

CHAPTER 5

INTRODUCTION TO BUSINESS DEDUCTIONS

2017 Edition	Topic	Status
Questions		
1	Deductions for/from AGI	Unchanged
2	Applicability of AGI to only individuals	Unchanged
3	Requirement to deduct business expenses	Unchanged
4	Two primary classifications of business expenses	Unchanged
5	Separate reporting of deductions for a conduit entity	Unchanged
6	Impact on taxable income of not separately reporting deductions from a conduit entity	Unchanged
7	Deductibility of personal expenses versus business expenses	Unchanged
8	Ability-to-pay concept	Unchanged
9	Mixed-use expenses and mixed-use assets	Unchanged
10	Distinguish the differences between a trade or business and a production of income activity	Unchanged
11	Requirements for determining trade or business and production of income activity	Unchanged
12	Deductibility of capital expenditures	Unchanged
13	Distinguishing between a deductible expenditure and capital expenditure	Unchanged
14	Start-up expenses	Unchanged
15	Political and lobbying expenditures	Unchanged
16	Deductibility of illegal expenditures	Unchanged
17	Deductibility of expenditures to produce tax-exempt income	Unchanged
18	Treatment of a hobby, vacation home, and home office	Unchanged
19	Determining if a principal residence is a vacation home or rental property	Unchanged
20	Requirements for deducting home office expenses	Unchanged
21	Criteria to deduct expenses for a cash basis taxpayer	Unchanged

2017 Edition	Topic	Status
22	Payment of an expense by a cash basis taxpayer	Unchanged
23	Current deduction for prepaid expenses by cash basis taxpayer	Unchanged
24	Criteria to deduct expenses for accrual basis taxpayer	Unchanged
25	Economic performance test	Unchanged
Problems		
26	Deductibility of work clothes	Unchanged
27	Deductibility of expenses - five scenarios	Unchanged
28	Deductibility of expenses - five scenarios	Unchanged
29	Reporting income and deductions from a partnership	Unchanged
30	Incorporating income and deductions from a partnership on an individual return	Unchanged
31-COMM	Determining if an individual is engaged in a trade or business - one-time job for a retired individual	Unchanged
32	Determining if an individual is engaged in a trade or business - renting property	Unchanged
33	Deductibility of expenses - embezzler	Unchanged
34	Allocation of expenses from a mixed use asset	Unchanged
35	Allocation of expenses from a mixed use asset/gain or loss from a mixed use asset	Unchanged
36-COMM	Ordinary, necessary and reasonable - related party	Unchanged
37	Ordinary, necessary and reasonable - five scenarios	Unchanged
38	Ordinary, necessary and reasonable - four scenarios	Unchanged
39	Current expenditure versus capital expenditure - four scenarios	Unchanged
40-COMM	Start-up expenses	Unchanged
41	Start-up expenses - three scenarios	Unchanged
42	Deductibility of illegal payments - three scenarios	Unchanged
43	Proper tax treatment of expenditures - four scenarios	Unchanged

2017 Edition	Topic	Status
44	Deductibility of political and lobbying expenses - four scenarios	Unchanged
45	Deductibility of lobbying expenses	Unchanged
46-COMM	Allocation of investment expenses between taxable and non-taxable investments	Unchanged
47	Allocation of investment expenses between taxable and non-taxable investments	Unchanged
48-COMM	Reporting income and deductions from an S corporation/allocating investment expenses	Unchanged
49	Payment of another's expense	Unchanged
50	Payment of another's expense – two scenarios	Unchanged
51	Deductibility of hobby expenses	Unchanged
52	Deductibility of hobby expenses	Unchanged
53	Tax treatment of vacation home	Unchanged
54	Vacation home - two scenarios (vacation home and rental use less than 14 days)	Unchanged
55	Rental/Vacation home rules - four scenarios	Unchanged
56	Rental/Vacation home rules - three scenarios	Unchanged
57-COMM	Home office deduction	Unchanged
58	Home office deduction - two scenarios (self-employed and employee)	Unchanged
59	Home office deduction	Unchanged
60	Payment of another's expense	Unchanged
61	Deductibility of interest expense - cash basis versus accrual basis	Unchanged
62-CT	Economic performance test - insurance expense	Unchanged
63	Economic performance test – warranty expense	Unchanged
64	Deductibility of self-insurance expense - cash basis taxpayer	Unchanged
65	All-events test	Unchanged
66	Deductibility of an expense - cash and accrual basis taxpayer	Unchanged

2017 Edition	Topic	Status
67	Deductibility of an expense - cash and accrual basis taxpayer	Unchanged
68	Related party transactions - cash and accrual basis taxpayer	Unchanged
69	Related party transactions - cash and accrual basis taxpayer	Unchanged
70	Temporary difference between accounting income and taxable income	Unchanged
71	Temporary difference between accounting income and taxable income	Unchanged
72-IID	Effect of certain expenses on AGI for self-employed taxpayer versus employee	Unchanged
73-IID	Deductibility of duplex expenses	Unchanged
74-IID	Reasonableness of salary expense - related party	Unchanged
75-IID	Current expenditure versus capital expenditure	Unchanged
76-IID	Determining if an expense should be capitalized or expensed	Unchanged
77-IID	Start-up costs	Unchanged
78-IID	Lobbying expenses	Unchanged
79-IID	Hobby versus trade or business	Unchanged
80-IID	Prepaid interest	Unchanged
81-IID	Economic performance test – progressive jackpot	Unchanged
82	RIA Tax Research Exercise	Unchanged
83	RIA Tax Research Exercise	Unchanged
84	TAX SIMULATION	Unchanged
85	INTERNET	Unchanged
86	INTERNET	Unchanged
87	Research Problem	Unchanged
88	Research Problem	Unchanged
89	Spreadsheet Problem	Unchanged

2017 Edition	Topic	Status
90	Tax Form Problem	Unchanged
91-ITRP	Integrative Tax Return Problem	Unchanged
92-C	Comprehensive Problem	Unchanged
93-DC	Capitalization versus current deduction for asbestos costs	Unchanged
94-DC	Comparing Vacation home versus rental use	Unchanged
95-DC	Determining whether an activity is a hobby or a business	Unchanged
96-TPC-CT	Impact on taxable income of changing between taxable and nontaxable investments	Unchanged
97-TPC-COMM	Determining the tax consequences between whether an activity is a hobby or a trade or business	Unchanged
98DC-CT	Deductibility of lobbying expenses - focuses on SSTS #1	Unchanged

CHAPTER 5

INTRODUCTION TO BUSINESS EXPENSES

DISCUSSION QUESTIONS

1. All allowable deductions of individual taxpayers are classified as either for adjusted gross income or from adjusted gross income. Why are deductions for adjusted gross income usually more advantageous than deductions from adjusted gross income?

Although both types of deductions reduce taxable income, deductions for adjusted gross income are always deductible. Taxpayers who incur allowable deductions from adjusted gross income may not receive the full advantage of the deduction. First, even though an allowable expense may be incurred, if the taxpayer's total itemized deductions do not exceed the standard deduction amount, then the taxpayer will deduct the standard deduction and receive no benefit from the allowable expenses. Second, many of the deductions are subject to limitations based on the taxpayer's adjusted gross income. For example, generally the deduction for medical expenses is reduced by 10% of the taxpayer's adjusted gross income. Thus, many of the allowable deductions from adjusted gross income are not deductible in full. In addition, total itemized deductions are subject to a reduction rule when the taxpayer's adjusted gross income exceeds a specified amount, further lowering the value of such deductions. Lastly, given the reductions based on adjusted gross income, any deductions for adjusted gross income have the effect of making the allowable deductions from adjusted gross income larger.

2. Why does the computation of adjusted gross income apply only to individual taxpayers and not to other tax entities such as corporations?

Individuals are allowed to deduct certain personal expenditures in computing their taxable income (e.g., medical expenses, home mortgage interest) that are not deductible under the general rules for deductions. In allowing these deductions, Congress separated them from individual deductions that have a business purpose and provided a minimum deduction that all taxpayers can deduct for personal expenditures (the standard deduction). Therefore, the personal nature of the deductions causes the split nature of individual deductions, requiring the intermediate computation of adjusted gross income. In contrast, corporations are separate legal entities formed for a business purpose. Therefore, all of their expenditures qualify for deduction under the general rules. Corporations make no personal expenditures, so there is no need to segregate their deductions.

3. What is the fundamental requirement that must be satisfied to deduct a business expense?

The *dominant motive* for incurring the expense must be to earn an economic benefit that is independent of any tax savings. Thus, the business purpose of the transaction must be a profit motive other than tax avoidance.

4. What are the two primary categories of business expense? Why is it necessary to classify business expenses in these two categories?

The two categories of business expense are:

- Trade or business expenses, and
- Expenses for the production of income (investment expenses).

All expenses must be classified into one of the categories to determine the proper reporting and limitations on the deduction of the expenses. A trade or business expense is fully deductible in calculating adjusted gross income of an individual. An expense for the production of income is usually subtracted from adjusted gross income as an itemized deduction. As an itemized deduction, the expense may be limited based on the taxpayer's adjusted gross income. Also, the taxpayer will only receive a benefit from a production of income expense if the taxpayer itemizes his/her deductions.

5. Why must a conduit entity report certain deductions separately?

Unlike a corporation, a conduit entity (partnership or S corporation) is not a separate taxable entity. The income and deductions from the conduit entity flow through to each owner. Separately reporting certain deductions preserves the tax treatment for the expenditure and assures that the expenditure receives the same tax treatment as if it was actually incurred by the taxpayer. For example, investment expenses are classified as miscellaneous itemized deductions and must be reduced by 2% of adjusted gross income. If investment expenses are included in determining the entity's ordinary taxable income, an individual would receive a greater deduction (the full amount) from the expenditure. The following deductions must be separately stated: charitable contributions, investment interest expense, investment expenses, Section 179 expense, and nondeductible expenses.

6. What is the effect on a partner's individual tax return if a partnership does not report separately the partner's pro rata share of investment expenses and instead includes these expenses in determining the partnership's ordinary taxable income?

The effect of not separately reporting investment expenses is to understate the individual's taxable income. For example, assume that Helen is a 50% partner in a partnership that has income net of deductions of \$10,000 (\$40,000 income - \$30,000 deductions), \$2,000 of which is for investment expenses. By including the investment expenses in computing ordinary taxable income, Helen's share of the partnership's ordinary taxable income is \$5,000 ($\$10,000 \times 50\%$). However, if the investment expenses are separately stated, the ordinary taxable income is \$12,000 [$\$40,000 - (\$30,000 - \$2,000)$] and Helen's share is \$6,000 ($\$12,000 \times 50\%$). As a 50% partner, Helen's share of the investment expense is \$1,000. If Helen's other itemized deductions are only \$2,000 then she would not receive any benefit from the investment expenses because her standard deduction would exceed her itemized deductions [$\$5,000 > (\$2,000 + \$1,000)$]. Therefore, Helen's taxable income increases by \$1,000 (\$6,000 versus \$5,000) because the investment expenses are reported separately. Instructor's Note: The purpose of the question is to illustrate the impact separately reporting items can have on a taxpayer's taxable income. At this stage of the course students do not know that investment expenses are reduced by 2% of adjusted gross income (see Chapter 8).

7. The rules for deducting business expenses assure that virtually all expenses related to a trade or business or a production of income activity are deductible at some time during the life of the activity. However, few personal expenditures are deductible. Why is there such a difference in treatment of the expenses?

Allowing individuals to deduct most of their individual living expenses would be an administrative nightmare. Individuals would have to document their expenses and the government would have to spend more time and effort ensuring that the expenses were valid. In addition, individuals with expensive life styles would receive proportionately more deductions than those who tend to save.

The tax law takes into account the fact that not all of the income earned by an individual is available for the payment of taxes by allowing certain personal expenditures as deductions from adjusted gross income. For those taxpayers that incur minimum amounts of the allowable expenditures, a minimum deduction for personal expenditures, called the standard deduction, is allowed. In addition, taxpayers are allowed to deduct exemption amounts for themselves and for other individuals that are dependent on them for support. These deductions are discussed in Chapter 8.

8. Discuss how well the rules for deducting expenses implement the ability-to-pay concept.

The deduction of expenses implements the ability-to-pay concept by allowing taxpayers with differing levels of expenses to pay a tax based on their net income. However, the rules for deducting expenses do create a bias toward a trade or business, which is allowed to deduct all ordinary, necessary, and reasonable expenses. The ordinary, necessary, and reasonable expenses related to the production of income are also deductible. However, such expenses (other than those related to rentals and royalties) are deductible from adjusted gross income for individuals. Therefore, individuals must itemize their deductions to be able to deduct their investment related expenses. Further, the expenses are generally deductible as miscellaneous itemized deductions which are subject to a 2% of adjusted gross income limitation. This reduces the deduction for such expenses and may cause individuals to pay more tax on their investment income than would be paid on comparable trade or business income. Only certain personal expenditures may be deducted. These expenses are allowed only as deductions from adjusted gross income and therefore, are deductible only if they exceed the standard deduction. In addition, many of the allowable deductions are subject to a limit based on the taxpayer's adjusted gross income. This has the effect of allowing more deductions for lower income taxpayers than for higher income taxpayers, thus enhancing the ability-to-pay concept. However, the restrictiveness of the allowable personal deductions puts them at a disadvantage relative to trade or business and production of income deductions.

9. How are mixed-use expenditures and expenses related to mixed-use assets treated for tax reporting?

A mixed-use expense must be analyzed to determine the portion of the expense that is allowed as a deduction. Only that portion of the expense that has a business purpose (or is an allowable personal expense) is deductible. This requires determination of the deductible business expense using a reasonable allocation method. The expense allocated to personal use is not deductible unless it qualifies as a specifically allowed itemized deduction.

10. What is the difference between a trade or business and a production of income activity and why is it important to distinguish a trade or business activity from a production of income activity?

The term trade or business has not been adequately defined in the Internal Revenue Code or the Treasury regulations. Whether an activity is a trade or business is determined on a case by case basis by examining the facts related to the activity.

The Supreme Court has indicated that the following factors are important in classifying an activity as a trade or business:

- 1. The primary purpose of the activity must be to earn a profit,**
- 2. There must be regularity and continuity in the taxpayer's involvement in the activity, and**
- 3. The activity must be engaged in to earn a livelihood and not as a hobby or for amusement.**

As a practical matter, selling goods and services will be viewed as a trade or business. In addition, an employee will normally be considered engaged in a trade or business. Generally, an investor in securities is not deemed to be in a trade or business regardless of the level of investment activity.

An activity will be considered to be for the production of income if it is profit motivated (i.e., it has a business purpose) but fails to satisfy the more rigorous trade or business tests. Thus, lack of regularity and continuity by the taxpayer in the activity can result in classification of an activity as being for the production of income. Also, involvement in an activity for profit but not to provide the taxpayer's livelihood can result in production of income classification.

All of the ordinary, necessary, and reasonable expenses of a trade or business and a production of income activity are deductible. However, trade or business expenses of individuals are deductible for adjusted gross income, while production of income expenses are deductible from adjusted gross income usually as miscellaneous itemized deductions. To deduct production of income expenses, an individual must itemize deductions, while trade or business expenses are always deductible in full. Trade or business expenses are not subject to any income limitation, while the deductible portion of production of income expenses is limited to the amount in excess of 2% of adjusted gross income. Because trade or business expenses reduce adjusted gross income, any itemized deductions that are subject to a limit based on adjusted gross income are increased as a result of deducting the business expenses, while production of income expense deductions have no effect on the amount of other allowable deductions.

11. What requirements must be met to deduct a trade or business expense? an expense related to the production of income?

In addition to having a profit motivated business purpose, several tests must be satisfied for an expenditure to be currently deductible as a trade or business expense or as an expense related to the production of income. The expense must be:

1. Ordinary,
2. Necessary,
3. Reasonable in amount,
4. Related to earning income and not a personal expense, and
5. For the taxpayer's benefit.

The expense may not be:

1. A personal expense,
2. Capital in nature,
3. A violation of public policy, or
4. Related to earning tax-free income.

12. When are capital expenditures deductible?

A capital expenditure is any expenditure in which the usefulness of the expenditure extends *substantially beyond* the end of the current tax year. As such, a capital expenditure must be capitalized and allocated to the periods benefited by the expenditure using an acceptable accounting method (i.e., amortization or depreciation). Depreciation is discussed in Chapter 10.

13. How do you distinguish a currently deductible expenditure from a capital expenditure? Give examples of each type of expenditure.

Determining whether an expenditure is a current expense versus a capital expenditure requires an analysis of the period benefited from the expenditure. If the expenditure benefits only the current period, it is deducted as a current period expense. Capital expenditures have a benefit that extends substantially beyond the end of the year in which the expenditure is made. Examples of current period expenses include salaries, utilities, taxes, interest, supplies, repairs, and maintenance costs. Capital expenditures include all long-lived asset purchases such as buildings, cars, machinery, equipment, furniture, land, and prepaid expenses.

14. Why are start-up costs related to the investigation of a business opportunity treated differently depending on the current trade or business of the taxpayer?

The difference in treatment stems from the business purpose of the expenditure and whether the expenditure is considered ordinary, necessary, and reasonable. When investigating the purchase of a business that is in the same trade or business that the taxpayer is currently engaged, the purpose is directly related to the taxpayer's trade or business. In addition, such investigation is considered ordinary, necessary, and reasonable (i.e., all businesses look toward expansion). Therefore, the costs associated with the investigation are currently deductible expenses.

When a taxpayer investigates the purchase of a business that is unrelated to their current trade or business, the business purpose of the expenditure is not related to their current trade or business. In addition, the courts have held that such expansion is not ordinary. Therefore, the costs are capital in nature. If the investigation does not result in the purchase of the business, the costs are considered to be personal (no business purpose has ever been established) and nondeductible. If the investigation results in the purchase of the business, a taxpayer who incurs less than \$50,000 of start-up costs can deduct up to \$5,000 of the start-up costs in the year the new business is started. Any amount in excess of \$5,000 must be amortized over 180 months. For taxpayers, with start-up costs in excess of \$50,000, the \$5,000 amount is phased-out on a dollar-by-dollar basis. Therefore, the deduction for start-up costs can be viewed as consisting of two parts. The first is a \$5,000 current deduction and a second part that amortizes the remaining start-up costs over 180 months.

15. Explain the rationale for not allowing a deduction for political and lobbying expenditures.

The conceptual reason for denying deductions for political contributions and lobbying expenses is that such expenses are not ordinary and necessary to a taxpayer's trade or business. In upholding the denial of a deduction for political contributions, the courts have maintained that the money had an "insidious influence" on politics and that the tax system should not promote expenditures that encourage the frustration of public policy. The rationale for disallowing lobbying expenses is to remove the tax incentive associated with a taxpayer's attempt to influence legislation. Note: A taxpayer who incurs a de minimus amount of lobbying expenses (up to \$2,000) is permitted to deduct the lobbying expenses.

16. Explain why the income tax concepts support a deduction for some of the expenses of an illegal business.

Under the all-inclusive income concept, all income received is taxable unless otherwise excluded. Thus, income from illegal activities is subject to tax. The ability-to-pay concept requires the tax to be an amount that the taxpayer can afford to pay. Therefore, unless Congress legislatively disallows a deduction for an expenditure(s) associated with an illegal activity, as they have for expenses incurred in the trade or business of illegal drugs, the expenditure is deductible.

17. Why are expenses related to the production of tax-exempt income not deductible?

Because the income is not subject to tax, no deduction is necessary to insure that the taxpayer has the ability-to-pay the tax. To allow a deduction for expenses related to tax-exempt income would create a situation in which an investment in tax-exempt income producing activities would lower the tax paid on taxable forms of income. This would create a double tax break for investments that produce tax-exempt income.

18. Explain the rationale for the treatment of deductions related to hobbies, vacation homes, and home offices.

Hobbies, vacation homes, and home offices all produce income that is taxable under the all-inclusive income concept. The ability-to-pay concept specifies that the cost of producing the income should be deductible. However, because hobbies, home offices, and vacation homes all involve a significant personal element, the amount of the allowable deductions is limited to the income generated.

19. What is/are the requirement(s) for determining whether a residence used for personal purposes is a vacation home or a true rental property?

A mechanical test based on the number of days of personal use of the property is used to determine whether the property is a vacation home or a true rental property. In order to qualify as a true rental property, the taxpayer's personal use of the property cannot exceed the greater of 1) 14 days, or 2) 10% of rental days. If personal use exceeds this amount, the property is a vacation home.

20. Under what circumstances can a taxpayer deduct the costs of a home office?

To deduct the cost of a home office, the office must be used regularly and exclusively as either the taxpayer's principal place of business or as a place for meeting customers or clients. Employees can only deduct home office expenses if the use of the office is "for the convenience of the employer." In most cases, employee use of a home office is for the employee's convenience, not the employer's. Therefore, situations in which an employee can deduct home office costs are relatively rare.

In addition, a taxpayer that uses a home office to conduct substantial administrative or management activities and has no other fixed location to conduct these activities is allowed to deduct the cost of a home office. The taxpayer still must use the home office exclusively and on a regular basis in carrying on a trade or business.

21. What is/are the criterion (criteria) for the deduction of an expense by a cash basis taxpayer?

Cash basis taxpayers are allowed to take a deduction in the year in which the expense is paid. However, even cash basis taxpayers cannot take current deductions for the full amount of current period capital expenditures.

22. What constitutes the payment of an expense by a cash basis taxpayer?

An expense can be paid with any cash-equivalent. Therefore, the strict payment of cash is not necessary to fix the year of deduction. If an expense is paid with property, the payment is made when title to the property passes. Expenses paid with services are deductible when the service is performed.

23. What are the criteria for the current deduction of a prepaid expense by a cash basis taxpayer?

To deduct a prepaid expense, the benefit of the payment must not extend substantially beyond the end of the tax year. This is interpreted to mean that the pre-payment was required and the benefit of the expense must be used or consumed before the end of the tax year following the year of payment (the one-year rule). There are exceptions to this rule - for example, prepaid taxes are always deductible in the year of payment, while prepaid interest (other than points paid to acquire a home mortgage) is never deductible under the one-year rule. The deduction for home mortgage points is discussed in Chapter 8.

24. What tests must be met for an accrual basis taxpayer to deduct an expense?

An accrual basis taxpayer deducts expenses when the all-events test and the economic performance tests are satisfied. The all-events test requires that all events have occurred that determine the fact that a liability exists and the amount of the liability must be known with reasonable accuracy. This last requirement generally requires that the payee of the expense be known in addition to the amount of the liability.

The economic performance test requires that economic performance with regard to the liability must have occurred. This generally means that services or property related to the liability have either been received or used by the taxpayer.

25. What is the general purpose of the economic performance test?

The purpose of the test is to disallow current deductions for costs that will not be paid in the near future. Thus, estimates of future contingent liabilities (e.g., estimated warranty costs) cannot be deducted until economic performance on the liability occurs.

PROBLEMS

26. Alexandra is a veterinarian employed by Fast Vet Services. Susan is a self-employed veterinarian. During the current year, Alexandra and Susan have the same amounts of income and deductions. Why might a deductible expense paid by Susan affect her taxable income differently from the payment of the same expense by Alexandra?

Because Susan is self-employed, her vet practice constitutes a trade or business. Therefore, all of her veterinary expenses are deductible for adjusted gross income. As an employee, Alexandra is also considered to be in a trade or business. However, the unreimbursed expenses of an employee are deducted as miscellaneous itemized deductions. Thus, Susan always gets the full benefit of the deduction, while Alexandra only benefits if she itemizes her deductions and then only to the extent that her unreimbursed business expenses exceed 2% of her adjusted gross income.

27. Discuss how an individual would deduct each of the following expenditures. If more than one treatment is possible, discuss the circumstances under which each type of deduction would be obtained:

- a. Amos purchased 500 shares of Lietzke stock for \$50 per share. He also paid \$1,200 in commissions on the purchase.

Commissions paid are part of the cost of acquiring the stock and must be added to the basis of the stock. Because stock does not have a definite life, capital recovery does not occur until Amos disposes of the stock.

- b. Dandy owns an optical store. She paid \$2,000 in medical insurance premiums on her employees and \$1,400 on a medical policy covering herself and her family.

The \$2,000 of premiums paid on employees' insurance is deductible as an ordinary and necessary business expense (for adjusted gross income). If Dandy owns the store as a sole proprietor, she is not an employee of the store and cannot deduct the \$1,400 as a business expense (just as an employee could not deduct the cost of personal medical insurance as a business expense). As a self-employed individual, Dandy can deduct all of the cost of her policy for adjusted gross income (see Chapter 6).

- c. Oscar is a finance professor at State University. He purchased professional journals costing \$400 which he uses to keep current on the latest developments in finance.

Oscar is considered to be in a trade or business and the journals are related to his trade or business. However, employees are only allowed to deduct expenses related to their employment as miscellaneous itemized deductions, which are subject to a 2% of adjusted gross income limitation (see Chapter 8).

- d. Gerry is a nurse. He paid \$350 for nursing uniforms.

Gerry is considered to be in a trade or business and special clothing required in a trade or business is deductible. If he is an employee of a hospital or doctor, he will only be allowed to deduct the cost of the uniforms as a miscellaneous itemized deduction (which is subject to a 2% of adjusted gross income limitation). However, if he is self-employed, the cost of the nursing uniforms would be deducted for adjusted gross income.

- e. Edgar owns a rental property. His rental income for the year was \$13,000, and his allowable expenses were \$9,000.

Rental expenses are always deductible for adjusted gross income without regard to whether the rental activity is a trade or business or a production of income activity. As a practical matter, the expenses are netted against the income from the rental and the net amount is reported on the tax return. In this case, \$4,000 (\$13,000 - \$9,000) would be included in gross income.

28. Determine how each of the following expenses would be deducted for tax purposes. If the expense is not deductible, explain why not.

- a. Chander paid \$500 in interest on a loan he used to purchase equipment for his retail business.

The interest is related to a trade or business and is fully deductible. If the business is a sole proprietorship, it will be a deduction for adjusted gross income.

- b. Peter paid \$500 in interest on a loan he used to purchase 1,000 shares of Pickled Pepper stock.

The interest is related to an investment. Investment interest expense is deductible as an itemized deduction. It is limited to the amount of the taxpayer's net investment income (see Chapter 8).

- c. Portia paid \$500 in interest on a loan she used to purchase her personal automobile.

The interest is related to a personal use asset and is not deductible.

- d. Jordan's primary source of income is his wholesale warehousing business. During the current year, he paid \$8,000 in state income taxes.

State income taxes are a personal expense that is allowed as an itemized deduction.

- e. Alphonse is a professional golfer who likes to race cars in his spare time. He spent \$60,000 on expenses related to racing cars during the current year.

The expenses are not related to his trade or business as a golfer. To determine the proper treatment of the expense, it would have to be determined whether Alphonse's involvement in the race car business meets the criteria for a trade or business. Based on the facts as given, it would appear that the activity has a significant pleasure element that would disqualify the activity as a trade or business. If so, it would most likely be a hobby. Hobby deductions are limited to hobby income and are only deductible as miscellaneous itemized deductions.

- f. Barry is an insurance agent. He bought a golf cart and had his insurance company logo put on the golf cart to attract customers while he played golf.

The cost of the golf cart would not be a deductible business expense since it is not used in Barry's trade or business. The cost of the logo is a form of advertising that is deductible as a business expense.

29. Andy, Azim, and Ashwin operate the Triple-A Steak House, a popular restaurant and bar. The three, who have been friends since childhood, are equal partners in the establishment. For the year, Triple-A reports the following:

Sales revenues	\$ 800,000
Short-term capital gains	24,000
Short-term capital losses	(12,000)
Business expenses	(560,000)
Investment expenses	(6,000)
Taxable income	<u>\$ 246,000</u>

How must the Triple-A Steak House report its results to each partner for tax purposes?

Because capital gains and losses and investment expenses are subject to special rules, these items cannot be used to calculate the partnership's ordinary taxable income. Instead, these items must be reported separately by the partnership. The short-term capital gains and losses are reported separately and netted with the partners' other capital gains and losses. The investment expenses are treated as miscellaneous itemized deductions and must be reduced by 2% of adjusted gross income on the partner's returns.

The ordinary taxable income of the partnership is \$240,000 (\$800,000 sales - \$560,000 trade and business expenses). Since Andy, Azim, and Ashwin are equal partners, the Triple-A partnership would report the following amounts to each partner:

Taxable ordinary income	$(\$ 240,000 \div 3)$	\$ 80,000
Short-term capital gain	$(\$24,000 \div 3)$	8,000
Short-term capital loss	$(\$12,000 \div 3)$	(4,000)
Investment expenses	$(\$ 6,000 \div 3)$	(2,000)

30. Manuel and Fernando own and operate an electronics store, Electronica, as an S corporation. Manuel owns 70%, and Fernando owns 30%. For the current year, the store reports the following:

Sales revenue	\$1,000,000
Long-term capital gains	8,000
Business expenses	(840,000)
Charitable contributions	(9,000)
Non-deductible expenses	(4,000)
Short-term capital losses	(15,000)
Operating income	<u>\$ 140,000</u>

- a. How must Electronica report its results to Manuel and Fernando for tax purposes?

Because capital gains and losses and charitable contributions are subject to special rules, these items cannot be used to calculate the corporation's ordinary taxable income. Instead, these items must be reported separately by the S corporation. Also, as their name suggests, non-deductible expenses cannot be used to determine taxable income. However, the expenses must be disclosed because these expenses affect the shareholders basis in the entity. The long-term capital gains and the short-term capital losses are reported separately and netted with the shareholder's other capital gains and losses. The charitable contributions are separately reported because these expenses deductible as itemized deductions.

The ordinary taxable income of the S corporation is \$160,000 (\$1,000,000 sales - \$840,000 trade and business expenses). The taxable ordinary income and the separately reported information are allocated to Manuel and Fernando based on their percentage of ownership. Electronica would report the following amounts to Manuel and Fernando:

	100% Total	70% Manuel	30% Fernando
Taxable ordinary income	\$ 160,000	\$112,000	\$ 48,000
Long-term capital gain	8,000	5,600	2,400
Short-term capital loss	(15,000)	(10,500)	(4,500)
Charitable contributions	(9,000)	(6,300)	(2,700)
Non-deductible expenses	(4,000)	(2,800)	(1,200)

- b. In addition to the income and deductions from Electronica, Manuel has interest and dividend income of \$3,500, long-term capital gains of \$1,500, and other itemized deductions of \$14,500. He is married and has two children. What is his taxable income?

Because Electronica is an S corporation, Manuel must report his pro rata share of its ordinary taxable income. In addition, he must include the items separately reported to him. Manuel's adjusted gross income is \$112,500 (\$112,000 + \$3,500 - \$3,000). He has a net short-term capital loss of \$3,400 (see below). However, only \$3,000 of the loss can be deducted in the current year. The remaining \$400 (\$3,400 - \$3,000) is carried forward to the following year. His adjusted gross income is reduced by his itemized deductions of \$20,800. The charitable contribution of \$6,300 from Electronica is added to his other itemized deductions of \$14,500. His personal and dependency exemptions of \$16,200 (\$4,050 x 4) reduce his taxable income to \$75,500.

Income from Electronica		\$ 112,000
Interest and dividends		3,500
Capital loss		<u>(3,000)</u>
Adjusted gross income		\$ 112,500
Itemized deductions:		
Charitable contributions	\$ 6,300	
Other deductions	<u>14,500</u>	(20,800)
Exemptions (4 x \$4,050)		<u>(16,200)</u>
Taxable income		<u>\$ 75,500</u>

Capital Gain and Loss Netting:

Short-term capital loss		\$ (10,500)
Long-term capital gain (Electronica)	\$5,600	
Long-term capital gain	<u>1,500</u>	
Total long-term capital gain		<u>\$ 7,100</u>
Net short-term capital loss		\$ (3,400)
Capital loss deduction		<u>3,000</u>
Short-term capital loss carryforward		<u>\$ 400</u>

31. Fernando is a retired auto mechanic. Since retiring four years ago, he has made stained glass windows. Because he has only occasional sales, Fernando treats this activity as a hobby. A friend of Fernando's recommends him to a local merchant who is renovating her office and needs someone to make and install 15 new windows. The job takes Fernando a month to complete, and he is paid \$3,000. In preparing his tax return, Fernando is unsure whether the \$3,000 is subject to self-employment tax. The instructions accompanying his federal income tax return indicate that a payment is subject to self-employment tax only if an individual is engaged in a trade or business. Write a letter to Fernando explaining whether he is engaged in a trade or business.

Whether a taxpayer is engaged in a trade or business is determined on a case by case basis by examining the facts related to the activity. The Supreme Court has indicated that the following factors are important in classifying an activity as a trade or business:

- 1. The primary purpose of the activity must be to earn a profit,**
- 2. There must be regularity and continuity in the taxpayer's involvement in the activity, and**
- 3. The activity must be engaged in to earn a livelihood and not as a hobby or for amusement.**

Applying the criteria established by the Supreme Court to this situation, one could reasonably assume that Fernando's primary purpose in taking the job is to make a profit (i.e., earn additional income). However, the facts also indicate that Fernando does not engage in this activity on a regular or continuous basis and therefore, he does not meet the second factor. In addition, because Fernando is retired and his primary activity is making stained glass windows (which he considers a hobby), it also is difficult to assert that this one-time project is necessary for him to earn a livelihood. Overall, it appears that Fernando fails to meet the factors necessary for him to be considered engaged in a trade or business. Therefore, the \$3,000 payment he received for installing the windows would not be subject to self-employment tax.

INSTRUCTORS NOTE: This problem was adopted from *Batok*, TCM 1992-727, where, on similar facts, the court concluded that the taxpayer's one-time job did not rise to the level of a trade or business.

32. Max owns an office building that he rents for \$750 a month. Under the terms of the lease, the tenant is responsible for paying all property taxes and costs related to the building's operation and maintenance. The only cost to Max in relation to the lease is an annual legal fee for renewing the lease. Is Max engaged in the trade or business of renting real estate? How would you classify his deduction for the attorney's fee?

The IRS historically viewed the rental of a single piece of improved real estate as a trade or business. If the IRS continues this position, the attorney fees are a deductible business expense.

However, the IRS has indicated that rental property must produce active income to be considered a trade or business. In determining whether rents are active business income, the scope of the lessor's ownership and management activities are important considerations. If the IRS continues this position, the attorney fees are expenses related to the production of income because Sam is not actively involved the operation of the rental activity.

Regardless of classification, expenses related to earning rental income are deductible for adjusted gross income.

33. Don was a senior vice president of a bank until its officials found he had embezzled more than \$1,000,000. Don had set up fictitious checking accounts and deposited the funds into the accounts. He then created fictitious loans to himself. The embezzled money was used for personal purposes and to keep the fictitious loan payments current. Thus, he created fictitious loans to make payments on prior fictitious loans. Don worked hard to keep the loans current so he would not be detected. Because of a tax audit, he is seeking your advice. If his embezzlement activity is a trade or business, he claims he should be able to deduct as an ordinary and necessary expense the payments on the loans to keep his actions secret. What advice would you give Don concerning his business and deductions? Explain.

The Courts have consistently held that embezzlement is not a trade or business because of public policy concerns (See *D.P. Flynn*, TC Memo 1981- 491). Employers have a right to expect integrity and honor from the people they hire.

The payments Don made on the loans are not deductible as a business expense based on the following:

- 1. The loan payments are not normal, customary, or usual in the banking business. The payments fail the ordinary and necessary tests.**
- 2. The loan repayments are on valid bank loans and were not restitution payments to the victim of embezzlement.**
- 3. Because the embezzled funds were not reported as income by a cash basis taxpayer, a deduction for repayment is not allowed.**

34. Hamid owns and lives in a duplex. He rents the other unit to an unrelated married couple for \$850 per month. During the current year, he incurs the following expenses related to the duplex:

Mortgage interest		\$ 7,500
Property taxes		1,100
Utilities		1,450
Repairs		
Paint exterior of duplex	\$2,200	
Fix plumbing in rental unit	320	
Shampoo carpet in both units	290	
Fix dishwasher in Hamid's unit	<u>120</u>	2,930
Homeowner's association fee		480
Insurance		800
Special property tax assessment to pave sidewalks		3,100
Depreciation (both units)		4,200

How should Hamid treat the expenditures related to the duplex? Explain.

Because the duplex is used for both a business purpose and a personal purpose, the costs must be allocated between the two units. Assuming that the two units are of equal size, 1/2 of each of the common costs are allocated to each unit. The repair to the dishwasher is not deductible because it involved Hamid's unit. The amounts expended for personal purposes are generally not deductible. However, Hamid can deduct the personal portion of the mortgage interest and property taxes as an itemized deduction. Painting the exterior of the duplex is a maintenance expense because it does not extend the useful life of the duplex. As with the other joint expenses, only the portion attributable to the duplex is deductible. The special property tax assessment is not a deductible tax and must be added to the basis of the land.

Rent income (\$850 x 12)		\$ 10,200
Deductions for adjusted gross income:		
Mortgage interest (\$7,500 x 1/2)	\$ 3,750	
Property taxes (\$1,100 x 1/2)	550	
Utilities (\$1,450 x 1/2)	725	
Shampoo carpeting (\$290 x 1/2)	145	
Repair plumbing	320	
Homeowner's association fee (\$480 x 1/2)	240	
Insurance (\$800 x 1/2)	400	
Painting exterior (\$2,200 x 1/2)	1,100	
Depreciation (\$4,200 x 1/2)	<u>2,100</u>	(9,330)
Net rental income		<u>\$ 870</u>

Itemized Deductions:

Mortgage interest	\$ 3,750
Property tax	550

35. In 2016, RayeAnn acquires a car for \$14,000. She uses the car in her advertising business and for personal purposes. Her records indicate the car is used 70% for business and that the total operating expenses, including depreciation, are \$3,800.

- a. How should RayeAnn treat the operating costs of the car for tax purposes?

The car is considered a mixed-use asset. The expenses associated with a mixed-use asset must be allocated between the business portion and the personal portion. In this case, 70% of RayeAnn's expenses are treated as a business expense. She can deduct \$2,660 ($\$3,800 \times 70\%$) of the cost of operating the car. The remaining \$1,140 is a personal expense and is not deductible.

- b. In 2018, RayeAnn sells the car for \$6,500. Her business use for 2016 through 2018 remains at 70%, and she properly deducted \$5,880 in depreciation. What is her taxable gain or loss from the sale of the car?

RayeAnn must treat the sale of the car as the sale of two assets - a business asset and a personal asset. The \$6,500 sales price and the \$14,000 purchase price is allocated between her business and personal use:

	<u>Business</u>	<u>Personal</u>
Selling price - $\$6,500 \times 70\%$	<u>\$ 4,550</u>	
- $\$6,500 \times 30\%$		\$ 1,950
Less: Adjusted basis		
Original cost - $\$14,000 \times 70\%$	\$ 9,800	
- $\$14,000 \times 30\%$		\$ 4,200
Less: Depreciation	<u>(5,880)</u>	<u>(3,920)</u>
Gain (loss) on sale	<u>\$ 630</u>	<u>\$(2,250)</u>

The gain on the sale of the business portion of the asset is considered a Section 1231 gain (discussed in Chapter 11). The loss on the personal portion of the asset is a nondeductible personal use loss.

36. Big Star Auto regularly advertises on local television. Carla, the owner of Big Star pays her 6-year-old grandson \$250 for each commercial in which he appears for Big Star. During the current year, the grandson appeared in 100 commercials. Big Star wants to deduct the full \$25,000 as a business expense. The grandson will report the \$25,000 as income. Write a letter to Carla explaining whether Big Star can deduct the advertising fee paid to her grandson.

Advertising expense qualifies as an ordinary and necessary business expense of a car dealer. However, the transactions between Big Star and the grandson are subject to special scrutiny because they are related parties.

Was the transaction between Big Star and the owner's grandson negotiated at arm's-length and in fact, a payment for grandson's services? If the fee was not actually paid for the grandson's services, the expense is not deductible.

Was the payment reasonable in amount? If the payment was not reasonable in amount, it will also fail the ordinary and necessary tests. As a result, only the part of the fee that is determined to be reasonable will be allowed as a deduction. The reasonableness of the payments is determined by comparing the fees paid to other actors appearing in similar commercials.

37. Discuss whether the following expenditures meet the ordinary, necessary, and reasonable requirements.

- a. Sadie owns 5 shares of Megaconglomerate stock. She spent \$4,000 to attend the annual shareholders' meeting.

The expenditure of \$4,000 to attend the shareholders' meeting would not be considered ordinary, nor would it be reasonable. It would not be ordinary because a prudent business person in the same situation would not make such a large expenditure on such a small investment. In addition, it is likely that the \$4,000 cost is greater than the amount invested, making it an unreasonable amount.

- b. Sam runs a successful medical practice. Because he has a substantial investment portfolio, he spent \$3,000 to attend a seminar on investing strategies.

The expenditure meets the ordinary, necessary, and reasonable test if Sam's investment portfolio is large in relation to the expenditure. However, the costs of attending seminars are deductible only if they are related to the trade or business of the taxpayer (discussed in Chapter 6).

- c. Alana is a self-employed tax attorney. She spent \$3,000 to attend the American Institute of Certified Public Accountants' annual conference on income tax developments.

The cost of attending the seminar would meet the ordinary, necessary, and reasonable tests. The purpose of the expenditure is directly related to Alana's trade or business as a tax attorney and would be a deductible education expense.

- d. Kevin owns a large ranching operation. He is deeply religious and feels it is important that his employees have access to religious counseling. He hired an ordained minister to live on the ranch and be available to counsel his employees on any religious problems they might have.

The expenditure would not be considered ordinary because it is not a common business practice in the ranching business. The necessity of the expenditure is also questionable because it does not directly benefit Kevin's business. The primary benefit is personal - Kevin gets the satisfaction of having a minister available for himself and his employees.

38. Discuss whether the following expenditures meet the ordinary, necessary, and reasonable requirements:

- a. The Brisbane Corporation is being sued in connection with allegations that it produced a faulty product. Brisbane has hired an expert witness to testify that the product was not faulty. The expert's standard fee is \$200 per day plus expenses. Brisbane has agreed to pay her standard fee plus expenses and a bonus of \$5,000 if the company wins the lawsuit.

Assuming the expenses are not lavish, the standard fee and the expenses paid to the expert witness are deductible business expenses because the expenses are considered ordinary, necessary and reasonable expenses in conducting a business. Business product liability suits are filed against corporations every day. However, the bonus paid to the expert witness is not deductible because the expense is not considered ordinary. The expense is not a common and accepted means of defense in litigation.

- b. Shannon is a professor who teaches film study at Burwood College. Her annual salary is \$45,000. She maintains an extensive library of films and books at her home. During the year, she spends \$15,000 on new material for her library. Most of the material is available at the university library.

Although the expenditure of \$15,000 for new material for her library is an employment related expense and might be considered a necessary or reasonable business expense the amount she spent is not reasonable. The expense would fail the reasonable requirement because the amount of the expenditure is excessive relative to her salary as a professor.

- c. Francis operates a video store and rents the building from his aunt Shirley who acquired it last year. He paid the previous owner \$600 a month in rent. When Francis's lease expires, his aunt increases the rent to \$750. Rent for a comparable building in the area is \$850.

The rent expense meets the ordinary, necessary, and reasonable requirements. The purpose of the expenditure is directly related to Francis' trade or business and would be a deductible business expense. Instructor's Note: The lower than fair market rent charged by Francis' aunt does not create a tax problem because Francis and his aunt are not considered related parties.

- d. Max owns a dairy farm in Wisconsin. During the year, he makes 10 phone calls to his sister Ruby, who is an accountant. The calls, which total \$150, are for financial and business advice. Ruby prepares Max's business and personal tax returns.

As long as the cost of the phone calls is reasonable, the \$150 phone expense would be considered an ordinary and necessary business expense directly related to Max's trade or business as a dairy farmer. Note: This is based on Lewis ¶89,078 PH Memo TC (aff'd by unpublished opinion, 6th Cir. 3-14-91), where, on similar facts, the court found in favor of the taxpayer. It should be mentioned that the IRS will always scrutinize related party transactions, especially those expenses that appear to be personal in nature.

39. For each of the following situations, discuss whether the expense is currently deductible or must be capitalized:

- a. The Mickleham Hotel installs a \$125,000 sprinkler system to comply with recently enacted fire regulations.

The cost of installing the sprinkler system is a capital expenditure. The sprinkler system has a useful life that extends substantially beyond the end of the tax year. The expense also increases the value of the building by reducing the chances of it being destroyed by fire and by making it safer for the occupants. The fact that the expenditure is required to conform the building to the new fire regulations does not make the expense immediately deductible.

- b. The Healesville Corporation pays a real estate commission of \$35,000 in acquiring its new office building.

The \$35,000 real estate commission is a capital expenditure that must be added to the cost of the building. The fee is considered a cost of acquiring the building.

- c. The Doverson Company pays \$25,000 to repave its parking lot.

The cost of repaving the parking lot is deductible in the current year as a repair expense. The repaving does not extend the useful life of the parking lot, but returns the lot to its original condition. Note: If the expenditure is to convert a dirt parking into an asphalt parking lot, the cost is considered a capital expenditure, because Doverson has more than maintained the parking lot — it has substantially improved and increased the value of the parking lot.

- d. The Watsonia Company pays \$56,000 to add an air-conditioning system to its warehouse. The company had agreed to air condition the warehouse as part of a three-year labor agreement with its employees.

The cost of installing the air-conditioning system is a capital expenditure. The air conditioning system has a useful life that extends substantially beyond the end of the tax year and increases the value of the warehouse. The fact that the expenditure is required under the current labor agreement does not change the treatment of the expense.

- e. Hua pays \$600 to repair the walls and ceiling of his rental property after his tenant moves out.

The \$600 cost of repairing the walls and ceiling are a current period expense. The expense is a repair expense because it does not extend the useful life of the rental property, but rather restores the property to its original condition.

40. Rebecca is the head chef at a local restaurant and is exploring the possibility of leaving her current job and opening her own restaurant in a nearby town. She has spent \$15,000 investigating potential locations for the restaurant and \$14,000 on an analysis of the demand for a restaurant specializing in Asian cuisine. Write a letter to Rebecca explaining the proper tax treatment of the investigation expenses.

A taxpayer who incurs less than \$50,000 of start-up costs can deduct up to \$5,000 of the start-up costs in the year the new business. Any amount in excess of \$5,000 must be amortized over 180 months. For taxpayers, with start-up costs in excess of \$50,000, the \$5,000 amount is phased-out on a dollar-by-dollar basis. Therefore, the deduction for start-up costs can be viewed as consisting of two parts. The first is a \$5,000 current deduction and a second part that amortizes the remaining start-up costs over 180 months.

Because Rebecca does not currently operate a restaurant, the expenses are not ordinary and necessary business expenses. If Rebecca opens the restaurant, she can deduct \$5,000 and amortizes the remaining \$24,000 (\$29,000 - \$5,000) over 180 months [i.e., $(\$24,000 \div 180 = \$133.33)$ per month]. Therefore, assuming the restaurant is open for 6 months, her deduction in the current year would be \$5,800 [$\$5,000 + (6 \times \$133.33)$].

If Rebecca does not open the restaurant, the investigation expenses are nondeductible personal expenditures. That is, she has no trade or business to write the expenses against and there is no personal deduction allowed for such expenses.

41. Neal and Ned spend \$25,000 on travel, surveys, and financial forecasts to investigate the possibility of opening a bagel shop in the city. Because their suburban bagel shop has been so successful, they would like to expand their operations. What is the proper treatment of their expenditures if

- a. They open a bagel shop in the city?

Because they are investigating the expansion of an existing business, they may deduct the \$25,000 as a current expense. The investigation is considered to be an ordinary and necessary business expense.

- b. They decide not to open a bagel shop in the city?

The \$25,000 is deductible even if they don't open a business in the new location. The expenses are related to expanding the existing active business, which is an ordinary and necessary business activity.

- c. Answer a and b assuming they are investigating opening a computer store in the city and they operate a bagel shop in the suburbs.

A taxpayer who incurs less than \$50,000 of start-up costs can deduct up to \$5,000 of the start-up costs in the year the new business. Any amount in excess of \$5,000 must be amortized over 180 months. For taxpayers, with start-up costs in excess of \$50,000, the \$5,000 amount is phased-out on a dollar-by-dollar basis. Therefore, the deduction for start-up costs can be viewed as consisting of two parts. The first is a \$5,000 current deduction and a second part that amortizes the remaining start-up costs over 180 months.

Because they are investigating a "new" business, the \$25,000 is a capital expenditure and is not currently deductible. If they open the computer store, they can deduct \$5,000 and amortize the remaining \$20,000 (\$25,000 - \$5,000) over 180 months [i.e., $(\$20,000 \div 180 = \$111.11)$ per month]. Therefore, assuming the computer store is open for 6 months, her deduction in the current year would be \$5,667 [$\$5,000 + (6 \times \$111.11)$].

If they do not open the computer store, the investigation expenses are nondeductible personal expenditures. That is, they have no trade or business to write the expenses against and there is no personal deduction allowed for such expenses.

42. What is the proper tax treatment for each of the following expenses?

- a. All apartment house construction in Sandy Beach must comply with local and state building codes. To ensure that these codes are observed, Rex, a city building inspector, regularly visits construction sites. Shoddy Construction deposits \$20,000 in a fund to provide a scholarship for Rex's son to attend college. The payment is in appreciation for Rex's help in getting around a building code violation.

Because the payment to the scholarship fund results from the relationship between Rex and Shoddy, the payment will probably be viewed as an indirect payment to Rex.

Shoddy's payment to Rex very likely violates city and/or state ordinances prohibiting such payments to public officials. Shoddy's payment would be viewed as a bribe or other illegal payment which is not deductible.

- b. Rachel operates a pharmacy. She pays a 10% commission on all Medicare and Medicaid business and a 5% commission on all other business sent her way by the Last Stop Nursing Home.

Rachel's payment to Last Stop violates the prohibition against the payment of bribes, kickbacks, or rebates by a provider of services or a supplier under Medicaid or Medicare. Thus, Rachel's payment is not deductible.

- c. Kelly is a registered nurse. She receives a \$1,750-per-month salary working for a local clinic. Because Kelly is five minutes late to work two days in a row, the clinic fines her \$25. Thus, her salary for the current month is \$1,725.

Kelly is being penalized for breaking her employer's rules. She has not violated a public law or a clearly defined public policy which is enforced. Kelly would have to report her salary of \$1,725, (as reduced by the \$25 fine) as gross income.

43. What is the proper tax treatment for each of the following expenses?

- a. Bernilyn, a commercial real estate broker, is late for a meeting with her boss when she is stopped and ticketed \$150 for speeding. She is using a company car when she receives the ticket.

The \$150 speeding ticket is a fine. Fines are not deductible business expenses because it is neither ordinary nor necessary to violate the law.

- b. Russell is an employee of the Dinsmore Corporation, a small plumbing repair business. He learns that his boss Simon, the sole owner of the business, was arrested twenty years ago for burglary. Because Simon needs access to homes and businesses to do his work, he pays Russell \$100 per month for his silence.

The \$1,200 (\$100 x 12) Simon paid Russell is not deductible. The payment to Russell is probably illegal under local or state law. The tax law explicitly states that illegal bribes are not deductible.

- c. Anastasia owns a travel agency. The daughter of the president of her largest corporate client is getting married, and Anastasia insists on paying for her bridal shower at a local restaurant.

The payment of the cost of a bridal shower for her largest client's daughter is not an ordinary or necessary business expense. The function is primarily personal in nature.

- d. The San Martin Construction Company pays local union officers \$20,000 to ensure that San Martin continues to receive construction contracts. The payments are standard practice in the area.

The payment of \$20,000 as a kickback is not considered a valid business expense because it violates public policy. This is true even though the payments are considered standard practice in the area. Instructors Note: If the payments are not illegal under state law (i.e., it is standard practice), the payment may be an ordinary and necessary business expense.

44. Are the following payments deductible?

- a. A contribution to a fund to finance Honest Abe's campaign for mayor.

Contributions to a political campaign are never deductible.

- b. A contribution to the Hardcore Gamblers' Association to fund efforts to persuade the public to vote for parimutuel betting on licensed turtle races.

A contribution to a fund to influence public opinion about how to vote is not deductible.

- c. Joyce, who is in the import-export business, sends an employee to Washington, D.C., to monitor current legislation. The expenses for the one-week trip are \$1,500.

Expenses incurred to monitor the impact of legislation on a business are deductible. The expenses associated with monitoring legislation are considered to be ordinary and necessary expenses incurred in a trade or business.

- d. Ruth, a small business owner, incurs \$3,000 in travel, lodging and meal expenses to testify in Washington, D.C., on the effect on small business of new environmental regulations.

The expenditures incurred by Ruth are considered lobbying expenses and as a general rule are not deductible.

45. During the current year, the Fremantle Corporation, a real estate development firm, incurs \$2,200 of expenses lobbying and testifying before the city council to change the zoning rules. The firm also spends \$3,500 testifying before the state legislature and lobbying to modify the existing law that restricts commercial building in areas that are classified as a wetlands. Can Fremantle deduct the cost of these lobbying efforts?

Freemantle can deduct the \$2,200 incurred to lobby and testify before the city council. The rules restricting the deductibility of lobbying expenses do not apply to expenses incurred to influence a local legislative body.

Freemantle cannot deduct the expense of testifying and lobbying before the state legislature. The expenses incurred to testify before the state legislature and lobby for the law change are considered lobbying expenses. However, any expenses incurred to monitor legislation are ordinary and necessary business expenses and are deductible.

46. During the current year, Maureen pays Universal Bank and Trust \$1,600 for investment advice. The fee is not directly related to any particular investment owned by Maureen. The company provides her with the following summary of her investments:

Type of Security	Fair Market Value of Securities	Income Earned
Taxable	\$72,000	\$7,300
Tax-exempt	\$48,000	\$2,700

Write a letter to Maureen explaining the proper tax treatment of the \$1,600 she paid for investment advice.

Maureen should allocate the deductible and nondeductible portion of the investment fees based on the fair market value of the securities. The important point is that Maureen must allocate the investment fee using a reasonable method and that she applies that method on a consistent basis. If Maureen allocates the investment fees based on the fair market value of the securities, the allocation between the nondeductible portion of the fee and the deductible portion is:

\$ 640 = [$\$1,600 \times (\$48,000 \div \$120,000)$] is not deductible.

\$ 960 = [$\$1,600 \times (\$72,000 \div \$120,000)$] is deductible.

Instructors Note: Unlike investment interest, investment expenses can be allocated based on investment income. However, she must use the method on a consistent basis.

\$ 432 = [$\$1,600 \times (\$2,700 \div \$10,000)$] is not deductible.

\$1,168 = [$\$1,600 \times (\$7,300 \div \$10,000)$] is deductible.

47. Ying pays an adviser \$300 to help manage her investments and provide investment advice. The adviser's fee is not directly related to any particular investment owned by Ying. She owns \$40,000 worth of municipal bonds that pay her \$2,400 in interest and \$20,000 worth of bonds that pay her taxable interest of \$2,000. What is the proper tax treatment of the \$300 fee for investment advice?

Ying should allocate the deductible and nondeductible portion of the investment fees based on the fair market value of the securities. The important point is that Ying must allocate the investment fee using a reasonable method and that she applies that method on a consistent basis. If Ying allocates the investment fees based on the fair market value of the securities, the allocation between the nondeductible portion of the fee and the deductible portion is:

\$ 200 = [$\$300 \times (\$40,000 \div \$60,000)$] is not deductible.

\$ 100 = [$\$300 \times (\$20,000 \div \$60,000)$] is deductible.

Instructors Note: Unlike investment interest, investment expenses can be allocated based on investment income. However, she must use the method on a consistent basis.

\$ 164 = [$\$300 \times (\$2,400 \div \$4,400)$] is not deductible.

\$ 136 = [$\$300 \times (\$2,000 \div \$4,400)$] is deductible.

48. Tracy and Brenda are equal partners in Crescent Home Furniture, which is organized as an S corporation. For the year, the company reports sales revenue of \$330,000 and business expenses of \$195,000. Crescent also earns \$15,000 in taxable interest and dividend income and \$3,700 in tax-exempt interest on its investments. The investment portfolio consists of \$35,000 in tax-exempt securities and \$100,000 in taxable securities. Not included in the business expenses is a \$3,400 fee Crescent paid for investment advice. As the staff accountant in charge of taxes for Crescent Home Furniture, write a memo to Judy, the accounting manager, explaining how the company must report its results to Tracy and Brenda.

Crescent Home is organized as an S corporation and therefore, must report certain items separately. These items include the taxable interest and dividends of \$15,000, the tax-exempt interest of \$3,700, the investment expenses of \$3,400 and the nondeductible expenses. Because the investment expenses relate to both taxable and nontaxable investments, Crescent must allocate the investment expenses between the deductible and nondeductible amount. Only \$2,727 $\{[\$15,000 \div \$18,700 (\$15,000 + \$3,700) \times \$3,400]\}$ of the \$3,400 investment expense is a deductible investment expense. The remaining \$673 $(\$3,400 - \$2,727)$ of investment expenses are classified as a nondeductible expense. The ordinary taxable income for the S corporation is \$135,000 $(\$330,000 - \$195,000)$. As equal partners, Crescent Home Furniture would report to Tracy and Brenda the following:

Ordinary income $(\$135,000 \times 50\%)$	\$ 67,500
Taxable interest and dividends $(\$15,000 \times 50\%)$	7,500
Tax-exempt interest $(\$3,700 \times 50\%)$	1,850
Investment expenses $(\$2,727 \times 50\%)$	1,364
Nondeductible expenses $(\$673 \times 50\%)$	336

Instructors Note: Crescent could also allocate the deductible and nondeductible portion of the investment fees based on the fair market value of the securities. The important point is that Crescent must allocate the investment fee using a reasonable method and that she applies that method on a consistent basis. If Crescent allocates the investment fees based on the fair market value of the securities, the allocation between the nondeductible portion of the fee and the deductible portion is:

\$ 881 = $[\$3,400 \times (\$35,000 \div \$135,000)]$ is not deductible.

\$ 2,519 = $[\$3,400 \times (\$100,000 \div \$135,000)]$ is deductible.

49. Determine the current tax deduction allowed in each of the following situations:
- a. Doug, John's son, buys a new car that is titled in Doug's name. John pays for Doug's auto license tag. The tag costs \$220: \$40 for registration plus \$180 in property taxes based on the value of the auto. Doug qualifies as John's dependent for tax purposes. Doug uses the auto for personal transportation.

Because the \$220 tag cost relates to personal use of the auto, it is not a business expense. Although the \$180 ad valorem property tax is an allowable itemized deduction, neither John nor Doug may claim the deduction. Unless John can demonstrate he benefited from Doug having the car, John is not entitled to the deduction because it is not an expense incurred for his benefit. Doug may not claim the deduction because he did not pay the expense. If John had made a gift of cash to Doug and Doug used the cash to pay the tax, Doug would be entitled to an itemized deduction.

- b. Elvis owns Ace Auto Repair. His head mechanic is arrested for drunken driving. Because Elvis needs the mechanic back at work as soon as possible, he pays the \$500 bail to get the mechanic out of jail. To keep him out of jail, he pays \$450 in attorney's fees and the \$500 fine the court imposes on the mechanic.

A deduction is generally not allowed for the payment of another's expense. However, in this case, a business purpose exists for the expenditures Elvis made on behalf of his mechanic. If the mechanic is required to repay the expenses, it would constitute a loan and not be deductible. However, if Elvis does not require the mechanic to repay the amounts paid on the mechanics behalf, the payments would constitute compensation to the mechanic. The mechanic would have income and Elvis would get a deduction for compensation paid.

50. Determine the current tax deduction allowed in each of the following situations:

- a. Sam owns and operates SoftPro, a software programming business. In June, the firm files for bankruptcy. Eighteen months earlier, Karl, had recommended SoftPro as a good investment to his clients. Three of Karl's clients each loaned SoftPro \$40,000 at 12% interest. To avoid losing his three clients, Karl repays the \$40,000 each client had loaned to SoftPro.

Karl is not allowed a deduction for the amount he paid to each of his clients. Although the expense might be necessary for Karl to maintain his business reputation, the expense would not be considered ordinary. For the expense to be considered ordinary, the expense must be commonly incurred in the taxpayer's business. In addition, the expense must be customary or usual in the taxpayer's business. Karl's payment to the clients does not meet either of these requirements.

- b. During the year, Susan's mother is hospitalized for 3 weeks and incurs \$36,000 of medical costs. Her mother's insurance company pays only \$22,000 of the medical expenses. Because her mother could pay only \$4,000 of the remaining medical costs, Susan pays the remaining \$10,000. Susan's mother does not qualify as her dependent.

To be deductible, an expenditure must be for the taxpayer's benefit or be the payment of a taxpayer's obligation. A payment of another person's obligation does not result in a tax deduction for either person. An exception to this is for medical expenses paid on behalf of a taxpayer's dependent. However, since Susan's mother does not qualify as a dependent this exception does not apply. Therefore, Susan cannot deduct the \$10,000 she pays for her mother's medical costs.

Instructor's Note: As discussed in Chapter 8, if Susan's mother did not qualify as a dependent because she fails to meet either the gross income or the joint return test (i.e., she meets the support test), then her mother is considered a dependent for purposes of deducting the \$10,000 in medical expenses.

51. As a hobby, Jane creates and sells oil paintings. During the current year, her sales total \$8,000. How is the tax treatment of her hobby different from the treatment of a trade or business, if

- a. Her business expenses total \$5,600?

Because Jane's activity is a hobby, her sales must be reported as gross income and her expenses are allowed as a miscellaneous itemized deduction. Her deductions will be subject to the general limitation (2% of adjusted gross income) on miscellaneous itemized deductions. Jane should report:

Gross Income	\$ 8,000
Miscellaneous Itemized Deductions	\$ 5,600

Instructor's Note: The solution in part a, b and c assumes that the expenses related to Jane's hobby are not for interest and taxes that could otherwise be deducted as itemized deductions.

- b. Her business expenses total \$10,000?

Because Jane's expenses exceed her gross income, her hobby expenses are limited to the \$8,000 of income from the hobby. She should report:

Gross Income	\$ 8,000
Miscellaneous Itemized Deductions	\$ 8,000
Nondeductible Personal Expense	\$ 2,000

- c. Assume that Jane itemizes her deductions and that she has an adjusted gross income of \$42,000 before considering the effect of the hobby. Discuss the actual amount of the deduction Jane would receive in parts a and b.

Hobby expenses are deductible as miscellaneous itemized deductions, which are subject to a 2% of adjusted gross income limitation. The \$8,000 of hobby income will increase her adjusted gross income to \$50,000. Assuming that Jane has no other miscellaneous itemized deductions, the allowable hobby deductions must be reduced by \$1,000 (\$50,000 x 2%). This will leave her with an actual deduction of \$4,600 (\$5,600 - \$1,000) in part a and \$7,000 (\$8,000 - \$1,000) in part b.

	Part a		Part b	
Gross Income		\$ 8,000		\$ 8,000
Hobby expenses	\$ 5,600		\$ 8,000	
Less: 2% of AGI (\$50,000 x .02)	(1,000)	(4,600)	(1,000)	(7,000)
Net income effect		<u>\$ 3,400</u>		<u>\$ 1,000</u>

52. Sharon is single and a data-processing manager for the phone company. She also owns and operates a sports memorabilia store. Sharon goes to shows, subscribes to numerous magazines on sports memorabilia, and maintains a Web page on the Internet. She has been engaged in the activity for the last 5 years. During that time, she reported a net loss in two of the years and net income in the other three. Overall, her sports memorabilia activity has shown a slight loss, but the value of her collection over the 5 years has increased by 20%. Sharon rents a 600-square-foot storefront for \$500 a month. Although the store is open only on Saturdays, she is usually in her office at the store 2 or 3 nights a week buying and selling sports memorabilia over the Internet. For the current year, she has an adjusted gross income of \$42,000 before considering the following income and expenses related to her sports memorabilia activity:

Sale of memorabilia	\$11,500
Cost of items sold	3,725
Cost of new memorabilia acquired	1,500
Registration and booth fees	750
Transportation to memorabilia shows	600
Meals attending shows	250
Cost of magazines	280
Cost of Internet connection	240
Office utilities	800
Phone	400
Depreciation on computer	200

- a. What is the proper tax treatment of these items if Sharon is engaged in a trade or business?

If Sharon is engaged in a trade or business, she is allowed to deduct all ordinary, necessary and reasonable expenses in determining her business income. Without considering whether Sharon can deduct any home office expenses, her loss from the card collecting activity is \$1,620:

Sales of cards		\$ 11,500
Cost of cards sold	\$ 3,725	
Rent (\$500 x 12)	6,000	
Registration and booth fees	750	
Transportation to card shows	600	
Meals attending shows (\$250 x 50%)	125	
Cost of magazines	280	
Cost of Internet connection	240	
Office utilities	800	
Phone	400	
Depreciation on computer	200	(13,120)
Net income from business		<u>\$ (1,620)</u>

The \$1,500 of memorabilia Sharon acquires is inventory and has been included in the calculation of cost of goods sold.

- b. What is the proper tax treatment of these items if she is engaged in a hobby?

Sharon must include the \$11,500 in gross income. She is allowed to deduct up to \$11,500 of expenses. The expenses must be taken in a specified order: with interest and taxes first, expenses other than depreciation second, and depreciation last. The deductions are from adjusted gross income and not deductions for adjusted gross income. In addition, for Sharon to receive any benefit for the expenses, she will have to be able to itemize her deductions. A further restriction is that the expenses are considered miscellaneous itemized deductions and are reduced by 2% of Sharon's adjusted gross income. Sharon is allowed to deduct only \$10,430 of the expenses.

Adjusted gross income before hobby	\$ 42,000
Hobby income	11,500
New adjusted gross income	<u>\$ 53,500</u>
Hobby expenses	\$ 11,500
Less: 2% of AGI (\$53,500 x .02)	(1,070)
Miscellaneous itemized deduction	<u>\$ 10,430</u>

- c. What factors (e.g., facts, aspects) of Sharon's sports memorabilia activity indicate that it is a hobby? a trade or business?

In determining whether Sharon's memorabilia activity is a trade business or a hobby, the IRS will examine the following nine factors:

- Whether the taxpayer carries on the activity in a business-like manner
- The expertise of the taxpayer or her reliance on expertise
- The history of income and profits
- The time and effort spent on the activity
- The taxpayer's success in similar activities
- Whether the activity is engaged in for personal pleasure or recreation
- The taxpayer's financial condition
- The expectation that the assets used in the business will appreciate
- The amount, if any, of occasional profits

53. Lee and Sally own a winter retreat in Harlingen, Texas, that qualifies as their second home. This year they spent 40 days in their cabin. Because of its ideal location, it is easy to rent at \$120 a day and was rented for 80 days this year. The total upkeep costs of the cabin for the year were as follows:

Mortgage interest	\$ 9,000
Real and personal property taxes	1,200
Insurance	750
Utilities	600
Repairs and maintenance	1,000
Depreciation	2,500

What is the proper treatment of this information on Lee and Sally's tax return?

Because the personal use of the home exceeds 14 days, the home is a vacation home and deductions are limited to rental income. Deductions must be taken in a specified order: interest and taxes first, expenses other than depreciation second, and depreciation last. The expenses are allocated based on actual days the vacation home is rented to total days used for either rental or personal use. Thus, 66.7% [$80 \div 120 (40 + 80)$] of the expenses are related to the rental activity.

Rent (80 days x \$120)	\$ 9,600
Interest and taxes ($\$10,200 \times 2/3$)	(6,800)
Balance of income	\$ 2,800
Operating expenses ($\$2,350 \times 2/3$)	(1,567)
Balance of Income	\$ 1,233
Depreciation ($\$2,500 \times 2/3 = \$1,668$)	1,233*
Balance of income	<u>\$ -0-</u>

* Limited to balance of income

The adjusted gross income from rents would be reported as zero. The \$438 ($\$1,668 - \$1,230$) of depreciation not allowed because of the income limit can be carried forward and deducted in a year when income is large enough to absorb the deductions.

The interest and taxes \$3,400 ($\$10,200 - \$6,800$) allocated to the personal use of the dwelling are allowed as an itemized deduction. Thus, if Lee and Sally can itemize their deductions, the rental will decrease their taxable income by the \$3,400 of itemized deductions.

54. Mel and Helen own a beachfront home in Myrtle Beach, S.C. During the year, they rented the house for 5 weeks (35 days) at \$800 per week and used the house for personal purposes 65 days. The costs of maintaining the house for the year were

Mortgage interest	\$ 5,500
Real property taxes	4,500
Insurance	650
Utilities	1,000
Repairs and maintenance	480
Depreciation (unallocated)	3,500

- a. What is the proper tax treatment of this information on their tax return?

Because the personal use of the home exceeds 14 days, the home is a vacation home and deductions are limited to rental income. Deductions must be taken in a specified order: interest and taxes first, expenses other than depreciation second, and depreciation last. The expenses are allocated based on actual days the vacation home is rented to total days used for either rental or personal use. Thus, 35% [$35 \div 100 (35 + 65)$] of the expenses are related to the rental activity.

Rent (\$800 x 5 weeks)	\$ 4,000
Interest and taxes (\$10,000 x 35%)	(3,500)
Balance of income	\$ 500
Operating expenses (\$2,130 x 35% = \$746)	(500)*
Balance of income	\$ -0-
Depreciation (\$3,500 x 35% = \$1,225)	-0- **
Income from rental	<u>\$ -0-</u>

* Limited to the balance of income, remaining amount is carried forward.

** Allocated amount is carried forward

The adjusted gross income from rents would be reported as zero. The remaining \$246 (\$746 - \$500) of expenses and the allocated depreciation of \$1,225 that is not allowed because of the income limit can be carried forward and deducted in a year when income is large enough to absorb the deductions.

The interest and taxes \$6,500 (\$10,000 - \$3,500) allocated to the personal use of the dwelling are allowed as an itemized deduction. Thus, if Mel and Helen itemize their deductions, the rental will decrease their taxable income by the \$6,500 of itemized deductions.

- b. What is the proper tax treatment if Helen and Mel rented the house for only 2 weeks (14 days)?

If the dwelling is rented 14 days or less, the \$1,600 of rental income (\$800 x 2 weeks) is not reported and expenses related to rental use are not deducted. The interest and taxes (\$10,000) are allowed as an itemized deduction.

55. Matilda owns a condominium on the beach in Rehoboth, Delaware. During the current year, she incurs the following expenses related to the property:

Mortgage interest	\$ 8,000
Property taxes	1,750
Utilities	1,050
Maintenance fees	600
Repairs	350
Depreciation (unallocated)	3,200

Determine the amount of Matilda's deductions in each of the following cases:

Case	Rental Income	Rental Days	Personal Use Days
A	\$ 12,000	365	0
B	\$ 3,800	80	20
C	\$ 600	14	86
D	\$ 9,050	275	25

In each case, you must first determine whether the property is a true rental (all allocable deductions allowed) or a vacation home (allocable deductions allowed to the extent of rental income with ordering of deductions).

CASE A

This is a true rental. Because there is no personal use, all expenses are deducted against rental income.

Rental income	\$ 12,000
Interest and taxes (\$8,000 + \$1,750)	(9,750)
Other rental expenses (\$1,050 + \$600 + \$350)	(2,000)
Depreciation	(3,200)
Net rental loss	<u>\$ (2,950)</u>

CASE B

This is a vacation home because the personal use of the home (20 days) exceeds the greater of 14 days or 8 days (10% of rental days). Therefore, the deductions are limited to rental income and must be taken in a specified order: interest and taxes first, expenses other than depreciation second, and depreciation last. The expenses are allocated based on actual days the vacation home is rented to total days used for either rental or personal use. Thus, 80% [$80 \div 100$ ($80 + 20$)] of the expenses are related to the rental activity.

Rental income	\$ 3,800
Interest and taxes [$\$9,750 \times 80\% = 7,800$]	(3,800)*
Balance of income	\$ -0-
Other rental expenses ($\$2,000 \times 80\% = \$1,600$)	-0- **
Balance of income	\$ -0-
Depreciation ($\$3,200 \times 80\% = \$2,560$)	-0- **
Income from rental	<u>\$ -0-</u>

* Limited to the balance of income, remaining amount is carried forward.

** Allocated amount is carried forward

The adjusted gross income from rents would be reported as zero. The remaining \$4,000 ($\$7,800 - \$3,800$) of interest and taxes, the \$1,600 of allocated expenses and the allocated depreciation of \$2,560 that are not allowed because of the income limit can be carried forward and deducted in a year when income is large enough to absorb the deductions.

The interest and taxes \$1,950 ($\$9,750 - \$7,800$) allocated to the personal use of the dwelling are allowed as an itemized deduction. Thus, if Matilda itemizes her deductions, the rental will decrease her taxable income by the \$1,950 of itemized deductions.

CASE C

Because the property is rented 14 days or less, no income is reported and the \$9,750 of interest and taxes are allowed as an itemized deduction.

CASE D

This is a true rental because the 25 personal use days are less than the greater of 14 days or 28 days (10% of rental days). Therefore, all allocable deductions are allowed for adjusted gross income.

Rental income	\$ 9,050
Interest and taxes [$\$9,750 \times (275 \div 300)$]	(8,938)
Other rental expenses [$\$2,000 \times (275 \div 300)$]	(1,833)
Depreciation [$\$3,200 \times (275 \div 300)$]	(2,933)
Net rental loss	<u>\$ (4,654)</u>

56. Haysad owns a house on Lake Tahoe. He uses a real estate firm to screen prospective renters, but he makes the final decision on all rentals. He also is responsible for setting the weekly rental price of the house. During the current year, the house rents for \$1,500 per week. Haysad pays a commission of \$150 and a cleaning fee of \$75 for each week the property is rented. During the current year, he incurs the following additional expenses related to the property:

Mortgage interest	\$ 12,000
Property taxes	2,700
Utilities	1,400
Landscaping fees	900
Repairs	450
Depreciation (unallocated)	7,500

- a. What is the proper tax treatment if Haysad rents the house for only 1 week (7 days) and uses it 50 days for personal purposes?

If Haysad rents the dwelling for 14 days or less, the \$1,500 of rental income is not reported and expenses related to rental use are not deducted. The interest and taxes are deductible as itemized deductions.

- b. What is the proper tax treatment if Haysad rents the house for 8 weeks (56 days) and uses it 44 days for personal purposes?

Because Haysad's personal use of the home exceeds 14 days (and 10% of the rental days), the property is a vacation home and deductions are limited to rental income. Deductions must be taken in a specified order: interest and taxes first, expenses other than depreciation second, and depreciation last. The expenses (other than the commission and cleaning expenses) are allocated based on actual days the vacation home is rented to total days used for either rental or personal use. Thus, 56% [$56 \div (56 + 44)$] of the expenses are related to the rental activity.

Rent (\$1,500 x 8 weeks)	\$ 12,000
Interest and taxes (\$14,700 x 56%)	(8,232)
Balance of income	\$ 3,768
Non-allocated operating expenses (\$225 X 8 x 100%)	(1,800)
Allocated operating expenses (\$2,750 x 56%)	(1,540)
Balance of income	\$ 428
Depreciation (\$7,500 x 56% = \$4,200)	(428)*
Income from rental	<u>\$ -0-</u>

*** The depreciation is limited to \$428. The remaining \$3,772 (\$4,200 - \$428) can be carried forward.**

In addition, the \$6,468 (\$14,700 - \$8,232) of interest and taxes are deductible as itemized deductions. If Haysad can itemize his deductions, the rental property reduces his taxable income by \$6,468.

- c. What is the proper tax treatment if Haysad rents the house for 25 weeks (175 days) and uses it 15 days for personal purposes?

Because Haysad's personal use is less than 10% of the days rented [15 < (175 x 10%)], the property is considered a true rental. However, only those expenses attributable to the rental are deductible against rental income. The expenses (other than the commission and cleaning expenses) are allocated based on actual days the vacation home is rented to total days used for either rental or personal use. As a result 92%* [175 ÷ (15 + 175)] of the other expenses are deducted for rental use. Due to the definition of qualifying home mortgage interest, the interest allocated to personal use is not deductible (see Chapter 8). However, the personal portion \$135 (\$2,700 - \$2,565) of the taxes is deductible as an itemized deduction.

Rent (\$1,500 x 25 weeks)	\$ 37,500
Interest (\$12,000 x 92%)	(11,040)
Taxes (\$2,700 x 92%)	(2,484)
Non-allocated operating expenses (\$5,625 x 100%)	(5,625)
Allocated operating expenses (\$2,750 x 92%)	(2,530)
Depreciation (\$7,500 x 92%)	(6,900)
Income from rental	<u>\$ 8,921</u>

* The 92% is rounded

Note: The non-allocated operating expenses consist of the cleaning fee of \$75 and the commission of \$150 for each week the house is rented. Thus the total non-allocated operating costs are \$5,675 [(\$75 + \$150) x 25 weeks].

57. Ray, 83, is a used car dealer. He lives in a rural community and operates the business out of his home. One room in his 6-room house is used exclusively for his business office. He parks the cars in his front yard, and when customers come along, they sit on the front porch and negotiate a sale price. The income statement for Ray's auto business is as follows:

Sales		\$110,000
Cost of cars sold		<u>78,000</u>
Gross profit		\$ 32,000
Interest expense on cars	\$ 4,200	
Property tax on cars	700	
Gas, oil, repairs	1,200	
Loan fees	3,200	
Depreciation on equipment	<u>1,800</u>	(11,100)
Net profit		<u>\$ 20,900</u>

If Ray's home were rental property, the annual depreciation would be \$2,900. The utilities and upkeep on the home cost Ray \$6,400 for the year. Ray's mortgage interest for the year is \$2,400. When asked about the loan fees, Ray bitterly responds that Jim, the bank loan officer, charges him 10% of his gross profit on cars financed through the bank. Ray says, "The money is under the table, and if I don't shell out the cash, Jim won't loan the money to my customers to buy my cars. Everybody goes to Jim -- he's got the cash."

Write a letter to Ray explaining the proper tax treatment of this information on his tax return.

The loan fees (\$3,200) are not deductible as an ordinary expense related to selling used cars. They are an illegal kickback. Since 1/6 of the home is used for business the following expenses are allowed as a home office deduction: *

Utilities	\$ 6,400 x 1/6	=	\$ 1,067
Interest	\$ 2,400 x 1/6	=	400
Depreciation	\$ 2,900 x 1/6	=	<u>483</u>
Total			<u>\$ 1,950</u>

The interest expense related to personal use of the home is an itemized deduction [$\$2,400 \times (5 \div 6) = \$2,000$].

Sales		\$110,000
Cost of cars sold		<u>78,000</u>
Gross profit		\$ 32,000
Interest expense on cars	\$ 4,200	
Property tax on cars	700	
Gas, oil, repairs	1,200	
Loan fees	-0-	
Depreciation on equipment	1,800	
Business use of home	<u>1,950</u>	(9,850)
Net profit		<u>\$ 22,150</u>

- * Some may question whether Ray qualifies for a home office deduction. However, because the home is his principal place of business, the office should qualify for deduction. Ray should report \$22,150 of adjusted gross income from his used car business.

58. Hromas uses a separate room in his home as an office. The room is 500 square feet of the total 2,000 square feet of the house. During the current year, Hromas incurs the following household expenses:

Mortgage interest		\$ 12,000
Property taxes		1,400
Insurance		450
Utilities		
Gas and electric	\$ 2,100	
Cable television	280	
Phone (\$15 per month for a separate phone number for the office)	<u>450</u>	2,830
House cleaning		1,820
Long-distance phone calls (business-related)		670
Depreciation (unallocated)		5,600

How much of a deduction is Hromas allowed for the cost of the home office in each of the following situations?

- a. Hromas is an independent salesperson who uses the room exclusively to call customers who buy goods from him. During the current year, his sales total \$83,000, cost of goods sold is \$33,000 and he incurs other valid business expenses unrelated to the office of \$25,000.

Because Hromas uses the office exclusively and on a regular basis as a principal place of business, he is allowed to deduct the costs associated with the home office. However, the home office deduction cannot exceed his income from the trade or business less the costs unrelated to the office. In addition, to the \$25,000 of expenses unrelated to his office, he can deduct \$180 for the extra phone line and the long distance phone calls of \$670 as business expenses. Therefore, he is limited to a maximum home office deduction of \$24,150 (\$83,000 - \$33,000 - \$25,000 - \$180 - \$670).

The costs of the home office must be allocated on some reasonable basis. The square footage of the office is 25% ($500 \div 2,000$) of the total square footage and provides a reasonable basis to allocate expenses that are related to the house. The cost of the cable TV is not deductible. In addition, only the \$15 per month cost of the office phone number is deductible. The long-distance business calls do not have to be allocated.

Interest (\$12,000 x 25%)	\$ 3,000
Property taxes (\$1,400 x 25%)	350
Insurance (\$450 x 25%)	113
Gas & electric (\$2,100 x 25%)	525
Cable TV	-0-
House cleaning (\$1,820 x 25%)	455
Depreciation (\$5,600 x 25%)	1,400
Total home office costs	<u>\$ 5,843</u>

- b. Hromas is an employee of Ace Computer Company. He uses the office primarily when he brings work home at nights and on weekends. He occasionally uses the office to pay personal bills and to study the stock market so he can make personal investments. His salary at Ace is \$80,000 per year. He is not paid extra for the time he spends working at home.

For an employee to deduct the cost of a home office, the exclusive and regular use tests must be met. In addition, the office must be for the convenience of the employer and required as a condition of employment. In this case, Hromas does not meet the exclusive use test (office work and personal work done in the office). In addition, the office is clearly for his convenience, not the employers, and there is no indication that Hromas must maintain the office in order to retain his job. Therefore, no deduction is allowed for the home office. He would be able to deduct all of the mortgage interest and property taxes as itemized deductions.

59. Charlotte owns a custom publishing business. She uses 500 square feet of her home (2,000 square feet) as an office and for storage. All her business has come from telemarketing (telephone sales), direct mailings, or referrals. In her first year of operation, she has revenues of \$37,000, cost of goods sold of \$25,900, and other business expenses of \$8,100. The total expenses related to her home are:

Home mortgage interest	\$6,400
Real property taxes	2,100
Insurance	560
Utilities	800
Repairs and maintenance	600
House cleaning	960
Depreciation (unallocated)	5,000

What amount can Charlotte deduct for her home office?

Because Charlotte uses the office exclusively and on a regular basis as a principal place of business, she is allowed to deduct the costs associated with the home office. However, the home office deduction cannot exceed her income from the trade or business less the costs unrelated to the office. In this case, she is limited to a maximum home office deduction of \$3,000 (\$37,000 - \$25,900 - \$8,100).

The costs of the home office must be allocated on some reasonable basis. The square footage of the office is 25% ($500 \div 2,000$) of the total square footage and provides a reasonable basis to allocate expenses that are related to the house.

Total home office costs are limited to	\$ 3,000
Home mortgage interest ($\$6,400 \times 25\%$)	(1,600)
Real property taxes ($\$2,100 \times 25\%$)	(525)
Balance of income	\$ 875
Insurance ($\$560 \times 25\%$)	(140)
Utilities ($\$800 \times 25\%$)	(200)
Repairs and maintenance ($\$600 \times 25\%$)	(150)
House cleaning ($\$960 \times 25\%$)	(240)
Balance of income	\$ 145
Depreciation ($\$5,000 \times 25\% = \$1,250$)	(145)
Total home office costs	<u>\$ -0-</u>

Charlotte has no income from her custom publishing business. She can deduct only \$3,000 of the \$4,105 of home office expenses because home office expenses cannot create a business loss. She must deduct the expenses related to interest and taxes first, then deduct her other business expenses, then depreciation. She may carry forward the \$1,105 (\$145 limit - \$1,250 current depreciation) not used in the current year to a future year when her business income can absorb the deduction.

60. The Adelaide Advertising Agency, a cash basis taxpayer, bills its clients for services it renders and any out-of-pocket expenses it pays to third parties on behalf of its clients. For example, in creating a television commercial for a client, Adelaide charges the client for its staff time in creating the commercial and the third-party costs of filming and editing the commercial. During the year, Adelaide bills its clients \$2,800,000. Of this amount, \$600,000 is for expenses it pays to third parties. On December 31, the accounts receivable ledger shows a balance due to Adelaide of \$400,000, \$35,000 of which is for third-party expenses. How much of the third-party expenses can Adelaide deduct during the current year?

Adelaide can only deduct the portion of the expenses \$565,000 (\$600,000 - \$35,000) that it has been reimbursed. The \$35,000 of unreimbursed expenses are incurred on behalf of another taxpayer - its clients, and cannot be deducted because it is not an expense incurred for Adelaide's benefit.

***Instructor's Note:* The facts of this problem are adopted from Private Letter Ruling 9432005. It should be noted that if Adelaide cannot collect the expenses or it decides not to collect the expenses, then it can deduct the expenses in the year the expenses are not collected.**

61. On July 1, 2016, Andaria borrows \$30,000 from the First Financial Bank. The loan is for 1-year at an annual interest rate of 10%. How much interest can Andaria deduct under each of the following situations?

- a. The bank deducts the interest from her the loan proceeds.

Prepaid interest is not generally deductible under the one-year rule. The only exception to this rule is for the payment of "points" on a loan to purchase a principal residence. Andaria is required to allocate the interest expense deduction of \$3,000 ($\$30,000 \times 10\%$) to the time periods the loan is outstanding. She can deduct \$1,500 [$(6 \div 12) \times \$3,000$] as interest expense in 2016 and the remaining \$1,500 in 2017.

- b. The \$30,000 loan proceeds are due at the end of the loan, but Andaria pays interest on the loan each month.

Assuming the interest on the loan is not compounded, (i.e., simple interest method) Andaria will pay \$250 [$(\$30,000 \times 10\%) \div 12$] of interest each month. Because Andaria pays interest on the loan each month, she can deduct \$1,500 ($\250×6 months) as interest expense in 2016 and \$1,500 of interest in 2017.

- c. The interest and loan proceeds are due June 30, 2017.

If Andaria is a cash basis taxpayer, the interest is not deductible until it is paid in 2017. In 2017, she would deduct \$3,000 ($\$30,000 \times 10\%$) of interest. If she is an accrual basis taxpayer, \$250 [$(\$30,000 \times 10\%) \div 12$] of interest will accrue each month. Andaria can deduct \$1,500 ($\250×6) in 2016 and \$1,500 ($\250×6) in 2017.

62. The Kane Corporation is an accrual basis taxpayer. State law requires that Kane acquire workers' compensation insurance from a third-party carrier or maintain a self-funded insurance plan. Kane has decided to create a self-fund workers' compensation plan and pays \$6 per month (the state minimum) for each of its 800 employees. During the year, the corporation pays \$52,500 in workers' compensation benefits to its employees. How much can Kane deduct as workers' compensation expense for the year? Discuss.

Under the economic performance requirement, Kane cannot deduct the workman compensation expense until the benefits have been paid to the employees. The \$57,600 (800 workers x \$6 x 12 months) payment into the fund is an estimate of a future liability and is not deductible until performance on the liability occurs. The \$52,500 of actual expenses can be deducted because economic performance has occurred.

63. Appliance Sales Corporation sells all types of appliances. In addition, it offers purchasers of its appliances the option of purchasing repair contracts. During the current year, Appliance estimates that repairs totaling \$13,100 will be made under the contracts sold during the current year. Actual repair costs are \$7,500 related to last year's contracts and \$2,450 on contracts sold during the current contract year. How much repair cost can Appliance deduct during the year?

If Appliance is a cash basis taxpayer (hybrid method for sales and purchases), it will deduct the \$9,950 (\$7,500 + \$2,450) of actual repair costs it pays during the year.

If Appliance is an accrual basis taxpayer it will only be allowed to deduct the \$9,950 of actual repair costs. Reserve accounting (i.e., the allowance method) is not allowed for warranties because the all-events test is not met with respect to the \$13,100 estimate. That is, although Appliance has a reasonable estimate of its expense, the all-events test requires that the actual payee be known. In addition, the economic performance test is not met until the repairs under the warranty contract are actually performed.

64. Gonzo Company is an accrual basis taxpayer. It provides medical insurance for its employees through a self-insured reimbursement plan. Gonzo pays \$150 per month per employee into the plan fund. The fund is then used to reimburse employees' medical expenses. During the current year, Gonzo pays \$90,000 into the fund and pays medical reimbursement claims totaling \$78,300. How much can Gonzo deduct for the provision of employee medical coverage? Discuss.

Under the economic performance requirement, Gonzo cannot deduct the medical insurance expense until the services have been rendered. The \$90,000 payment into the fund is an estimate of a future liability and is not deductible until performance on the liability occurs. The \$78,300 of actual expenses can be deducted because economic performance has occurred.

65. Damon's Lawn and Garden Supply, an accrual basis taxpayer, is the exclusive dealer for Tru-Cut lawn mowers. In 2016, Damon's agrees to pay the Dash Corporation, the manufacturer of Tru-Cut, an additional \$15 per lawn mower. In exchange, the Dash Corporation will provide advertising and promotion to Damon's over for a 2-year period. Damon's purchases and pays for 200 lawn mowers in 2016 and 350 lawn mowers in 2017. The Dash Corporation pays \$2,750 for advertising and promotion in 2016 and \$5,500 in 2017. How much of the amount paid to the Dash Corporation for advertising and promotional services can Damon's deduct in 2016? in 2017?

For Damon's to deduct the promotion expenses, both the all-events test and the economic performance test must be met. The all-events test requires that the liability exists and the amount of the liability can be determined with reasonable accuracy. Economic performance occurs when services or property are provided to the taxpayer or when the taxpayer uses the property. Although Dash corporation receives \$3,000 ($200 \times \15) for advertising and promotion from Damon's in 2016, only \$2,750 is spent by Dash. Therefore, Damon's can only deduct \$2,750, because economic performance for services occurs when the services are provided to the taxpayer.

In 2017, Damon's can deduct \$5,500 for promotion expenses. This includes the \$5,250 ($350 \times \15) paid in 2017 and the \$250 from 2016 that met the all-events test, but not the economic performance test because the services were not provided by Dash. The \$5,500 in services is provided in 2017 and the economic performance test is met.

66. Joy incurs the following expenses in her business. When can she deduct the expenses if she uses the accrual method of accounting? the cash method?
- a. Joy rents an office building for \$750 a month. Because of a cash-flow problem, she is unable to pay the rent for November and December 2016. On January 5, 2017, Joy pays the \$2,250 rent due for November, December, and January.

If Joy uses the accrual method, she can deduct \$1,500 of accrued rent expense for November and December 2016. Both the all-events test and the economic performance tests are satisfied. Economic performance occurred as Joy used the office building in November and December. The January rent is deducted in 2017.

As a cash basis taxpayer, Joy can deduct the \$2,250 when paid in cash (or its equivalent) on January 5, 2017.

- b. Joy borrows \$60,000 on a 1-year note on October 1, 2016. To get the loan, she has to prepay \$6,200 in interest.

Under the accrual method, Joy is required to allocate the interest expense deduction to the time periods the loan is outstanding. Joy deducts \$1,550 of interest expense for 2016 $[(3 \div 12) \times \$6,200]$. The remaining \$4,650 is deducted in 2017.

Cash basis taxpayers can deduct prepaid expenses in the year paid if the payment does not create an asset that extends substantially beyond the end of the year. Under the one-year rule for prepaid expenses, the prepaid expense is deductible in the year of payment if the prepayment will be used up before the end of the tax year following the year of prepayment.

Prepaid interest is not generally deductible under the one-year rule. The only exception to this rule is for the payment of "points" on a loan to purchase a principal residence. Joy is required to allocate the interest expense deduction to the time periods the loan is outstanding. Joy deducts \$1,550 of interest expense for 2016 $[(3 \div 12) \times \$6,200]$. Thus, Joy is effectively treated as an accrual basis taxpayer for purposes of deducting prepaid interest expense. Joy deducts the remaining \$4,650 in 2017.

- c. Joy owes employees accrued wages totaling \$20,000 as of December 31, 2016. The accrued wages are paid in the regular payroll on January 5, 2017.

If Joy uses the accrual method, Joy can deduct \$20,000 of accrued wages on December 31, 2016. The all-events and economic performance tests have been met. Economic performance occurred as the employees rendered services to Joy.

As a cash basis taxpayer, Joy can deduct the wages when paid on January 5, 2017.

- d. Joy purchases \$2,400-worth of supplies from a local vender. The supplies are delivered on January 29, 2016. They are fully used up on December 30, 2016. Because of unusual circumstances, a bill for the supplies arrives from the vendor on January 10, 2017, and is promptly paid.

If Joy uses the accrual method, Joy can deduct the supplies expense when they are delivered on January 29, 2016. The all-events test and economic performance tests are met when the supplies are delivered to Joy.

As a cash basis taxpayer, Joy can deduct the supplies expense when she pays the invoice in cash (or its equivalent) in January 2017.

- e. While at a trade convention, Joy purchases some pens and paperweights to send out as holiday gifts to her clients. She charges the \$700 cost to her credit card in December 2016. She pays the credit card bill in January 2017.

The \$700 cost is a deductible advertising cost. As an accrual basis taxpayer, both the all-events test and the economic performance test have been met. Economic performance occurs when Joy gives the pens and paperweights. Joy will be able to deduct the cost in 2016 when she charged the cost to her credit card.

As a cash basis taxpayer, Joy would be allowed the deduction in 2016. Joy will be able to deduct the cost in 2016 when she charged the cost to her credit card. Payment is considered made when money is borrowed from a third party - the credit card company.

67. The Parr Corporation incurs the following expenses. When can it deduct the expenses if it uses the accrual method of accounting? the cash method?
- a. Parr Corporation mails a check for \$5,000 to the United Way on December 26, 2016. The company's canceled check shows that the United Way did not deposit the check until January 16, 2017.

If Parr is an accrual basis taxpayer, Parr can deduct the \$5,000 in 2016 because both the all-events test and the economic performance tests are met. Economic performance occurs when Parr provides (mails) the check to the United Way.

If Parr is a cash basis taxpayer, the \$5,000 is deductible in 2016 as long as the check is honored when it is deposited by the United Way. The fact that it took the United Way 3 weeks to deposit the check does not have an impact on Parr's deduction.

- b. For 2016, Parr Corporation estimates its warranty expense to be 1.5% of sales. The company's sales for 2016 were \$2,100,000. The actual warranty costs paid in 2016 were \$40,000.

Although for financial purposes Parr will accrue \$31,500 ($\$2,100,000 \times 1.5\%$) in warranty expenses, Parr's deduction for tax purposes is \$40,000. The all-events test (the liability exists and the amount of the liability can be determined) and the economic performance test have been met only with respect to the \$40,000 of actual warranty costs.

A cash basis taxpayer can deduct expenses as the expenses are paid. As a cash basis taxpayer, Parr can deduct \$40,000.

- c. On August 1, 2016, Parr Corporation borrows \$225,000 on a 1-year note. Since the company is experiencing a cash flow problem, the bank agrees to let Parr pay the interest when the note matures. In exchange, the interest rate on the note is 10% - - 3% above the current market rate.

Interest relates to the use of money over-time. The accrual method requires Parr to allocate the interest deduction of \$22,500 ($\$225,000 \times 10\%$) over the life of the loan. Therefore, Parr's interest deduction for 2016 is \$9,375 [$(5 \div 12) \times \$22,500$]. The remaining \$13,125 is deductible in 2017.

If Parr is a cash basis taxpayer, none of the interest is deductible in 2016 since the interest is not paid until 2017. When the interest is paid in 2017, Parr deducts \$22,500 ($\$225,000 \times 10\%$).

- d. Parr Corporation advertises on radio and in the newspaper. During the year, the company is billed \$16,500 for advertising. The beginning balance in the advertising payable account on January 1, 2016, is \$2,500 and the ending balance on December 31, 2016 is \$3,300.

As an accrual basis taxpayer, Parr's advertising deduction for 2016 is \$16,500. The amount charged to the advertising payable account is deductible because both the all-events test and economic performance test have been met. Economic performance occurred as the advertising services were provided.

As a cash basis taxpayer, Parr only can deduct the amount paid for advertising in 2016. Parr's advertising deduction for 2016 is \$15,700. Because the advertising payable account increased by \$800 (\$2,500 - \$3,300), one can assume that Parr only paid \$15,700 (\$16,500 - \$800), the \$16,500 billed in 2016 minus the \$800 liability incurred but not paid during the year.

- e. On August 1, 2016, Parr Corporation pays \$3,200 for a 1-year fire insurance policy for the period August 1, 2016, through July 31, 2017. Parr's insurance company requires the 1-year prepayment, which the company makes every year.

As an accrual basis taxpayer, Parr would be able to deduct the \$3,200 in the current year only if the expense meets the recurring item exception to the economic performance test. Congress intended this exception to apply primarily to accrued expenses - - those expenses that have not yet been paid but that meet the all-events test and will be paid within a reasonable time after the close of the year. To meet this exception the expense must be immaterial for both financial accounting and tax purposes and the relationship between the cost of insurance and Parr's other items of income and expenses must be immaterial. If Parr cannot meet this exception then it can only deduct \$1,333 $[(5 \div 12) \times \$3,200]$ in 2016. The remaining \$1,867 ($\$3,200 - \$1,333$) is deducted in 2017.

If Parr is a cash basis taxpayer, the corporation is allowed to deduct the entire amount (\$3,200) in 2016. Under the one-year rule for prepaid expenses, a cash basis taxpayer can deduct the entire amount of an expense, if the taxpayer can show that the prepayment is required and the benefit will be consumed or used up before the end of the tax year following the year of payment.

68. Kai, a cash basis taxpayer, is a 75% owner and president of Finnigan Fish Market. Finnigan, an S corporation, uses the accrual method of accounting. On December 28, 2016, Finnigan accrues a bonus of \$40,000 to Kai. The bonus is payable on February 1, 2017. When is the bonus deductible? How would your answer change if Finnigan is a cash basis taxpayer?

Generally, an accrual basis corporation can deduct an expense in the tax year in which the payment is made to a cash basis taxpayer. However, because Kai and Finnigan are related parties, Finnigan must wait to deduct the expense until 2017, the tax year Kai reports the bonus as income. Finnigan can deduct the expense on its tax return for the year ended December 31, 2017 and Kai will report the bonus as income on his 2017 tax return. Note that the effect of the related party rule is to always have the income and the corresponding deduction reported in the same year.

If both Kai and Finnigan are cash basis taxpayers, then Finnigan will deduct the bonus when it is paid in 2017 and Kai will report the bonus as income in 2017.

69. Lonnie owns 100% of Quality Company's common stock. Lonnie, the president of Quality, is a cash basis taxpayer. Quality is short of cash as of December 31, 2016, the close of its tax year. As a result, it is necessary to accrue a \$50,000 bonus payable to Lonnie. As soon as the cash becomes available on January 15, 2017, Quality pays Lonnie the bonus in cash. When is the bonus deductible for the accrual basis corporation? How would your answer change if Lonnie is an accrual basis taxpayer?

Generally, an accrual basis corporation can deduct an expense in the tax year in which the payment is made to a cash basis taxpayer. However, because Lonnie and Quality are related parties, Quality must wait to deduct the expense until 2017, the tax year Lonnie reports the bonus as income. Quality will deduct the expense on its tax return for the year ended December 31, 2017 and Lonnie will report the bonus as income on his 2017 tax return. Note that the effect of the related party rule is to always have the income and the corresponding deduction reported in the same year.

If both Lonnie and Quality are accrual basis taxpayers, then Quality will accrue and deduct the bonus as an expense in 2016 and Lonnie will accrue the bonus as income in 2016.

70. During the current year, Covino Construction makes \$5,000 in political contributions to ten political candidates. What amount can Covino deduct for financial accounting purposes? for tax purposes?

For financial accounting purposes, Covino can deduct the \$50,000 ($\$5,000 \times 10$) in political contributions as a business expense. However, for tax purposes the political contributions are not deductible. The expense is not ordinary and necessary to the taxpayer's trade or business. In upholding the denial of a deduction for political contributions, the courts have maintained that the money has an "insidious influence" on politics and that the tax system should not promote expenditures that encourage the frustration of public policy. The \$50,000 difference between the amount deducted for financial purposes and tax purposes is treated as a permanent difference.

71. Martin Corporation is an accrual basis taxpayer that manufactures cellular phones. The company provides a 5-year limited warranty on its phones and estimates that warranty expenses will be 1.5% of sales. During the current year, Martin has sales of \$12,000,000 and incurs \$149,000 of warranty expenses. What amount can Martin deduct for financial accounting purposes? for tax purposes?

For financial accounting purposes, Martin Corporation can deduct \$180,000 ($\$12,000,000 \times 1.5\%$) in warranty expenses. Under generally accepted accounting principles (GAAP), a corporation can deduct an estimate of its future obligations under a warranty contract. However, for tax purposes, Martin is only allowed to deduct the \$149,000 of warranty costs it actually incurs. Reserve accounting (i.e., the allowance method) is not allowed for warranties because the all-events test is not met with respect to the \$180,000 estimate. That is, although Martin has a reasonable estimate of its expense, the all-events test requires that the actual payee be known. In addition, the economic performance test is not met until the repairs under the warranty contract are actually performed.

The \$31,000 difference between the amount deducted for financial purposes (\$180,000) and tax purposes (\$149,000) is treated as a temporary difference.

ISSUE IDENTIFICATION PROBLEMS

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

72. Shuana works as a lawyer for a large law firm where professional dress is expected. Her friend, Carissa, is a nurse at a local hospital. Shuana spends \$1,500 a year on clothing, shoes, and accessories that she wears to work. Carissa spends \$500 on uniforms and shoes for her job.

The issue is whether clothes used by Carissa and Shuana in their jobs can be deducted as a business expense. Carissa is allowed to deduct the cost of her uniform and shoes. The cost of these items are deductible because Carissa acquired and used these items exclusively in her job as a nurse. It is not common for a nurse to wear these items outside of the hospital (i.e., for personal use). The \$500 is an unreimbursed employee expense and is deducted as a miscellaneous itemized deduction (see Chapter 8).

Shuana cannot deduct the cost of the clothes, shoes and accessories that she wears to work. Unlike Carissa, the clothes Shauna wears to her job are not used exclusively in her job as a lawyer. It is common for a taxpayer to also use these items for personal purposes.

Instructors Note: It could be argued that the clothes are a mixed use asset. However, the government, under the administrative convenience concept, feels that is easier to disallow the deduction than to determine whether the taxpayer properly allocated the cost of the clothes between business and personal use.

73. Angela owns a duplex. She rents out one unit and lives in the other. During the current year, she pays \$4,500 in interest on the loan she used to buy the duplex, \$900 in property taxes on the duplex, and \$1,200 in dues to the duplex association which maintains the grounds and the swimming pool.

The two issues that should be considered are which expenses can Angela deduct and the deductible amount of each expense. The duplex is a mixed-use asset and the expenses related to the duplex are mixed-use expenditures. Angela will be able to deduct all expenses related to the rental unit against her rental income as a deduction for adjusted gross income. Assuming that the two units are equivalent (for example, based on square footage of each unit), half of the interest, taxes and association dues are deducted as rental expenses. The remainder of each expense is a personal expense. Home mortgage interest and property taxes are deductible as itemized deductions. The personal portion of the association dues would not be deductible.

	<u>Rent Expense</u>	<u>Personal</u>
Interest	\$2,250	\$2,250
Property taxes	450	450
Dues	600	600

74. Harry and Sydney each inherited 50% of the stock in their father's corporation when he died. Harry had been working for their father and wanted to retain control of the business. Sydney was not really interested in the family business and wanted to sell her stock to outsiders. To retain control of the corporation, Harry made Sydney a vice president of the corporation with an annual salary of \$200,000. The only requirements of the position were that Sydney not sell her stock and that she let Harry run the business.

The issue is whether the corporation will be allowed to deduct the \$200,000 it paid to Sydney. The corporation will not be entitled to a deduction because the amount paid is not reasonable considering her responsibilities and duties to the corporation. The substance of the transaction is that it is a guaranteed dividend payment. Thus, Sydney will be taxed on the \$200,000, but the corporation is not allowed a deduction for the dividend payment.

75. Leonard owns an apartment complex. During the current year, he pays \$14,000 to have all the apartments painted and re-carpeted. Gena purchases an apartment complex during the current year. Before she can rent out the apartments, she pays \$14,000 to have them painted and re-carpeted.

The issue is whether the expenses are currently deductible or should be capitalized. Painting and re-carpeting apartments is generally considered to be an ongoing maintenance expense. Because Leonard has owned the apartment in prior years, he would be allowed to deduct the \$14,000 as a current period expense. Because Gena purchased her apartments in the current year and the work was necessary to rent them out, they are capital expenditures. That is, they are part of the cost of getting the apartments ready to rent and must be added (i.e., capitalized) to the cost of the building and deducted through depreciation.

76. In auditing the Philbin Corporation's repair expense account, Sara finds a \$28,000 entry. Since the amount is so large, she obtains supporting documentation. The invoice lists the Fradin Roofing Company as providing the service, but no description of the work the company performed is attached to the invoice. However, a notation on the check says "office roof."

The issue is whether the roof repair is currently deductible or should be capitalized. Sara must determine whether the repair either increases the useful life of the building or increases the value of the building. If so, the \$28,000 expense must be capitalized and Philbin Corporation will recover the cost of the roof over the tax life of the building (depreciation is discussed in Chapter 10). If the expense for the roof is incurred only to maintain the building in its normal operating condition, then the \$28,000 is deductible in the current period.

For example, if a new roof would cost the Philbin Corporation \$600,000, then the \$28,000 expenditure should be considered a repair expense. The amount spent on the roof does not extend the useful life of the building, rather, the expense maintains the building in its normal operating condition. However, if the cost of a new roof would cost \$35,000, then the \$28,000 expenditure should be treated as a capital expenditure, since the amount spent on the roof extends the useful life of the building.

77. Gary and Wes operate a wholesale meat company. The company sells to restaurants, golf clubs and other dining establishments. Recently they spent \$20,000 for market and demographic surveys, financial projections and real estate appraisals to help them decide whether to open a retail store.

The issue is whether opening the retail store is related to their current trade or business. If so, the \$20,000 in costs are considered ordinary and necessary business expenses and are deductible regardless of whether they open the new store.

If the retail store is not related to their current trade or business, the costs are start-up costs. A taxpayer who incurs less than \$50,000 of start-up costs can deduct up to \$5,000 of the start-up costs in the year the new business begins. Any amount in excess of \$5,000 must be amortized over 180 months. For taxpayers, with start-up costs in excess of \$50,000, the \$5,000 amount is phased-out on a dollar-by-dollar basis. Therefore, the deduction for start-up costs can be viewed as consisting of two parts. The first is a \$5,000 current deduction and a second part that amortizes the remaining start-up costs over 180 months. If they do not open the store, then the expenses are considered a personal capital expenditure and are not deductible.

78. Marcus is the vice president of human resources for Griffin Industries. He spent one week testifying before Congress on the impact health care legislation will have on small business. His trip cost \$2,750.

The issue is whether Marcus's trip is a business expense or a lobbying expense. The trip is not deductible because it is considered a lobbying expense. Only the cost of monitoring legislation is a deductible business expense.

79. Russell is employed as a prosecutor for the town of Swansea. He also works 15-20 hours a week raising purebred Labradors. Over the last 7 years, he has reported an average net income from this activity of \$7,000 per year. However, in two of those years, he has had losses of \$3,000 and \$4,000. He believes he could make more money from the activity if he kept better records, was less stubborn, and listened more to the advice of his cousin who has won national awards in dog breeding.

The issue is whether Russell is engaged in the trade or business of raising Labradors or whether the activity is a hobby. In determining whether Russell is engaged in a trade or business or a hobby, the IRS will examine the following nine factors:

- **Whether the taxpayer carries on the activity in a business-like manner**
- **The expertise of the taxpayer or her reliance on expertise**
- **The history of income and profits**
- **The time and effort spent on the activity**
- **The taxpayer's success in similar activities**
- **Whether the activity is engaged in for personal pleasure or recreation**
- **The taxpayer's financial condition**
- **The expectation that the assets used in the business will appreciate**
- **The amount, if any, of occasional profits**

The fact that Russell has made money in most years is beneficial in proving that he is engaged in a trade or business. However, the fact that he does not conduct the activity in a business-like manner (i.e., his poor records) and does not rely on the expertise of a professional (i.e., his cousin) will work against him.

80. Chin, a cash basis taxpayer, borrows \$25,000 on a 2-year loan from State Bank to purchase business equipment. Under the terms of the loan, State Bank deducts \$4,500 in interest on the loan and gives Chin the \$20,500 net proceeds. Chin will repay State Bank \$25,000 in 2 years.

The issue is when can Chin deduct the \$4,500 in interest on the loan. Can basis taxpayers can only deduct expenses as they are paid. In this case Chin will deduct the \$4,500 of interest in 2 years when the loan is repaid.

81. The Showgate Hotel Casino is an accrual basis taxpayer and maintains its records on a calendar year. It has 3,000 slot machines, one of them a progressive machine whose jackpot increases based on the amount wagered. The casino guarantees that a person who hits the jackpot will receive the lesser of 5% of the amount wagered to date or \$250,000. On December 1, 2016, the progressive slot machine reaches the \$250,000 maximum payoff. The following January, a hotel guest wins the \$250,000 jackpot.

The issue is whether Showgate can deduct the \$250,000 payment in 2016. Accrual basis taxpayers can only deduct expenses when the all-events and economic performance tests have been met. Although the liability for the jackpot exists, and the amount is known, since Showgate does not know the payee, it does not meet the all-events test. The economic performance test requires that economic performance with regard to the liability must have occurred. This generally means that property (in this case cash) related to the liability must have been received by the winner. Because the actual payment to the winner is not made until 2017, the economic performance test is not met and the casino cannot take a deduction for jackpot until 2017.

Instructors Note: This is a modification of an example in the regulations [Reg. Sec. 1.461-4(g)(8)].

82. **RIA RESEARCH EXERCISE** Use the RIA Checkpoint database to answer the following questions. Cut and paste the relevant Internal Revenue Code and Regulation section(s) into your solution and explain how the authority answers the tax issue in question. Give the most specific citation applicable [e.g., Section 168 (a) (1)] to the question. Note: If the answer can be found in both the code and regulations you must provide both authorities.
1. Sally is a teacher. In her spare time, she enjoys painting watercolors. Occasionally she sells one of her paintings. Last year, Sally spent \$800 on paint supplies, and received \$1,000 from the sale of her paintings. What code section and/or regulation allows Sally to deduct some of the expenses from her hobby?

Sec. 183 (b) sets forth the type of expenses that can be deducted if the taxpayer is engaged in a hobby (activity not engaged in for a profit). Although not obvious, the Code in (b)(1) is referring to interest and taxes, where in (b)(2) it is referring to other business expenses (e.g., supplies, utilities and depreciation). These distinctions become clearer upon reading Reg § 1.183-1 (b) (1).

Sec. 183 Activities not engaged in for profit.

(b) Deductions allowable. In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

Reg § 1.183-1. Activities not engaged in for profit.

(b) Deductions allowable.

(1) Manner and extent. *If an activity is not engaged in for profit, deductions are allowable under section 183(b) in the following order and only to the following extent:*

(i) *Amounts allowable as deductions during the taxable year under chapter 1 of the Code without regard to whether the activity giving rise to such amounts was engaged in for profit are allowable to the full extent allowed by the relevant sections of the Code, determined after taking into account any limitations or exceptions with respect to the allowability of such amounts. For example, the allowability-of-interest expenses incurred with respect to activities not engaged in for profit is limited by the rules contained in section 163(d).*

(ii) *Amounts otherwise allowable as deductions during the taxable year under chapter 1 of the Code, but only if such allowance does not result in an adjustment to the basis of property, determined as if the activity giving rise to such amounts was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivision (i) of this subparagraph.*

(iii) *Amounts otherwise allowable as deductions for the taxable year under chapter 1 of the Code which result in (or if otherwise allowed would have resulted in) an adjustment to the basis of property, determined as if the activity giving rise to such deductions was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivisions (i) and (ii) of this subparagraph. Deductions falling within this subdivision include such items as depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premium.*

2. Jerry, a salesman, sends his five best clients gift baskets on their birthdays. The gift baskets cost Jerry \$50 each. What code section and/or regulation allows Jerry to deduct \$25 of the price of each gift?

Sec. 162 (b) specifically disallows a deduction for business gifts. However, relief is found in Sec. 274 and the regulations of that code section.

Sec. 162 Trade or Business Expenses

(a) In general.

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business

(b) Charitable contributions and gifts excepted.

No deduction shall be allowed under subsection (a) for any contribution or gift which would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section.

Both Sec. 274 (b)(1) and Reg. Sec. 1-274-3(a) limit the amount of a deduction for a gift to \$25. Both authorities also make it clear that the \$25 limit is not a per gift limit, but a yearly deduction limit per individual.

Sec. 274 Disallowance of certain entertainment, etc., expenses.

(b) Gifts.

(1) Limitation. No deduction shall be allowed under section 162 or section 212 for any expense for gifts made directly or indirectly to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds \$25. For purposes of this section, the term "gift" means any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of this chapter, but such term does not include—

Reg § 1.274-3. Disallowance of deduction for gifts.

(a) In general. No deduction shall be allowed under section 162 or 212 for any expense for a gift made directly or indirectly by a taxpayer to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the taxpayer's taxable year, exceeds \$25.

3. Marvin's house is damaged by a tornado. What code section and/or regulation allows him to deduct any loss he suffers due to the tornado?

Sec. 165(a) allows an individual to deduct losses not compensated by insurance, if the loss arises from a casualty. **Sec. 165(c)(3)** and **Reg. 1.165-7(a)(1)** all list the types of casualties that qualify as a casualty but this is not to be interpreted as an exhaustive list. A tornado is considered a storm.

§ 165 Losses.

(a) General rule. There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of deduction. For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

Sec. 165(c)(3) and **Reg. Sec. 1.165-7(a)(1)** limits personal losses of individuals to those from fire, storm, shipwreck or other casualty.

(c) Limitation on losses of individuals. In the case of an individual, the deduction under subsection (a) shall be limited to

- (1) losses incurred in a trade or business;***
- (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and***
- (3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into***

for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

Reg § 1.165-7. Casualty losses.

(a) In general. (1) Allowance of deduction. Except as otherwise provided in paragraphs (b)(4) and (c) of this section, any loss arising from fire, storm, shipwreck, or other casualty is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained. However, see §1.165-6, relating to farming losses, and §1.165-11, relating to an election by a taxpayer to deduct disaster losses in the taxable year immediately preceding the taxable year in which the disaster occurred. The manner of determining the amount of a casualty loss allowable as a deduction in computing taxable income under section 63 is the same whether the loss has been incurred in a trade or business or in any transaction entered into for profit, or whether it has been a loss of property not connected with a trade or business and not incurred in any transaction entered into for profit. The amount of a casualty loss shall be determined in accordance with paragraph (b) of this section. For other rules relating to the treatment of deductible casualty losses, see §1.1231-1, relating to the involuntary conversion of property.

4. Peter undergoes a medical procedure to prevent him from snoring. His insurance company will not reimburse him for the \$2,000 procedure since he does not suffer from sleep apnea and contends that the procedure is cosmetic surgery. What code section and/or regulation does not allow him to deduct the cost of the procedure if the medical procedure is considered cosmetic surgery?

Sec. 213 (a) provides that a taxpayer can deduct unreimbursed medical care incurred on behalf of the taxpayer, their spouse or their dependent. Reg. Sec. 1.213-1(a)(1) reiterates the allowance of the deduction for unreimbursed medical expenses. If the cosmetic surgery is medical care, Peter can deduct the cost of the procedure to correct his snoring.

§ 213 Medical, dental, etc., expenses

(a) Allowance of deduction. There shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent (as defined in section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof), to the extent that such expenses exceed 7.5 percent of adjusted gross income.

Reg § 1.213-1. Medical, dental, etc., expenses.

(a) Allowance of deduction.

(1) Section 213 permits a deduction of payments for certain medical expenses (including expenses for medicine and drugs). Except as provided in paragraph (d) of this section (relating to special rule for decedents) a deduction is allowable only to individuals and only with respect to medical expenses actually paid during the taxable year, regardless of when the incident or event which occasioned the expenses occurred and regardless of the method of accounting employed by the taxpayer in making his income tax return. Thus, if the medical expenses are incurred but not paid during the taxable year, no deduction for such expenses shall be allowed for such year.

Sec. 213(d)(1)(A) defines medical care as amounts paid “for the purpose of affecting any structure or function of the body” This would allow Peter a deduction for the cosmetic surgery.

§ 213 Medical, dental, etc., expenses.

(d) Definitions. For purposes of this section —

- (1) The term “medical care” means amounts paid—***
(A) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body,
(B) for transportation primarily for and essential to medical care referred to in subparagraph (A),
(C) for qualified long-term care services (as defined in section 7702B(c)), or

(D) for insurance (including amounts paid as premiums under part B of title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged) covering medical care referred to in subparagraphs (A) and (B) or for any qualified long-term care insurance contract (as defined in section 7720B(b)).

However, Sec. 213(d)(9)(A) specifically states that medical care does not include cosmetic surgery. The definition of cosmetic surgery is found in Sec. 213(d)(9)(B).

§ 213 Medical, dental, etc., expenses.

(9) Cosmetic surgery.

(A) In general. The term “medical care” does not include cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease.

(B) Cosmetic surgery defined. For purposes of this paragraph , the term “cosmetic surgery” means any procedure which is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease.

83. **RIA RESEARCH EXERCISE** Use the RIA Checkpoint database to answer the following questions. Cut and paste the relevant Internal Revenue Code and Regulation section(s) into your solution and explain how the authority answers the tax issue in question. Give the most specific citation applicable [e.g., Section 168 (a) (1)] to the question. Note: If the answer can be found in both the code and regulations you must provide both authorities.

Carmela is single, 52 years old, and has an adjusted gross income of \$62,000. Carmela is covered by a qualified employee pension plan and she contributes the maximum amount to her Individual Retirement Account (IRA).

- a. What code section and/or regulation allows a deduction for contributions to an IRA?

Sec. 219(a) allows a deduction for a contribution to a qualified retirement plan.

Sec. 219 Retirement savings.

(a) Allowance of deduction. *In the case of an individual, there shall be allowed as a deduction an amount equal to the qualified retirement contributions of the individual for the taxable year.*

Reg. Sec. 1.219-1(a) provides that the taxpayer is allowed a deduction for adjusted gross income up to the maximum amount provided in Sec 219 (b)(1).

Reg § 1.219-1(a)

(a) In general. *Subject to the limitations and restrictions of paragraph (b) and the special rules of paragraph (c)(3) of this section, there shall be allowed a deduction under section 62 from gross income of amounts paid for the taxable year of an individual on behalf of such individual to an individual retirement account described in section 408(a), for an individual retirement annuity described in section 408(b), or for a retirement bond described in section 409. The deduction described in the preceding sentence shall be allowed only to the individual on whose behalf such individual retirement account, individual retirement annuity, or retirement bond is maintained. The first sentence of this paragraph shall apply only in the case of a contribution of cash. A contribution of property other than cash is not allowable as a deduction under this section. In the case of a retirement bond, a deduction will not be allowed if the bond is redeemed within 12 months of its issue date.*

- b. What code section and/or regulation limits the amount that can be contributed to an IRA?

Sec. 219(b)(1) limits the amount that can be deducted to the lesser of earned income or the deductible amount. **Sec. 219(b)(5)(A)** provides the maximum deductible amount. For 2016, the maximum amount is \$5,500.

Sec. 219 Retirement savings.

(b) Maximum amount of deduction.

(1) In general. *The amount allowable as a deduction under subsection (a) to any individual for any taxable year shall not exceed the lesser of—*

(A) the deductible amount, or

(B) an amount equal to the compensation includible in the individual's gross income for such taxable year.

(5) Deductible amount. For purposes of paragraph (1)(A)—

(A) In general. The deductible amount shall be determined in accordance with the following table:

For taxable years beginning in: The deductible amount is:

2003 through 2005	\$3,000
2006 through 2008	\$4,000
2009 and thereafter	\$5,000.

Beginning for tax years after 2009 the deductible amount of \$5,000 is indexed for inflation. For 2016, the amount is \$5,500.

219(b)(5)(D) Cost-of-living adjustment. —

219(b)(5)(D)(i) In general. —In the case of any taxable year beginning in a calendar year after 2014, the \$5,000 amount under subparagraph (A) shall be increased by an amount equal to —

219(b)(5)(D)(i)(I) such dollar amount, multiplied by

219(b)(5)(D)(i)(II) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting “calendar year 2012” for “calendar year 1992” in subparagraph (B) thereof.

219(b)(5)(D)(ii) Rounding rules. —If any amount after adjustment under clause (i) is not a multiple of \$500, such amount shall be rounded to the next lower multiple of \$500.

Proposed Reg § 1.219(a)-2(b)(1) also discusses the limits. However, the regulations have not been updated since 1981.

Prop Reg § 1.219(a)-2

b) Limitations and restrictions.

(1) Maximum deduction. The amount allowable as a deduction for contributions to an individual retirement plan to an individual for any taxable year cannot exceed the lesser of—

(i) \$2,000, or

(ii) An amount equal to the compensation includible in the individual's gross income for the taxable year, reduced by the amount of the individual's qualified voluntary employee contributions for the taxable year.

- c. What code section and/or regulation allows an increased IRA contribution due to age?

For 2016, Sec. 219(b)(5)(B)(ii) allows taxpayers age 50 and over to contribute and deduct an additional \$1,000 to their IRA accounts.

Sec. 219 Retirement savings.

(5) Deductible amount.

(B) Catch-up contributions for individuals 50 or older.

- (i) In general. In the case of an individual who has attained the age of 50 before the close of the taxable year, the deductible amount for such taxable year shall be increased by the applicable amount.**
- (ii) Applicable amount. For purposes of clause (i), the applicable amount shall be the amount determined in accordance with the following table:**

Year	Amount
2002 through 2005	\$ 500
2006 and thereafter	\$1,000

- d. What code section and/or regulation limits the amount of the IRA deduction for members of a qualified employee pension plan?

Sec. 219(g)(1) specifies that if an individual or the individual's spouse is a active participant in a pension plan, the amount of the taxpayer's contribution that can be deducted is reduced as specified in Sec. 219 (g)(2). The reduction is phased out over a \$10,000 range as specified in Sec. 219(g)(2)(A)(ii).

Sec. 219 Retirement savings.

(g) Limitation on deduction for active participants in certain pension plans.

- (1) In general. If (for any part of any plan year ending with or within a taxable year) an individual or the individual's spouse is an active participant, each of the dollar limitations contained in subsections (b)(1)(A) and (c)(1)(A) for such taxable year shall be reduced (but not below zero) by the amount determined under paragraph (2).**

(2) Amount of reduction.

- (A) In general. The amount determined under this paragraph with respect to any dollar limitation shall be the amount which bears the same ratio to such limitation as—**

(i) the excess of —

(I) the taxpayer's adjusted gross income for such taxable year, over

(II) the applicable dollar amount, bears to

(ii) \$10,000 (\$20,000 in the case of a joint return for a taxable year beginning after December 31, 2008).

- (B) No reduction below \$200 until complete phase-out. No dollar limitation shall be reduced below \$200 under paragraph (1) unless (without regard to this subparagraph) such limitation is reduced to zero.**

- (C) Rounding. Any amount determined under this paragraph which is not a multiple of \$10 shall be rounded to the next lowest \$10.**

(3) Adjusted gross income; applicable dollar amount

- (B) Applicable dollar amount. The term "applicable dollar amount" means the following:**

- (i) In the case of a taxpayer filing a joint return: The applicable dollar amount is:**

Year	Amount
1998	\$50,000
1999	\$51,000
2000	\$52,000
2001	\$53,000
2002	\$54,000
2003	\$60,000
2004	\$65,000
2005	\$70,000
2006	\$75,000
2007 and thereafter	\$80,000

(ii) In the case of any other taxpayer (other than a married individual filing a separate return): The applicable dollar amount is:

Year	Amount
1998	\$30,000
1999	\$31,000
2000	\$32,000
2001	\$33,000
2002	\$34,000
2003	\$40,000
2004	\$45,000
2005 and thereafter	\$50,000

As with the deductible amount of an IRA contribution, beginning for tax years after 2005, the adjusted gross income levels at which the deduction begins to be phased out are indexed for inflation. For 2016 the phase out for joint returns begins at \$98,000 and ends at \$118,000. For single taxpayers the phase out begins at \$61,000 and ends at \$71,000.

219(g)(8) Inflation adjustment. —*In the case of any taxable year beginning in a calendar year after 2008, the dollar amount in the last row of the table contained in paragraph (3)(B)(i), the dollar amount in the last row of the table contained in paragraph (3)(B)(ii), and the dollar amount contained in paragraph (7)(A), shall each be increased by an amount equal to —*

219(g)(8)(A) such dollar amount, multiplied by

219(g)(8)(B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting “calendar year 2008” for “calendar year 1992” in subparagraph (B) thereof.

Any increase determined under the preceding sentence shall be rounded to the nearest multiple of \$1,000.

84. **TAX SIMULATION.** In April of the current year, the Mojena Corporation, a computer power supply manufacturer, was found guilty of price fixing under the Sherman Anti-Trust Act and fined \$50,000. In addition, The United States sued Mojena under Section 4A of the Clayton Act for \$140,000, of which \$100,000 represents the actual damages (compensatory damages) resulting from the price fixing and \$40,000 represents court costs. In July, Mojena Corp. pays the United States \$190,000 (\$50,000 + \$100,000 + \$40,000) in full settlement of the charges.

Required: Determine the amount Mojena can deduct on its tax return. Search a tax research database and find the relevant authority (ies) that form the basis for your answer. Your answer should include the exact text of the authority (ies) and an explanation of the application of the authority to Mojena's facts. If there is any uncertainty about the validity of your answer, indicate the cause for the uncertainty.

Sec. 162(a) allows a deduction all ordinary and necessary expenses incurred in carrying on a trade or business.

Sec. 162(a) There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business

However, Sec. 162(f) prohibits a deduction for any fine paid to the government.

Sec. 162 (f) Fines and penalties. No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law.

While it is clear from the above Code Section that the \$50,000 fine is not deductible, it is not clear whether the \$100,000 of actual damages and the \$40,000 of court costs are considered a fine or a penalty under Sec. 162(f). Reg. Sec. 1.162-21(b)(2) provides clarification of what is considered a fine or penalty by stating that amounts paid as compensatory damages and for court costs are not considered to be fines or penalties.

The amount of a fine or penalty does not include legal fees and related expenses paid or incurred in the defense of a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty, nor court costs assessed against the taxpayer, or stenographic and printing charges. Compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

Based on the above, it would appear that Mojena would be able to deduct the \$100,000 of compensatory damages and the \$40,000 of court costs. However, Sec. 162 (g) states:

Sec. 162 Treble damage payments under the antitrust laws. If in a criminal proceeding a taxpayer is convicted of a violation of the antitrust laws, or his plea of guilty or nolo contendere to an indictment or information charging such a violation is entered or accepted in such a proceeding, no deduction shall be allowed under subsection (a) for two-thirds of any amount paid or incurred—

(1) on any judgment for damages entered against the taxpayer under section 4 of the Act entitled “An Act to supplement existing laws against unlawful restraints and monopolies, and for other purposes”, approved October 15, 1914 (commonly known as the Clayton Act), on account of such violation or any related violation of the antitrust laws which occurred prior to the date of the final judgment of such conviction, or

(2) in settlement of any action brought under such section 4 on account of such violation or related violation. The preceding sentence shall not apply with respect to any conviction or plea before January 1, 1970, or to any conviction or plea on or after such date in a new trial following an appeal of a conviction before such date.

Therefore, it appears as if based solely on the Code and Regulations there is uncertainty as to whether an entity would lose 2/3 of its deduction for payments made under the Clayton Act or only those payments in which the payment is not specified as a compensatory payment.

85. **INTERNET ASSIGNMENT** Many legislative, administrative, and judicial resources are available on the Internet. Court cases can be located using a search engine provided by your browser or a tax directory site on the Internet. Using a search engine or one of the tax directory sites provided in Exhibit 16-6 (Chapter 16), find the 1987 Supreme Court decision that provides the current criteria for determining what constitutes a trade or business. Trace the process you used to find this case (search engine or tax directory used and key words). Describe the facts that led to this decision.

The Tax and Accounting Sites Directory <http://www.taxsites.com/> is a good tax directory to start your search. Clicking on Federal Tax Law will take the student to a page that lists Court Decisions. From there, clicking on U.S. Supreme Court Decisions will take the student to Findlaw (<http://www.findlaw.com/casecode/supreme.html>). Using the search term "tax and trade and business" a list of all cases with this search term and the standard cite for the case will appear. The first 1987 case that appears on the list is *Commissioner v Groetzinger*, 480 U.S. 23 (1987).

Case Background:

For most of 1978, respondent devoted 60 to 80 hours per week to pari-mutuel wagering on dog races with a view to earning a living from such activity, had no other employment, and gambled solely for his own account. His efforts generated gross winnings of \$70,000 on bets of \$72,032, for a net gambling loss for the year of \$2,032. Although he reported this loss on his 1978 tax return, he did not utilize it in computing his adjusted gross income or claim it as a deduction. Upon audit, the Commissioner of Internal Revenue determined that, under the Internal Revenue Code of 1954 (Code) as it existed in 1978, respondent was subject to a minimum tax because part of the gambling loss deduction to which he was entitled was an "item of tax preference." Under the Code, such items could be lessened by certain deductions that were "attributable to a trade or business carried on by the taxpayer." The Supreme Court held that a full-time gambler who makes wagers solely for his own account is engaged in a "trade or business" within the meaning of Code 162(a) and 62(1).

INSTRUCTOR'S NOTE: Information on the Internet is constantly changing, so this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment. In addition, a hint to the students to help in the search process is that the case deals with a gambler.

86. **INTERNET ASSIGNMENT** Articles on tax topics are often useful in understanding the income tax law. One journal that is free and accessible through the Internet is the *CPA Journal*. Go to the *CPA Journal* web page (<http://www.cpajournal.com/>) and find an article discussing the tax deductibility of environmental cleanup costs. Summarize the information in the article.

Using the search terms “environmental and cleanup” the student will find 6 documents. One article listed is entitled “New Ruling on Treatment of Environmental Clean-up Costs” by Charles E. Price and Leonard G. Weld. The article discusses the Revenue Ruling 2004-18, which now requires that previously deductible environmental clean-up costs must be capitalized as indirect costs of inventory.

INSTRUCTOR’S NOTE: Information on the Internet is constantly changing, so this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

87. **RESEARCH PROBLEM** Spencer and Richard own S&R Sports, a regional chain of 15 sporting goods stores. They have decided to expand their business by opening three new stores. The stores will employ 90 people, most of whom will work part-time. Over the years, S&R Sports has been able to keep its employee turnover lower than the competition by having its new employees attend a three-day training seminar. The cost of training the new employees will be \$45,000. Explain whether S&R Sports can deduct the cost of training the new employees in the current year.

To be deductible in the current period, the expense must be ordinary, necessary and reasonable and not create a benefit to the taxpayer beyond one-year. The question to be resolved is whether the training costs benefit the taxpayer for more than one-year (i.e., it is a capital expenditure).

The research problem is based on Rev. Rul. 96-62, 1999-2 CB 9. In this ruling the IRS determined that amounts paid or incurred for training, including the costs of trainers and routine updates of training materials, are generally deductible as business expenses even though they may have some future benefit. Training costs must be capitalized only in the unusual circumstance where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer's trade or business. Given the facts of this case, the training costs would be deductible.

88. **RESEARCH PROBLEM** Calvin and Lorna live in Nebraska and own rental property in the Ozark Mountains. They have always prepared their own tax return and have allocated their rental expenses including their mortgage interest and property taxes using the ratio of personal days to total days of use. During the year, they rent the property for 75 days and use it for 25 days. They receive \$8,500 in rental income and incurred the following expenses:

Mortgage interest	\$ 7,500
Property taxes	1,800
Insurance	550
Maintenance	300
Utilities	650
Depreciation (unallocated)	4,200

One of Calvin's neighbors tells him that there is a better way to deduct the mortgage interest and property taxes on the rental that results in a greater tax deduction. Find authority for a different method for deducting mortgage interest and property taxes on Calvin and Lorna's rental property, and calculate the effect of that method on their taxable income.

Based on the discussion in the text, because the personal use of the home exceeds 14 days, the property is a vacation home and deductions are limited to rental income. Deductions must be taken in a specified order: interest and taxes first, expenses other than depreciation second, and depreciation last. The IRS requires all vacation home expenses to be allocated based on days of use. Thus, 75% [$75 \div (25 + 75)$] of the expenses are related to the rental activity.

Rental income	\$ 8,500
Interest and taxes ($\$9,300 \times 75\%$)	(6,975)
Balance of income	\$ 1,525
Operating expenses ($\$1,500 \times 75\%$)	(1,125)
Balance of Income	\$ 400
Depreciation ($\$4,200 \times 75\% = \$3,150$)	400*
Balance of income	<u>\$ -0-</u>

* Limited to balance of income

The amount reported in gross income from the rental property is zero. The \$2,750 ($\$3,150 - \400) of depreciation not allowed because of the income limit can be carried forward and deducted in a year when income is large enough to absorb the deductions.

The remaining interest and taxes \$2,325 ($\$9,300 - \$6,975$) allocated to the personal use of the dwelling may be allowed as an itemized deduction. Thus, if Calvin and Lorna itemize their deductions, the rental property will decrease their taxable income by the \$2,325 of itemized deductions.

The research problem is based on the Ninth Circuit case *Dorance Bolton, v. Com.*, 51 AFTR 2d 83-305, (1982, CA9) and the Tenth Circuit case *Edith McKinney v. Com.*, 52 AFTR 2d 83-6281, (1983, CA10). These circuit court cases maintain that the proper ratio to deduct interest and taxes is based on the number of rental days to total number of the days in the year in the year (i.e. 365 or 366 days).

If Calvin and Lorna use the approach advocated by the Courts the deductions still must be taken in a specified order: interest and taxes first, expenses other than depreciation second, and depreciation last. However, under the court's allocation method, interest and taxes are allocated between rental and personal use based on 365 days. Other expenses are allocated based on actual days the vacation home is used for either rental or personal use. As a result of the allocation, 21%* ($75 \div 365$) of the interest and taxes are deducted for rental use while 75% [$75 \div 100$ ($75 + 25$)] of the other expenses are considered related to the rental of the home.

Rental income	\$ 8,500
Interest and taxes ($\$9,300 \times 21\%$)	(1,953)
Balance of income	<u>\$ 6,547</u>
Operating expenses ($\$1,500 \times 75\%$)	(1,125)
Balance of Income	<u>\$ 5,422</u>
Depreciation ($\$4,200 \times 75\% = \$3,150$)	3,150
Balance of income	<u><u>\$ 2,272</u></u>

* The 21% is rounded

The rental property increases their adjusted gross income by \$2,272. In addition, the remaining \$7,347 ($\$9,300 - \$1,953$) of interest and taxes are deductible as itemized deductions. If Calvin and Lorna itemize deductions, the vacation home reduces their taxable income by \$5,075 ($\$7,347$ itemized deduction - $\$2,272$ rental income). Therefore, they are better off by \$2,750 ($\$5,075 - \$2,325$) using the court's allocation method. In essence, the \$2,750 represents the amount of depreciation that is not allowed when using the IRS method but must be carryforward.

89. **SPREADSHEET PROBLEM** Teresa owns a condominium in Florida. During the current year, she incurs the following expenses related to the property:

Mortgage interest	\$ 10,200
Property taxes	1,500
Utilities	800
Maintenance fees	1,000
Repairs	600
Depreciation (unallocated)	5,000

Prepare a spreadsheet calculating Teresa's rental income or loss for each of the following cases. The spreadsheet should be prepared so that it will calculate the rental income or loss by changing the number of rental and personal days.

Case	Rental Income	Rental Days	Personal Use Days
A	\$ 9,000	40	10
B	\$ 9,000	40	20
C	\$ 1,000	12	48

In each case, you must first determine whether the property is a true rental (all allocable deductions allowed) or a vacation home (allocable deductions allowed to the extent of rental income with ordering of deductions).

CASE A

This is a true rental because the personal use is less than 14 days. However, only those expenses attributable to the rental are deductible against rental income. Because all deductions in this case are allowed for adjusted gross income, the IRS allocation method will result in the largest total deduction. Due to the definition of qualifying home mortgage interest (see Chapter 8), none of the interest allocated to personal use is deductible.

Input Area:

Personal Days	10
Rental Days	40
Total Days	50
Type of Property	R

	Total	Rental	Personal
Rental Income	\$ 9,000	\$ 9,000	\$ -
Mortgage interest	\$ (10,200)	\$ (8,160)	\$ -
Property taxes	\$ (1,500)	\$ (1,200)	(300)
Utilities	\$ (800)	\$ (640)	(160)
Maintenance fees	\$ (1,000)	\$ (800)	(200)
Repairs	\$ (600)	\$ (480)	(120)
Depreciation (unallocated)	\$ (5,000)	\$ (4,000)	(1,000)
Net Income(Loss)		\$ (6,280)	
Itemized Deductions			(300)

CASE B

This is a vacation home because the personal use of the home (20 days) exceeds the greater of 14 days or 4 days (10% of rental days). Therefore, the deductions are limited to rental income and must be taken in a specified order: interest and taxes first, expenses other than depreciation second, and depreciation last. The expenses are allocated based on actual days the vacation home is rented to total days used for either rental or personal use. Thus, 66.7% [$40 \div 60$ ($40 + 20$)] of the expenses are related to the rental activity.

The adjusted gross income from rents would be reported as zero. The remaining \$400 (\$1,600 - \$1,200) of expenses and the allocated depreciation of \$3,335 that is not allowed because of the income limit can be carried forward and deducted in a year when income is large enough to absorb the deductions.

The interest and taxes \$3,900 (\$11,700 - \$7,800) allocated to the personal use of the dwelling are allowed as an itemized deduction. Thus, if Theresa itemizes her deductions, the rental will decrease her taxable income by the \$3,900 of itemized deductions.

Input Area:

Personal Days	20
Rental Days	40
Total Days	60
Type of Property	P

	Total	Rental	Personal
Rental Income	\$ 9,000	\$ 9,000	\$ -
Mortgage interest	\$(10,200)	\$(6,800)	\$(3,400)
Property taxes	\$ (1,500)	\$(1,000)	(500)
Utilities	\$ (800)	\$ (533)	(267)
Maintenance fees	\$ (1,000)	\$ (667)	(333)
Repairs	\$ (600)	\$ (400)	(200)
Depreciation (unallocated)	\$ (5,000)	\$(3,333)	(1,667)
Net Income(Loss)		\$(3,733)	
Itemized Deductions			(3,900)

CASE C

Because the property is rented less than 14 days, no income is reported and the \$11,700 of interest and taxes is allowed as an itemized deduction.

Input Area:

Personal Days	48
Rental Days	12
Total Days	60
Type of Property	N

	Total	Rental	Personal
Rental Income	\$ 1,000	\$ -	\$ -
Mortgage interest	\$(10,200)	\$ -	\$(10,200)
Property taxes	\$(1,500)	\$ -	(1,500)
Utilities	\$ (800)	\$ -	-
Maintenance fees	\$ (1,000)	\$ -	-
Repairs	\$ (600)	\$ -	-
Depreciation (unallocated)	\$(5,000)	\$ -	-
Net Income(Loss)		\$ -	
Itemized Deductions			(11,700)

	A	B	C
1		Input Area:	
2		Personal Days	48
3		Rental Days	12
4		Total Days	=SUM(C2:C3)
5		Type of Property	=IF((C3<14),"N",IF((C2>14),"P","R"))
6			
7		Rental Income	
8		Mortgage interest	
9		Property taxes	
10		Utilities	
11		Maintenance fees	
12		Repairs	
13		Depreciation (unallocated)	
14		Net Income(Loss)	
15			
16		Itemized Deductions	

Total	Rental
9000	=IF((C5="N"),0,E7)
-10200	=IF((\$C\$5="N"),0,E8*(\$C\$3/\$C\$4))
-1500	=IF((\$C\$5="N"),0,E9*(\$C\$3/\$C\$4))
-800	=IF((\$C\$5="N"),0,E10*(\$C\$3/\$C\$4))
-1000	=IF((\$C\$5="N"),0,E11*(\$C\$3/\$C\$4))
-600	=IF((\$C\$5="N"),0,E12*(\$C\$3/\$C\$4))
-5000	=IF((\$C\$5="N"),0,E13*(\$C\$3/\$C\$4))
	=IF(AND(C5="p",SUM(F8:F13)>F7),0,SUM(F7:F13))

Personal

0
 =IF((\$C\$5="R"),0,IF((\$C\$5="N"),E8,E8*(\$C\$2/\$C\$4)))
 =IF((\$C\$5="N"),E9,(E9*(\$C\$2/\$C\$4)))
 =IF((\$C\$5="N"),0,(E10*(\$C\$2/\$C\$4)))
 =IF((\$C\$5="N"),0,(E11*(\$C\$2/\$C\$4)))
 =IF((\$C\$5="N"),0,(E12*(\$C\$2/\$C\$4)))
 =IF((\$C\$5="N"),0,(E13*(\$C\$2/\$C\$4)))

=G8+G9

90. **TAX FORM PROBLEM** Mark Pari is a self-employed electrician who exclusively uses a room in his home to perform the administrative functions related to his business. The room is 250 square feet of the 2,500 total square feet of his home. Mark's income from his business before considering the cost of his home office is \$62,890. He incurs the following expenses related to his home:

Mortgage interest	\$ 10,000
Property taxes	1,500
Insurance	600
Gas and electric	1,800
Repairs and maintenance	500
Cable television	350
Phone (\$15 per month for a separate phone number for the office)	420
House cleaning	1,400
Long-distance phone calls (business-related)	670
Kitchen renovations	4,700

Assume that the home is worth \$200,000, Mark's basis is \$140,000, the value of the land is 20% of basis, and the applicable depreciation percentage is 2.564%. Complete Form 8829 using the above information. Mark's Social Security number is 136-42-5677. Forms and instructions can be downloaded from the IRS web site (<http://www.irs.gov/formspub/index.html>).

The per monthly phone charge and the long distance phone calls are not included in the home office calculation because these expenses are business expenses and would be deductible by Mark in calculating his net business income before the home office deduction. The kitchen renovation is a capital expenditure not related to his trade or business and is not added to the basis of the house for calculating depreciation. The cable television expense is a non-deductible personal expense.

Instructor's Note: The complete tax form solution is included separately in file SM_Ch_05_Problem_90.pdf located on the Instructor's Resource CD within the folder 'Solutions Manual' and also on the companion website, www.cengagebrain.com.

91. Integrative Tax Return Problem This is the third part of a six part problem that will allow you to prepare the 2015 tax return for Laurie and Lynn Norris. As with the previous parts, this part of the problem will ask you to prepare a portion of their tax return. You should complete the appropriate portion of each form or schedule indicated in the instructions. The following basic information is provided for preparing their 2015 tax return:

- The Norris' contribute \$250 to the political campaign of Fred Smithers who was running for Santa Fe city council.
- Lynn spent \$4,300 in lawyer and accounting fees to investigate the possibility of acquiring a competing handyman website company. Due to legal constraints, Lynn was unable to purchase the company.
- Lynn began his business in October 2013. He uses a room in their home to operate his business. The room is 300 square feet of the 2,400 total square feet of the home. The Norris' incur the following expenses related to their home:

Mortgage interest	\$ 7,000
Property taxes	2,200
Insurance	850
Gas and electric	1,600
Repairs and maintenance	400
Cable television	350
Phone (\$10 per month for a separate phone number for the office)	245
House cleaning	650

The home was worth \$215,000 in October 2013, their basis is \$175,000, the value of the land is 15% of basis, and the applicable depreciation percentage is 2.564%.

Required: Based on the information provided above, only fill out the appropriate portions of Form 1040 Schedule C and Form 8829.

Instructor's Note: The solution to the tax form problem is included separately in files **SM_Ch_05_Problem_91A.pdf** and **SM_Ch_05_Problem_91B.pdf** located on the Instructor's Resource CD with the folder 'Solutions Manual' and also on the companion website, <http://www.cengagebrain.com>

COMPREHENSIVE PROBLEM

92. Carol is a single mother who owns a wholesale auto parts distributorship. The business is organized as a sole proprietorship. Her business has advanced, and she can no longer devote the time necessary to do her own tax return. Because she always has prepared her own return, Carol is familiar with most tax rules applicable to her business and personal affairs. However, she has come to you for advice with respect to a number of items she paid during the current year. You are to determine whether she can take a deduction for the expenditures in the current year.

- a. Carol purchased a small building on March 2 to use as a warehouse for her auto parts inventory. To purchase the building, she borrowed \$180,000 on a 30-year loan and paid \$20,000 in additional cash. Carol also incurred \$3,200 in legal and other fees to purchase the building. The bank charged her \$3,600 in points (prepaid interest) to obtain the loan. After acquiring the building, Carol spent an additional \$25,000 to renovate it for use as a warehouse. The \$25,000 included \$8,000 for painting.

Carol must capitalize all of the costs associated with acquiring the building and getting it ready for use. Therefore, the \$3,200 in fees and the \$25,000 of renovation costs are added to the \$200,000 purchase price (\$20,000 + \$180,000), giving her a basis in the building of \$228,200 (\$200,000 + \$25,000 + \$3,200). The points paid on the loan must be capitalized and amortized over the term of the loan. Prepaid interest is not deductible until it accrues. The only exception for prepaid interest is for points paid to acquire a home mortgage. Therefore, she can deduct \$10 per month [$\$3,600 \div 360$ (30 x 12)] of the prepaid interest and \$100 (\$10 x \$10 months) in the current year.

- b. Carol had her office building painted at a cost of \$14,000 and paid \$6,000 to have it landscaped. She paid for the building renovation in part a and the office building work by borrowing \$60,000 on April 1 at 7% interest. (See part f for details of the interest payments.)

The painting is a maintenance cost and can be deducted. The painting does not extend the useful life or increase the value of the building. The painting expense maintains the building in its normal operating condition. The landscaping is a capital expenditure since it increases the value of the land and is added to the basis of the land.

- c. On April 1, Carol prepaid a 1-year fire insurance policy on her 2 buildings. The policy cost \$1,500, and the insurer required the prepayment. On September 1, Carol prepaid a \$5,000, 2-year maintenance contract on the buildings.

Because Carol is an accrual basis taxpayer (she has inventories), she would be able to deduct the \$1,500 insurance policy cost in the current year only if the expense meets the recurring item exception to the economic performance test. Congress intended this exception to apply primarily to accrued expenses - - those expenses that have not yet been paid but that meet the all-events test and will be paid within a reasonable time after the close of the year. To meet this exception the expense must be immaterial for both financial accounting and tax purposes and the relationship between the cost of insurance and Carol's other items of income and expenses must be immaterial. If Carol cannot meet this exception then she only can deduct \$1,125 $[(9 \div 12) \times \$1,500]$ in the current year.

The 2-year maintenance contract would have to be deducted as the services are provided under the contract. During the current year, 4 months of services have been performed and she can deduct \$833 $[(\$5,000 \times (4 \div 24))]$.

- d. Carol started a self-insured medical reimbursement plan for her employees this year. Based on actuarial assumptions, she deposited \$13,500 in a fund to pay employees' medical expenses. Actual payments from the fund totaled \$11,200.

Under the economic performance requirement, Carol cannot deduct the medical insurance expense until the services have been rendered. The \$13,500 payment into the fund is an estimate of a future liability and is not deductible until performance on the liability occurs. The \$11,200 of actual expenses can be deducted because economic performance has occurred.

- e. Carol purchased a new automobile costing \$32,000. She can document that her business use of the automobile came to 90% and that her out-of-pocket operating costs totaled \$3,600.

The auto is a mixed-use expenditure. The portion of the automobile used for business, \$28,800 $(\$32,000 \times 90\%)$ is capitalized and depreciated. The \$3,200 personal use portion is not deductible. Similarly, only \$3,240 $(\$3,600 \times 90\%)$ of the expenses associated with operating the auto can be deducted. The \$360 personal portion is not deductible.

- f. Carol paid the following interest on business-related loans:

Warehouse	\$15,300
Office building	4,000
Renovation loan	5,400

The renovation loan was for \$60,000. Because she spent only \$45,000 renovating the new building and painting and landscaping the old one, she used the additional \$15,000 to purchase city of Seattle bonds with a yield of 6%.

The interest paid on the warehouse and the office building is fully deductible. The interest on the portion of the renovation loan that was used to purchase the Seattle bonds is not deductible because the interest income received on the bonds is tax-exempt. Therefore, \$1,350 [$\$5,400 \times (\$15,000 \div \$60,000)$] of the interest is not deductible, leaving \$4,050 of interest related to her trade or business. Her total interest deduction is \$23,350 ($\$15,300 + \$4,000 + \$4,050$).

- g. Carol became active in politics and contributed \$1,000 to the presidential campaign of an independent candidate. She made the contribution because she believed that, if elected, the candidate would institute policies beneficial to her business. The candidate lost the election and immediately started a grass roots lobbying organization. The purpose of the organization is to keep track of elected officials' campaign promises and report to the public when they vote contrary to their stated campaign promises. Carol paid \$1,600 in dues to join the lobbying organization.

The \$1,000 political campaign contribution is not deductible. Deductions for political contributions are not allowed because it is believed that the contribution (i.e., money) has an "insidious influence" and that the tax system should not promote expenditures that encourage the frustration of public policy. Dues paid to organizations that lobby for the common business interest of a group of taxpayers are not deductible because Congress wants to remove the tax incentive associated with a taxpayer's attempt to influence legislation.

- h. Carol's oldest son began college during the current year. She paid his tuition and living expenses, a total of \$13,300, out of the company's checking account. During the summer, her son worked for the business, and Carol paid him \$4,300, the same amount she paid other college students working during the summer. Because she consults her son from time to time on the operation of the business, she thinks that at least some of the \$13,300 should be deductible.

The \$4,300 paid to her son is a deductible business expense because it does not appear to be unreasonable under the circumstances. The \$13,300 paid for her son's tuition and living expenses is a personal, nondeductible expense. It was not paid in an attempt to compensate her son for any service her son provided to the business. To deduct any of the cost, Carol will have to show what services her son provided and what is the reasonable cost of his consulting services.

- i. Carol has always itemized her deductions. This year, her mother and father

retired and could no longer afford the mortgage interest and property taxes on their home. Rather than have them sell the house, Carol made the payments for them. They received a statement from their bank indicating that a total of \$8,125 in mortgage interest and taxes were paid in the current year. Carol knows that mortgage interest and property taxes are deductible as itemized deductions and would like to add them to her personal interest and property tax payments.

Taxpayers are only allowed to deduct their own expenses. Because Carol is not legally obligated to pay the interest and property taxes, she cannot deduct them (neither can her parents because they did not pay them).

Note: If Carol had gifted the \$8,125 to her parents and they paid the interest and taxes, Carol's parents are allowed an itemized deduction for the \$8,125 in interest and property taxes.

- j. Because of the success of her business, Carol has received many offers to invest in various business ventures. One offer was to establish a chain of nursing homes in Florida. Carol spent two weeks in Florida evaluating the prospects of the proposed venture and incurred costs of \$2,100. After careful consideration, she decided the venture was too risky and decided not to expand into the health-care business.

None of the \$2,100 is deductible. The business investigation costs are not related to her current auto parts business. Because she did not invest in any of the new business ventures and the expenses do not relate to Carol's trade or business, the expense is considered to be personal and nondeductible.

DISCUSSION CASES

93. Malloy Industries manufactures air conditioners. The machines used to manufacture the air conditioners are usually insulated with asbestos. Because of health risks associated with asbestos, the Occupational Safety and Health Administration (OSHA) lowered the permissible level of asbestos fibers in the air. In addition, employers who have asbestos insulated buildings or machines are required to monitor the amount of asbestos fibers in the air to ensure that they do not exceed the permissible level. Malloy Industries, a leader in providing its employees with a safe and healthy work environment, decided to remove the asbestos insulation from its 45 machines and replaced it with another insulation material. The company determined that it would be less expensive to remove the asbestos insulation from its machines than to monitor asbestos levels on a daily basis. The company has found that the replacement material is 10% less efficient than the asbestos insulation. Should Malloy Industries capitalize or deduct the expense of replacing the asbestos insulation? Explain.

The issue to examine is whether Malloy Industries, by replacing the insulation in the machines with a non-asbestos material, has either extended the useful life of the machines or increased their value. The facts of this case are based on Private Letter Ruling 9240004, where the IRS concluded that the removal of asbestos from the machines is not a current deduction. Rather, the IRS ruled that the expense must be capitalized and deducted over the life of the machine. The IRS concluded that by removing the asbestos Malloy Industries had both extended the useful life of the machines and increased the value of its machines. The IRS determined that the expenditure had (1) eliminated the health risks associated with asbestos, (2) increased the resale value of the machines and (3) provided a permanent cure to a pre-existing problem. However, in reaching its conclusion the IRS did not consider that the new insulation reduced the efficiency of the machines. Logically, this should have reduced the value of the machines.

The IRS has also ruled in Field Service Advice 200335021 that the cost of removing asbestos insulation when making routine inspections and repairs of machinery is not a current deduction.

Surprisingly, the IRS has reached a different conclusion when the expenditures are incurred to encapsulate (enclose) the exposed asbestos. In Private Letter Ruling 9411002, the IRS found that expenditures to encapsulate asbestos are currently deductible. Unlike removal, the expenditure does not increase the value of the property, it fails to reduce the health threat from asbestos, and it provides only a temporary solution to the problem.

Note: This issue is far from resolved. The Department of the Treasury which oversees the IRS has formed a study group to re-examine the conclusions reached in these two rulings, along with the application of the tax law to other environmental clean-up expenditures.

94. Conrad purchases a condominium in Aspen, Colorado. Because of his hectic work schedule, Conrad is unsure how much he will be able to use the condo over the next few years. A friend of his who has a condo in Aspen tells him that the condominium is both a great investment and an excellent tax shelter. Conrad's friend has been able to rent his condominium for \$1,000 per week. Conrad expects to incur the following expenses related to the condominium:

Home mortgage interest	\$16,000
Real property taxes	5,500
Insurance	825
Utilities	2,150
Condominium fee	2,400
Maintenance	300
Depreciation (unallocated)	6,500

Conrad is somewhat hesitant to rent his new condo out for the entire year, just in case he can sneak away from work for a few days. Therefore, he wants to explore all his options. Explain the different tax treatments of his condominium expenses depending on the number of days he uses it.

A mechanical test based on the number of days of personal use of the property is used to determine whether the property is a vacation home or a true rental property. To qualify as a true rental property, Conrad's personal use of the property cannot exceed the greater of 1) 14 days, or 2) 10% of rental days. If his personal use exceeds this amount, the property is a vacation home. Also, if he rents the property for 14 days or less, no income is reported and the interest and taxes are allowed as an itemized deduction. The other expenses attributable to the rental property are considered personal expenses. If the property is treated as a vacation home, then Conrad's deductions are limited to the amount of his rental income. The rental expenses are deducted based on the ratio of the rental days to the total days used. The deductions must be taken in a specified order: interest and taxes first, expenses other than depreciation second, and depreciation last. The portion of interest and real estate taxes allocated to personal use are included with Conrad's other itemized deductions. All other expenses are considered personal expenses and are not deductible.

If the property is treated as a true rental, then Conrad will report the rental income from the property and deduct the rental expenses based on the ratio of the rental days to the total days used. The portion of real estate taxes allocated to personal use are included with Conrad's other itemized deductions. The interest expense allocated to personal use cannot be deducted because it is not considered home mortgage interest but rather personal interest. All other expenses are considered personal expenses and are not deductible. If the rental expenses exceed the rental income then Conrad will be report a loss. He will be able to deduct this loss if he meets the tests discussed in Chapter 7.

95. During the current year, Benjamin and Valerie were notified that their 2014 tax return was being audited. The IRS commissioner has disallowed all the losses attributable to Valerie's cattle breeding and showing venture.

Valerie was raised on a small ranch where her family raised commercial cattle. When she was 18, she left to attend college, where she obtained an accounting degree. Valerie is now employed as a full-time accountant by Veltkamp, Stannebein & Bateson, a local accounting firm, and receives an annual salary of \$45,000. Ben, a full-time househusband, takes care of their children, Kody and Jaycee.

In 2010, Valerie purchased 10 impregnated purebred Maine Anjou heifers, an exotic breed of cattle from France, for a total price of \$16,375. She entered into a contract with a local farmer to obtain pasture land for her herd. The contract requires a payment of \$20 a month from April through October for each cow and calf. From November through March, the cost of feeding each cow and calf is \$1.50 per day. In February 2012, Valerie purchased a bull with an exceptional pedigree for \$7,500 to improve the quality of her calves.

She sells any inferior animals to the meat market, keeps her best heifers for breeding, and shows her best bull calves in livestock shows. The livestock shows provide her with the opportunity to show and sell her exotic cattle. Until 2014, Valerie had been responsible for getting the animals ready to show, which requires approximately 4 hours per day from November through January. Unfortunately, Valerie was injured while working with one of her bulls and was forced to pay someone to finish breaking and showing the bulls. During the summer months, Valerie pays someone to watch the cattle so she can spend time with her family.

In 2010 and 2011, Valerie realized losses of \$4,125 and \$1,894, respectively. In 2012 and 2013, she realized gains of \$3,000 and \$750, respectively. For 2014, Valerie realized an operating loss of \$1,200 and a casualty loss of \$7,500 because her new bull was struck by lightning and killed. Valerie has maintained adequate records for all tax years since she began her cattle venture.

Explain whether Valerie's ranching activity is a trade or business.

In determining whether Valerie's breeding and showing venture is a trade business or a hobby, the IRS will examine the following nine factors:

- **Whether the taxpayer carries on the activity in a business-like manner**
- **The expertise of the taxpayer or her reliance on expertise**
- **The history of income and profits**
- **The time and effort spent on the activity**
- **The taxpayer's success in similar activities**
- **Whether the activity is engaged in for personal pleasure or recreation**
- **The taxpayer's financial condition**
- **The expectation that the assets used in the business will appreciate**
- **The amount, if any, of occasional profits**

The factors used are not weighted but are subjectively evaluated based on the facts and circumstances of each case. Based on the facts of this case, it appears that Valerie does conduct the business in a professional manner. This is evident by the books and records she keeps on the venture. Having grown up and worked on a ranch as a child, Valerie does possess the needed expertise to be engaged in the breeding and showing of cattle. The history of profits is somewhat mixed since Valerie has had 2 years with profits and 3 years with losses. Overall, she has a net loss from the activity of \$3,469. The casualty loss should not be factored into the assessment of profit or loss, since the death of the new bull was outside of Valerie's control.

The time and effort criteria are the most crucial and also the most difficult to assess. It appears that Valerie does spend most of her available time with the activity. However, whether that amount of time is enough to raise the activity to the level of a trade or business is extremely subjective. Based on the facts of the case, an argument could be made for either side. Although the time she did not spend breaking or showing the bulls in 2014 due to her injury should not count against her, the hiring of an individual to watch the cattle during the summer months does hurt her argument. An important question is how much time is needed to watch the herd during the summer months.

There is no information to assess whether Valerie has had success in a similar venture. Also the facts do not indicate that the Jones family is wealthy or that the assets used in the business are expected to appreciate in value. Finally, breaking and showing cattle is not glamorous work, so she should be able to argue that recreation and pleasure are not motives for her engaging in the activity.

Overall, Valerie can make a good argument that the breeding and showing activity is a trade or business and her losses should be allowed to offset her other income. However, if the activity is considered a hobby, the allowable deductions are personal in nature and must be deducted as itemized deductions. Therefore, only if she itemizes her deductions will she benefit from the hobby expense deductions. In addition, the tax law specifies that hobby expenses are deducted as miscellaneous itemized deductions and are limited to the amount in excess of 2% of adjusted gross income. This can result in the full amount of the allowable hobby expenses not being deductible. Note: Even if the expenses are not deductible, Valerie must report all the income from the cattle and showing venture.

TAX PLANNING CASES

96. Rosita's grandmother dies in November 2015 and leaves her an investment portfolio worth \$180,000. In January 2016, when Rosita receives ownership to the investments, the portfolio consists of \$112,000 of tax-exempt securities and \$68,000 of taxable securities. Her grandmother's accountant estimated that the tax-exempt securities would earn \$8,175 of interest and the taxable securities would pay \$7,140 in dividends in 2016. The management expenses were estimated at \$2,100. Rosita, single, has no other investments and earns \$55,000 as an engineer. She expects that her itemized deductions, not including the management expenses, will include state income taxes of \$2,800; real estate taxes of \$1,600; and home mortgage interest of \$4,000.

- a. What is Rosita's projected taxable income for 2016?

Rosita's adjusted gross income of \$ 62,140 is determined by adding her dividend income of \$7,140 to her salary of \$55,000. Currently, Rosita is earning 7.3% ($\$8,175 \div \$112,000$) on her tax-exempt investments and 10.5% ($\$7,140 \div \$68,000$) on her taxable investments. Since Rosita's portfolio is split between taxable and non-taxable investments, Rosita needs to determine what portion of the investment expenses are deductible. She should determine the deductible portion of the investment expenses based on the ratio of the taxable portfolio to the total portfolio. In this case, only 37.78% [$\$68,000 \div (\$68,000 + \$112,000)$] of the \$2,100 investment expense (\$794) is deductible. However, since the investment expense is a miscellaneous itemized deduction, the \$794 must be reduced by 2% of her adjusted gross income [$\$1,243 = (\$62,140 \times .02)$]. Because the \$1,243 exceeds \$794, no portion of the investment expenses is deductible.

The next step in determining taxable income is to deduct from adjusted gross income the greater of Rosita's total itemized deductions \$8,400 ($\$2,800 + \$1,600 + \$4,000$) or her standard deduction of \$6,300. The final step in determining taxable income is to deduct her personal exemption of \$4,050. To calculate the tax liability, the dividend income must be subtracted from taxable income since it is taxed at a rate (15%) lower than Rosita's marginal tax rate. The calculation is summarized below:

Salary			\$ 55,000
Dividend income			7,140
Adjusted gross income			<u>62,140</u>
Greater of:	Itemized deductions	\$8,400	
or			
Standard deduction		\$6,300	(8,400)
Personal exemption			(4,050)
Taxable income			<u>\$ 49,690</u>
Tax liability:			
Taxable Income	\$49,690		
Dividends	(7,140)	x 15%	\$ 1,071.00
Revised taxable income	<u>\$42,550</u>		
Tax on	37,650	Tax rate schedule	\$ 5,183.75
Tax on excess	<u>\$ 4,900</u>	x 25%	1,225.00
Total tax			<u>\$ 7,479.75</u>

- b. Assume that Rosita switches \$40,000 from tax-exempt securities to taxable securities and the rate of return on both portfolios remains the same. In switching the securities, Rosita has a \$10,000 gain on the sale of the tax-exempt securities and pays \$1,500 in tax. Instead of reducing the value of her portfolio, she pays the tax from her other income. All the other information would remain unchanged, except that state income taxes would increase by \$500. What is the effect on her taxable income of changing her investment strategy?

As a result of changing her investment strategy, Rosita's taxable income will increase by \$14,750 (\$64,440 - \$49,690). Rosita's dividend income will increase to \$12,390 [(\$108,000 + \$10,000 gain) x 10.5%]. Although the rate of return is the same as in part a, because her investment portfolio has changed (from \$68,000 in taxable investments to \$108,000), Rosita must recalculate the portion of the investment fee that is tax deductible. In this case, 60% [$\$108,000 \div (\$108,000 + \$72,000)$] of the \$2,100 investment expense (\$1,260) is deductible. As before, she must reduce this amount by 2% of her adjusted gross income. Her adjusted gross income is \$77,390 (\$55,000 + \$12,390 + \$10,000). Rosita must reduce the \$1,260 by \$1,548 ($\$77,390 \times .02$). Because the \$1,548 exceeds \$1,260, no portion of the investment expenses is deductible.

The next step in determining taxable income is to deduct from adjusted gross income the greater of Rosita's total itemized deductions \$8,900 (\$3,300 + \$1,600 + \$4,000) or her standard deduction of \$6,300. Her itemized deductions increased from part a because of an increase in her state income taxes of \$500. The final step in determining taxable income is to deduct her personal exemption of \$4,050. To calculate the tax liability, the dividend income and capital gain must be subtracted from taxable income since it is taxed at a rate (15%) lower than Rosita's marginal tax rate. The calculation is summarized below:

Salary		\$ 55,000
Gain on sale		10,000
Dividend income		12,390
Adjusted gross income		<u>\$ 77,390</u>
Greater of: Itemized deductions	\$8,900	
or		
Standard deduction	\$6,300	(8,900)
Personal exemption		(4,050)
Taxable income		<u><u>\$ 64,440</u></u>
Tax liability:		
Taxable income	\$ 64,440	
Capital gain	(10,000) x 15%	\$ 1,500.00
Dividends	(12,390) x 15%	1,858.50
Revised taxable income	<u>\$ 42,050</u>	
Tax on	37,650	Per rate schedule 5,183.75
Tax on excess	<u>\$ 4,400</u> x 25%	1,100.00
Total tax		<u><u>\$ 9,642.25</u></u>

- c. Should Rosita switch \$40,000 in her portfolio from tax-exempt securities to taxable securities? Explain.

Rosita should convert \$40,000 of her taxable securities to tax-exempt securities. This will allow her to increase her overall portfolio by the \$10,000 gain. Without considering the one-time tax on the sale of the securities (\$9,642 tax - \$1,500 tax on gain = \$8,142 tax without the gain), this strategy provides her with a greater after-tax cash flow than she is currently receiving. By changing \$40,000 of her investment portfolio from tax-exempt securities to taxable securities, Rosita's taxable income (without the gain on the sale) has increased by \$4,750 (\$54,440 - \$49,690) and her tax liability is increased by \$662 [(\$4,750 x 15%) - (\$500 x 25%)]. This represents the 15% tax on the additional dividend income minus the tax benefit from the \$500 increase in Rosita's state tax liability. However, her total investment income (taxable and tax-exempt) has increased from \$15,315 (\$8,175 + \$7,140) in part a to \$17,646 in part b [\$12,390 + (\$72,000 x .073 = \$5,256)]. Therefore, Rosita's net after-tax cash flow, as set forth below increases by \$1,169 (\$53,504 - \$52,335).

The following provides a summary of the two strategies on a cash-flow basis.

	A	B*
Salary	\$ 55,000	\$ 55,000
Dividend income	7,140	12,390
Interest income	8,175	5,256
Total income	<u>\$ 70,315</u>	<u>\$ 72,646</u>
State taxes	(2,800)	(3,300)**
Real estate taxes	(1,600)	(1,600)
Home mortgage interest	(4,000)	(4,000)
Management expenses	(2,100)	(2,100)
Federal taxes	(7,480)	(8,142)
Net cash-flow	<u>\$ 52,335</u>	<u>\$ 53,504</u>

* The gain on the sale of securities is not included in the cash flow analysis since it doesn't generate additional cash for Rosita (i.e., it remains in her portfolio). The tax on the sale is not included so that it is easier to compare how the change would affect future years. If the tax is included, the after tax cash-flow is \$331 (\$1,500 - \$1,169) greater for alternative A in the first year. In addition, one could argue that alternative B does not become the better alternative (not considering the time value of money) until the fifth year when the yearly cash flow increase of \$331 ($\$331 \times 5 > \$1,500$) exceeds the \$1,500 tax on the gain.

** The problem indicates that in part b state income taxes would increase by \$500.

Instructor's Note: However, her tax liability under each scenario is necessary in determining the after-tax cash flow under each scenario. The after-tax cash flow is critical in determining whether switching from tax-exempt securities to taxable securities was beneficial.

97. Allison and Paul are married and have no children. Paul is a lawyer who earns a salary of \$80,000. In November 2015, Allison quit her job as a copy editor and began exploring the possibility of breeding and showing horses. She would run the business on their property. Allison expects to travel to nine or ten horse shows during the year. While researching the activity, she came across an article entitled: "IRS Cracking Down on Horse Breeding –Is It Really a Business or Is It a Hobby?" She is unsure of the tax ramifications discussed in the article and has come to you for advice on whether her activity will be considered a business or a hobby. Allison provides you with the following projections of the 2016 income and expense items for the horse breeding and showing activity:

Revenue:	
Sale of horses	\$ 13,500
Prizes	4,200
Expenses:	
Hay	7,200
Veterinarian fees	3,100
Utilities	880
Property taxes	470
Registration and papers for horses	2,100
Interest expense on the barn	1,230
Depreciation	6,000

Paul and Allison expect to receive \$6,000 in interest and dividend income, they will have an \$8,000 net long-term capital gain, and their other itemized deductions will total \$16,300 in 2016. Write a letter to Allison explaining the factors the IRS will use to determine whether she is engaged in a trade or business or a hobby. You should also provide her with a calculation of their taxable income and tax liability and explain the difference(s) caused by the classification of the horse breeding and showing activity as a business or as a hobby.

In determining whether Allison's breeding and showing is a trade business or a hobby, the IRS will examine the following nine factors:

- **Whether the taxpayer carries on the activity in a business-like manner**
- **The expertise of the taxpayer or her reliance on expertise**
- **The history of income and profits**
- **The time and effort spent on the activity**
- **The taxpayer's success in similar activities**
- **Whether the activity is engaged in for personal pleasure or recreation**
- **The taxpayer's financial condition**
- **The expectation that the assets used in the business will appreciate**
- **The amount, if any, of occasional profits**

If the activity is treated as a business, Allison and Paul will be able to deduct all of the costs associated with the horse breeding and showing against the revenue earned by the activity. They will report a net loss of \$3,280 from the business.

Gross income		\$17,700
Hay	\$ 7,200	
Veterinarian fees	3,100	
Utilities	880	
Property taxes	470	
Registration and papers for horses	2,100	
Interest expense on the barn	1,230	
Depreciation	<u>6,000</u>	<u>\$20,980</u>
Net loss from business		<u><u>\$ (3,280)</u></u>

Allison and Paul's taxable income for 2016 will be \$66,320.

Paul's salary	\$ 80,000
Interest and dividends	6,000
Long-term capital gain	8,000
Loss from horse business	(3,280)
Adjusted gross income	<u>\$ 90,720</u>
Itemized deductions	(16,300)
Personal exemptions (\$4,050 x 2)	(8,100)
Taxable Income	<u><u>\$ 66,320</u></u>

If the activity is considered a hobby, Allison and Paul must include the amount from the sale of horses (\$13,500) and the prize money (\$4,200) in gross income but can only deduct expenses to the extent of their income \$17,700 (\$13,500 + \$4,200) from the activity. In addition, they must deduct her expenses in the following order:

1. expenses that could be deducted as either business expenses or itemized deductions
2. expenses related to the hobby that could be deducted if the activity had qualified as a trade or business
3. depreciation

A further restriction is that the expenses listed in 2 and 3 above are considered miscellaneous itemized deductions and are reduced by 2% of their adjusted gross income. The deductible expenses from the hobby are as follows:

Gross income		\$17,700
Less Category 1:		
Property taxes		<u>470</u>
Balance of income		<u>\$17,230</u>
Less Category 2:		
Hay	\$ 7,200	
Veterinarian fees	3,100	
Utilities	880	
Registration and papers for horses	2,100	
Interest expense on the barn	<u>1,230</u>	<u>\$14,510</u>
Balance of income		<u>\$ 2,720</u>
Less Category 3:		
Depreciation		<u>2,720*</u>
Balance of income		<u><u>\$ -0-</u></u>

The depreciation of \$6,000 is limited to \$2,720.

If the activity is considered a hobby, their taxable income for 2016 is \$71,834.

Paul's salary			\$ 80,000
Interest and dividends			6,000
Long-term capital gain			8,000
Revenue from horse business			17,700
Adjusted gross income			<u>\$ 111,700</u>
Other itemized deductions	\$ 16,300		
Hobby property taxes		470	
Miscellaneous hobby deductions	\$17,230		
2% of adjusted gross income	<u>(2,234)</u>	<u>14,996</u>	
Total itemized deductions			(31,766)
Personal exemptions (\$4,050 x 2)			<u>(8,100)</u>
Taxable Income			<u><u>\$ 71,834</u></u>

The difference between the taxable income if the activity is treated as a business versus a hobby consists of two parts. The first part is the \$3,280 (\$6,000 - \$2,720) of depreciation that is disallowed if the activity is treated as a hobby. Since the amount of allowable hobby expenses is limited to hobby income, Allison and Paul only can deduct \$2,720 of the \$6,000 of depreciation expense. The second part is the \$2,234 of expenses that are "lost" because the hobby expenses are treated as miscellaneous itemized deductions and must be reduced by 2% of their adjusted gross income. The property taxes are not subject to the 2% limitation because the property taxes are allowed as an itemized deduction regardless of whether Allison and Paul are engaged in a trade or business or are pursuing a hobby. That is, the property taxes are deductible if the land is used solely as part of their principal residence.

Reconciliation of Taxable Incomes:

Taxable income if the activity is a business	\$66,320
Depreciation not allowed if activity is a hobby	3,280
Expenses not deductible due to 2% of AGI requirement	2,234
Taxable income if the activity is a hobby	<u><u>\$71,834</u></u>

ETHICS DISCUSSION CASE

98. Dan owns a successful sports bar in downtown Providence. The state is considering legislation that would restrict the sale of alcohol in restaurants and bars on Saturdays and Sundays until after 7:00 P.M. The association of Providence restaurant owners is thinking about hiring a lobbyist to fight the legislation. The lobbyist has told the association that the lobbying effort would cost each owner \$6,000. Dan's accountant has informed him that his \$6,000 contribution would not be deductible for tax purposes. Dan has told his 30 employees, most of whom are students at a local college, that if the legislation passes, he will have to lay off employees. In addition, he told them that most local restaurant owners cannot afford to pay the lobbyist \$6,000 to fight the legislation because it is not tax deductible. Ann, one of Dan's employees and an accounting major, suggests that Dan pay each employee an extra \$200 dollars in salary ($30 \times \$200 = \$6,000$) and that they forward the payments to the lobbyist. That way, Ann reasons, the cost will be deductible as salary expense. Dan tells his accountant about Ann's idea, and his accountant thinks it is great. In fact, he is so impressed with the idea that he has offered Ann a job when she graduates next spring. Do you think Ann's idea is a legal way to deduct the lobbying expenses? What ethical standards has Dan's accountant violated? (refer to the Statements on Standards for Tax Services)

Based on the facts of the case, Dan's accountant appears to be more impressed by the form of the transaction rather than the substance. The accountant believes that because Dan is paying the employee a salary supplement, which is forwarded to the lobbyist, the expenditure is a valid deduction. However, the courts have long looked to the substance of the transaction rather than its form. Therefore, the transaction would probably be viewed as tax evasion and not tax avoidance.

Statements on Standards for Tax Services (SSTS) #1, paragraph .07 requires that the CPA believe the position she/he is taking is warranted in existing law or can be supported by a good faith argument. Paragraph .09 of SSTS #1 also requires that Dan's accountant not take a "frivolous" position on the tax return. A frivolous position is defined as one that is knowingly advanced in bad faith and is patently improper. Because Dan's accountant is aware of and endorses this scheme, Dan's accountant is in violation of this standard. SSTS #1 also admonishes a CPA who recommends a tax return position that exploits the IRS audit selection process. A possible reason why the accountant is so impressed with Ann's idea is that he realizes the chance of Dan's business being audited is minimal. Further, if Dan's business is audited, the likelihood of the auditor uncovering the transaction is even more remote because the transaction would only draw the auditor's attention if the total salaries appeared to be excessive.

In conclusion, Dan's accountant has violated various provisions of SSTS #1 because the transaction described would probably be viewed as tax evasion and not tax avoidance. By allowing Dan to deduct the salary supplement, the IRS would probably determine that the accountant has taken a frivolous position.

Chapter 5

Check Figures

26. a. Susan - expenses deductible for AGI b. Alexandra - Misc. itemized deduction
27. a. Add to basis b. \$2,000 deductible for AGI
c. Misc. itemized deduction d. Misc. itemized deduction
e. Deducted for AGI - \$4,000 rental income
28. a. Fully deductible for AGI b. Itemized deduction
c. Not deductible d. Itemized deduction
e. Misc. itemized deduction f. Golf cart - not deductible
Advertisement is deductible
29. Each partner: Ordinary income \$80,000; ST capital gain \$8,000
ST capital loss \$4,000; Investment expense \$2,000
30. a. Manuel: Taxable ordinary income \$112,000; LT capital gain \$5,600
ST capital loss \$10,500; Charitable contribution \$6,300
Non deductible expenses \$2,800
b. Taxable income: \$75,500
31. Not a trade or business
32. Deductible for AGI
33. Not deductible
34. Net rental income \$870
35. a. Mixed use asset - \$2,660 business b. business portion \$630 gain
36. Yes, if reasonable in amount
37. a. \$4,000 not ordinary or reasonable b. Yes
c. Yes d. Not ordinary
38. a. \$200 ordinary, necessary - bonus not deductible not ordinary
b. Not necessary
c. Rent - ordinary, necessary
d. Ordinary, necessary
39. a. Capital b. Capital
c. Repair expense d. Capital
e. Repair expense
40. Open – amortize (\$5,800); Don't open - nondeductible
41. a. Deduct b. Related - deductible
c. Open – amortize (\$5,667); Don't open - nondeductible
42. a. Not deductible b. Not deductible
c. \$1,725 gross income

43. a. Not deductible
c. Not deductible
- b. Not deductible
d. Not deductible
44. a. Not deductible
c. Deductible
- b. Not deductible
d. Deductible
45. Local - deductible; State - nondeductible
46. \$640 not deductible
47. \$200 not deductible
48. Ordinary income \$67,500; Taxable interest and dividends \$7,500
Tax exempt interest \$1,850; Investment interest \$1,364
Nondeductible expenses \$336
49. a. \$220 not deductible
- b. Deductible - business purpose exists
50. a. Not deductible – not ordinary
- b. Not deductible – not taxpayer's expense
51. a. Misc. itemized deduction \$5,600
before 2% of AGI
c. Part a net income effect \$3,400
Part b net income effect \$1,000
- b. Misc. itemized deduction \$8,000
before 2% of AGI
52. a. Net loss from business \$1,620
c. Nine factors (see page 193-194 text)
- b. Misc. itemized deduction \$10,430
53. a. Income from rental - \$0; balance of income limited to \$1,230
54. a. Income form rental \$0; balance of income limited to \$500
b. Income not reported; expenses not deducted; interest and taxes itemized deduction
55. Case A - net rental loss \$2,950
Case C - No income reported
- Case B - Net rental loss \$0
Case D - Net rental loss \$4,654
56. a. Income not reported
interest and taxes itemized deduction
c. Net rental income \$8,921
- b. Net rental income \$0
57. Net profit \$22,150
58. a. Home office costs \$5,843
- b. No deduction
59. a. Home office costs limited to \$3,000; \$1,105 carryforward
60. Deduct \$565,000
61. a. Deduct \$1,500 in 2016
c. Deduct \$0 in 2016 if cash; \$1,500 if accrual
- b. Deduct \$1,500 in 2016
62. \$52,500 deduction
63. Deduct \$9,950

- 64. Deduct \$78,300
- 65. 2016 - \$2,750; 2017 - \$5,500
- 66.
 - a. accrual \$1,500 in 2016; cash \$2,250 in 2017
 - b. accrual \$1,550 in 2016; cash \$1,550 in 2016
 - c. accrual \$20,000 in 2016; cash \$20,000 in 2017
 - d. accrual \$2,400 in 2016; cash \$2,400 in 2017
 - e. accrual \$700 in 2016; cash \$700 in 2016
- 67.
 - a. accrual \$5,000 in 2016; cash \$5,000 in 2016
 - b. accrual \$40,000 in 2016; cash \$40,000 in 2016
 - c. accrual \$9,375 in 2016; cash \$22,500 in 2017
 - d. accrual \$16,500 in 2016; cash \$15,700 in 2016
 - e. accrual \$3,200 in 2016; cash if meets exception \$3,200 in 2016
- 68. Related parties deduct in 2017; cash basis deduct in 2017
- 69. Related parties deduct in 2017; accrual deduct in 2016
- 70. Deduct financial \$50,000; tax \$0
- 71. Deduct financial \$180,000; tax \$149,000