

- I. When must income be reported and deductions taken under the cash and accrual methods of accounting?
 - a. Cash Method
 - i. Include in income when:
 1. Actually received
 2. Constructively received
 - a. So close to being cash in hand that it is cash in hand
 - b. TP constructively receives any amt. over which he has unfettered control:
 - i. The amt. is set aside for TP and
 - ii. Is available for TP's use
 - iii. Dependent solely on TP's volition
 1. Not subject to substantial restrictions or limitations
 2. TP turns his back on the income
 3. Deferred compensation
 - a. If TP is not yet entitled to payment (b/c the parties are still negotiating), TP is free to structure the transaction any way he chooses b/c it is not yet owed to him
 4. Cash equivalent received

- a. Readily marketable and immediately convertible to cash
- b. If a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by TP rather than the obligor

5. Economic benefit received

- a. Economic or financial benefit, to the extent it has an ascertainable value, conferred upon TP
 - i. Catch-all: you have rec'd benefit in year and should be included in gross income

6. Have under a claim of right

- a. Treatment upon repayment: TP receives a deduction in the later year when he repays money received under a claim or right and he is entitled to figure the deduction at the tax bracket of either:
 - i. The year of receipt IF it produces a bigger tax savings than the deduction alternative, or
 - ii. The year of repayment

7. Receive prepayments

- a. i.e. advance payment of rent

ii. Deduct

- 1. When paid,
- 2. No constructive payment doctrine

3. Credit card, cash, and check all allow TP to take a deduction when paid
4. With an in-store credit card no deduction is permitted until the goods are actually paid for by check/cash

b. Accrual Method

i. Include in income when:

1. Meet the all events test:

a. Right to income is fixed; and

- i. A seller of goods accrues income when all the events have occurred establishing TP's right to income (i.e. buyer's obligation to pay has been established)

b. Amt. can be determined with reasonable accuracy

2. Hold under a claim of rt.,

3. Receive a prepayment

ii. Except, if:

1. Amount is contingent and unlikely to be paid (on date enter into contract)

- a. TP must make a strong showing to establish doubts about collectibility. Unless TP can show a high probability that he won't get paid, TP must accrue it

- b. Reasoning: Despite the condition of the treasury of GA when the free schoolbook fund was inaugurated and for several years thereafter, there was no reasonable expectation that the sums owed by the state to petitioner's publishers and, consequently, the commissions to petitioner itself, would n/ ultimately be paid. GA is a state possessing great resources

and a fine record of fiscal probity, and undoubtedly it can and will meet its obligations. The fact that petitioner, on behalf of its principals, continued to sell and deliver school books to the state indicates that there was no serious doubt as to the ultimate collection of the accounts involved. Petitioner's commission on all books purchased by the state through it in the taxable years should have been accrued and returned as income in those years

2. TP can more clearly reflect pre-paid income using a different method
 - a. TP can show exactly when the services are going to be performed via a fixed schedule that matches prepaid income w/ services so as to clearly reflect prepaid income
3. Will perform under K w/in 2 years, then can spread income over 2 years (71-21)
 - a. Gov't allowed
 - b. Match up income in what years the services are provided
 - c. If services are to be completed by the end of the following year, T can defer to the following yr. whatever portion of the advance payment is attributable to that year's services
 - i. Prepaid rent must still be reported in the year received

iii. Deduct

1. When meet the all-events test:
 - a. Fixed obligation (unconditional duty to pay)
 - i. If TP disputes its liability for an expense, TP recognizes no unconditional obligation and is not permitted to accrue the item as a deduction

ii. Reasoning: The Mooney bond invokes an unconditional duty on the part of Mooney aircraft to refund \$1,000 to the owner of the plane when the plane is retired

b. Amt. can be determined w/ reasonable accuracy

c. Economic performance

i. Economic performance does n/ occur until the services or property are actually provided

ii. Ex.: Suppose that in year 1 TP agrees to pay \$5,000 for stationary to be delivered in year 3. The cost of the stationary is not deductible until year 3

iii. Reasoning: Here, the length of time before the \$1,000 refund is paid to the owner of the plane is just too long (20 to 30 years) for TP to take a deduction for the cost of the bond in year 1. Since economic performance will not occur until Mooney refunds the \$1,000 to the owner of the aircraft, it is not entitled to a deduction until the plane is officially retired in 20 to 30 years. Before Congress enacted the economic performance rule TPs were using their deductions for economic purposes by saving money for taking deductions up front and financing their payment later on down the road

2. TPs who are insolvent have been allowed to deduct unpaid expenses even though these items may never be paid

c. Annual accounting issues

i. Claim of Right

1. Applicable if:

- a. Included amt. in income b/c appeared the TP had a right to the income, and
- b. Subsequently determine the TP did not have a right
 - i. No Right
 - 1. Embezzler has no right
 - ii. Middle Range
 - 1. No. American Oil
 - iii. Absolute Right
 - 1. TP wanted to avoid a protracted courtroom battle and bad publicity by paying the money back so he had an absolute right

2. Options:

- a. Take deduction in year discover not entitled to income or
 - i. SS 1341(a) provides a tax decrease, against the current year's tax liability in an amt. equal to the added tax occasioned by the prior year's inclusion in income only when the tax decrease produces a bigger tax savings than the deduction alternative
- b. Compute tax without deduction, but get credit for having paid tax on amount not entitled to

ii. Tax benefit rule

- 1. Applicable when claim deduction, followed by recovery of amt. deducted. T must include the recovery of an item previously deduct in income in the brackets of the recovery year
- 2. Elements

- a. Took deduction
- b. Subsequently determine no longer entitled to deduction

3. Rule:

- a. Include amt. in income when have recovery
- b. No options
- c. Not required to include amount in income if no tax benefit was received from previous deduction