Chapter 6

Deductions and Losses: In General

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LEARNING OBJECTIVES

LO.1 - Differentiate between deductions for and from adjusted gross income and describe the relevance of the differentiation.

LO.2 - Describe the cash and accrual methods of accounting with emphasis on the deduction aspects.

LO.3 - Apply the Internal Revenue Code deduction disallowance provisions associated with the following: public policy limitations, political activities, excessive executive compensation, investigation of business opportunities, hobby losses, vacation home rentals, payment of others' expenses, personal expenditures, capital expenditures, related-party transactions, business interest expense, and expenses related to tax-exempt income.

LO.4 - Identify tax planning opportunities for maximizing deductions and minimizing the disallowance of deductions

The Big Picture (1 of 2)

- Dr. Cliff Payne determines that the deductible expenses associated with his dental practice (a sole proprietorship) are as follows:

Salaries including FICA ($5,000 are unpaid at year-end)	$120,000
Building rent	24,000
Depreciation of dental and office furnishings and equipment	52,000
Insurance (malpractice, dental equipment and office furnishings and equipment)	22,000
Dental supplies	16,000
Office supplies	3,000
Investigation expenses	6,000
Contribution to State Senate campaign fund of Tom Smith	1,000
Contribution to State Senate campaign fund of Virginia White	1,000
Legal expenses associated with patient lawsuit	4,000
Fine imposed by city for improper disposal of medical waste	3,000
Dues paid to The Dental Society	10,000
Draw by Dr. Payne for living expenses ($5,000 monthly)	60,000

The Big Picture (2 of 2)

- Has Dr. Payne correctly calculated the deductible business expenses for his dental practice?
  - Read the chapter and formulate your response

Classification of Deductible Expenses (1 of 2)

- Deductions *for* AGI
  - Can be claimed even if taxpayer does not itemize
  - Important in determining the amount of certain itemized deductions
    - Certain itemized deductions are limited to amounts in excess of specified percentages of AGI
      - For example, medical expenses and personal casualty losses

Classification of Deductible Expenses (2 of 2)

- Deductions *from* AGI:
  - In total, must exceed the standard deduction to provide any tax benefit
  - Called itemized deductions

Common Deductions *for* AGI (1 of 2)

- list includes:
  - Alimony payments (divorce decrees before 2019)
  - Expenses attributable to property held for the production of rents and royalties
  - Expenses attributable to a trade or business
  - Employee business expenses (reimbursed)
  - Professional development and supplies (up to $250) for elementary and secondary school teachers
  - Student loan interest
  - Contributions to retirement plans

Common Deductions *for* AGI (2 of 2)

- list includes:
  - Medical insurance premiums paid by a self-employed taxpayer
  - Self employment taxes
  - Losses on the sale or exchange of property
  - Penalty on premature withdrawal of funds from time savings accounts

Section 212 Expenses (1 of 2)

- § 212 allows deductions for ordinary and necessary expenses paid or incurred for the following:
  - The production or collection of income
  - The management, conservation, or maintenance of property held for the production of income
  - Expenses paid in connection with the determination, collection, or refund of any tax

Section 212 Expenses (2 of 2)

- § 212 expenses that are deductions *for* AGI include:
  - Expenses related to rent and royalty income
  - Professional fees paid by a sole proprietor or a farmer
- All other § 212 expenses are itemized deductions (deductions *from* AGI)
  - For example, investment interest expense
  - All other investment-related expenses (e.g., safe deposit box rentals) are miscellaneous itemized deductions and, from 2018 through 2025, are not deductible

Section 162 Trade or Business Deductions (1 of 2)

- § 162(a) permits a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business including:
  - Reasonable salaries paid for services
  - Expenses for the use of business property
  - One-half of self-employment taxes paid
- Such expenses are deducted *for* AGI

Section 162 Trade or Business Deductions (2 of 2)

- Section 162 excludes the following items from classification as trade or business expenses:
  - Charitable contributions or gifts
  - Illegal bribes and kickbacks and certain treble damage payments
  - Fines and penalties

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Deduction Criteria for § 162 and § 212

- To be deductible, expenses must be:
  - Ordinary: normal, usual, or customary for others in similar business, and not capital in nature
  - Necessary: prudent businessperson would incur same expense
  - Reasonable: question of fact

Personal Expenses

- Expenses are usually deductions from AGI
- Common deductions are
  - Contributions to qualified charitable organizations
  - Mortgage interest expense
  - State and local taxes
  - Medical expenses
  - Personal casualty losses

Business and Nonbusiness Losses

- Deductible losses of individual taxpayers are limited to those:
  - Incurred in a trade or business,
  - Incurred in a transaction entered into for profit
- Individuals may also deduct casualty losses from fire, storm, shipwreck, and theft that occurred in a Federally declared disaster area

Deduction for Qualified Business Income (1 of 3)

- An individual is allowed a 20% deduction for "Qualified Business Income" (QBI) from a sole proprietorship, a partnership, or an S corporation
  - In general, the *from* AGI deduction for QBI is the lesser of 20% of:
    - Qualified business income, or
    - Modified taxable income (taxable income before the QBI deduction, reduced by any net capital gain)
  - QBI is the ordinary income less ordinary deductions from a "qualified trade or business"
    - QBI does not include wages, capital gains or losses, dividend income, and interest income

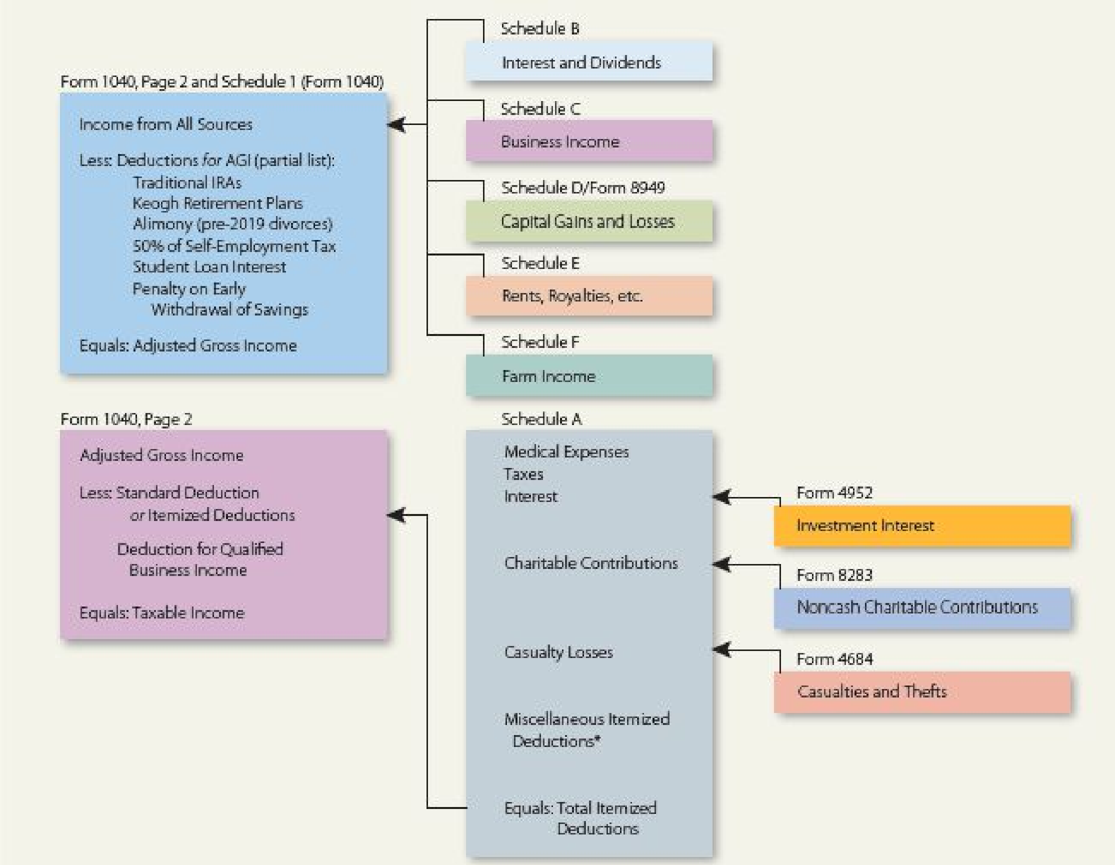
Deduction for Qualified Business Income (2 of 3)

- Limit on the QBI deduction
  - If taxable income before the QBI deduction is more than \$326,600 (married, filing jointly) or \$163,300 (single and head of household), the QBI deduction cannot exceed the *greater of*:
    - 50% of the W–2 wages relating to the qualified trade or business, or
    - The sum of:
      - 25% of W–2 wages relating to the qualified trade or business, and
      - 2.5% of the unadjusted basis (immediately after acquisition) of all qualified property
  - This limit is phased in over \$100,000 (married, filing jointly) or \$50,000 (all other taxpayers) of taxable income
    - Once a married couple has taxable income over \$426,600 (\$213,300 for singles and heads of household), the W–2 wages and capital investment limitation will be completely in play

Deduction for Qualified Business Income (3 of 3)

- A qualified trade or business means any trade or business other than a "specified service trade or business"
  - Specified services include:
    - Health
    - Law
    - Accounting
    - Actuarial Science
    - Performing Arts
    - Consulting
    - Athletics
    - Financial Services
    - Brokerage Services
  - Special rules apply to specified service businesses

Format of Form 1040



*Deductions subject to the 2%-of-AGI floor are suspended from 2018 through 2025.

Importance of Taxpayer’s Method of Accounting (1 of 2)

- The method of accounting affects when deductions are taken
  - Cash: Expenses are deductible only when paid
  - Accrual: Expenses are deductible when incurred
    - Apply the *all events test* and the *economic performance test*
  - For both cash and accrual taxpayers, a “12-month” rule applies for prepaid expenses

Importance of Taxpayer's Method of Accounting
(2 of 2)

- Exception to the economic performance test for *recurring items* allows immediate deduction if:
  - The item is recurring in nature and is treated consistently
  - Either the accrued item is not material or accruing it in the current period results in better matching of income and expenses
  - All of the events have occurred that determine the existence of the liability, and the amount of the liability can be determined with reasonable accuracy
  - Economic performance occurs within a reasonable period (but not later than 8½ months after the close of the taxable year)

Prepaid Expenses – The “12-Month Rule”

- Taxpayer doesn’t have to capitalize amounts paid to create a benefit that doesn’t extent beyond the earlier
  - 12 months after the first date on which the taxpayer realized the benefit or
  - The end of the tax year following the tax year in which the payment was made (the “12-month rule”)

Disallowance Possibilities

- The tax law disallows the deduction of certain types of expenses for a variety of reasons
- The tax law may restrict a taxpayer's attempts to deduct certain items that, in reality, are personal expenditures
  - For example, specific tax rules are provided to determine whether an expense is for trade or business purposes or is related to a personal hobby

Public Policy Limitation

- Deductions are disallowed for certain specific types of expenditures that are considered contrary to public policy
  - Examples: penalties, fines, bribes and kickbacks, two-thirds of treble damage payments for violation of anti-trust law

The Big Picture—Nondeductible Fines

- Return to the facts of *The Big Picture*
- Dr. Payne had not instituted proper procedures for disposing of medical waste from his laboratory
  - During the current tax year, he was fined $3,000 by the city
  - Dr. Payne believes the fine should be deducted as an ordinary business expense
- However, because the fine was due to a violation of public policy and fines are disallowed, the $3,000 is not deductible

Legal Expenses Incurred In Defense of Civil Or Criminal Penalties

- To deduct legal expenses, the taxpayer must be able to show that the origin and character of the claim are directly related to:
  - A trade or business
  - An income producing activity
- Personal legal expenses are not deductible
- Ordinary and necessary expenses incurred in connection with a trade or business or with rental or royalty property held for the production of income are deductible *for* AGI

Expenses Relating To An Illegal Business

- Usual expenses of operating an illegal business are deductible
  - However, deduction for fines, bribes to public officials, illegal kickbacks, and other illegal payments are disallowed
- Drug dealers are not allowed a deduction for ordinary and necessary business expenses incurred in their business, except for cost of goods sold

Political Contributions And Lobbying Activities

- Generally, no business deduction is allowed for payments made for political purposes
- Lobbying expenses incurred in attempting to influence local, state, or Federal legislation or the actions of certain high-ranking public officials are not deductible
  - Exceptions are allowed for lobbying:
    - To monitor legislation, and
    - De minimis exception for annual in-house expenses (limited to $2,000)
      - If greater than $2,000, none can be deducted

The Big Picture—Political Contributions (1 of 2)

- Return to the facts of *The Big Picture*
- Dr. Payne had made political contributions to the State Senate campaigns of Tom Smith and Virginia White
  - Dr. Payne made these contributions to encourage these senators to support a new bill that is beneficial to the state's dental profession
  - Therefore, he assumed that these would be deductible business expenses
- However, political contributions are not deductible, so he will receive no tax benefit from them

The Big Picture—Political Contributions (2 of 2)

- Return to the facts of *The Big Picture*
- Dr. Payne had made contributions to The Dental Society, a trade association for dentists
  - The trade association estimates that 70% of its dues are allocated to lobbying activities
  - As a result, his deduction on Schedule C is limited to \$3,000 (\$10,000 × 30%)

Excessive Executive Compensation

- For publicly held corporations:
  - Deduction for compensation paid to covered executives is limited to $1 million annually
    - Covered employees are the CEO, the CFO, and the three other most highly compensated executives
      - Any individual who is a covered employee after 2016 will be subject to this rule for all future years
  - Applies to compensation, commissions based on individual performance, and performance-based compensation tied to overall company performance
    - Before 2018, the $1 million limit *excluded* commissions and performance-based compensation
      - Contracts in place on November 2, 2017, are grandfathered into pre-2018 law as long as there are no material changes to the contract

Investigation of a Business (1 of 3)

- Investigation expenses: Paid or incurred to determine the feasibility of entering a new business or expanding an existing business
  - Include costs such as travel, engineering, architectural surveys, marketing reports and various legal and accounting services
- Tax treatment of these expenses depends on:
  - The current business, if any, of the taxpayer
  - The nature of the business being investigated
  - The extent to which the investigation has proceeded
  - Whether the acquisition actually takes place

Investigation of a Business (2 of 3)

- If the taxpayer is in a business that is the *same as or similar to* that being investigated
  - Investigation expenses are deductible in the year paid or incurred
    - The tax result is the same whether or not the taxpayer acquires the business being investigated

Investigation of a Business (3 of 3)

- When the taxpayer is not in a business the *same as or similar to* the one being investigated
  - Tax result depends on whether new business is acquired
    - If not acquired
      - All investigation expenses generally are nondeductible
    - If acquired
      - Investigation expenses must be capitalized as "startup expenditures"
      - May elect to deduct the first $5,000 of expenses currently
      - Any excess expenses can be amortized over a period of not less than 180 months (15 years)
      - In arriving at the $5,000 immediate deduction allowed, a dollar-for-dollar reduction must be made for those expenses in excess of $50,000

The Big Picture—Investigation of a Business (1 of 2)

- Return to the facts of *The Big Picture*
- Dr. Payne believes that his administrative and business skills can be used to turn around dental practices whose revenues have been declining
  - He investigates Teeth Restoration LLC, a local dental practice that is for sale
  - Expenses paid to consultants and accountants as part of this investigation totaled $6,000
  - He determined that Teeth Restoration would not be a good investment, so he did not buy it

The Big Picture—Investigation of a Business (2 of 2)

- The $6,000 spent to investigate this business is deductible as a business expense because Dr. Payne is already in the dental business
  - Expenses incurred to Investigate new business opportunities in one’s current trade or business are deductible as ordinary and necessary business expense

Hobby Losses (1 of 5)

- Hobby defined
  - Activity not entered into for profit
    - Personal pleasure associated with activity
    - Examples: raising horses and operating a farm used as a weekend residence
- If an activity is not engaged in for profit, the hobby loss rules apply
  - Hobby expenses are deductible only to the extent of hobby income

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Hobby Losses (2 of 5)

- Nine factors to consider whether an activity is profit-seeking or is a hobby
  - Whether the activity is conducted in a businesslike manner
  - The expertise of the taxpayers or their advisers
  - The time and effort expended
  - The expectation that the assets of the activity will appreciate in value
  - The taxpayer's previous success in conducting similar activities
  - The history of income or losses from the activity

Hobby Losses (3 of 5)

- The relationship of profits earned to losses incurred
- The financial status of the taxpayer (e.g., if the taxpayer does not have substantial amounts of other income, this may indicate that the activity is engaged in for profit)
- Elements of personal pleasure or recreation in the activity

Hobby Losses (4 of 5)

- Presumptive rule of § 183
  - If activity shows profit in three out of five years (two out of seven years for horses), the activity is presumed to be a trade or business rather than a personal hobby
    - Rebuttable presumption, shifts burden of proof to IRS
  - Otherwise, taxpayer has burden to prove profit motive

Hobby Losses (5 of 5)

- If an activity is a hobby:
  - Expenses are deductible only to the extent of the gross income from the hobby
  - Expenses must be deducted in the following order
    - Amounts deductible under other Code sections without regard to the nature of the activity – property taxes and home mortgage interest
    - Amounts deductible under other Code sections if the activity had been engaged in for profit, but only if those amounts do not affect adjusted basis – maintenance, utilities, and supplies
    - Amounts for depreciation, amortization, and depletion

Rental of Vacation Homes (1 of 5)

- May have both personal and rental use of a vacation home
- Deduction of rental expenses may be limited to rental income if primarily used for personal purposes
- Determination of vacation home treatment is dependent upon the relative time the residence is used for personal use versus rental use

Rental of Vacation Homes (2 of 5)

- Primarily personal use
  - Less than 15 days: No gross income recognized from rentals and no deductible rental expenses
    - Mortgage interest and real estate taxes treated as if on personal residence
  - 15 or more days: Treatment depends on amount of personal use

Rental of Vacation Homes (3 of 5)

- Primarily rental use
  - If rented for 15 days or more and personal use days NOT more than the greater of 14 days or 10 percent of fair rental days
  - Allocate expenses between personal and rental days if there are any personal use days during the year
  - Can deduct allocated rental expenses even if loss results
    - Rental loss subject to at-risk and passive loss rules

Rental of Vacation Homes (4 of 5)

- Personal/rental use
  - If rented for 15 days or more and personal use days exceed the greater of 14 days or 10% of total rental days
  - Treated similar to hobby
    - Rental expenses deducted in three step process
    - No rental loss allowed
    - Carryforward of disallowed rental expenses

Rental of Vacation Homes (5 of 5)

- Allocation of expenses between personal and rental
  - Mortgage interest and real estate taxes
    - IRS requires allocation based on total days used
    - Courts have allowed allocation based on days in year
  - Other expenses are allocated based on total days used

Expenditures Incurred for Taxpayer's Benefit or Taxpayer's Obligation

- No deduction is allowed for payment of another taxpayer's expenses
  - Must be incurred for taxpayer's benefit or arise from taxpayer's obligation
  - Exception: Payment of medical expenses for a dependent

Disallowance of Personal Expenditures

- Unless otherwise provided in the Code, personal expenses are not deductible

Disallowance of Deductions for Capital Expenditures

- Deductions not allowed for amounts paid for new buildings or for permanent improvements or betterments that increase the value of any property
- Amounts are capitalized
- Incidental repairs and maintenance of the property are not capital expenditures and can be deducted as ordinary and necessary business expenses
- Asset may be subject to depreciation (or cost recovery), amortization, or depletion

Transactions Between Related Parties

- The Code disallows losses from sales or exchanges of property between related parties
  - Constructive ownership provisions apply
  - Loss disallowed may reduce gain on subsequent disposition to unrelated third party

Substantiation Requirements

- The taxpayer has the burden of proof for substantiating expenses deducted on the returns and must retain adequate records
- Upon audit, the IRS can disallow any undocumented or unsubstantiated deductions
- Substantiation is also important for establishing the basis of an asset

Expenses and Interest Relating to Tax-Exempt Income

- Expenses relating to production of tax-exempt income are not deductible
  - Example: interest on debt used to purchase or hold tax-exempt financial instruments

Other Disallowances

- The following expenditures also are disallowed:
  - Settlements or payments, including attorney's fees, related to sexual harassment or sexual abuse if subject to a nondisclosure disagreement
  - Payments for qualified transportation fringe benefits, including mass transit and qualified parking
  - Net interest expense, which is limited to business interest income plus 30 percent of adjusted taxable income – does not apply to businesses that have annual average gross receipts of $26 million or less during the prior three taxable years
  - Any disallowed interest is carried forward indefinitely

Refocus On The Big Picture (1 of 2)

- Of the expenses incurred by Dr. Payne, several comments need to be made
  - Being personal in nature, none of the $5,000 monthly draw is deductible. Nor is the amount involved subject to the reasonableness test
    - Dr. Payne is a sole proprietor and not in an employment relationship
  - The fine paid for violating waste control rules comes under the public policy limitations and is specifically made nondeductible by Code § 162(f)
  - Along the same line, the political contributions are made nondeductible by § 162(e)

Refocus On The Big Picture (2 of 2)

- However, Dr. Payne's investigation of the practice of another dental firm appears reasonable and the expense incurred is deductible
- The dues paid to The Dental Society are not 100 percent deductible because 70 percent of the Society's efforts relate to lobbying activities
- Although not specifically discussed in the text, his legal fees incurred in connection with a lawsuit filed by a patient appear related to his practice
  - As a result, they are deductible because they are ordinary and necessary to his trade or business