

Study Unit One

Entity Types, Methods, and Periods

1.1	<i>Business Entities</i>	1
1.2	<i>Accounting Methods</i>	8
1.3	<i>Inventory Valuation</i>	16
1.4	<i>Accounting Periods</i>	19

One of the most important decisions a business can make is its choice of entity type. Each type of business form has advantages and disadvantages from both tax and liability perspectives. Each taxpayer must figure taxable income on an annual accounting period called a tax year. The calendar year is the most common tax year. Each taxpayer must also use a consistent accounting method, which is a set of rules for determining how and when to report income and expenses. The most commonly used accounting methods are the cash method and the accrual method.

1.1 Business Entities

Several different forms of businesses have been made available to taxpayers over the years. Each of these business forms has characteristics that are favorable or unfavorable to the taxpayer.

Sole Proprietorship

The sole proprietorship is the most common form of business entity.

- A sole proprietorship is not a legal entity separate and apart from its owner.
- Income or loss is reported by the taxpayer on Schedule C (Form 1040), *Profit or Loss From Business (Sole Proprietorship)*.
- The owner has unlimited liability with regard to the sole proprietorship.
 - The owner's personal assets are exposed without limitation to any and all liabilities related to the business.
- Sole proprietorships are easy to establish and require no special forms.
 - A sole proprietor's return is due on the 15th day of the 4th month following the end of the tax year.

- The business cannot be transferred.
 - If the business is sold, the owner reports the sale as if each asset were sold.
- Spouses filing a joint return may elect out of partnership treatment by choosing to be a **qualified joint venture**.
 - Each spouse will file a Schedule C and is treated as a sole proprietor, allowing both to receive Social Security benefits.

Corporations

Corporations were created to allow for the limited liability of the owners. The owners' personal assets are protected from creditors. Creditors can only look to the assets of the corporation for settlement of debts.

- Regular corporations are referred to as C corporations.
 - C corporations have double taxation.
 - ▶ First, the income is taxed to the corporation as it is earned.
 - ▶ Second, the income is taxed when the corporation distributes the income in the form of dividends.
- The corporation files a return separate from its owners. The tax return is due the 15th day of the 4th month following the end of its tax year.
- A corporation is closely held if both of the following apply:
 - It is not a personal service corporation.
 - At any time during the last half of the tax year, more than 50% of the value of its outstanding stock is directly or indirectly owned by or for five or fewer individuals. "Individuals" includes certain trusts and private foundations.

S Corporations

The S corporation is a special type of corporation that avoids the double taxation described above.

- The S corporation is not taxed, and the income is taxed to the shareholders when earned by the S corporation.
- The S corporation has the limited liability feature of the C corporation. However, there are several ownership restrictions placed on the S corporation.
- S corporations comprise over one-half of all corporations.
 - S corporations tend to be small in size and number of owners.
 - Over half of all S corporations have only one owner.
 - For the most part, S corporations are required to be on a calendar tax year.
 - S corporation tax returns are due the 15th day of the 3rd month following the end of its tax year.

Partnerships

There are several forms of partnerships available for taxpayers.

- Partnerships have the advantage that income is taxed only once.
 - The partnership does not pay tax; the income flows through and is taxed on each owner's personal tax return.
 - The main disadvantage of the partnership form of organization is that the owners can be held liable for the partnership's debts if there are not enough assets to cover the partnership liabilities. This form of partnership is referred to as a **general partnership**.
 - Partnership tax returns are due by the 15th day of the 3rd month following the close of the partnership tax year.

Limited partnerships were created to allow for the limited liability feature of the corporation while at the same time retaining the single form of taxation.

- The owners are divided into general partners and limited partners. Only the limited partners have the limited liability feature.
 - However, the limited partner is not allowed to participate in the operations of the business.

The **limited liability partnership** quickly followed the limited liability company in adoption by all states and is very similar to the limited liability company.

- The limited liability partnership is primarily used by personal service taxpayers.
- Several states require that the owners remain personally liable for the contracted debts of the entity.

Limited Liability Companies (LLCs)

An LLC is a noncorporate hybrid business structure that combines the limited liability of a corporation with the tax advantages of a general partnership.

An LLC is a domestic entity that is not specifically classified as a corporation, is classified as a partnership (if it has two or more members), or is disregarded as an entity separate from its owner (if it has only one owner). Thus, for federal tax purposes, the default classification for a domestic LLC with at least two members is to be treated as a partnership. However, the check-the-box regulations discussed on the next page allow an LLC to elect to be treated as a corporation.

- LLCs are the only business entities that allow
 - Complete pass-through tax advantages and the operational flexibility of a partnership,
 - Corporation-style limited liability under state law,
 - No restrictions on the number or types of members, and
 - Management participation by all members (members are owners or shareholders of the LLC).

- Most states follow federal taxation of LLCs. Texas and Tennessee tax LLCs as corporations. Michigan imposes a 4.95% business income tax and a modified gross receipts tax on all forms of business at a tax rate of 0.8%.
- LLCs allow the inclusion of entity-level liabilities in tax basis.
- There is no uniform LLC agreement among states; an LLC doing business out of state may have to live with unacceptable uncertainty as to its legal status. Every state and the District of Columbia permit a single-member LLC.

Single-Member Limited Liability Companies

A single-member LLC is generally treated as a disregarded entity unless it elects to be taxed as a corporation.

For individuals, the profit or loss from a disregarded entity is simply reported on Schedule C of the member's Form 1040 along with Schedule SE (Form 1040), *Self-Employment Tax*. A rental real estate operation reports its income or loss on Schedule E (Form 1040), *Supplemental Income and Loss (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)*.

- For businesses, the profit or loss from a disregarded entity is reported on the member's return as an unincorporated branch or division of the member.
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Entity Classification Election -- Check-the-Box Regulations

An eligible entity can use Form 8832, *Entity Classification Election*, to elect how it will be classified for federal tax purposes: as a corporation, a partnership, or an entity inseparable from its owner.

- An eligible entity is classified for federal tax purposes under the default rules unless it filed Form 8832 or Form 2553, *Election by a Small Business Corporation*, to elect a classification or change its current classification.
- Unless an election is made on Form 8832, a domestic eligible entity is
 - A partnership if it has two or more members
 - Disregarded as an entity separate from its owners if it has a single owner
- Unless an election is made on Form 8832, a foreign eligible entity is
 - A partnership if it has two or more members and at least one member does not have limited liability
 - An association taxable as a corporation if all members have limited liability
 - Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability
- A corporation organized under a state law can only be taxed as a corporation. However, the entity may be eligible to be classified as an S corporation.

Summary of Business Entities

Business Entity	Owner's Liability	Taxation
Sole Proprietorship	Unlimited	Flow through to individual.
Corporations	Limited	At corporate level.
S Corporations	Limited	Flow through taxation on a per-day and per-share basis. Flow through to owner.
Partnership	General partners – Unlimited Limited partners – Limited	Flow through to partner.
Limited Liability Company (LLC)	Limited	Default is flow through to member. However, may elect to be treated as a different type of entity.
Single-Member LLC (disregarded entity)	Limited	Default is flow through to member. However, may elect to be treated as a different type of entity.

Trusts and Estates

Trusts and estates are separate entities from their owners.

- Trusts may be created to hold assets for the beneficiaries.
- The trust income is usually distributed to the beneficiaries.
- The beneficiary pays an income tax on the income of the trust that is required to be distributed.
- The trust only pays tax on income that is not required to be distributed. Thus, the income of a trust is taxed only once.

An estate comes into place after the taxpayer dies.

- The estate is required to pay tax on income that is earned on the assets of the decedent before the assets are distributed to the beneficiaries.
- Similar to the trust, the beneficiaries pay the tax on any income that is distributed and the estate pays tax on the remaining income.

Employer Identification Number

An employer identification number (EIN) is the business/entity equivalent of a taxpayer identification number (TIN).

- Use Form SS-4, *Application for Employer Identification Number*, to apply for an EIN. An EIN is a nine-digit number assigned to sole proprietors, corporations, partnerships, estates, trusts, and other entities for tax filing and reporting purposes.
- A sole proprietorship or self-employed farmer who establishes a qualified retirement plan or is required to file excise, employment, alcohol, tobacco, or firearms returns must have an EIN regardless of the number of employees.
- A partnership, corporation, real estate mortgage investment conduit, nonprofit organization, or farmers' cooperative must use an EIN for any tax-related purposes even if the entity does not have employees. Take note that sole proprietors without employees and without excise or pension plan return filings are not included in this group required to use an EIN.
- Generally, a sole proprietor should file only one Form SS-4 and needs only one EIN, regardless of the number of businesses operated as a sole proprietorship or trade names under which a business operates.
 - If the proprietorship incorporates or enters into a partnership, a new EIN is required.
 - Each corporation in an affiliated group must have its own EIN.
- The reporting and payment of employment taxes for employees of the LLC must be made using the name and EIN of the LLC.
- Do not apply for a new EIN if the existing entity only elected on Form 8832 to change the way it is taxed (or is covered by the default rules).
- Do not use the EIN of the prior business unless a taxpayer became the owner of a corporation by acquiring its stock.
 - An existing corporation that is electing or revoking S corporation status should use its previously assigned EIN.
- In some situations, a name change may require a new EIN or a final return.

Principal Business or Professional Activity Codes

The codes for the principal business or professional activity, as found in the instructions for Schedule C (Form 1040), classify sole proprietorships by the type of activity they are engaged in to facilitate the administration of the Internal Revenue Code. These 6-digit codes are based on the North American Industry Classification System (NAICS).

- The taxpayer selects the category that best describes his or her primary business activity (e.g., real estate). Then the taxpayer selects the activity that best identifies the principal source of sales or receipts (e.g., real estate agent). Finally, the taxpayer finds the 6-digit code assigned to this activity (e.g., 531210, the code for offices of real estate agents and brokers) and enters it on Schedule C, line B.

Characteristics of Business Entities

	Formation	Capitalization	Operation	Liability	Transferability	Taxation	Termination
General Partnership	No formalities. No filings. Formed based on written or oral agreement.	Resources of general partners.	Each partner has right to equal participation in management. Can restrict management rights to one or more partners.	Partners are jointly and severally liable for any partnership obligation.	Partner may transfer financial interest without loss of rights, duties, and liabilities as partner.	Tax reporting entity only. Partners subject to tax.	Dissociation followed by dissolution and winding up.
Limited Partnership	Formalities. Must file written certificate of limited partnership with state.	Resources of general and limited partners.	General partner has full management rights. Limited partner has no management rights.	General partner has unlimited liability for partnership obligations. Limited partner liable only to extent of capital contribution.	General partner may transfer financial interest without loss of rights, duties, and liabilities as partner. Limited partner may assign interest.	Tax reporting entity only. Partners subject to tax.	Event of withdrawal of a general partner.
Limited Liability Partnership	Formalities. Must file with secretary of state and maintain professional liability insurance.	Resources of partners.	Favorable form of organization for professionals (e.g., lawyers, CPAs, etc.). All partners are general partners with limited liability.	Not personally liable for partnership obligations except to extent of LLP's assets. Partners remain personally liable for their own malpractice.	Partner may transfer financial interest without loss of rights, duties, and liabilities as partner.	Tax reporting entity only. Partners subject to tax.	Dissociation followed by dissolution and winding up.
Limited Liability Company	Formalities. Must file articles of organization with secretary of state.	Contributions of members.	Unless provided otherwise, all members have equal management rights.	Owners who participate in management have limited liability.	A member can transfer his or her distributional interest. This interest is personal property.	May elect flow-through taxation or be taxed as an entity.	Dissolution followed by liquidation.
S Corporation	Formalities. Files articles of incorporation with state. Elects S corporation status.	Members and shareholders (number of shareholders may not exceed 100).	Shareholder-elected board appoints officers to manage daily operations.	Shareholders generally are liable only to the extent of their investment.	Shareholders generally may transfer their interests to qualifying shareholders.	Flow-through taxation on a per-day and per-share basis.	If entity ceases to qualify as an S corporation, it becomes a C corporation.
C Corporation	Formalities. Files articles of incorporation with state.	May sell common and preferred stock. May issue debt.	Shareholder-elected board appoints officers to manage daily operations.	Shareholders generally are liable only to the extent of their investment.	Shareholders generally are free to transfer their interests.	Income taxed at corporate level. Shareholders pay tax on dividends received.	Perpetual existence. A shareholder's death, bankruptcy, or withdrawal does not terminate corporation.

1.2 Accounting Methods

An accounting method is a set of rules used to determine the tax year in which an item is includible or deductible in computing taxable income. The method must clearly reflect income and remain the same from year to year.

Generally, a taxpayer can choose any permitted accounting method when filing the first tax return. The taxpayer does not need to obtain IRS approval to choose the initial accounting method. The taxpayer must, however, use the method consistently from year to year, and it must clearly reflect income.

The cash method and the accrual method are the most commonly used methods. However, other methods, such as the installment method, are allowed. Specific provisions of the Internal Revenue Code (IRC) may override and require specific treatment of certain items.

Change in Methods

Change in accounting methods generally requires consent of the IRS, including change in either the overall system of accounting for gross income or deductions or treatment of any material item used in the system.

- The taxpayer should file Form 3115, *Application for Change in Accounting Method*, to request consent for such changes.

IRS consent is not required for the following changes:

- Adopting LIFO inventory valuation
 - Switching to LIFO inventory requires IRS consent. Form 970, *Application to Use LIFO Inventory Method*, must be filed.
- Switching from declining-balance depreciation to straight-line
- Making an adjustment in useful life of certain assets
- Correcting an error in computing tax, e.g., omission
- Certain method situations involving small businesses (i.e., businesses with no more than \$31 million in average annual gross receipts for the 3-taxable-year period immediately preceding the current taxable year)

Cash Method

A cash-method taxpayer accounts for income when one of the following occurs:

- Cash is actually received
- A cash equivalent is actually received
- Cash or its equivalent is constructively received

Cash Equivalent

At the time a person receives noncash forms of income, such as property or services, the fair market value is included in gross income. This applies even if the property or service can be currently converted into cash at an amount lower than face value.

- A cash equivalent is property that is readily convertible into cash and typically has a maturity of 3 months or less. Cash equivalents are so near to maturity that the risk of loss due to a change in value is immaterial. The following are considered cash equivalents:
 - Checks, valued at face
 - Property, e.g., land, transferable at current FMV
 - Promissory notes, valued at FMV
- If the value of property received cannot be determined, the value of what was given in exchange for it is treated as the amount of income received.

Example 1-1 Indeterminate Value of Property

An accountant performs various services for a start-up company in exchange for stock options. If the value of the stock options cannot be determined, the value of the services performed is included in income.

- If both the property received and the property given are impossible to value, e.g., an unsecured promise to pay from a person with unknown creditworthiness, the transaction is treated as open, and the consideration is not viewed as income until its value can be ascertained.

Constructive Receipt

Under the doctrine of constructive receipt, an item is included in gross income when a person has an unqualified right to immediate possession.

- A person constructively receives income in the tax year during which it is credited to his or her account, set apart for him or her, or otherwise made available so that (s)he may draw upon it at any time.
 - It is more than a billing or an offer, or mere promise, to pay.
 - It includes ability to use on demand, as with escrowed funds subject to a person's order.
 - Deferring deposit of a check does not defer income. However, dishonor retroactively negates the income.
- Income is not constructively received if the taxpayer's control of its receipt is subject to substantial restrictions or limitations, e.g., a valid deferred compensation agreement.

Receipt or constructive **receipt by an agent** is imputed to the principal.

Economic Benefit

The courts have interpreted the definition of gross income to include any economic or financial benefit conferred on an employee as compensation. This economic benefit theory is applied by the IRS in situations in which an employee or independent contractor receives a transfer of property that confers an economic benefit that is equivalent to cash.

Example 1-2 Economic Benefit of Property Received Included in Gross Income

The fair rental value of a car that a dealership provides for the personal use of its president is gross income.

- The economic benefit theory applies even when the taxpayer cannot choose to take the equivalent value of the income in cash.

Dividends

Dividends are constructively received when made subject to the unqualified demand of a shareholder.

- If a corporation declares a dividend in December and pays such that the shareholders receive it in January, the dividend is not treated as received in December.

Bonds

When a bond is sold between interest payment dates, the interest accrued up to the sale date is added to the selling price of the bond. The seller includes the accrued interest in gross income.

Prepaid Rent

Prepaid rent is gross income when received.

- Security deposits are not considered income.
- Tenant improvements, in lieu of rent, are included.
- Lease cancellations are included.
- Advance rental payments must be deducted as an expense by the payor during the tax periods to which the payments apply.

Tips and Overtime Compensation

Taxpayers can deduct **qualified tips** (up to \$25,000 per year) from the taxpayer's income subject to federal income tax.

- The deduction decreases by \$100 for each \$1,000 by which the taxpayer's modified adjusted gross income exceeds \$150,000 (\$300,000 for married filing jointly).
- The tip must be voluntary by the payor without any penalty if not paid.
 - For example, a 20% tip required by a restaurant on parties larger than six people would not be classified as a qualified tip.
- The tip is still subject to payroll taxes and state income taxes.
- Taxpayers must include their Social Security numbers on their tax returns.

An employee who receives \$20 or more in tips a month working for any employer must report the tips to the employer by the 10th day of the following month. The tips are gross income when reported.

Taxpayers may deduct **qualified overtime compensation** of \$12,500 (\$25,000 married filing jointly) from their income subject to federal income tax.

- The deduction decreases by \$100 for each \$1,000 by which the taxpayer's modified adjusted gross income exceeds \$150,000 (\$300,000 for married filing jointly).
- The overtime compensation is still subject to payroll taxes and state income taxes.
- Taxpayers must include their Social Security numbers on their tax returns.
- The overtime deduction is only for the additional amount paid.
 - For example, if regular pay is \$30/hour and overtime pay is \$45/hour, only the additional \$15/hour qualifies for the deduction.

Both tips and overtime compensation deductions are reported on Schedule 1-A (Form 1040), *Additional Deductions*.

Employers and other payors will not be required to separately account for cash tips or qualified overtime compensation on those forms or the written statements (copies of the forms) furnished to individuals for 2025.

- In the absence of this information reporting, the IRS encourages employers to track the applicable tips and overtime compensation and report the information in box 14 of the 2025 Form W-2.

Deductions

A cash-method taxpayer deducts expenditures when actually paid, except for prepaid rent.

- A promise to pay, without more, is not payment.
- A check represents payment when delivered or sent.
- A third-party (e.g., bank) credit card charge transaction represents current payment with loan proceeds. A second-party (e.g., store) credit card charge transaction is not paid until the charge is paid off.
- Bad debt. Adjusted basis in accounts receivable is deductible when the debt becomes worthless. Since a cash-method taxpayer usually has no basis in accounts receivable, (s)he may not deduct bad debts.
- **Interest on a loan** issued at discount, or unstated (imputed) interest, is deductible pro rata over the life of the loan.
- A person who uses the cash method to report gross income must use the cash method to report expenses.

Advance Payment of Expenses

In general, expenses paid in advance can be deducted only in the year to which they apply, even under the cash method of accounting.

- However, an exception exists for farmers (but not farming syndicates). They may deduct prepaid feed when the expenditure is incurred even if it is to be consumed by the livestock in a subsequent year. The deduction is limited to 50% of other farm expenses.

Corporations

The cash method cannot be used by corporations (other than S corporations), partnerships having a corporation (other than an S corporation) as a partner, or tax shelters.

- However, an exception allows the following entities to use the cash method:
 - A farm corporation (family or otherwise) with gross receipts of \$31 million or less
 - Corporations whose business is operating nurseries or sod farms and raisers and harvesters of trees (other than fruit and nut trees)
 - Qualified personal service corporations
 - A corporation or partnership with a corporate partner, other than a tax shelter, with average annual gross receipts of \$31 million or less

Accrual Method

An accrual-method taxpayer accounts for income in the period it is actually earned.

Under the accrual method, income items generally have to be included no later than they are included for financial accounting purposes.

The accrual method is required of certain persons and for certain transactions.

- If the accrual method is used to report expenses, it must be used to report income items.
- A taxpayer that maintains inventory must use the accrual method with regard to purchases and sales. Exceptions to this inventory rule include
 - **Qualifying taxpayers** who satisfy the gross receipts test for each test year.
 - ▶ The average annual gross receipts (consisting of the test year and the preceding 2 years) for each test year must be \$31 million or less.
 - **Qualifying small business taxpayers** who satisfy the gross receipts test for each test year.
 - ▶ The average annual gross receipts must be \$31 million or less.
 - ▶ The taxpayer must not be a corporation (other than an S corporation) or a partnership with a corporate partner.
 - ▶ The principal business activity cannot be mining, manufacturing, wholesale trade, retail trade, or information industries.
- Generally, C corporations, partnerships with a C corporation as a partner, charitable trusts with unrelated income, and tax shelters must use the accrual method.
 - Tax shelters include any arrangement for which the principal purpose is avoidance of tax, any syndicates, and any enterprise in which the interests must be registered as a security.
 - Exceptions to the general rule allow the following taxpayers to use the cash method if the entity is not a tax shelter:
 - ▶ Qualified personal service corporations
 - ▶ Farming or tree-raising businesses

Income is included when all the events have occurred that fix the right to receive it and the amount can be determined with reasonable accuracy.

- A right is not fixed if it is contingent on a future event.

Example 1-3 Income Not Constructively Received

John is awarded a \$10,000 bonus in 2025. If only half of the bonus is payable in 2025 with the other half paid at the end of 2026, contingent upon John completing another year of service for his employer, only \$5,000 is taxable in 2025.

- The all-events test is satisfied when goods shipped on consignment are sold.
- Only in rare and unusual circumstances, in which neither the FMV received nor the FMV given can be ascertained, will the IRS respect holding a transaction open once the right to receive income is fixed. In those circumstances, income is accrued upon receipt.
 - Proceeds from settlement of a lawsuit are determinable in amount with reasonable accuracy when received.

Prepaid income must generally be included in income when received.

- Prepaid rent is includible in gross income in the year received. This rule applies to both cash-method and accrual-method taxpayers.
- Prepaid income for services may be accrued over the period for which the services are to be performed, but only if it does not extend beyond the end of the next tax year.
 - If the taxpayer does not complete the performance within that period, the prepaid income is included in the year following receipt.
- Merchandise sales. The right to income is fixed when it is earned, e.g., when goods are shipped.
 - Prepayments for goods must be included when reported for accounting purposes if reported earlier than when earned.
- Taxpayers who use an accrual method of accounting, derive all their income from services, and do not charge interest or penalties for late payments may use the nonaccrual-experience method to report bad debts.
 - For example, a corporation may accrue 2% of gross sales as bad debt expense when, over the last 8 years, roughly 2% of gross sales have been uncollectible.

Deductions

Expenses are generally deductible in the period in which they accrue.

- The accrual-method taxpayer may claim an allowable deduction when both of the following requirements are met:
 - All events have occurred that establish the fact of the liability, including that economic performance has occurred.
 - The amount can be determined with reasonable accuracy.
- To the extent the amount of a liability is disputed, the test is not met. But any portion of a (still) contested amount that is paid is deductible.
- Economic performance occurs as services are performed or as property is provided or used.
- Other liabilities for which economic performance occurs as the taxpayer makes payments include liabilities for breach of contract (to the extent of incidental, consequential, and liquidated damages), violation of law, rebates and refunds, awards, prizes, jackpots, insurance, and warranty and service contracts.

Hybrid Methods

Any combination of permissible accounting methods may be permitted if the combination clearly reflects income and is consistently used.

- If inventory is used, the accrual method must be used for purchases and sales. The cash method may be used for other receipts and expenses if income is clearly reflected.
 - A person may use different methods for separate businesses as long as the method used for each business clearly reflects the income of that particular enterprise.
 - Any hybrid method for reporting expenses that includes the cash method is treated as the cash method and is subject to the limitations that apply to the cash method.
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Related Parties

The Code requires matching of a deduction claimed by a payor and income reported by a payee in related-party cases of expense or interest transactions.

- Typically, if the payee is a cash-basis taxpayer, (s)he will include the payment in income in the taxable year received, and the payor will then deduct the payment in the same year.
- Related parties include a spouse; child; grandchild; parent; brother/sister (half or whole); or a related corporation, S corporation, partnership, estate, or trust.
- Deduction of an amount payable to a related party is allowed only when includible in gross income of the related party.

Example 1-4 Deduction of a Payable to a Related Party

An individual cash-method taxpayer owns 55% of an accrual-method corporation. The corporation owes the individual \$5,000 for rent incurred in Year 1. In Year 2, \$5,000 was paid and reported as income by the individual. Because the corporation and individual are related parties, the corporation must wait to take the deduction of \$5,000 until Year 2, the year it was reported as income by the related party.

1.3 Inventory Valuation

Identification Methods

There are three methods of identifying items in inventory:

Specific

The specific-identification method is used to identify the cost of each item of inventory by matching it with its cost of acquisition.

First-In, First-Out (FIFO)

The FIFO method assumes that the items first acquired are the first sold. Thus, the items remaining in inventory are the last items acquired.

Last-In, First-Out (LIFO)

The LIFO method assumes that the latest goods to be acquired are the first to be sold. Thus, the oldest goods are considered to remain in inventory, and the cost of the oldest goods is used for valuing inventory.

Valuation Methods

The fundamental requirements for inventory valuation are that it conforms as nearly as possible to the best accounting practice in the trade or business and that it clearly reflects income. Approved methods include the following.

NOTE: Once a valuation method is chosen, it cannot be changed without consent from the IRS.

Cost Method

The cost method includes all direct and indirect costs associated with the inventory. The costs that must be included in inventory are found in Sec. 263A, known as the Uniform Capitalization rules (UNICAP). Section 263A states allocable costs related to property produced or to property acquired and held for resale by the taxpayer are not deductible and must be capitalized to the property. Allocable costs include direct costs as well as the property's appropriate share of indirect costs.

- For beginning inventory, cost means the value of goods held at the end of the prior year.
- For inventory purchased, cost means the price, minus (trade or cash) discounts, plus freight-in and other costs of acquisition. As an alternative to a reduction/deduction, cash discounts may instead be included in income.
 - If the merchant purchased inventory items and withdrew some of these items for personal use, the merchant must reduce the cost of purchases by the cost of the personal-use items.
- For inventory produced, cost means all direct and indirect costs that are required to be capitalized under the uniform capitalization rules.

Lower-of-Cost-or-Market (LCM)

The LCM method values inventory at the lesser of the market value of the inventory or its cost at year end.

- Each item in the inventory must be valued separately.
- The LCM method cannot be used in conjunction with LIFO.

Rolling Average

Taxpayers using rolling-average inventory valuation for financial accounting purposes may use the same valuation method for federal income tax purposes. Use of this method is only allowed if

- The taxpayer recomputes the rolling average cost of an inventory item on one of the following bases:
 - Each time the taxpayer purchases or produces an additional unit or units of that item or
 - On a regular basis but no less frequently than once per month, and
- The taxpayer satisfies one of the following conditions:
 - The variance percentage does not exceed 1% $[(\text{Rolling average cost} - \text{Actual cost}) \div \text{Rolling average cost}]$ or
 - The entire inventory of a taxpayer's trade or business turns at least four times per year $(\text{COGS} \div \text{Average inventory})$.

Retail Method

The retail inventory method may be used to value ending inventory for a department, a class of goods, or a stock-keeping unit.

- A taxpayer maintaining more than one department or dealing in classes of goods with different percentages of gross profit must compute cost complements separately for each department or class of goods.
- The retail selling price of ending inventory is converted to approximate cost or approximate LCM by using a cost-to-retail ratio or cost complement.
 - A taxpayer may use the retail inventory method instead of valuing inventory at cost or LCM.
 - The value of ending inventory is equal to the retail selling prices of goods on hand at the end of the tax year, multiplied by the cost complement.

FOB Shipping or Destination

FOB shipping point indicates that the buyer is responsible for the goods as soon as the goods are shipped.

FOB destination implies that the seller is responsible for the goods, and a sale is not recognized until the goods have reached the designated destination.

Consignment

Inventory out on consignment is included in ending inventory. The sale of consignment inventory is contingent on a future event (the person holding the inventory selling it).

Cash Method Inventory

Taxpayers with inventory who are allowed to use the cash method under the annual gross receipts test (i.e., less than \$31 million in average annual gross receipts) treat the inventory as non-incidental materials and supplies.

- Non-incidental materials and supplies are those whose use or consumption are tracked and accounted for. Their cost is deducted in the year of use or consumption.

Unacceptable Inventory Valuation Methods

Examples of unacceptable methods of valuing inventory include

- Deducting a reserve for price changes or an estimated amount for depreciation in the value of the inventory.
- Taking work in process, or other parts of the inventory, at a nominal price or at less than its full value.
- Omitting part of the stock on hand.
- Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.
- Including stock in transit, shipped either to or by the taxpayer, the title to which the taxpayer does not hold.
- Segregating indirect production costs into fixed and variable production cost classifications and allocating only the variable costs to cost of goods produced, while treating fixed costs as period costs that are currently deductible (the direct cost method).
- Treating all or almost all indirect production costs (whether fixed or variable) as period costs that are currently deductible (the prime cost method).

1.4 Accounting Periods

The taxpayer adopts a tax year when the first income tax return is filed.

Tax Year

The term “tax year” is defined as follows:

- The annual accounting period regularly used by a taxpayer for keeping records of income, whether it be a calendar year or a fiscal year;
 - The calendar year, if the taxpayer keeps no books, has no annual accounting period, or has an annual accounting period other than a calendar year that does not qualify as fiscal year; or
 - The period for which the return is made, if for a period of less than 12 months.
-

Available Tax Years

The tax year may be either a calendar or fiscal year or the period for which a return is made, if the return is made for a period of less than 12 months (a short-period tax year).

- A calendar year is a period of 12 months ending on December 31.
- A fiscal year is a period of 12 months ending on the last day of any month other than December, or a 52- or 53-week tax year.
 - A fiscal year will be recognized only if it is established as the taxpayer's annual accounting period and only if the books are kept in accord with it.
 - A 52- or 53-week tax year. The taxpayer may elect to use a fiscal tax year that varies from 52 to 53 weeks if such period always ends on the same day of the week, either
 - ▶ The last such day in a calendar month (e.g., January 31) or
 - ▶ The closest such day to the last day of a calendar month (e.g., the last Friday in January).

Short Tax Year

A return for a period of less than 12 months may be filed by a taxpayer that

- Existed during only part of what would otherwise be the taxable year or
- Changed the annual accounting period, e.g., from fiscal to calendar year.
 - There are three steps to calculate the tax for a short tax year.
 - ▶ The income must first be annualized.
 - ▶ The tax on the annualized income is calculated.
 - ▶ The short tax year portion of tax is determined.

$$\text{Annualized income} = \text{Short tax year income} \times \frac{12 \text{ months}}{\text{Short tax year months}}$$

$$\text{Annualized income tax} = \text{Annualized income} \times \text{Tax rate}$$

$$\text{Short tax year tax} = \text{Annualized income tax} \times \frac{\text{Short tax year months}}{12 \text{ months}}$$

Change of Tax Year

Form 1128, *Application To Adopt, Change, or Retain a Tax Year*, is generally filed with the IRS to request the change in tax year.

- The form must be filed by the due date (not including extensions) of the federal income tax return for the first effective year.
- Permission to change tax years is normally granted when a substantial business purpose exists.
- When the sole purpose of the change is to obtain a favorable tax status, the substantial business purpose test is not met.

Form 8716, *Election To Have a Tax Year Other Than a Required Tax Year*, is filed with the IRS by partnerships, S corporations, and personal service corporations (PSCs) to request a change in tax year other than a required tax year.

- This is called a Sec. 444 election.
- A Sec. 444 election may be made without first requesting permission to use the tax year and being denied permission.

Example 1-5 Request for a Change of Tax Year

A partnership has a calendar year. Corporation X acquires over 50% ownership in the partnership. Corporation X has a June 30 tax year. Form 1128 is filed to change the partnership to a June 30 year end. June 30 is a required year end of the partnership. Form 8716 is filed instead of Form 1128 if the change is to a year end other than a required one.

Study Unit Two

Income and Farms

2.1	Gross Income	1
2.2	Self-Employment Income	7
2.3	Farming Income and Expense	12

Businesses define gross income the same as individuals. Also like individuals, some business transactions do not currently recognize or indefinitely exclude recognition of income, but instead defer recognition until a later period. This study unit also covers unique aspects of self-employment income and farm income.

2.1 Gross Income

The Internal Revenue Code (IRC) defines gross income as all income from whatever source derived except as otherwise provided.

Section 61(a) enumerates types of income that constitute gross income. The list is not exhaustive.

- Compensation for services, including fees, commissions, and fringe benefits
- Gross income derived from business
- Gains derived from dealings in property
- Interest
- Rents
- Royalties
- Dividends
- Annuities
- Income from life insurance and endowment contracts
- Pensions
- Income from discharge of indebtedness
- Distributive share of partnership gross income
- Income in respect of a decedent (income earned but not received before death)
- Income from an interest in an estate or trust

Other types of income also constitute gross income unless a statute specifically provides for their exclusion.

Business Income

Gross income includes all income from a trade or business.

- Gross income from a business that sells products or commodities is

$$\begin{array}{r} \text{Gross sales (receipts)} \\ - \text{Cost of goods sold} \\ + \text{Other gross income (e.g., rentals)} \\ \hline = \text{Gross income from the business} \end{array}$$

- Cost of goods sold (COGS) is essentially treated as a return of capital. A return of capital is not income for tax purposes. Typically, COGS for a tax year is

$$\begin{array}{r} \text{Beginning inventory} \\ + \text{Inventory purchased during year} \\ - \text{Year-end inventory} \\ \hline = \text{COGS} \end{array}$$

- COGS should be determined in accordance with the method of accounting consistently used by the business.
- State and local sales taxes imposed on a buyer, which are required to be collected and paid to state or local governments, are not income. When a sale is completed, the amount of sales tax charged to the customer becomes a liability, or money owed.

Prepaid Income

Generally, amounts that are received in advance for future services are required to be included in the year of receipt. However, accrual-basis taxpayers can elect to defer recognition until the time of performance, up to the year after the payment date.

Discharge of Debt

Gross income includes **discharge (cancellation) of indebtedness** when a debt is canceled in whole or part for consideration.

- If a debtor performs services to satisfy a debt, the debtor must recognize the amount of the debt as income. However, income is not recognized from a canceled debt to the extent the payment would have been a deduction.
- If a creditor gratuitously cancels a debt, the amount forgiven is treated as a gift.

When a taxpayer excludes discharge of indebtedness, the taxpayer must reduce his or her tax attributes in the following order:

- NOLs
- General business credit
- Minimum tax credit
- Capital loss carryovers
- Basis reductions

NOTE: However, the taxpayer may first elect to decrease the basis in depreciable property.

Generally, the creditor will send the taxpayer Form 1099-C listing the amount of cancellation of debt to be reported.

Gross income **does not include** discharges that

- Occur in bankruptcy.
- Occur when the debtor is insolvent but not in bankruptcy.
 - The maximum amount that can be excluded is the amount by which liabilities exceed the FMV of assets.
- Are related to qualified farm indebtedness.
- Are related to a purchase-money debt reduction in which a seller reduces the debt and the debtor is not in bankruptcy and is not insolvent. The discharge is treated as a purchase price adjustment.

Other Taxable Income

Examples of other taxable income include the following:

- Gross income such as the **recovery of tax benefit** items in a prior year

Example 2-1 Recovery of Tax Benefit -- Bad Debt

Taxpayer writes off bad debt in Year 1. In Year 7, the debtor pays Taxpayer the principal of the debt written off, which must be included in gross income because the deduction in Year 1 reduced the tax liability.

- Amounts recovered during the tax year that did **not** provide a tax benefit in the prior year are excluded.

Example 2-2 Recovery Not Providing a Tax Benefit

Taxpayer pays state income tax in excess of the standard deduction and itemizes deductions. Subsequent refunds in excess of the applicable standard deduction must be included in gross income. However, if Taxpayer elected the standard deduction, the refund would not be included because no tax benefit from payment of state income tax was realized.

- A similar rule applies to credits.
- Prizes and awards
- Gasoline or fuel credits or refunds
- Gambling winnings (e.g., lottery and raffle winnings)
- Jury duty fees
- Income from the rental of personal property if the taxpayer engages in the activity for profit but is not in the business of renting property
- Income from an activity not engaged in for profit (e.g., hobby income)
 - Hobby-related expenses are not deductible.
- Reimbursements for items deducted in an earlier tax return (e.g., state income taxes, bad debts, and medical expenses)
- Advances of wages and commissions
 - Such advances are considered income when received.

- Supplemental wages, which are compensation paid in addition to an employee's regular wages
 - They do not include payments for travel reimbursements paid at the federal government per diem rate.
- Finance reserve income
- Scrap sales
- Cooperative patronage dividends

Assignment of Income

Gross income includes income attributable to a taxpayer even though the income is received by other taxpayers. This doctrine imposes the tax on income on those who earn it, produce the right to receive it or enjoy the benefit of it when paid, or control property that is its source.

Example 2-3 Assignment of Income

Swift, a life insurance salesperson, directs his employer to pay his commissions to his daughter. The commissions paid to Swift's daughter are gross income to Swift.

- The doctrine applies to income earned by personal services or derived from property.

Example 2-4 Assignment of Interest Income Earned on Securities

Taxpayer makes a gift of interest earned on securities to her 20-year-old daughter who attends college. The interest is gross income to Taxpayer.

- Assignment of an income-producing asset is effective to shift the gross income to the assignee.

Example 2-5 Assignment of Interest Income from Transferred Securities

Taxpayer gives the underlying securities to her 20-year-old daughter. Interest earned after the transfer is gross income to the daughter.

- Effective assignment requires that
 - The transfer of property be complete and bona fide,
 - No control is retained over either the property or the income it produces, and
 - The transfer take place before the income is actually earned.

Rental Income

Amounts received or accrued as rent must be included in gross income. Rental income is any payment received for the use or occupation of property.

- Cash-basis taxpayers report rental income in the year it is received, regardless of when it was earned. Accrual-method taxpayers generally report income when it is earned rather than when it is received. However, prepaid rent is income when received for both accrual-method and cash-basis taxpayers.
- Payment by a lessee of any expenses of a lessor is generally considered additional rental income to the lessor.
 - Capital improvements made by a lessee are not income unless in lieu of paying rent or in exchange for a reduction in rent.
 - The income is taxed when the property is sold.
- Consideration received by a lessor for cancellation of a lease is a substitution for rental payments and not a return of capital.
- Property or services received as rent in lieu of cash must be included in rental income at the fair market value of the property or services.

Example 2-6 Service in Lieu of Rent

Taxpayer's tenant is a painter and offers to paint Taxpayer's rental property instead of paying rent for 2 months. If Taxpayer accepts the offer, Taxpayer includes in rental income the amount the tenant would have paid for 2 months' rent.

- Security deposits used as final payments of rent are considered advance rent and are included in income when received.
 - A security deposit is not included in income when received if the lessor plans to return it to the tenant at the end of the lease.
 - Any part of a security deposit kept during any year because the tenant does not live up to the terms of the lease is included in income for that year.
- A lease with an option to buy is a rental agreement that gives the tenant the right to buy the rental property. Payments received under such an agreement are generally rental income.
- An individual lessor generally reports rental real estate income and expenses on Schedule E (Form 1040), *Supplemental Income and Loss (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)*, but Schedule C (Form 1040), *Profit or Loss From Business (Sole Proprietorship)*, is used if the taxpayer provided significant services to the real property lessee.
- A corporate lessor (non-pass-through entity) generally reports rental real estate income and expenses on Form 1120, *U.S. Corporation Income Tax Return*.

Income from Bonds

For bonds issued at a premium, income is recognized to the extent of the amortized bond premium. The premium is amortized over the life of the bond.

2.2 Self-Employment Income

A FICA tax liability is imposed on net earnings from self-employment (SE).

Included

Net earnings from self-employment include

- Net income from a trade or business,
- General distributive share of the ordinary income or loss of a partnership (whether active or not),
- Guaranteed payments for services from a partnership,
- Corporate directors' fees, and
- Payments for lost earnings.

Excluded

Net earnings from self-employment do not include

- Salaries, fees, and other income subject to Social Security or Medicare tax that a taxpayer received for performing services as an employee
- Rent from real estate and personal property leased with real estate unless services are provided to tenants
 - Services generally are provided for the occupants if they are primarily for their convenience and not services normally provided with the rental of rooms for occupancy only (Publication 334).
- Dividends on shares of stock and interest from any bond, debenture, note, certificate, or other indebtedness issued with interest coupons or in registered form by a corporation unless they are received by a dealer in stocks or securities in the ordinary course of his or her business
- An S corporation shareholder's distributive share of income or loss
- Income received as a retired partner under a written partnership plan that provides for lifelong periodic retirement payments, assuming
 - No other interest in the partnership
 - Services were not performed during the year
- The sale, exchange, involuntary conversion (gains resulting from casualty or theft losses), or other disposition of property unless the property is stock in the business or property that is considered inventory primarily held for sale to customers in the ordinary course of business
- Fees received for services performed as a notary public

Self-Employment Tax

The FICA tax liability is imposed on net earnings from self-employment at twice the rate that applies to an employer, that is, 15.3% [$2 \times (6.20\% \text{ Social Security tax} + 1.45\% \text{ Medicare tax})$].

$$\text{NI from self-employment} - \left(.0765 \times \text{NI from self-employment} \right) = \text{Net earnings from self-employment}$$

- Net income from self-employment does not include the following:
 - Gain or loss from disposition of business property
 - ▶ Gains from casualty losses of inventory are considered self-employment income.
 - Capital gain or loss
 - Nonbusiness interest
 - Dividends
 - Income or expenses related to personal activities
 - Wages, salaries, or tips received as an employee

- Rental income is normally not subject to self-employment tax unless services are provided to tenants. Services generally are provided for the occupants if they are primarily for their convenience and not services normally provided with the rental of rooms for occupancy only.
- Payment received from lost earnings are included in net earnings from self-employment.
- A self-employed person is allowed a deduction for the employer's portion of the FICA taxes paid to arrive at his or her AGI. For 2025, this equals
 - 6.20% of the first \$176,100 of net self-employment income plus
 - 1.45% of net self-employment income (no cap).
- An individual who is engaged in the business of selling real estate to customers for profit is a real estate dealer.
 - A real estate dealer who holds property both for sale to customers in the ordinary course of business and for investment is subject to self-employment tax only on net rent from property held for sale in the ordinary course of trade or business as a real estate dealer.
 - Rent from property held for investment or speculation is not subject to self-employment tax.
- A partner's share of partnership income as well as any guaranteed payments from a partnership are subject to self-employment tax, whether or not the partner is an active participant. However, S corporation earnings required to be included in a shareholder's gross income are not self-employment income.
- A limited partner's share of income from a partnership is generally not subject to self-employment tax. However, any guaranteed payments paid to the limited partner are subject to self-employment tax.
- A decedent partner includes partnership income (or loss) through the end of the month of death on the final return of the decedent.
- Interest earned on accounts receivable is not self-employment income.
- An ordained, licensed, or commissioned minister must include the rental value of a home provided to him or her as part of his or her pay for duties performed as earnings from self-employment for purposes of the self-employment tax. This is true even though the rental value of such a home is not included in gross income for income tax purposes.
- The employee's portion of the FICA taxes is not deductible.
- The self-employment tax is computed using the total earnings from self-employment; therefore, no change in computation is necessary if the self-employed person has more than one trade or business.
- For 2025, the maximum amount of wages subject to Social Security tax is \$176,100. However, the Medicare component does not have a cap amount.

- The employee portion includes an additional 0.9% for high-income earnings, i.e., earnings in excess of \$200,000 (\$250,000 MFJ, \$125,000 MFS).
 - Individuals with wages and self-employment income calculate their liabilities in three steps:
 - ▶ Tax is calculated on any wages in excess of the applicable threshold without regard to any withholding;
 - ▶ The applicable threshold is reduced by the total amount of Medicare wages received, but not below zero; and
 - ▶ The tax is calculated on any self-employment income in excess of the reduced threshold.

Example 2-7 Tax on Self-Employment Income

C, a single filer, has \$130,000 in wages and \$145,000 in self-employment income. C's wages are not in excess of the \$200,000 threshold for single filers, so C is not liable for the surtax on these wages. Before calculating the tax on self-employment income, the \$200,000 threshold for single filers is reduced by C's \$130,000 in wages, resulting in a reduced self-employment threshold of \$70,000. C is liable to pay the tax on \$75,000 of self-employment income (\$145,000 – \$70,000).

- In 2025, self-employed persons may deduct 100% of amounts paid for health insurance from gross income (AGI). The deduction does not reduce self-employment income and is taken on Schedule 1. The insurance can be for themselves, their spouses, or their dependents. There is an exception for self-employed taxpayers whose spouse's employer offers coverage.
- Contributions to a qualified retirement plan for a self-employed individual do not constitute a business expense. Therefore, they are not deductible when computing self-employment tax.

Farm Optional Method

A taxpayer may use this method to figure net earnings from farm self-employment if gross farm income was \$10,860 or less or net farm profits were less than \$7,840 for 2025.

- Net farm profits are the total of specified amounts from Schedule F (Form 1040), *Profit or Loss From Farming*, and Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, minus the amount the taxpayer would have entered on Schedule SE (Form 1040), *Self-Employment Tax*, from specified Social Security benefits, had the taxpayer not used the optional method.
- There is no limit on how many years this method can be used.