Income Tax Concepts

CHAPTER LEARNING OBJECTIVES

- Discuss the operation of the U.S. income tax as a system and how concepts, constructs, and doctrines provide overall guidance in the tax treatment of items that affect taxable income.

- Identify the general concepts that underlie the tax system and explain how the concepts affect taxation.

- Explain the effect of accounting concepts, how such concepts provide guidance in determining when an item of income should be included in gross income, and when an expense item is deductible.

- Describe income concepts and explain how they aid in determining which items constitute gross income for tax purposes.

- Discuss deduction concepts and how such concepts affect what may be deducted for income tax purposes.
The federal income tax is based on a system of rules and regulations that determine the treatment of various items of income and expense. The key point to be made is that federal income taxation is based on a system. As such, it shares the characteristics of any type of system. We are all familiar with systems; our society is organized by systems of rules. Some systems are natural and afford us little leeway in abiding by them. For example, gravity is part of the environmental system in which we live and a force that cannot be overcome without great difficulty. Because of our knowledge of and experience with the concept of gravity, we have learned that we must be aware of its effects on our behavior. For example, because of the effect of gravity, you cannot walk off a cliff without suffering grave consequences.

Most of the legal and social systems we deal with every day are artificial. That is, people make rules and prescribe actions to enforce them. In these systems, detailed rules are developed for general concepts. For example, all states have testing requirements that must be met to get a driver’s license. A person who moves from one state to another generally has no problem passing the test in the new state, because the general concepts involved in driving an automobile do not change from location to location.

Artificial systems are distinguished from natural systems by exceptions to the general rules of the system. These exceptions are necessary to meet specific needs. Returning to our driving example, we know that most states permit you to make a right turn at a red light after making a complete stop (i.e., the general rule). However, traffic experts have determined that some intersections are so hazardous that the general rule cannot be followed. The result is an exception to the law—we cannot make a right turn on red after a complete stop at some intersections. How do we identify those instances in which we may not make a right turn on red? Simple—the rules provide that an appropriately labeled sign be posted to alert us to the exception.

As with all artificial systems, the federal income tax system has been developed around general concepts that guide us in its application to various types of transactions. There are, of course, exceptions that do not follow from the application of the general concepts. These exceptions generally stem from the desire to use the tax system to promote some social, economic, or political goal. For example, the income tax law provides an exclusion from income for employer-provided health insurance policies. This payment of the employee’s expenses by the employer could be taxed. However, to encourage employers to provide health-care coverage for their employees (a social goal), Congress has excluded such payments from the employee’s income. Another example of an exception involves losses on the sale of stocks. Net loss deductions on the sale of stocks by individuals are limited to $3,000 per year. However, to encourage investment in small companies (an economic goal), a special provision in the tax law allows the deduction of up to $50,000 in losses from an investment in the stock of a new company. The only effective way to learn the exceptions in the tax law is through experience and study. That is, there are no explicit “no right turn on red” signs in the tax law. The major exceptions to the general concepts of taxation are presented in this book, but the focus is on developing the ability to determine the treatment of transactions by applying the general concepts of taxation.

This chapter groups income tax concepts by their major function(s) within the income tax system. The four major groupings for discussion purposes are general concepts, accounting concepts, income concepts, and deduction concepts. Throughout the remaining chapters, the text constantly refers to these concepts to help explain the tax treatments being presented. You must understand these concepts, so we suggest that you return to this chapter and review the applicable concepts before you begin reading a new chapter. To help you, each chapter begins with a summary of the concepts applicable to the chapter’s material.

Before beginning the discussion of the concepts, it is necessary to introduce a bit of terminology used throughout the remainder of the book. A concept is a broad principle that provides guidance on the income tax treatment of transactions. Because a specific concept covers many transactions, concepts are broad. A construct is a mechanism that has been developed to implement a concept. A doctrine is a
construct that has been developed by the courts. Thus, constructs and doctrines are the interpretive devices necessary to apply a concept. When this book refers to a concept, the text includes all its related constructs and doctrines. An example of a concept is the annual accounting period concept; it requires all income tax entities to report their results on an annual basis. To properly identify the income of each annual period, each entity must select an accounting method. In this example, annual accounting period is the concept, and accounting method is the construct necessary to implement the concept. Thus, when we talk about the annual accounting period concept, the accounting method construct is implicitly a part of the concept.

This chapter introduces and discusses the fundamental concepts of income taxation. The discussion of each concept includes the fundamental constructs and doctrines necessary to begin the study of income taxation.

**General Concepts**

General concepts provide guidance on the overall operation and implementation of the income tax system. As such, these concepts apply to almost every aspect of the system, be it an accounting issue, an income issue, or a deduction issue.

**Ability-to-Pay Concept**

A fundamental concept underlying the income tax structure is the ability-to-pay concept. This concept states that the tax levied on a taxpayer should be based on the amount that the taxpayer can afford to pay. The first result of this concept is that the income tax base is a net income number (i.e., income minus deductions and losses) rather than a gross figure such as total income received. Therefore, the tax base recognizes different deduction levels incurred by taxpayers as well as different levels of income.

▲ **EXAMPLE 1** Jerry and Jody each have a total income of $65,000. Jerry’s allowable deductions are $20,000, and Jody’s allowable deductions are $35,000.

**Discussion:** Although Jerry and Jody have identical total incomes, Jerry’s allowable deductions are $15,000 less than Jody’s. Thus, Jerry has a greater ability to pay taxes than does Jody. Allowing deductions in the income tax base recognizes taxpayers’ varying abilities to pay.

The example of Jerry and Jody illustrates that the notions of income and deduction are fundamental constructs that are used to implement one aspect of the ability-to-pay concept. Losses and tax credits also reduce the amount of tax due and are related to a taxpayer’s ability to pay tax. These constructs were defined and discussed in Chapter 1, and we will not elaborate further at this juncture. However, we would note that the study of income taxation is essentially the study of what makes up these constructs. It is important to remember that these constructs are really the basic elements of the system.

A second aspect of the ability-to-pay concept is the use of a progressive tax rate structure. Recall that a progressive tax is one in which higher levels of the tax base are subjected to increasingly higher tax rates. Individuals with large taxable incomes pay a higher marginal tax rate than do individuals with small taxable incomes. Thus, both the tax base—taxable income—and the tax rate applied to the base are determined by the taxpayer’s ability to pay tax. It should be noted that the ability-to-pay concept is undermined by provisions that exclude certain types of income from the tax base. That is, to the extent that a taxpayer has income that is not subject to tax because of an allowable exclusion, the taxpayer is being taxed at less than her or his ability to pay.

▲ **EXAMPLE 2** Dewitt and Gloria are a retired couple with a taxable income of $32,000. The primary source of their taxable income is Gloria’s pension and taxable dividends and interest. In addition, Dewitt and Gloria own municipal bonds that pay annual interest of $14,000 that is not included in their taxable income. What is the effect of the exclusion of the bond interest on the ability-to-pay concept?
**Discussion:** Because the $14,000 in interest from the bonds is available to pay Dewitt and Gloria’s taxes, the exclusion of the interest from the tax base allows them to pay less tax than they could afford to pay. This effect is somewhat mitigated by the lower interest rates found on tax-exempt bonds when compared with taxable bonds. That is, by investing in municipal bonds, Dewitt and Gloria have accepted a lower interest rate than they could have obtained by investing in taxable bonds. Thus, they have paid some implicit tax on the bonds (although none of it goes to the federal government) by accepting the lower tax-exempt bond rate.

### Administrative Convenience Concept

Throughout the discussion of the income tax, a particular item often is not treated consistently with the basic concept applicable to the situation. Many of these treatments result from the **administrative convenience concept**. This concept states that items may be omitted from the tax base whenever the cost of implementing a concept exceeds the benefit of using it. The cost is generally the time and effort for taxpayers to accumulate the information necessary to implement the concept as well as the cost to the government of ensuring compliance with the concept. The benefit received from implementation is generally the amount of tax that would be collected. Thus, many items that meet the definition of *income* are not taxed, because the cost of collecting the information necessary to ensure compliance would be greater than the tax produced by the income.

▲ **EXAMPLE 3** Bravo Company provides a break room for its employees. Free coffee is provided to the employees there at a cost to Bravo of ten cents per cup. Leroy is an employee of Bravo Company who drinks three cups of coffee in the break room on an average day. Is Leroy taxed on the free coffee he receives from Bravo Company?

**Discussion:** Under general concepts of income recognition (discussed later in this chapter and in depth in Chapter 3), Leroy receives income when he drinks the free coffee provided by his employer. This is, in effect, a form of compensation Bravo provides to its employees. However, the cost of each employee’s tracking his or her consumption of coffee, as well as the cost of the government’s ensuring that all employees include the cost of their free coffee in their income, exceeds the additional tax that would be collected. Thus, under the administrative convenience concept, Leroy is not taxed on the free coffee.

Another aspect of this concept relates to deductions for individuals. The tax law lets individuals take deductions for certain personal expenditures (e.g., medical expenses, charitable contributions). However, many individuals incur only small amounts of these allowable personal deductions. In these situations, the tax law lets a taxpayer take a standard deduction in lieu of accumulating the information necessary to deduct the actual allowable deductions. This treatment saves taxpayers’ time in accumulating and reporting deduction information and the government’s time in ensuring the accuracy of the information reported (i.e., the standard deduction does not need to be audited).

▲ **EXAMPLE 4** Tara believes that she probably does not have a significant amount of allowable personal deductions in 2003. Even if she searches her records, she figures it’s unlikely she can document more than $4,750, the 2003 standard deduction for a single taxpayer.

**Discussion:** Tara may elect to deduct the $4,750 standard deduction. This relieves her of having to document her small amount of allowable personal deductions, and the government incurs no cost to ensure that her deductions are correct. When taxpayers’ allowable personal deductions are close to the amount of their allowable standard deduction, it is more convenient for them to deduct the allowable standard deduction than spend a lot of time trying to document deductions that may provide very little tax savings.

### Arm’s-Length Transaction Concept

In seeking to pay the minimum amount of tax, taxpayers often structure transactions that may not reflect economic reality. In many such cases, the transaction is not given any tax effect, because the transaction is deemed not to conform with the
arm’s-length transaction concept. An arm’s-length transaction is one in which all parties have bargained in good faith and for their individual benefits, not for the benefit of the transaction group. Transactions that are not made at arm’s length are generally not given any tax effect or are not given the intended tax effect.

**EXAMPLE 5**  Bo, the sole shareholder of Shoe Company, owns a shoe-stretching machine for which he paid $15,000 and that is worth $18,000. He sells the machine to Shoe Company for $5,000. Can Bo deduct the loss on the sale of the machine to Shoe Company?  

**Discussion:** Because Bo was, in effect, negotiating with himself when he sold the machine to Shoe Company, the transaction was not made at arm’s length, and Bo will not be allowed to deduct the loss on the sale. **NOTE:** Bo can deal at arm’s length with Shoe Company. However, the tax law assumes that related parties (defined subsequently) do not transact at arm’s length. One effect of this assumption is that losses on sales to related parties are always disallowed, even if the transaction is made at arm’s length and the price reflects fair market value.

As example 5 shows, transactions that are not made at arm’s length generally involve an element of self-dealing. The tax law has formally incorporated the notion of self-dealing through a set of related party provisions. Some of the more-common related party relationships (depicted in Figure 2–1) are:

1. Individuals and their families. Family members include a spouse, brothers, sisters, lineal descendants (children, grandchildren), and ancestors (parents, grandparents).
2. Individuals and a corporation (or a partnership) if the individual owns more than 50 percent of the corporation (or the partnership).
3. A corporation and a partnership if the same person owns more than 50 percent of both the corporation and the partnership.

Note that all these relationships have the potential for self-dealing, either because of family relationships or a substantial ownership interest in an entity. The more-than-50-percent test for corporations and partnerships is based on the level of
ownership necessary to control the actions of these entities. In example 5, Bo and Shoe Company are related parties, because Bo owns more than 50 percent of Shoe Company and effectively controls Shoe Company’s actions. Thus, when Bo deals with Shoe Company, he really deals with himself. In trying to circumvent the related party rules, individuals might reduce their direct ownership in a corporation or a partnership by distributing ownership among family members, other corporations, or partnerships that they control. This effort is stymied by the constructive ownership rules, which state the relationships within which an individual is deemed to indirectly own an interest actually owned by another person or entity. These rules can be complex and are beyond the scope of this text.

**Pay-as-You-Go Concept**

The U.S. income tax system is one in which voluntary compliance is essential to the operation of the system. Most taxpayers comply with the requirement that they file a return each year and pay the tax due on their taxable income. However, the payment of the entire tax bill at the end of the year could be unduly burdensome for those taxpayers who do not have the foresight to save money for the payment of the tax or who do not have the ability to adequately estimate the amount of the tax they owe. To alleviate situations in which taxpayers are faced with a huge tax bill at the end of the year, the pay-as-you-go concept requires taxpayers to pay tax as they generate income. This concept is implemented through withholding and estimated tax payment requirements. The withholding provisions require employers to withhold amounts from each employee’s paycheck to pay the tax on the income in that check. The withheld amounts are remitted to the government, and taxpayers receive credit on their tax returns for the tax paid through withholding. This minimizes the probability of a taxpayer facing a huge tax bill at the end of the year. Note that the taxpayer might pay too much tax through this process. In such cases, the government simply refunds the excess tax that has been paid.

▲ **EXAMPLE 6** Giovanna is a machinist who works for Adilia Company. During the current year, she earned $32,500 and had $3,450 of federal income tax withheld from her paycheck. In filing her return, Giovanna’s actual tax was determined to be $3,675. How much tax must Giovanna pay when she files her return for the current year?

**Discussion:** Although Giovanna’s actual tax is $3,675, she has already paid in $3,450 through withholding. Therefore, she has to pay only $225 ($3,675 – $3,450) when she files her current year’s return. Note: The withholding provisions ease for Giovanna the burden of having to come up with the full $3,675 when she files her tax return. By having Giovanna pay as she goes (her employer withholds tax payments), the tax system encourages voluntary compliance; it spreads the burden of taxes over the period of time during which the income is being earned.

Although salaries paid by employers constitute a large percentage of the income taxed in the United States, it is by no means the only source of income for individual taxpayers. That is, taxpayers often earn income independent of any employee-employer relationship. Many people are their own bosses (i.e., self-employed), others earn income from investments such as savings accounts, dividends from stock, and sales of assets, and retired individuals collect pensions, Social Security benefits, and income from investments. To ensure that such taxpayers have the means to pay the tax due on these various sources of income, all individual taxpayers are required to make quarterly estimated tax payments—to meet the estimated tax payment requirements—when their estimated tax due for the year is at least $1,000. Corporations also must file quarterly estimated tax payments. Thus, taxpayers who have significant amounts of income that are not subject to withholding by employers are also required to adhere to the pay-as-you-go concept. Failure to make the required estimated tax payments will result in a penalty for underpayment of estimated taxes.
Accounting concepts guide the proper accounting for and recording of transactions that affect the tax liability of taxpayers. To determine the treatment of a transaction, we must first identify the appropriate taxpaying unit. Next, we must ascertain the rationale that controls its tax treatment in order to record it. Finally, the transaction must be reported in the correct tax period. These ideas appear to be rather simplistic and part of basic bookkeeping. That is partly true. However, without these basic accounting concepts, the tax system could not function in an orderly and efficient manner. Perhaps even more important, without these concepts, taxpayers could manipulate their affairs so as to avoid paying taxes for many years.

Entity Concept
The most basic accounting concept is the entity concept. According to the entity concept, each tax unit must keep separate records and report the results of its operations separate and apart from other tax units. The tax law requires that all tax units be classified as one of two basic entity types: taxable or conduit. The characteristics and unique features of each of the taxable and conduit entities are discussed in detail in Chapters 13 and 14.

Taxable entities are those that are liable for the payment of tax. That is, taxable entities must pay a tax based on their taxable income. The four entities responsible for the payment of income tax are individuals; regular, or C corporations; estates; and some trusts.

Conduit entities are nontaxable reporting entities. A conduit entity is one in which the tax attributes (income, deductions, losses, credits) of the entity flow through the entity to the owner(s) of the entity for tax purposes. The conduit entity records transactions undertaken by the entity and report the results to the government. However, these entities pay no tax on the results of their operations. Rather, the tax characteristics (i.e., the income, deductions, losses, tax credits, etc.) of the operating results are passed through the conduit entity and are taxed to its owners. NOTE: All conduit entities are owned by one or more taxable entities. Two types of conduit entities authorized by the tax law are partnerships and subchapter S corporations. Hereafter, any reference to a corporation means a taxable C corporation. Conduit corporations are referred to as S corporations.

Trusts are a mixture of taxable and conduit entities. A trust is an arrangement in which a trustee manages assets for the benefit of another, referred to as the beneficiary. The trust reports the results of its operations to the government (a conduit characteristic). Any income distributed by the trust to the beneficiary is taxable to the beneficiary. However, the trust must pay income tax on any income that is earned but not distributed to the beneficiary (a taxable entity characteristic). Thus, trusts are both taxable and conduit entities in that they are taxed on income that is retained and are not taxed on income that is distributed.

To illustrate the relationship between the two basic types of entities, consider a 100-percent owner of a corporation. The corporation is recognized as an entity separate from its owner for purposes of recording transactions. That is, the owner cannot commingle personal transactions with those of the corporation for tax purposes. All income, deductions, losses, and credits attributable to the operation of the business are identified and recorded on the books of the corporation. The summarized results of these transactions are then reported on the corporation’s tax return, and a tax is paid on the corporate taxable income. The owner of the corporation only includes as income on an individual tax return any salary or dividends she or he receives from the corporation. However, a different result is obtained if the corporation is organized as an S corporation. As a conduit entity, the S corporation still identifies and records on its books only those items that are attributable to the operation of the corporation. The summarized results of the transactions are reported to the government, but the S corporation pays no tax on its income. Rather, the income of the S corporation is reported on the tax return of the owner, along with the owner’s other items of income and deductions, and a tax is paid based on the owner’s taxable income.
EXAMPLE 7  Martina and Fran each own 50% of the stock of Card Corporation. During
the current year, Card Corporation had a taxable income of $80,000 and paid a total
of $20,000 in dividends. What are the tax effects of Card Corporation’s income and divi-
dend distributions?

Discussion:  As a separate and distinct taxable entity, Card Corporation must pay the tax
on its $80,000 in taxable income. Martina and Fran each must include the $10,000 in divi-
dends she received from Card Corporation in her calculation of taxable income. Note that
the dividends are being taxed twice—once when included as income by the corporation and
again when distributed to the shareholders.

EXAMPLE 8  Assume the same facts as in example 7, except that Card Corporation is
an S corporation. What are the tax effects of Card Corporation’s income and dividend
distributions?

Discussion:  An S corporation is a conduit entity. Therefore, the $80,000 in taxable in-
come flows through to the owners and is included on their tax returns. Card Corporation
pays no income tax. Martina and Fran each must include $40,000 in income on her indi-
vidual tax return. Because the $80,000 is being taxed to the owners, the dividends paid are
not taxed again to the owners. Rather, the dividends are considered a repayment of their
investment that reduces the amount invested in the stock of the corporation.

The distinction between entities becomes blurred when a business is owned as a
sole proprietorship. Although not technically a conduit entity, the sole proprietorship
does not pay tax on its income. The books of the sole proprietorship are kept sepa-
rate and distinct from the personal transactions of the owner. However, the income
tax attributes of the business are reported on the owner’s return, in much the same
manner as a conduit entity.

EXAMPLE 9  Karina is a machinist for Silver Marine Company. At nights and on week-
ends, she repairs washing machines and dryers. During the current year, Karina’s income
from her repair business was $10,000, and she incurred $3,500 in expenses to produce this
income. She also earned a salary of $30,000 from Silver Marine and had $400 in interest
income from a savings account. How should Karina treat these items on her tax return?

Discussion:  Karina’s repair business is a sole proprietorship, which is similar to a con-
duit entity. In accounting for the repair business, she must keep the results of the repair
business separate from her other taxable transactions. The business income of $10,000 and
business expenses of $3,500 result in an income of $6,500 from the repair business. The
$6,500 in business income is then added to her salary and interest income on her individ-
ual return, and Karina pays tax on the sum of all her income.

The result for our sole proprietor appears to be much ado about nothing. How-
ever, two important aspects of this entity treatment prevent income manipulation.
First, because the commingling of business and personal transactions is not allowed,
owners cannot turn nondeductible personal items into deductible business expenses.
The classic example of this separation is interest expense. As we shall see in Chapter
5, all interest paid on debt incurred in a trade or business (i.e., the sole proprietorship)
is fully deductible, whereas interest paid on debt used for personal purposes (other
than qualified home mortgage interest and education loan interest) is not deductible.
The entity concept requires the owner to identify these two types of interest for each
entity and deduct them according to the rules for that entity. Without such a split,
business owners would effectively be allowed to deduct all their interest, and basic
wage earners would get no deduction for interest on their personal debts. This treat-
ment would result in an inequity most taxpayers would not tolerate.

EXAMPLE 10  In example 9, assume that Karina owns a van that she uses on repair
calls. She also drives the van to work at Silver Marine and for various other personal pur-
poses such as trips to the store, taking the kids to school, and so on. How should Karina
account for the van and its operating costs?

Discussion:  For tax purposes, the van is viewed as two distinct assets. One asset is used
in her repair business, whereas the other asset is used as a personal vehicle. Karina must
keep records that adequately document the use of the van in her repair business. She can
deduct the costs incurred in using the van in her repair business. The costs incurred for
her personal use of the van are not deductible. This separation of business and personal use is required by the entity concept.

The second major aspect of the reporting of a conduit entity’s income on the return of the owner of the entity is that conduit entities are not useful in income-shifting strategies. This results from the progressive nature of the federal income tax. Recall that in a progressive tax rate structure, the higher your taxable income is, the greater your marginal tax rate becomes. If each conduit entity paid tax on its separate income, taxpayers would be able to arrange their affairs into a multitude of conduit entities, all of which are taxed at the lowest marginal income tax rate. Under such circumstances, the income tax would effectively become a flat tax at the lowest tax rate instead of the progressive rate desired. By passing the income through to the owners of the conduit entity, income shifting by using such entities is not an effective tax-planning strategy. As an aside, it should be noted that the tax laws’ requirement that taxable entities aggregate results from all their income-producing activities also contains a positive element. That is, if the conduit entity posts a loss from its operations, the taxable entity or entities that own the conduit are generally allowed to use this loss to offset income from other sources.

▲ EXAMPLE 11  Assume the same facts as in example 9, except that Karina’s repair income was $8,000 and her expenses for producing this income were $11,000. How should Karina treat this on her tax return?

Discussion: The loss from the repair business flows through to Karina’s individual return. The $3,000 loss is deductible on Karina’s individual tax return, reducing the tax she would have paid on her other income.

Assignment-of-Income Doctrine. One corollary of the entity concept is the judicially developed assignment-of-income doctrine. According to this doctrine, all income earned from services provided by an entity is to be taxed to that entity, and income from property is to be taxed to the entity that owns the property. Merely directing payment of income (i.e., assigning income) that has been earned by one entity to another, although legal, does not relieve the owner of the income from paying tax. Thus, it is not possible to avoid the payment of tax on wages earned by simply having them paid to someone else. Although you may legally assign the right to receive income to another, the income tax is imposed on the person who earns the income.

▲ EXAMPLE 12  Sharon owns a landscaping business. She has a two-year-old son, Jeffrey. To provide funds for Jeffrey’s college education, Sharon has every tenth customer make her or his check payable to Jeffrey. Sharon deposits the checks in a savings account in Jeffrey’s name. Is Sharon taxed on the amounts paid to Jeffrey?

Discussion: Under the assignment-of-income doctrine, Sharon cannot escape taxation on the income from her labor by directing the payments to Jeffrey. Sharon is taxed on all income earned by the landscaping business, regardless of who receives payment for the services.

Similarly, the owner of a building cannot escape taxation on the income from the building by having the rents paid to another entity. The only legal way for the building owner to pass the taxability of the income to the other entity is to legally transfer ownership of the building to that entity.

▲ EXAMPLE 13  Andrea owns a house that she rents out to college students attending State University. Her grandson Andy is a student at State University. To help Andy with his college expenses, Andrea has her tenants pay the rent to Andy. Is Andrea taxed on the rental income?

Discussion: Because Andrea owns the rental property, she is taxed on all rents, whether she or Andy receives the payments. Under the assignment-of-income doctrine, the owner of property is taxed on the income of the property, regardless of who actually receives the income.

Discussion: For Andrea to avoid payment of tax on the rental income, she would have to make a valid gift of the house to Andy. This would make Andy the owner of the
property and thus taxable on the rental income. Andy would pay no income tax on the receipt of the gift property. Andrea may or may not have to pay a gift tax on such a transfer.

**Annual Accounting Period Concept**

The second accounting concept is that of an annual accounting period. The **annual accounting period concept** states that all entities must report the results of their operations on an annual basis and that each taxable year is to stand on its own, apart from other tax years. The most basic result of this concept is that all entities must choose an annual accounting period for reporting their results to the government. The two basic types of accounting periods are calendar years, which end December 31, and fiscal years, which end on the last day of any other month the taxpayer chooses. Although all entities are allowed to choose their accounting period, most individuals elect to be calendar-year taxpayers. This book assumes the taxpayer is using the calendar year unless otherwise noted. The election of a fiscal year carries some important restrictions, the most important of which are discussed in Chapter 13.

**Accounting Method.** An important outgrowth of the annual accounting period requirement is that each taxpayer must select an **accounting method** to determine the year(s) in which taxable transactions are to be reported. The two basic allowable methods are the **cash basis of accounting** and the **accrual basis of accounting**. Taxpayers using the cash basis are taxed on income as it is received and take deductions as they are paid. In contrast, accrual basis taxpayers report their income as it is earned and take deductions as they are incurred, without regard to the actual receipt or payment of cash. At this point, a simple example will illustrate the basic differences between the two methods of accounting.


**Discussion:** Assume that both Steen, Inc., and Gary are cash basis taxpayers. Although Steen earns the $200 during 2003, it is not taxed on the $200 until payment is received in 2004. Similarly, Gary takes the deduction for the carpet-cleaning expense in 2004 when he makes the payment.

▲ **EXAMPLE 15** Assume that in example 14, both Steen, Inc., and Gary are accrual basis taxpayers.

**Discussion:** Steen must include the $200 in the year in which it was earned, 2003, and Gary takes his deduction in the year the carpet-cleaning expense is incurred, 2003.

**Discussion:** Assume that Steen, Inc., is on the cash basis and Gary is on the accrual basis of accounting. Steen does not include the $200 in income until it is received in 2004. Gary deducts the carpet-cleaning expense in the year incurred, 2003.

Note that the use of the cash method violates generally accepted accounting principals (GAAP), which require books to be kept using the accrual method. The accrual method used for tax purposes is generally the same as that used in financial accounting under GAAP. However, various limitations and exceptions apply to the application of each method. The most important of these are discussed as they apply to income recognition in Chapter 3 and to deductions in Chapter 5.

**Tax Benefit Rule.** The requirement that each tax year stand on its own, apart from other tax years, leads to some problems when circumstances arise in which one transaction could affect more than one year. This has led to development of the **tax benefit rule**. Under this rule, any deduction taken in a prior year that is recovered in a subsequent year is reported as income in the year it is recovered, to the extent that a tax benefit is received from the deduction. The tax benefit received means the amount by which taxable income was actually reduced by the deduction recovered. Consider the following examples:
EXAMPLE 16  Rayson Corporation is an accrual basis taxpayer selling widgets for cash and on account. Late in 2001, Rayson sells $500 worth of widgets on account to Tom. In 2002, before any payment is made to Rayson, Tom is sentenced to 20 years in prison for embezzlement. How should the corporation account for this series of events?

Discussion: Because Rayson Corporation is on the accrual basis, it includes the $500 sale to Tom as income in the year of the sale, 2001. The tax law does not generally allow taxpayers to use the allowance method of accounting for bad debts, so Rayson must wait until it determines that Tom’s debt is worthless to take a bad debt deduction. Going to jail for 20 years is enough evidence that Tom won’t pay the debt, so Rayson should take a bad debt deduction of $500 in 2002. The recognition of the bad debt in 2002 stems from the requirement that the events of each tax year stand alone. Rayson Corporation does not go back to amend the income reported in 2001.

EXAMPLE 17  While Tom is in prison, his aunt dies and leaves him a considerable inheritance. He had always felt badly about not paying Rayson Corporation for the widgets, so in 2003, he sends Rayson a check for the $500. How should Rayson account for the $500?

Discussion: Because Rayson Corporation took a deduction for Tom’s bad debt in 2002, the tax benefit rule requires it to include the $500 in its 2003 income. Note again that there is no attempt to adjust the prior year’s income. The events of each tax year stand apart from each other under the annual accounting period concept.

As these examples demonstrate, the tax benefit rule has its most common applications in situations in which an annual accounting period and an accounting method interact. It is necessary to put accrual basis and cash basis taxpayers in the same position after accounting for all years involved. In example 16, if Rayson Corporation had been a cash basis taxpayer, it would have recognized no income from the initial sale to Tom, because it never received payment. However, when Rayson received the $500 payment in 2003, it would have been included in income under the cash basis. Thus, over the three-year period, both a cash basis and an accrual basis taxpayer would have recognized income of $500 from the transactions in examples 16 and 17.

Substance-over-Form Doctrine. The accounting concepts, constructs, and doctrines presented to this point require that all transactions be traced to and recorded by the entity responsible for that transaction in accordance with the method of accounting selected by that entity. Occasionally, the basis for recording the transaction is not clear. That is, taxpayers attempting to avoid taxation sometimes carefully sculpt transactions that are unrealistic in the ordinary sense.

EXAMPLE 18  Bill is the sole proprietor of Bill’s Sub Shop. To lower his tax on the income from the sub shop, Bill “employs” his three-year-old daughter as a janitor at a salary of $200 per week. Is Bill’s employment of his daughter unrealistic?

Discussion: Because it is unlikely that a three-year-old could perform such services, Bill’s characterization of his daughter as an employee is unrealistic.

Although the courts have consistently held that taxpayers are under no legal obligation to pay more tax than the law prescribes (i.e., tax avoidance is a legal activity), the courts have also said that transactions must bear some semblance of reality. This judicially created concept is referred to as the substance-over-form doctrine. The doctrine states that the taxability of a transaction is determined by the reality of the transaction, rather than some (perhaps contrived) appearance. This is generally interpreted to mean that a transaction is to be taken at its face value only when it has some business or economic purpose other than the avoidance of tax.

EXAMPLE 19  In example 18, should Bill be allowed to deduct the salary paid to his daughter?

Discussion: Because the payment of the salary to his daughter is unrealistic under the circumstances, Bill would not be allowed a deduction for salary. This arrangement lacks economic substance and is solely for the purpose of tax avoidance. Thus, the form of the arrangement (daughter as an employee) is ignored, and the tax treatment is based on the substance of the transaction (a gift to his daughter, which is not deductible).
When might substance over form apply? This is a difficult and subjective question that has no hard-and-fast answers that apply in every situation. However, a few factors should alert us to the possibility of this doctrine being invoked by the IRS. The major element to look for is whether the transaction has economic substance. Most legitimate business transactions are made at arm’s length between two parties, neither of which stands to benefit by mutual manipulation of the transaction. Consider the following examples:

▲ **EXAMPLE 20**  Selma is the president and chief executive officer of Megainternational Corporation. Megainternational is a large, publicly held corporation which operates in more than 50 countries around the world. During the current year, Selma receives a salary of $1,000,000 and a bonus of $2,000,000. The bonus is based on a percentage of Megainternational’s profits. Can Megainternational deduct the $3,000,000 salary and bonus paid to Selma?

**Discussion:**  Megainternational can deduct the entire $3,000,000 in salary and bonus paid to Selma. The salary-and-bonus contract was negotiated at arm’s length between Selma and Megainternational. Because Megainternational is a publicly held corporation, Selma is not able to exert undue influence over her contract, and the salary and bonus paid to her would be typical of such a position.

▲ **EXAMPLE 21**  Eugene is the president and chief executive officer of Florence Dunes Company. Florence is a corporation that is wholly owned by Eugene and his wife, Dahlia. Florence pays Eugene a salary of $300,000 during the current year and a bonus of $200,000. The bonus is paid even though Florence has only $250,000 in income. Although Florence has been in business for more than 10 years, it has never paid a dividend. Can Florence deduct the $500,000 in salary and bonus it pays to Eugene?

**Discussion:**  Because Florence is wholly owned by Eugene and Dahlia, salary payments to the owners are subject to extra scrutiny. All deductions are subject to the requirement that they be reasonable under the facts and circumstances. In Eugene’s case, the first question is whether the $300,000 salary is reasonable when compared with the salaries paid by comparable companies to executives who do not control the corporation. Any portion of the salary that is unreasonable is considered a dividend paid to the owner. Dividends are not deductible expenses of a corporation.

Eugene’s bonus payment is suspicious under the circumstances. Because Florence has never paid a dividend, the payment of such a large bonus relative to the income of the corporation to a 100-percent owner appears to be more in the nature of a dividend distribution. Thus, although the form of the payment is a salary bonus, the substance of the payment is that of a dividend distribution under the facts presented. It is unlikely that the bonus can be deducted as a salary payment by Florence.

In many situations, the tax law itself specifies that certain transaction forms be treated according to their underlying substance. For example, in the area of alimony and child support, the tax law specifies that the amount of an alimony payment that varies according to some contingency related to a child is treated as a child support payment. This distinction is critical, because alimony is taxable to the receiver and deductible by the payer, whereas child support payments have no effect on the taxable income of either party.

▲ **EXAMPLE 22**  Dick and Jane divorce in the current year. They have 2 children who are in Jane’s custody throughout the year. The divorce decree specifies that Jane will receive $100 per month per child for child support and $2,000 per month as alimony. However, the alimony will be reduced by $600 per month per child when the child reaches age 18, marries, or dies. How much of the $2,000 payment is alimony, and how much is child support?

**Discussion:**  Because the alimony is reduced when an event related to the children occurs, the tax law treats the reduction in alimony related to the contingency as child support. That is, the agreed-upon alimony will ultimately be reduced by $1,200 per month, at which time Jane will receive only $800. The $800 is considered the true alimony payment to Jane, and the remaining $1,200 is child support for income tax purposes. From the $2,200 Jane receives each month, $1,400 [$1,200 + (2 × $100)] is child support, and $800 is alimony.
**Income Concepts**

Income concepts determine what constitutes taxable income, explain why one type of income is taxed differently than other income, and establish the period in which income is to be reported.

**All-Inclusive Income Concept**

The broadest income concept is the all-inclusive income concept. Under this concept, all income received is considered taxable unless some specific provision can be found in the tax law that excludes the item in question from taxation. Income can be received in any form: cash, property, services, and so on. Thus, the tax law always starts with the proposition that anything of value received is taxable.11 Many situations dealing with income recognition are covered in Chapter 3, so we are using only one example here to illustrate the pervasive nature of this concept.

▲ **EXAMPLE 23** Felicia is a tax accountant with Oil Rich Company. Alice is a plumber. Both are cash basis taxpayers. Felicia had a problem with her plumbing that Alice fixed. The normal charge for this service would have been $300. However, Alice agreed to waive her fee in exchange for some tax advice from Felicia relating to her business. Does either Felicia or Alice have taxable income from this agreement?

**Discussion:** Both Felicia and Alice have income from rendering services, Alice from the plumbing repair and Felicia from the provision of tax advice. Although income was never reduced to cash by either party, both received something of value in exchange for their services. Alice should report the $300 as income when she receives the promised tax advice. Felicia should report $300 of income when Alice fixes her plumbing.

We noted earlier that certain items of income are not subject to tax. How do we know which items are taxable and which are not? As with all exceptions to the general concepts, only study and experience in working with the tax laws provide answers. Chapter 4 discusses some major income items that are excluded from taxation.

**Legislative Grace Concept**

Exclusions are based on the legislative grace concept. This concept states that any tax relief provided to taxpayers is the result of specific acts of Congress that must be applied and interpreted strictly. Note that relief from taxes on income received can take several forms. Income can be either permanently excluded from tax, or it may be deferred for taxation in a future period (resulting in a time value of money savings). Legislative grace means that only Congress can grant an exclusion from income, and the exclusion must be taken in its narrowest sense. An example illustrates these two related notions.

▲ **EXAMPLE 24** Jorge receives 200 shares of MNO Corporation common stock as a gift from his grandfather. At the date of the gift, the shares have a fair market value of $20,000. During the current year, Jorge receives dividends totaling $2,000 on the stock. Recall that the tax law excludes the value of a gift from the gross income of the recipient. What are the tax effects for Jorge of the gift from his grandfather?

**Discussion:** The receipt of the stock as a gift from the grandfather is specifically excluded from Jorge’s income by the tax law. However, the exclusion applies only to the value of the gift received and does not exclude from tax any subsequent income Jorge receives on the gift property.12 Therefore, Jorge is taxed on the $2,000 in dividends received on the stock.

One other form of tax relief that Congress has provided is special treatment for certain types of income. Most income received and allowable losses incurred by taxpayers are simply added to (or deducted from, in the case of losses) the income tax return of the taxpayer and taxed according to the taxpayer’s marginal tax rate. In tax jargon, this is referred to as ordinary income (loss). Congress has created a special class of income treatment for gains and losses arising from the sale of capital assets. A capital asset is generally defined as any asset that is not a receivable, inventory, real or depreciable property used in a trade or business, or certain intangible assets, such
as copyrights. Thus, capital assets primarily consist of stocks, bonds, and other investment-related assets. In addition, all personal use assets (home, furniture, clothing, automobile, etc.) of individual taxpayers are capital assets.

The gains and losses from the sale of capital assets, known as capital gains and capital losses, must be separated from other gains and losses and aggregated through a prescribed netting procedure before they enter into the taxpayer’s income calculation. Net long-term capital gains are currently given preferential treatment through a reduction in the tax rate that must be paid on this type of income. Currently, the tax rate paid on net long-term capital gains is 20 percent (10 percent if the taxpayer is in the 15 percent marginal tax rate bracket), versus the top marginal tax rate of 38.6 percent for individual taxpayers. If the netting procedure results in a net capital loss for the year, only $3,000 of the net capital loss can be deducted from an individual’s tax return per year. Chapter 3 provides an overview of capital gains, and Chapter 11 covers capital gains and losses in more detail. For now, just remember that capital gains and losses are treated differently than all other types of income and losses.

**Capital Recovery Concept**

Once it has been determined that an item of taxable income has been received, the next logical step is to determine the amount of the income that belongs in the calculation of taxable income. In most cases, this is straightforward. However, sales of investment and/or business assets require more guidance. The capital recovery concept states that no income is taxed until all capital previously invested in the asset is recovered. That is, on any asset purchased, all investment in the asset must be recorded to determine the amount of profit (or loss) made upon disposition of the asset. The amount invested in an asset is referred to as its basis.

▲ **EXAMPLE 25** Earl purchases 100 shares of ABC Company’s common stock at a total cost of $1,000. When he sells the stock, one lot of 50 shares is sold for $600 and the other 50 shares are sold for $300. What are the tax effects of these sales?

**Discussion:** Because there are 2 separate sales of the stock at different prices, each sale must be considered separately. Each 50-share lot has a basis of $500 (half the $1,000 purchase price). The lot sold for $600 results in a $100 ($600 – $500) taxable gain. That is, Earl has recovered $100 more than he invested in the 50 shares.

The 50 shares sold for $300 result in a loss of $200 ($300 – $500). Note that a loss is nothing more than invested capital that has not been recovered. Because of the capital recovery concept, we recognize gains only when the recovery from the disposition of an asset is greater than the amount invested in the asset. A loss results when all the capital invested in an asset is not recovered upon its disposition.

**Realization Concept**

A crucial question regarding income items is when to recognize the income (i.e., in which accounting period it should be taxed). In this regard, the taxpayer’s accounting method resolves many of the problems. However, some general concepts provide additional guidance. The most basic recognition concept is the realization concept. This concept states that no income is recognized for tax purposes (i.e., is included in taxable income) until it has been realized by the taxpayer. In most cases, realization occurs when an arm’s-length transaction takes place: Goods are sold, services are rendered, and so on. Mere changes in value without the advent of a realization event—in which the taxpayer receives the change in value—do not result in a taxable recognition.

▲ **EXAMPLE 26** Assume that in example 25, Earl purchases the 100 shares of ABC common stock on July 2, 2002. On December 31, 2002, the 100 shares have a fair market value of $1,200. The first lot of 50 shares is sold for $600 on February 5, 2003. As of December 31, 2003, the remaining 50 shares have a fair market value of $400. What is Earl’s recognized income from the stock in 2002? in 2003?

**Discussion:** Although the shares gain $200 in value as of December 31, 2002, Earl still holds the shares and has not realized the increase in value. Therefore, the change in value
does not result in a recognition of income in 2002. He realizes the $100 gain from the sale of the first 50 shares in 2003 and reports it in that year. The loss in value of $100 as of December 31, 2003, has not been realized, so Earl cannot deduct this loss in value until he realizes it through sale.

**Claim-of-Right Doctrine.** To aid in determining when a realization has occurred, the *claim-of-right doctrine* states that a realization occurs whenever an amount is received without restriction as to its disposition. An item is received without restriction when the receiver has no definitive obligation to repay the amount received. Income received under a claim of right is reported in the year of receipt. If income is realized under a claim of right and a repayment of part or all of the receipt occurs in a later year, it is accounted for as a deduction in the year of repayment because of the annual accounting period concept. When a taxpayer receives amounts with their use restricted in some substantial manner, those amounts are not realized until the restriction is removed.

▲ **EXAMPLE 27** Sadie, a landlord and a cash basis taxpayer, enters into a 1-year lease agreement with Bob, a tenant, on December 1, 2003. The agreement calls for a monthly rent of $500, with payment of first and last months’ rents upon signing. In addition, Bob is required to pay a $100 cleaning deposit that is to be returned at the end of the lease if the property is returned in good condition. What are the tax effects for Sadie of receiving the $1,100?

**Discussion:** The first and last months’ rents are taxable when received. Sadie is on a cash basis and has an unrestricted right to the use of the rent payments. However, she must return the cleaning deposit at the end of the lease if Bob abides by its terms. Because of this restriction, Sadie does not have a claim of right to the cleaning deposit when she receives it, and it is not taxed at that time. If Sadie keeps all or part of the deposit at the end of the lease, it is included in her income at that time.

▲ **EXAMPLE 28** Assume that in example 27, Sadie sells the building in 2004 before the end of the lease term. Because of the sale, Sadie returns the last month’s rent prepayment to Bob. How should Sadie account for the repayment of the last month’s rent?

**Discussion:** Because Sadie had previously included the last month’s rent in her 2003 income, she is allowed to deduct the repayment in 2004. **Note:** The mere possibility that a repayment might be required does not negate Sadie’s unrestricted use of the rent prepayment when she receives it.

Note that the claim-of-right doctrine applies when something of value has been received by the taxpayer. The question to be answered in such cases is whether the receipt has resulted in a realization of income. If the taxpayer has a clear obligation to repay the amount received, *the taxpayer does not* have a claim of right to the amount and *is not* taxable on the receipt. However, if there is no clear and definitive obligation to repay, the taxpayer is deemed to have received income.

▲ **EXAMPLE 29** Herbert Corporation borrowed $10,000 from Local Bank to purchase a stamping machine. Herbert will repay the $10,000 by making monthly payments with interest at 14% over the next 6 years. Does Herbert Corporation have income from the receipt of the $10,000 it borrowed from Local Bank?

**Discussion:** Because Herbert Corporation is obligated to repay the $10,000 loan, it does not have a claim of right and is not required to recognize the $10,000 as income.

**Constructive Receipt Doctrine.** An accrual basis taxpayer recognizes income when it has been earned, whereas a cash basis taxpayer recognizes income when it is received. Whether a receipt has occurred is not critical for accrual basis taxpayers. However, a major question for cash basis taxpayers is when is income received? That is, is income received only when it has been physically received in the form of cash? The all-inclusive income concept tells us that income can be received in any form—cash, property, or services. Thus, it is not necessary for a cash basis taxpayer to reduce the income to cash to be in receipt of income. A more fundamental problem is what constitutes a receipt. Based on the *constructive receipt doctrine*, cash basis
taxpayers are deemed to be in receipt of income when it is credited to their accounts or otherwise made unconditionally available to them.\textsuperscript{19} For example, interest income is taxed on the day it is credited to a savings account, regardless of when the taxpayer actually withdraws it. That is, the interest income is available for use by the taxpayer when it is credited to the account and is taxed at that time. Physical possession of the interest income is not required for it to be taxed. Note that this is not a problem for an accrual basis taxpayer—the interest income would be taxed in the period in which the income was earned, regardless of when the actual payment was received. Once income has been made unconditionally available, taxpayers cannot turn their backs on it and thus select the year for taxation.\textsuperscript{20} To be considered unconditionally available, the taxpayer must be aware that the income is available for use.

\textbf{EXAMPLE 30} At the December 12, 2003, meeting of the board of directors of Gould Company, the board awards bonuses to all officers in the amount of 5\% of their annual compensation. The bonuses are to be paid in December. Samantha, the controller of Gould Company, requests that her bonus not be paid until January 2004. In what year is Samantha taxed on the bonus?

\textit{Discussion:} Because the board made the bonus unconditionally available to Samantha in December, she is in constructive receipt of the bonus in 2003 and is taxed as if she received the bonus in that year.

However, income is \textit{not} constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions.

\textbf{EXAMPLE 31} Aardvark Corporation mails its annual dividend checks to shareholders on December 31, 2003. Alana receives her dividend check on January 4, 2004. In what year is the dividend taxable to Alana?

\textit{Discussion:} Because Alana does not have any control over the dividend check and does not have unrestricted use of the check until she receives it on January 4, 2004, she is taxed on the dividend in 2004. Although she knows that the check is coming, it is not available for use as of December 31, 2003.

\textbf{EXAMPLE 32} Assume that Aardvark Corporation policy is to mail its annual dividend checks to shareholders so that the checks arrive on or before December 31 of each year. Alana has been a shareholder of Aardvark for 5 years. Alana’s dividend check arrives in her mailbox on December 31, 2003. However, Alana is out of town to visit relatives for the holiday and does not return until January 4, 2004, at which time she deposits the check in her checking account. In what year is the dividend taxable to Alana?

\textit{Discussion:} Because the dividend is made annually, Alana is aware that the check is coming. She is taxed on the dividend in 2003, because it is available to her on December 31 and she knew that the check was coming.

\textbf{EXAMPLE 33} Paul is selected the outstanding player in the Super Bowl on December 31, 1964. He is awarded a car worth $10,000, which he picks up 3 days later at the dealer that supplied the car. When is Paul taxed on the award?

\textit{Discussion:} As long as Paul could not have picked up the car under any condition on December 31, it is not made unconditionally available to him until the first date on which he can pick it up. Therefore, he is taxed on the value of the car in 1965.\textsuperscript{21}

These are just a few applications of the constructive receipt doctrine. More detail on different types of restrictions and conditions is covered in the discussion of income sources in Chapter 3. At this point, the important point to remember is that cash basis taxpayers do not have to actually receive cash to trigger income recognition; the only requirement is that the income be unconditionally within their control.

\textbf{Comparing Claim of Right and Constructive Receipt.} One of the most difficult problems encountered by beginning tax students is determining when the claim-of-right and constructive receipt doctrines apply. Figure 2–2 presents a time line that differentiates the two doctrines. In Figure 2–2, note that the constructive receipt doctrine applies when an item of income has not yet been physically received by the taxpayer. The question to be answered in determining whether the item is
Currently taxable is whether the taxpayer has the income within his or her control. This is in contrast to the claim-of-right doctrine where an amount has been received. The question in this case is whether the amount received is currently taxable.

**Wherewithal-to-Pay Concept**

The income tax system is philosophically based on the ability-to-pay concept. Features such as progressive tax rates and taxation based on the net income of a taxpayer are derived from the concept that the amount of tax paid should be in relationship to the ability of the taxpayer to pay the tax. Ability to pay the tax in the current tax year is also important for income-recognition purposes. To distinguish general ability-to-pay principles and income-recognition applications, we use the wherewithal-to-pay concept. This concept states that income should be recognized and a tax paid on the income when the taxpayer has the resources to pay the tax. Although this would generally require that the transaction in question provide cash to pay the tax, the receipt of other asset forms and relief from debts are considered forms of receipt with which tax can be paid.22 NOTE: The concept applies equally to both cash and accrual basis taxpayers.

The wherewithal-to-pay concept provides the rationale for the deferral of recognition on several types of realized gains.

▲ EXAMPLE 34  Mike exchanges a computer with a basis of $600 that he uses in his dental practice for a new computer. The new computer cost $3,000, but Mike is given a trade-in value of $1,000 for his old computer and has to pay only $2,000 out of pocket for the new computer. Has Mike realized a gain from the exchange? If so, is the gain available to pay tax?

Discussion: An exchange does constitute a realization. Mike has disposed of the computer in an arm’s-length transaction and converted its value toward the purchase of the new computer. The substance of the transaction is a sale of the old computer for $1,000 and the purchase of the new computer for $3,000.

Although Mike has realized a gain of $400 ($1,000 – $600) on the exchange, all the gain has been reinvested in the purchase of the new computer, and none of the $1,000 he received for his old computer is available to pay the tax on the $400 gain.
Mike’s computer transaction is an example of a like-kind exchange. Because Mike exchanged business property that is of like kind (in this case, one computer for another computer), the tax law allows him to defer recognition of the gain until he disposes of the new computer in a transaction that gives him cash (or other assets) with which to pay the tax. Like-kind exchanges and other types of transactions in which gains are deferred under the wherewithal-to-pay concept are discussed in Chapter 12.

Another important application of this concept is the acceleration of income recognition by accrual basis taxpayers on advance receipts for goods and services. In general, accrual basis taxpayers recognize income in the tax year in which the income is earned, without regard to when cash payment is actually received. However, when an accrual basis taxpayer receives an advance payment for goods and services, the IRS takes the position that the taxpayer is in the best position to pay the tax in the period in which the cash is received rather than when it is earned.23

▲ Example 35 Return to the facts of example 27. Assume that Sadie, the landlord, is an accrual basis taxpayer. She receives the first and last months’ rent on the 1-year lease in December 2003. In which year(s) should the $1,000 first and last months’ rent receipts be taxed?

Discussion: Under the accrual method of accounting used in financial accounting, Sadie is deemed to have earned only the December rent in 2003; the $500 advance receipt for the last month’s rent is not recognized until it is earned in 2004.

Application of the wherewithal-to-pay concept causes the entire $1,000 received in December to be taxed in 2003. That is, the $500 advance receipt for the last month’s rent that will not be earned until next year is available for Sadie to use to pay her taxes and should be taxed at the time she receives it.

The income concepts discussed here apply to income-recognition problems. No attempt has been made to cover every situation in which these concepts might apply. Rather, throughout the remaining chapters, these concepts serve as the basis for discussing the treatment of income items.

The federal income tax is based on the general proposition that taxpayers will pay tax according to their ability to pay. This results in the tax being assessed on the income net of the costs of producing that income. The tax law provides for this through the allowance of deductions (and losses) in computing a taxpayer’s taxable income. The fundamental questions that need to be answered in regard to deductions are what types of expenditures are deductible, how much is deductible, and when the deduction can be taken. Deduction concepts provide the basis for resolving these issues.

Legislative Grace Concept

The most fundamental deduction concept is that of legislative grace. Applied to deductions, this concept means that deductions are allowed only as a result of a specific act of Congress and that any relief granted in the form of a deduction must be strictly interpreted. In contrast to the all-inclusive income approach to the recognition of income—where we assume that everything is taxable unless we can find a provision exempting an item from tax—deductions must be approached with the philosophy that nothing is deductible unless a provision in the tax law allows the deduction.

Business Purpose Concept

The allowance of deductions is governed by the business purpose concept.24 This concept means that a deduction is allowed only for an expenditure that is made for some business or economic purpose that exceeds any tax avoidance motive. This concept has been interpreted to mean that the expenditure was made in connection with a profit-seeking activity.25 Note that a transaction may be entered into for a
profit and for the additional profit from the tax savings associated with the deductibility of the expenditures related to the transaction. Two general types of expense deductions in the tax law embody this profit motive requirement: expenses incurred in a trade or business and those related to the production of income (investment activity). These two general types of expenses are commonly referred to as trade or business expenses and investment expenses.

A third category of expenses that is specifically disallowed (with a few specific exceptions) are those expenses that are personal in nature, known as personal expenses. As stated in Chapter 1, the tax law does allow individuals to deduct certain personal expenditures from adjusted gross income. The list of deductible personal expenses includes medical expenses, home mortgage interest, income and property taxes, personal casualty losses, and charitable contributions. Recall that these expenses are deductible only if they exceed the taxpayer’s allowable standard deduction amount. In addition, many of the expenses are limited to a percentage in excess of the individual’s adjusted gross income.

To determine the tax treatment of any expenditure, the motive behind the transaction must be determined. Based on the motive—profit or personal purposes—it is categorized in one of these general classes:

1. Trade or business expenses
2. Investment expenses
3. Personal expenses

Distinguishing a personal expenditure (category 3) from a profit-motivated activity (i.e., categories 1 and 2) is generally a fairly easy task.

▲ EXAMPLE 36  Peter pays $1,000 for a new couch for his home. Is this a personal expenditure?
Discussion:  As long as the couch is not used in Peter’s trade or business or is not held as an investment by Peter, its use is personal and no deduction would be allowed for the purchase of the couch.

▲ EXAMPLE 37  Peter purchases a couch for the reception area of his optometry practice. What is the proper treatment of the couch?
Discussion:  Because providing a place for clients to sit while they wait is something that businesses normally do, the couch is properly classified as related to his trade or business of optometry. Peter can therefore take the deductions allowed for the couch.

A more difficult task is distinguishing a trade or business activity from an investment activity. This is covered in depth in Chapter 5, but consider the following examples:

▲ EXAMPLE 38  Roger owns Gould Trucking Company. The physical layout of the company’s location includes an office building, a parking lot for his trucks, and a maintenance shop. During the current year, Roger purchases the house next door to his trucking company and rents it out to individuals unrelated to the trucking company. Is the house an investment activity or part of his trucking business?
Discussion:  Because Roger purchased the house to produce rents, which is an investment activity unrelated to his trucking business, it is considered an investment activity. He must account for the house and any related expenses under the rules for investments, not as part of his trade or business of trucking.

▲ EXAMPLE 39  Assume that instead of renting the house out, Roger lets his drivers stay in the house during rest periods between trucking runs. How should the house be treated?
Discussion:  In this case, the use of the house is related to his trucking business. Therefore, the house is considered a trade or business asset and is accounted for under the rules for trade or business assets.

Once the general category to which an expenditure belongs has been determined, the tax law provides specific rules regarding deductibility for each category. For example, business expenses are generally limited only by the reasonableness
(i.e., what a prudent businessperson would pay in the same circumstances) of their amount, whereas deductions for investment expenses of individuals are often subject to a limitation based on the income of that taxpayer. Losses incurred in a trade or business are fully deductible, but losses from the sale of personal use assets (automobile, furniture, clothing, personal residence, etc.) are generally not deductible. These are just a few general examples of the importance of distinguishing the activity in which an expenditure has been incurred. Chapters 5 through 7 discuss the specifics of differences in deductions and losses in the three classes of expenditures. For now, consider the following treatments of the sale of an automobile:

**EXAMPLE 40**  Jill owns an automobile that has a basis of $8,000. She sells the automobile for $5,000. How much of the $3,000 loss can Jill deduct on her tax return?

Discussion:  The deductibility of the loss depends on the use of the automobile. If Jill uses the automobile in a business, the loss would be fully deductible. However, if the use of the automobile were purely personal, no loss on the sale would be allowed.

**EXAMPLE 41**  Assume that Jill sells the automobile for $9,000, resulting in a $1,000 gain. Is the gain taxable in all cases?

Discussion:  Yes, the gain would be taxed even if it were used for purely personal purposes. Remember that the all-inclusive income concept requires that all income be taxed unless specifically excluded by the tax law. There is no exclusion in the tax law for income from the sale of personal use assets.

Although the tax law provides a general disallowance of deductions for personal expenditures of individuals, some specific deductions are allowed for personal expenditures. Based on the ability-to-pay concept, the tax law lets individuals take personal and dependency exemption deductions. That is, each individual is allowed to deduct a predetermined amount for oneself or oneself and for each person who is dependent on that person for her or his living expenses. This deduction recognizes that a basic cost of living must be paid in order to live and that this money is not available for the payment of taxes.

Certain personal expenditures, referred to as *itemized deductions*, for medical care, charitable contributions, home mortgage interest, casualty losses, and other miscellaneous types of personal expenses are also allowed as deductions. As with exemptions, these are items that Congress feels are necessary living expenditures that are not available for the payment of tax. To create some equity for taxpayers of different means and for administrative convenience, a minimum deduction for these types of expenditures (itemized deductions) is allowed to all individual taxpayers through the provision of a standard deduction.

**EXAMPLE 42**  Mary and Tom are both single taxpayers. Mary makes a salary of $50,000 and Tom makes $20,000. Mary has total allowable itemized deductions of $8,000 for 2003. Tom’s total allowable itemized deductions are $2,000. The standard deduction for a single taxpayer in 2003 is $4,750, and the personal exemption deduction amount is $3,050. Given these facts, what are Mary’s and Tom’s total allowable deductions for 2003?

Discussion:  Each is entitled to the $3,050 personal exemption deduction. Because Mary’s itemized deductions exceed the standard deduction, she is allowed to deduct her actual $8,000 in expenditures, for a total deduction of $11,050. Tom’s itemized deductions are less than the minimum allowable standard deduction, so he is allowed to deduct the $4,750 standard deduction in lieu of his $2,000 in actual expenditures, for a total deduction of $7,800.

The allowance of a standard deduction is unique to individual taxpayers. Individuals, estates, and trusts are allowed to take exemption deductions. The constructs of exemptions and standard deduction amounts do not apply to other tax entities, which may take only those deductions that are based on the business purpose concept in connection with a profit-motivated activity.
Capital Recovery Concept

After establishing the category of an expenditure, the next question to be answered is how much of the expenditure can be deducted. In general, the amount of a deduction can never exceed its cost. This is derived from the capital recovery concept discussed earlier. Under this concept, no income is realized until the amount invested has been recovered. The amount of investment in an asset is referred to as the asset’s basis. Thus, the amount invested in an item, its cost, is the maximum amount that can be deducted in determining taxable income.

▲ EXAMPLE 43  Wojo’s Warblers, Inc., sells miniature porcelain birds. Wojo’s purchased a shipment of the birds several months ago at a per-unit cost of $45. Wojo’s recently sold the entire shipment for $65 per unit. It will cost $50 per unit to replace the birds sold. How much income does Wojo’s, Inc., have from the sale of each bird?

Discussion: Although it will cost Wojo’s $50 to replace each porcelain bird, its income calculation is based on the amount actually invested in each bird. Therefore, the per-bird profit is $20 ($65 – $45).

The year(s) in which expenditures may be deducted is generally determined by the taxpayer’s accounting method. However, even cash basis taxpayers cannot deduct capital expenditures in total in the period in which they are paid. The main characteristic of a capital expenditure is that its usefulness extends substantially beyond the end of the tax year in which the expenditure is made. The classic example of a capital expenditure is the purchase of a long-lived asset such as a building.

▲ EXAMPLE 44  In 2003, Amy Corporation, a cash basis taxpayer, purchases a computer to use in its consulting business. Amy pays $15,000 for the computer, which it expects to be able to use in its business for at least 5 years. When can Amy Corporation deduct the $15,000 investment in the computer?

Discussion: Because the use of the computer extends beyond the end of 2003, Amy cannot deduct the entire $15,000 in 2003, even though it is on the cash basis. Amy Corporation must capitalize the $15,000 cost and deduct it over its tax life through depreciation deductions. Specific rules for depreciating property for tax purposes are covered in Chapter 10.

In example 44, the computer would have an original basis equal to its cost, $15,000. As depreciation deductions are taken on the computer, the investment is being recovered against current period income. Therefore, the basis must be reduced whenever part of the investment is recovered through a tax deduction. To understand why the basis is reduced for recoveries, consider the following example:

▲ EXAMPLE 45  Amy Corporation takes depreciation on its computer at $3,000 per year. At the end of 5 years, when total depreciation taken has amounted to $15,000, it sells the computer for $5,000. What is Amy Corporation’s gain or loss on the sale of the computer?

Discussion: Amy Corporation’s gain is $5,000. When the computer is sold, it has no capital investment remaining in the computer, because it has deducted the entire $15,000 cost against income during the 5 years it used the computer.

Note that if the basis were not reduced for the depreciation deductions taken, Amy Corporation would have a loss of $10,000 ($5,000 – $15,000) on the sale. Allowing the corporation to deduct a $10,000 loss and $15,000 of depreciation would result in a total deduction of $25,000. This would be a violation of the capital recovery concept, which limits deductions to the amount invested in an asset.

Similarly, any additional capital expenditures pertaining to the computer would be added to the computer’s basis for recovery over the remaining tax life. Because the amount of capital invested in a long-lived asset varies throughout its tax life because of these adjustments to its basis, the investment in an asset is more appropri-
nately referred to as its *adjusted basis*.\(^{32}\) An asset’s *adjusted basis* is the amount of unrecovered investment in it after considering increases and decreases in the original amount invested in the asset.\(^{33}\)

For any given expenditure, a deduction for the expenditure can take place at three points in time:

- In the period paid or incurred
- Over the useful life of the expenditure
- Upon disposition of the asset created by the expenditure

When the benefit of expenditures does not extend beyond the end of the current tax year, the expenditures are deducted in the year in which they are incurred (accrual basis) or paid (cash basis). These are the normal, recurring expenditures commonly made to produce the income being generated. Examples of currently deductible expenditures include salaries, rental payments, supplies, bank charges, and utilities.

Expenditures that benefit more than the current tax year must be capitalized. If the asset created by the expenditure is depreciable in nature, its cost is recovered by depreciation deductions over its useful tax life.\(^{34}\) Long-lived assets that do not depreciate are recovered through amortization over the useful life of the asset. To be depreciable or amortizable, the asset must have a determinable life or period of usefulness to which the cost can be attributed.

▲ **EXAMPLE 46**  Joe, a cash basis taxpayer, prepays the rent on his business building for 3 years on July 1, 2003. The monthly rent is $1,000, resulting in a $36,000 prepayment. How much rent can Joe deduct from 2003 through 2006?

**Discussion:** Although Joe uses the cash method of accounting, the rent prepayment benefits tax years 2003, 2004, 2005, and 2006, and must be capitalized and amortized according to the number of rental months in each year. In 2003, the building is rented for 6 months, resulting in a $6,000 deduction. In 2004 and 2005, Joe can deduct 12 months of rent, $12,000, with the remaining $6,000 deductible in 2006.

Assets such as land and common stock that do not have determinable lives are neither depreciable nor amortizable. Capital recovery on this type of asset does not take place until there is a disposition of the asset.

▲ **EXAMPLE 47**  The Stephanie Partnership purchases some land in 1999 for $20,000. The land is held until 2003, when it is sold for $30,000. What deductions can the partnership take on the land and when can it take them?

**Discussion:** Land is not a depreciable asset, because it has no determinable life, so no capital recovery deductions are allowed until the land is sold. In 2003, Stephanie recognizes a gain of $10,000 from the sale of the land. That is, the $20,000 basis is deducted from the $30,000 selling price.

It is possible for capital recovery to occur at more than one point in time for any given asset.

▲ **EXAMPLE 48**  Raul purchases a heavy-duty truck for use in his construction business in 2001 at a cost of $44,000. He uses the truck until 2003, when it is sold for $5,000. How much can Raul deduct in 2001, 2002, and 2003 for use of the truck, and what is his gain or loss on the sale of the truck?

**Discussion:** The heavy-duty truck is eligible for a special-election-to-expense (the Section 179 election to expense, discussed in Chapter 10) deduction of $24,000 in the year of purchase, 2001.\(^{35}\) In addition, the remaining $20,000 of cost can be depreciated over 5 years for tax purposes. Under the rules for straight-line depreciation (discussed in Chapter 10), Raul is allowed a depreciation deduction of $2,000 in 2001, $4,000 in 2002, and
$2,000 in 2003. This leaves him an adjusted basis of $12,000 at the date of the sale and a loss on the sale of $7,000:

**Calculation of Adjusted Basis**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original basis</td>
<td>$44,000</td>
</tr>
<tr>
<td>Less: Amounts recovered (deducted) against income</td>
<td></td>
</tr>
<tr>
<td>First year election to expense</td>
<td>(24,000)</td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>(2,000)</td>
</tr>
<tr>
<td>2002</td>
<td>(4,000)</td>
</tr>
<tr>
<td>2003</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Total recovered through deductions against income</td>
<td>(32,000)</td>
</tr>
<tr>
<td>Adjusted basis at date of sale</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

**Calculation of Loss on Sale**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$5,000</td>
</tr>
<tr>
<td>Less: adjusted basis</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Loss on sale</td>
<td>(7,000)</td>
</tr>
</tbody>
</table>

**Discussion:** In this example, Raul recovers his $44,000 investment in the truck as follows: (1) $24,000 in the year of purchase through the election to expense, (2) $8,000 in depreciation during the period he uses the truck, and (3) $12,000 recovered against the $5,000 selling price when the truck is sold.

These deduction concepts are applicable to all deduction situations. As with the other concepts presented, this chapter does not attempt to cover all applications of the deduction concepts. Throughout the remaining chapters, the discussion of deductions is presented with reference to the applicable deduction concepts.

**Concept Challenge**

Reinforce the concepts covered in this chapter by completing the on-line tutorials located at the Concepts in Federal Taxation website.

**Summary**

The federal income tax is based on a system of rules and regulations. These rules and regulations are based on general concepts that can be used to determine the income tax treatment of most transactions. As with all systems devised by human beings, the federal income tax system contains exceptions to the treatments prescribed by the system’s concepts. Throughout the remaining chapters, the treatment of various transactions is developed by reference to the applicable concepts. To deal with the federal income tax system effectively, knowledge of the concepts on which it is based is essential. This chapter has presented the basic tax concepts and categorized them according to their use within the tax system: general, accounting, income, and deduction concepts. For reference purposes, each category is summarized in Table 2–1.

**Key Terms**

- ability-to-pay concept (p. 48)
- accounting method (p. 55)
- accrual basis of accounting (p. 55)
- administrative convenience concept (p. 49)
- all-inclusive income concept (p. 58)
- annual accounting period concept (p. 55)
- arm’s-length transaction concept (p. 50)
- assignment-of-income doctrine (p. 54)
- basis (p. 59)
- business purpose concept (p. 63)
- capital asset (p. 58)
- capital expenditure (p. 66)
- capital gains (p. 59)
- capital losses (p. 59)
- capital recovery concept (p. 59)
- cash basis of accounting (p. 55)
- claim-of-right doctrine (p. 60)
- concept (p. 47)
- conduit entity (p. 52)
- construct (p. 47)
- constructive ownership rules (p. 51)
- constructive receipt doctrine (p. 60)
- doctrine (p. 47)
- entity concept (p. 52)
- investment expense (p. 64)
- legislative grace concept (p. 58)
- pay-as-you-go concept (p. 51)
- personal expense (p. 64)
- realization concept (p. 59)
- related party provisions (p. 50)
- substance-over-form doctrine (p. 56)
- taxable entity (p. 52)
- tax benefit rule (p. 55)
- trade or business expense (p. 64)
- wherewithal-to-pay concept (p. 62)
### Table 2–1

**Income Tax Concepts with Related Constructs and Doctrines**

<table>
<thead>
<tr>
<th>General Concepts</th>
<th>Income Concepts</th>
<th>Accounting Concepts</th>
<th>Deduction Concepts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ability to Pay</td>
<td>All-Inclusive Income</td>
<td>Entity</td>
<td>Legislative Grace</td>
</tr>
<tr>
<td>Income, exclusions, deductions, losses, tax credits</td>
<td>Legislative Grace</td>
<td>Taxable/Conduit</td>
<td>Business Purpose</td>
</tr>
<tr>
<td>Progressive rate structure</td>
<td>Capital asset—Capital gains and losses</td>
<td>Assignment of income</td>
<td>Purpose</td>
</tr>
<tr>
<td>Administrative Convenience</td>
<td>Capital Recovery</td>
<td>Annual Accounting Period</td>
<td>Capital Recovery</td>
</tr>
<tr>
<td>Standard deduction</td>
<td>Basis</td>
<td>Accounting method</td>
<td>Basis</td>
</tr>
<tr>
<td>Pay as You Go</td>
<td>Realization</td>
<td>Tax benefit rule</td>
<td>Capital expenditure</td>
</tr>
<tr>
<td>Related party</td>
<td>Claim of right</td>
<td>Substance over form</td>
<td></td>
</tr>
<tr>
<td>Constructive ownership</td>
<td>Constructive receipt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wherewithal to Pay</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. Sec. 267— Defines related parties and limits deductibility of certain transactions between related parties.
2. Sec. 6654—Provides that all individuals must pay estimated taxes when their tax liability is expected to be greater than $1,000; imposes a penalty for not paying the proper amount of estimated tax.
3. Sec. 701—Provides that partners, not the partnership, are responsible for payment of tax on the income of the partnership.
4. Sec. 1336—Prescribes the taxation of income of S corporations.
5. Lucas v. Earl, 281 U.S. 111 (1930)—Established the assignment-of-income doctrine in holding that salaries and fees earned by the taxpayer but paid to his wife under a valid agreement were still income to the taxpayer who earned the income.
6. Sec. 111—Provides the general definition of **gross income** as all income from whatever source derived.
7. Willcuts v. Bunn, 282 U.S. 216 (1931)—Determined that gain on the sale of tax-exempt securities is taxable income.
8. Sec. 1221—Defines **capital assets**.
9. Sec. 1211—Sets forth the limit on deductions of capital losses of corporations and individuals.
10. Sec. 1001—Prescribes the calculation of gains and losses on dispositions of property; defines **amount realized** for purposes of determining gain or loss on dispositions.
11. Sec. 1012—Defines **basis** of property: The general rule for the initial basis of a property is its cost.
12. Eisner v. Macomber, 252 U.S. 189 (1920)—In holding that a stock dividend did not constitute gross income, determined that increases in value that have not been realized are not subject to tax.
18 North American Oil Consol. v. Burnet, 286 U.S. 417 (1932)—Established the claim-of-right doctrine in holding that an amount received under the clear control of the taxpayer was income even if some portion of the amount received might have to be repaid in the future.

19 Reg. Sec. 1.446-1—Requires all items that constitute gross income to be included in gross income in the tax year in which the item is actually or constructively received.

20 Hamilton National Bank of Chattanooga v. CIR, 29 B.T.A. 63 (1933)—Held that “a taxpayer may not deliberately turn his back upon income and thus select the year for which he will report it.”

21 Hornung v. CIR, 47 T.C. 428 (1967)—Held that the value of an automobile received by a football player as most valuable player in a championship game was not included in income until the player had actual possession made available to him.

22 Reg. Sec. 1.61-1—States that income can be realized in any form, including cash, services, and property received.

23 Reg. Sec. 1.61-8—States that advance receipts of rents are included in gross income in the year of receipt, regardless of the taxpayer’s accounting method.

24 Helvering v. Gregory, 293 U.S. 465 (1935)—Originated the business purpose concept; held that the transaction in question had no business purpose, therefore the applicable tax law did not apply.

25 CIR v. Transport Trading & Terminal Corp., 176 F.2d 510 (2d Cir. 1949)—Expanded the application of the business purpose concept enunciated in Helvering v. Gregory to include any tax law provisions pertaining to commercial transactions.

26 Sec. 162—Allows the deduction of all ordinary and necessary expenses incurred in a trade or business of the taxpayer.

27 Sec. 212—Allows the deduction of all ordinary and necessary expenses incurred in a production-of-income activity of the taxpayer.

28 Sec. 262—Provides the general rule for the disallowance of deductions for personal expenditures by individuals.

29 Sec. 211—Generally allows specific personal expenditures as itemized deductions of individuals.

30 Sec. 263—Provides the general rule that disallows current period deductions for capital expenditures.

31 Reg. Sec. 1.461-1—Specifies that expenditures that create an asset with a life expectancy that extends substantially beyond the end of the tax year must be capitalized.

32 Sec. 1011—Provides general rules for determining the adjusted basis of property.

33 Sec. 1016—Provides the general rules for adjustments to basis of property for capital expenditures and recoveries of capital subsequent to purchase.

34 Sec. 167—Allows a depreciation deduction for property subject to exhaustion and wear and tear on property used in a trade or business or held for the production of income.

35 Sec. 179—Provides an election to expense up to $17,500 of the cost of depreciable tangible personal property in the year of purchase for tax years after 1992. In 2001, the election to expense is increased to $24,000. The election increases to $25,000 in 2003.

Discussion Questions

1. This chapter compared the operation of the income tax system with the operation of other systems we have devised to govern our everyday lives. Choose an example of a system you deal with in your everyday life, and explain part of its operation in terms of concepts, constructs, and exceptions to the general concepts and constructs.

2. The chapter stated that the ability-to-pay concept is fundamental to the operation of the income tax system. What is the ability-to-pay concept, and what two basic aspects of the income tax system are derived from the concept? What might the tax system be like without this concept?

3. What is an arm’s-length transaction? What is its significance to income taxation?

4. Explain how the related party construct and the arm’s-length transaction concept interact.

5. Why is the pay-as-you-go concept important to the successful operation of the income tax system? What other types of taxes are based on this concept?

6. What is the difference between a taxable entity and a conduit entity?

7. Why is the tax benefit rule necessary? That is, which concept drives the need for this construct? Explain.
8. What are the two basic methods of accounting that may be used by taxpayers? How do the two basic methods differ?

9. What is the effect of the capital recovery concept on income recognition?

10. Chapter 1 discussed how gross income is equal to all income received, less exclusions. Which concepts form the basis for this calculation of gross income? Explain.

11. What is capital gain income? How is it different from ordinary income?

12. Why does the doctrine of constructive receipt apply only to cash basis taxpayers?

13. How is the wherewithal-to-pay concept different from the ability-to-pay concept?

14. Explain how the business purpose concept provides the basis for determining which expenses are deductible.

15. What is a capital expenditure?

16. The legislative grace concept is both an income concept and a deduction concept. Explain how the application of the concept differs for income items and deduction items.

17. The capital recovery concept is both an income concept and a deduction concept. Explain how the application of the concept differs for income items and deduction items.

18. Which of the following are based on an ability to pay? Explain.
   a. State Y collects a sales tax of 5% on all purchases of goods and services.
   b. State X collects a sales tax of 5% on all purchases of goods and services but gives low-income families a tax credit for sales taxes.
   c. Students at State University are given free parking in designated lots. Faculty and staff members must pay $125 per year for parking at State University.
   d. Barton City charges all customers a flat monthly rate of $10 for garbage pickup.

19. Which of the following are based on an ability to pay? Explain.
   a. Local County assesses property taxes at the rate of 1% of assessed value.
   b. The university library lets all students, faculty, and staff members check out books free. Students who do not return books by the due date are fined $1 for each day the book is late. Staff members are fined 50 cents for each day a book is late. Faculty members are not fined when they return books late.
   c. The country of Lacyland assesses an income tax based on the following schedule:

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Income Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0- to $20,000</td>
<td>0% of taxable income</td>
</tr>
<tr>
<td>$20,001 to $60,000</td>
<td>$4,000 + 15% of taxable income in excess of $20,000</td>
</tr>
<tr>
<td>$60,001 and above</td>
<td>$10,000 + 10% of taxable income in excess of $60,000</td>
</tr>
</tbody>
</table>
   d. State Z imposes a 10-cent-per-gallon tax on gasoline but gives low-income taxpayers a tax credit for gasoline taxes paid.

20. Sheila, a single taxpayer, is a retired computer executive with a taxable income of $80,000 in the current year. She receives $20,000 per year in tax-exempt municipal bond interest. Adam and Tanya are married and have no children. Adam and Tanya’s $80,000 taxable income is comprised solely of wages they earn from their jobs. Calculate and compare the amount of tax Sheila pays with Adam and Tanya’s tax. How well does the ability-to-pay concept work in this situation?

21. Andrew and Barbara each receive a salary of $80,000. Neither Andrew nor Barbara has any other source of income. During the current year, Barbara paid $800 more in tax than Andrew. What might explain why Barbara paid more tax than Andrew when they both have the same income?

22. Which of the following are related parties?
   a. Harvey and his sister Janice.
   b. Harvey and the Madison Partnership. Harvey owns a 60% interest in the partnership. Three of Harvey’s friends own the remaining partnership interest.
   c. Harvey and his grandfather Maurice.
   d. Harvey and Noti Corporation. Harvey owns 40% of Noti Corporation. Three unrelated parties own 20% each.
   e. Harvey and his uncle Elmer.
23. In each of the following cases, determine whether Inez is a related party:
   a. Inez owns 500 shares of XYZ Corporation's common stock. XYZ has 50,000 shares of common stock outstanding.
   b. Inez owns a 40% interest in the Tetra Partnership. The other 60% interest is owned by 3 of Inez's friends.
   c. Inez owns 40% of the stock in Alabaster Company. Her husband, Bruce, owns 30% and her brother-in-law, Michael, owns the remaining 30%.
   d. Inez is a 100% owner of Nancy Corporation.

24. Doiko Corporation owns 90% of the stock in Nall, Inc. Trebor owns 40% of the stock of Doiko. Trebor's sister owns the remaining 60% of Doiko. During the current year, Trebor purchased land from Nall for $43,000. Nall had purchased the land for $62,000. Write a memorandum to the controller of Nall, Inc., explaining the potential tax problem with the sale of the land to Trebor.

25. Ed runs an auto repair business out of the garage attached to his personal residence. How should he account for each of the following items?
   a. Cash received from repair services, $28,000.
   b. Interest paid on his home mortgage, $7,300.
   c. Power jack hoist purchased at a cost of $12,000.
   d. Electricity bills, $3,600. (Ed does not have separate electricity service to the garage.)
   e. Checks received from customers that were returned by his bank, $1,600. The bank charged Ed's account $35 for processing the bad checks.
   f. Telephone bill for phone in the garage, $420. (Ed has a separately listed phone in his house.)
   g. Advertising in the local newspaper, $800.
   h. Interest paid on home furniture loan, $600.

26. Jie owns a lawn mower repair business. Her repair shop is in a building she constructed on the lot on which her personal residence is located. How should Jie account for each of the following?
   a. Interest paid on her home mortgage, $9,200. Interest of $4,000 is paid on a separate loan that she used to construct the repair shop.
   b. Property taxes, $1,800.
   c. Electricity bills, $3,800. (Jie is not billed separately for electricity service to her repair shop.)
   d. Cost of remodeling the kitchen, $3,200.
   e. Telephone bills, $970. Jie uses one telephone number for her residence and her business. The cost of having an extra line to the shop is $30 per month. The $970 includes a charge of $250 for an ad in the business section of the telephone directory.
   f. Cost of operating her van for one year, $7,800. Jie uses the van in her repair business and for personal use.

27. Aiko, Lani, and Charlie own the 3-Star Partnership, sharing profits and losses 20:50:30. During the current year, 3-Star has total gross income of $500,000 and total allowable deductions of $300,000. How should each of the following taxpayers account for 3-Star's results? Explain.
   a. 3-Star Partnership
   b. Aiko
   c. Lani
   d. Charlie

28. Wendy owns 20% of the common stock of Britton Company. During the current year, Britton reported a taxable income of $90,000 and paid $40,000 in cash dividends. What are the income tax effects for Wendy of her investment in Britton Company if Britton is organized as
   a. A corporation?
   b. An S corporation?

29. Binh owns several businesses. The total income generated by all his businesses puts him in the highest marginal tax bracket. Seeking to lower the overall tax on his business income, Binh is thinking of creating two S corporations and putting half his business interests in each. Will this arrangement lower his overall tax? Write a letter to Binh in which you explain the tax effects of organizing his businesses as two S corporations. In your letter, suggest an alternative plan that might lower his tax.
30. Christie purchases a one-third interest in the Corporate Capital Partnership (CCP) in 2002 for $40,000. During 2002, CCP earns an income of $90,000, and Christie withdraws $30,000 in cash from the partnership. In 2003, CCP suffers a loss of $30,000, and Christie withdraws $10,000. What are the tax consequences for Christie of this investment in 2002 and 2003?

31. Arnie is a self-employed handyman. During the current year, customers pay him $10,000 in cash for his services. Arnie gives the $10,000 to his daughter, Ariel, who uses it to pay college expenses. Is Arnie or Ariel taxed on the $10,000? Explain.

32. Esmeralda is an attorney. Before 2003, she is employed by the law firm of Ellis and Morgan (E&M). Esmeralda is not a partner in E&M; her compensation consists of a fixed salary and a percentage of any fees generated by clients she brings or refers to the firm. In January 2003, she becomes a partner in the law firm of Thomas, Gooch, and Frankel (TGF). As a partner, Esmeralda agrees to turn over to TGF any income from the practice of law from the date of her admittance to the practice. In leaving E&M, it is agreed that she will continue to receive her percentage of fees from clients she referred to E&M during her employment there. In return, Esmeralda agrees that, upon request, she will consult with E&M attorneys regarding those clients. During 2003, she consults with 2 of her former E&M clients and receives $12,000 from E&M per their agreement. The $12,000 consists of $10,000 as a percentage of fees for client referrals after she left E&M and $2,000 as a percentage for work done before she left E&M. Esmeralda turns the $12,000 over to TGF per her partnership agreement. Write a letter to Esmeralda explaining whether she is taxed on the $12,000 she receives from E&M.

33. For each of the following situations, determine the proper year for recognition of the income or deduction if the taxpayer is (1) a cash basis taxpayer and (2) an accrual basis taxpayer:
   b. Raashan pays his employee, Sara, $22,450 in salary up to December 23, 2003. As of December 31, 2003, Raashan owes Sara $560 for the period of December 23 through December 31. The $560 is to be paid on the next pay date, which is January 5, 2004.
   d. Devi sells Aaron a car on August 1, 2003, for $36,000. The terms of the sale call for Aaron to pay Devi $18,000 on August 1, 2003, and $9,000 on August 1 of 2004 and 2005.
   e. Barnie’s Paint Barn purchases new spray painters on January 15, 2003, at a cost of $3,000. The spray painters have an estimated useful life of 10 years, but the tax life is 5 years.

34. For each of the following situations, determine the proper year for recognition of the income or deduction if the taxpayer is (1) a cash basis taxpayer and (2) an accrual basis taxpayer:
   b. The Outback Brewing Company purchases a new delivery van on October 30, 2003. The purchase is financed with a note that will be paid off over 3 years. Outback expects to use the van for 3 years, but the tax life of the van is 5 years.
   c. Morbid Marble Mortuaries, Inc., sells a headstone to Lorissa for $6,000. The terms of the sale call for Lorissa to pay $3,000 in the year of the sale and $1,000 in each of the succeeding 3 years.
   d. Maury’s Computer Consultants, Inc., performs work for Janis in 2003. Maury’s bills Janis in 2003, but no payment is received. In 2004, Janis files for bankruptcy, and Maury’s determines that it will be able to collect nothing on her account.

35. Tim has state income taxes of $4,500 withheld from his salary during 2002. On his 2002 federal income tax return, Tim properly deducts the $4,500 as state taxes paid. Upon filing his 2002 state income tax return, he determines that his actual state income tax for 2002 is only $3,900, and the state sends him a $600 refund. What are the tax consequences of the refund? Explain in terms of the concepts presented in the chapter. How would your answer change if Tim’s actual state income tax is $4,900 and he has to pay $400 with his state return?
36. Jamal Corporation is an accrual basis taxpayer. In 2002, Jamal writes off a $1,000 account receivable from a customer who has died. In 2003, the former customer’s estate sends Jamal a check for $600. What are the tax effects of the receipt of the $600 in 2003? Explain. How would your answer be different if Jamal Corporation were a cash basis taxpayer?

37. Angela enrolls as a student at Local College during the current year. Before she starts school, her parents lend Angela $80,000 with the stipulation that she will lend the entire $80,000 back to them. The loan is evidenced by a non-interest-bearing note payable in 10 years. Several days later, Angela returns the $80,000 to her parents in exchange for their $80,000 note secured by a mortgage on their personal residence. The note has an 8% interest rate and requires monthly interest payments, with the principal due in 10 years. Angela’s parents pay her $6,400 in interest on the loan during the current year. Mortgage interest on a principal residence is deductible as an itemized deduction. Discuss whether Angela’s parents should be allowed a deduction for the $6,400 in interest paid to Angela.

38. For each of the following tax treatments, determine the concept, construct, or doctrine that provides the rationale for the treatment:
   a. Lester purchases some stock for a total cost of $2,500. On December 31, 2002, the stock is worth $2,800. In August 2003, he sells the stock to his brother Rufus for $2,000. Lester has no income from the stock in 2002, and he is not allowed to deduct the $500 loss on the sale of the stock to Rufus in 2003.
   b. Kerry is an employee of Ross Company. During the year, Ross withholds federal income taxes of $3,500 from her salary. Her tax liability for the year is only $3,200, so she receives a refund of $300.
   c. Catherine is a city government employee. She often uses the city’s photocopier to make personal photocopies and has her secretary type an occasional personal letter. The value of these services for the current year is approximately $55 but is not included in Catherine’s gross income.
   d. Dante’s allowable personal deductions are only $2,800 this year, so he deducts the standard deduction in computing his taxable income.

39. For each of the following tax treatments, determine the concept, construct, or doctrine that provides the rationale for the treatment:
   a. During the current year, Trafalger Corporation pays $475,000 in estimated tax payments. Trafalger determines that its actual tax liability is $490,000, so it pays only $15,000 with its tax return.
   b. The Parsnip Partnership is an accrual basis taxpayer. During 2002, Parsnip deducted as a bad debt expense a $5,000 account receivable that it determined it could not collect. In 2003, Parsnip receives a $1,000 payment on the account. Parsnip must include the $1,000 in its 2003 gross income.
   c. Kuri sells land for $30,000; its cost was $20,000. Under the sales agreement, the buyer is to pay Kuri’s son $10,000 of the sales price. Kuri must recognize a gain of $10,000 on the sale.
   d. Jevon owns 20% of the stock of Cowdery, Inc., an S corporation. During the current year, Cowdery reports income of $45,000 and pays no dividends. Jevon must include $9,000 in gross income.

40. Postum Partnership purchases a building in 2000 for $250,000. It deducts $5,600 in depreciation on the building in 2000, $6,400 in 2001, $6,400 in 2002, and $3,200 in 2003. It sells the building in 2003 for $260,000. What is the partnership’s gain or loss on the sale of the building?

41. Chelsea, who is single, purchases land for investment purposes in 1998 at a cost of $22,000. In 2003, she sells the land for $38,000. Chelsea’s taxable income without considering the land sale is $75,000. What is the effect of the sale of the land on her taxable income, and what is her tax liability?

42. George purchases stock in Dodo Corporation in 1999 at a cost of $50,000. In 2003, he sells the stock for $32,000. What is the effect of the sale of stock on George’s taxable income? Assume that George sells no other assets in 2003.
CHAPTER 2 Income Tax Concepts

43. Determine whether the taxpayer in each of the following situations has realized income. Explain why there has or has not been a realization, and determine the amount of income to be reported.

a. Alfredo owns a one-third interest in Bayou Partnership. During the current year, Bayou’s taxable income is $45,000.

b. Janet owns a pest-control service. She charges customers $50 per month for basic pest control. Alternatively, customers can pay a lump sum of $500 for one year of basic monthly pest control. During the current year, Janet receives $13,000 in monthly payments and $26,000 in 1-year prepayments.

c. Monte owns 1,000 shares of Ali, Inc., common stock. During the current year, Ali declares and distributes a 20% stock dividend. As a result, Monte receives an additional 200 shares of stock.

d. Rogers Trucking Company owes Big Truck Sales, Inc., $200,000 for the purchase of 3 trucks. Rogers is having a bad year and is unable to make full payment on the debt to Big Truck. Rather than foreclose on Rogers, Big Truck reduces the debt to $170,000 so that Rogers can stay in business.

44. Determine whether the taxpayer in each of the following situations has realized income. Explain why there has or has not been a realization, and determine the amount of income to be reported:

a. Ramrod Development Company purchases land costing $230,000. Ramrod subdivides the land into 100 lots, incurring legal fees of $20,000. It also spends $50,000 to install utility and sewer connections to each lot. The lots are priced to sell at $50,000 each, but none sold during the year.

b. Eugene is a computer consultant. Rashid is an accounting professor. Rashid needs help installing new software on his home computer. Eugene offers to install the software if Rashid will help him set up the books for a new company he is forming. Eugene installs the software in December. Rashid sets up the books in February.

c. Sasha is an employee of Chasteen Hair Products. Chasteen provides all employees with free medical coverage. During the current year, the cost of Sasha’s coverage is $1,900.

d. In November, Ira wins an all-expense-paid trip for two to the Super Bowl in January. He plans to take his best friend to the game. The estimated value of the trip is $4,300.

45. Shannon signs a $100,000 contract to develop a plan for integrating the computer operations of State University in December. Under the contract, she receives a $30,000 advance against future payments on the contract upon signing the contract. The contract stipulates that if Shannon does not produce an acceptable plan, she must repay any portion of the advance not earned to date. Does Shannon have any income from the receipt of the advance? Explain in terms of the income tax concepts presented in the chapter.

46. Determine whether the taxpayer in each of the following situations has a claim of right to the income received:

a. Trigger, Inc., receives a $5,000 stud fee for services rendered by one of its prized horses. Under its standard contract, Trigger will return the fee if a live foal is not born.

b. Orville works as a salesman for Brewster Company. He receives a travel allowance of $1,000 at the beginning of each quarter. At the end of each quarter, he must make a full accounting of his travel expenses and reimburse Brewster for any of the $1,000 not spent on approved travel.

c. Assume that in part b, Orville is not required to account for his actual travel expenses for Brewster and is not required to return unused portions of the travel advance.

d. Arco Architecture, Inc., receives $10,000 from a client for work done by a subcontractor on the client’s project. Arco, in turn, pays $10,000 to the subcontractor.
47. Determine whether the taxpayer in each of the following situations has a claim of right to the income received:
   a. Sulley’s Spa Spot sells hot tubs that have a 2-year warranty. The warranty provides for the replacement of all parts and the cost of labor to replace the parts. In addition, Sulley’s may replace the hot tub in lieu of repairing it. During the current year, Sulley’s hot tub sales total $250,000. Sulley’s estimates that 10% of all hot tubs sold will require warranty work.
   b. In 2001, Retro Fit Construction Company purchased equipment by borrowing $100,000 from Fifth State Bank. After paying off $30,000 of the loan, Retro has financial problems in the current year and cannot afford to make its regular payment. Rather than have Retro default on the loan, Fifth State Bank agrees to reduce the debt to $50,000.
   c. Larry’s Lawncare Service provides lawn mowing and fertilization services to residential customers. Customers can pay by the month, or they can purchase a one-season contract for $1,000. The contracts obligate Larry’s to provide the necessary mowing and fertilization from April through October. In September, Larry’s has a “pre-season” sale that lets current customers purchase next season’s contract for $800. Fourteen customers buy the discounted contract in September.

48. Consider the following two situations. Although they are similar, their treatments are exactly opposite. Identify the concept underlying both treatments, and explain why the concept treats the two situations differently.
   a. Sam is an employee of Dunbar Company. The company regularly mails salary checks to employees to arrive on or before the last day of each month. Sam’s regular paycheck arrives at his house on December 31, 2003, but Sam is away on a ski trip and does not return until January 2, 2004. Sam deposits the check in his bank account the following day. The check is included in Sam’s 2003 income.
   b. Percy is an employee of Daly Company. In November 2003, Percy’s position is eliminated in a “streamlining” of company costs. As part of the cost reduction program, Percy is entitled to severance pay; however, his boss tells him that it will be 3 or 4 months before the severance payments are made. The check arrives by mail on December 31, 2003, while Percy is away on a ski trip. He returns on January 2, 2004, and deposits the check in his bank account the following day. The severance pay check is not taxable until 2004.

49. Determine whether the taxpayer in each of the following situations is in constructive receipt of income. If not, explain when the income will be constructively received.
   b. Regan is an employee of BIF Manufacturing, earning $3,000 per month. She purchases merchandise from BIF costing $2,000 in January of the current year. To pay for the merchandise, BIF agrees to deduct $75 per month from her pay, reducing it to $2,925 per month before other withholdings.
   c. Marnie owns $50,000 par value of 6% coupon bonds. The interest coupons may be clipped and redeemed on May 30 and November 30 each year. Marnie does not redeem the November 30, 2003, coupon interest until January 8, 2004.

50. Using the income concepts presented in this chapter, discuss whether the taxpayer has realized income in each of the following situations:
   a. Adco Corporation pays the health insurance premiums for all its employees. Adrian is an employee of Adco. Health insurance premiums Adco pays for Adrian cost $1,150 for the current year.
   b. The Sung Partnership buys a parcel of unimproved land for $32,000. Sung spends an additional $22,000 to put in roads and sewerage and to grade the property for subdividing. The property is subdivided into 15 lots and offered for sale at $10,000 per lot.
   c. Doctors and nurses at Valley View Hospital are allowed to eat free of charge in the hospital cafeteria during their shifts. Sue, a doctor, eats meals valued at $1,900 during the current year.
   d. Wayman wins the golf championship at his country club. In addition to a handsome trophy, he receives merchandise worth $500 for winning the tournament.
   e. Rock signs a contract to play football for the Rangers. In addition to a salary of $1,000,000 per year for 5 years, he is to receive a signing bonus of $5,000,000 to be paid 10 years from the date the contract was signed.
51. Nina leases a building to Downtown Computer Systems for $5,000 per month under a 5-year lease. The terms of the lease provide that any improvements to the building made by Downtown revert to Nina upon termination of the lease. Downtown remodels the building at a cost of $40,000. At the end of the lease, the fair market value of the remodeling improvements is $50,000. Nina sells the building one year later for $250,000.

a. List three points at which Nina might recognize income from the improvements made by Downtown Computer Systems.

b. According to the income concepts presented in the chapter, when should Nina recognize income from the lease? Explain.

c. Would your answer to part b be different if the lease provides that any improvements made by Downtown Computer Systems can be deducted from the rental payment made to Nina?

52. For each tax treatment described, determine the applicable income tax concept(s), and explain how it forms the basis for the treatment:

a. Jackson owned coupon bonds with detachable interest coupons. He detached coupons worth $5,000 and gave them to his son to buy a car. Jackson is taxed on the $5,000 of interest, even though he never actually received the interest.

b. Joan’s barn on her ranch was destroyed by a tornado. The barn had an adjusted basis of $24,000. Joan received insurance proceeds of $35,000 and built a new barn costing $40,000. Joan does not have to recognize the gain realized on the barn in the current period.

c. Elvis borrowed $30,000 from University Credit Union to purchase a new X car. He is not taxed on the receipt of the $30,000.

d. Kelley lost the diamond ring she received from her husband, Ian. The ring had a basis of $2,000, and she received $3,000 from her insurance company. Kelley used the money to pay off medical bills. Kelley must recognize a $1,000 gain on the loss of her ring.

53. During the current year, Errol starts a management consulting service which he operates from an office in his home. He uses one room of the house as his office. He purchases office furniture for $6,000 and a computer for $3,000. He uses the computer primarily in his consulting business but also uses it to track his personal investments and for other personal purposes. What tax problems might Errol face regarding his office, the furniture, and the computer? Explain.

54. For each of the following situations, determine the deduction concepts involved, and explain how they form the basis for the tax treatment described:

a. Individuals are allowed to deduct medical expenses.

b. Happy Burgers, Inc., owns a chain of drive-in restaurants in California. Seeking to expand its operations, Happy spends $90,000 investigating locations in Oregon. Happy decides that expanding into Oregon is not a wise move, but it is allowed to deduct the $90,000.

c. Lage’s Licorice Company suffers a fire in one of its warehouses. Equipment that cost $40,000 and that had been depreciated $15,000 is destroyed. The equipment, which cost $50,000 to replace, is uninsured. Lage is allowed to deduct a loss of $25,000 on the equipment.

d. While Ray is out to dinner one night, someone breaks into his personal car. The thief steals his stereo and his golf clubs. The fair market value of the items stolen is $300. Because he has a $500 deductible on his insurance policy, he receives no reimbursement from his auto insurance. To make matters worse, no tax deduction for his loss is allowed.

55. For each of the following situations, determine the deduction concepts involved, and explain how they form the basis for the tax treatment described:

a. Jamie sells her personal residence at a loss of $9,000. She is not allowed a deduction for the loss.

b. Jamie sells a building used in her business at a loss of $9,000. She is allowed to deduct a $9,000 loss on the sale of the building.

c. Last year, Gardner Corporation purchased equipment costing $10,000. The equipment was eligible for a special expense election, and Gardner deducted the $10,000 cost in the year of purchase. Gardner is not allowed a depreciation deduction on the equipment in the current year.

d. The Orlando Jams Partnership borrows $500,000 to use as working capital. During the current year, the partnership pays $45,000 in interest on the loan and repays $100,000 of the loan principal. Orlando can deduct the $45,000 interest payment but cannot deduct the repayment of the loan principal.
56. Sidney lives in Hayes, Kansas. He owns land in Cotulla, Texas, that he inherited from his father several years ago. The land is unimproved and has never produced income. On January 26, 2003, Sidney receives a statement of delinquent taxes on the property for 2000, 2001, and 2002 for $120. On February 10, 2003, Sidney and his wife, Ellen, start to drive to Cotulla; they arrive on February 20 and pay the taxes on the same day. The cost of the trip for Sidney and Ellen is $450. Sidney and Ellen would like to deduct the cost of the trip. Write a letter to Sidney and Ellen in which you explain what they can deduct.

57. Explain why the legal fees paid in the following three situations are treated differently for income tax purposes:
   a. Jim pays $10,000 in legal fees in obtaining a divorce. None of the $10,000 is deductible.
   b. Camella invents and patents a device that shells nuts. When she learns that another company is selling copies of her device, she pays an attorney $10,000 to enforce her patent. The $10,000 is fully deductible.
   c. Melody pays $10,000 in legal fees for advice relating to investments she owns. Only $6,000 of the fees is deductible.

58. Explain why the loss resulting from the sale of a computer in the following three situations is treated differently for income tax purposes:
   a. Monica sells her personal computer at a loss of $1,300. None of the loss is deductible.
   b. Omar sells a computer used in his carpeting business at a loss of $4,300. The loss is fully deductible.
   c. Jerry sells his computer at a loss of $3,800. Jerry used the computer to keep track of his investment portfolio. Only $3,000 of the loss is deductible.

59. A truck owned by Duster Demolition Services is involved in an accident. The truck originally cost $40,000, and $25,000 of depreciation had been taken on the truck as of the date of the accident. The cost of repairing the truck is $10,000, for which the insurance company reimburses Duster $8,000.
   a. How much of a loss, if any, is Duster entitled to deduct as a result of the accident?
   b. What is the adjusted basis of the truck after the accident?

60. Determine the proper treatment of each of the following expenditures:
   a. Zoe purchases land costing $8,000. During the current year, she pays $2,000 to have utilities and sewer lines installed on the property. Zoe also pays $600 in interest on the loan used to obtain the land and $300 in property taxes on the land.
   b. On August 2, Carruth Corporation pays $11,000 for a 2-year fire insurance policy on its manufacturing facility.
   c. The Freeborn Partnership purchases a rental property costing $125,000. Before it rents out the building, Freeborn repaints it at a cost of $2,000 and spends $1,200 on minor repairs. After the property is rented, a pipe bursts, requiring $2,000 in repairs.
   d. Aqua Robotics, Inc., purchases and pays for supplies costing $1,400 on December 26. As of December 31, the company has not used $1,200 worth of the supplies.

61. Determine the taxpayer's adjusted basis in each of the following situations. If any changes are made in the original basis of the asset, explain why they are necessary:
   b. Symbol Corporation purchases a building in 2000 at a cost of $240,000. Annual maintenance costs on the building are $80,000. In 2002, Symbol adds a wing to the building at a cost of $60,000. In 2003, the building is painted at a cost of $25,000. Symbol deducts $4,800 in depreciation in 2000, $7,300 in 2001, and $8,100 in 2002 and 2003.
   c. Lorissa purchases land as an investment in 2001, for $33,000. Property taxes on the property are $400 per year. In 2002, Lorissa is assessed $2,000 by the county assessor for her share of a sidewalk that the county builds adjacent to the land. Lorissa pays the assessment in 2003.
   d. The Barton Brothers Partnership purchases a computer in 2001 for $8,000. The partnership elects to deduct the entire cost of the computer in 2001. In 2003, Barton Brothers spends $300 to repair the computer.
62. Davidson Industries manufactures golf course maintenance equipment. The equipment comes with a 4-year warranty. Davidson’s engineers estimate that approximately 10% of the equipment will be defective and require payment under the warranty. Discuss the propriety of allowing Davidson a deduction for warranty costs in the current year if
a. Davidson is a cash basis taxpayer.
b. Davidson is an accrual basis taxpayer.

In each of the following problems, identify the tax issue(s) posed by the facts presented. Determine the possible tax consequences of each issue that you identify.

63. Junior bought some stock several years ago for $8,000. He is thinking of selling it and has 2 offers. His broker told him he could sell the stock for $8,300 and would have to pay a $600 commission, for a net realization of $7,700. His sister Bonnie offered to pay Junior $7,700 with no commissions paid on the transaction.

64. Henrietta is the president and sole shareholder of Clutter Corporation. In 2000, Henrietta transferred ownership of her personal residence to the corporation. As part of the transfer, Clutter Corporation assumed Henrietta’s mortgage on the house. At the same time, she and the corporation entered into an agreement that lets Henrietta lease the property for as long as she wants at an amount approximating the monthly mortgage payments on the house. During the current year, Clutter paints the house at a cost of $5,000, makes other repairs totaling $3,000, and adds an entertainment room at a cost of $30,000. Current-year property taxes and interest paid by Clutter on the house are $1,400 and $18,000, respectively. Henrietta paid $18,000 in rent to Clutter.

65. Milton is an inventor who has also written several successful mystery novels. Because he didn’t really need the income from the novels, Milton wrote them under an assumed name and had the royalties paid to Hammer Corporation. When Milton incorporated Hammer, he gave all the stock to his three sons. The sons are employed by the corporation, with salaries approximately equal to the royalties earned each year from the novels.

66. Jerry and his wife, Joanie, own a successful concrete company that is organized as a corporation. Jerry spends all his time running the company, whereas Joanie has a full-time job as a legal secretary. The corporation pays Joanie a salary of $45,000 a year as vice president.

67. The Perry Development Partnership purchases 40 acres of land for $30,000. It spends $8,000 subdividing the land into 2-acre parcels and $17,000 to install a sewer line and utilities to each parcel. Perry intends to sell the 2-acre parcels for $12,000, but none of them are sold by the end of the current year.

68. Ayah signs a contract to write a book for East Publishing Company in the current year. Under its terms, she receives a $5,000 advance against future royalty payments upon signing the contract. The contract provides that if Ayah does not write a suitable book or if the book’s royalties are insufficient to cover the advance, she must repay any portion not earned.

69. Aretha is an executive vice president of Franklin, Inc. On December 18, 2003, the Franklin, Inc., board of directors awards her a $20,000 bonus. Aretha asks Franklin’s controller to delay processing the bonus check until January. The controller agrees to her request, and she receives the $20,000 bonus check on January 10, 2004.

70. Arnold is a college professor specializing in robotics. During the current year, he attends a meeting on robotics in San Diego. Because of the desirable location of the meeting, he takes along his wife, Hortense, and their 2 children. The meeting lasts for 3 days, but Arnold and his family stay for 2 weeks.

71. Doris purchases a ski cabin in Montana during the current year. She hires a real estate management company to rent out the cabin on a daily basis. The real estate management company tells Doris to expect an average of 70 rental days per year. Doris intends to use the cabin for her vacation 3 weeks during the year.
72. INTERNET ASSIGNMENT Many legislative, administrative, and judicial resources are available on the Internet. They can be located using a search engine provided by your browser or a tax directory site located on the Internet. The purpose of this assignment is to practice searching the Internet to locate tax materials. Using a search engine or one of the tax directory sites provided in Exhibit 16–6 (Chapter 16), find the Treasury Regulation that provides the treatment of advance receipts of rental income. Trace the process you used to find this regulation (search engine or tax directory used and key words). Print the text of the regulation.

73. INTERNET ASSIGNMENT Many legislative, administrative, and judicial resources are available on the Internet. They can be located using a search engine provided by your browser or a tax directory site located on the Internet. The purpose of this assignment is to practice searching the Internet to locate tax materials. Using a search engine or one of the tax directory sites provided in Exhibit 16–6 (Chapter 16), find the U.S. Supreme Court decision that established the claim of right doctrine. Provide the citation to the case and explain the facts that led to the creation of the claim of right doctrine.

74. RESEARCH PROBLEM The assignment of income doctrine states that income is taxed to the entity owning the income, regardless of who actually receives the income. That is, income taxation cannot be escaped by assigning the payment of income to another entity. Find the court case that led to this doctrine and explain the facts surrounding the court's decision.

75. RESEARCH PROBLEM Under a reimbursement plan that has been in effect for 5 years, Simmons Corporation advances travel expenses to its sales employees. The advances are deducted from the employees' commissions as they are earned. The employees have an unconditional obligation to repay any advances not repaid through the commission offset. Up to the current year, the sales employees' commissions have never been sufficient to fully offset the advances made under the plan. To boost morale, Simmons charges off the balance of the advances. What are the tax effects of the reimbursement plan and the subsequent write-off of the advance balances?

76. TAX FORM PROBLEM Kimberly Cerny is a graduate student. She is 22 years old and works part-time as a graduate assistant in the biology department. In the summer, Kimberly was an intern at Neutrobio, Inc. Details regarding her salary and withholdings from her employment follows.

<table>
<thead>
<tr>
<th>Biology Department</th>
<th>Neutrobio, Inc.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$2,200</td>
</tr>
<tr>
<td>Federal withholding</td>
<td>200</td>
</tr>
<tr>
<td>State withholding</td>
<td>97</td>
</tr>
<tr>
<td>Social Security</td>
<td>168</td>
</tr>
</tbody>
</table>

Kimberly also received $1,200 in interest from a savings account that was set up by her grandparents to help pay her college expenses. Kimberly lives at 499 Hillside Drive, Portland, Oregon, 97208. She is a dependent of her parents, her Social Security number is 324-99-8020, and does not wish to contribute to the Presidential Campaign Election Fund. She has asked you to help her with her federal income tax return. Prepare Form 1040EZ for Kimberly. Forms and instructions can be downloaded from the IRS web site (http://www.irs.ustreas.gov/formspubs/index.html).

77. DISCUSSION CASES

The controller of Newform Oil Company has come to you for advice. Newform recently cleared a forested area and began drilling an oil well on the site. The well is a gusher, and Newform’s geologists estimate that it will produce for at least 10 years. Environmental restoration laws will require Newform to completely reforest and restore the oil well site when the well is taken out of production. An engineering firm hired by Newform estimates that the cost of complying with the environmental requirements will be $8,000,000. For financial accounting purposes, Newform intends to amortize the estimated cost over the 10-year expected life. In addition, it plans to put $500,000 per year into an account that should provide the $8,000,000 necessary to perform the restoration.

The controller would like your advice on the deductibility of the costs of restoration. That is, when can Newform deduct the costs and how much can it deduct? Based on the concepts discussed in this chapter, explain what you think is the proper treatment of the restoration costs for tax purposes.
78. The Prevetti Partnership is engaged in the purchase and management of apartment complexes. The partnership entered into an agreement with Parsnip Development Company on July 1 of the current year to purchase the Perry Apartments. The sales agreement stated the purchase price of $5,000,000. It also provided for “other payments to seller,” composed of a $500,000 payment for a covenant not to compete, $50,000 for the seller’s management advice during the ownership transition, and a financing fee of $100,000. In addition, the seller is to receive the first $400,000 of the rent collected by Prevetti. The purchase was completed on August 5. Monthly rentals on the property are $90,000. Prevetti paid Parsnip the first $400,000 of rent it collected per the purchase agreement. How much rental income does the Prevetti Partnership have for the current year? Explain.

79. Biko owns a snowmobile manufacturing business, and Miles owns a mountain bike manufacturing business. Because each business is seasonal, their manufacturing plants are idle during their respective off-seasons. Biko and Miles have decided to consolidate their businesses as one operation. In so doing, they expect to increase their sales by 15% and cut their costs by 30%. Biko and Miles own their businesses as sole proprietors and provide the following summary of their 2002 taxable incomes:

<table>
<thead>
<tr>
<th></th>
<th>Biko</th>
<th>Miles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>$600,000</td>
<td>$450,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>(400,000)</td>
<td>(300,000)</td>
</tr>
<tr>
<td>Other expenses</td>
<td>(100,000)</td>
<td>(75,000)</td>
</tr>
<tr>
<td>Business taxable income</td>
<td>$100,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>Other taxable income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(net of allowable deductions)</td>
<td>20,000</td>
<td>35,000</td>
</tr>
<tr>
<td>2002 taxable income</td>
<td>$120,000</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

Biko and Miles don’t know what type of entity they should use for their combined business. They would like to know the tax implications of forming a partnership versus a corporation. Under either form, Biko will own 55% of the business and Miles will own 45%. They each require $60,000 from the business and would like to increase that by $5,000 per year.

Based on the information provided, do a three-year projection of the income of the business and the total taxes for a partnership and for a corporation. In doing the projections, assume that after the initial 30% decrease in total costs, their annual costs will increase in proportion to sales. Also, assume that their nonbusiness taxable income remains unchanged. Use the 2003 tax rate schedules to compute the tax for each year of the analysis.

80. You are a CPA who has been preparing tax returns for Sign, Seal, and Deliver, a midsize CPA firm, for the last 5 years. During the current year, you are assigned the individual return of a new client, Guadalupe Piaz. Guadalupe has completed and returned the tax return questionnaire that the firm sent to her.

In reviewing the questionnaire, you notice that Guadalupe has included an entry for $10,000 in cash dividends received from Quinn Corporation. However, there is no supporting documentation for the dividend payment in the information Guadalupe provided.

What concerns you is that until this year, you had prepared the tax return for Quinn Corporation. (It was reassigned to another firm member when you were promoted late last year.) You know that Quinn Corporation was organized as an S corporation during the years that you prepared the return. During that period, Quinn was equally owned by 3 shareholders, and Guadalupe was not among them. In addition, the corporation was highly profitable, averaging approximately $6,000,000 per year in taxable income. Given this information, what are your obligations under the Statements on Standards for Tax Services (Appendix D)? Write a memorandum to your supervisor explaining your concerns and what actions, if any, you will need to take before you can prepare Guadalupe’s return.