Chapter 7

Deductions and Losses: Certain Business Expenses and Losses

LEARNING OBJECTIVES (1 of 2)

LO.1- Determine the amount, classification, and timing of the bad debt deduction.

LO.2 - State and illustrate the tax treatment of worthless securities, including § 1244 stock.

LO.3 - Distinguish between deductible and nondeductible losses of individuals.

LO.4 - Identify a casualty and determine the amount,

classification, and timing of casualty and theft losses.

LO.5 - State and apply the alternative tax treatments for research and experimental expenditures.

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LEARNING OBJECTIVES (2 of 2)

LO.6 - Apply the excess business loss limitation rules.

LO.7 - Determine the amount of the net operating loss and review the effect of the carryover provisions on previous and subsequent years' taxable income.

LO.8 - Identify tax planning opportunities in deducting certain business expenses, business losses, and personal losses.

The Big Picture (1 of 4)

- Martha, a cash basis and calendar year taxpayer, is nearing the end of a year she would like to forget
- Several years ago she loaned a friend, Janice, $25,000 to enable her to start a business
  - Janice had made scheduled payments of $7,000 ($1,000 of this was interest) when she unexpectedly died in January
    - At the time of her death, Janice was insolvent
  - Martha's attempts to collect on the debt were fruitless

The Big Picture (2 of 4)

- On October 1, 2019, Martha invested $50,000 in the stock of a pharmaceutical company that previously had been profitable
    - However, as a result of losing a patent infringement suit, the company declared bankruptcy on May 31, 2020
    - The bankruptcy trustee has informed shareholders that they should not expect to receive anything from the company
- Martha has owned and operated a bookstore as a sole proprietorship for the past 10 years
    - The bookstore previously produced annual profits of about $75,000
    - Due to the continued growth of online vendors and e-books, Martha’s bookstore sustained a net loss of $180,000 this year

The Big Picture (3 of 4)

- On September 28, 2020, a hurricane caused a large oak tree to blow over onto Martha’s house
  - In the aftermath of the hurricane, Martha’s country was designated a Federal disaster area by the President
  - The cost of removing the tree and making repairs was $32,000
  - Martha received a check for $25,000 from her insurance company in final settlement of the claim
  - Her adjusted basis for the house was $280,000

The Big Picture (4 of 4)

- On March 8, 2019, Martha purchased what she believed to be “small business stock” (§ 1244 stock) from her friend Peter for $20,000
  - The stock’s value began to decline significantly soon after its purchase
  - On November 2, 2020, Martha sold the stock for $12,000
- Can you help to relieve Martha’s feeling of despair by making her aware of beneficial loss provisions in the tax law?
  - Read the chapter and formulate your response

Bad Debts

- If an account receivable arising from credit sale of goods or services becomes worthless
  - A bad debt deduction is allowed only if income related to the account receivable was previously included in income
  - No deduction is allowed if taxpayer is on the cash basis since no income is reported until the cash has been collected

The Big Picture—Bad Debts—Cash Basis Taxpayer

- Return to the facts of *The Big Picture*
- Because Martha is a cash basis taxpayer
  - She cannot take a bad debt deduction for unpaid accrued interest on the loan to Janice (her friend) because the interest was never recognized as income

Business Bad Debts (1 of 3)

- Specific charge-off method must be used
  - Exception: Reserve method is allowed for some financial institutions
- Claim deduction in the year when a specific business debt becomes either partially or wholly worthless

Business Bad Debts (2 of 3)

- In the case of business debt, partial worthlessness can result in a deduction
  - Only the balance of the debt that is deemed to be uncollectible can be deducted in the later year

Business Bad Debts (3 of 3)

- Business bad debt is treated as an ordinary deduction in the year incurred
- If a receivable has been written off
  - The collection of the receivable in a later tax year may result in income being recognized
  - Income will result if the deduction yielded a tax benefit in the year it was taken

Nonbusiness Bad Debts

- Nonbusiness bad debt
  - Debt unrelated to the taxpayer’s trade or business
- Treated as a short-term capital loss
  - No deduction is allowed for partial worthlessness of a nonbusiness bad debt
- Loans to relatives or friends are the most common type of nonbusiness bad debt

Loans between Related Parties (1 of 2)

- Loans between related parties raise the issue of whether the transaction was a *bona fide* loan or a gift
- Regulations indicate that individual circumstances must be examined to determine whether advances between related parties are gifts or loans

Loans between Related Parties (2 of 2)

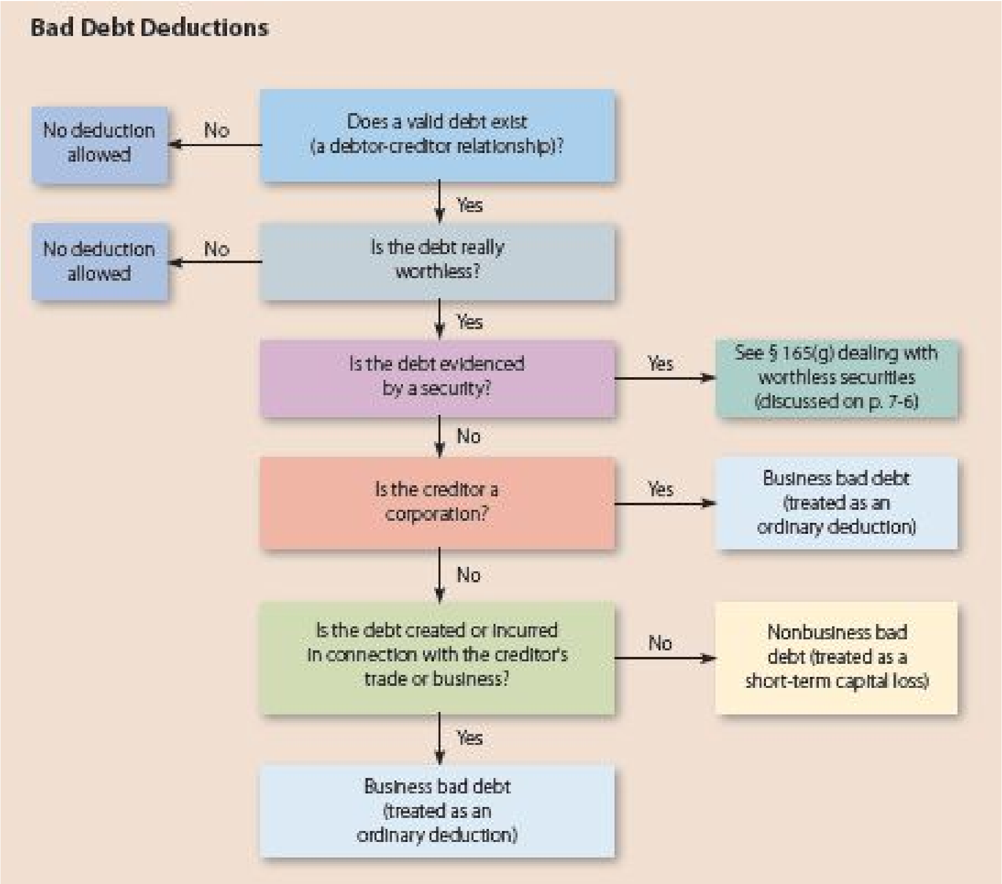
- Some considerations are:
  - Was a note properly executed?
  - Was there a reasonable rate of interest?
  - Was collateral provided?
  - What collection efforts were made?
  - What was the intent of the parties?

The Big Picture—Nonbusiness Bad Debts

- Return to the facts of *The Big Picture*
- Martha loaned her friend, Janice, $25,000
  - Janice used the money to start a business, which subsequently failed
  - When Janice died after having made payments of $7,000 on the loan, she was insolvent
- Even though the proceeds of the loan were used in a business, the loan is a nonbusiness bad debt
  - The business was Janice's, not Martha's, and Martha is not in the business of lending money

Bad Debt Deductions Summary

Bad Debt Deductions



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Worthless Securities

- Loss on worthless securities is deductible in the year they become completely worthless
  - These losses are capital losses deemed to have occurred on the last day of the taxable year in which the securities became worthless
  - Capital losses may be of limited benefit due to the $3,000 net capital loss limitation

The Big Picture—Worthless Securities

- Return to the facts of *The Big Picture*
- Martha owned stock in a pharmaceutical company
  - She acquired as an investment on October 1, 2019
    - Cost was $50,000
  - On May 31, 2020, the stock became worthless when the company declared bankruptcy
- The stock is deemed to have become worthless as of December 31, 2020
  - Martha has a capital loss from an asset held for 15 months (a long-term capital loss)

Small Business Stock(§ 1244 Stock)Losses (1 of 2)

- Sale or worthlessness of § 1244 stock results in ordinary loss rather than capital loss for individuals
  - Ordinary loss treatment (per year) is limited to $50,000 ($100,000 for M F J taxpayers)
    - Loss in excess of per year limit is treated as capital loss

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Small Business Stock(§ 1244 Stock)Losses (2 of 2)

- § 1244 loss treatment is limited to stock owned by original purchaser who acquired the stock from the corporation
- The corporation issuing the stock must be a “small business corporation”
- Corporation must meet certain requirements for its stock to qualify
    - Major requirement is limit of $1 million of capital contributions
- § 1244 does not apply to gains

The Big Picture—§ 1244 Stock

- Return to the facts of *The Big Picture*
- On March 8, 2020, Martha purchases what she believes is “small business stock” (§1244 stock) from her friend Peter for $20,000
    - On November 2, 2020, she sells the stock in the marketplace for $12,000
- Because Martha did not acquire the stock from the corporation, the stock is not § 1244 stock to Martha
    - As a result, Martha has an $8,000 short-term capital loss

Losses of Individuals

- Only the following losses are deductible by individuals under §165(c):
  - Losses incurred in a trade or business
  - Losses incurred in a transaction entered into for profit
  - Losses caused by fire, storm, shipwreck, or other casualty or by theft
    - From 2018 through 2025, personal casualty or theft losses are deductible only if attributable to a Federally declared disaster area

Casualty Loss

- Losses or damages to the taxpayer’s property that arise from fire, storm, shipwreck, or other casualty or theft
  - Loss is from event that is identifiable, damaging to taxpayer’s property, and sudden, unexpected, and unusual in nature

Events That Are Not Casualties

- Not all acts of nature are treated as casualty losses for income tax purposes
- Casualties must be sudden, unexpected, unusual
  - Losses resulting from a decline in value rather than an actual loss of the property is not a casualty
  - Events not treated as casualties include disease and insect damage

Theft Losses

- Theft includes, but is not necessarily limited to, larceny, embezzlement and robbery
  - Does not include misplaced items
- Theft losses are deducted in the year of discovery, which may not be the same as the year of the theft

When to Deduct Casualty Losses (1 of 2)

- **General Rule**
  - A casualty loss is deducted in the year the loss occurs
- **Disaster Area Losses**
  - An exception to the general rule for the time of deduction is allowed for disaster area losses, which are casualties sustained in an area designated as a disaster are by the President of the United States

When to Deduct Casualty Losses (2 of 2)

- If reasonable prospect of full recovery:
  - No casualty loss is permitted
  - Deduct in year of settlement any amount not reimbursed
- If only partial recovery is expected, deduct in year of loss any amount not covered
  - Remainder is deducted in year claim is settled

The Big Picture—Disaster Area Losses (1 of 2)

- Return to the facts of *The Big Picture*
- On September 28, 2020, Martha's personal residence was damaged when a hurricane caused an oak tree to fall onto the house
  - The amount of her uninsured loss was $7,000 ($25,000 insurance settlement - $32,000 damages incurred)
  - Because of the extent of the damage in the area, the President of the United States designated the area a disaster area

The Big Picture—Disaster Area Losses (2 of 2)

- Because Martha's loss is a disaster area loss,
  - She may elect to file an amended return for 2019 and take the loss in that year
  - Alternatively, she may take the loss on her 2020 income tax return

Measuring the Amount of Loss (1 of 3)

- Amount of loss
  - The rules for determining the amount of a loss depend in part on:
    - Whether business use, income-producing use, or personal use property was involved
    - Whether the property was partially or completely destroyed

Measuring the Amount of Loss (2 of 3)

- If a business or rental property is completely destroyed, the loss is equal to the adjusted basis of the property at the time of destruction
- Different measurement rules applies for partial destruction of business or rental property and for partial or complete destruction of personal use property. Here, the loss is the lesser of the following:
  - The adjusted basis of the property
  - The difference between the FMV of the property before the event and the FMV immediately after the event

Measuring the Amount of Loss (3 of 3)

- Personal Use Loss Reductions: The $100-per-Event and 10%-of-AGI Floors
  - The amount of the allowed loss for personal use property must be further reduced by a $100-per-event floor and a 10%-of-AGI aggregate floor
  - The $100 floor applies separately to each casualty and applies to the entire loss from each casualty
  - The losses are then added together, and the total is reduced by 10 percent of the taxpayer’s AGI

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Personal Casualty Gains and Losses (1 of 4)

- If a taxpayer has both personal casualty & theft gains as well as losses, an exception to the rule that disallows a deduction for personal casualty losses other than those in Federally declared disaster areas applies
  - In this case, the taxpayer may use a personal casualty loss (or losses) *not* attributable to a Federally declared disaster to offset any personal casualty gains
    - After this netting process, if any loss remains, it is not deductible (since it relates to a non-Federally declared disaster area casualty)
    - If, however, a net personal casualty gain remains, it is offset by any Federally declared disaster area casualty losses

Personal Casualty Gains and Losses (2 of 4)

- If the gains exceed the losses, the gains and losses are treated as gains and losses from the sale of capital assets
  - The capital gains and losses are short term or long term, depending on how long the taxpayer held each of the assets
  - Personal casualty and theft gains and losses are not netted with the gains and losses on business and income producing property
- If personal casualty losses exceed personal casualty gains, all gains and losses are treated as ordinary items

Personal Casualty Gains and Losses (3 of 4)

- Calculating Personal Casualty Gains and Losses
  - During 2020, Emmanuel has AGI of $50,000 and the following personal casualty gains and losses (after deducting the $100 floor):

Asset	Item	Gain or (Loss)
A	Personal casualty gain	$ 2,500
B	Personal casualty loss (non-Federally declared disaster area)	(2,000)
C	Personal casualty loss (Federally declared disaster area)	(9,000)

  - Emmanuel first offsets the non-Federally declared disaster area losses against the personal casualty gain, resulting in an excess personal casualty gain of $500, computed as follows:

Personal casualty gain	$ 2,500
Personal casualty loss (non-Federally declared disaster area)	(2,000)
Excess personal casualty gain	$ (500)

Personal Casualty Gains and Losses (4 of 4)

- Calculating Personal Casualty Gains and Losses
  - Next, the excess personal casualty gain offsets the Federally declared disaster area loss. Emmanuel's overall net personal casualty loss is $8,500, computed as follows:

Personal casualty loss (Federally declared disaster area)	$ 9,000
Less: Excess personal casualty gain	500
Overall net personal casualty loss	$ 8,500

- After this second netting process, because a net personal casualty loss remains, it will be deductible to the extent of the 10%-of-AGI floor. Emmanuel's itemized deduction for casualty losses is $3,500, computed as follows:

Net personal casualty loss	$ 8,500
Less: 10% of AGI (10% × $50,000)	(5,000)
Itemized deduction for casualty loss	$ 3,500

Research and Experimental Expenditures (1 of 5)

- Meaning of research and experimental expenditures
  - Costs incident to the for the development or improvement of a product (including an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property)
  - The term includes the costs of obtaining a patent, such as attorney’s fees expended in making and perfecting a patent application

Research and Experimental Expenditures (2 of 5)

- Three alternatives are available for handling research and experimental expenditures:
  - Expensed in the year paid or incurred
  - Deferred and amortized
  - Capitalized

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Research and Experimental Expenditures (3 of 5)

- Expense Method
  - Taxpayers can expense all of the research and experimental expenditures incurred provided this method is adopted for the first taxable year in which these expenditures were paid or incurred
  - The taxpayer must continue to expense all qualifying expenditures unless a request for a change is made to, and approved by, the IRS
  - Expense method will not be available in taxable years beginning after December 31, 2021

Research and Experimental Expenditures (4 of 5)

- Deferral and Amortization Method
  - Taxable years beginning before January 1, 2022
    - Research and experimental expenditures may be deferred and amortized ratably over a period of not less than 60 months
    - Any change in the election requires permission form the IRS
    - Usually employed when a company does not have sufficient income to offset the expenses

Research and Experimental Expenditures (5 of 5)

- Deferral and Amortization Method
  - Taxable years beginning after December 31, 2021
    - Research and experimental expenditures paid or incurred in taxable years beginning after December 31, 2021, must be capitalized and amortized
    - Amortization begins at the midpoint of the year the expenses are paid or incurred, rather than the month in which the taxpayer first realizes benefits
    - The expenditures are amortized ratably over a five-year period (15 years for foreign research expenses), rather than ratably over a period of not less than 60 months

Excess Business Losses (1 of 3)

- If a noncorporate taxpayer has an excess business loss for the year, it is not allowed
    - Instead, it is carried forward and treated as part of the taxpayer’s net operating loss (NOL) carryforward in subsequent years
    - An “excess business loss” is defined as
        - The aggregate deductions for the year attributable to the taxpayer’s businesses
        - Less: The sum of aggregate gross income or gain of the taxpayer
        - Less: A threshold amount
            - $518,000 for married taxpayers filing a joint return in 2020
            - $259,000 for all other taxpayers in 2020

Excess Business Losses (2 of 3)

- The purpose is to limit the amount of nonbusiness income that can be "sheltered" from tax as a result of business losses
- Applies to the aggregate gross income and deductions from all of a taxpayer's trades or businesses
    - If a married couple files a joint return, information from all of the couple's trades or businesses must be consolidated
        - The losses of one spouse can be used to offset the other spouse's nonbusiness income (up to the $518,000 limit in 2020)

Excess Business Losses (3 of 3)

- Losses from Partnerships or S Corporations
  - For a partnership or an S corporation, the excess business loss limitation applies at the partner or shareholder level
  - The rules also treat similarly situated owners differently (based on their filing status
- Other Rules
  - The excess business loss limitation is applied after the application of the § 469 passive activity loss rules

Net Operating Losses (1 of 8)

- NOLs for any one year can be offset against taxable income of other years
  - Only losses from the operation of a trade or business and casualty and theft losses can create an NOL

Net Operating Losses (2 of 8)

- Carryforward Only
  - In general, an NOL can be carried forward indefinitely
    - In taxable years prior to 2018, an NOL could be carried back 2 tax years and forward 20 years
    - Beginning in 2018, taxpayers must wait at least one year to receive a tax benefit from the loss
- NOL Deduction Limit
  - In general, an NOL deduction is limited to 80% of taxable income, determined without regard to the NOL deduction itself
    - If the NOL carryover is less than the computed limitation, the entire carryover is allowed as a deduction

Net Operating Losses (3 of 8)

- NOLs and the Deduction for Qualified Business Income
  - The deduction for qualified business income will not create or increase a net operating loss
    - Losses from qualified businesses are carried over separately and will offset future income from qualified businesses, reducing the related deduction for qualified business income
- NOLs and Self-Employment Taxes
  - An NOL cannot be used to reduce self-employment income
    - As a result, a taxpayer’s self-employment tax liability will not change as the result of an NOL deduction

Net Operating Losses (4 of 8)

- Computation of the Net Operating Loss
  - To arrive at the NOL for an individual, taxable income must be adjusted as follows
    - No deduction is allowed for personal and dependency exemptions
    - The NOL carryover from another year is not allowed in the computation
    - The qualified business income deduction (§ 199A) is not allowed
    - Capital losses and nonbusiness deductions are limited

Net Operating Losses (5 of 8)

Computation of Net Operating Loss

Taxable income shown on the return

Add back:

1. Personal and dependency exemptions (suspended from 2018 through 2025)
2. Net operating loss carryover from another year
3. The qualified business income deduction (§ 199A)
4. The excess of nonbusiness capital losses over nonbusiness capital gains
5. The excess of nonbusiness deductions over the sum of nonbusiness income plus *net* nonbusiness capital gains
6. The excess of business capital losses over the sum of business capital gains plus the excess of nonbusiness income and *net* nonbusiness capital gains over nonbusiness deductions

Note: The add-back from the total of items 4 and 6 will not exceed $3,000 because of the capital loss limitation rules

Equals: The net operating loss

Net Operating Losses (6 of 8)

- Computation of Taxable Income for Year to Which Net Operating Loss Is Carried
  - Taxable income and income tax for the year is determined by including the NOL as a deduction *for* AGI
  - Several deductions (such as medical expenses and charitable contributions) are based on the amount of AGI
    - These deductions must be determined on the basis of the AGI after the NOL has been applied

Net Operating Losses (7 of 8)

- Calculation of the Remaining Net Operating Loss
  - After computing the taxable income for the initial carryforward year, it is necessary to determine the extent to which any NOL remains to carry over to future years
  - Amount of this carryover loss is the excess of the NOL over the taxable income of the year to which the loss is being applied
  - The taxable income of the year to which the loss is being applied must be determined with the following modification:
    - No deduction is allowed for excess capital losses over capital gains

Net Operating Losses (8 of 8)

- No deduction is allowed for an NOL that is being carried back
- Any deduction claimed that are based on or limited by AGI must be determined after making the preceding adjustments
- The qualified business income deduction is not allowed
- No deduction is allowed for personal and dependency exemptions

Refocus On The Big Picture (1 of 4)

- Martha can receive tax benefits associated with her unfortunate occurrences during the current tax year. Some of the losses, however, will provide a greater tax benefit than others as a result of different tax provisions governing the amount and the classification of the losses
- Bad Debt
    - Based on the facts provided, It appears that Martha's loan to her friend was a *bona fide* debt. Otherwise nothing would be deductible
        - The amount of the deduction is the unpaid principal balance of $19,000 ($25,000 − $6,000)
        - Unfortunately, because the bad debt is a nonbusiness bad debt, it is classified as a short-term capital loss

Refocus On The Big Picture (2 of 4)

- Loss from Investments
  - The $50,000 loss from the pharmaceutical company stock is deductible. However, it appears that the loss should be classified as a long-term capital loss rather than as a short-term capital loss
    - Although the actual holding period was not greater than one year (October through May), the disposal date for the stock (which qualifies as a worthless security) is deemed to be the last day of the tax year (October of last year through end of December of the current year)
    - Further, the loss does not appear to qualify for ordinary loss treatment under § 1244
  - The stock she purchased from her friend Peter results in an $8,000 short-term capital loss (and does not qualify under § 1244)

Refocus On The Big Picture (3 of 4)

- Loss from Bookstore
  - The $180,000 loss from Martha's sole proprietorship (her bookstore) is reported on Schedule C of Form 1040
    - It is an ordinary loss, and it qualifies for NOL treatment
    - Martha can carry forward any net loss and offset it against future taxable income.
      - However, the NOL carryforward will be limited (each year) to the lesser of the NOL or 80% of taxable income (computed without regard to the NOL carryforward)

Refocus On The Big Picture (4 of 4)

- Casualty Loss
  - The loss from the damage to Martha's personal residence is classified as a personal casualty loss
    - Using the cost of repairs method, the amount of the casualty loss is $7,000 ($25,000 − $32,000)
    - However, this amount must be reduced by the $100-per-event floor and the 10%-of-AGI floor
  - Because the President classified the county in which Martha's house is located as a Federal disaster area, Martha has the option of deducting the casualty loss on the prior year's tax return

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