Rent Payments vs. Installment Purchases

- If a business rents anything necessary for the business, such as an office, a copier, machinery, etc., 100% of the rent can usually be deducted as an ordinary business expense. The lessor, of course, has to include 100% of the lease payment as business income.
- If a business purchases an asset and pays in installments, it cannot deduct simply the cost of the payments, as that wouldn't account for the fact that the business now owns this asset.
- Instead, the purchaser business deducts the *interest* paid on the loan plus any applicable depreciation.
- The seller/lender must include only the interest as ordinary income, but of course, must pay capital gains tax if the sale price was above its basis.

Determining Whether An Arrangement is a Lease or Sale

- For assets that last an indefinite period of time (like a building), it's easy to tell whether a transaction is a lease or sale.
  - If title stays with the original party, it's a lease
  - If title transfers to the "buying" party, it's a sale
- However, when something has a limited life expectancy, the two may amount to the same thing.
  - For example, if a car would normally last 10 years, is there really a practical difference whether you "buy" the car or "lease" it for 10 years?
- If something is leased for its whole life expectancy or if it's unrealistic for it to ever go back to the seller (e.g., a sprinkler system installed in a building), the IRS can take the position that it's really a sale even if called a lease, and treat it like a sale, even if the parties call it a lease!

Goodwill and Other Intangible Benefits

- Something that is not an ordinary business expense but is just done to generate goodwill (such as giving perks to good customers, etc.) cannot generally be deducted as ordinary business expenses.
- Goodwill includes:
  - Obtaining licenses
  - Obtaining intellectual property protection
  - Building a new franchise
- §197 of the IRC allows businesses to amortize these expenses over a 15 year period (deduct them over that span), no matter what the actual term of the value of the goodwill gesture will bring (which is often impossible to figure out)

What is an “ordinary and necessary” business expense?

- Anything normally included in the cost of doing business, including:
  - First class airfare for a business trip even though they could have flown a lower class
  - Private plane used to fly executives around

- Things that are only for the enjoyment of the taxpayer or are too far removed from the business purpose are not ordinary business expenses.

- Perks for employees are deductible but are also taxable income to the employees unless it fits an exception discussed earlier in the course.

Employee Compensation

- Compensation of employees is generally deductible to the employer as an ordinary business expense. However, the compensation has to be “reasonable.”

- If compensation is too high based on market conditions, the IRS can take the position that it’s a disguised gift or means to gain a tax advantage and disallow the compensation that’s in excess of what is reasonable.

- For a public corporation, executives’ income is deductible only to the extent of $1,000,000 per year.

Income from Illegal Activities

- Income from illegal or immoral activities is taxable as ordinary income (just ask Al Capone…).

- Expenses incurred in making that money through illegal means are generally not deductible unless the expense really had little to do with the illegal activity.

- Examples of non-deductible expenses include:
  - Bribes and kickbacks paid
  - Fines and Penalties

- Some expenses relating to illegal activities, such as criminal defense fees, can be deductible.

Depreciation - the Concept

- When property with a limited lifespan owned by a business decreases in value, it is a loss for the company. The depreciation rules allow this loss to be written off as a deduction for the business.

- Rather than having each business determine the lost value of each asset each year (which would be hard to do and harder to prove), the IRC sets certain specific rules about the depreciation that can be taken for an asset each year.

Depreciation- the Method

- The amount by which an asset can be "depreciated" each year is based on 3 factors:
  - Applicable Recovery Period (based on its longevity)
    - This is set by IRC Rules for each type of property. For example:
      - Residential real estate: 27.5 years
      - Commercial real estate: 39 years
      - Car or light truck: 5 years
  - Applicable convention (when it was placed into "service")
  - Applicable Depreciation Method can be:
    - "Straight Line" method: Divide the property by the number of years in the recovery period and divide by that number
    - "Declining Balance" basically allows you to accelerate depreciation

Depreciation (continued)

- Note that any amount by which the property is depreciated must be taken off of the taxpayer's cost basis of the property thus potentially increasing applicable capital gains tax

- "Depletion" is a similar concept allowed when resources will be drawn from property (such as an oil field or coal mine). The taxpayer can choose:
  - Cost Depletion: Estimate the over-all amount of resources that will be drawn from the property and deduct the percentage of the value of the property that corresponds to the percentage of resources extracted that year; or
  - Percentage Depletion: Deduct a percentage of the property each year, as allowed by the IRS tables.

Alternative Minimum Tax

- This limits the amount of deductions that a taxpayer can take. It says that a taxpayer’s adjusted gross income over and above a certain exemption amount must be taxed at a minimum rate, all deductions notwithstanding.
- The exemption amount (under which the AMT is irrelevant) is quite low (under $50,000 until recently). Over that, the exemption is phased out.
- Taxpayers with higher incomes and high exemptions and local taxes are most likely to be hit by the AMT.
- There is strong political momentum to increase the exemption amount and this make is less relevant for many people. Congress did raise the exemption in 2007.
- The corporate AMT is a flat 20% from dollar one.