2026 National Income Tax Workbook

Chapter 11 – Business Tax Issues
PP 387 - 433

Land Grant University
Tax Education Foundation

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Business Tax Issues – Learning Objectives

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Session #1 – Today

- Corporate Charitable Contributions
- Qualified Business Income Deduction (QBI!)
- Pass –through Entity Tax
- Fringe Benefits

Session #2 – next week Wednesday

- Settlements, Fines and Penalties
- Valuing closely held entities
- Cash and Accrual methods of Accounting

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Issue #1 Corporate Charitable Contributions

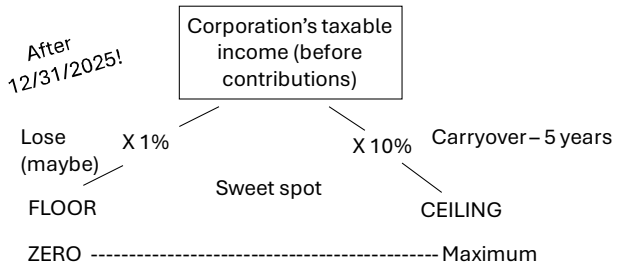
389

Old Law	1/1/26	New Law
No Floor 25% Cap		1% Floor 10% Cap

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Charitable contributions made by corporations

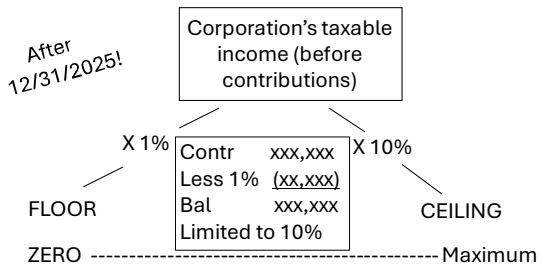
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Charitable contributions made by corporations

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Taxable Income

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Taxable Income (normal calculation)
Less:

- Charitable contributions
- Special deductions – dividends received, bond premium, foreign derived deductions....
- NOL carryback
- Capital loss carryback

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Carryforward

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Key points:

- Contributions that exceed 10% can be carried over 5 years.
- "If a contribution is disallowed only because it does not exceed the 1% floor, it can be carried forward only if the 10% limit was exceeded in that year." WHAT??
- Carryovers are utilized on a FIFO basis.
- Charitable carryovers cannot increase an NOL

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Carryforward (example not in book)

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C corporation → Contribution 120,000 → CHARITY

Taxable Income 1,000,000

Floor 1%	(10,000)
Balance	110,000
Ceiling 10%	(100,000)
Carryover	10,000
+ floor	10,000
Carryforward	20,000

I get it!!

X

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Issue #2- Qualified Business Income Deduction

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QBI is back in the class!!

Remember 2018!!



New:

- Made permanent
- Minimum Deduction - 400

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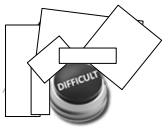
Qualified Business Income Deduction

QBI lesser of:
- 20% of QBI
- 20% of Taxable income before QBI deduction



Limitations:
- W-2 wage and capital limit
- Specified service trade or business





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Definition of QBI

- NET amount of qualified items of income, gains, deduction and loss with respect to any qualified trade or business
- Trade or business – defined with reference to IRC 162 and certain self rentals.
- Performing services as an employee is not a trade or business. (also guaranteed payments)

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Definition of QBI

- Must be effectively connected to a US trade or business and used in computing taxable income
- *QBI excludes:*
  - Capital gains and losses
  - Dividends
  - Interest, unless allocated to a trade or business
  - Foreign personal holding companies
  - Annuities – unless connected to a trade or business



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Definition of QBI

Schedule C or F:

Reduce QBI by:
Deductible portion of Self-employment tax

Self employed health insurance deduction

Deductions for contributions to qualified retirement plans

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NEW LAW

Minimum deduction of 400 (indexed - 415 for 2027)

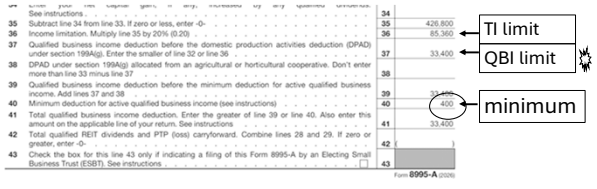
"*Applicable Taxpayer*" for the minimum deduction:

Aggregate qualified business income from all the taxpayer's active qualified trade or business is at least 1,000 (indexed).

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NEW 400 minimum deduction



Factors in the W-2 limit and Specified Service trade or business limitation

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NEW 400 minimum deduction

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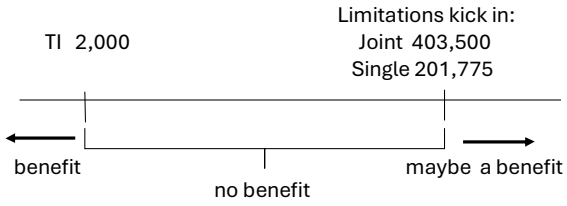
How does the new 400 minimum tie into the 20% x Taxable Income Limit?
It will help a taxpayer with under 2,000 of taxable income.

Say taxable income 2,100 x 20% = 420. More than 400
Say taxable income 2,000 x 20% = 400. Same amount
Say taxable income 1,900 x 20% = 380. 400 is greater

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NEW 400 minimum deduction

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Limitations on QBI deductions

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Where are we going?

1. Taxable Income limitation
2. W-2 wage and capital limit
3. Specified service trade or business

NEW LAW
May get
400

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Taxable Income Limitation

easy

Taxable income before QBI (normal calculation)	XXX,XXX
Reduce by net capital gains	(XX,XXX)
Taxable income limit for QBI purposes	XXX,XXX)
Rate	x 20%
limitation	XX,XXX

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Limitations on QBI deductions



Where are we going?

1. Taxable Income limitation
2. W-2 wage and capital limit
3. Specified service trade or business

NEW LAW
May get
400

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W-2 Wage and Capital Limit

Limitation kicks in if taxable income is ABOVE the "lower threshold"
NOTE: based on taxable income not QBI income

		JOINT
Below threshold	- does not apply	403,500
In phase –in range	- partially applies	403,500 – 553,500
Above phase in range	- fully applies	above 553,500

Notice phase in range is 150,000. We will need to know that for the calculation

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W-2 Wage and Capital Limit



Limitation is the greater of:

50% of W-2 wages with respect to the qualified trade or business

or

25% of the W-2 wages, plus 2.5% of the unadjusted basis immediately after acquisition (UBIA) of all property

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Example 11.4

Brendan Cook

Taxable income 285,000
Info needed to calculate limitation:
15,000 share of Wages from S corp
10,000 share of UBIA from S corp

Since income above 276,750 phase-in range, limitation applies in full:
15,000 wages x 50% = 7,500 greater of
15,000 wages x 25% = 3,750
10,000 UBIA x 2.5% = 250 4,000

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Taxable within the threshold range

Not in book

Must calculate the "disallowance percentage"

Taxable income – say MFJ	450,000	How much are you over bottom threshold?
Less (lower threshold for joint)	(403,500)	
	46,500	

46,500 = 31% x difference between:
150,000 deduction w/o W-2 wage and capital limit
deduction with W-2 wage and capital limit

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Example 11.5 Within the threshold range

FIGURE 11.1
Jen and Jerry Carpenter's 2026 Taxable Income—without the QBI Deduction

Jen's salary income	$284,400
Jerry's QBI (non-SSTB)	175,000
AGI	$459,400
Standard deduction	(32,200)
Taxable income	$426,800
Wages paid 50,000	

T.I	426,800	
Lower limit	(403,500)	
excess	23,300	
23,300/150,000 = 16%		
175,000 x .20 =	35,000	No limit
50,000 x .50 =	25,000	limit
Excess	10,000	
.16 x 10,000 =	(1,600)	lose
can use	8,400	

QBI deduction: 25,000 + 8,400 = **33,400**

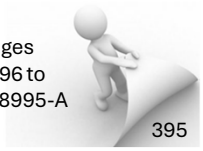
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Example 11.5 Within the threshold range

Turn to pages 395 and 396 to see form 8995-A

Turn to pages 395 and 396 to see Form 8995-A



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NEW LAW

Book doesn't discuss it, but if the W-2 Wage and Capital limit generates a deduction less than 400, the taxpayer would get the 400 minimum. (assuming 1,000 of Active Trade or Business Income)

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Limitations on QBI deductions



Where are we going?

1. Taxable Income limitation
2. W-2 wage and capital limit
3. Specified Service Trade or Business

NEW LAW
May get 400

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Specified Service Trade or Business Limitation

If a taxpayer is a "specified service trade or business" the taxpayer's QBI deduction may be limited. INCLUDES:

- Health
- Actuarial
- Brokerage
- Principal asset is the reputation or skill of one or more employee
- Accounting
- Law
- Financial Services
- Consulting
- Athletics
- Investing trading
- Engineering and Architecture not included
- Performing Arts

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Practitioner Note

- Deduction for qualified tips does not apply to tips earned in an SSTB.
- Proposed Regs takes this definition of an SSTB, but the final regulations do not. This approach leaves the room for future guidance.

Discussed in Chapter 3 – Payroll and Estimated Tax

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Calculating the limitation

General Rule:

- BELOW LOWER THRESHOLD: The SSTB limit does not apply to individuals with income at or below the threshold amount.
- ABOVE UPPER THRESHOLD: If a trade or business is a SSTB, no QBI, W-2 wages or UBIA may be taken into account by an individual whose taxable income exceeds the phase in range. (but get 400)
- IN PHASE IN RANGE: Prorate

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Example 11.6 above phase in range

Kalinda Joshi

Single Accountant (SSTB)
320,000 taxable income
Firm paid 200,000 in wages
UBIA – 55,000

Taxable income above 276,750 phase in range for single. The SSTB limitation results in no section 199A.

- BUT, because this is an active trade or business Kalinda can claim the 400 minimum deduction

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Taxable income within the phase in range

Taxpayers within the phase in range can take an applicable percentage of QBI, W-2 wages and UBIA used to calculate the QBI deduction.

The applicable percentage is 100%, reduced by the percentage equal to the ratio that taxable income in excess of the amount bears to 150,000 (75,000 other)

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Example 11.7 in the Phase-in range

Miguel Allande

Single Actor
Business income 227,850
Standard deduction (16,100)
Taxable income 211,750
Paid wages 46,000

Taxable Income	211,750
Lower threshold	(201,750)
Excess	10,000

10,000/75,000 = 13%
100% - 13% = 87%

Can use 87% of QBI and W-2 wages

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Example 11.7 in the Phase-in range

Go to page 399

Line 2 - QBI - 227,650
Line 3 - W-2 wages 46,000
Lines 5 – 10 calculates the 87%
Line 11 – QBI 227,650 x 87% = 198,230 x 20% = 39,645
Line 12 - W-2 wages 46,000 x 87% = 40,020 x 50% = 20,010

lesser

X

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400

Issue #3 -Pass-through entity tax



OBBBA increased the deduction for state and local taxes from 10,000 to 40,000 (MFJ) through 2029.

How does this impact the decision to make the pass-through entity tax (PTET) election?

The PTET election decreases AGI which may lower tax rate or increase deductions or credits



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400

SALT Limitation

2018 – 2024	2025 - 2029
TCJA	OBBBA
SALT = 10,000	2025 SALT = 40,000 2026 SALT = 40,400 2027 SALT = 40,804 Phased down based on Modified Adjusted Gross Income

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400

Phase down of SALT

2026 MFJ example

MAGI		
606,333	SALT = 10,000 floor	Phasedown period
101,333	X 30% = (30,400)	
505,000	SALT = 40,400	

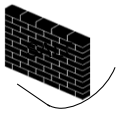
Increased 1% per year through 2029

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PTET election

Work around



OBBBA does not specifically disallow the election

Partnerships and S corporations can pay and deduct state and local taxes at the entity level and pass a deduction or credit through to individual partners or shareholders, depending on state law.

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Notice 2020-75

- Intent to issue proposed regulations
- Partnerships and S corporations are allowed a deduction in computing non-separately stated taxable income
- *Specified Income Tax Payment (SITP)* - payment to satisfy it's income tax liability imposed by a domestic jurisdiction (State and Local)
- Results in a benefit that is similar to what was provided before the SALT limitation

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Impact of election?

1065 1120S	1040 Income	1040 Schedule A	State and Local Tax Return
Additional deduction	Decrease in AGI affects various items	Impact will depend on: standard vs itemized SALT limitation	Deduction or credit?

Impact on taxable income?

States handle differently

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Example 11.8

California partnership → Evelyn Brown

Distribution 160,000
AGI 205,000 California tax 14,880

No PTET election		PTET election	
AGI	205,000	AGI	205,000
		Less California tax	(14,880)
		Reduced AGI	190,120
loose these benefits		Avoids 32% bracket	
		Under QBI threshold (other impacts)	
		Reduces child tax credit phaseout	

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PTET refunds

What if the Pass-through entity (PTE) receives a refund of the Specified Income Tax Payment (SITP)? How do you handle the refund?

Partnership or S corp deducts only the net amount.

Refund was not deducted, so not included in income

or

Partnership or S corp deducts the total amount of payments

Need to report the refunds.

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Example 11.9 – estimated PTET payments

F & F Excavation 1120S

Made 18,000 PTET payments
On state returns, PTET only 16,500
Corporation only deducted 16,500
State refunded the 1,500

Refund of 1,500 not taxable because it was not deducted.

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402

State PTET refund – Tax benefit rule

What happens when the Partnership or S corp deducts the full amount of the PTET and receives a refund?

Tax Benefit Rule requires the taxpayer to include the refund in income only if the amount claimed in the prior year provided a **tax benefit**.

An item gives rise to a tax benefit if it reduces the tax liability for any year. There must be a direct connection between the original loss, credit or deduction and the recovered amount

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403

Example 11.11

Raj Sarma 2026

Paid 52,000 in state and local taxes
Claimed the max SALT – 40,000
Received 6,000 state refund.
No tax benefit
Refund not taxable

12,000 diff



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Example 11.12 – Specified Income Tax Payment

Summit Partnership 2026

Ordinary income	330,000
Share of SITP	(30,000)
Net ordinary income	300,000
Standard deduction	(16,100)
Taxable income	283,900

Ahmed Khouri Parther

Received tax benefit?

FIGURE 11.5.
Ahmed Khouri's State Taxable Income

Federal adjusted gross income	$300,000
SITP	30,000
State standard deduction	(10,000)
State taxable income	$320,000
State tax rate	× 5.0%
State tax liability	$ 16,000
SITP credit	[30,000]
State tax refund	$(14,000)

Taxable

Yes, Ahmed received a benefit of the full 30,000 so 14,000 taxable

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Ordering Rules

State taxes may be paid in various ways:
- SITP from a partnership or S Corp
- Estimated payments
- Withholding



Which tax payment was refunded?

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Example 11.13

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Summit Partnership 2026

Ordinary income	330,000
Share of SITP	(30,000)
Net ordinary income	300,000
Standard deduction	(16,000)
Taxable income	283,900

Ahmed Khouri Parther

Item	Amount
State tax liability	$16,000
Estimated tax payments	(10,000)
SITP credit	(30,000)
Refund	$24,000

If the 24,000 comes out of the 30,000 its fully taxable

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Example 11.13

403

Summit Partnership 2026

Ordinary income	330,000
Share of SITP	(30,000)
Net ordinary income	300,000
Standard deduction	(16,000)
Taxable income	283,900

Ahmed Khouri Parther

Payment Applied Last

Item	Amount
State tax liability	$16,000
SITP credit	(30,000)
Estimated tax payments	(10,000)
Refund	$24,000

If the 24,000 comes out of:
Est payments 10,000 non taxable
SITP credits 14,000 taxable

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State of Michigan ordering rules

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Michigan's functional ordering is: **compute Michigan tax and required FTE-tax addbacks, apply the refundable FTE credit, apply estimated payments and withholding, then refund or credit any excess**. Entity-level FTE overpayments belong to the entity and do not enlarge the member credit. If an entity refund is later passed through and included in a Part 1 member's federal adjusted gross income, the member generally deducts the allocated refund on the Michigan return. [1] [2] [3] [5]

So refunds would first come out of withholding, then estimated payments then lastly FTE credit.

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Michigan Department of Treasury
6072 (09-25)

FORM 6072

For Filer's Tax Year Ending (MM-YY)

MICHIGAN Schedule FTE

Attachment 36

The *Michigan Schedule FTE* (Schedule FTE) is required to be filed with any Form MI-1040 or MI-1041 that claims a credit, addition, or subtraction related to the Flow-Through Entity Tax (FTE tax) under Part 4 of the Michigan Income Tax Act. The information you report should typically come from the statement issued by the flow-through entity (FTE) you directly own. For each credit identified on this schedule, include the Michigan Flow-Through Entity Tax Information Reports (or same information in another format) that you received from a flow-through entity you directly own.

Filer's Name Shown on Tax Return	Identifying Number

PART 1: DIRECT FTE CREDITS AND ADJUSTMENTS

Enter the required information for each FTE tax credit or tax base adjustment you are claiming on your return that was generated by direct ownership in the electing flow-through entity. The term "filer" in this table includes both the filer and spouse, if filing jointly.

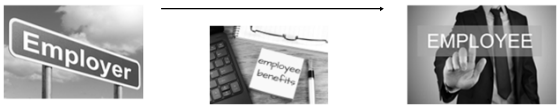
A Name of Direct Entity	B Direct Entity's FEIN	C Direct Entity's Tax Year End (MM-YY)	D Prior Year Late-Funded Credits	E Credit Funded by Entity's Deadline	F Filer's Share of SALT Deducted	G Filer's Share of Refunds in Income
Enter Part 1 subtotal from additional Schedule FTE forms (if applicable)....						
1. Part 1 subtotals.....						

X

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Issue #4 - Fringe Benefits



For performance of services

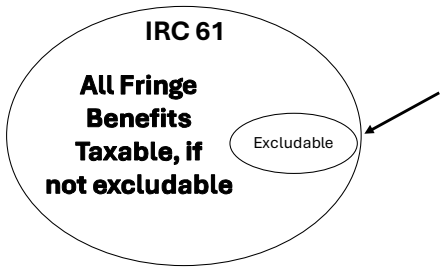
GENERALLY – included in wages

Some fringe benefits SPECIFICALLY excluded

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Fringe Benefits



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Excluded Fringe Benefits

Where we are going?

- ☆ Meals furnished on employer premises, for the convenience of employer (exception)
- ☆ De minimis fringe benefits
- ☆ No-additional-cost services
- ☆ Employee discounts

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Company paid meals Deductible?

Zero! 50% 100%

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1. Meals furnished to an employee

IRC 119

- Meals provided on employer's premises
- Convenience of employer



2025 and before	2026 and after
1. ***50%*** employer deduction	1. ***No*** employer deduction
2. ***Excluded*** from employee's income	2. ***Excluded*** from employee's income

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Meals – on premises, convenience of employer

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EXCEPTION – "meals that are sold to customers"
IRC 274(e)(8)
"in a bona fide transaction for an adequate consideration"



IE: Meals provided to restaurant employees provided for employer's convenience.

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Example 11.14

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Olive Tree Bistro







Lunch provided



Chris

50% deduction for Olive Tree
Non-taxable to Chris

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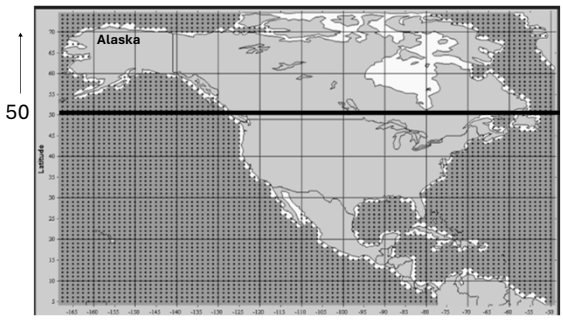
Exceptions to 50% limit

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1. Crew members
2. Oil gas platform
3. Certain fishing boats and fish processing facilities
   - Above 50 degrees North Latitude (Alaska)
   - Not located in metropolitan area

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Business Meals

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Business meals are 50% deductible if:
1. Qualified business purpose
2. Not lavish or extravagant
3. Involve the taxpayer or employee

50%

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Business Meals

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Not 50%!

Business meals are 100% deductible if:
1. Expenses treated as compensation (including persons who are not employees)
2. Reimbursed expenses
3. Recreational Expenses
4. Items available to the public
5. Goods and services sold to the public
6. Occasional meals that are de minimis

100% deductible

Discussed next

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Company paid meals Deductible?

Zero!	50%	100%
Meals provided on the premises for the convenience of the employer	Qualified business purpose Not lavish or extravagant Involve the taxpayer or employee	Compensation Reimbursed Recreation For public For sale De minimis X

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2. De Minimis Fringe Benefits



Exclude from income → Employee

What is that?

Except: >2% S corp shareholder (rules of attribution apply)

Next slide

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De Minimis Fringe Benefits



"So little value that accounting for it would be unreasonable or administratively impractical."



Cash or cash equivalent, gift cards, use of credit cards, always taxable.



Meal money because of overtime on occasional basis not taxable.

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De Minimis Fringe Benefits

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Frequency Value

Taxable

Non Taxable

See page 407 for list of Occasional

Not disguised compensation

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De Minimis Fringe Benefits

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Are De Minimis fringe benefits still deductible, even if not taxable to the employee?

Yes, under IRS 162(a), if they are ordinary and necessary expenses of the trade or business.

However, de minimis meal expense is limited to 50%, except company parties, picnics, etc..

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Non-excludable De Minimis Fringe Benefits

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Season tickets



Country Club membership

Commuting in company car

Use of leased facilities for the weekend

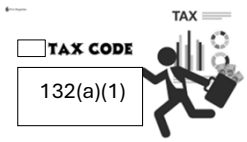
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3. No additional-cost services

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Employer can exclude from employee wages
Even partners who provide services and 2% S Corp S/H
Applies to reduced price
Can't discriminate



- Service offered for sale to customers
- Employer incurs no substantial additional cost

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No additional-cost services

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Airlines
Bus
Train
Hotel
Telephone service

To determine whether employer incurred substantial additional costs, lost revenue is included as a "cost".

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Example 11.16

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Airline allows it employees to take personal flights at no charge and receive reserved seating.

No-additional-cost exclusion does not apply.

Airline gave up potential revenue.

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Definition of employee

- For this purpose, "employee" is defined broadly:
  - Current employee
  - Former employee (retired or disability)
  - Surviving spouse of employee who died
- Services provided to the spouse or dependent child of employee qualify

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Line of business limitation

408 - 409

Taxpayer's line of business

Employee must perform services in the line of business



Enterprise Standard Industrial classification Manual (2 digit code) Old - 1974

Proposed regs will use North American Industry Classification system (4 digit code) see page 603

X

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4. Qualified Employee Discount

"Qualified Employee Discounts" are excluded from employee's wages

Available to partners who perform services and 2% S Corp shareholders.

Reduction in price of property or services offered to customers in the line of business in which the employee performs substantial services

Cannot favor highly compensated employees

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Eligible Discounts

Property	Services
Employer's gross profit % multiplied by the price at which it is being offered by the employer to customers	20% of the price at which the services are being offered by the employer to customers
Calculated separately for each line of business	

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Example 11.20

Sam's Appliance Center

30% discount on purchases → Apple Nelson

600 normal price

Normal gross Profit = 25%



600 x 30% = ***180*** discount. Paid 420

Exclusion limited to ***150*** (600 x 25%)

30 of income

X

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Issue #5 – Settlements, Fine and Penalties



- Taxation of settlements – taxable?
- Fines and penalties - deductible?
- Attorney fees received - taxable?
  Attorney fees paid – deductible?

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Judgements vs Settlements

Judgement



Court order- judge or jury

Settlement



Settled prior to court judgement

Generally, same rules apply for taxability

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Settlements



Section 61 – all income taxable, unless specifically excluded

Section 104 – excludes settlement if derived from personal injury or physical sickness

Need to discuss how 104 applies to:
- Personal injury lawsuits
- Lost wages
- Punitive damages
- Nonphysical injuries – emotional distress

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Personal Injury Lawsuits



Non-taxable (IRC 104!)

(except punitive damages)

May take years to settle!



Settlement for medical and did not itemize in prior years, nontaxable

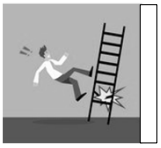
Settlement for medical and did itemize the medical costs in prior year– taxable (tax benefit doctrine)

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Lost wages – because of personal injury

"lost wages" sounds like it would be taxable



But, if because of a personal physical injury, non-taxable (IRC 104)

82

413

Example 11.21 – part 1



Eric fired by an airline when he turned 60. Sued for age discrimination. Settlement designated as "back pay and liquidating damages".

Taxable?

83

413

Example 11.21 – part 1



Eric fired by an airline when he turned 60. Sued for age discrimination. Settlement designated as "back pay and liquidating damages".

Taxable Income

84

413

Example 11.21 – part 2



- Eric injured in car accident and suffered lost wages.
- Recovered lost wages on account of personal injuries

Taxable?

85

413

Example 11.21 – part 2



- Eric injured in car accident and suffered lost wages.
- Recovered lost wages on account of personal injuries

Not taxable

Good old IRC 104!

86

413

Punitive damages

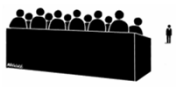


Usually taxable, even if they were received in a settlement for personal physical injuries or sickness. No 104 benefit!

(limited exception for certain civil wrongful death cases – IRC 104(c))

Punishment

Send a message



87

Emotional distress or mental anguish

413



Based on physical injury

Excluded from income

IRC 104!!

Based on nonphysical injury

General rule - taxable

Can exclude actual medical expenses not previously deducted

88

Employment related lawsuits

413 - 414



Lost wages and lost business income generally taxable.

Unless, personal physical injury caused the loss. IRC 104

Ie: unlawful discrimination or involuntary termination

Separate question- Subject to employment taxes or self-employment tax? NEXT

89

Income tax ≠ Social Security tax (FICA or Self-employment tax)

90

414

Back Pay / Front Pay / Severance Pay

Subject to employment taxes?

Back Pay – taxable for employment tax purposes, even if employee performed no services.

Front Pay – awarded for future services. IRS – subject to employment taxes. Some Courts have disagreed with this position.

Severance Pay – Generally, taxable for employment tax purposes. Rev Rul 90-72 not subject to employment taxes if linked to receipt of State unemployment.

91

Example 11.22 No SE income on Business Interruption Insurance

415

Newberry v. Comm



- Grocery Store destroyed by fire
- 11,000 received for "business interruption" insurance based on store's profits.
- Subject to income tax
- Not subject to SE tax. Not derived from a trade or business.

92

Example 11.23 No SE tax on Termination payments

415

Jackson v. Comm



- State Farm Insurance Agent - Independent contractor
- Retired. Received 43,000 in "termination payments"
- Based on prior year compensation
- Subject to income tax
- Not subject to SE tax. Not derived from carrying on an insurance business.

X

93



What's taxable → What's deductible
to

94

Government Fines and Penalties 415

Old IRC 162(f)	TCJA – amended 162(f) (2017)
Disallowed an ordinary and necessary business deduction for any fine or similar penalty paid to a government for a ***violation of any law***	Deny a deduction for an otherwise deductible amount paid or incurred (whether by suit, agreement or otherwise) to or at the direction of a government or specified ***nongovernmental entity*** in relation to the violation of any law or **potential violation of any law.**

95

Government Fines and Penalties 415

Old IRC 162(f)	TCJA – amended 162(f)
	Only where government is complainant or investigator. Even if taxpayer does not admit guilt (exceptions of amount paid as restitution or taxes owed)

96

Government Entity

416

Includes Governmental entity



Also includes non-governmental entity treated as a governmental agency:
Exercises self-regulatory powers in connection with:
- a qualified board or exchange
- performing an essential governmental function

97

Exceptions to 162(f) disallowance rule

416

1. Restitution
2. Taxes
3. Non-governmental fines and penalties

98

Exception to disallowance rule

416



Restitution

Good for the taxpayer!

- Including remediation of property
- Amounts required to come into compliance with law
- Must have court order or settlement agreement that identifies the restitution
- Must have documentary evidence

99

Example 11.24

417



- Leslie – Chiropractor
- Medicare Fraud determined Leslie billed for general wellness visits. Not allowed.
- Leslie entered into an agreement to repay 780,000 to Florida Medicaid.
- Since restitution payment is identified in the settlement agreement and she had proof of payment, 162(f) does not disallow the deduction.

100

Example 11.25 – Payments to comply with law

417





Not cold enough

Health Inspector issued warning letter. Fines if not fixed in 60 days.

- Paid 10,000 to bring refrigerator into compliance
- Can deduct, if identification and establishment requirements were met

101

Routine Investigations

417



Costs for audits or inspections required to ensure compliance

162(f) does not disallow expense

102

Exception to 162(f) disallowance -Taxes

418



- Exception to the general disallowance rule of IRC 162(f)
- Restitution for failure to pay any tax under the Internal Revenue Code & interest…
  - To the extent it would have been allowed as a deduction if it had been timely paid.

KEY

Penalties and interest related to the tax payment not deductible.

103

Exception to 162(f) disallowance Non-Government Fines and Penalties

418



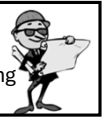
- 162(f) does not apply to suits between private parties or non-government fines and penalties
- Amounts paid for "reasonable and necessary" business expenses may be deducted.

104

Example 11.27

418

Culvert Engineering



Design and build rail project within 5 years

City of Bluffton





- Did not complete within 5 years
- City sued for breach of contract
- Awarded 100,000 in damages
- 162(f) will not disallow deduction. City enforced it's rights as a private citizen.

105

Section 6050X reporting

418

Government agency

Settlement over 50,000

1098-F

Party to the suit



Total
Violation
Restitution
Compliance

106

Shifting Gears

Attorney fees
Received - taxable?
Paid – deductible?



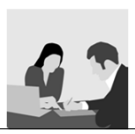
107

Attorney's Fees awarded – taxable?

418 - 419



Attorney fees awarded in a judgement or settlement



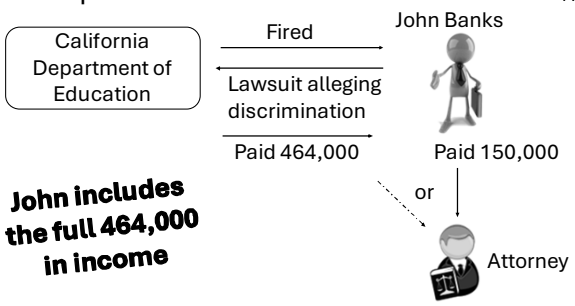
Normally included in income

Even if paid directly to attorney

108

Example 11.28

419



John includes the full 464,000 in income

109

Exception - Personal physical injury

419



Nonpunitive amount received on account of personal injury (104!)

Non-taxable



Award of legal fees also non-taxable



110

Attorney fees – employment taxes

419

Rev Ruling 80-364 – claims for back pay subject to employment taxes? FICA- wages means all remuneration for employment. 3 situations discussed:

Situation #1
Awarded: 8,000 back pay, 1,000 attorney fee, 1,000 interest
Full 10,000 taxable. But, only the 8,000 wages for employment taxes

111

Attorney fees – employment taxes

419 - 420

Situation #2
Awarded: 10,000, no portion for attorney fees
Employee paid 1,000 to attorney
Full 10,000 wages for employment taxes

Situation #3
Union filed claim for breach of collective bargaining
Company paid Union 40,000 to settle all claims
Union paid 6,000 to attorney, distributed 34,000 to employees.
6,000 not renumeration for income tax or employment taxes.

112

Attorney fees paid – deductible?

420

Taxpayer → Paid fee. Deductible?



IRC 162 yes
Trade or business
Ordinary and Necessary

IRC 262 + 263 no
personal or capital



If settlement excluded from income, attorney fees not deductible



113

Example 11.29 *Guill v. Com*

420



George

George sells life insurance as independent contractor. Terminated contract. Supposed to pay renewal commissions, but didn't



George sued. Court awarded unpaid commissions and punitive damages.

George can deduct legal fees. Ordinary and necessary

114

Discrimination Suits / Whistleblower 421

IRC 62(a)– Adjusted Gross Income defined. Gross income minus:
1.
2.
3.
… last 2
20. Costs involving discrimination suits
21. Attorney Fees related to awards to whistleblowers

115

Discrimination Suits / Whistleblower 421

Couple of exceptions that allows a taxpayer to take an above the line deduction:

- Unlawful discrimination, certain claims against the Federal Government ,Medicare secondary payer claims
- Suits involving whistleblower awards for providing certain information

X

116

Issue #6 – Valuing a Closely held entity 422

Valuing closely held stock. WHEN?



Gift Tax

Estate Tax

Buy/Sell Agreement

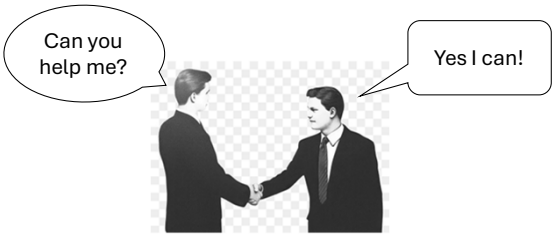
Stock Sale

Stock Redemption

Marital or Corporate dissolutions

Valuing Stock Compensation

117



You're meeting with a client to discuss how much a corporation is worth. What questions would you ask and what documents would you want to see?

118

Fall back on Experts

423

APPRAISER

Accredited Senior Appraiser



Accredited Business Valuation



Certified Valuation Analysis

119

Treasury Regulations

422

FMV = price at which the property would change hands between a willing buyer and a willing seller when neither party is under any compulsion to buy or sell. Both parties have reasonable knowledge of relevant facts. IE:



After the fact

1. Appraisal
2. Demonstrates earning capacity
3. Other: goodwill, industry outlook,
4. Complete financial data

120

Start here: Rev Rul 59-60 423



Initially designed for estate and gift tax valuations



Provides 8 factors that have proved the test of time. Not all inclusive, but are fundamental.

Gives you a road map to follow, if you're not sure exactly how to proceed.

121

#1 -Nature and History 423

Today

Past stability/instability
Growth
Diversity
Risk involved
Product /Services
Assets
Sales records

Ask

122

#2 - Economic Outlook 423

Today

Ask

In general
Specific industry
More/less successful than competitors
Continuity of management
Trained personnel

123

#3 - Book Value / Financial Condition

423

ABC Corporation

Assets	2025	2026
Cash	$93,000	$47,500
Accounts receivable	89,800	57,900
Inventory	120,000	101,000
Investments	84,600	86,900
Equipment	249,000	205,000
Accumulated depreciation—equipment	(49,600)	(40,100)
	$586,800	$458,200
Liabilities and Stockholders' Equity		
Accounts payable	$58,000	$ 48,800
Accrued expenses payable	11,800	17,800
Bonds payable	103,000	69,700
Common stock	251,000	193,000
Retained earnings	163,000	128,900
	$586,800	$458,200



Liquid position
Gross /Net book value
Working Capital
Long-term indebtedness
Capital Structure
Net Worth

Look at several years

124

#4 - Earnings Capacity

424

ABC Corporation

Sales		$ 450,000
Cost of goods sold:		
Merchandise inventory, beginning balance (BB)	$ 350,000	
Add net purchases (TI)	260,000	
Cost of goods available for sale	$ 610,000	
Less merchandise inventory, ending balance (EB)	$ 320,000	
Cost of goods sold		290,000
Gross profit		$ 160,000
Less operating expenses:		
Selling		90,000
General and administrative		40,000
Operating profit		$ 30,000



Gross Income
Principal deductions
Net income available for dividends
Retained earnings

Separate recurring from nonrecurring
Potential future income (using prior earnings records)

125

#5 – Dividend Paying Capacity

424

Today →

Not as important – History of paying dividend. (may be controlled by income needs of stockholder)

Dividend Paying capacity

After looking at the Earning statement

126

#6 – Goodwill and other intangibles

424

GOODWILL

Net Earnings > Fair return on tangible assets = Earning capacity

Intangible



Difficult!

127

#7 - Sales of stock

424

YES

If represent arms length transactions



WATCH FOR:

Forced or distressed
Isolated sales
Controlling interest
Minority interest

Remember, the value is what a willing seller and willing buyer agree to?

128

#8 Market Price of similar stock

424

FACTORS:
Engaged in similar line of business
Listed on an exchange
Publicly traded
Lines of business must be similar
Class of stock
Business viability – declining vs progressing

research

129

IRS Job Aid

425

LINK on IRS.GOV

VALUATION OF NON-CONTROLLING INTERESTS IN BUSINESS ENTITIES ELECTING TO BE TREATED AS S CORPORATIONS FOR FEDERAL TAX PURPOSES

A JOB AID FOR IRS VALUATION ANALYSTS

PREPARED BY REPRESENTATIVES OF THE

LARGE BUSINESS AND INTERNATIONAL DIVISION NRC INDUSTRY, ENGINEERING PROGRAM

AND THE

SMALL BUSINESS /SELF-EMPLOYED DIVISION ESTATE AND GIFT TAX PROGRAM

Good Reference

Applies the guideline of Rev. Rul 59-60

130

Weighing the different factors

425



Certain factors may carry more weight

Depending on type of business

131

Capitalization Rates

425

In valuing earnings and dividends must capitalize current results at an appropriate rate

No standard table of capitalization rates

Consider:
Nature of business
Risk involved
Stability of earnings

132

Restrictive Agreements

425



Closely held stock may have a restriction on sale or transfer



Agreement may specify a value.

Must consider the relationship of the parties to determine if bona fide.

133

Valuation discounts

425 - 426

Lack of marketability / Lack of control

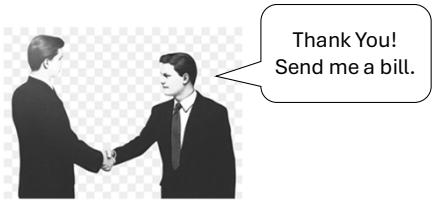


Pierce v. Comm T.C Memo 2025-29
Used income approach which capitalizes income and discounts cashflows.

Taxpayer's appraiser used 25% marketability & 5% control discounts

Court Agreed

134



Arrive at a valuation that you can feel confident in by using the factors found in Rev Rul 59-60.

X

135

General Rules for Methods of Accounting 427

Method used for books ⟷ IRC 446(a) Same? ⟷ Method used for tax

Default



Courts and IRS rulings: can use different methods, if "clearly reflects income"

136

Initial method of accounting 427

First tax return with business income:

- Can adopt any permissible method that clearly reflects income
- Consistent application of generally accepted accounting principals ordinarily will clearly reflect income
- Must be treated consistently from year to year.
- Must obtain consent from IRS to change method of accounting (see last years book for info)

137



Cash or Accrual?
Why?

138

Cash receipts and disbursement method 428

Not everyone can use

GENERAL RULE:
C corps, partnerships with C corp partners and tax shelters cannot use cash method

3 EXCEPTIONS:
- Certain farming businesses
- Qualified personal service corps
- Small taxpayers: Under 32,000,000 Gross Receipts prior 3 year average



139

Inventory Accounting 428

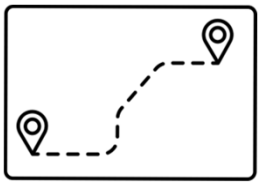
If required to use inventories = accrual for sales and purchases

But:  Pretty big exception

Small taxpayer can choose not to keep inventories, must still must use a method of accounting for inventories that clearly reflects income ???

140

Where we're headed



Cash method – Income
Cash method – expenses

Accrual method – Income
Accrual method - expenses

141

Cash Method: Income

428

Actually or constructively received

- Actually received
  - Received the cash
- Constructively received
  - Yes: Credited to account; Set apart for taxpayer; Made available
  - No: Substantial limitation or restriction on receipt of income

X

142

Cash Method: Expenses

429

- For current accounting period - yes
- Expense paid
- For future accounting period - maybe

Prepaid expense – only deductible in the year the service or property that was purchased is used or consumed

Exception: 12 month rule - benefit does not exceed 12 months

143

Example 11.31

429

Smith Industries

12/1/25 — 2/2/26 — 1/31/27

Paid 10,000 Insurance premium

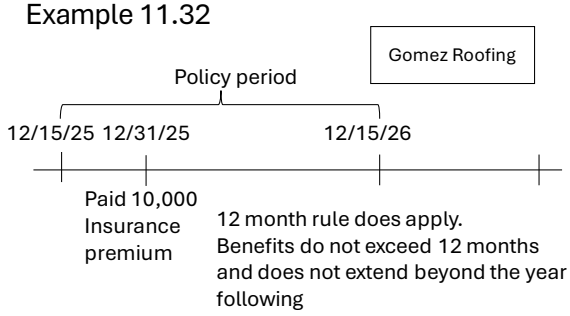
Policy period

Prepaid expense
12 month rule does not apply.
Benefit extends beyond 12/31/26
Must capitalize

144

Example 11.32

429



145

Accrual Method - Income

430

Income earned and included in income when:

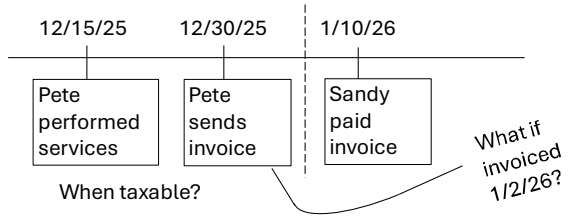
- All the events have occurred that fix the right to receive the income
- Amount of income can be determined with reasonable accuracy

146

Example 11.33

430

Pete independent contractor who performed 200.00 in services for Sandy. Sandy agreed to pay.

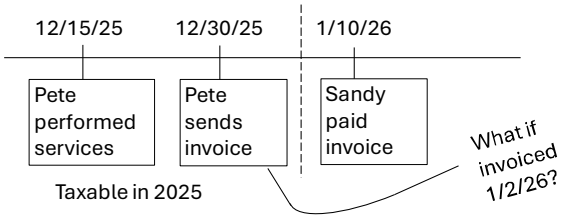


147

Example 11.33

430

Pete independent contractor who performed 200.00 in services for Sandy. Sandy agreed to pay.



148

Applicable Financial Statements

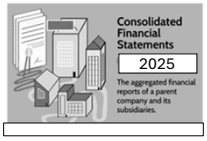
430

Certified as being prepared in accordance with generally accepted accounting principles

Prepared and used for some non-tax purpose. Ie:
SEC or shareholders



Higher bar



149

Applicable Financial Statements

430

Applicable Financial Statements ⟷ AFS income inclusion rule: Tax Return

How does this fit in?

Earliest of: Receipt of payment
Income amount is due
Income is earned
Title passes
Income included in revenue in AFS

(Small businesses with internal financial statements don't have AFRs)

150

Accrual Method - Advanced Payments

430 - 431

2025	2026
Receive advanced payment for goods and services	Elect to postpone including until the next year. IRC 451(c)

Only if:

- Full inclusion in year of receipt is permissible
- Portion included in income in subsequent year
- Advanced payment is for goods, services or such other items identified by IRS

151

Accrual Method - Advanced Payments

431

Rent / Insurance prepayments are ineligible for deferral method

What if you don't have AFS and elect to use this deferral method?

2025	2026	
Received		
Must make election - 3115	Earned 2025	Balance 2026
		Allocate
		X

152

Accrual Method - Expenses

431

All Events Test

Claim liability in year which:

Similar to test for income:

- All events have occurred that establishes the fact of the liability
- The amount of the liability can be dertermined with reasonable accuracy

Only for expenses:

- Economic performance has occurred

153

Economic Performance

431

"When the provision of service or property is provided"

Taxpayer		Customer
Use of property by the taxpayer	← Ratably →	Owns property
Provide services or property	As **costs** incurred →	Receives services or property

What if not all at once?

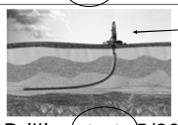
154

Example 11.34

431

Feldstein owns land

12/23 pays 200,000 →



Drilling starts 5/26 and finishes 12/26

Big Rig Drilling to drill an oil well by 12/31/26.

When is the 200,000 deductible?

A: as services are provided, so deductible in 2026.

155

Example 11.35

431 - 432

Flying High, Inc
Accrual

Charters aircraft to customers



It doesn't own the jets, it leases them from Fast Jets, Inc for 500,000/year for 4 years starting 1/1/25.

It doesn't matter when Flying High actually makes the payments. Economic performance occurs ratably over the 4 years. So 125,000 deductible in 2025.

156

Example 11.36

432

Deep Wells, LLC Leased land from Energy, Inc



installed platform and began drilling

Terms of Lease required Deep Wells to remove platform when abandoned or termination of lease

2017 Liability to remove lease When deductible? 2026

200,000

Economic performance occurs in 2026

157

Recurring Item Exception

432

Exception to the Economic performance rule for recurring items.

Accrual Basis taxpayer can elect the recurring items exception as a method of accounting

12/31

Liability occurs | Economic performance occurs

158

Recurring Item Exception

432

Recurring liabilities treated as incurred during the year even though economic performance has not occurred if:

1. As of end of tax year the all events test met
2. Economic performance occurs on or before the earlier of a reasonable period after the close of the tax year or 8 ½ months after the close of the tax year.
3. Liability is recurring
4. Amount of liability is not material or provides a better matching of income and expense

159

Example 11.37

433

AI powered smart home devises

Y Tech Corp sells  Refund if not happy Customer

2025	2026	9/15
100 purchasers each wanted 500 back – 50,000	30,000 refunded	20,000 refunded
← Deductible in 2025		2026

160

Deferred Compensation

433

Economic performance test satisfied if employee receives the compensation on or before 15th day of 3rd month after end of tax year (2 ½ month rule)

2025	12/31	3/15
Bonus accrued	bonus paid	bonus paid
	Deductible In 2025	**Not Deductible In 2025**

161

Example 11.38

433

Precision Manufacturing

2026	12/31
Non-executive incentive comp plan	Paid in January
Bonuses fixed & determinable	**Deductible in 2026**

162

Contingent Bonus

433

Bonuses declared, but contingent of the employee being employed on date of payment

Bonus paid

Not deductible

X

163

Do you know the basic rules?

Cash method – Income
Cash method – expenses

Accrual method – Income
Accrual method - expenses

164



165