions, then by the end of the second tax year after the year in which you receive substantial advance payments, ***you must include in income*** all advance payments you have received to date that have not already been included in income under your accrual method of accounting for advance payments. Also by the end of ***this second year***, you must deduct ***all actual or estimated*** inventorial costs of goods necessary to satisfy the contract.

Any difference between the estimated and the actual costs in fulfilling the contract must be taken into account as an adjustment to cost of goods sold when the goods are delivered. ***After*** the second tax year, any more advanced payments received on this contract are reported in income ***in the year received*** because no further deferral is allowable on this contract.

Substantial Advance Payments. Under an agreement for a future sale, substantial advance payments are considered received by the end of a tax year. But the total advance payments received during the current and preceding tax years must be equal to or more than the total costs and expenditures reasonably estimated to be includible in inventory because of the agreement.

Example. You are a calendar year, accrual method taxpayer who accounts for advance payments under the alternative method. In Year 1, you entered into a contract for the sale of goods that are properly includible in your inventory. The total contract price is \$50,000 and you estimate that your total inventorial costs for the goods will be \$25,000. You receive the following advance payments under the contract:

Year 1	\$ 17,500
Year 2	\$ 10,000
Year 3	\$ 7,500
Year 4	\$ 5,000
Year 5	\$ 5,000
Year 6	\$ 5,000

Your customer asked you to deliver the goods in Year 6. In your Year 2 closing inventory, you had enough of the type of goods specified in the contract on hand to satisfy the contract. Since the advance payments you had received by the end of Year 2 **were more than** the inventorial costs you estimated you would have, the payments are substantial advance payments.

All payments you receive by the end of Year 4, **the second tax year** following the tax year in which substantial advance payments are received, are included in income for Year 4. Therefore, you must include \$40,000 in income for Year 4, and you must include in your cost of goods sold the cost of the goods (or similar goods) on hand or, if no such goods are on hand, the estimated inventorial cost necessary to satisfy the contract.

Because no further deferral is allowable for the contract, you must include in your gross income for each remaining year of the contract the advance payments you receive in each of those years. Any difference between the estimated costs and the costs you actually have in satisfying the contract will be taken into account in Year 7, when you deliver the goods.

Information Schedule. If you use this alternative method of treating advance payments for sales of goods, attach to your income tax return for each tax year a statement that shows the following:

1. Total advance payments you received in the current tax year.
2. Total advance payments you received in earlier tax years that you have not included in income before the current tax year.
3. Total payments you received in earlier tax years that you have included in income for the current tax year.

To change to this method of reporting your income, you must first get consent from the IRS.

REVIEW QUESTIONS

CHAPTER 6 – BUSINESS INCOME

1. Which one of the following statements is ***incorrect*** in regard to income to a sole proprietor?
 - A. Cash payments received are income.
 - B. The value of property received is income.
 - C. Payments received from services rendered is income.
 - D. Distributive shares of partnership gross income is not income to a sole proprietor.

2. Sole proprietors sometimes consign merchandise to others to sell. Which one of the following statements is ***incorrect*** in this regard?
 - A. The title to merchandise that you have consigned out remains with you.
 - B. You have no profit until the merchandise has been sold by the consignee.
 - C. Merchandise you receive on consignment is included in your inventory.
 - D. Merchandise that you have shipped out on consignment is included in your inventory until sold.

3. Which one of the following statements is ***incorrect*** in regard to prepaid income?
 - A. Prepaid income is generally included in your gross income in the year that it is received.
 - B. To be treated as your gross income, the amount received must be subject to your free and unrestricted use.
 - C. In order to qualify as gross income to you, you must have free and unrestricted use of it and you must use the cash method of accounting.
 - D. In order to qualify as gross income to you, you must have free and unrestricted use of it, and must use only the accrual method of accounting.

RESPONSES TO REVIEW QUESTIONS

CHAPTER 6 – BUSINESS INCOME

1.

- A. **Correct.** Cash payments received are includible in income whether you are income whether you are a calendar year or a fiscal year taxpayer.
- B. **Correct.** The value of property received is includible in a sole proprietor's income.
- C. **Correct.** Payments received for services rendered including commissions and fringe benefits are includible in income.
- D. **Incorrect.** Distributive shares of a partnership gross income is income to a sole proprietor.

2.

- A. **Correct.** Merchandise you consign to others is not sales. The title remains with you.
- B. **Correct.** You have no profit when the merchandise is consigned out, only when the consignee sells it.
- C. **Incorrect.** Merchandise you receive on consignment should not be included in your inventory. Your profit is realized only when you sell the merchandise.
- D. **Correct.** Merchandise that you ship out on consignment must be included in your inventory until the consignee sells it.

3.

- A. **Correct.** Prepaid income is included in gross income in the year it is received if you have the free and unrestricted use of it.
- B. **Correct.** Prepaid income must be included in income whether you use the cash or accrual method of accounting.
- C. **Correct.** You may use either the cash method or the accrual method.
- D. **Incorrect.** You may use ***either*** the cash method or the accrual method of accounting.

CHAPTER 7

COST OF GOODS SOLD

If you make or buy goods to sell, you are entitled to deduct the cost of goods sold on your tax return. You deduct these costs from your gross receipts. However, to determine these costs, you must maintain inventories. You cannot (correctly) simply count your purchases as your cost of goods sold for the year.

Generally, if you engaged in a trade or business in which the production, purchase, or sale of merchandise was an income-producing factor, you must take inventories into account at the beginning and end of your tax year.

Under this accounting method, inventory costs for raw materials purchased for use in producing finished goods and merchandise purchased for resale are deductible in the year the finished goods or merchandise are sold (but not before the year you paid for the raw materials or merchandise, if you are also using the cash method).

Accrual Accounting Method Required. If you must account for inventories in your business, ***you must use*** an accrual method of accounting for your purchases and sales. The calculation for cost of goods sold (as shown later) is based on the accrual method. This calculation is the same as is included in Form 1040, Schedule C.

Accrual Method Not Required. Personal service businesses, such as those of doctors, lawyers, carpenters, and painters, ***usually are not required*** to use inventories. Their gross business income usually is the same as their gross receipts, and most of them use the cash method of accounting. However, if they also sell or charge for the materials and supplies that are normally used in their businesses or professions, they must use inventories.

FIGURING COST OF GOODS SOLD

Add to your beginning inventory the cost of inventory items purchased during the year, including all other items entering into the cost of obtaining or producing the inventory. From this total, subtract your inventory at the end of the year. The remainder represents the cost of goods sold during the tax period. It should not include selling expenses or any other expenses that are not directly related to obtaining or producing the goods sold.

The following computation of the cost of goods sold is keyed by numbers to a discussion below of each item used in the computation.

1. Inventory at beginning of year.....	\$30,700	
Minus: Cost of merchandise contributed to charitable organizations during the year.....	<u>\$400</u>	\$30,300

Add:

2. Merchandise (or raw materials) purchased during the year.....	\$60,000	
3. Labor.....	20,000	
4. Materials and supplies.....	4,000	
5. Other costs.....	<u>6,000</u>	<u>90,000</u>
6. Cost of goods in inventory.....		\$120,300

Subtract:

7. Inventory at end of year.....	<u>35,000</u>	
8. Cost of goods sold.....	<u>85,300</u>	

1. Inventory at Beginning of Year

For a manufacturer or producer, the beginning inventory includes the total value of raw materials, work in process, finished goods, and materials and supplies used in manufacturing the goods. For merchants, it consists of merchandise held for sale.

2. Merchandise or Raw Materials Purchased

For manufacturers or producers, this includes the cost of all raw materials or parts purchased for manufacture into a finished product. For merchants, it includes all merchandise bought for sale.

Trade Discounts. The differences between the stated prices of articles and the actual prices you pay for them are called trade discounts. The prices ***you pay*** (not the stated prices) ***must be used*** in figuring your cost of purchases. ***Do not*** show the discount amount ***separately*** as an item in gross income.

A dealer must record the cost of an article in inventory reduced by the amount of a manufacturer's rebate that represents a trade discount.

Cash Discounts. Cash discounts are amounts your suppliers let you deduct from your purchase invoices for prompt payments. There are **two methods** of accounting for cash discounts. You may **either** credit them to a separate discount account **or** deduct them from total purchases for the year. Whichever method you use, you must be consistent. If you want to change your method of figuring inventory cost by valuing inventory items at net purchase price (invoice price minus cash discount), you must get consent from the IRS.

If you credit cash discounts to a separate account, you must include this credit balance in your business income at the end of the tax year. If you use this method, do not reduce your cost of goods sold by the cash discounts.

Purchase Returns and Allowances. All returns and allowances must be deducted from your total purchases during the year.

Merchandise Withdrawn from Sale. If you withdraw merchandise for your personal or family use, **you must exclude** this cost from the total amount of merchandise you bought for sale. You do this **by crediting** the purchases or sales account with the cost of merchandise you withdraw for personal use. The amount should be charged to your drawing account. You should keep a separate account of all goods you withdraw **for** personal or family use.

3. Labor

Labor costs usually are an element of cost of goods sold **only** in a manufacturing or mining business. Small merchandising concerns **usually do not have** labor costs that can properly be charged to cost of goods sold. In a manufacturing business, labor costs that are properly allocable to the cost of goods sold **include both** the direct and indirect labor used in fabricating the raw material into a finished, salable product.

Direct Labor. Direct labor costs are the wages paid to those employees who spend **all their time** working directly on the product being manufactured. They also include a part of the wages paid to employees who work directly on the product part time, if that part of their wages can be determined.

Indirect Labor. Indirect labor costs are the wages paid to employees who perform a general factory function that does not have **any immediate or direct** connection with making the salable product, but that is a necessary part of the manufacturing process.

Other Labor. Other labor costs that are not properly chargeable to the cost of goods sold may be deducted as selling or administrative expenses. Generally, the only kinds of labor costs that are properly chargeable to your cost of goods sold are the direct or indirect labor costs, and certain other costs that are treated as overhead expenses properly charged to the manufacturing process, as discussed below under **Other Costs**.

4. Materials and Supplies

Materials and supplies, such as hardware and chemicals, used in manufacturing goods are charged to cost of goods sold. Those that are not used in the manufacturing process are treated as deferred charges, deductible as a business expense when used.

5. Other Costs

Examples of other costs incurred in a manufacturing or mining process that are chargeable to your cost of goods sold are as follows.

Containers. Containers and packages that are an integral part of the product manufactured are a part of your cost of goods sold. If they are not an integral part of the manufactured product, their costs are shipping or selling expenses.

Freight-In. Freight-in, express-in, and cartage-in on raw materials, supplies that are used in production, and merchandise that is purchased for sale are all part of cost of goods sold.

Overhead Expenses. Overhead expenses include such expenses as rent, heat, light, power, insurance, depreciation, taxes, maintenance, labor, and supervision. The overhead expenses you have as direct and necessary expenses of the manufacturing operation **are included** in your cost of goods sold.

COST OF GOODS AVAILABLE FOR SALE

The total of items 1 through 5 represents the cost of goods available for sale during the year.

INVENTORY AT END OF YEAR

The value of your closing inventory (including, as appropriate, the allocable parts of the cost of raw materials and supplies, direct labor, and overhead expenses) is subtracted from the cost of goods available for sale.

COST OF GOODS SOLD

When your closing inventory is subtracted from the cost of goods available for sale, the remainder is your cost of goods sold during the tax year. When you subtract your cost of goods sold from your adjusted gross receipts, the remainder is your gross profit from sales.

INVENTORIES

Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor in your business.

The most common kinds of inventories are:

1. Merchandise or stock in trade,
2. Raw materials,
3. Work in process,
4. Finished products, and
5. Supplies that physically become a part of the item intended for sale.

The value of inventories at the beginning and end of each tax year is required to determine taxable income. To determine the value of your inventory, you need a method for **identifying** the items in your inventory and a method for **valuing** these items.

Inventory valuation rules cannot be the same for all kinds of businesses. The method you use must conform to generally accepted accounting practices used for similar businesses, and it must clearly show income. To clearly show income, you must consistently **use the same** inventory method from year to year.

Items Included in Inventory. Inventories include all your finished or partly finished goods and raw materials and supplies that **will become** a part of the merchandise you intend to sell.

The rules discussed here only apply if they **do not** conflict with the uniform capitalization rules.

Merchandise. You include merchandise in your inventory **only if** you have title to it. You include merchandise you purchase in inventory if title to it has passed to you, even though it is in transit or you do not have physical possession of it for some other reason. Your inventory also includes:

1. Goods under contract for sale that you have not yet segregated and applied to the contract;
2. Goods out on consignment, and
3. Goods that are in display rooms, merchandise mart rooms, or booths that are located away from your place of business.

In figuring gross income, you may be permitted to account for the sale of your product when the goods are shipped, when the product is delivered or accepted, **or** when title to the goods passes to the customer, whether or not billed, depending upon the method you use for keeping your books. Do not include the goods you have sold in your inventory.

Containers. You include containers in your inventory if title to them ***has not passed*** to the buyer of the contents. Containers include such items as kegs, bottles, and cases, whether or not on hand and whether or not returnable. If title has passed to a buyer, ***you exclude*** the containers from inventory. Under certain circumstances, some containers may be depreciated.

C.O.D. Mail Sales. If you sell merchandise by mail and intend payment and delivery to happen at the same time, title passes ***when payment*** is made. Include the merchandise in your closing inventory ***until*** the buyer pays for it.

Items Excluded from Inventory. Exclude from your inventory all goods you have sold, but be sure that the title to them has passed to the buyer. Also exclude goods in your possession that are consigned to you and goods you ordered for future delivery if you do not yet have title to them.

Other Assets. Other assets such as land, buildings, and equipment used in your business, as well as notes and accounts receivable, and similar assets, ***are not included*** in your inventory. Also, real estate held for sale by a real estate dealer in the ordinary course of business is not included in inventory.

COST IDENTIFICATION

There are ***three methods*** of identifying items in inventory--specific identification, first-in first-out (FIFO), and last-in first-out (LIFO).

Specific Identification Method. The specific identification method is used to identify the cost of each inventoried item by matching the item with its cost of acquisition in addition to other allocable costs, such as labor and transportation.

If there is ***no specific identification*** of items with their costs, you must make an assumption to decide which items were sold and which remain in inventory. Make this identification by either the FIFO method, or the LIFO method.

FIFO and LIFO Methods. The ***FIFO method*** assumes that the items you purchased or produced ***first*** are the ***first items you sold***, consumed, or otherwise disposed of.

The items in inventory at the end of the year are valued as the items most recently purchased or produced. If there is intermingling of the same type of goods in your inventory so that ***they cannot be identified*** with specific invoices, ***you must use*** the FIFO method to value these items, unless you elect to use the LIFO method.

The ***LIFO method*** assumes that the items of inventory that you purchased or produced ***last*** are sold or removed from inventory ***first***. Thus, items included in your closing inventory are considered to be, first, those from the opening inventory in order of acquisition and, second, those items acquired in the current year.

The FIFO method and the LIFO method produce different results in income depending on the trend of price levels of the goods included in those inventories. In times of inflation **when prices are rising**, LIFO will produce a **larger cost** of goods sold and a lower closing inventory. Under FIFO, the cost of goods sold will be lower and the closing inventory will be higher. However, in times of **falling prices**, LIFO will produce a **smaller cost of goods sold** and a higher closing inventory. Under FIFO the reverse will be true.

VALUING INVENTORY

Since valuing the items in your inventory is a major factor in figuring your taxable income, the method you use to value your inventory is very important. The two common methods to value non-LIFO inventory are the specific cost identification, or **cost method** and the **lower of cost or market method**.

For a new business not using LIFO, you may select either method to value your inventory. You must use the same method to value your **entire** inventory, and you may not change to another method without the consent from the IRS.

Cost Method. To properly value your inventory at cost, you must include all direct and indirect costs which are associated with it. Apply the following rules:

1. For merchandise on hand at the beginning of the tax year, cost means the **inventory price** of the goods.
2. For merchandise purchased during the year, cost means the **invoice price less** appropriate discounts plus transportation or other charges you incur in acquiring the goods.
3. For merchandise produced during the year, cost means **all direct and indirect costs** which are required to be capitalized under the uniform capitalization rules.

Discounts. You must reduce the cost of your inventory by trade discounts for volume purchases. You may **choose** whether to deduct cash discounts for prompt payment, but you must treat them the same way from year to year. If you **do not deduct** the cash discounts from your inventory costs, you **must include** them in your business income.

Lower of Cost or Market Method. Lower of cost or market means that you compare the market value of each item on hand at the inventory date with its cost and use the lower value as its inventory value. Thus, if at the end of your tax year you had the following items on hand, the value of your closing inventory would be \$600.

<u>Items</u>	<u>Cost</u>	<u>Market</u>	<u>Lower</u>
R	\$300	\$ 500	\$ 300
S.....	200	100	100
T.....	450	200	200
Total.....	<u>\$ 950</u>	<u>\$ 800</u>	<u>\$ 600</u>

If you use this method, you must value each item in the inventory. You may not value the entire inventory at cost (\$950) and at market (\$800) and use the lower figure. If you use the cost method, the value of your closing inventory would be \$950.

Market Value. Under ordinary circumstances and for normal goods, market value means the usual bid price at the date of your inventory. This price is based on the volume of merchandise you usually buy. Thus, if you buy items in small lots at \$10 an item and a competitor buys identical items in larger lots at \$8.50 an item, your usual market price is higher than your competitor's.

Lower Than Market. When, in the regular course of business, you have offered merchandise for sale at prices lower than market, the inventory may be valued at these prices, less the direct costs of disposition. Figure these prices from the actual sales for a reasonable period before and after the date of your inventory. Prices significantly different from the actual prices determined are not acceptable as reflecting the market.

Unsalable Goods. Unsalable goods are goods in your inventory that you cannot sell at normal prices or in the usual way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange. You value these goods at selling prices minus direct costs of disposition, no matter what method you use to value the rest of your inventory. If these goods consist of raw materials or partly finished goods held for use or consumption, they are valued on a reasonable basis, considering the usability and condition of the goods. Do not value them for less than scrap value.

Physical Inventories. You must take physical inventories at reasonable intervals and the book figure for inventory must be adjusted to agree with the actual inventory.

Practices Not Approved. The following are some of the inventory practices ***that are not recognized*** for tax purposes:

1. Deducting a reserve for price changes or an estimated amount for depreciation in the value of your inventory,
2. Taking work in process or other parts of your inventory at a nominal price or less than its full value,
3. Omitting part of your stock on hand,

4. Using a constant price or nominal value for so-called normal quantity of materials or goods in stock,
5. Including stock in transit, shipped either to or by you, the title to which you do not hold,
6. Separating indirect production costs into fixed and variable production cost classifications and then allocating only the variable costs to cost of goods produced while treating fixed costs as period costs that are currently deductible (the direct cost method), or
7. Treating all or almost all indirect production costs (whether fixed or variable) as period costs that are currently deductible (the prime cost method).

Again, the above seven inventory practices **are not** acceptable for income tax purposes.

Gains and Losses. If items included in inventory are damaged by a fire or other casualty, or are stolen, a casualty or theft loss may result. You do not claim a loss if the cost of the damaged or lost goods has been included in cost of goods sold.

REVIEW QUESTIONS

CHAPTER 7 – COST OF GOODS SOLD

1. Which one of the following statements is ***incorrect*** regarding the most common kinds of inventories?
 - A. Raw materials are not items of inventory.
 - B. Work in process is an item of inventory.
 - C. Supplies that physically become a part of the item intended for sale are items of inventory.
 - D. Finished products are items of inventory.
2. Which one of the following is ***not*** a method of identifying items in inventory?
 - A. Specific identification
 - B. First-In, First-Out (FIFO)
 - C. Last-In, First-Out (LIFO)
 - D. Last-In, Last-Out (LILO)

RESPONSES TO REVIEW QUESTIONS

CHAPTER 7 – COST OF GOODS SOLD

1.
 - A. **Incorrect.** Raw materials are used to produce the end product. Their value is included in inventory.
 - B. **Correct.** Work in process is an item of inventory. This phase is the process that produces the final goods to be sold.
 - C. **Correct.** The cost of supplies destined to become part of the finished product must be included in inventory.
 - D. **Correct.** Finished products that will become part of the merchandise that you intended to sell must be included in inventory.
2.
 - A. The ***specific identification*** method requires that you match each item with its cost of acquisition and the selling price of the same item.
 - B. The First-In, First-Out (FIFO) method requires that you sell the item with the oldest acquisition as the first one you sell.
 - C. The Last-In, First-Out (LIFO) method requires that you sell the most recent item acquisition as the first one you sell.
 - D. The Last-In, Last-Out method is ***not*** an acceptable method of valuing inventory.

CHAPTER 8

BUSINESS DEDUCTIONS

This chapter discusses business expenses that you can deduct from gross profit to find the net income or loss of your business. Business expenses are the normal and current costs of operating a business.

To be deductible, a business expense must be **ordinary** in your business and **necessary** for its operation. An ordinary expense is one that is **common and accepted** in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense **does not** have to be **indispensable** to be considered necessary.

EMPLOYEES' PAY

Salaries, wages, and other forms of pay you give employees for work they perform in your business are generally deductible business expenses.

You **cannot deduct** salaries and other payments incurred for constructing capital assets. Instead, you include them in the **basis of the constructed asset** and recover your cost for them through depreciation deductions.

Relatives. You can deduct salaries and wages paid to employees who are your relatives, including your minor child, if the payments meet the **four tests** for deductibility, discussed later.

The question is often asked as to the reason the IRS is "picky" about salaries and wages meeting four tests in order to be **deductible**. At "First Glance" you would think that if a sole proprietor were foolhardy enough to pay wages at random, the IRS wouldn't care. Here's one reason why they do.

A successful sole proprietor in a high tax bracket (in some cases, as high as 35%) might pay "wages" to his minor children who did not perform any work. The sole proprietor would **effectively** be transferring his or her taxable income in the 35% tax bracket to a member of his or her family who would then file a return and pay taxes at the **10% rate**.

Example. Ted operated a highly successful sole proprietorship. Ted paid taxes on a substantial amount of his profits at the top tax bracket of 35%. Ted speculated that he could pay his 6-year old son, Ned, wages that would net Ned \$6,000 in **taxable** income. Ted would then file a tax return for Ned who would owe \$600 in taxes (\$6,000 x 10%). Ted's savings would be \$1,500 (the difference of 35% and 10% (25%) times \$6,000).

Assuming Ted had four children and paid each of them \$6,000 he would have a tax savings of \$6,000 (4 x \$1,500)! The IRS was somewhat less than pleased about Ted's ingenuity. So they established the following tests for employees' pay to be deductible.

Test 1. Ordinary and Necessary. You must be able to show that salaries, wages, and other payments for services employees render are ordinary and necessary expenses and ***are directly connected*** with your trade or business.

The fact that you pay your employees for legitimate business purposes is not sufficient, by itself, for deducting the amounts as business expenses. You can deduct payments for services of your employees ***only*** if the payments are ***ordinary and necessary to carry on*** your trade or business.

Test 2. Reasonable. What is reasonable pay is determined by the facts. Generally, it is the amount that would ***ordinarily*** be paid for these services by like enterprises ***under similar*** circumstances.

You must be able to prove that the pay is ***reasonable***. This test is based on the circumstances at the time you contract for the services, and not those existing when the amount of pay is questioned. If the pay is excessive, you can deduct ***only*** the part that is reasonable.

Factors to be Considered. You should consider the following factors and any other pertinent data to determine if pay is ***reasonable***.

1. The duties performed by the employee,
2. The volume of business handled,
3. The character and amount of responsibility,
4. The complexities of your business,
5. The amount of time required,
6. The general cost of living in the locality,
7. The ability and achievements of the individual performing the service,
8. The pay compared with the amount of gross and net income of the business as well as with distributions to shareholders,
9. Your policy regarding pay for all employees, and

10. The history of pay for each employee.

Test 3. For Services Performed. You must be able to prove that the payments were made for services **actually** performed.

Test 4. Paid or Incurred. You must have actually made the payments or incurred the expense during the tax year.

If you use the cash method of accounting, your expense for salaries and wages can be deducted **only** in the year paid.

If you use an accrual method of accounting, your expense for salaries and wages is deducted when you establish your obligation to make the payments and when economic performance occurs. Economic performance occurs generally when an employee performs his or her services for you.

BONUSES AND GIFTS

You can deduct bonuses and gifts to your employees if they meet certain conditions.

Bonuses. Bonuses you pay to employees are allowable deductions if they are intended as **additional pay for services**, not as gifts, and are paid for services actually performed. However, when you add the bonuses to regular salaries and other pay, the total **must be reasonable** for the services performed to deduct the amount as wages. The bonuses are includible in an employee's income. You can pay bonuses in cash, property, or a combination of both.

Gifts of Nominal Value. If, in order to promote employee goodwill, you distribute turkeys, hams, or other merchandise **of nominal value** to your employees at holidays, the value of these items is **not** salary or wages. You **can deduct** the cost of these items as a business expense.

If you distribute cash, gift certificates, or similar items of easily **convertible cash value**, the value of such items is considered **additional wages** or salary **regardless** of the amount.

VACATION PAY

Vacation pay is any amount you pay or will pay to your employee while the employee is on vacation. It includes amounts you pay an employee even if the employee chooses not to take a vacation. Vacation pay does not include sick pay or holiday pay.

Cash Basis Taxpayers. If you are a cash basis taxpayer, you can deduct vacation pay as wages when you pay your employee.

Accrual Basis Taxpayers. You can deduct vacation pay earned by your employees as wages in the year earned only if you pay it:

1. By the close of your tax year, or
2. If the amount is vested, within 2½ months after the close of the year.

If you pay it later than this, you deduct it in the year actually paid.

EMPLOYEE BENEFIT PROGRAMS

Sole proprietors may provide forms of pay other than cash to their employees. These include life, health, or accident insurance, cafeteria plans, and other benefit programs. The following discussion explains what costs you can and cannot deduct how to claim a deduction on your tax return, whether it is includible or excludable from your employees' income, and whether it is subject to employment and income tax withholding.

ADOPTION EXPENSES

You can deduct the cost of an adoption assistance program you provide for your employees on the "Employee benefit programs" line of your business income tax return.

You can deduct up to \$14,010 in 2019 that you pay or incur under an adoption assistance program for an employee's ***qualified*** adoption expenses.

Adoption Assistance Program. An adoption assistance program must meet all of the following tests.

1. It is a separate written plan that only provides adoption assistance to your employees.
2. It benefits employees who qualify under rules set up by you, which do not favor highly compensated employees or their dependents. To determine whether your plan meets this test, do not consider employees excluded from your plan who are covered by a collective bargaining agreement, if there is evidence that adoption assistance was a subject of good-faith bargaining.
3. It does not pay more than 5% of its benefits during the year for shareholders or owners (or their spouses or dependents). A shareholder or owner is someone who owns (on any day of the year) more than 5% of the stock or of the capital or profits interest of your business.
4. You give reasonable notice of the plan to eligible employees.

5. Employees provide reasonable substantiation that payments or reimbursements are for qualifying expenses.

An adoption assistance program can be part of your cafeteria plan. An adoption assistance program also includes programs that reimburse members of the Armed Forces and Coast Guard for adoption expenses.

Employment taxes. Amounts you pay or incur under your adoption assistance program for an employee's qualifying adoption expenses are not subject to income tax withholding. However, these amounts are subject to social security, Medicare, and federal unemployment taxes.

Form W-2. You must report all qualifying adoption expenses you paid or reimbursed under your adoption assistance program for each employee for the year in box 12 of the employee's Form W-2. Use Code "T" to identify this amount. Also include this amount in the totals for social security wages in box 3 and Medicare wages in box 5.

However, do not include this amount with the employee's wages in box 1

BUSINESS BAD DEBT

If someone owes you money you cannot collect, you have a bad debt. There are two kinds of bad debts—business bad debts and nonbusiness bad debts.

A business bad debt is generally one that comes from operating your trade or business. You may be able to deduct business bad debts as an expense on your business tax return.

Business Bad Debt. A business bad debt is a loss from the worthlessness of a debt that was either of the following.

1. Created or acquired in your business.
2. Closely related to your business when it became partly or totally worthless.

A debt is closely related to your business if your primary motive for incurring the debt is a business reason. Business bad debts are mainly the result of credit sales to customers. They can also be the result of loans to suppliers, clients, employees, or distributors. Goods and services a customer has not paid for are shown in your books as either accounts receivable or notes receivable. If you are unable to collect any part of these accounts or notes receivable, the uncollectible part is a business bad debt.

Note: You can take a bad debt deduction for these accounts and notes receivable only if the amount owed was included in your gross income either for the year the deduction is claimed or for a prior year.

Accrual method. If you use an accrual method of accounting, you normally report income as you earn it. You can take a bad debt deduction for an uncollectible receivable if you have included the uncollectible amount in income.

Cash method. If you use the cash method of accounting, you normally report income when you receive payment. You cannot take a bad debt deduction for amounts owed to you that you have not received and cannot collect if you never included those amounts in income.

SUPPLEMENTAL UNEMPLOYMENT BENEFITS

You can deduct costs you pay to a **welfare benefit fund** which provides supplemental unemployment benefits for your employees if the costs are ordinary and necessary business expenses. Your deduction cannot be more than the fund's **qualified cost** for the tax year.

These amounts are deducted on the line titled "Employee benefit programs" on your business tax return.

Welfare Benefit Fund Defined. A welfare benefit fund is any fund which is part of an employer's plan through which you provide welfare benefits to employees or their beneficiaries.

CAFETERIA PLANS

You can deduct your contributions to a cafeteria plan on the "Employee benefit programs" line of your tax return.

Cafeteria plans, including flexible spending arrangements, are written plans that allow your employees to choose among two or more benefits consisting of cash and qualified benefits.

Generally, a plan that provides for deferred compensation is not a cafeteria plan. However, certain profit sharing or stock bonus plans, and certain life insurance plans maintained by educational institutions can be offered through a cafeteria plan even though they provide for deferred compensation.

Qualified Benefits. Qualified benefits include any other benefits your employees are allowed to exclude from their income because of specific provisions of the law. Generally, qualified benefits include accident or health plans, dependent care assistance benefits, and group term life insurance. The cost of group term life insurance in excess of \$50,000 and employer-provided dependent group term life insurance are includible in gross income.

MEALS AND LODGING FOR EMPLOYEES

Generally, you can deduct the costs of furnishing meals and lodging to your employees if the expense is an ordinary and necessary business expense. You can usually deduct only 50% of the cost of food or beverages you furnish.

If the meals and lodging meet the three rules for exclusion of meals and lodging, described later, their value is not included in the gross income of your employees.

If the value of the meals and lodging is not included in income, it is not subject to social security, Medicare, FUTA, or income tax withholding.

RULES FOR EXCLUSION OF MEALS

For your employees to exclude the value of meals and lodging you furnished to them without charge from their gross income, the meals and lodging must meet the following rules.

Rule 1. The meals or lodging must be furnished on ***your business premises***.

Rule 2. The meals or lodging must be furnished for ***your convenience***.

Rule 3. In the case of lodging (but not meals), the employees must be required to accept the lodging as a ***condition of their employment***. This means that they must accept the lodging in order for them to properly perform their duties.

If the employees have a choice of either receiving additional pay or meals or lodging, you treat the value of the meals or lodging as income to your employees.

EXCLUSION OF FRINGE BENEFITS

You can exclude from your employees' gross income certain fringe benefits that you provide. If the fringe benefits are excludable from income, the benefits are also not subject to federal income tax withholding, social security and Medicare taxes (FICA), or federal unemployment tax (FUTA). The fringe benefits that are excludable from gross income include:

1. A no-additional-cost service,
2. A qualified employee discount,
3. A working condition fringe,

4. A de minimis (minimal) fringe,
5. A qualified transportation fringe, and
6. Certain athletic facilities.

The value of meals you provide to your employees at an eating facility operated by you on or near your business premises is a de minimis fringe only if the annual revenue from the facility equals or exceeds the direct operating costs of the facility.

You can exclude from your employees' gross income the value of an on-premises gym or other athletic facility you provide and operate if substantially all the use during the calendar year is by your employees, their spouses, and their dependent children.

RENT EXPENSE

Rent is any amount you pay for the use of property that you do not own. You can generally deduct rent as an expense only if the rent is for property that you use in your trade or business. If you have or will receive equity in or title to the property, the rent is not deductible.

Unreasonable Rent. You cannot take a rental deduction for rents that are unreasonable. Ordinarily, the issue of reasonableness of the rent will not arise unless you and the lessor are related. Rent paid to a related person is reasonable if it is the same amount that would be paid to a stranger for use of the same property. A percentage rental is reasonable if the rental paid is reasonable.

Rent Paid in Advance. Generally, rent paid in connection with your trade or business is deductible in the year paid or accrued. If you pay rent in advance, you can deduct ***only*** the amount that applies to your use of the rented property during the tax year. The balance can be deducted only over the period to which it applies.

Example 1. In May, you leased a building for 5 years, beginning July 1, and ending June 30, 5 years later. According to the terms of the lease, your rent is \$12,000 per year. You paid the first year's rent (\$12,000) on June 30. On your income tax return for the starting year of the lease, you can deduct only \$6,000 ($6/12 \times \$12,000$).

Example 2. In January, you leased property for 3 years for \$6,000 a year. You paid the full \$18,000 ($3 \times \$6,000$) during the first year of the lease. In the first year of the lease, you can deduct only \$6,000, the part of the rent that applies to the first year. You can deduct the balance (\$12,000) over the remaining 2-year term of the lease, at \$6,000 each year.

TAXES ON LEASED PROPERTY

If you lease business property, you can deduct as additional rent any taxes that you have to pay to or **for the lessor**. When you can deduct these taxes as additional rent depends on your accounting method.

Cash Method. If you use the cash method of accounting, you can only deduct the taxes as additional rent for the tax year in which you pay them.

Accrual Method. If you use an accrual method of accounting, you can deduct taxes as additional rent for the tax year in which you can determine:

1. That you have a liability for taxes on the leased property,
2. How much the liability is, and
3. That economic performance occurred.

The liability and amount of taxes are determined by state or local law, and also by the lease agreement. Economic performance occurs as you use the property.

IMPROVEMENTS BY LESSEE

If you add buildings or make other permanent improvements to leased property, you depreciate the cost of the improvements using the modified accelerated cost recovery system (MACRS). The property is depreciated over its appropriate recovery period. You are **not allowed to amortize** the cost over the **remaining term** of the lease.

If you do not keep the improvements when the lease is terminated, your gain or loss is based on your adjusted basis of the improvements at that time.

BAD DEBTS

If someone owes you, as a sole proprietor, money you cannot collect, you have a bad debt. You can generally deduct the amount of the bad debt owed you when you figure your income for tax purposes. For a bad debt to qualify for the deduction there must be a **true** creditor-debtor relationship between you and the person or organization that owes you the money. There **must be a legal obligation** to pay you a fixed sum of money. You must realize a loss because of your inability to collect the money owed to you.

To take the bad debt deduction, you must show that the debt is **worthless** and will remain that way. You must have taken reasonable steps to collect the debt. However, it is not necessary to go to court if you can show that a judgment from the court would be uncollectible. Bankruptcy is generally good evidence of the worthlessness of at least part of an unsecured and unpreferred debt.

A bad debt can be either totally **or** partly worthless. If you can collect part, but not all, of the amount owed you, you have a partly worthless bad debt. If you cannot collect any of the amount owed you, even if you collected some of it in the past, you have a totally worthless bad debt.

You can take a bad debt deduction **only** if you have an actual loss of money, or if you have already reported the amount you were to be paid as income.

A business deducts its bad debts from gross income when figuring its taxable income. **Unlike nonbusiness** bad debts, you **do not** deduct business bad debts as short-term capital losses. Consequently you are not subject to the \$3,000 per year limitation on capital losses. A sole proprietor can deduct the **entire amount** of the bad debt **in the year** it becomes worthless.

To be deductible as a business bad debt, a debt must **closely relate** to the activity of your business. There must have been a **dominant business reason** for you to have entered into the transaction as the creditor.

Example. John Smith, an advertising agent, made loans to certain clients to retain their business. His **dominant reason** for making these loans was his business. One of these clients later went bankrupt and could not repay him. Since John's business was the dominant reason for making the loan, the debt was a business debt and he can take a business bad debt deduction.

Credit Transactions. Business bad debts are mainly the result of credit sales to customers. They can also be loans to suppliers, clients, employees, or distributors. Goods and services customers have not paid for are shown in your books as either **accounts receivable or notes receivable**.

If you are unable to collect any part of these accounts or notes receivable, the uncollectible part is a business bad debt. Accounts or notes receivable valued at fair market value at the time of the transaction are deductible only at fair market value, even though that value may be less than face value.

You can take a bad debt deduction for your accounts and notes receivable **only** if you **included** the amount owed you in your gross income. This applies to amounts owed you from all sources of taxable income, such as sales, services, rents, and interest.

Accrual Method Taxpayers. Accrual method taxpayers normally report income as they earn it. Therefore, they can take a bad debt deduction when they cannot collect what is owed them, if they included that amount in income.

Cash Method Taxpayers. Cash method taxpayers normally do not report income until they receive payment. Therefore, they **cannot** take a bad debt deduction for payments they have not received or cannot collect.

METHODS OF TREATING BUSINESS BAD DEBTS

There are two ways to treat uncollectible amounts: the specific charge-off and nonaccrual-experience methods. **All taxpayers** except certain financial institutions must generally use the **specific charge-off method**. You can use the nonaccrual-experience method if you meet the requirements, discussed later.

SPECIFIC CHARGE-OFF METHOD

Using the specific charge-off method, you deduct specific business bad debts that become either partly or totally worthless during the tax year.

Partly Worthless Debts. You can deduct specific bad debts that are partly uncollectible. But limit your deduction to the amount you charge off on your books during the tax year. You do not have to **annually** charge off and deduct your partly worthless debts. Instead you **can delay** the charge-off until a later year. You can wait until more of the debt becomes worthless, or collect all you can and it is totally worthless. You cannot, however, deduct any part of a debt **after the year** it becomes totally worthless.

Deduction Disallowed. Usually, you can take a partial bad debt deduction only in the year you make the charge-off on your books.

Totally Worthless Debts. Deduct a totally worthless bad debt **only** in the tax year it becomes totally worthless. The deduction for the debt must not include any amount deducted in an earlier tax year when the debt was only partly worthless.

You do not have to make an actual charge-off on your books to claim a bad debt deduction for a totally worthless debt. However, you may want to do so. If a debt you claim to be totally worthless is not charged off on your books and the IRS later rules that the debt is only partly worthless, you will not be allowed any subsequent deduction. A deduction of a partly worthless bad debt is limited to the amount actually charged off.

Recovery of a Bad Debt. If you deduct a bad debt and later recover (collect) all or part of it, you may have to include the amount you recover in gross income. However, **you can exclude** from gross income the amount recovered up to the amount of the deduction that **did not reduce** your tax in the year deducted.

Example. Fred had gross income of \$158,000, a bad debt deduction of \$3,500, and other allowable deductions of \$49,437. Fred reported on an accrual method of accounting and used the specific charge-off method for bad debts. In the following year, Fred recovers part of the \$3,500 that was deducted in the previous year. Fred must include the part recovered in

income for the current year. The entire bad debt deduction reduced the tax on the previous year's return. Fred reports the recovery as "Other Income" on his current year's business return.

Net Operating Loss. A bad debt deduction can produce or increase a net operating loss. If you have a net operating loss one year, you can carry it back or forward to other tax years and deduct it from income you earned in those years. As a result, a bad debt deduction that contributes to a net operating loss may lower taxes in the year to which you carry the net operating loss.

NONACCRUAL-EXPERIENCE METHOD

If you use an accrual method of accounting and qualify under certain rules, you can use the nonaccrual-experience method of accounting for bad debts. Under this method, you ***do not have to*** accrue income that you ***do not*** expect to collect.

The nonaccrual-experience method applies ***only*** to amounts you will receive (accounts receivable) ***for performing services***. You cannot use it if you charge interest or penalties on late payments. If you determine, based on your experience, ***you will not collect*** your accounts receivable, do not include it in gross income for the tax year.

Performing Services. You can use the nonaccrual-experience method ***only*** for amounts earned by performing services that you would otherwise include in income.

FORMER BUSINESS

If you sell your business but keep its accounts receivable, these debts are business debts ***since they arose*** in your trade or business. If an account becomes worthless, the loss is a business bad debt. These accounts would also be business bad debts if sold to the new owner of the business.

If you sell your business to one person and sell your accounts receivable to someone else, the character of the debts as business or nonbusiness is based on the activities of the holder of these debts. If the new holder engages in a trade or business, a loss from these accounts is a business bad debt. If the new holder does not engage in a trade or business, a loss from these accounts is a nonbusiness bad debt.

DEBTS OWED BY POLITICAL PARTIES

If a political party (or other organization that accepts contributions or spends money to influence elections) owes you money and the debt becomes worthless, you cannot take a bad debt deduction unless you use an accrual method of accounting and meet all the following tests:

1. The debt was from the sale of goods and services in the ordinary course of your trade or business,

2. More than 30% of all your receivables in the year of the sale were from sales made to political parties, and
3. You made substantial continuing efforts to collect on the debt.

INTEREST EXPENSE

Interest is the amount you pay for the use of borrowed money. You can generally deduct all interest you pay or accrue during the tax year on debts related to your trade or business. To deduct the interest paid, you must be legally liable for its payment.

Note: The Tax Cut and Jobs Act limits the net interest deduction to 30% of the businesses adjusted taxable income. Small businesses with average gross receipts of \$25 million or less are **exempt** from this limitation.

ALLOCATION OF INTEREST

The rules for deducting interest vary, depending on whether the loan proceeds are used for business, personal, home mortgage, investment, or passive activities. If you use the proceeds of a loan for more than one expense, you must make an **allocation** to determine the amount of interest for each use of the loan's proceeds.

Example. Dan obtained a \$10,000 unsecured loan. He used \$3,000 of it to consolidate his personal credit card bills and used the remaining \$7,000 in his sole proprietorship business. Seventy percent of the interest he paid on the loan is deductible as a business expense on Schedule C. The remaining 30% is consumer interest and is not deductible.

Allocation Based on the Use of the Loan's Proceeds. You allocate interest on a loan in the same way as the loan is allocated for the same period. Loan proceeds and the related interest are allocated only by reference to the use of the proceeds. Allocation is not affected by the use of property that secures the loan.

Example. You **secure** a loan with property used in **your business**. You use the loan proceeds to buy an automobile for personal use. You must allocate interest expense on the loan **to personal use** (purchase of the automobile) even though the loan is secured by business property. (However, the interest from a qualified home equity loan is deductible as home mortgage interest if you itemize your deductions on Form 1040, Schedule A.)

Loan Repayments. When any part of a loan allocated to **more than one use** is repaid, you are treated as repaying the loan in the following order:

1. Amounts allocated to personal use,
2. Amounts allocated to investments and passive activities,
3. Amounts allocated to trade or business use.

Partial Payments on a Nontax Debt. If you make partial payments on a debt (other than a debt owed to the IRS), the payments, *in the absence* of any agreement between you and the lender, are applied *first to interest* and the remainder to principal. You can deduct only the interest.

INSURANCE

You can deduct the cost of insurance for your sole proprietorship or profession as a business expense if the insurance is an ordinary and necessary expense in carrying on your trade or business.

WHEN TO DEDUCT

You usually deduct premiums in the tax year to which they apply.

Cash Method. If you use the cash method of accounting and you pay a premium for insurance that covers *an earlier tax year*, you can deduct the payment *only* in the tax year it is paid.

If you make an *advance payment* of a premium for an insurance policy that covers *more than one* tax year, you *cannot deduct* the entire premium in the year you make the payment even if you are a cash basis taxpayer. You can deduct *only* the part of the premium that applies to the *current* tax year.

In each later tax year you deduct the part that applies to that year.

Example. You operate a sole proprietorship and file your returns on a calendar year basis. You bought a fire insurance policy on your building effective October 1, and paid in advance a premium of \$1,200 for 2 years. On your return for the year you first bought the policy, you can deduct only the part of the total premium that applies to the 3-months' coverage for the first year. The part of the premium that applies to the second year and third year can be deducted in those years. Since the total policy premium is \$1,200 for 2 years, the yearly rate is \$600 and the monthly rate is \$50. For the 3-month period in the first year of the policy, you can deduct \$150; for the second year, you can deduct \$600; and for the 9-month period in the third year, you can deduct \$450.

If you use the cash method of accounting and you do not pay the \$1,200 premium until January of the second year, you cannot deduct on your return for the first year the \$150 for that year. However, you can deduct \$750 (the \$150 that applies to the first year plus the \$600 that applies to the second year) on your return for the second year.

Accrual Method. If you use an accrual method of accounting, your insurance expense deduction depends on ***when*** economic performance occurs. If you have a liability to make premium payments, economic performance generally occurs as the insurance protection is provided to you.

DEDUCTIBLE PREMIUMS

You can deduct the following kinds of insurance premiums that are related to your sole proprietorship.

1. Fire, theft, flood, or other casualty insurance.
2. Merchandise and inventory insurance.
3. Credit insurance to cover losses from unpaid debts. Report any proceeds from this insurance as ordinary income.
4. Employees' group hospitalization and medical insurance for a group health plan if the plan is required to provide continuation coverage to employees and their beneficiaries when certain events occur.
5. Employers' liability insurance.
6. Liability insurance that covers your liability for bodily injuries suffered by persons who are not your employees and for property damage to others.
7. Malpractice insurance that covers your professional personal liability for negligence resulting in injury or damage to patients or clients.
8. Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in your business, regardless of fault.
9. Contributions to a state unemployment insurance fund. You can deduct these contributions as taxes if they are considered taxes under state law.

10. Use and occupancy and business interruption insurance. This insurance pays you for lost profits if your business is shut down due to a fire or other cause. Report the proceeds as ordinary income.
11. Overhead insurance. This insurance pays you for business overhead expenses you have during long periods of disability caused by your injury or sickness. Report the proceeds as ordinary income.

GENERALLY

Loss of Earnings. You cannot deduct premiums for a policy that pays for your lost earnings due to sickness or disability.

Life Insurance Policies. You cannot deduct premiums on a life insurance policy covering yourself, an employee, or any person financially interested in your business if you are directly or indirectly a **beneficiary** of the policy.

TAXES

If you conduct business as a sole proprietor, deduct your business taxes on Schedule C (Form 1040).

Federal income, estate, and gift taxes and state inheritance, legacy, and succession taxes **are not** deductible.

If you use the cash method of accounting, your deduction for taxes can be taken **only** in the **year paid**. If you use the accrual method, your deduction can be taken only in the year the taxes are properly **accrued**.

Deductible Taxes. Taxes that are deductible are broken down into broad categories:

1. Real estate taxes;
2. State and local income taxes;
3. Employment taxes; and
4. Other taxes.

STATE AND LOCAL INCOME TAXES

State income taxes imposed on an individual are not deductible as an expense of a business even though the taxes were generated solely by the profits from the individual's sole proprietorship. These state income taxes can only be deducted on the sole proprietor's Form 1040, Schedule A as an itemized deduction.

However, a state tax on gross income (as distinguished from net income) directly attributable to a trade or business carried on by a sole proprietor **is** deductible on Form 1040, Schedule C as an expense of the business.

Accrual of Additional State Income Taxes. If an accrual method of accounting is used and liability is contested, any increase in deductible business taxes for a previous year will accrue and be **deductible** in the year the amount is **finally** determined.

OTHER TAXES

The following are other taxes that you can deduct if they are incurred in the ordinary course of your sole proprietorship.

Personal Property Tax. You can deduct any tax imposed by a state or local government on personal property **used** in your trade or business. Personal property taxes are **ad valorem**--that is, the amount of the tax is based on the value of the property.

You can deduct **registration fees** imposed by a state or local government for the right to use property within the state in your trade or business. If the fee is based on value, you can deduct it as a personal property tax.

Sales Tax. If you pay or accrue **sales tax** on the purchase of property, the tax is treated as part of the **cost** of the property. Thus, if you acquire depreciable property for use in a business, any sales tax paid or accrued on the purchase is **added to the basis** of the property and treated as part of the property's cost for depreciation purposes.

If a sole proprietor buys a **nondepreciable** item that is **deductible** as a business expense, the sales tax on the purchase is also deductible as a business expense.

If you pay sales tax on the purchase of merchandise for resale, the sales tax is treated as part of the merchandise cost.

Sales tax imposed on sales of property or services at retail and measured by gross sales price or gross receipts may be deductible. Rentals qualify as sales if so treated under local law.

Sales taxes collected and paid over to the state **are not** deductible if you **have not included** them in gross receipts. If you have included them in gross receipts, you deduct the sales tax on Form 1040, Schedule C.

Sales Tax Imposed on the Seller or Retailer. If state law imposes the sales tax on the seller or retailer and **allows the seller** or retailer to state it separately or pass it on to the consumer, that consumer may deduct, as a business expense, the sales tax paid in purchasing property used in a trade or business, provided that the property is not a capital item (generally, a depreciable asset) or an inventory item. If the property is a capital item

or an inventory item, the consumer (business person) must treat the sales tax as part of the cost of the item.

Use Tax. A compensating use tax is treated as a general sales tax. This tax is imposed on the use, storage, or consumption of an item brought in from another taxing jurisdiction. It is often imposed at the same rate as the general sales tax and is often complementary to a general sales tax on retail sales of similar items in the taxing jurisdiction. It is deductible on Schedule C.

Fuel Taxes. Taxes on gasoline, diesel fuel, and other motor fuels that are used in your business are deductible. They *usually* are included as part of the cost of the fuel itself and are ***not deducted*** as a separate item.

State Unemployment Payments. As an employer, you may be required to make payments to a state unemployment compensation fund or to a state disability benefit fund. These payments ***are deductible*** as taxes.

Franchise Taxes. Corporate franchise taxes are deductible as a business expense. If you are a cash-basis taxpayer, you deduct the franchise tax in the year paid. If you are an accrual-basis taxpayer, you take a deduction in the year you become legally liable to pay the tax regardless of the year the tax is based on.

Excise Taxes. All excise taxes you pay or incur ***as ordinary and necessary*** expenses of carrying on your trade or business can be deducted as operating expenses.

OTHER BUSINESS EXPENSES

Some of the following expenses are deductible by sole proprietors and some are not. So that you may find the different types of expenses more readily, they are in alphabetical order.

Advertising Expenses. You can deduct ***reasonable*** advertising expenses if they relate to your business activities. You cannot deduct the cost of advertising to ***influence legislation***.

You can usually deduct as a business expense the cost of ***public service advertising*** to keep your name before the community if it relates to the business you reasonably expect to gain in the future. For example, the cost of advertising which encourages people to contribute to the Red Cross, to buy U.S. Saving Bonds, or to participate in similar causes is usually deductible.

Foreign Expenses. You ***cannot deduct*** the cost of advertising on foreign radio and television (including cable) where the advertising is primarily for a market in the United States. However, this rule ***only applies*** to advertising expenses in countries ***that deny a deduction*** for advertising on a United States broadcast primarily for that country's market.

Anticipated Liabilities. Anticipated liabilities or reserves for anticipated liabilities **are not** deductible. For example, assume you sold one-year TV service contracts this year totaling \$50,000. From past experience you know you will have expenses of about \$15,000 in the coming year for these contracts. Neither you nor a person controlled by you sold the television sets covered by the contracts.

You **cannot deduct** any of the \$15,000 this year by charging expenses to a reserve or liability account. You can deduct your expenses **only when you actually pay** or accrue them, depending on your accounting method.

Black Lung Benefit Trust Contributions. If you, as a coal mine operator, make a contribution to a qualified black lung benefit trust, you can deduct it.

Bribes and Kickbacks. You cannot deduct bribes, kickbacks, or similar payments **if they are either** of the following:

1. Payments directly or indirectly to an official or employee of **any** government or an agency or instrumentality of any government **in violation of the law**. If the government is a foreign government, the payments are **not** deductible if they are **unlawful** under the Foreign Corrupt Practices Act of 1977.
2. Payments directly or indirectly to a person in violation of any federal or state law **(but only if that state law is generally enforced)** that provides for a criminal penalty or for the loss of a license or privilege to engage in a trade or business.

Meaning of "Generally Enforced". A state law is considered generally enforced **unless** it is never enforced **or** enforced **only** for infamous persons or persons whose violations are extraordinarily flagrant. For example, a state law is generally enforced unless proper reporting of a violation of the law results in enforcement only under unusual circumstances.

A kickback includes a payment for referring a client, patient, or customer. The common kickback situation occurs when money or property is given to someone as payment for influencing **a third party** to purchase from, use the services of, or otherwise deal with the person **who pays** the kickback. In **many cases**, the person whose business is being sought or enjoyed by the person who pays the kickback **does not know** of the payment.

Example. Mr. Green, an insurance broker, pays car dealers who refer insurance customers to him a part of the insurance commissions he earns. The car dealers are not licensed to sell insurance. **If** these payments are made in violation of any federal or state law, as explained in (2) above, Mr. Green **cannot** deduct them.

Medicare or Medicaid. Kickbacks, bribes, and rebates paid in Medicare or Medicaid programs are not deductible.

Form 1099-MISC. If you pay kickbacks, whether or not they are deductible on your return, file an information return, Form 1099-MISC, for every person to whom you pay \$600 or more during the year.

Business Use of Your Home. If you use part of your home ***exclusively and regularly*** as the principal place of business for your trade or business or as a place where you meet or deal with customers in your business, you can deduct the expenses for the part of your home used for business. Also, you may be allowed to deduct expenses for use of part of your home as a day-care facility or as a place to store inventory you sell in your business, even if that part of your home is sometimes used for personal purposes.

Charitable Contributions. In what may come as a surprise to some, sole proprietors ***cannot deduct*** charitable contributions on Form 1040, Schedule C. Charitable contribution ***payments*** can be made from a sole proprietor's ***profits*** but they can be deducted ***only*** on his or her ***individual return*** on Schedule A. There is a reason for this. As you may know, there is a limitation on the amount of charitable contributions ***individuals*** can deduct. The limitation is based on a percentage of adjusted gross income on Form 1040 and further based on the type of gift (cash or property). A sole proprietor could circumvent these limitations if he or she could contribute directly from his or her business and deduct it from income on Schedule C. Thus, this is the reason for not being allowed to deduct charitable contributions on Schedule C.

A sole proprietor ***can deduct*** payments to charitable ***organizations*** if the payments are for qualified business purposes.

Example. You paid \$15 to a local church for a half-page ad in a program for a concert it is sponsoring. You can deduct the \$15 as an advertising expense.

Dues and Subscriptions. You can deduct membership dues you pay to trade or professional organizations. You can also deduct dues you pay to the Chamber of Commerce if your membership promotes your business interests. However, initiation dues or admission fees ***for memberships*** are capital expenses.

You can deduct donations to other business organizations as business expenses if they relate directly to your trade or business, and you reasonably expect a financial return in line with your donation. For example, a contribution you make to a committee organized by a chamber of commerce to bring a national convention to your city may be deductible.

You can deduct as a business expense subscriptions to professional, technical, and trade journals that deal with your business field.

Note. No deduction is allowed for **dues paid** or incurred for membership in any club organized for business, pleasure, recreation, or any other social purpose. This includes business, social, athletic, luncheon, sporting, airline and hotel clubs.

Educational Expenses. You can deduct two kinds of expenses for education. **One** is the ordinary and necessary expenses you pay for the education and training of your employees.

The other is for amounts you spend for **your own** education in your trade, business, or profession, along with certain related travel, including meals, lodging, and transportation expenses. You must be able to show that the education **maintains or improves** skills required in your trade, business, or profession, **or** it is required by law or regulations for keeping your pay, status, or job.

You **cannot** deduct education expenses you incur to meet the **minimum requirements** of your present trade, business, or profession **or** those that qualify you **for a new trade**, business, profession, even if the education maintains or improves skills presently required in your business.

Interview Expense Allowance. Reimbursements you make to **job candidates** for transportation or other expenses for interviews are not wages. They are not subject to social security and Medicare taxes (FICA), federal unemployment taxes (FUTA), or income tax withholding. You can deduct the allowance as a business expense.

Legal and Professional Fees. Legal and professional fees, such as fees charged by accountants, that are ordinary and necessary expenses directly related to your business are deductible as business expenses. However, you usually **cannot** deduct legal fees you pay **to acquire** business assets. Add them to the basis of the property.

If the fees include payments for work of a personal nature (such as making a will), you can take a business deduction only for the part of the fee directly related to your business.

Tax Preparation Fees. You can deduct as a trade or business expense on Schedule C (Form 1040) the cost of preparing **that part** of your tax return relating to your business as a sole proprietor. You can deduct the **remaining** cost on Schedule A (Form 1040) if you itemize your deductions. You should request your tax preparation fees for your **business** be separately stated so your deduction on Schedule C can be supported.

You can also take a deduction on Schedule C for the amount you pay or incur in resolving asserted tax deficiencies for your business.

Licenses and Regulatory Fees. Licenses and regulatory fees for your trade or business paid each year to state or local governments are deductible.

Medical Expenses. If you are disabled, you can deduct expenses necessary for you to be able to work (impairment-related expenses) **as business expenses**, rather than medical expenses.

You can deduct the expenses **as business expenses** if:

1. Your work clearly requires the expenses for you to perform the work satisfactorily,
2. The goods or services purchased are clearly not needed or used, other than incidentally, in your personal activities, and
3. Their treatment is not otherwise specified by other tax law provisions.

Example. Because of a physical handicap, you are confined to a wheelchair. When you attend out-of-town business and professional meetings you have your spouse, a friend, or a colleague go with you to help you overcome architectural barriers, carry your luggage, and accompany you on transportation that does not accept a wheelchair passenger unless accompanied by an attendant. You do not need or use the services of a helper in your personal or business activities in your hometown. You pay no salary to any of your helpers, but you do pay for their travel when they accompany you on trips.

Because your expenses for your helpers are part of travel expenses paid in **carrying on your business** and meet the test above, you generally **can deduct** them as **business expenses**, instead of medical expenses.

Penalties and Fines. Penalties you pay for late performance or nonperformance of a contract are **generally deductible**. For instance, if you contracted to construct a building by a certain date and had to pay an amount for each day the building was not finished after that date, you can deduct the amounts paid or incurred.

On the other hand, you cannot deduct penalties or fines you pay to any government agency or instrumentality because of a **violation of any law**.

A fine or penalty does not include:

1. Legal fees and related expenses to defend yourself in a prosecution or civil action for a violation of the law imposing the fine or civil penalty.
2. Court costs or stenographic and printing charges.
3. Compensatory damages paid to a government.

Nonconformance Penalty. You **can deduct** a nonconformance penalty assessed by the Environmental Protection Agency for failing to meet certain emission standards.

Political Contributions. You **cannot deduct** contributions or gifts to political parties or candidates as business expenses. In addition, you **cannot deduct** expenses you pay or incur to take part in any political campaign of a candidate for public office.

Repairs. The cost of repairing or improving property used in your trade or business is either a deductible **or** capital expense. You can deduct expenses to keep your property in a normal and efficient operating condition. But you **must capitalize** expenses that **add to the value** of your property or significantly increase its life. Although you cannot deduct capital expenses as current expenses, you can usually deduct them over a period of time as depreciation.

Repairs **neither** add to the value or usefulness of property nor do they appreciably lengthen its life. They merely **maintain** the property in a normal efficient operating condition. Deductible repairs include the cost of labor, supplies, and certain other items. However, you **cannot** deduct the value of your own labor.

Examples of repair include:

1. Patching and repairing floors.
2. Repainting the inside and outside of a building.
3. Repairing roofs and gutters.
4. Mending leaks.

Supplies and Materials. You can deduct the cost of incidental supplies and materials, such as office supplies and wrapping paper, used in your business during the tax year. However, if you make unusually large purchases of these items you may not be allowed to deduct the entire cost in the year you buy them.

You can also deduct the cost of books, professional instruments, equipment, etc., if you normally use them up in less than a year.

Utilities. Your business expenses for heat, lights, power, and telephone are deductible. However, any part due to personal use is not deductible.

Telephone. If you have an office in your home that qualifies for use in your business, you cannot deduct the basic local telephone service charge (including any taxes) for the first line you have in your home. However, long distance charges on the first line as well as the cost of a second line used exclusively for business are deductible business expenses.

Cellular Telephone. Effective September 2011, cellular telephones are no longer considered ***listed property***. If listed property is not used more than 50% for qualified business use during any tax year, the section 179 deduction is not allowed and the depreciation deductions are limited.

REVIEW QUESTIONS

CHAPTER EIGHT – BUSINESS DEDUCTIONS

1. In order to deduct wages paid to relatives, the payments must meet certain tests. Which one of the following statements is **incorrect** in this regard?
 - A. You must be able to prove that the services were directly connected to your business.
 - B. You must be able to prove that the payments were made for services actually performed.
 - C. You are not required to prove that the pay was reasonable.
 - D. You must be able to show the wages were ordinary and necessary to carry on your trade or business.

2. An employer can deduct the cost of an adoption assistance program for each employee if the assistance program meets certain requirements. Which one of the following statements is **incorrect** in this regard?
 - A. The plan must be in writing.
 - B. The program cannot be part of a cafeteria plan.
 - C. Employees must be given reasonable notice of the plan.
 - D. The plan must not favor highly compensated owners.

3. Employers can deduct contributions to a “cafeteria” employee benefit plan if certain conditions are met. Which one of the following statements is **incorrect** in this regard?
 - A. The plan may include accident and health benefits.
 - B. The plan may include group term life insurance.
 - C. The plan may include deferred compensation as a benefit.
 - D. The plan may include dependent care assistance benefits.

4. Generally, the value of meals and lodging furnished to an employee by an employer must be included in the employee's gross income. However, if certain conditions are met, the employee can exclude the value. Which one of the following statements is **incorrect** in this regard?
- A. The meals and lodging must be furnished on the employer's business premises.
 - B. The meal and lodging must be furnished for the employee's convenience.
 - C. The employees must be required to accept the lodging as a condition of their employment.
 - D. The employees are not required to accept meals as a condition of their employment.
5. An employer can exclude from an employee's gross income certain benefits that the employer provides. Which one of the following statements is **incorrect** in this regard?
- A. A qualified employee discount is excludable.
 - B. The value of an employee's use of an on-premise athletic facility is excludable.
 - C. Excludable benefits that are not subject to income tax are still subject to social security tax.
 - D. A working condition fringe is excludable.
6. Which one of the following statements is **incorrect** in regard to taxes you have to pay for the lessor?
- A. A taxpayer using the cash method of accounting can only deduct the taxes as additional rent in the year he or she pays them.
 - B. A taxpayer using the accrual method of accounting is not required to have a liability for the taxes.
 - C. A taxpayer using the accrual method of accounting can deduct the taxes only if economic performance has occurred.
 - D. Economic performance occurs only as you use the property.

7. Generally, sole proprietors must use the specific charge-off method in deducting bad debts. Which one of the following statements is **incorrect** in regard to the specific charge-off method?
- A. You can deduct bad debts that are partly worthless.
 - B. You do not have to annually charge-off and deduct annually, your partly worthless debts.
 - C. You can deduct any part of a debt **after** the year in which it becomes totally worthless.
 - D. You do not have to make a charge-off on your books to claim a bad debt deduction for a totally worthless debt.
8. To take a deduction for a bad debt owed to you by a political party, certain conditions must be met. Which one of the following statements is **incorrect** in this regard?
- A. For the debt to be deductible, the debt must have been from the sale of goods and services in the ordinary course of business.
 - B. For the debt to be deductible, more than 30% of all your receivables in the year of the sale were from sales to political parties.
 - C. To be deductible, you must use the cash method of accounting.
 - D. To be deductible you must have made substantial and continuing efforts to collect the debt.
9. When any part of a loan is allocated to more than one use, you are treated as repaying the loan in a certain order. Which one of the following statements is **incorrect** in this regard?
- A. Repayment amounts are first allocated to personal use.
 - B. Repayment amounts are next allocated to investment and passive activities.
 - C. Repayment amounts are next allocated to trade or business use.
 - D. Partial repayment amounts are applied first to principal and then to interest.
10. Fred paid a \$600 insurance premium on his business in July of Year One. The policy covered his property from July 1 of Year One until June 30 of Year Two. What is the correct allocation of the 12-month policy premium?
- A. \$600 in Year One.
 - B. \$600 in Year Two.
 - C. \$300 in Year One and \$300 in Year Two.
 - D. Any allocation that Fred chooses.

11. Which one of the following statements is **incorrect** in regard to the deductibility of insurance premiums related to a sole proprietorship?
- A. Inventory insurance premiums are deductible.
 - B. Credit insurance premium to cover losses from unpaid debts are not deductible.
 - C. Employers' liability insurance premiums are deductible.
 - D. Business interruption insurance premiums are deductible.
12. Which one of the following statements is **incorrect** in regard to a sole proprietor's deductible taxes?
- A. Real estate taxes are deductible.
 - B. Estate and gift taxes are not deductible.
 - C. State and local income taxes are not deductible.
 - D. State inheritance taxes are not deductible.
13. Which one of the following statements is **incorrect** regarding the deduction of taxes by a sole proprietor?
- A. A compensating use tax is treated as a general sales tax and is deductible.
 - B. Fuel taxes paid in connection with your business are deductible.
 - C. Corporate franchise taxes are not deductible.
 - D. Excise taxes you pay as ordinary and necessary business expenses are deductible.
14. Which one of the following statements is **incorrect** in regard to deducting business expenses?
- A. You can deduct anticipated liabilities or reserves the same as a business expense.
 - B. You can deduct advertising expenses relating to your business.
 - C. You can deduct public service advertising.
 - D. You cannot deduct the cost of advertising to influence legislation.

15. Which one of the following statements is **correct** in regard to a sole proprietor deducting charitable contributions made by his sole proprietorship?
- A. The contributions may be deducted as a business charitable contribution.
 - B. The contribution may be made as a contribution on the sole proprietor's income tax return.
 - C. The contribution cannot be made on either his business return or his individual tax return.
 - D. The sole proprietor can allocate 50% to his business return and 50% to his individual return.
16. Certain legal and professional fees that are ordinary and necessary and directly related to your business are deductible as business expenses. Which one of the following statements is **incorrect** in this regard?
- A. Accountant's fees are deductible.
 - B. Tax preparation fees that relate to that part of your tax return relating to your business are deductible.
 - C. Legal fees you pay to acquire business assets are deductible, as an ordinary expense.
 - D. Regulatory fees for your trade or business paid to state or local governments are deductible expenses.
17. Which one of the following statements is **incorrect** in regard to deducting the cost of repairs on your property?
- A. The cost of patching floors is deductible.
 - B. The cost of repainting a building is deductible.
 - C. The cost of your own labor in relation to A and B is deductible.
 - D. The cost of repairing roofs and gutters is deductible.
18. Beth had a qualified home office that she used in her business. She had two phone lines in her home. The basic local telephone service for each line was \$15 per month. What is the maximum deduction she can take for her **basic** monthly local rate?
- A. \$15
 - B. \$30
 - C. \$20
 - D. \$0

RESPONSES TO REVIEW QUESTIONS

CHAPTER 8 – BUSINESS DEDUCTIONS

1.
 - A. **Correct.** The payments must be directly connected to your trade or business to be deductible.
 - B. **Correct.** You must be able to show that the individual had the ability to perform the services and the duties were actually performed by the individual.
 - C. **Incorrect.** To prove the payments were reasonable, you must consider the duties performed, the amount of time the individual worked and the pay compared with the amount of gross and net income of the business.
 - D. **Correct.** To prove the pay was reasonable you must apply your policy regarding pay for all employees, the duties performed by the employee and the amount of time required to receive the pay.
2.
 - A. **Correct.** It must be a separate written plan that only provides adoption assistance to your employees.
 - B. **Incorrect.** An adoption assistance plan can be part of your cafeteria plan. The amounts you pay are not subject to income tax withholding but are subject to employment tax withholding.
 - C. **Correct.** You must give reasonable notice to all eligible employees. Employees must give evidence that the payments are qualifying expenses.
 - D. **Correct.** The plan must not pay more than 5% of its benefits during the year to shareholders or owners.
3.
 - A. **Correct.** The plan may include health plans and dependent care benefits.
 - B. **Correct.** The plan may include group term life insurance. However, the premiums on any amount in excess of \$50,000 must be included in gross income.
 - C. **Incorrect.** The plan may not include deferred compensation.
 - D. **Correct.** The plan may include dependent care assistance benefits and dependent group term life insurance.

- 4.
- A. **Correct.** The meals and lodging must be furnished on the employer's business premises.
 - B. **Incorrect.** The meals or lodging must be furnished for the employer's convenience.
 - C. **Correct.** The employees must be required to accept the lodging (but not the meals) as a condition of their employment. They must accept the lodging in order to properly perform their duties.
 - D. **Correct.** The employee is not required to accept meals as a condition of his or her employment. If the employee accepts additional pay in lieu of meals, the additional pay must be included in income.
- 5.
- A. **Correct.** A qualified employee discount is excludable from income.
 - B. **Correct.** The value of an on-premises athletic facility is excludable if substantially all of its use is by your employees and their families.
 - C. **Incorrect.** If fringe benefits are excludable from income, they are not subject to income tax or employment tax.
 - D. **Correct.** A working condition fringe and a qualified transportation fringe are excludable from gross income.
- 6.
- A. **Correct.** The taxes may be deducted in the year paid, even if the taxes cover more than one year.
 - B. **Incorrect.** An accrual method taxpayer is required to have a liability to pay taxes before they are eligible for the deduction
 - C. **Correct.** Economic performance is required for both cash method and accrual method taxpayers in order to deduct taxes.
 - D. **Correct.** Economic performance does not occur until you use the property. In the case of taxes, it is the time period for which you are liable for the taxes.
- 7.
- A. **Correct.** You can deduct specific bad debts that are partly uncollectible. However, the amount is limited to the amount you charge off each year.
 - B. **Correct.** Instead, you can delay the charge-off until a later year.
 - C. **Incorrect.** You cannot deduct any part of a debt after the year in which it becomes totally worthless.
 - D. **Correct.** However, if a debt you claim to be totally worthless and it is not charged off on your books, you may not be allowed any deduction if the IRS later rules that the debt is only partially worthless.

- 8.
- A. **Correct.** The debt must have been from the sale of goods or services.
 - B. **Correct.** You must have had sales of more than 30% of all your receivables accrued in the year of the sales to political parties in order to deduct any bad debt for them.
 - C. **Incorrect.** You cannot take a bad debt deduction to a political party if you use the cash method or accounting. You must use the accrual method.
 - D. **Correct.** You must have made a substantial and continuing effort to collect a bad debt from a political party before you can deduct it.
- 9.
- A. **Correct.** Any amount of repayment must be first allocated to the personal use.
 - B. **Correct.** After any repayments are allocated to personal use, then the next allocation must be made to investment and passive activities.
 - C. **Correct.** After repayments are allocated to personal use and investment and passive activity uses, the remaining repayment is applied to trade or business use.
 - D. **Incorrect.** In all A, B, and C above, in the absence of a special agreement with the lender, payments are applied to interest first and then to principal.
- 10.
- A. **Incorrect.** Fred must allocate \$300 to Year One and \$300 to Year Two.
 - B. **Incorrect.** Fred must allocate \$300 to Year One and \$300 to Year Two.
 - C. **Correct.** Fred must allocate an amount that reflects the ratio of the **time** between the two partial years the premium covers.
 - D. **Incorrect.** Fred cannot choose an allocation. It must be the same ratio as the two years ratio to the total of the two years.
- 11.
- A. **Correct.** Inventory and merchandise insurance premiums are deductible.
 - B. **Incorrect.** Premiums to cover losses from unpaid debts are deductible. However, you must report any proceeds from this insurance as ordinary income.
 - C. **Correct.** Employer's liability insurance is deductible.
 - D. **Correct.** Insurance premiums for a business interruption are deductible. However, you must report any proceeds you receive from this insurance as ordinary income.

12.

- A. **Correct.** Real estate taxes relating to business activities are deductible as a business expense by a sole proprietor.
- B. **Correct.** Federal income tax and estate and gift taxes ***are not deductible*** as a business expense by sole proprietors.
- C. **Incorrect.** State and local income tax paid by a sole proprietor are deductible on Schedule C, Form 1040.
- D. **Correct.** State inheritance taxes ***are not deductible*** by a sole proprietor as a business expense.

13.

- A. **Correct.** This tax is imposed on the use, storage or consumption of an item brought in from another jurisdiction. It is usually in lieu of a general sales tax.
- B. **Correct.** They usually are included as part of the cost of the fuel itself and are deductible as a separate item.
- C. **Incorrect.** Cash-basis taxpayers deduct the taxes in the year paid. Accrual-basis taxpayers take the deduction in the year they become legally liable to pay the tax regardless of the year the tax is based on.
- D. **Correct.** Excise taxes you pay as ordinary and necessary expenses can be deducted as operating expenses.

14.

- A. **Incorrect.** Anticipated liabilities and reserves are not deductible. You can deduct your expenses ***only*** when you actually pay or accrue them depending on your accounting method.
- B. **Correct.** You can deduct reasonable advertising if they relate to your business activities.
- C. **Correct.** You can deduct the cost of public service advertising to keep your name before the public if you reasonably expect to gain from it in the future.
- D. **Correct.** You cannot deduct the cost of advertising to influence legislation.

15.

- A. **Incorrect.** A sole proprietor cannot deduct a contribution as a business expense. He may, however, deduct it on his individual 1040 return if it otherwise qualifies.
- B. **Correct.** The sole proprietor may deduct a “company” charitable contribution on his 1040 tax return if it otherwise qualifies. However, there is sometimes a “fine line” between what may be an advertisement as opposed to a charitable contribution.
- C. **Incorrect.** Even though the contribution is not deductible on the “business return”, it would generally be deductible on the taxpayers 1040 return.
- D. **Incorrect.** No allocation is allowed. The sole proprietor is not allowed **any** deduction on his “company” return, the entire amount would be allowed on his 1040 return if it otherwise qualifies.

16.

- A. **Correct.** Legal fees and accounting fees that are ordinary and necessary expenses directly related to your business are deductible as business expenses.
- B. **Correct.** The cost of preparing ***the business portion of your tax return (Sch C)*** are deductible on Schedule C. Any fee in excess of this may be deducted on your Schedule A, Form 1040.
- C. **Incorrect.** Legal fees you pay to acquire business assets must be added to the basis of the assets.
- D. **Correct.** They are deductible on Schedule C.

17.

- A. **Correct.** However, you cannot deduct the cost of your own labor.
- B. **Correct.** This applies to the inside or outside of the building.
- C. **Incorrect.** The cost of your labor is not deductible.
- D. **Correct.** Also, the cost of mending leaks is deductible.

18.

- A. **Correct.** Beth is permitted to deduct the cost of the basic local service on ***one line only.***
- B. **Incorrect.** Beth is limited to the cost of one line of basic local service.
- C. **Incorrect.** Beth is allowed to deduct \$15 per month, the cost of basic local service on one line only.
- D. **Incorrect.** Beth is allowed to deduct the cost of the first local line only.

CHAPTER 9

TRAVEL, MEALS, AND ENTERTAINMENT EXPENSES

If you travel from your tax home, you can use this chapter to determine if you have deductible travel expenses. This material covers travel only inside the United States.

Travel Expenses Defined. For tax purposes, travel expenses are ordinary and necessary expenses that you pay while traveling ***away from home*** for your business or profession. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate to your business. An expense does not have to be indispensable to be considered necessary. However, you cannot deduct expenses to the extent they are lavish or extravagant. Deductible expenses include the cost of travel, meals, lodging, business-related entertainment, and gifts. Most deductible travel expenses are listed in the following chart.

If you have expenses for...	Then you can deduct the cost of.....
Transportation	Travel by airplane, train, bus, or car between your home and your business destination. If you were provided with a ticket or you are riding free as a result of a frequent traveler or similar program, your cost is zero. If you travel by ship, see <i>Luxury Water Travel and Cruise</i> (under <i>Conventions</i>) for additional rules and limits.
Taxi, Commuter Bus, and Airport Limousine	Fares for these and other types of transportation that take you between: 1. The airport or station and your hotel, and 2. The hotel and the work location of your customers or clients, your business meeting place, or your temporary work location.
Baggage and Shipping	Sending baggage and sample or display material between your regular and temporary work locations.
Car	Operating and maintaining your car when traveling away from home on business. You can deduct actual expenses or the standard mileage rate, as well as business-related tolls and parking. If you rent a car while away from home on business, you can deduct only the business-use portion of the expenses.
Lodging and Meals	Your lodging and meals if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. Meals include amounts spent for food, beverages, taxes, and related tips. See <i>Meals</i> for additional rules and limits.
Cleaning	Dry cleaning and laundry.

Telephone	Business calls while on your business trip. This includes business communication by fax machine or other communication devices.
Tips	Tips you pay for any expenses in this chart.
Other	Other similar ordinary and necessary expenses related to your business travel. These expenses might include transportation to or from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.

Lavish or Extravagant. You cannot deduct expenses for meals to the extent they are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable based on the facts and circumstances. Expenses will not be disallowed merely because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, night clubs, or resorts.

TRAVEL EXPENSES FOR ANOTHER INDIVIDUAL

You ***cannot deduct*** the travel expenses you pay or incur for an individual, ***including your spouse***, who accompanies you on business travel unless the individual meets ***all*** of the following conditions:

1. The individual is your employee,
2. The individual has a bona fide business purpose for the travel, ***and***
3. The individual would otherwise be allowed to deduct the travel expenses.

If the individual does not meet ***all*** of the above conditions, you ***cannot*** deduct his or her travel expenses.

TRIP PRIMARILY FOR BUSINESS

You can deduct all of your travel expenses if your trip was entirely business related. If your trip was primarily for business and, while at your business destination, you extended your stay for a vacation, made a nonbusiness side trip, or had other nonbusiness activities, you can deduct your business-related ***travel expenses***. These expenses include the travel costs of getting ***to and from*** your business destination and any business-related expenses ***at*** your business destination.

Example. Your business is in Atlanta and you take a business trip to New Orleans. On your way home, you stop in Mobile to visit your parents. You spend \$630 for the 9 days you are away from home for travel, meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days, and your total cost would have been

\$580. You can deduct \$580 for your trip, including the **entire cost** of round-trip transportation to and from New Orleans. The cost of your **meals** is subject to a 50% limit to be discussed later.

STANDARD MEAL ALLOWANCE

Generally, you can use the “standard meal allowance” method as an alternative to the actual cost method. It allows you to use a set amount for your daily meals and incidental expenses (M&IE), instead of keeping records of your actual costs. The set amount varies depending on where and when you travel. In this material, “standard meal allowance” refers to the federal rate for M&IE, discussed later under, ***Amount of the Standard Meal Allowance***. If you use the standard meal allowance, you still must keep records to prove the time, place, and business purpose of your travel.

Incidental Expenses. The term “incidental expenses” means:

- Fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships and hotel servants in foreign countries,
- Transportation between places of lodging or business and places where meals are taken, if suitable meals cannot be obtained at the temporary duty site, and
- Mailing costs associated with filing travel vouchers and payment of employer-sponsored charge card billings.

Incidental expenses do not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the costs of telegrams or telephone calls.

Incidental Expenses Only Method. You can use an optional method (instead of actual cost) for deducting incidental expenses only. The amount of the deduction is \$5 a day. You can use this method only if you did not pay or incur any meal expenses. You cannot use this method on any day that you use the standard meal allowance.

Who Can Use the Standard Meal Allowance. You can use the standard meal allowance whether you are an employee or sole proprietor. You cannot use the standard meal allowance, however, if you are related to your employer.

You can use the standard meal allowance whether or not you are reimbursed for your traveling expenses. If you are not reimbursed or if you are reimbursed under a nonaccountable plan and you are deducting amounts that are more than your reimbursements, you can deduct only 50% of the excess amount.

This 50% limit is figured when you complete 2106, Form 2106-EZ, or Schedule C. If you file Schedule C-EZ, enter the total amount of your business expenses on line 2. You can

only include 50% of the standard meal allowance (or the amount of your meals that exceeds your reimbursement for meals) in that total.

Amount of the Standard Meal Allowance. The standard meal allowance is the federal M & IE rate. The standard rate for most small localities is \$51 a day. The standard meal allowance can vary from city to city throughout the United States. In addition to the **standard** meal allowance, there are 2 higher “standard amounts” at various cities/locations throughout the U.S. Internal Revenue Service Publication 1542, “Per Diem Rates”, and lists over 450 locations where these different rates variously apply. The rates as of this writing range from the standard rate of \$51 a day up to \$74 a day in the highest cost areas of the U.S. And to complicate the matter more, some of these rates are changed at different times during the calendar year. The other method is the High-Low Method. The rate for a low cost locality is \$57 a day and a high cost locality is \$68 a day.

Related to employer. You are related to your employer if:

1. Your employer is your brother or sister, half-brother or half-sister, spouse, ancestor, or lineal descendant.
2. Your employer is a corporation in which you own, directly or indirectly, more than 10% in value of the outstanding stock, or
3. Certain fiduciary relationships exist between you and your employer involving grantors, trusts, beneficiaries, etc.

You may be considered to indirectly own stock, for purposes of (2) above, if you have an interest in a corporation, partnership, estate, or trust that owns the stock or if a family member or partner owns that stock.

However, the **net amount** of these standard meals and incidental allowances that can be deducted is **50% of these standard rates**.

Standard Meal Allowance Not Allowed. You cannot use the standard meal allowance to prove the amount of your meals if you are traveling for **medical, charitable, or moving purposes**. You **can** use it if you are traveling for **investment** reasons. You can also use the standard meal allowance to prove meal expenses you incurred in connection with **qualified educational expenses** while traveling away from home.

ENTERTAINMENT EXPENSES

You may be able to deduct business-related entertainment expenses you have for entertaining a client, customer, or employee and under the new **Tax Cut and Jobs Act** has placed additional limitations on meals and entertainment expenses. **The TCJA has eliminated all directly paid or reimbursed business entertainment expenses** incurred or paid after December 31, 2017 unless they fall under the specific exceptions found under Code Section 274(e) which will be listed below. Business meals provided for

the convenience of the employer are now only 50% deductible where before they were 100% deductible. These meals will be totally nondeductible after 2025 barring further action from Congress.

You must still must continue to account for meals and entertainment expenses by classification in order to apply the correct limitation, with the addition of a new category in 2018 for entertainment meals. So you still must also meet the recordkeeping requirements discussed later.

To be deductible, the expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

Under prior law, the business meal and entertainment expense ***had*** to meet one of two tests:

1. Directly-related test, or
2. Associated test.

This still applies to a point but the tests now state that the meal expenses must be otherwise deductible considering the fact that the expense must be incurred in carrying on business. On the other hand these tests no longer apply to the entertainment expense because the entertainment expense is basically repealed. ***Also, the repeal of the entertainment expense deduction will also eliminate the deduction for meals if the meal is entertainment related.***

EXCEPTIONS TO CODE SECTION 274(e)

- Expenses for food and beverages (and facilities used in connection) furnished on the business premises of the company for their employees.
- Expenses for goods, services, and facilities provided by the company for the entertainment, amusement, or recreation for the employee as employee compensation for such employee.
- Reimbursed expenses
- Expenses for recreational, social or similar activities primarily for the benefit of the employees.
- Expenses incurred which are directly related to business meetings of his employees, stockholders, agents, or directors.

- Expenses directly related and necessary for attendance at a business meeting or convention of any organization such as business leagues, chamber of commerce, real estate boards, boards of trade.
- Expenses for goods, services, and facilities made available to the general public.
- Entertainment expenses for goods and services (including the use of facilities) sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth.
- Expenses includible in income for individuals who are not employees.

THE FOLLOWING EXPENSES REMAIN DEDUCTIBLE SUBJECT TO THE 50% LIMIT

- Meal expenses for business meetings of employees, stockholders, agents, and directors. Office meetings and partner meetings also fall into this category. There must be a business purpose to the meal or else it is totally non-deductible.
- Any meal during business travel. If any portion of the business travel is for personal purposes and not related to the business portion then the meal expenses of the personal portion are non-deductible.
- Meals at a convention, seminar, or any type of meeting even if the meals cost is not separately stated from the cost of the event. If it's not separately stated, the meal cost must be calculated based on reasonableness or per diem rates for that location.
- Meals with people related to the business such as clients, customers, and vendors provided that there is a business purpose or that some benefit to the business will result. The taxpayer must be present and the amount spent is not lavish or extravagant.

THE FOLLOWING EXPENSES WERE 100% DEDUCTIBLE PRIOR TO THE TAX CUT AND JOBS ACT BUT ARE NOW SUBJECT TO THE 50% LIMIT

- Meals provided on the employer's premises to more than half of the employees for the convenience of the employer. Also meals provided to employees occasionally to enable them to work late, work weekends or overtime. While such meals satisfy the *de minimis* rules and are nontaxable to employees, these meals are not 100% deductible as they were prior to tax year 2018.

- Office snacks such as coffee, soft drinks, bottled water, donuts and similar snacks or beverages provided to employees on business premises. These items satisfy the *de minimis* rules fringe benefit rules but are no longer excepted from Section code 274(n)(1).
- Meals provided as part of a package involving a charitable sports ticket. The sports ticket (package) was deductible under prior tax law but is no longer tax deductible.

These expenses will be nondeductible after 2025.

THE FOLLOWING EXPENSES ARE STILL 100% DEDUCTIBLE

- Meal expenses for a company picnic or holiday party.
- Food made available to the public for free such as part of a promotional campaign.
- If the meal expense is included as taxable income to the employee or independent contractor and is included on their W-2 or 1099-Misc Form.
- Meal expenses that are sold to a client or customer.
- Transportation expenses to and from the restaurant for a client business meal.

THE FOLLOWING EXPENSES ARE STILL NONDEDUCTIBLE

- A meal with a customer, client or employee without a business purpose or discussion.
- Club dues such as country clubs, golf clubs and athletic clubs.
- Lavish or extravagant entertainment expenses.

As noted, entertainment expenses are now non-deductible as are meals associated with entertainment activities. Expenses incurred at a club organized for business, pleasure, recreation, or other social purposes are now non-deductible as well, even if related to an active trade or business.

WHAT ENTERTAINMENT EXPENSES ARE DEDUCTIBLE?

Entertainment expenses incurred or paid after December 31, 2017 are nondeductible unless they fall under the exceptions in Code Section 274e which were listed above.

Entertainment. Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Examples include entertaining guests at night clubs; at theaters; at sporting events; on yachts; or on hunting, fishing, vacation, and similar trips.

Entertainment also may include meeting personal, living, or family needs of individuals, such as providing meals, a hotel suite, or a car to business customers or their families.

A Meal as a Form of Entertainment. Entertainment includes the cost of a meal you provide to a customer, or client, whether the meal is a part of other entertainment or by itself. ***A meal sold as a normal course of your business is not entertainment.***

If the meal is entertainment related it is no longer deductible under the Tax Cut and Job Act.

Deduction May Depend on Your Type of Business. Your kind of business may determine if a particular activity constitutes entertainment. For example, if you are a dress designer and have a fashion show to introduce your new designs to store buyers, the show generally is not considered entertainment because fashion shows are typical in your business. But, if you are an appliance distributor and hold a fashion show for the spouses of your retailers, the show generally is considered entertainment.

Taking Turns Paying for Meals or Entertainment. Expenses are ***not*** deductible when a group of business acquaintances take turns picking up each other's meal or entertainment checks without regard to whether any business purposes are served.

Lavish or Extravagant Expenses. You cannot deduct expenses for entertainment to the extent they are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable considering the facts and circumstances. Expenses will not be disallowed merely because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, night clubs, or resorts.

Allocating Between Business and Nonbusiness Expenses. If you entertain business and nonbusiness individuals at the same event, you must divide your entertainment expenses between business and nonbusiness. You can deduct only the business part. If you cannot establish the part of the expense for each person participating, allocate the expense to each participant on a pro rata basis. For example, if you entertain a group of individuals that includes yourself, three business prospects, and seven social guests; ***only 4/11 of the expense*** qualifies for the deduction. You ***cannot deduct*** the expenses for the ***seven social guests*** because those costs are considered nonbusiness expenses.

Trade Association Meetings. You can deduct expenses that are directly related to and necessary for attending business meetings or conventions of certain exempt organizations. These organizations include business leagues, chambers of commerce, real estate boards, trade associations, and professional associations. The expenses of

your attendance must be related to your active trade or business. These expenses are subject to the 50% limit on entertainment expenses.

Entertainment Tickets. *No longer deductible and everything under this heading applies to the prior tax law.*

When figuring your deduction, you can only take into account the face value of the ticket even if you paid a higher price. For example, you cannot include amounts ***in excess of face value*** that you pay to scalpers, ticket agencies, and ticket brokers.

However, different rules apply when the cost of a ticket to a sports event benefits a charitable organization. ***You*** can take into account the ***full cost*** you pay for the ticket, even if it is more than the face value, ***if***:

1. The event's main purpose is to benefit a qualified charitable organization,
2. The entire net proceeds go to the charity, and
3. The event uses volunteers to perform substantially all the event's work.

The 50% limit on entertainment does not apply to any expense covered by a package deal involving a ticket to such a charitable sports event.

Example 1. A golf tournament is organized by the local volunteer fire company with all of the net proceeds from the event going to the acquisition of new fire equipment. The volunteers will run the tournament. You can deduct the entire cost of tickets to this event if they otherwise qualify as an entertainment expense.

Example 2. You purchase tickets to a college football game through a ticket broker. After having a business discussion, you take a client to the game. Net proceeds from the game go to colleges that qualify as charitable organizations. However, since the colleges ***also pay individuals*** to perform services, such as coaching and recruiting, you ***can only use the face value*** of the tickets in determining your deduction. Also, your deduction is subject to the 50% limit.

Skyboxes and Other Private Luxury Boxes. *No longer deductible and everything under this heading applies to prior tax law.* Restrictions generally apply to the amount of entertainment expense you can deduct for the rental of skyboxes and other private luxury boxes for more than one event at the same sports arena. Even if the restrictions explained below do not apply, the deduction is generally subject to the 50% limit on entertainment expenses.

In determining whether a skybox has been rented for more than one event, each game or other performance counts as one event. Therefore, renting a skybox for a series of games, such as the World Series, counts as renting it for more than one event. In addition, all skyboxes that you rent in the same arena, along with any rentals by related parties, are considered in making this determination. Related parties include:

1. Family members (spouses, ancestors, and lineal descendants),
2. Parties who have made a reciprocal arrangement involving the sharing of skyboxes,
3. Related corporations,
4. A partnership and its principal partners, and
5. A corporation and a partnership with common ownership.

If you rent a skybox for more than one event, your deduction is limited to the price of a regular nonluxury box seat ticket.

Example. You pay \$3,000 to rent a 10-seat skybox at X Stadium for three baseball games. The cost of regular nonluxury box seats at each event is \$20 a seat. The allowable amount (subject to the 50% limit) is \$600 $\{(10 \text{ seats} \times \$20 \text{ each}) \times 3 \text{ events}\}$. The net deductible amount is \$300 $(50\% \times \$600)$.

DIRECTLY-RELATED TEST

Under prior law, in order to deduct business meal and entertainment expenses, the expense had to be either directly related to or associated with the active conduct of business or for the production or the collection of income. Under the new tax law this still applies but the rule states that meal expenses must otherwise be deductible. To meet the directly-related test you must show that:

1. The main purpose of the combined business and entertainment was the active conduct of business,
2. You did engage in business with the person during the entertainment period, and
3. You had more than a general expectation of getting income or some other specific business benefit at some future time.

Business is not considered to be the main purpose when business and entertainment are combined on hunting or fishing trips, or on yachts or other pleasure boats, unless you can

show otherwise. Even if you show that business was the main purpose, you generally cannot deduct the expenses for the use of an entertainment facility.

You must consider all the facts including the nature of the business transacted and the reasons for conducting business during the entertainment. It is not necessary to devote more time to business than to the meal. However, if the business discussion is **only incidental** to the meal, it is not directly related.

You are **not required** to show that business income or other business benefit **actually resulted** from each expense.

Expenses Not Considered Directly Related. Expenses generally are not considered directly related when a business meal occurs where, because of substantial distractions; there is little or no possibility of engaging in the active conduct of business. Examples are meetings at night clubs, theaters, sporting events, or essentially social gatherings. This includes cocktail parties, or meetings with a group that includes persons other than business associates at places such as cocktail lounges, country clubs, golf clubs, athletic clubs, or vacation resorts. However, you may still prove that the business meal is directly related by showing that you engaged in a substantial business discussion during the meal.

ASSOCIATED TEST

Even if your expenses do not meet the directly-related test, they may meet the associated test.

To meet the associated test you must show that the meal is associated with your trade or business and that it directly **precedes or follows** a substantial business discussion (defined below).

Generally, any ordinary and necessary expense is associated with the active conduct of your trade or business if you can show that you had a clear business purpose for having the expense. The purpose may be to get new business or to encourage the continuation of an existing business relationship. However, if part of the business meal expense is for persons not closely connected with your guests who attended the substantial business discussion, that part of the expense would not qualify for the associated test.

Substantial Business Discussion. Whether a business discussion is substantial depends on all the facts of each case. You must show that you or your representative actively engaged in a discussion, meeting, negotiation, or other business transaction to get income or some other specific business benefit.

The meeting does not have to be for any specified length of time, but you must show that the business discussion was substantial in relation to the meal. It is **not necessary** that you devote **more time** to business than to the meal.

Meetings at Conventions. You are considered to have a substantial business discussion if you attend meetings at a convention or similar event, or at a trade or business meeting sponsored and conducted by a business or professional organization. However, you must attend the convention or meeting to further your trade or business. In addition, the organization that sponsors the convention or meeting must schedule a program of business activities that is the main activity of the convention or meeting.

Directly Before or After Business Discussion. A business meal that is held on the same day as the business discussion is considered to be held directly before or after the business discussion. However, if the meal and the business discussion are not held on the same day, you must consider the facts of each case to see if the associated test is met. Among the facts to consider is the place, date, and duration of the business discussion.

Also, if you or your business associates are from out of town, you must consider the dates of arrival and departure, and the reasons the meal and the discussion did not take place on the same day.

CLUB DUES

You are not allowed any deduction for club dues and fees. This applies to ***all*** clubs that are organized for business, pleasure, recreation, or other social purposes. You can still deduct specific business expenses (such as meals) that you incur at a club if the expenses meet certain requirements.

RECORDKEEPING

This material discusses the written records you need to keep if you plan to deduct an expense discussed in this chapter. By keeping timely and accurate records, you will have support to show the IRS if your tax return is ever examined.

Proof Required. You must be able to prove (substantiate) your deductions for travel, meals, business gifts, and local transportation expenses. You should keep adequate records or have sufficient evidence that will support your own statement. Estimates or approximations do not qualify as proof of an expense.

Timely Recordkeeping. You do not need to write down the elements of every expense at the time of the expense. However, a record of the elements of an expense or of a business use made at or near the time of the expense or use, and supported by sufficient documentary evidence, has more value than a statement prepared later when generally there is a lack of accurate recall. A log maintained on a weekly basis, which accounts for use during the week, is considered a record made at or near the time of the expense or use.

Adequate Records. You should keep the proof you need for these items in an account book, diary, statement of expense, or similar record, and keep adequate documentary

evidence (such as receipts, canceled checks, or bills), that together will support each element of an expense. Written evidence has considerably more value than oral evidence alone.

PROOF OF TRAVEL EXPENSES

To deduct travel expenses, you **must** be able to prove the following **four** elements:

1. Each **separate amount** you spent for **travel away** from home, such as the cost of your transportation or lodging. **You may total** the **daily cost** of your breakfast, lunch, and dinner, and other incidental elements of such travel if they are listed in reasonable categories, such as meals and taxi fares. If your employer reimburses you using a per diem allowance (including a meals only allowance), you may not need proof of separate amounts spent for meals, lodging, or incidental expenses.
2. The dates you left and returned home for each trip, and the number of days spent on business while traveling away from home.
3. The destination or the area of your travel, described by the name of the city, town, or similar designation.
4. The business reason for your travel or the business benefit gained (or expected to be gained) from your travel.

PROOF OF MEAL EXPENSES

Note: Because entertainment related meals are now treated differently from client business meals, it may be necessary to establish new documentation procedures or information management systems to account for each separate category of meals. Client business meals are deductible only if they are not lavish and extravagant, and only if the taxpayer is present with the client. Now that entertainment-related meals are not deductible it will be necessary to state why the meal expense incurred was not entertainment related.

To deduct meal expenses you **must** be able to prove the following **six** elements:

1. The amount of each separate meal expense. Incidental items, such as taxi fares and telephone calls, may be totaled on a daily basis.
2. The date the meal took place.
3. The name (if any), address or location of where the meal took place.

4. The reason for the business meal, or the business benefit gained or expected to be gained, and the nature of any business discussion or activity that took place.
5. The occupation or other information about the person or persons for whom the business meal expense is being claimed. Include name, title, or other designation sufficient to establish the business relationship to you.
6. The presence of you or your employee at a business meal given for a client.

If you entertain a large number of people, you do not have to record each person's name in a readily identifiable group of people. It is enough to designate the class. However, if the identity of the class is not enough to identify the persons entertained, then each person's name must be listed.

Before or After Business Discussion. To deduct the cost of meals directly before or after a business discussion, you must be able to:

1. Prove items (1), (2), (3), (5), and (6) just listed,
2. Prove the date, place, and duration of the business discussion,
3. Show the nature of the business discussion and the business reason for the entertainment or the business benefit gained (or expected to be gained), and
4. Identify the people who ***participated*** in both the business discussion and in the entertainment activity.

Canceled Check. A canceled check, together with a bill from the payee, ordinarily establishes the cost. However, ***a canceled check by itself does not prove a business expense*** without other evidence to show that it was for a business purpose.

Confidential Information. Confidential information relating to an element of a deductible expense, such as the place, business purpose, or business relationship, need not be put in your account book, diary, or other record. However, the information has to be recorded elsewhere at or near the time of the expense and be available to fully prove that element of the expense.

HOW LONG TO KEEP RECORDS AND RECEIPTS

You must keep proof to support your claim to a deduction as long as your income tax return can be examined. Generally, it will be necessary for you to keep your records for 3

years from the date you file the income tax return on which the deduction is claimed. A return filed early is considered as filed on the due date.

Employees who give their records and documentation to their employers and are reimbursed for their expenses generally do not have to keep duplicate copies of this information.

REVIEW QUESTIONS

CHAPTER NINE – TRAVEL, MEAL, AND ENTERTAINMENT? EXPENSES

1. Which one of the following statements is **incorrect** in regard to deducting travel expenses as a business deduction?
 - A. The expenses must be ordinary and necessary while traveling away from home for your business or profession.
 - B. The expenses must be indispensable to be considered necessary.
 - C. A necessary expense is one that is helpful and appropriate to your business.
 - D. You cannot deduct expenses that are lavish or extravagant.
2. Which one of the following statements is **incorrect** in regard to deductible travel expenses?
 - A. Train fares between your home and your business destination are deductible.
 - B. Travel by airline on a frequent flyer free ticket is deductible.
 - C. Taxi fares from the airport to your hotel are deductible.
 - D. Dry cleaning and laundry expenses are deductible.
3. Which one of the following statements is **incorrect** in regard to deducting expenses for meals?
 - A. You cannot deduct expenses for meals to the extent they are lavish or extravagant.
 - B. A meal expense is not considered lavish or extravagant if it is reasonable based on the facts and circumstances.
 - C. Expenses for meals will not be disallowed merely because they are more than a fixed dollar amount.
 - D. Expenses will not be allowed if they are incurred at deluxe accommodations.
4. Which one of the following statements is **incorrect** in regard to deducting travel expenses for another individual traveling with you?
 - A. The individual must be your employee.
 - B. The individual must have a bona fide business purpose for the travel.
 - C. The individual would qualify for deducting expenses if he or she were traveling alone.
 - D. A taxpayer's spouse traveling with taxpayer is not subject to A, B or C.

5. Amy traveled from her tax home to city "A" on a 2-day business trip. Her round-trip air fare was \$500. After she concluded her two days of business activities, she decided to stay on for two more days for a short vacation. Her lodging expenses were \$100 per day for each of the four days she stayed. What is Amy's combined deductible air fare and lodging expenses for her business trip?
- A. \$450
 - B. \$900
 - C. \$700
 - D. \$500
6. You can deduct a standard amount for your meals and incidental expenses while you are traveling on a business trip. Which one of the following statements is **incorrect** regarding incidental expenses?
- A. Incidental expenses include the cost of laundry and cleaning of clothes.
 - B. Incidental expenses include tips to baggage handlers.
 - C. Incidental expenses do not include expenses for the cost of telephone calls.
 - D. Incidental expenses include tips to hotel servants in foreign countries.
7. In regard to deducting the standard amount for meals instead of the actual cost, which one of the following statements is **incorrect**?
- A. It allows you to deduct a set amount, instead of keeping records of actual meal expenses.
 - B. You still must keep records of the time, place, and business purpose of your travel.
 - C. You cannot use the standard meal allowance if you are an employee.
 - D. A sole proprietor can use the standard meal allowance.
8. Which one of the following statements is **correct** in regard to using the standard meal allowance?
- A. You do not have to keep track of your actual costs.
 - B. You are not required to keep records to prove the meal took place.
 - C. You are not required to keep records to prove the location the meal took place.
 - D. You are not required to keep records to prove the business purpose of your travel.

9. Which one of the following statements is **incorrect** regarding the standard meal allowance?
- A. You cannot use it if you are traveling for medical purposes.
 - B. You cannot use it if you are traveling for charitable purposes.
 - C. You cannot use it if you are traveling for investment reasons.
 - D. You cannot use it if you are traveling for moving purposes.
10. Which one of the following statements is **incorrect** regarding the deduction of business meal expenses?
- A. To be deductible, the expense must be both ordinary and necessary.
 - B. A necessary expense is one that is helpful and appropriate for your business.
 - C. You do not need to meet the recordkeeping requirement.
 - D. An expense does not have to be indispensable to be considered necessary.
11. Business meals provided for the convenience of the employer are entitled to a deduction of a certain percentage of the expense. What is that percentage?
- A. 0%
 - B. 50%
 - C. 75%
 - D. 100%
12. Which one of the following statements is **not** an exception under IRC Code 274(e)?
- A. Expenses for club dues at a country club for an employee.
 - B. Expenses for a company picnic for your employees.
 - C. Expenses for lunch at a company stockholder meeting.
 - D. Expenses includible in income for individuals who are not employees.
13. Which one of the following statements is **incorrect** in regard to proof of your business travel and meal expenses?
- A. You must be able to prove your deductions for travel.
 - B. You must be able to prove your deductions for business gifts.
 - C. You must be able to prove your meal expenses.
 - D. An estimate of your expenses will qualify as proof.

14. Which one of the following statements is **correct** regarding proving your deduction for meal expenses?
- A. You must be able to prove the date the meal took place.
 - B. You are not required to report the occupation or other information about the person who is attending the meal.
 - C. You are not required to prove the amount of each meal expense.
 - D. You are not required to prove the reason for the meal.
15. Which one of the following statements is **incorrect** in regard to proving a business expense?
- A. A cancelled check by itself does not prove a business expense.
 - B. A cancelled check with a bill from the payee ordinarily proves the expense.
 - C. A bill from the payee without a check ordinarily will prove your business deduction.
 - D. Records proving your business expense must be kept as long as your tax return can be audited.
16. You must keep proof to support your claim to a deduction as long as your tax return can be examined. Generally, what is the amount of time?
- A. Three years after the calendar year for which the return is filed.
 - B. Four years after the calendar year for which the return is filed.
 - C. Three years from the date you file the return for which the deduction was claimed.
 - D. Four years from the date you file the return for which the deduction was claimed.

RESPONSES TO REVIEW QUESTIONS

CHAPTER NINE – TRAVEL, MEAL, AND ENTERTAINMENT EXPENSES

1.
 - A. **Correct.** The expenses must be ordinary and necessary while traveling away from home.
 - B. **Incorrect.** The expense must be helpful and appropriate to your business but need not be indispensable to be considered necessary.
 - C. **Correct.** The expense does not have to be indispensable.
 - D. **Correct.** You cannot deduct expenses that are lavish or extravagant.
2.
 - A. **Correct.** Train, airplane, bus or car expenses between your home and your business destination are deductible.
 - B. **Incorrect.** The cost of your flight on a frequent flyer ticket is not deductible.
 - C. **Correct.** Also, taxi fares between your hotel and your business meeting place are deductible.
 - D. **Correct.** Dry cleaning and laundry expenses are deductible.
3.
 - A. **Correct.** You cannot deduct expenses for meals to the extent they are lavish or extravagant. However, an expense is not considered lavish or extravagant if it is reasonably based on the facts and circumstances.
 - B. **Correct.** See “A” above.
 - C. **Correct.** Also, the expenses will not be disallowed because they take place at deluxe restaurants or hotels.
 - D. **Incorrect.** They will not be disallowed because they take place at deluxe accommodations.
4.
 - A. **Correct.** The individual must be your employee.
 - B. **Correct.** Even though the individual is your employee, he or she still must have a bona fide purpose for the travel.
 - C. **Correct.** For the individual to qualify, he or she would have to have qualified if he or she were traveling alone.
 - D. **Incorrect.** A taxpayer’s spouse would have to meet all three of the above conditions.

- 5.
- A. **Incorrect.** Amy can deduct her **round trip** air fare **plus** two days lodging for a \$700 total deduction.
 - B. **Incorrect.** Amy is limited to her round-trip air fare (\$500) plus two days **only** of lodging (\$200).
 - C. **Correct.** Amy is allowed to deduct her \$500 round-trip air fare plus 2 days lodging (\$200) for a total \$700 deduction.
 - D. **Incorrect.** Amy is **not only** allowed to deduct her \$500 round-trip air fare, **but also** two days lodging cost (\$200).
- 6.
- A. **Incorrect.** Incidental expenses are not deductible for laundry, cleaning and pressing.
 - B. **Correct.** Incidental expenses include fees and tips given to porters, bell hops and other service personnel.
 - C. **Correct.** Incidental expenses do not include the cost of telephone calls.
 - D. **Correct.** Incidental expenses include fees and tips to hotel servants in foreign countries.
- 7.
- A. **Correct.** You do not have to keep records of your actual costs.
 - B. **Correct.** You must still keep records to prove the time, place and business purpose of the meal.
 - C. **Incorrect.** An employee can use the standard meal allowance.
 - D. **Correct.** A sole proprietor can use the standard meal allowance.
- 8.
- A. **Correct.** The standard meal allowance allows you to use a **set amount** for your daily meal as incidental expenses. The “set amount” is dictated by the IRS and changes from year to year.
 - B. **Incorrect.** You are required to keep records of the time (date) the meals took place.
 - C. **Incorrect.** You are required to keep records of the place (location) the meals took place.
 - D. **Incorrect.** You are required to keep records of the time, place, and the business purpose of your meals.

- 9.
- A. **Correct.** You cannot use the standard meal allowance if you are traveling for medical purposes.
 - B. **Correct.** You cannot use the standard meal allowance If you are traveling for charitable purposes.
 - C. **Incorrect.** You can use the standard meal allowance If you are traveling for investment purposes.
 - D. **Correct.** You cannot use the standard meal allowance If you are traveling for moving purposes.
- 10.
- A. **Correct.** An ordinary and necessary expense is one that is common and accepted in your field of business.
 - B. **Correct.** It does not have to be indispensable to be considered necessary.
 - C. **Incorrect.** You still need to account for meals and entertainment expenses in order to apply the correct limitation..
 - D. **Correct.** An entertainment expense needs only to be helpful and appropriate in your business to be deductible.
- 11.
- A. **Incorrect.** The maximum amount you can deduct is 50% of the cost.
 - B. **Correct.** You can deduct a maximum amount of 50% of the cost of the meal as a business expense.
 - C. **Incorrect.** The maximum amount you can deduct for your meal and incidental expenses combines is 50%.
 - D. **Incorrect.** The maximum amount you can deduct is 50%
- 12.
- A. **Correct.** Club dues for a country club are still nondeductible as a business expense and does not fall under the exception.
 - B. **Incorrect.** Meal expenses for a company picnic are an exception under 274(e) and are still 100% deductible.
 - C. **Incorrect.** Expenses for lunch at a company stockholder meeting fall under the 274 exception and are 50% deductible.
 - D. **Incorrect.** Expenses includible in income for an individual are a 274e exception and are 100% deductible.

13.

- A. **Correct.** You must keep records of the separate amounts you spent on transportation and lodging costs while away from home.
- B. **Correct.** You must keep records of the cost of business gifts. Estimates or approximations will not qualify.
- C. **Correct.** You must be able to prove the amount of each meal expense including the date, the place, and the reason for the expense.
- D. **Incorrect.** You must have the ***actual*** amount of each expense. Estimates or approximations will not qualify as proof.

14.

- A. **Correct.** You also must prove the name and address of the place the meal took place.
- B. **Incorrect.** You must also include the name and title of your guest in order to establish the business relationship.
- C. **Incorrect.** You are required to prove the amount of each separate expense. Incidental items may be totaled on a daily basis.
- D. **Incorrect.** As an alternative, you may prove the business benefit gained and the nature of any business discussion that took place.

15.

- A. **Correct.** A cancelled check by itself will not qualify as proof of an expense.
- B. **Correct.** Cancelled checks together with a bill from the payee will ordinarily qualify as proof of an expense.
- C. **Incorrect.** A bill alone from a payee ordinarily will not prove an expense.
- D. **Correct.** Records proving your business expenses must be kept for as long as your tax return can be audited.

16.

- A. **Incorrect.** It is three years from the date ***you file the return.***
- B. **Incorrect.** It is three years from the date ***you file the return.***
- C. **Correct.** But note that a return filed early is considered as filed on the due date.
- D. **Incorrect.** It is ***three years*** from the date you file the return on which the deduction is claimed.

CHAPTER 10

DEPRECIATION

INTRODUCTION

The material included in this chapter is divided into three sections:

- Section I. MACRS Depreciation, the General Depreciation System (GDS),
- Section II. The section 179 deduction, and
- Section III. Listed property (including automobiles).

Form 4562, ***Depreciation and Amortization*** is used to report MACRS, section 179 and listed property depreciation. However, some taxpayers are exempt from filing Form 4562. To be exempt the taxpayer must not have had:

1. Any depreciation or amortization of property placed in service in the year for which the tax return is filed,
2. Any section 179 expense (including carryovers),
3. Any depreciation on listed property (no matter when it was placed in service),
4. Any auto mileage expense deduction using the standard mileage rate (unless Form 2106 was used).
5. A deduction for amortization of costs that began in the year for which the return was filed.

As example, if a taxpayer placed no assets in service in the current year and had depreciation only from rental real estate placed in service prior to the current year, the taxpayer **would not** be required to file Form 4562. The basis and amounts claimed for depreciation should be part of your permanent books and records. However, you are not required to attach any record to your tax return. Form 4562, Part III, provides for the inclusion of depreciation of assets placed in service in prior years. A worksheet for calculating this depreciation is included at the end of this chapter. It may be copied and used if desired.

You should prepare and submit a separate Form 4562 for each business or activity on your return. However, complete **only one** Part I **in its entirety** when computing your allowable section 179 expense deduction.

WHAT CAN BE DEPRECIATED

You can depreciate most types of tangible property (except land), such as buildings, machinery, vehicles, furniture and equipment. You can also depreciate certain intangible property, such as patents, copyrights and computer software.

For property to be depreciable, it must first meet all of the following basic requirements:

1. It must be property you own.
2. The property must be used in business or held to produce income,
3. The property must have a determinable useful life longer than one year, and
4. The property must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes.

To claim depreciation, you usually must be the owner of the property. You are considered as owner of the property even if it is subject to debt.

Example 1. Tom made a down payment to purchase rental property and assumed the previous owner's mortgage. Tom now owns the property and can now depreciate it.

Example 2. John bought a new van which he will use exclusively for his courier business. He will be making payments on the van over the next 5 years. John owns the van and can depreciate it.

Leased property. You can depreciate leased property only if you retain the incidents of ownership in the property. This means you bear the burden of exhaustion of the capital investment in the property. Therefore, if you lease property from someone to use in your business or for the production of income, you generally cannot depreciate its cost because you do not retain the incidents of ownership. You can, however, ***depreciate any capital improvements you make to the property.***

Incidents of ownership. Incidents of ownership in property include the following:

1. The legal title to the property.
2. The legal obligation to pay for the property.
3. The responsibility to pay maintenance and operating expenses.
4. The duty to pay any taxes on the property.

5. The risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion.

Life tenant. Generally, if you hold business or investment property as a life tenant, you can depreciate it as if you were the absolute owner of the property.

Cooperative apartments. If you are a tenant-stockholder in a co-op housing corporation and use your co-op apartment in your business or for the production of income, you can depreciate your stock in the corporation, even though the corporation owns the property.

AMORTIZATION OF CERTAIN INTANGIBLES

A major change in the treatment of certain intangibles (goodwill, patents, copyrights, etc.) became effective for acquisitions after August 10, 1993.

You can amortize **over 15 years**, the capitalized costs of certain intangibles that you acquire. These intangibles are called "amortizable **section 197 intangibles**" and are defined later. They must be held in connection with your trade or business or in an activity engaged in for the production of income. The amount of your deduction is the adjusted basis (for purposes of determining gain) of the intangible amortized over a 15-year period beginning with the month acquired. No other depreciation or amortization deduction is allowed for section 197 intangibles. (Do not confuse "**Section 197**" with "**Section 179**." Section 179 applies to an "expense" deduction to be discussed later.)

SECTION 197 INTANGIBLES

The following assets are section 197 intangibles:

1. Goodwill,
2. Going concern value,
3. Workforce in place including its composition, terms, and conditions (contractual or otherwise) of employment,
4. Business books and records, operating systems, and any other information base including lists, or other information with respect to current or future customers,
5. A patent, copyright, formula, process, design, pattern, know-how, format, or similar item,
6. A customer-based intangible,
7. A supplier-based intangible,

8. A license, permit, or other right granted by a governmental unit or agency,
9. A covenant not to compete entered into in connection with an acquisition of an interest in a trade or business, and
10. A franchise, trademark, or trade name.

You cannot amortize any of the intangibles listed in items 1 through 7 that you created, unless you created it in connection with the acquisition of a substantial portion of a business. A 15-year useful life is assigned to ***all*** of the above intangibles notwithstanding what the actual useful life may be.

WHAT CANNOT BE DEPRECIATED

Certain property cannot be depreciated. This includes land and certain excepted property.

Land. Land cannot be depreciated because it does not wear out, become obsolete or get used up. The cost of land usually includes the cost of clearing, grading, planting, and landscaping.

Although land cannot be depreciated, you can depreciate certain land preparation costs, such as landscaping, incurred in preparing land for business use.

Excepted Property. Even if requirements for a property to be depreciable are met, you cannot depreciate the following property.

- Property placed in service and disposed of in the same year.
- Equipment used to build capital improvements. Any allowable depreciation on the equipment during the period of construction must be added to the basis of the improvements.
- Section 197 intangibles. You must amortize these costs.
- Certain term interests.

Certain term interests. You cannot depreciate a term interest in property created or acquired after July 27, 1989, for any period during which the remainder interest is held, directly or indirectly, ***by a person related to you.*** A term interest in property means a life interest in property, an interest in property for a term of years, or an income interest in a trust.

PLACED IN SERVICE

For depreciation purposes, property is considered placed in service when it is ready and available for a specific use, whether in trade or business, the production of income, a tax-exempt activity, or a personal activity. Even if the property is not actually used yet, it is in service when it is ready and available for its specific use. However, depreciation is allowable only when the property is used in a trade or business or for the production of income.

Example 1. You bought a home in 2009 and used it as your personal residence until the current year when you converted it to rental property. Although its specific use was personal and no depreciation was allowable, the home was placed in service in 2009. However, you can claim a depreciation deduction in the current year because its use changed to a business use at that time.

Example 2. You are a farmer and bought a planter for your farm business late in the year after harvest was over. You take a depreciation deduction for the planter for that year since it was ready and available for its specific use.

RETIRED FROM SERVICE

A retirement is a permanent withdrawal of depreciable property from use in a trade or business or an income-producing activity even if you have not fully recovered its costs or other basis. When a retirement occurs, the period for depreciation ends.

You retire property from service when you permanently withdraw it from use in a trade or business or from use in the production of income because of any of the following events:

- The property is sold or exchanged..
- The property is converted to personal use.
- The property is abandoned.
- The property is destroyed.
- The property is transferred to a supplies or scrap account.

IDLE PROPERTY

You must claim a deduction for depreciation on property usually used in your business but temporarily idle. For example, treat an item of property as used in your business even if there is a temporary lack of a market for the product made with that item of property.

Dispositions. A disposition is the permanent withdrawal of property from use in your trade or business or in the production of income. A withdrawal can be made by sale, exchange, retirement, abandonment, or destruction. You generally recognize gain or loss on the disposition of an asset by sale.

Abandoned Property. If you physically abandon property, you can deduct as a loss the adjusted basis of the asset at the time of its abandonment. Your intent must be to discard the asset so that you will not use it again or retrieve it for sale, exchange, or other disposition.

INCORRECT AMOUNT OF DEPRECIATION DEDUCTED

If you deducted an incorrect amount of depreciation in any year, you may be able to make a correction by filing an amended return for that year. See ***Filing an Amended Return***, next. If you are not allowed to make the correction on an amended return, you may be able to change your **accounting method** to claim the correct amount of depreciation. See ***Changing Your Accounting Method***, later.

FILING AN AMENDED RETURN

You can file an amended return to correct amount of the depreciation claimed for any property in any of the following situations.

- You claimed the incorrect amount because of a mathematical error made in any year.
- You claimed the incorrect amount because of a posting error made in any year.
- You have not adopted a method of accounting for property placed in service by you in tax years ending after December 29, 2003.
- You claimed the incorrect amount on property placed in service by you in tax years ending before December 30, 2003.

Adoption of Accounting Method Defined. Generally, you adopt a method of accounting for depreciation by using a permissible method of determining depreciation when you file your first tax return, or by using the same impermissible method of determining depreciation in two or more consecutively filed tax returns.

When to File. If an amended return is allowed, you must file it by the later of the following.

- 3 years from the date you filed your original return for the year in which you did not deduct the correct amount. A return filed before an unextended due date is considered filed on that due date.

- 2 years from the time you paid your tax for that year.

CHANGING YOUR ACCOUNTING METHOD

Generally, you must get IRS approval to change your method of accounting. You generally must file Form 3115, ***Application for Change in Accounting Method***, to request a change in your method of accounting for depreciation.

The following are examples of a change in method of accounting for depreciation.

- A change from an impermissible method of determining depreciation for depreciable property, if the impermissible method was used in two or more consecutively filed tax returns.
- A change in the treatment of an asset from nondepreciable to depreciable or vice versa.
- A change in the depreciation method, period of recovery, or convention of a depreciable asset.
- A change from not claiming to claiming the special depreciation allowance if you did not make the election to not claim any special allowance.
- A change from claiming a 50% special depreciation allowance to claiming a 30% special depreciation allowance for qualified property (including property that is included in a class of property for which you elected a 30% special allowance instead of a 50% special allowance).

Changes in depreciation that are not a change in the method of accounting (and may only be made on an amended return) include the following.

- An adjustment in the useful life of a depreciable asset for which depreciation is determined under section 167.
- A change in use of an asset in the hands of the same taxpayers.
- Making a late depreciation election or revoking a timely valid depreciation election. If you elected not to claim any special allowance, a change from not claiming to claiming the special allowance is a revocation of the election and is not an accounting method change. Also, if the property is qualified property, a change from not claiming to claim any special allowance is a late election and is not an accounting method change.

- Any change in the placed-in-service date of a depreciable asset.

SECTION I

MODIFIED ACCELERATED COST RECOVERY SYSTEM (MACRS)

THE GENERAL DEPRECIATION SYSTEM (GDS)

The MACRS General Depreciation System applying to tangible property placed in service after 1986 is discussed in this section. The rules for the section 179 deduction and for listed property and passenger automobiles are discussed in subsequent sections.

Depreciable Basis. To deduct the proper amount of depreciation each year, first determine your depreciable basis in the property. The basis used for figuring MACRS depreciation is your original basis in the property reduced by any section 179 deduction claimed on the property.

Your original basis is usually the purchase price. However, if you acquire the property in some other way, such as inheriting it, receiving it as a gift, or building it yourself, you have to figure your original basis in another way.

Property Converted to Business or Rental Use. When you hold property for personal use and change it into business use or use in the production of income, such as rent, the basis for depreciation is the lesser of:

1. The fair market value (FMV) of the property on the date of the change, or
2. Your original cost or other basis of the property, plus the cost of any permanent improvements or additions since you got it, and minus deductions for any casualty losses claimed on earlier years' income tax returns and other charges to basis.

PROPERTY CLASSES AND RECOVERY PERIODS

Each item of property depreciated under the general rule of the MACRS regular GDS, is assigned to a property class. The property classes establish the number of years over which the basis of items in a class is recovered. This period of time is called a recovery period. The eight main classes of property are:

3-Year Property. This class includes tractor units for use over-the-road and any race horse over 2 years old when placed in service (All race horses placed in service after December 31, 2008, and before January 1, 2018, are

deemed to be 3 year property, regardless of age.) Any other horse over 12 years old when placed in service. Any qualified rent-to-own property.

5-Year Property. This class includes automobiles, taxis, buses, trucks, computers and peripheral equipment, office ***machinery*** (typewriters, calculators, copiers, etc.), and any property used in research and experimentation. Also appliances, carpets, furniture used in a residential rental real estate activity. Breeding cattle and dairy cattle. Certain geothermal, solar, and wind energy property.

7-Year Property. This class includes office furniture and fixtures (desks, files, and safes). Agricultural machinery and equipment, railroad track, certain motorsports entertainment complex property placed in service before January 1, 2018. Any natural gas gathering line placed in service after April 11, 2005. Also, any property that does not have a class life and has not been designated by law as being in any other class.

10-Year Property. This class includes vessels, barges, tugs, similar water transportation equipment, any single purpose agricultural or horticultural structure, and any tree or vine bearing fruits or nuts. Also qualified small electric meter and qualified smart electric grid system placed in service on or after October 3, 2008.

15-Year Property. This class includes roads, shrubbery, wharves (if depreciable), and any municipal wastewater treatment plant. Any retail motor fuels outlet, any qualified leasehold improvement property placed in service before January 1, 2018. Initial clearing and grading land improvements for gas utility property.

20-Year Property. This class includes farm buildings and any municipal sewers not classified as 25 year property. Initial clearing and grading land improvements for electric utility transmission and distribution plants.

25-Year Property. This class is water utility property, which is either of the following, property that is an integral part of the gathering, treatment, or commercial distribution of water, and without regard to this provision would be 20-year property. Also, municipal sewers other than property placed in effect at all times since June 9, 1996.

Residential Rental Property. This class includes any real property that is a rental building or structure (including mobile homes) for which 80% or more of the gross rental income for the tax year is rental income from ***dwelling units***. If any part of the building or structure is occupied by the taxpayer, the gross rental income includes the fair rental value of the part the taxpayer occupies. This property is depreciated over 27.5 years. A dwelling unit is a house or apartment used to provide living accommodations in a building

or structure. It **does not include** a unit in a hotel, motel, inn, or other establishment where **more than half** the units are used on a transient basis.

Nonresidential Real Property. This class includes any real property that is not residential rental property, usually commercial rental property. The recovery period for nonresidential real property is:

- 31.5 years for property you placed in service **before** May 13, 1993, or
- 39 years for property you placed in service **after** May 12, 1993.

Additions or Improvements to Property. Additions or improvements you make to any property, including **leased property**, are treated as separate property items for depreciation purposes. The recovery period for an addition or improvement to property begins on the later of:

1. The date the addition or improvement is placed in service, or
2. The date the property to which the addition or improvement is made is placed in service.

The recovery class **of the addition or improvement** is the recovery class that would apply to the **underlying property** if it were placed in service **at the same time** as the addition or improvement.

Example. You own a residential rental house that you are depreciating under ACRS. If you put an addition on the house which you place in service on January 31, of the current year, you use MACRS to depreciate the addition. Under MACRS, the addition is depreciated as residential rental property because the house to which the addition is made would be residential rental property if it had been placed in service on January 31, of the current year.

Office in the Home. If you begin to use part of your home as an office before May 13, 1993, you depreciate that part of your home as nonresidential real property under MACRS, 31.5 years recovery period. If you begin to use part of your home as an office **after** May 12, 1993, you depreciate it over **39 years**.

DEPRECIATION METHODS

The MACRS General Depreciation System provides three ways to depreciate property, the 200% and the 150% declining balance method and the straight line method over a GDS recovery period (if elected).

Under the declining balance methods, you get larger deductions in the early years of the recovery period. Your deduction for depreciation of your property gets smaller each year.

Under the straight line method, you deduct the depreciable basis of your property in equal annual amounts over its GDS recovery period.

The 200% and 150% Declining Balance Methods. For property in the 3-, 5-, 7-, or 10-year class, you can use the double (200%) declining balance method over the 3, 5, 7, or 10 year GDS recovery period. For property in the 15- or 20-year class, you can use the 150% declining balance method over the 15 or 20 year GDS recovery period. For these classes of property, you change to the straight line method in the first tax year for which that method, when applied to the adjusted basis at the beginning of the year, will yield a larger deduction. You must always use the straight line method for residential rental and nonresidential real property from the first date the property is placed in service.

You can figure your GDS depreciation in one of two ways:

1. You can actually compute the deduction using the applicable depreciation method and convention over the recovery period of the property, or
2. You can use the MACRS GDS percentage tables located later in this section. These percentage tables have the "switch to straight line method" built into their percentages.

Tax preparers who manually prepare tax returns almost universally use these precalculated percentages from the tables.

CONVENTIONS

The General Depreciation System simplifies the way you figure your depreciation deduction by providing three preset conventions. These conventions determine how many months you can depreciate your property in the first year it is placed in service and in the year of disposition.

Half-Year Convention. Incorporated in Table A is what is called the ***Half-Year Convention***. What this means is that a ***half-year*** of depreciation is allowable for the first year property is placed in service, ***regardless of when*** the property is placed in service during the tax year. For each of the remaining years of the recovery period, you will take a ***full year*** of depreciation. If you hold the property for the ***entire recovery period***, a ***half-year*** of depreciation is allowable for the ***year following*** the end of the recovery period. If you dispose of the property before the end of the recovery period, a half-year of depreciation is allowable for the year of disposition. This half-year convention applies only to personal property.

Example. Tom paid \$5,000 for a machine for use in his business. He bought the machine on September 1, and placed it in service the same day. The machine qualified as a 5-year property. Tom refers to Table A (included later), in the column for 5-year property on the line for the first

year depreciation rate and determines that 20% is the applicable rate. This 20% includes a calculation for the IRS applicable declining balance method (200%) and divided in half to reflect the **half-year** convention. Tom's depreciation for the first year is \$1,000 ($\$5,000 \times 20\%$). For the following year, Tom's depreciation is \$1,600 ($\$5,000 \times 32\%$).

However, it may be important that you understand how the percentages in the tables were arrived at. First, each class of property is assigned a specific method of depreciation as follows:

For property in the 3-, 5-, 7-, or 10-year class, you use the double (200%) declining balance method over 3, 5, 7, or 10 years **and** a half-year convention. For property in the 15- or 20-year class, you use the 150% declining balance method over 15 or 20 years **and** a half-year convention. For these classes of property, you change to the straight line method for the first tax year for which that method when applied to the adjusted basis at the beginning of the year will yield a larger deduction. (In addition to the above half-year convention there is also, under specified circumstances, a **mid-quarter convention** which will be discussed later.)

Example. On January 2, Larry paid \$8,000 for a qualifying 5-year machine to be used in his business. Larry placed the machine in service on the same day he acquired it. Five-year property is depreciated by using the 200% declining balance depreciation method. Straight line depreciation is 20% per year, so 200% declining balance is 40%. At first it would appear that Larry could deduct \$3,200 depreciation ($40\% \times \$8,000$). However, because of the half-year convention, Larry is allowed only \$1,600 depreciation ($\$3,200$ divided by 2).

Mid-Month Convention. For nonresidential real and residential rental property, a mid-month convention is used in **all** situations. Under a **mid-month convention**, all property placed in service or disposed of during any month, is treated as placed in service, or disposed of, on the **midpoint** of the month.

Mid-Quarter Convention. If, during any tax year, the **total basis** of depreciable property placed in service during the **last 3 months** of that tax year exceeds 40% of the total basis of **all** depreciable property placed in service during the entire tax year (whether or not all of the property is subject to MACRS), you must use a **mid-quarter convention** instead of half-year convention. In determining the total basis of the property, you do not include the basis of **either**:

1. Residential rental property,
2. Nonresidential real property, or
3. Property placed in service and disposed of in the same tax year.

Under a mid-quarter convention, **all property** placed in service, or disposed of, **during any quarter** of a tax year is treated as placed in service, or disposed of, **on the midpoint** of the quarter.

Example 1. Helen operated a flower shop. Helen was in need of a new refrigeration display case. Helen decided to buy the unit in December so she could obtain the benefit of a tax deduction for the year. On December 1, Helen bought **and** placed in service a unit that cost \$15,000. The refrigeration unit qualified as 7 year property. Helen does not elect to deduct any section 179 expense (to be discussed later) and this unit is the **only asset** she placed in service in the year. Helen had assumed that she would be eligible to deduct 14.29% of the \$15,000 cost (the predetermined percentage from Table A of this chapter) (included later).

However, because the \$15,000 acquisition represents **more than 40%** of her total acquisitions for the year, (it actually represents 100%), Helen **cannot use** Table A with half-year convention benefits.

Instead, Helen must use Table E which incorporates **mid-quarter** convention. Helen is allowed only 3.57% of the \$15,000 asset cost. This amount represents a calculation based of the date of November 15, **the midpoint** of the fourth quarter of the year, otherwise referred to as the mid-quarter convention.

Example 2. Assume all of the facts in Helen's Example 1 are the same; except that, Helen had bought and placed in service a 7-year property asset costing \$5,000 on June 1. However, since the December \$15,000 acquisition is still **more than 40%** (it's 75%) of her total acquisitions for the year, Helen must still use the mid-quarter convention. She uses **Table E for the December** acquisition (3.57%) and **Table C for the June acquisition** (17.85%).

For the following year, Helen uses the second horizontal line of Table E for her December acquisition (27.55%) and the second horizontal line of Table C for her **June acquisition** (23.47%).

In summary, if a taxpayer acquires assets in each of the four calendar quarters and his or her acquisitions in the **fourth quarter** total **more than 40%** of the total acquisitions for the year, the mid-quarter convention must be used for the assets that were acquired in **each of the four quarters**; Table B for assets acquired in the first quarter; Table C for assets acquired in the second quarter; Table D for assets acquired in the third quarter and Table E for assets acquired in the fourth quarter.

Example 3. Assume all of the facts for Helen are the same as in Example 2 except that Helen had paid \$25,000 for an asset on January 2. In this case Helen's total acquisitions would total \$45,000 for the year. **Now** the

\$15,000 December acquisition represents **less than 40%** (33%) of her total acquisitions for the year. Now Helen uses Table A for **all** of her acquisitions. She applies 14.29% to all of her acquisitions.

As noted earlier, this mid-quarter depreciation **does not** apply to real property.

The percentage rates included in Tables A through E are always applied against the original cost/basis, as reduced by any section 179 deduction. The table's rates **automatically switch to straight line** when that method becomes more advantageous.

For your information included below, are the six classes of personal property and the depreciation year that straight line yields a higher depreciation deduction.

Class or Recovery Period	Year in which straight-line yields greater depreciation
3-year.....	3rd year
5-year.....	4th year
7-year.....	5th year
10-year.....	7th year
15-year.....	7th year
20-year.....	9th year

Placed in Service. For depreciation purposes, property is considered placed in service when it is in a condition or state of readiness and availability for a specifically assigned functions whether in trade or business, in the production of income, a tax-exempt activity, or in a personal activity. However, depreciation applies only to property placed in service in a trade or business or in the production of income. For example, if property is placed in service in a personal use, no depreciation would be allowable.

If the use of the property is changed to a business or income producing activity, depreciation would begin at the time of the change in use.

Example 1. On November 22, Donald Steep purchased a machine for his business. The machine was delivered on December 7. However, the machine was not installed and operational until January 3, of the following year. Since the machine was not operational until January of the following year, it is considered **placed in service** in January of that year. If the machine had been ready for use when it was delivered in December, it would be considered placed in service in December even if it was not actually used until January.

Example 2. On April 6, Peter Douglas purchased a house to use as residential rental property. Peter made extensive repairs to the house and had the house ready to rent on July 5, at which time Peter began to advertise the house for rent. Peter began to rent the house on September

1. The house is considered placed in service in July when it was ready and available for rent. Peter can begin to depreciate the house in July.

TABLE A
(Half-Year Convention)

Use this table for tangible *personal property in service after* December 31, 1986

All of the following factors are "Built-In" the tables:

General Depreciation System - MACRS

Applicable Depreciation Method: 200 or 150 percent

Declining Balance Switching to Straight Line when Straight Line exceeds Declining Balance

Applicable Recovery Periods: 3, 5, 7, 10, 15, 20 years

YEAR	DEPRECIATION RATE FOR RECOVERY PERIOD					
	3-YEAR	5-YEAR	7-YEAR	10-YEAR	15-YEAR	20-YEAR
1	33.33	20.00	14.29	10.00	5.00	3.750
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52	12.49	11.52	7.70	6.177
5		11.52	8.93	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55	5.90	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

TABLE B
(Mid-Quarter Convention)

ONLY IF: *More than 40%* of the total dollar costs of all of your personal property assets were placed in service in the *last quarter of the year* (October, November, and December)

PLACED IN SERVICE IN FIRST QUARTER

YEAR	DEPRECIATION RATE FOR RECOVERY PERIOD					
	3-YEAR	5-YEAR	7-YEAR	10-YEAR	15-YEAR	20-YEAR
1	58.33	35.00	25.00	17.50	8.75	6.563
2	27.78	26.00	21.43	16.50	9.13	7.000
3	12.35	15.60	15.31	13.20	8.21	6.482
4	1.54	11.01	10.93	10.56	7.39	5.996
5		11.01	8.75	8.45	6.65	5.546
6		1.38	8.74	6.76	5.99	5.130
7			8.75	6.55	5.90	4.746
8			1.09	6.55	5.91	4.459
9				6.56	5.90	4.459
10				6.55	5.91	4.450
11				0.82	5.90	4.459
12					5.91	4.460
13					5.90	4.459
14					5.91	4.460
15					5.90	4.459
16					0.74	4.460
17						4.459
18						4.460
19						4.459
20						4.460
21						0.557

TABLE C
(Mid-Quarter Convention)

ONLY IF: *More than 40%* of the total dollar costs of all of your personal property assets were placed in service in the *last quarter of the year* (October, November and December)

PLACED IN SERVICE IN SECOND QUARTER

YEAR	DEPRECIATION RATE FOR RECOVERY PERIOD					
	3-YEAR	5-YEAR	7-YEAR	10-YEAR	15-YEAR	20-YEAR
1	41.67	25.00	17.85	12.50	6.25	4.688
2	38.89	30.00	23.47	17.50	9.38	7.146
3	14.14	18.00	16.76	14.00	8.44	6.612
4	5.30	11.37	11.97	11.20	7.59	6.116
5		11.37	8.87	8.96	6.83	5.658
6		4.26	8.87	7.17	6.15	5.233
7			8.87	6.55	5.91	4.841
8			3.33	6.55	5.90	4.478
9				6.56	5.91	4.463
10				6.55	5.90	4.463
11				2.46	5.91	4.463
12					5.90	4.463
13					5.91	4.463
14					5.90	4.463
15					5.91	4.462
16					2.21	4.463
17						4.462
18						4.463
19						4.462
20						4.463
21						1.673

TABLE D
(Mid-Quarter Convention)

ONLY IF: *More than 40%* of the total dollar costs of all of your personal property assets were placed in service in the ***last quarter of the year*** (October, November and December)

PLACED IN SERVICE IN THIRD QUARTER

YEAR	DEPRECIATION RATE FOR RECOVERY PERIOD					
	3-YEAR	5-YEAR	7-YEAR	10-YEAR	15-YEAR	20-YEAR
1	25.00	15.00	10.71	7.50	3.75	2.813
2	50.00	34.00	25.51	18.50	9.63	7.289
3	16.67	20.40	18.22	14.80	8.66	6.742
4	8.33	12.24	13.02	11.84	7.80	6.237
5		11.30	9.30	9.47	7.02	5.769
6		7.06	8.85	7.58	6.31	5.336
7			8.86	6.55	5.90	4.936
8			5.53	6.55	5.90	4.566
9				6.56	5.91	4.460
10				6.55	5.90	4.460
11				4.10	5.91	4.460
12					5.90	4.460
13					5.91	4.461
14					5.90	4.460
15					5.91	4.461
16					3.69	4.460
17						4.461
18						4.460
19						4.461
20						4.460
21						2.788

TABLE E
(Mid-Quarter Convention)

ONLY IF: *More than 40%* of the total dollar costs of all of your personal property assets were placed in service in the ***last quarter of the year*** (October, November, and December)

PLACED IN SERVICE IN FOURTH QUARTER

YEAR	DEPRECIATION RATE FOR RECOVERY PERIOD					
	3-YEAR	5-YEAR	7-YEAR	10-YEAR	15-YEAR	20-YEAR
1	8.33	5.00	3.57	2.50	1.25	0.938
2	61.11	38.00	27.55	19.50	9.88	7.430
3	20.37	22.80	19.68	15.60	8.89	6.872
4	10.19	13.68	14.06	12.48	8.00	6.357
5		10.94	10.04	9.98	7.20	5.880
6		9.58	8.73	7.99	6.48	5.439
7			8.73	6.55	5.90	5.031
8			7.64	6.55	5.90	4.654
9				6.56	5.90	4.458
10				6.55	5.91	4.458
11				5.74	5.90	4.458
12					5.91	4.458
13					5.90	4.458
14					5.91	4.458
15					5.90	4.458
16					5.17	4.458
17						4.458
18						4.459
19						4.458
20						4.459
21						3.901

SECTION II

THE SECTION 179 EXPENSE DEDUCTION

You can elect to treat all or part of the cost of certain qualifying property as an expense rather than a capital expenditure. This means you can deduct all or part of the cost in one year rather than taking depreciation deductions spread over several years.

If you make the election for a section 179 deduction, you can deduct up to the maximum allowable amount of the cost of qualifying property the first year you place the property in service. Also, you can take the full allowable deduction no matter what time of the year you place the asset in service.

Under the Tax Cut and Jobs Act the maximum Section 179 deduction has been increased to a limitation of \$1 million for property placed in service after December 31, 2017. This amount will be indexed for inflation after tax year 2018. For 2019, the maximum Section 179 deduction will be \$1,020,000.

QUALIFYING PROPERTY

Qualifying property is depreciable property that is **section 1245 property** (defined later) and that is bought for use in the active conduct of your trade or business. You **cannot** elect to deduct the cost of property held merely for the **production of income**. Nor can you take depreciation to the extent that you elect to take the section 179 deduction.

The determination of whether property is qualifying section 1245 property is made in the **first year** the property is placed in service. If you place property in service in a tax year and it **does not qualify** for the section 179 deduction, no section 179 deduction **is ever allowed** for it, **even though** it becomes section 179 qualifying property in a later tax year.

Placed in Service. Property is considered placed in service in the tax year it is **first ready and available** for its specified use, whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity.

Example. In the current year, you bought a new car and used it entirely for personal purposes. In the following year you begin to use the car in your business. Even though the car is used for business in the **second** year, and is **now eligible for depreciation**, no section 179 deduction is allowable. The car was placed in service in the previous year when you began to use it for personal purposes.

Section 1245 Property. Section 1245 property is depreciable property and includes:

1. Tangible personal property,
2. Other tangible property (except most buildings and their structural components),
3. Single purpose livestock or horticultural structures, and
4. Storage facilities (except buildings and their structural components) used in the distribution of petroleum or any primary product of petroleum.
5. Off-the shelf computer software.
6. Qualified real property.

Estates and Trusts. Estates and trusts are ***not eligible*** to elect the section 179 deduction.

Sport Utility and Certain Other Vehicles. You cannot elect to expense more than \$25,000 of the cost of any heavy sport utility vehicle (SUV) and certain other vehicles placed in service. This rule applies to any 4-wheeled vehicle primarily designed or used to carry passengers over public streets, roads, or highways that is rated ***at more than*** 6,000 pounds gross vehicle weight and ***not more than*** 14,000 pounds gross vehicle weight. However, the \$25,000 limit does not apply to any vehicle:

- Designed to seat more than nine passengers behind the driver's seat,
- Equipped with a cargo area (either open or enclosed by a cap) of at least six feet in interior length that is not readily accessible from the passenger compartment, or
- That has an integral enclosure fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

DEDUCTION LIMIT

The total cost you can elect to deduct cannot exceed the maximum allowable amount for that given year. The maximum dollar limit applies to ***each taxpayer*** and not to each business operated by a taxpayer.

Investment Limit. For each dollar cost of section 179 property placed in service in a tax year, the yearly maximum deduction is reduced (but not below zero) by one dollar. ***The investment limit for property placed in service after December 31, 2017 is \$2,500,000. This amount will be indexed for inflation after tax year 2018. For 2019, the amount is \$2,550,000.***

TAXABLE INCOME LIMIT

The total cost that can be deducted in each year ***is limited*** to the ***taxable income*** from the active conduct of ***any*** trade or business during the tax year.

Taxable income for this purpose is figured by aggregating the net income (or loss) from ***all*** trades and businesses you and your spouse (if filing a joint return) actively conducted during the tax year. Items of income derived from a trade or business actively conducted by you include section 1231 gains (or losses), and interest from working capital of your trade or business. ***Also include*** in aggregate taxable income ***any wages, salaries, tips, or other compensation earned as an employee.***

In addition, taxable income is figured ***without*** regard to:

1. The section 179 expense deduction,
2. The self-employment tax deduction, and
3. Any net operating loss carryback or carry forward.
4. Any unreimbursed employee business expenses.

Example 1. Ray owned a candy store. He paid \$9,000 for a qualifying section 179 machine and placed it in service. Ray had a \$5,000 net profit (without regard to the three offsets above). Ray had no other income in the year. Ray's maximum section 179 deduction for the year is \$5,000 which was the net profit from his business.

Example 2. Assume all of the facts for the above "Ray" example are the same, except Ray had a part time job and earned \$7,000 in wages. Ray would be able to deduct the entire \$9,000 cost of the machine against his ***combined*** \$7,000 wages and \$5,000 net profit.

As to any disallowed section 179 deduction because of the investment limit or the taxable income limit, the disallowed amount can be carried over to subsequent years and deducted under the basic rules presented here.

BASIS ADJUSTMENT

A partner must reduce the basis of his or her partnership interest by the total amount of section 179 expenses allocated from the partnership regardless of whether the partner can currently deduct the full amount of allocated section 179 expenses. If a partner disposes of his or her interest in a partnership, the partner's basis for determining gain or loss is increased by any outstanding carryover of disallowed deduction of section 179 expenses allocated from the partnership.

Married Taxpayers Filing Separate Returns. A husband and wife filing separate returns for a tax year are treated as one taxpayer for purposes of the maximum dollar limit and the investment limit. Unless they elect otherwise, 50% of the cost of section 179 property, before the taxable income limit is applied, will be allocated to each. In other words, each spouse is limited to a maximum deduction of one-half of the applicable dollar limit for the year.

Allocation. Taxpayers who place in service more than one qualifying asset in one year have the option of allocating the maximum applicable section 179 deduction to the various assets in any proportion they choose.

Cost. The cost of property for purposes of the section 179 deduction does not include that part of the basis of the property that is determined by reference to the basis of other property held at any time by the person acquiring this property. For example, if you buy a new truck to use in your business, your cost for purposes of the section 179 deduction **does not** include the adjusted basis of the truck you trade in, on the new vehicle.

If you use property for **both** business and nonbusiness, you are eligible to elect the section 179 deduction **only if more** than 50% of the property's use in the tax year the property is placed in service is for trade or business purposes. You must allocate the cost of the property to reflect only the business use of the property. This is done by multiplying the cost of the property by the percentage of business use. You use this adjusted cost to figure your section 179 deduction.

Election. You must make an election to take the section 179 deduction. You make this election in the first tax year the property is placed in service. The election can be made on a **timely filed** amended tax return (including extensions), but **not** on an originally filed return for any year **after** the property was placed in service.

Revocation of Election. Once made, the election can be revoked only with IRS consent. Consent to revoke a section 179 election will be granted only in extraordinary circumstances.

Recapture of Section 179 Deductions. If you deduct the cost of property placed in service and the property is **not used more than 50%** in a trade or business for any tax year before the end of the property's recovery period, you must include in income the benefit you received from the deduction.

Any recapture of the section 179 deduction is reported on Form 4797, ***Sales of Business Property***.

The amount to be included in income is figured by subtracting the depreciation ***that you would have been eligible for*** in the prior years and the recapture year from the section 179 deduction ***that you actually took***.

Dispositions. If you elect the section 179 deduction, the amount deducted is treated as depreciation for purposes of the recapture rules. Thus, any gain you recognize on disposition of the property is treated as ordinary income to the extent of the 179 deduction and depreciation taken.

SECTION 179 PLANNING TACTICS

Since the maximum applicable amount of the section 179 deduction can be deducted ***entirely in one year*** (as opposed to depreciating it over a number of years) it gives taxpayers an opportunity to do some beneficial tax planning.

Unlike depreciation, there is ***no allocation*** of the cost of a section 179 asset if it is placed in service at a time other than the first day of the year. A qualifying asset acquired and placed in service on December 31st is eligible for the maximum allowable amount or lesser cost. Hence, a tax planning opportunity exists.

If a taxpayer is planning to acquire qualifying assets, he or she should consider placing them in service at a time that is beneficial tax wise to him or her. If a taxpayer is having a good year, profit-wise, he or she might benefit by acquiring the asset ***before*** the end of the year instead of waiting until the next year. Conversely if he or she is having a bad year, profit-wise, then he or she might consider delaying the purchase of any section 179 assets until the start of the next year.

And finally, if ***more than one*** qualifying asset is involved, the taxpayer might consider acquiring part of the assets late in one year and the remainder of the assets in the first part of the next year depending on the circumstances.

SECTION III

LISTED PROPERTY (INCLUDING AUTOMOBILES)

Automobiles, computers, and certain property used for entertainment, recreation or amusement purposes are eligible for depreciation and/or the section 179 deduction when used in a trade or business. However, because of the high interest in using this property also for personal use, abuses developed.

To stop the abuses, Congress placed limitations and restrictions under what circumstances and on how much depreciation could be deducted if this property was used less than 50% in a trade or business. A ***list*** of the items that were subject to depreciation abuse was compiled. Thus the term ***listed property***.

LISTED PROPERTY DEFINED

Listed property is any of the following:

1. Any passenger automobile weighting 6,000 pounds or less.
2. Any other property used as a means of transportation, unless it is an excepted vehicle.
3. Any property of a type generally used for entertainment, recreation, or amusement (including photographic, phonographic, communication, and video recording equipment).
4. Any computer and related peripheral equipment, except for any computer (including peripheral equipment) used only at a regular business establishment and owned or leased by the person operating the establishment. A regular business establishment includes a portion of a dwelling unit, if and only if, that portion is used both regularly and exclusively for business,

If listed property is not used predominantly (by definition, more than 50%) in a qualified business use:

1. The section 179 deduction is ***not allowed, and***
2. The property must be depreciated using the MACRS ***ADS (straight line method)*** over the ADS recovery period.

PASSENGER AUTOMOBILES

A passenger automobile is any four-wheeled vehicle made primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less of unloaded gross vehicle weight (6,000 pounds or less of gross vehicle weight for trucks and vans). It includes any part, component, or other item physically attached to the automobile or usually included in the purchase price of an automobile.

The following vehicles are not considered passenger automobiles for these purposes.

- An ambulance, hearse, or combination ambulance-hearse used directly in a trade or business.

- A vehicle used directly in the trade or business of transporting persons or property for pay or hire.
- A truck or van that is a qualified nonpersonal use vehicle.

OTHER PROPERTY USED FOR TRANSPORTATION

Other property used for transportation includes trucks, buses, boats, airplanes, motorcycles, and any other vehicles used to transport persons or goods.

Excepted Vehicles. Other property used for transportation does not include the following qualified nonpersonal use vehicles (defined earlier under ***Passenger Automobiles***).

- Clearly marked police and fire vehicles.
- Unmarked vehicles used by law enforcement officers if the use is officially authorized.
- Ambulances used as such and hearses used as such.
- Any vehicle with a loaded gross vehicle weight of over 14,000 pounds that is designed to carry cargo.
- Bucket trucks (cherry pickers), cement mixers, dump trucks (including garbage trucks), flatbed trucks, and refrigerated trucks.
- Combines, cranes and derricks, and forklifts.
- Delivery trucks with seating only for the driver, or only for the driver plus a folding jump seat.
- Qualified moving vans.
- Qualified specialized utility repair trucks.
- School buses used in transporting students and employees of schools.
- Other buses with a capacity of at least 20 passengers that are used as passenger buses.
- Tractors and other special purpose farm vehicles.

COMPUTERS AND RELATED PERIPHERAL EQUIPMENT

A computer is a programmable electronically activated device that:

1. Is capable of accepting information, applying prescribed processes to the information, and supplying the results of those processes with or without human interventions, and
2. Consists of a central processing unit with extensive storage, logic, arithmetic, and control capabilities.

Related peripheral equipment is any auxiliary machine which is designed to be controlled by the central processing unit of a computer.

Computer or peripheral equipment does not include:

1. Any equipment which is an integral part of property which is not a computer,
2. Typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and
3. Equipment used primarily for the user's amusement or entertainment.

PREDOMINANT USE TEST

Listed property meets the predominant use test for any tax year if its business use is **more than** 50% of its total use. You must allocate the use of any item of listed property used for more than one purpose during the tax year among its various uses. The percentage of **investment use** of listed property **cannot be used** as part of the percentage of qualified business use to meet the predominant use test. **However, the combined total of business and investment use** is taken into account to figure your depreciation deduction for the property.

Note: Property does not stop being predominantly used in a qualified business use because of a transfer at death.

Example 1. Sarah uses a home computer 50% of the time to manage her investments. She also uses the computer 40% of the time in her part-time consumer research business. Because her **business use** of the computer **does not exceed** 50%, the computer is not predominantly used in a qualified business use for the taxable year. Since she does not meet the predominant use test, she **cannot elect** a section 179 deduction for this property and her combined rate of business/investment use for determining her depreciation deduction using **ADS** is 90%.

Example 2. If Sarah in Example (1) uses her computer 30% of the time to manage her investments and 60% of the time in her consumer research business, her property meets the predominant use test. Therefore, she can elect a section 179 deduction and her combined business/ investment use for determining her depreciation deduction using **GDS** is 90%.

ENTERTAINMENT USE

The use of listed property for entertainment, recreation, or amusement purposes is treated as a qualified business use only to the extent that expenses (other than interest and property tax expenses) attributable to its use are deductible as ordinary and necessary business expenses.

FIRST RECOVERY YEAR

If any item of listed property is not used predominately in a qualified business use in the **first year** it is placed in service:

1. The property is not eligible for a section 179 deduction, and
2. The depreciation deduction must be figured using the MACRS straight line method.

Example. On July 1, James bought and placed in service a computer, which is 5-year property, costing \$4,000. He uses the computer 40% in a qualified business use, 30% for investment purposes (to produce income), and 30% for personal use. Since the qualified business use is only 40%, he cannot elect any section 179 deduction and must use the straight line method to figure depreciation. He figures his depreciation deduction by using the straight line method over the 5-year recovery period. To determine his deduction, he must first determine the business/investment portion of his property cost. He does this by multiplying the total cost by the business/investment use percentage ($\$4,000 \times 70\%$). He then figures his depreciation deduction. A full year's deduction would be 20%. However, since he must use a **half-year convention**, his applicable percentage is 10%. He then multiplies the business/investment portion of the cost by the first-year straight line rate ($\$2,800 \times 10\%$). The result is a depreciation deduction of \$280.

YEARS AFTER THE FIRST RECOVERY YEAR

If any item of listed property is used predominately in a qualified business use in **the year** it is placed in service **but not** in a later year during the recovery period, you must determine your depreciation using the straight line method. You figure your depreciation **for the later year** and all years after that as if the property were not predominately used

in a qualified business use in the year it was placed in service and no section 179 amount was claimed.

If in a later year after you place an item of listed property in service, you fail to meet the predominant use for that item of property, you may be required to recapture part of the section 179 and depreciation deduction claimed. You will also be required to figure your depreciation in a different way.

SPECIAL RULE FOR PASSENGER AUTOMOBILES

A passenger automobile is listed property and is subject to special limits. For passenger automobiles, the total depreciation deduction (including the section 179 deduction) that can be claimed is limited. The limits are increased by the automobile price inflation adjustment.

REVIEW QUESTIONS

CHAPTER 10 – DEPRECIATION

1. For property to be depreciable, certain conditions must be met. Which one of the following statements is ***incorrect*** in this regard?
 - A. The property must be used in business or held to produce income.
 - B. The property must have a determinable useful life longer than one year.
 - C. A repair to property cannot be depreciated even though it lengthens the life of the property.
 - D. The property must be something that gets used up, wears out, becomes obsolete or loses its value from natural causes.
2. Which one of the following statements is ***incorrect*** regarding section 197 intangibles?
 - A. Goodwill is a section 197 intangible.
 - B. A patent is a section 197 intangible.
 - C. Going concern value is not a section 197 intangible.
 - D. A license granted by a government agency is a section 197 intangible.
3. Section 197 intangibles are all preassigned a certain useful life. How long is that useful life?
 - A. 5 years
 - B. 10 years
 - C. 15 years
 - D. 20 years
4. For depreciation purposes, to qualify as residential rental property, a minimum amount of its gross rental income for the tax year must come from dwelling units. Which one of the following is the minimum amount?
 - A. 80%
 - B. 100%
 - C. 51%
 - D. 60%

5. Sam purchased and placed in service a unit of nonresidential commercial real estate in the current year. What is the correct MACRS depreciation recovery period?
- A. 39 years
 - B. 27.5 years
 - C. 31.5 years
 - D. 25 years
6. The part of your home that you use for a qualified business use may be depreciated. What is the correct recovery period for depreciation for a business use?
- A. 27.5 years
 - B. 30 years
 - C. 39 years
 - D. 31.5 years
7. The MACRS general depreciation system provides three ways to depreciate property. Which one of the following statements is **incorrect** in this regard?
- A. The 150% declining balance method is an acceptable method.
 - B. The 200% declining balance method is an acceptable method.
 - C. The 300% declining method over a GDS recovery period is an acceptable method.
 - D. A straight-line method over a GDS recovery period is an acceptable method.
8. The MACRS general depreciation system provides three preset conventions that determine how many months you can depreciate property in the first year it is placed in service. Which one of the following is **incorrect** in this respect?
- A. The half-year convention is a preset convention.
 - B. The mid-quarter convention is a preset convention.
 - C. The full-year convention is a preset convention.
 - D. The mid-month convention is a preset convention.

9. Which one of the following statements is **incorrect** in regard to Section 179 expense deduction?
- A. Qualifying property is Section 1245 property.
 - B. The determination of whether the property is Section 1245 property must be made in the first year the property is placed in service.
 - C. You cannot take depreciation to the extent that you take the Section 179 deduction.
 - D. You may take the Section 179 deduction on property that is held only for the production of income.
10. The total cost of section 179 property is limited to the taxable income from any trade or business. Which of the following statements is **incorrect** in this regard?
- A. The section 179 expense deduction, itself is not taken into account in figuring taxable income.
 - B. The self-employment tax deduction is not taken into account in figuring taxable income.
 - C. An individual's wage or salary income from an unrelated source is not taken into account in figuring taxable income.
 - D. Any unreimbursed employee business expense is not taken into account in figuring taxable income.
11. Ted placed two qualifying Section 179 properties in the year. Property "A" cost \$600 and property "B" cost \$1,000. Which one of the following statements is **correct** in regard to Ted's allocation of the costs?
- A. Ted must take the entire \$600 cost of property "A" before allocating any amount to property "B".
 - B. Ted must take the entire \$1,000 cost of property "B" before allocating any amount to "A".
 - C. Ted must take an equal percentage of each "A" and "B".
 - D. Ted is allowed to make any allocation of each of the properties as he chooses.

RESPONSES TO REVIEW QUESTIONS

CHAPTER 10 – DEPRECIATION

1.
 - A. **Correct.** It also must be something that wears out, gets used up or loses its value from other natural causes.
 - B. **Correct.** However, a repair or replacement that does not lengthen the asset's useful life, make it more useful or increase the asset's value may be currently deducted as a repair.
 - C. **Incorrect.** It must be depreciated if it lengthens the useful life of the asset.
 - D. **Correct.** However, if the useful life is one year or less, it may be currently deducted as a repair.
2.
 - A. **Correct.** It is a **Section 197** asset and can be amortized over a 15-year period starting with the first month it is acquired.
 - B. **Correct.** It can be amortized over a 15-year period. It is in the same category as copyrights, patterns and other similar items.
 - C. **Incorrect.** Going concern value is a Section 197 asset that can be amortized over 15 years.
 - D. **Correct.** A government license is a Section 197 asset. This asset plus the assets included in A,B and C can be amortized over a 15 year useful life notwithstanding the actual useful lives.
3.
 - A. **Incorrect.** Section 197 intangibles must be held in connection with your trade or business or for the production of income and all items have a predetermined allowable useful life of 15 years.
 - B. **Incorrect.** Ten years useful life applies to certain Section 179 depreciable assets.
 - C. **Correct.** Fifteen years is the predetermined fixed useful life for all Section 197 intangible assets.
 - D. **Incorrect.** Twenty years applies to the predetermined useful life of farm buildings under MACRS depreciation.

4.

- A. **Correct.** In a “mixed-use” rental property, the nonresidential income must be less than 20%.
- B. **Incorrect.** A minimum amount of 80% of the gross income from a rental property must come from dwelling units in order to qualify for being depreciated as a ***residential rental property***.
- C. **Incorrect.** To qualify for depreciating a rental property as a ***residential rental property***, a minimum of 80% of the gross income must come from dwelling units.
- D. **Incorrect.** The correct amount is 80%. Note: if the taxpayer occupies one of the units, the fair market value of his or her unit is included in the rental total to determine if the minimum amount of 80% is reached.

5.

- A. **Correct.** Thirty-nine years is correct. The 39-year recovery period first became effective in 1993.
- B. **Incorrect.** The 27.5 year recovery period applies to ***residential*** rental property. This 27.5-year recovery period first became effective in 1987.
- C. **Incorrect.** Thirty-nine years is the correct answer. This 31.5-year recovery was applicable through 1993 only.
- D. **Incorrect.** Twenty-five years was a widely accepted, but not official, recovery period for most rental property placed in service before (ACRS) became effective. This system assigned IRS ***predetermined recovery periods*** for the depreciation of most assets including real property.

6.

- A. **Incorrect.** Thirty-nine years is correct. The depreciation for an office-in-home comes under the classification of ***nonresidential rental property*** and thus, 39 years.
- B. **Incorrect.** Thirty years is the widely applicable period for the ***amortization*** of a residential real estate loan.
- C. **Correct.** The thirty-nine years first became effective in 1993. Prior to then it was 31.5 years.
- D. **Incorrect.** This recovery period for nonresidential rental property ended in 1993.

7.

- A. **Correct.** The 150% declining balance method is one method of depreciation under the General Depreciation System (GDS).
- B. **Correct.** The 200% declining balance method is an acceptable method of depreciation under the GDS system.
- C. **Incorrect.** The 300% declining balance method is not an acceptable method of depreciation under the GDS system.
- D. **Correct.** Under either A, or B, your depreciation gets smaller each year.

8.

- A. **Correct.** The half-year convention allows only 6 months of depreciation in the first year the property is placed in service regardless of which month it was placed in service.
- B. **Correct.** If more than 40% of all the year's total basis of property is placed in service in the last 3 months of the year, you must use the mid-quarter convention to calculate depreciation.
- C. **Incorrect.** The only conventions are the half-year, mid-month and mid-quarter conventions.
- D. **Correct.** The mid-month convention applies to residential rental property and nonresidential rental property. All of this property is treated as having been placed in service on the midpoint of the month (usually the 15th).

9.

- A. **Correct.** To qualify for the Section 179 deduction, the property must be Section 1245 property that is bought for use in the active conduct of your trade or business.
- B. **Correct.** The decision whether the property is qualifying Section 1245 property (and thus eligible for the Section 179 deduction) must be made in the first year the property is placed in service.
- C. **Correct.** You may elect to deduct some part of Section 179 property as depreciation and some part as a Section 179 deduction. But you cannot take depreciation to the extent of the amount you take as a Section 179 deduction.
- D. **Incorrect.** You cannot take a Section 179 deduction on property that is held for the production of income. It must be used for use in the active conduct of your trade or business.

10.

- A. **Correct.** This means that in determining the maximum income to be used in figuring your section 179 deduction it **does not** include the section 179 expense deduction.
- B. **Correct.** The self-employment deduction is not taken into account when figuring taxable income when figuring the section 179 deduction.
- C. **Incorrect.** An individual's salary income from **is** taken into account when figuring the section 179 deduction.
- D. **Correct.** Any unreimbursed employee business expense is not taken into account when figuring the section 179 deduction.

11.

- A. **Incorrect.** Ted is allowed to allocate the \$1,000 any ratio he chooses to the respective items "A" and "B".
- B. **Incorrect.** Ted is allowed to allocate part or all of the \$1,000 to "A" first and "B" second as he chooses.
- C. **Incorrect.** Ted is allowed to allocate the \$1,000 to "A" and "B" in any proportion he chooses.
- D. **Correct.** Ted is allowed to make any allocation he chooses and furthermore, is not required to deduct all of the \$1,000 as a Section 179 expense.

CHAPTER 11

SELF-EMPLOYMENT TAXES

The self-employment tax is a Social Security and Medicare tax for individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of wage earners.

In an employer/employee situation, the employer withholds a designated percentage from the employee's salary for Social Security tax and a separate percentage amount for Medicare. The amount of the salary to which the Social Security tax applies has a fixed maximum. This maximum amount increases each year and is based on predetermined amounts set by Congress. However, for the Medicare tax, there is no maximum amount to which the tax applies. The predetermined percentage applies to an unlimited amount of income.

To the amount that is withheld from the **employee's** salary, the employer must pay **an equal** amount into the employee's account.

As a sole **proprietor** you are responsible for **both** the "employee's" and the "employer's" part of the self-employment (i.e., Social Security/Medicare tax). Self-employment tax is based on your **net income** from Schedule C. If you have **more than** one business, you **combine** the amounts (profits and/or losses) from **all** of your Schedule C's. The self-employment tax is reported on Schedule SE.

However, a Sole Proprietor receives some relief from the payment of the combined amount of tax. The Sole Proprietor can take **one-half** of the self-employment **tax paid** as an **adjustment** to income on Form 1040.

Minimum Income. You must have \$433.13 or more of net self-employment income, **before reduction** by the 7.65% deduction, to be subject to the tax ($.92235 \times \$433.13 = \400). If your **net income is less than** \$433.13 before 7.65% reduction, you do **not have to file** Schedule SE (Form 1040) or pay the tax.

Aliens. Resident aliens are generally subject to the same rules as U.S. citizens. Nonresident aliens do not pay self-employment tax unless an international social security agreement in effect determines that they are covered under the U.S. social security system.

Capital Gains and Losses. Capital gains and losses, such as gain or loss on the sale of investment property, are excluded from self-employment income.

Other Gains and Losses. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is ***not included*** when figuring self-employment income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion.

Interest. Interest is ***not*** self-employment income unless you receive it in your trade or business.

Lost Income Payments. If you are self-employed and reduce or stop your business activities, any payment you receive for the ***lost income*** of your business from insurance or other sources ***is*** self-employment income. If you are not working when you receive the payment, it still relates to your business (even though it is temporarily inactive) ***and is*** self-employment income.

Part-Time Business. Income from an activity you carry on part-time ***is*** self-employment income.

Real Estate Rent. Rent from real estate and personal property leased with real estate is not self-employment income.

Hotels, Apartments, Etc. Rents received for the use or occupancy of hotels, boarding houses, or apartment houses are not rentals from real estate ***if services are provided*** for the occupants. These rental payments ***are included*** in figuring net income from self-employment.

Husband and Wife Partners. You and your spouse may operate a business as a partnership. If you and your spouse join together in the conduct of a business and share in the profits and losses, ***a partnership has been created***. You and your spouse must report the business income on a partnership return, Form 1065. Attach Schedules K-1 to Form 1065 to show each partner's share of the net income and file ***separate*** Schedule SE (Form 1040) to report each partner's self-employment tax. However, if your spouse is not your partner but rather your employee, you must pay Social Security and Medicare taxes for him and her.

Exception. If you and your spouse each materially participate as the only members of a jointly owned and operated business, and you file a joint return for the tax year, you can make a joint election to be treated as a qualified joint venture instead of a partnership for the tax year. Making this election will allow you to avoid the complexity of Form 1065 but still give each spouse the credit for social security earnings on which retirement benefits are based.

Joint Return. You ***cannot file*** a joint Schedule SE (Form 1040) ***even if*** you file a joint income tax return. Your spouse is not considered self-employed just because you are. If your spouse has self-employment income, it is independently subject to the self-employment tax and should be reported on a ***separate*** Schedule SE. If you file a joint return and you both have self-employment income, ***each of you*** must complete a ***separate Schedule*** SE (Form 1040); attach both schedules to the joint return.

Community Income. If any of the income from a trade or business is community income under state law, it is subject to self-employment tax as the income of the spouse carrying on the trade or business. The identity of the person carrying on the trade or business is determined by the facts in each case.

CHAPTER 12

SALE OF A BUSINESS

If you are a sole proprietor and sell your business, you are really selling all the individual assets of your business.

Classification of Assets. To determine whether the gain or loss on the sale of an asset is capital gain or loss or ordinary gain or loss, you must classify the assets sold as:

1. Capital assets,
2. Real property and depreciable property used in your business and held for more than one year, **and**
3. Other property--for example, stock-in-trade, inventory, or property used in your business and held one year or less.

Accounts and Notes Receivable. Accounts and notes receivable acquired in the ordinary course of your business for services rendered, or from the sale of stock-in-trade, are not capital assets. They should be classified in category (3).

Installment Notes. Installment notes from the sale of stock-in-trade should be classified in category (3). The gain, which is the difference between the basis of the note and the amount realized, is ordinary income.

Merchandise Inventories. Merchandise inventories are not capital assets and belong in category (3).

Land and Leaseholds. Land and leaseholds used in your business are not capital assets. If you hold them for more than one year, they belong in category (2), and if you hold them one year or less, in category (3).

Buildings, Machinery, Furniture, and Fixtures. Buildings, machinery, furniture, and fixtures that you use in your business are not capital assets. You should put them in category (2) if you hold them for more than one year and in (3) if you hold them for one year or less.

Patents. Patents that you use in your business should ordinarily be classified in category (2) if you hold them more than one year and in (3) if you hold them one year or less.

Copyrights. Copyrights that you use in your business should be classified in category (2) if you hold them more than one year and in (3) if you hold them one year or less. However, if you sell a copyright that you created, or if you sell a copyright that gets its basis from the person who created the property, you should not classify it in category (2). Instead, you should classify it in category (3).

Goodwill. Goodwill is a capital asset. It belongs in category (1). The basis of goodwill is usually its cost if you bought it. When you buy a going business and intend to continue the business, goodwill may be included in the price.

Agreement Not to Compete. If an agreement not to compete (also called a covenant not to compete) for a fixed number of years can be separated from goodwill, the agreement should be classified in category (3). However, if an agreement not to compete accompanies the transfer of goodwill in the sale of a going concern and its main purpose is to assure the purchaser of the beneficial enjoyment of the goodwill acquired, the agreement cannot be separated from goodwill. It is a capital asset and should be classified in category (1). You must establish from the facts and circumstances in your case whether you have sold goodwill or have entered into an agreement not to compete.

Professional Skill or Other Characteristics of an Owner. The amount received from the sale of a professional practice that is *for goodwill* is determined by the facts in the particular case and not by whether the business is, or is not, dependent solely on the owner's professional skill or other personal characteristics.

If the seller has the right to keep fees collected after the sale for services performed before the sale, or receives payment for giving up all or part of the right to these fees, the amount received is treated as if it were for services performed **before** the sale **rather** than to the sale of goodwill, and is ordinary income.

If the seller retains a right to any fees or revenue collected for services performed after the sale, or if the purchaser agrees to pay an amount equal to any part of these fees or revenues, these amounts are **ordinary income** from the business, **not** proceeds from the sale of goodwill.

Amounts received by a professional person when admitting partners to that person's practice may be payment for a partial transfer of goodwill (rather than an assignment of anticipated future earnings). In such a case, the goodwill must in fact exist and the consideration allocated to it must actually be a payment for it.

Allocation of Selling Price. You must allocate the selling price proportionately among all the assets sold. The allocation is based on the same principle as discussed in an earlier Chapter 5, "**Basis of Business Assets.**" This allocation must be made to figure your gain or loss on the sale of a business.

Trade or Business Acquired. If you sell a group of assets that is a trade or business to which goodwill or going concern value could attach, you ***must*** use the following method to allocate the selling price to the various assets sold.

Allocate the selling price to:

1. Cash, demand deposits, and similar accounts, and then
2. Allocate the remaining purchase price to the following assets by allocating each asset an amount proportionate to, ***but not in excess of***, its FMV in the following order:
 - a. Certificates of deposit, U.S. Government securities, readily marketable stock or securities, and foreign currency, and
 - b. All other assets except goodwill and going concern value.

Any remainder of your selling price, after you make these allocations, ***is your basis in goodwill*** and going concern value.

Example. Amy sold her Widget shop. She received \$100,000. Amy and the buyer agreed to the following price allocation for the equipment and inventory:

1. \$40,000 for the equipment in the store, and
2. \$50,000 for the cost basis of her widget inventory.

The combined allocation for the equipment and inventory is \$90,000 (\$40,000 for equipment and \$50,000 for inventory). This leaves \$10,000 (\$100,000 selling price less \$90,000 allocation) to be allocated to goodwill.

If you and the buyer agree ***in writing*** to allocate the consideration, or to allocate the fair market value of any asset, the agreement ***is binding*** on both you and the buyer ***unless*** the IRS determines either to be inappropriate.

If you are a seller of a group of assets that is a trade or business, both you and the buyer must file Form 8594 with your income tax return for the year of sale.

Figuring Gain or Loss. After classifying each asset sold and allocating the selling price, you are ready to figure your gain or loss. You must figure separately the gain or losses for each asset sold, and then treat it according to its classification.

Transactions Between Related Parties. If there is a direct or indirect sale or exchange of depreciable property between related parties, any gain will be taxed as ***ordinary income***.

Other Dispositions of a Business. You can change the present form of your business without selling your assets. You may do this by joining one or more persons who want to consolidate their individual businesses into a partnership or other form of organization and by transferring your assets to the new form of business. You may change the form of your business by incorporating a sole proprietorship. You also may transfer the property of a sole proprietorship to a previously existing corporation.

SPECIAL RULE

The sale of a business usually is not a sale of one asset. Instead, all the assets of the business are sold. Generally, when this occurs, each asset is treated as being sold separately for determining the treatment of gain or loss.

Both the buyer and seller involved in the sale of a business must report to the IRS the allocation of the sales price among the business assets. Use Form 8594, Asset Acquisition Statement Under Section 1060, to provide this information. The buyer and seller should each attach Form 8594 to their federal income tax return for the year in which the sale occurred.

CHAPTER 13

SIMPLE IRA PLANS FOR SMALL BUSINESSES

A SIMPLE (Savings Incentive Match Plan for Employees of Small Employers) IRA plan offers advantages for businesses that meet two basic criteria.

- First, the business must have 100 or fewer employees (who earned \$5,000 or more during the preceding calendar year).
- Second, the business cannot currently have another retirement plan.

A SIMPLE IRA plan provides you and your employees with a simplified way to contribute towards retirement. It reduces taxes and, at the same time, attracts and retains quality employees. And compared to other types of retirement plans, SIMPLE IRA plans offer lower start-up and annual costs and they are simple to operate.

OTHER ADVANTAGES OF A SIMPLE IRA PLAN

- SIMPLE IRA plans are easy to set up and run – your financial institution handles most of the details.
- Employees can contribute, on a tax-deferred basis, through convenient payroll deductions.
- You can choose either to match the employee contributions of those **who decide** to participate **or** to contribute a fixed percentage **of all eligible** employees' pay.
- You may be eligible for a tax credit of up to \$500 per year for each of the first 3 years for the cost of starting a SIMPLE IRA plan. (IRS Form 8881, **Credit for Small Employer Pension Plan Startup Costs**.)
- Administrative costs are low.
- You are not required to file annual financial reports.

ESTABLISHING THE PLAN

Starting a SIMPLE IRA plan is easy to do.

Step 1. Contact a retirement plan professional or a representative of a financial institution that offers retirement plans. Many financial institutions will probably have a ***pre-approved*** SIMPLE IRA plan form that you can review.

Step 2. Choosing a financial institution to maintain employees' SIMPLE IRAs is one of the most important decisions you will make, since that entity becomes a trustee to the plan. (Alternately, you can decide to let employees choose the financial institution that will receive their contributions.)

Regardless of who makes the choice, only the following institutions can be designated as trustees of SIMPLE IRA plans: banks, mutual funds, insurance companies that issue annuity contracts, and certain other financial institutions ***that have been approved*** by the IRS. Trustees agree to:

- Receive and invest contributions, and
- Provide the employer with a summary description of the plan features each year.

Step 3. Choose a model form or other plan document offered by your financial institution. If your financial institution offers a model SIMPLE IRA plan document, you will have ***a choice of two*** forms to use:

- IRS Form 5304-SIMPLE, Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) – Not for Use With a Designated Financial Institution, or
- IRS Form 5305-SIMPLE, Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) – for Use With a Designated Financial Institution.

The model form you use will depend on whether you decide to select the financial institution that will receive contributions or to let your employees select their financial institutions.

- If employees are allowed to select the financial institutions that will receive their SIMPLE IRA plan contributions, you will fill out Form 5304-SIMPLE.
- If you require that all contributions under the SIMPLE IRA plan be initially deposited with a designated financial institution, you will fill out Form 5305-SIMPLE.

Your choice of the employees covered will be set out in your selected plan document. You ***can choose*** to cover all employees without restriction. Alternately, you ***can limit*** the employees covered to those who received at least \$5,000 in compensation during

any 2 years prior to the current calendar year and who are reasonably expected to receive at least \$5,000 during the current calendar year.

Step 4. Complete and sign the selected IRS form (or other plan document, if not using a model form). When it is completed and signed, this document becomes the plan's basic legal document, describing your employees' rights and benefits.

OPERATING THE PLAN

A SIMPLE IRA plan is true to its name when it comes to plan operation. Contributions under the plan (employees' and yours) are simply deposited into IRAs.

PARTICIPANTS IN A SIMPLE IRA PLAN

Employees who elect to make contributions or to whose accounts you deposit contributions are participants. Your obligation is to provide information to your financial institution on those employees who can participate as described in your plan document. You will want to keep your financial institution aware of any changes in the status of those employees who can participate (for example new employees).

ENROLLING EMPLOYEES IN A SIMPLE IRA PLAN

SIMPLE IRA plans operate on a calendar year basis. An employer may initially **set up** a SIMPLE IRA plan **as late as October 1**.

A SIMPLE IRA must be set up for each employee with contributions under the plan. Employees must receive notice of their right to participate, to make salary deduction contributions, and to receive employer contributions. In addition, employees must receive information about the plan, including a copy of the summary description. The required notice also informs employees of the plan's election periods during which eligible employees can decide to contribute to the plan.

If the plan provides for automatic enrollment, employers can choose to automatically enroll employees in SIMPLE IRA plans as long as the employees are allowed to choose not to have salary reduction contributions made to their SIMPLE IRAs or to have salary reduction contributions made in a different amount.

EMPLOYEE CONTRIBUTIONS

Employees can make salary reduction contributions in any amount to a SIMPLE IRA plan up to the legal limits. The **maximum amount** that an employee can contribute is \$13,000 per year for 2019 if you are under the age of 50 and \$16,000 if you are 50 or over. Additional employee contributions (known as catch-up contributions) are allowed for employees age 50 or over. The additional contribution limit is \$3,000 per year for 2019

Each year, employees can change their contribution levels during the plan's election period. This election period must be at least 60 days long, and employees must receive prior notice about an upcoming election opportunity. SIMPLE IRA plans that have already been established must have an annual election period that extends from November 2 to December 31. A plan can have more election periods each year in addition to this 60-day election period.

EMPLOYER CONTRIBUTIONS

You have two choices in determining your contributions to the SIMPLE IRA plan:

- A 2 percent ***nonelective*** employer contribution, where employees eligible to participate receive an employer contribution equal to 2 percent of their compensation (limited to \$280,000 per year for 2019), ***regardless of whether*** they make their own contributions.
- A dollar-for-dollar ***match up to 3 percent*** of compensation, where only the participating employees who have elected to make contributions will receive an employer contribution, i.e., the matching contribution.

Each year, ***you can choose*** which one you will use for the next year's contributions. The choice is part of the information you are required to communicate to employees before the beginning of the 60-day election period.

DEPOSITING AND INVESTING PLAN CONTRIBUTIONS

Employee contributions must be deposited in the financial institution serving as trustee for the plan ***within 30 days*** after the end of the month in which amounts would otherwise have been payable to the employee in cash. Your employer contributions must be made ***by the due date*** (including extensions) for filing your business's Federal income tax return for the year.

After forwarding the SIMPLE IRA plan contributions to the trustee, the trustee will invest the funds, in many cases at the direction of the participants. SIMPLE IRAs can be invested in stocks, bonds, mutual funds, and similar types of investments. Employee and employer contributions are always 100 percent vested—that is, the money an employee has put aside plus employer contributions and earnings from investments cannot be forfeited. Employees can move their SIMPLE IRA assets from one SIMPLE IRA plan in accordance with the procedures of the financial institution.

EMPLOYEE COMMUNICATIONS

There are two key disclosure documents that keep participants informed about the basics of how the plan operates, inform them of changes in the plan's structure and

operation, and provide them a chance to make decisions and take timely action with respect to their accounts.

The **summary description** is a plain-language explanation of the plan and is comprehensive enough to inform participants of their rights and responsibilities under the plan. It also informs participants about the features of the plan. This document is usually provided by the financial institution and is given to participants at the plan's inception, when employees first join the plan, and annually thereafter.

A summary description must include:

1. The names and addresses of the employer and trustee,
2. A description of the requirements for eligibility to participate,
3. The benefits provided,
4. The time and method of making salary elections, and
5. The procedure for, and effects of, withdrawals and rollovers (including the penalties for early withdrawals).

You can satisfy the summary description requirement by providing employees with the most recent copy of IRS Form 5304-SIMPLE or 5305-SIMPLE provided by the financial institution (if one of these model forms is used to establish the SIMPLE IRA plan), along with the financial institution's procedures for withdrawals and transfers.

Each year, in addition to the information above, employees must receive an **annual election notice** describing their right to make salary reduction contributions and your decision to make either matching or nonelective contributions for the following year. For employers that use one of the model forms, page 3 of Form 5304-SIMPLE and page 3 of Form 5305-SIMPLE contain a **Model Notification to Eligible Employees** that can be used to provide this information to employees.

Each year, during the 60-day election period at the end of the year, employees must be given the opportunity to enter into a salary reduction agreement or to modify an existing agreement.

REPORTING TO THE GOVERNMENT

SIMPLE IRA plans are **not** required to file annual financial reports with the government.

Distributions from the plan are reported by the financial institution making the distributions to both the IRS and the recipients of the distributions on Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

WHEN EMPLOYEES WANT TO STOP CONTRIBUTIONS

Employees may elect to terminate their salary reduction contributions to a SIMPLE IRA plan at any time. If they do so, the SIMPLE IRA plan may preclude them from resuming salary reduction contributions until the beginning of the next calendar year. Employers making nonelective employer contributions must continue to make them for these employees.

DISTRIBUTIONS

Participants cannot take loans from their SIMPLE IRAs.

SIMPLE IRA contributions and earnings can be withdrawn at any time. When participants take a distribution, they typically can elect to:

- Take a lump sum distribution of their account, or
- Roll over their account to an IRA or another employer's retirement plan.

TERMINATING THE PLAN

Although SIMPLE IRA plans are established with the intention of being ongoing, the time may come when a SIMPLE IRA plan no longer suits the purposes of your business.

To terminate a SIMPLE IRA plan, notify the financial institution that you will not make a contribution for the next calendar year and that you want to terminate the contract or agreement.

You must also notify your employees that the SIMPLE IRA plan will be discontinued.

You do not need to give any notice to the IRS that the SIMPLE IRA plan has been terminated.

REVIEW QUESTIONS

CHAPTER 13 – SIMPLE IRA

1. To qualify for a SIMPLE IRA plan, a business is limited to a maximum number of employees. What is that number?
 - A. 10
 - B. 25
 - C. 50
 - D. 100
2. What is the latest date an employer may initially set up a SIMPLE IRA plan?
 - A. April 15th
 - B. June 30th
 - C. October 1st
 - D. December 31st
3. What is the maximum salary reduction contribution amount an employee, under age 50, can make for 2019?
 - A. \$12,000
 - B. \$12,500
 - C. \$13,000
 - D. \$13,500
4. A **nonelective** employer may make a fixed percentage contribution amount to a SIMPLE IRA for all eligible employees. What is that amount for 2019?
 - A. One percent of the first \$275,000 of the employee's wages.
 - B. Two percent of the first \$275,000 of the employee's wages.
 - C. Three percent of the first \$275,000 of the employee's wages.
 - D. Four percent of the first \$275,000 of the employee's wages.

RESPONSES TO REVIEW QUESTIONS

CHAPTER 13 – SIMPLE IRA

1.
 - A. **Incorrect.** The business can have up to 100 employees and qualify for a SIMPLE IRA.
 - B. **Incorrect.** The business can have up to 100 employees.
 - C. **Incorrect.** The business can have up to 100 employees and must not currently have another retirement plan.
 - D. **Correct.** The business must have 100 or fewer employees who earned \$5,000 or more during the preceding calendar year.
2.
 - A. **Incorrect.** A SIMPLE IRA plan can be set up as late as October 1.
 - B. **Incorrect.** A SIMPLE IRA plan can be set up as late as October 1.
 - C. **Correct.** A SIMPLE IRA plan can be set up as late as October 1.
 - D. **Incorrect.** A SIMPLE IRA plan must be set up prior to October 1.
3.
 - A. **Incorrect.** The maximum amount that an employee, under age 50, can contribute for 2019 is \$13,000.
 - B. **Incorrect.** The maximum amount that an employee, under age 50, can contribute in 2019 is \$13,000.
 - C. **Correct.** The maximum amount that an employee, under age 50, can contribute in 2019 is \$13,000.
 - D. **Incorrect.** The maximum amount that an employee, under age 50, can contribute in 2019 is \$12,500. For 2018, the maximum amount you could contribute was the same at \$12,500.
4.
 - A. **Incorrect.** A non-elective employer must make a contribution equal to two percent of the employee's compensation (limited to \$280,000 per year of the employee's compensation).
 - B. **Correct.** A nonelective employer must make a two percent contribution to an employee's salary (limited to an employee's \$280,000 yearly salary).
 - C. **Incorrect.** A nonelective employer is required to contribute only a maximum of two percent of the employee's first \$280,000 salary per year.
 - D. **Incorrect.** A nonelective employer is required to contribute only a maximum of two percent of the employee's first \$280,000 per year.

CHAPTER 14

SECTION 199A DEDUCTION FOR QUALIFIED BUSINESS INCOME

In General. One of the most complex and controversial provisions of The Tax Cut and Jobs Act is the deduction for ***qualified business income***. While the purpose of 199A is clear, the calculation to arrive at the deduction is not. For taxable years after December 31, 2017, taxpayers other than C corporations may be entitled to a deduction of up to 20% of their ***qualified business income*** from a ***qualified trade or business***.

Factors in calculating the deduction.

- The type of trade or business.
- The taxpayer's taxable income
- The amount of W-2 wages paid with respect to the qualified trade or business.
- The unadjusted basis of qualified property held by the trade or business.

Who is entitled to claim the deduction.

- Owners of a sole proprietorship
- Owners of rental properties
- S Corporations
- Partnerships
- Trusts and Estates
- Real Estate Investment Trusts(REITs)
- Qualified cooperatives

Who is not entitled to claim the deduction.

1. C Corporations

Income from LLC's qualifies if the LLC is treated as a sole proprietorship(SMLLC), partnership, or S Corporation.

Where Will It Be Deducted. IRC 199A specifies that the deduction is not taken in computing adjusted gross income and is allowed for either taxpayers with the standard

deduction or using itemized deductions. It looks like the deduction will appear on page 2 on Form 1040 after standard and itemized deduction.

Qualified Trade or Business. A taxpayer must be engaged in a ***qualified trade or business*** to claim the 199A deduction. The code defines a qualified trade or business by ***exclusion***. Every trade or business is qualified other than:

1. The trade or business of performing services as an employee. This prevents an employee from claiming a 20% deduction against their wage income.
2. ***A specified trade or business.*** The code defines this as follows: Any trade or business involving the performance of services in the fields of law, health, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of the trade or business is the reputation or skill of 1 or more of its employees or owners.

Qualified Business Income. Calculating the ***Qualified Business Income*** (QBI) is the initial step in determining the Section 199A deduction. QBI must be calculated separately for each of the taxpayer's qualified businesses.

QBI is defined by the code as, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss of any qualified trade or business of the taxpayer. The qualified trade or business must be located in the United States or Puerto Rico. As usual with the 199A there are numerous exceptions. Here is a list of investment-related income that is ***not included*** in the QBI calculation.

- Short and long term capital gain or loss.
- Dividends or payments in lieu of dividends.
- Interest income that is not allocable to the trade or business.
- Net gain from foreign currency and commodities transaction.
- Net income from notional principal contracts.
- Annuity income.

There is also some noninvestment-related items that will ***not be included*** in the QBI calculation.

- Reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered.

- Guaranteed payments to partners or payments made to partners under IRC707(a) for services rendered to the partnership not in their capacity as partners.
- Qualified REIT dividends, PTP income, and cooperative dividends.

If the taxpayer's overall business income is less than zero, no deduction is allowed and the loss is carried over to the next year as a business loss. It looks like that losses will accumulate over the years. For example XYZ has business income of \$5,000 loss in 2018 and \$7,500 loss in 2019 XYZ will carry forward a \$12,500 loss into 2020.

The trade or business income computation is definitely influenced on where the taxpayer's taxable income falls relative to the phaseout range for the taxpayer's filing status.

PHASEOUTS FOR 2019

Filing Status	Phaseout Range	Size of Phaseout Range
Married Filing Joint	\$321,400 - \$421,400	\$100,000
Married Filing Separate	\$157,500 - \$207,500	\$50,000
Single, Head of Household	\$160,700 - \$210,700	\$50,000

Note: The phaseout range is based on the taxpayer's taxable income before the 199A deduction and for purposes of this calculation, the taxable income ***is not reduced*** by net capital gains.

In relation to the phaseouts you are faced with three different scenarios when calculating the 199A deduction.

1. At or below the taxable income threshold (pretty easy)
2. At or above the taxable income threshold (difficult)
3. In between the phaseout range (most complex)

WHEN TAXABLE INCOME IS AT OR BELOW THE PHASEOUT THRESHOLD

The following issues do not come into play when calculating the 199A deduction in this scenario:

- W-2 wage limitation.
- Phaseout limitations.
- It does not matter if business is service or nonservice.

The Calculation. First, the taxpayer calculates the deductible QBI amount for each qualified business. Then the taxpayer adds up the all deductible QBI to arrive at a combined QBI amount. If the taxpayer has only one qualified business, the combined QBI amount is the deductible QBI for that business. The deduction is equal to 20% of the **lesser** of:

- The combined QBI amount or
- The taxable income before the 199A deduction and after the reduction of any capital gains.

Example 1. George have reportable taxable income of \$140,000 with capital gains of \$20,000. His QBI is \$100,000. His 199A deduction is the lessor of $((\$100,000 \times 20\%) = \$20,000)$ or $((\$140,000 - \$20,000 = \$120,000) \times 20\% = \$24,000)$. George's Sec 199A deduction in this example is \$20,000.

Example 2. Ted and Sherry, filing jointly, have reportable taxable income of \$180,000 with capital gains of \$40,000. Their QBI is \$150,000. Their 199A deduction is the lessor of $((\$150,000 \times 20\%) = \$30,000)$ or $((\$180,000 - \$40,000) = \$140,000) \times 20\% = \$28,000)$. Their 199A deduction is \$28,000.

WHEN TAXABLE INCOME IS AT OR ABOVE THE PHASEOUT THRESHOLD

A couple of issues come into play here. One is if your business is a service(specified trade or business) or a nonservice business.

A specified trade or business. The code defines this as follows: Any trade or business involving the performance of services in the fields of law, health, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of the trade or business is the reputation or skill of 1 or more of its employees or owners.

If your trade or business falls into this category and the taxable income is \$421,400 or more for your business you will not be entitled to the Section 199A deduction. Therefore if your business is a non-specified trade or business, (i.e., engineering, architecture, manufacturing, etc.) you will be eligible for the 199A deduction regardless of taxable income.

Example 1. Ted and Sherry, filing jointly, have reportable taxable income of \$561,000 from their consulting business. Their consulting business is a

specified trade with taxable income of over \$421,400 so therefore they would be ineligible for the 199A deduction.

Example 2. Same as Example 1 but Ted and Sherry have an Architectural firm. They would be entitled to the Section 199A barring any W2 and depreciable asset limits.

The second issue is when your taxable income is at or over the phaseout range, and is a nonspecified trade or business is the deductible QBI amount is subject to **W2 wage** and capital limitation(of **qualified property**).

W2 Wages. are total wages subject to wage withholding, elective deferrals, and deferred compensation paid during the tax year that are attributable to QBI.

Qualified Property. The basis of qualified property is calculated as the unadjusted basis immediately after the purchase of the property. Qualified property is defined as the following:

1. Tangible property
2. Depreciable property
3. Available for use in the business at the close of the tax year.
4. Used in production of QBI at any time during the year.
5. The depreciable period has not ended before the end of the tax year.

The Calculation. The QBI deductible amount for the business is equal to the **lessor** of:

1. 20% of the QBI or
2. The **greater** of:
 - a. 50% of the wages paid by the business, including wages paid to the owner/employee or
 - b. The sum of
 - 25% of the wages paid by the business plus
 - 2.5% of the unadjusted basis of the qualified property.

Example 1. Ralph, a single filer, reports taxable income of \$260,000 and had QBI of \$220,000. He operates a nonspecified business and paid \$100,000 in wages. He also had \$480,000 of qualified property. The calculation for Ralph's 199A deduction is as follows:

1. $(20\% \times \$220,000 = \$44,000)$ or
2. The greater of:
 - a. $(50\% \times \$100,000 = \$50,000)$

$$b. (((25\% \times \$100,000 = \$25,000) + (2.5\% \times \$480,000 = \$12,000) = \$37,000)).$$

Ralph's 199A deduction is \$44,000.

WHEN TAXABLE INCOME IS IN BETWEEN THE THRESHOLD RANGE

Taxpayers with taxable income in between the threshold range are subject to a ratable phase-in of the **wage and capital limitation**. The thresholds are between \$321,400 to \$421,400 for married filing jointly taxpayers, \$157,500 to \$207,500 for married filing separate and \$160,700 to \$210,700 for single and head of household filers. For taxpayers owning a specified trade or business who are between the thresholds the deduction limitation is also phased in allowing them at least a partial 199A deduction.

Wage and Capital Limitation Phased In. Taxpayers between the taxable income thresholds and are not a **specified trade or business** are subject to only a **partial** wage and capital limitation. In calculating the deductible QBI amount for a business is 20% of QBI, minus the **reduction ratio** multiplied by the **excess amount**.

Reduction ratio is defined as the taxable income amount in excess of the lower threshold amount divided by 100,000 for joint filers and 50,000 for all others.

Example. Jane and Max, filing jointly, have taxable income of \$401,400 with their nonspecified business. Their reduction ratio is computed as follows: $((\$401,400 - \$321,400)/100,000) = 80\%$.

Excess amount is defined as the difference between the deductible QBI amount of the qualified business with no wage or capital limitation and the deductible QBI amount of the qualified business with a fully phased-in capital and wage limitation. Once you have this amount it is multiplied by the reduction ratio to determine the reduction of the wage and capital limitation. Here is an example of how to calculate the **excess amount**.

Example. We will use Jane and Max from the example above and add the following. Wages paid were \$70,000 and the unadjusted basis of qualified property were \$600,000. Their QBI was \$350,000. The calculation of the **excess amount**:

20% of QBI $(\$350,000 \times 20\%) = \$70,000$

Minus the greater of

50% of W2 wages $(\$70,000 \times 50\%) = \$35,000$

Or

25% of W2 wages + 2.5% of unadjusted basis of qualified property (($\$70,000 \times 25\%$))
+ ($\$600,000 \times 2.5\%$) = $\$17,500 + \$15,000 = \$32,500$.

The **excess amount** is $\$70,000 - \$35,000 = \$35,000$. When you multiply the reduction ratio by the excess amount you have the amount of the QBI that is phased out. In this case the phase-out amount is $\$28,000$.

Using the information from above we can calculate the Section 199A deduction for Jane and Max = 20% of QBI - **reduction ratio** X **excess amount**.

$\$70,000 - \$28,000 = \$42,000$.

The calculation is a little different for **specified(service) trade or businesses**. Now we must calculate an **applicable percentage**. The **applicable percentage** is 100% minus the ratio of taxable income in excess of the lower threshold amount, divided by $\$100,000$. This is basically the inverse of the **reduction ratio**.

Example. We will once again use the information from the Jane and Max example from above. $(\$401,400 - \$321,400)/\$100,000 = 1 - .80 = .20$. The **applicable percentage** is 20%.

Next, we multiply the **applicable percentage** to QBI, W-2 wages and the unadjusted basis of all qualified property to determine the **includible amount** of these items.

Example. To review from the Jane and Max scenario, their taxable income is $\$395,000$, QBI is $\$350,000$, W2 wages paid is $\$70,000$ and the unadjusted basis of qualified property is $\$600,000$.

Includible amount of QBI = $\$350,000 \times 20\% = \$70,000$

Includible amount of W2 wages paid = $\$70,000 \times 20\% = \$14,000$

Includible amount of unadjusted basis of qualified property = $\$600,000 \times 20\% = \$120,000$

Now we can proceed in calculating the deductible QBI amount for the business. We will use the info from the Jane and Max example but let's assume they have a service business. The **reduction ratio** and **includible amounts** will remain the same but the **excess amount** will have to be recalculated because we are using the **includible amounts**.

The calculation of the excess amount for a service business:

20% of the includible QBI($\$70,000 \times 20\%$) = $\$14,000$

Minus the greater of

50% of the includible W2 wages paid($\$14,000 \times 50\%$) = $\$7,000$

or

25% of includible W2 wages + 2.5% of includible unadjusted basis of qualified property $(\$14,000 \times 25\%) + (\$120,000 \times 2.5\%) = \$3,500 + \$3,000 = \$6,500$
The excess amount is $\$14,000 - \$7,000 = \$7,000$

The deductible QBI = 20% of QBI - (reduction ratio x excess amount) = $\$14,000 - (80\% \times \$7,000) = \$8,400$.

REVIEW QUESTIONS

CHAPTER 14 - SECTION 199A DEDUCTION FOR QUALIFIED BUSINESS INCOME

1. Taxpayers may be entitled to a deduction of a percentage of their qualified business income. What is that percentage?
 - A. 5%
 - B. 10%
 - C. 15%
 - D. 20%
2. The taxpayer must be engaged in a qualified trade or business to qualify for the Section 199A deduction. Which one of the following is a qualified trade or business?
 - A. Performing services as an employee is a qualified trade.
 - B. Financial services is a qualified business.
 - C. Engineering is a qualifying business.
 - D. Accounting is a qualifying business.
3. In regards to the Section 199A deduction what is the size of the phase-out range for married filing joint filers?
 - A. There is no phase-out range for the 199A deduction.
 - B. \$50,000
 - C. \$100,000
 - D. \$150,000
4. Howard has a qualified business with taxable income of \$130,000 for the year. His qualified business income is \$110,000 and also had capital gains of \$10,000. What is Howard's Section 199A deduction?
 - A. \$20,000
 - B. \$22,000
 - C. \$24,000
 - D. \$26,000

5. Ted and Alice, who are married filing joint filers with a qualified business, had taxable income of \$366,400. What is their reduction ratio?
- A. 0%
 - B. 25%
 - C. 45%
 - D. 60%

RESPONSES TO REVIEW QUESTIONS

CHAPTER 14 - SECTION 199A DEDUCTION FOR QUALIFIED BUSINESS INCOME

1.
 - A. **Incorrect.** The maximum Section 199A deduction is 20% for a qualified trade or business.
 - B. **Incorrect.** See A above.
 - C. **Incorrect.** See A above.
 - D. **Correct.** See A above.
2.
 - A. **Incorrect.** Performing services as an employee is definitely not a qualified trade or business.
 - B. **Incorrect.** Financial services is considered a specified business and therefore not a qualified business.
 - C. **Correct.** Engineering is not an excluded trade or business so it's considered a qualified business.
 - D. **Incorrect.** Accounting is a specified trade or business so it is not a qualified trade or business.
3.
 - A. **Incorrect.** There are two phase-out ranges depending on your filing status.
 - B. **Incorrect.** This is the phase-out range for all other filers **except** for married filing joint filers.
 - C. **Correct.** The phase-out range for married filing joint filers is from \$321,400 to \$421,400.
 - D. **Incorrect.** The phase-out range for married filing joint filers is \$100,000.
4.
 - A. **Incorrect.** The 199A deduction is 20% of the lessor of the combined qualified business income or the taxable income before the 199A deduction minus capital gains.
 - B. **Correct.** The deduction is the lessor of : $.2 \times \$110,000 = \$22,000$ or $(\$130,000 - \$10,000) \times .2 = \$24,000$. The 199A deduction is \$22,000.
 - C. **Incorrect.** See B above.
 - D. **Incorrect.** See B above.

5.

- A. **Incorrect.** The reduction ratio is used when the taxable income is in between the upper and lower threshold of the phase-out range.
- B. **Incorrect.** See C below.
- C. **Correct.** The reduction ratio = $(\$366,400 - \$321,400)/100,000 = 45\%$
- D. **Incorrect.** See C above.

ADDENDUM A

SELECTED COMPARATIVE FEATURES OF SOLE PROPRIETORSHIPS, “C” CORPORATIONS, “S” CORPORATIONS AND LIMITED LIABILITY COMPANIES.

Note: The “S” in the S Corporation’s title is a common reference to the fact that the subchapter S rules of the Internal Revenue Code apply to it. S Corporations have certain rules that apply to it that do not apply to regular “C” Corporations.

The “C” in C Corporations is a commonly used identification used to distinguish it from “S” Corporations. More information is included later.

ORGANIZATION

Sole Proprietorships. They consist of only one individual who is solely responsible for the operation of the business. He or she is the recipient of any profit or loss from the business. However, a married individual, filing a joint return, would include the business profit on the joint return.

Partnerships. This is a group of two or more individuals joined together in a business venture to make a profit. Each partnership must have one or more general partners. The partnership agreement can be either verbal or in writing. The profits and losses can be allocated by any agreed on formula. In the absence of any agreement, the profits or losses pass through to the partners based on their respective percentage interest in the partnership.

C Corporations. This is a stand-alone entity unto itself. The shareholders elect officers of the corporation to carry on the business and make other corporate decisions. Corporations must hold periodic board meetings and keep minutes. Corporations must comply with Federal and state laws. The shareholders can change the existing corporate officers by majority vote.

S Corporations. This is simply a regular “C” Corporation that has applied to the Internal Revenue Service (and approved) to be allowed special income tax treatment. To become a S Corporation the individuals desiring S corporation status must **first** form a regular C Corporation under existing state laws, and then apply to the IRS for S Corporation status.

Limited Liability Companies. This is an entity formed under state law that includes the income, credit and deduction features of a partnership and the limited liability of a corporation.

PERSONAL LIABILITY

Sole Proprietorship. The sole proprietor is personally liable for all business debts. In the event there is a money judgment against the business and there are insufficient assets to pay, the sole proprietor's personal assets would be subject to attachment.

Partnerships. The general partners' are personally liable for all partnership debts. For this (and other) reasons, the general partner normally is much more generously financially rewarded than the limited partners.

C Corporations. Shareholders are not liable for the debts of the corporation. They could not be liable for more than the amount of their investments.

S Corporations. The shareholders are not liable for the S Corporation's debts. Their liability is generally limited to the amount of their investment in the S Corporation.

Limited Liability Companies. The liability for members of limited liability companies varies from state to state. Some states' limits of liability are similar to corporations while others have a mixed set of rules for liability.

CONTROL OF BUSINESS OPERATIONS

Sole Proprietorship. The owner makes all business decisions.

Partnerships. The general partner(s) usually are responsible for the business decisions. However, the general partner is answerable to the limited partners. The general partner can be replaced by the limited partners. In that sense, the limited partners control the business operations of the partnership.

C Corporations. Shareholders have control over the corporation to the extent that they own stock (normally voting stock).

S Corporations. As in the case of C Corporations, shareholders have control to the extent of their voting stock.

Limited Liability Companies. The control of limited liability companies is divided among the members.

TAXATION

Sole Proprietorship. A sole proprietor's net profit or loss is calculated on Schedule C and reported on his or her Form 1040.

Partnerships. Partnership income, credits and deductions are calculated on Form 1065 and are passed through to the individual partners on Schedule K-1. All of the pass-through items retain the same taxable character to the partner as they were in the

hands of the partnership. The partners' pass-through income is subject to income tax even if the income is not distributed to the partner.

C Corporations. A corporation calculates its profits on Form 1120 and pays tax on profits at the corporate rate. If the corporation pays its shareholders dividends from the profits, the shareholders then pay income tax on these dividends. This is what is referred to as "double taxation". The corporation has the option of **not** paying dividends.

S Corporations. The principal reason for establishing an S Corporation is the more favorable taxation. An S Corporation is taxed similarly to a partnership. The profits are passed through to the shareholders. The pass-through items retain the same taxable status in the hands of the shareholders as they were in the hands of the S Corporation. That is, if the income was ordinary income in the hands of the S Corporation, it is treated as ordinary income in the hands of the shareholder and any capital gain passed through to the shareholder is treated as capital gain to the shareholder.

One notable exception to the pass-through of income and credits is the section 179 deduction. The S Corporation's maximum section 179 deduction is the same maximum as an individual's. It is passed through in proportion to the individual's interest in the S Corporation. Also, the amount passed through to the individual shareholder must be added to that individual's other section 179 deduction (if any) so as to not exceed the maximum yearly limit for an individual.

Limited Liability Companies. A limited liability company is taxed similarly to a partnership or an S Corporation described above. The L.L.C.'s profits are passed through to its members.

WAGES AND SELF-EMPLOYMENT TAX

Sole Proprietorships. The owner is subject to a 12.4% Social Security tax and a 2.9% Medicare tax for a total of 15.3% on the net profit of his or her business subject to yearly limitations. He or she then receives an **adjustment** of 50% of the self-employment tax against his or her **combined** Form 1040 gross income.

Partnerships. A general partner's share of business income (including guaranteed payments) is subject to SE tax.

A limited partner's share of income is not subject to SE tax unless the limited partner performs services for the partnership. If the limited partner does not perform services, his share of income would be derived from his investment and as such, would not be subject to employment taxes.

C Corporations. Shareholders who perform services for C Corporations are treated as **employees**. Their wages are subject to regular employee employment taxes (7.65% combines Social Security and Medicare taxes). The C Corporation (the employer)

matches this 7.65% amount. These regular employee employment taxes apply only to payment for services performed and **not** to any dividends distributed.

S Corporations. Payments to an employee-shareholder are considered wages for services rendered and are subject to employee/employer taxes as in the case of the above discussion of C Corporations. Any net profits after deductions for wages and other expenses are passed through to the shareholders and are subject to income taxes but **not** subject to SE tax.

Limited Liability Companies. Profits are taxed in the same manner as partnerships. Members' income and guaranteed payments are subject to SE tax.

LOSSES

Sole Proprietorships. The net loss of a sole proprietorship is calculated on Schedule C. The losses then offset other income included on Form 1040.

Partnerships. Any partnership loss passes through to the partners in the same manner as income passes through. The partners' deduction of these losses may be limited by his or her basis, by the at-risk rules or by the passive activity rules that apply to individuals.

C Corporations. The **capital losses** of a C Corporation are deductible by the corporation but are allowed only to the extent of the capital gain. Net operating losses are **not** passed through to the shareholders but may be carried over against future corporate income.

S Corporations. Losses pass through to the shareholders in the same manner as income passes through. However, the shareholders' deduction of these losses may be limited by his or her basis, the at-risk rules or by the passive activity rules that apply to individuals.

Limited Liability Companies. Any losses pass through to the members in the same manner as income passes through. However, the members' deduction of these losses may be limited by his or her basis, the at-risk rules or by the passive activity rules that apply to individuals.

TRANSFER OF OWNERSHIP

Sole Proprietorships. The selling of a sole proprietorship is effectively the sale of the assets. These assets may include merchandise, equipment, accounts receivable and goodwill. A seller and a buyer usually negotiate a combined dollar price, but for income tax reporting purposes, a set dollar value must be assigned to each of the various assets.

Partnerships. The partnership agreement may place limitations on the sale of the partnership interest and control the terms of the sale. A limited partner's interest is not always easy to sell because the value of the interest is not as readily determined as, say, the sale of publicly traded stock of a corporation.

C Corporations. The ownership of a C Corporation is easily transferred by the sale of stock. However, the sale of shares by stockholders may be subject to restrictions of the C Corporation.

S Corporations. The transfer of ownership of a S Corporation is made by the sale of shares of stock. However, the sale of shares may have certain restrictions based on the corporate charter.

Limited Liability Companies. The ownership agreement dictates the conditions of the transfer of the ownership interests.

ADVANTAGES AND DISADVANTAGES

Sole Proprietorships.

Advantages

1. Very few legal restrictions.
2. You are the “boss” and sole decision maker.
3. Easy to close down the business

Disadvantages

1. You have unlimited liability—your personal nonbusiness assets can be seized.
2. You are not allowed new co-owners with additional capital contributions.
3. You cannot retain profits in business to defer payment of income taxes.
4. If business loses money, you either have to put in additional personal assets or close the business.

Partnerships.

Advantages

1. Partnerships can be used to bring in individual investors who do not want any personal liability—limited partners.
2. A good way to gather a variety of participants with a diversity of skills.

Disadvantages

1. It is sometimes difficult for a partner to sell his or her interest in the partnership.
2. General partners have unlimited liability.

C Corporations.

Advantages

1. Limited liability.
2. Generally, easier to raise capital through the sale of shares.
3. The corporation is a stand-alone entity that is not dependent on shareholders for a continuing existence.
4. Transfer of ownership is simple through the sale of shares.

Disadvantages

1. Double taxation of profits (dividends).
2. Types of business activities limited by corporate charter.
3. Subject to Federal and state regulations.

S Corporations.

Advantages

1. Limited liability.
2. No double taxation of profits (dividends).
3. Pass through profits are generally subject to income tax but not SE tax.
4. Transfer of ownership is simple through the sale of shares.

Disadvantages

1. Shareholder pays income tax on profits even though they are not distributed.
2. Types of business activities limited by corporate charter.
3. Subject to Federal and state regulations.

Limited Liability Companies.

Advantages

1. Avoids most S corporation restrictions.
2. Avoids double taxation of profits—no dividend payout.

Disadvantages

1. Different treatment by the various states of the U.S.
2. To qualify to be taxed as a partnership, it must have two or more owners.

GLOSSARY – SYSTEM TEN

Accounts Receivable. The balance in the accounts of customers who owe money to a company.

Accrual Method. Income is required to be reported in the year **earned** even if it is received in a later year.

Advance Income. Income received before it is legally due.

Amortization. The reduction of an asset's book value by an amount, usually in equal ratable amounts, over a period of time.

Bartering. An exchange of your property or services for someone else's property or services.

Basis. The value of an asset for figuring its tax implications. Cost is the usual starting point but often, positive and/or negative **adjustments to cost** will increase or reduce its depreciable or other value.

Calendar Tax Year. The period of time used in compiling your tax records from January 1 through December 31.

Community Income. The combined income **earned** by both a husband and wife while residents of one of the nine United States community property states.

Community Property. Property that is equally owned by both a husband and wife in one of the nine United States community property states. It does not include assets owned by either spouse **before** the marriage and **does not** include any **non-community** assets acquired during the marriage by either of the spouses (usually by gift or inheritance).

Constructive Receipt. A dollar amount that is credited to your account for your use **without restriction**, even if you do not have physical possession of it.

Conventions. In depreciation, an arbitrary timetable that dictates the manner of calculating your deductible amount for the year without regard to the actual date during the year that you actually acquired an asset. For depreciation, the conventions are: mid-month, mid-quarter, and half-year.

Cost of Goods Sold. The cost of merchandise that you sell during your financial year. It generally is the dollar amount that you start with **plus** the dollar amount that you purchase during the year, **less** the dollar amount that you have at the end of your financial year.

Currently Deductible. This means that the amount of a business expense is deductible (usually in full) as an **ordinary expense** in the current year. Depreciation, amortization and depletion must be taken over a period of years and are not “currently deductible”.

Depreciation. The method used to recover (deduct) your cost of an asset you use in your trade or business. “Recovering your cost” means deducting from income as a business expense the amount you paid for the asset. Depreciation applies **only** to assets that are expected to (and normally do) have a useful life in your business of over one year.

Double-Entry. A double-entry system contains one account for debits and one account for credits. It is self-balancing because the “debit side” and the “credit side” must balance out.

Employer Identification Number (EIN). An employer identification number is required for all business by the Internal Revenue Service. This is the formal identification number of your business. It is a nine-digit number 00-0000000 issued by request to the IRS.

FIFO Method. The initials stand for “first-in”, “first-out”. This is an IRS accepted method for a business to account for inventory value. If you elect to calculate your inventory value based on what you originally paid for an item, then you must use that figure to figure the items that you sold. You cannot use the price you first paid and then the price you paid for the most recent purchase of that item to calculate value.

Fiscal Year. A fiscal year is:

- A. Any tax year of 12 consecutive months ending on the last day of any month **except** December 31. (A tax year ending on December 31 is a **calendar year** for income tax purposes).
- B. A 52-53 week year that always ends on the same day of the week that occurs on a particular month.

Goodwill. Goodwill is the amount of a business’s value **after** the value of all other of the assets is subtracted.

Half-Year Convention. In depreciation, the half-year convention allows **only** six months of depreciation in the **first year** the asset in service **without regard** to the actual date it is placed in service.

Improvements. The value of additions to a business asset that is expected to last more than one year. Generally, this “over one-year” addition will lengthen the time you can use it or adapt it to a different business use.

Installment Notes. Contracts for payments (usually equal) over a predetermined period of time until the debt is paid in full.

Intangible Property. Intangible property is property that has a business value but cannot be physically felt or touched. Examples are trademarks, franchises, promissory notes, copyrights and goodwill. Some of these items may be recorded by a paper document, but the paper document is **not** the value. It merely **documents** the items value.

LIFO Method. The opposite of the FIFO method. The LIFO method of inventory valuation requires that the relationship of the cost of the **last item purchased** is used with the cost of the **first item sold** to determine inventory value.

Mid-Month Convention. For nonresidential real and residential rental property, a mid-month convention dictates that all property is placed in service, or disposed of on the **midpoint** of the month. This is usually the 15th of the month and dictates the depreciation calculation.

Mid-Quarter Convention. Mid-quarter convention dictates that if the **total combined basis** of all non-real estate depreciable property that is placed in service in the last three months of the tax year exceeds 40% of the **total combined basis of all** non-real estate depreciable property placed in service during the **entire year**, you must use the IRS's **four** mid-quarter tables to calculate depreciation.

Modified Accelerated Cost Recovery System (MACRS). MACRS depreciation provides three ways to depreciate property, the 200% and the 150% declining balance method and a straight-line method. It dictates an arbitrary useful life for all varieties of assets with IRS tables for all variations.

Personal Property. Real property is land and anything fixed to the land. Everything else is personal property.

Real Property. Real property is land and anything fixed to it.

Section 179 Expense Deduction. This is a deduction for non-real estate assets that may be taken in lieu of depreciation. The amount taken reduces any remaining amount of available depreciation by the amount of the section 179 deduction taken. The current (2019) maximum amount allowed is \$1,020,000 and is limited by certain income and investments limits.

Section 197 Intangible Assets. Certain intangible business assets may be **amortized** over a 15-year period. These assets include goodwill, a franchise, a trademark, patents, copyrights, going concern value and other similar assets.

Single-Entry. A single-entry system records the flow of income and expense through the use of:

- A. A daily summary of cash receipts and
- B. A monthly summary of cash receipts and disbursements.

Separate Property. Separate property is all property that is not community property. For a married couple, a distinction is made for property that was owned by either spouse **prior** to the marriage **plus** any non-community property acquired during the marriage, usually by gift or inheritance.

Sport Utility Vehicles (SUVs). Sport utility vehicles are essentially vans rated at more than 6,000 pounds and no more than 14,000 pounds. They are defined as four-wheeled vehicles primarily to be used to carry passengers over public streets or roads. SUVs have a special maximum limit of either a \$25,500 section 179 deduction or its basis may be depreciated using MACRS rules.

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